SB
119

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

go00179s

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

<u>Summary & Sectional Analysis</u>

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 cor :tion. The foreign parent corporation is not required to r t, only the subsidiaries doing business in the U.S. W edge filing is not extended to foreign corporatio at directly do business in Alaska.

Firms filing a water's edge r t must provide a domestic disclosure spreadsheet verifying sistency among returns filed in different U.S. states. Inco 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.

Sincerely,

/s/
Steve Cowper
Governor

SB 120

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

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

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

SB 121

SENATE BILL NO. 121 by Senator 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 Szurgulewski, 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.

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)

	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94
GENERAL FUND	-	-	-	-	-	-
FEDERAL FUNDS	-	-	-	-	-	-
OTHER	-	-	-	-	-	-
TOTAL	-	-	-	-	-	-

POSITIONS:

	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94
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 [illegible], 1988

Approved by Commissioner: Hugh Malone
Agency: Department of Revenue
Date: November 18, 1988

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

STATE OF ALASKA
1989 LEGISLATIVE SESSION

BILL VERSION: ____________
PUBLISH DATE: ____________

FISCAL NOTE

REQUEST: ____________

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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)

	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94
GENERAL FUND	-	-	-	-	-	-
FEDERAL FUNDS	-	-	-	-	-	-
OTHER	-	-	-	-	-	-
TOTAL	-	-	-	-	-	-

POSITIONS:

	FY 89	FY 90	FY 91	FY 92	FY 93	FY 94
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
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 these 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 ba[illegible] 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 [illegible] a state. Al-t[illegible] not a perfect so[illegible], the author ad[illegible]es 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 $2 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 hope[illegible] with further refinement, this approach w[illegible]ke a form that will be considered reason[illegible]e 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.

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

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

Water's Edge Reporting Method

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

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 $1.4 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.

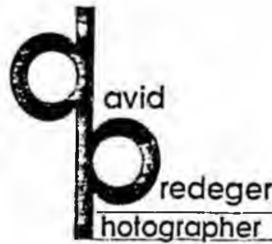
President Reagan resisted pressure to endorse a federal law against the worldwide reporting requirement on the basis that such a law would violate states' rights, but he did appoint a task force headed by then-Treasury Secretary Donald Regan to study the issue. Its recommendations:

- 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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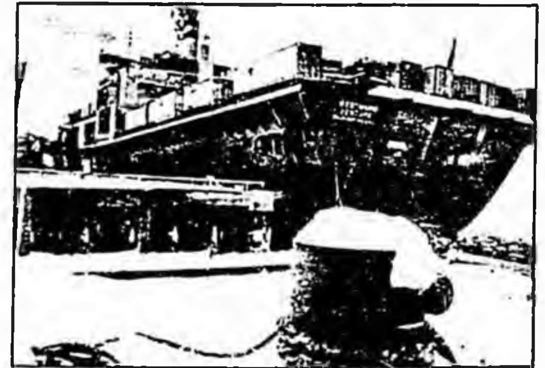

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ment's total revenues, and like state revenues in general, it's come almost exclusively from the oil industry.

"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.

1987 David Predeger

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 [illegible] away from uniformity, have shifted the [illegible], and we have looked for an economic boom that [illegible] 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.

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 state market place. That means that the taxpayer must determine what portion of its income is attributable to Alaska. The amount of tax any company pays to Alaska is determined on the basis of the ratio of its activities in Alaska to its activities everywhere else. The formula method measures the level of business activity conducted in the state. The more or less business in Alaska, as measured by property, payroll and sales factors results in a corresponding reduction or rise in the amount of income subject to tax. The unitary method of taxation is designed to tax corporations based on their actual business relationships rather than the mere form of their relationships.

SECTION TWO

WHAT IS A UNITARY BUSINESS?

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

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

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

HOW DOES ALASKA'S LAW WORK?

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

STANDARD 3 FACTOR APPORTIONMENT FORMULA

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

MODIFIED APPORTIONMENT FORMULA FOR OIL AND GAS PRODUCERS

Total Apportionable Income X

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

MODIFIED APPORTIONMENT FORMULA FOR PIPELINE COMPANIES

Total Apportionment Income X

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

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 1

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

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

ISSN 0022 9695

No. 113 /October 1988 — BIMONTHLY —

KEIDANREN REVIEW on Japanese Economy

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.

Published by Public Affairs Department, KEIDANREN
(Japan Federation of Economic Organizations)
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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Kyoto Office:
1st fl., Kyoto Tower Bldg.,
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 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（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
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

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
千代田化工営業第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 嚭道
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.

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Japan Federation of Economic Organizations

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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 B

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

TABLE D-32
CORPORATE PROFITS TAX ON ADDED DOLLAR OF PROFIT ($1,000,000 TO $1,000,001)
1986

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).

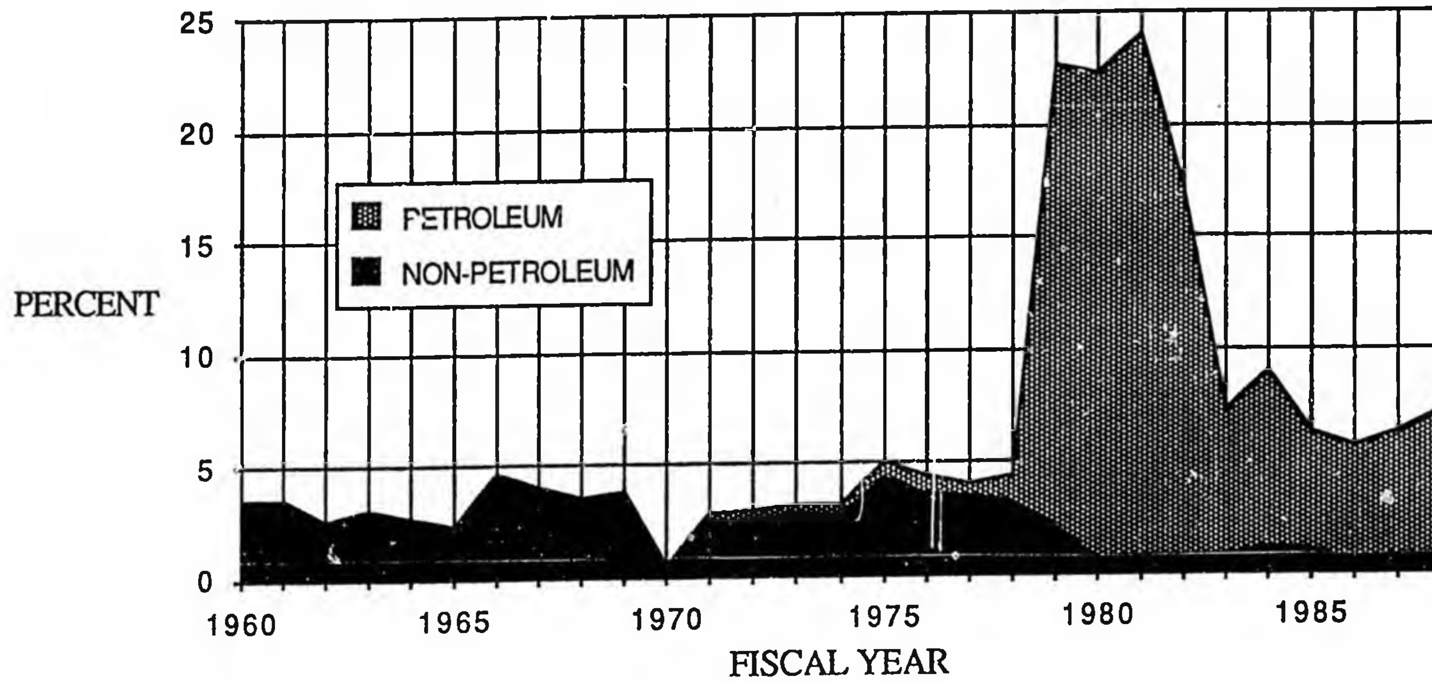
ATTACHMENT D

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



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Phone: (907) 465-3114

MEMORANDUM

To: Senator Jan Faiks
President of the Senate

From: Richard Rainery
Senior Analyst

Date: December 14, 1987

Subject: Worldwide Combined Reporting and Foreign Investment
Research Request 87-003211

Your memorardum of September 15, 1987 posed two questions concerning worldwide combined reporting requirements for corporate income tax in other states. These questions were:

1. Whether Alaska is the only state still employing the worldwide method and what methods other states are actually using;

2. Whether repeal of the worldwide method had spurred new foreign investment in other states.

In answering the first question, I have placed particular emphasis on those states which have had or still have in place a worldwide combined reporting system. If you wish more detailed information on other states, I would be happy to supplement the text of this memorandum. The cases of individual states are considered for both questions.

I. Summary

Alaska is not the only state which currently employs a worldwide combined reporting system. Although a number of the thirteen states which had, or were reputed to have had, such a requirement have indeed altered or discarded it over the last five years, several still employ it. Those that still employ it fall into two categories: 1) those states in which a revised approach has yet to take effect and 2) those states which have not repealed the worldwide requirement, but have instituted an option allowing corporations to report on another basis, generally a water's edge combined report. A number of other states have long employed a

water's edge approach, which considers only U.S. domestic income, but the majority utilize a separate accounting method.

Little information is currently available concerning the effect of reporting changes on foreign investment in most states which have dropped or will soon drop worldwide reporting requirements. The reasons are two: 1) most of the repeals are so recent that the foreign business community has not had time yet to react and 2) factors other than state tax policy have substantial influence in foreign investors' decisions. At least one state, Oregon, has reported significant new foreign investment as a result of the repeal of worldwide reporting and one or two others note modest changes. Multinational corporations certainly strongly support states limiting their reach to U.S. income.

II. Reporting Requirements in Other States

Twenty-eight states and the District of Columbia[1], or 64 percent of the states which tax corporate income, currently determine taxable income for corporations through the use of some variety of separate accounting, which essentially allows each corporation to be treated as a separate tax entity, with its income isolated and reported without regard for the fact that it may be a member of a group of related corporations. Few of these states have the ability to measure the true taxable income of individual members of integrated multicorporate groups. They do not, as does the federal government, have the resources to determine whether transactions between related corporations are conducted at "arms-length" (at fair market value) or whether income is being shifted to avoid taxes in certain jurisdictions. Most states also employ a formula comparing a corporation's payroll, sales, and property within an individual state to the total of those factors for the company to apportion taxable income to that state if that corporation has multi-jurisdictional operations. Such formulas are also used by states embracing the unitary principle.

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[1] Tallies of the number of states employing separate accounting or unitary systems vary, principally because some states which essentially follow one system allow, under certain circumstances, revenue agencies to require and/or corporations to select the other reporting approach.

Seventeen states[2] utilize a unitary approach to determine taxable corporate income. A unitary reporting system requires that corporate entities which are substantially integrated in ownership, direction, and/or operations with a group must report the taxable income of the entire group for apportionment between states. A variety of definitions of substantial integration are employed. Most unitary states now tax income earned by domestic multinational and foreign multinational unitary groups only to the "water's edge" of the United States, but a few still include the income of foreign parents or U.S. subsidiaries and that of foreign subsidiaries of U.S. parents. This latter approach is known as worldwide combination. In the remainder of this section, the current reporting requirements of the states which have utilized worldwide combination are discussed on a state by state basis.

The twelve former or current worldwide combined reporting states (excluding Alaska) fall into two groups. The first is that group for which the repeal or modification of the unitary system is already effective. This includes Illinois, Indiana, New Hampshire, Florida, Colorado, Massachusetts, Utah, and Oregon. The second group, California, Idaho, Montana, and North Dakota, has enacted modifying legislation which has yet to take effect.

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1. Illinois - The first state to repeal worldwide combined reporting in 1982, Illinois now calculates taxable income for unitary groups on a water's edge basis. In other words, only the income derived from the U.S. operations of a group are subject to apportionment to Illinois for taxation. The two significant corollary questions in a water's edge system are how it treats foreign source dividends, either from subsidiaries of foreign or of domestic multinationals, and whether it includes 80/20 corporations, which are U.S. owned businesses with 80% or more of their assets, personnel, and sales in other nations. Illinois excludes the income of 80/20 corporations (based only on assets and personnel) from unitary group income. It excludes all foreign source dividends to at least [illegible]% of their value from taxable income and up to 100% if the payee corporation owns at least 15% of the payor corporation. Illinois also excludes domestic international sales corporations (DISCs), but may

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[2] Alaska, Arizona, California, Colorado, Idaho, Illinois, Kansas, Kentucky, Maine Minnesota, Montana, Nebraska, New Hampshire, New York, North Dakota, Oregon, and Utah.

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include foreign sales corporations (FSCs) under certain circumstances.[3] At the time Illinois limited its reach after the taxable income of unitary groups to the water's edge, it also raised its corporate income tax rate by twenty percent, from 4.0% to 4.8%. At the time, the state expected to lose $100 million to $175 million in revenue annually (15% to [illegible]% of corporate income tax collections and 1% to 1.5% of total general revenues) as a consequence of the limitation. It was hoped that increased sales, property, and personal income tax collections would also help reduce that amount (Sherwood, 1984). No subsequent analysis of actual revenue losses has been undertaken.

2. Florida - When Florida repealed the use of worldwide combination in 1984, it departed totally from the unitary concept. It now determines taxable corporate income on a separate accounting basis. The option to file a federal consolidated tax return, under which a group of commonly controlled corporations are treated as a single enterprise, is available to those companies operating in Florida which are eligible to file such a return with the Internal Revenue Service. Once a corporate group opts to file on the consolidated basis, it must continue to do so unless the Florida Department of Revenue grants permission to switch to a separate entity basis. All income generated outside of the state is exempted from taxation under the separate accounting system. Only the Florida income of 80/20s is subject to taxation. Under certain circumstances, determined by federal law, foreign source dividends paid to Florida parent corporations are excluded. If dividends are exempted from federal taxation under the IRC foreign source section 78 gross up[4], then they are also excluded from Florida taxation. Originally, all foreign source income was excluded. [illegible] raised its corporate income tax rate [illegible] (a 10% increase) and it also repealed deductions for other state taxes available to corporations. About $27 million in annual revenues, approximately 4% of corporate taxes and .3% of overall general revenues, were foregone as a result of the change in system.

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[3] FSCs are the successors to DISCs (which still exist) and are corporations located abroad which sell the products of U.S. corporations. Although related to their U.S. suppliers, FSCs are considered separate taxable entities by the federal government.

[4] Dividends received from certain foreign corporations by domestic corporations choosing a federal foreign tax credit [illegible]

3. Massachusetts - The state Supreme Court of Massachusetts, on December 11, 1984, ruled unconstitutional that state's worldwide combination reporting requirement. The court held that the Department of Revenue lacked the statutory authority to apportion by regulation income of related corporations by the unitary method. Massachusetts never arrived at the point at which it actually collected taxes based on worldwide combined income and never attempted to include the income of parent foreign multinationals in a unitary group (Schiffman, pers. com., 1987). The legal challenge that overturned that approach was filed as a result of Massachusetts Department of Revenue attempts to apply that system upon auditing businesses. The state now determines taxable income on a separate accounting basis. It does allow corporate groups doing business only in Massachusetts to elect to file on a unitary basis. Interestingly, the state is now being sued by some domestic unitary groups with multistate operations to allow filing on a unitary basis. All foreign dividends are exempt from taxation if the payee corporation owns at least 15% of the payor. Since worldwide combination was struck down before it really had any effect, Massachusetts experienced no revenue loss as a consequence.

4. Oregon - During a 1984 special session called for that purpose, the Oregon legislature abandoned worldwide combination, effective January 1, 1986. In its place, Oregon has adopted a two part reporting system, which is limited to considering, for apportionment, the domestic income of corporations doing business in Oregon. Any corporation which files a separate federal income tax return is required to do likewise in Oregon. Any corporation which files a consolidated federal return with a group of affiliated companies must file on that basis in Oregon. Each member of a consolidated group must meet unitary requirements in the areas of management, administrative functions, and the flow of goods and services or be excluded from the consolidated return. Additionally, if the apportionment factors applied to any member of a consolidated group differ from those applied to the remainder, that entity may not be part of the group. Dividends, regardless of source, receive an 85% deduction. 80/20 corporation income is excluded. Oregon expected to lose about $3 million in tax revenue the first year and $15 million per year thereafter (10% of corporate collections and .5% of general revenues). However, it was expected that about $15.9 million in increased state personal and corporate income tax collections and local property tax revenues would be generated by economic expansion. If initial long range plans were realized, Oregon state and local governments were forecast to receive as much as $31.7 million annually in new revenues (Carson, 1985).

5. Indiana - Although Indiana is generally included in the list of states which formerly required worldwide combined reporting, that inclusion was the result of misinterpretation of Indiana statute and practice, according to the Indiana Department of Revenue. Despite the perceptions of some foreign multinational corporations, which apparently misled domestic observers, Indiana did not practice worldwide combination in determining taxable income (Connelly, pers. com., 1987). Indiana law has and does still allow either a corporate group to elect to file on a unitary basis or the revenue department to require a combined report if that more fairly reflects a taxpayer's income. In 1985, effective that tax year, although the state had always limited its grasp of corporate income to the water's edge, except in isolated instances, a law prohibiting the application of worldwide combination was enacted to calm the fears of some foreign multinationals. Dividends are treated as taxable income regardless of source. 80/20 corporations are not captured within the water's edge net. FSC income taxable under the Internal Revenue Code is also taxable in Indiana. No loss in revenue to the state was anticipated as a result of the change.

6. Colorado - During the 1985 legislative session, Colorado repealed worldwide combination (overriding a gubernatorial veto), effective with tax years beginning January 1, 1986. Unitary groups are taxed on income to the water's edge only. Eligible corporate groups doing business only in Colorado may elect to file a federal consolidated return. 80/20s are excluded from unitary groups. Foreign source dividends are included as income and fully taxed, unless a federal foreign tax credit is claimed, in which case dividends are excluded to the extent that the foreign tax is less than U.S. federal taxes would have been on comparable U.S. income. Concurrently with the worldwide combination repeal, Colorado initiated a package of other business incentives. In addition, a schedule of increasing annual reductions to corporate income tax liability, originally set to take effect in 1986 was postponed until 1988 and a state sales tax is now set take effect in 1988. Motor fuel and cigarette taxes were also increased in 1986. Estimates of annual corporate tax revenue declines due to the worldwide repeal were pegged at $10.9 million in FY 1987 and $16.4 million in FY 1988 (Colorado Business Magazine, July 1986), which was 16% of FY 1985 corporate income taxes and half a percent of general revenues. The Colorado Department of Revenue indicated that the actual effect will not be known until after audits for the 1986 tax year are completed in the fall of 1987.

7. Utah - In 1985, the Utah legislature, by concurrent resolution, endorsed the adoption of a water's edge approach to the unitary method by the Utah Tax Commission. By regulation, the commission switched to a water's edge system, effective January 1, 1986. Unitary groups may, however, elect to file on a worldwide basis. Once that course is chosen, the taxpayer is locked into it and may escape only with the consent of the state, granted only upon demonstration of a significant change in business circumstances. Utah excludes 50% of the income of 80/20 corporations from unitary income. The treatment of foreign subsidiary dividends is somewhat complicated, but in general, 50% of such dividends are included in taxable income. FSCs are considered foreign corporations and thus their income is not considered. The tax commission may grant relief or exclusion of 80/20 income or foreign dividends in calculating unitary group income under certain circumstances. The Utah Tax Commission advocated that a domestic spreadsheet requirement be made part of the move to restrict unitary income to domestic operations, but was unable to achieve this. The domestic spreadsheet issue was an important one during the deliberations of the working group of state, federal, and business officials convened by the U.S. Treasury Department to consider the unitary question. A domestic spreadsheet would provide details of the state-by-state payroll, assets, sales, and income of a unitary group. It had been expected that such a requirement and the resources to analyze spreadsheets would be part of a threatened federal law prohibiting worldwide combination and in fact, Utah referred to federal audit of spreadsheets as an early condition of their move to water's edge. The federal effort faded as individual states took action to modify their reporting systems. Initial estimates of revenue losses in Utah were from $2 million to $4 million annually, but this assumed the federal requirement of a domestic spreadsheet. Absent the spreadsheet, the decline is now predicted at about $7 million, which is about 10% or more of corporate tax revenue and [illegible]% of general revenue in recent years (McDonald, pers. com., 1987). In a putatively unrelated action, Utah adopted a 4% surtax on both corporate and personal income taxes in calendar year 1988 for education funding.

8. New Hampshire - New Hampshire's constitution stipulates that all businesses must be treated similarly in tax matters, so it levies a business profits tax on all commercial entities. Effective June 30, 1986, worldwide combination was rolled back to a U.S. domestic basis. Unitary groups do have the option to file on a worldwide basis, if desired. Dividends from domestic unitary subsidiaries are included in group income, as are those from foreign sources, although the latter are computed under a

special apportionment formula. 80/20 corporations are excluded, again because the state constitution will not allow U.S. businesses operating overseas to be treated differently than foreign businesses. Foreign subsidiaries may be excluded from the unitary group upon certification that inter-group transactions are conducted on an arms-length basis. The New Hampshire Department of Revenue Administration (NHDRA) does have the option to require such businesses to file on a worldwide basis in the event that IRS audits indicate that transactions are not in fact on an arms-length basis. In New Hampshire, ownership is not a determining factor in whether a group of business entities is considered to be unitary. No comprehensive estimate of revenue changes resulting from the change has been done, but the NHDRA said that a sample of 40 to 50 audits indicated that those taxpayers would see their liability reduced by at least $7 million (this alone is 7% of total business profits tax collections and 1% of general revenues). Coincidentally, New Hampshire increased the [illegible] from [illegible] to 8.25% for the 1985 - 1987 biennium, but the general feeling was that the present healthy growth of the local economy would substantially offset revenue declines.

9. California - The first state to embrace worldwide combination, California was also the prime target of multinationals in the campaign to eliminate worldwide combined reporting. Although the 1986 compromise passed by the legislature was not precisely what anyone wanted, it was provisionally accepted (a number of amendments to the law are currently under consideration). Effective January 1, [illegible] California will not drop worldwide combination, but rather provide the option to corporate groups to file on a water's edge basis. Those that elect to so file are locked in for a ten year period and must pay an annual election fee equal to .03% of the value of their California property, payroll, and sales. The level of the fee can be decreased to a minimum of .01%. For each new dollar of investment in California, a group's fee is correspondingly reduced by a dollar. An exemption of 75% of foreign subsidiary dividends is provided. If a firm's domestic payroll rises faster than its foreign payroll, the relief factor will increase and vice versa. 80/20 companies are included in the water's edge group, as are DISCs and FSCs. Unitary groups with assets in excess of $[illegible],000,000 in value must file a domestic spreadsheet with the California Franchise Tax Board.[5] There are presently legislative proposals

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[5]They must also make certain information available to and cooperate with state auditors.

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pending to lower the election fee, shorten the election period, and limit the information required on domestic spreadsheets. A superior court decision currently under appeal by the state has given a British corporation the right to file on a water's edge basis, without election fee or other standards. The present law is admittedly slanted against elections (Zamaripps, pers. com., 1987); an official with the Multistate Tax Commission (MTC) opined that better than 60% of unitary groups in California would not opt for the water's edge choice (Corrigan, pers. com., 1987). Potential revenue losses have been estimated at up to $250,000,000 (about 6% of total corporate taxes). Proceeds from annual election fees (which are dedicated to infrastructure projects and economic development programs) are expected to be about $40,000,000. In conjunction with the creation of the water's edge option, California chose to close two corporate tax loopholes in conformity with the 1986 federal tax reform act. The total revenue decline is forecast to be $[illegible] million annually as a result, or approximately 2.3% of franchise tax receipts and .2% of general revenues.

10. Idaho - As of January 1, 1988, Idaho will allow an option for unitary groups to report on a water's edge basis. Water's edge groups will be limited to domestic corporations and domestic affiliates at least 50% owned. Foreign corporations with over 20% of property and payroll in the U.S. and at least 50% owned by a domestic parent are also included. The election is a one time thing and is permanent thereafter. An exemption of up to 85% of foreign source dividends is allowed. 80/20s are excluded as are corporations domiciled in tax havens. DISCS and FSCs are included in water's edge groups. Electors must file a domestic spreadsheet. Anticipated effects on revenues are that $8 million less in corporate income taxes will be collected annually. This represents a loss of 14% of the FY 1989 corporate income tax revenue and .7% of general revenues. In 1987, Idaho's corporate income tax rate was increased to 8.0% from 7.7%.

11. Montana - Effective January 1, 1988, Montana will provide an election for unitary groups to file on a water's edge basis. Eligibility will be limited to domestic corporations, except in the case of foreign companies with over 20 percent of property and payroll in the U.S. Dividends from foreign subsidiaries will have an 80% exclusion. Twenty percent of the after tax net income of 80/20 firms will be included in water's edge income. Election periods will run for three years (extension to worldwide combination is possible with permission of the state) and domestic spreadsheets must be filed with the Montana Department of Revenue. Water's edge groups will pay an income tax rate of

7.0% compared to a 6.75% rate for other corporations. All corporations will be assessed a 4% surtax for one year beginning in 1988. Revenue losses of approximately [illegible] million are forecast, 4.4% to 6.7% of annual collections the last three years and .2% of general revenues. The rate increase and surtax are not expected to compensate fully (Miller, pers. com., 1987).

12. North Dakota - The last state to do so, North Dakota will allow its unitary groups a water's edge option beginning in tax years after December 31, 1988. A ten year binding election, current North Dakota taxpayers must now be filing on a worldwide basis in order to qualify. All foreign subsidiaries are excluded unless 20% or more of their property and payroll is in the state. For current taxpayers, 60% of foreign source dividends must be reported as domestic income. This portion will fall to 30% in the 1995 tax year. Companies new to the state will report 30% of these dividends from day one. While 80/20 firms are excluded from the water's edge group, domestic parents must bring back 60% of after tax income and 30% of dividends for U.S. apportionment, which figures will both drop to 30% in 1995. New companies again begin at 30%. Current taxpayers may, however, immediately go to the 30% level if their North Dakota property and payroll increases by 25%. DISCs and FSCs will be included in domestic unitary groups. A domestic spreadsheet filing is required. Although the original legislation establishing the option contained a revenue neutral proviso, that was dropped from the final version. The North Dakota Department of Revenue predicts a $6 million to $7.6 million fall in corporate income taxes for the 1989 to 1991 biennium, about a 3.6% to 4.6% change in corporate collections and a .3% reduction in general revenues.

The "dirty dozen" (as they were formerly labelled by some business groups) have thus all reformed. Two states have completely renounced unitary principles, going to a separate accounting system. Six states have, by law, limited the reach of corporate income taxes to the water's edge of the United States. The four most recently modifying their practices have retained worldwide combination, but added an option allowing filing on a water's edge basis. In none of these four has that option as yet become effective. Eight of twelve states eliminating or revising unitary systems have concurrently adopted other taxation measures. Five increased corporate tax rates (one limiting the increase to corporations opting for a water's edge approach). Another has required a fee for those opting out of worldwide reporting. Still another has instituted a sales tax and raised excise taxes. Two states implemented temporary surtaxes (one of these was described as unrelated to the unitary issue).

III. Changes in Foreign Investment

It has long been the conventional wisdom, with occasional dissent, among economists and other analysts that state tax systems have had little appreciable impact on business location decisions. Study after study over the last three decades has indicated that state taxation has ranked well below a variety of other factors, such as labor costs, proximity to suppliers and markets, and economies associated with existing operations, in the corporate decision process. Although state tax systems have not been ignored in commercial expansion or relocation matters, they most often and most significantly come into play when a general site has been selected that offers the opportunity to choose between competing taxing jurisdictions. This situation may be changing as more and more foreign investors come to the United States. Perhaps the major reason state taxes figure more prominently in the business decisions of foreign corporations is the simple fact that fifty states have fifty different regimes. Most overseas investors are essentially unfamiliar with a federal system that, that in addition to the U.S. Internal Revenue Code, allows each state great latitude to construct and enforce its own tax code (Coopers and Lybrand, 1982; MTC, 1987). Unitary reporting, as practiced by the states, is substantially different from the federal system, which is based on separate accounting. For at least five years now, worldwide combined reporting has been the target of vociferous criticism from many foreign and domestic multinational concerns and of foreign governments, most notably Japan and Great Britain.

Foreign rebukes have revolved around a number of issues, such as administrative burden and double taxation, and retaliation has been threatened, but the most important threat in this context has been that multinational corporations will not invest in states that practice worldwide combination. The question is whether the foreign investment picture in those states that have renounced worldwide combination has changed or can be expected to change as a consequence. The difficulty in answering this question stems from two interrelated factors. In most of the twelve states in question, the modification of reporting requirements has been very recent or has yet to take effect and foreign investors' reactions, particularly in terms of expanding or establishing facilities and employment activity, to actual or prospective changes naturally lags such changes by a substantial period of time. In most instances, the evidence concerning foreign investment is anecdotal, the value of which is open to question. Again, a state-by-state analysis follows.

1. Illinois - Previous to the governor's signing into law of the prohibition of worldwide combination, the Illinois Department of Revenue contracted with the big eight accounting firm of Coopers and Lybrand to study the economic impacts associated with worldwide combination. The study, done within an extremely constricted time frame, produced no forecast of the probable economic consequences of repeal but essentially repeated the accepted views on the subject. It did however assert that state taxes were becoming a more significant issue to business than they had been in the past, particularly to multinationals. The high tech industries were seen as more sensitive to state tax policy because they were not part of an established system with traditional ties to particular locations. That observation has been repeated by many others. Coopers and Lybrand noted that many corporate officers felt that perception was more important than actual liability and that worldwide combined reporting had negative connotations in many Illinois quarters (this sentiment was also echoed in other states). They added, that despite Illinois' reputation as a high tax state and its adherence to worldwide reporting, the state was still a center for economic activity, primarily because of its history as a corporate center and its central location in the U.S. Although it has now been five years since Illinois restricted unitary groups to domestic reporting, no analysis of the economic effects of that limitation has been undertaken. It is unlikely that any surge in investment would have resulted. Illinois led the move away from worldwide combination by two years, making the change before, in fact, the voices of multinationals and foreign governments in opposition had reached their crescendo.

2. Florida - The consequences of the repeal of unitary reporting in Florida have almost certainly had no implications for the level of foreign investment in the state. Worldwide combination was in place for only a few months in 1984 before the "bad press" it generated sparked a special session for its repeal[5]. According to the Florida Department of Commerce economic growth continued at a normal pace during the controversy and after the repeal (Gilleland, pers. com., 1987). Opposition to the worldwide movement was led by Sony and IBM. IBM asserted that it would never build a planned plant on property it held in Florida so long as the worldwide income was subject to state taxation. Over three years after the state switched to separate accounting, the

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5 Great Britain cancelled a major trade delegation visit following the passage of worldwide combination and neighboring Georgia was quick to point that it was a non-unitary state.

IBM property still stands vacant. Other economic factors militated against the construction of a personal computer plant in Florida. The state's location and increased competition in the industry were likely more significant determinants in this instance. The Florida Department of Revenue is planning to study patterns of foreign investment in conjunction with a proposed revision of the state's income apportionment formula.

B. Massachusetts - No broad and fervent public debate over the worldwide reporting issue was joined in Massachusetts before the court decision striking down the practice was issued. The plaintiffs were all domestically based multinationals (led by Polaroid). No taxpayer actually paid taxes on worldwide income, so the matter was essentially a non-factor in terms of any effect on foreign investment in the state.

C. Oregon - On the opposite end of the spectrum, Oregon may be the one state in which the dropping of worldwide reporting has been a factor spurring substantial foreign investment. It is the only state among those that modified reporting requirements relatively early on which has closely monitored changes in foreign investment following legislative action in 1984 and the institution of the new system beginning with tax years starting January 1, 1986. [illegible] of the Oregon Economic Development Department (OEDD) has provided detailed statistics on current and prospective investment and associated employment on the part of foreign corporations. The latest figures are attached to this memorandum. Eleven of the twelve foreign investors that have built new facilities or expanded existing plants are Japanese firms (the twelfth is West German). Direct employment and investment figures are shown below.

Oregon Foreign Investment
(as of August [illegible], 1987)

Initial investment	$[illegible] million
Potential investment	$[illegible] million
Initial employment	[illegible]
Potential employment	[illegible]

Source: OEDD, 1986 and 1987

Early projections of employment and investment have been scaled back somewhat. For example, the OEDD in 1986 projected initial

investment of $270 million and employment of [illegible] for just five of the twelve companies included in the above statistics. All of the businesses included in the foreign expansion are high technology firms with the exceptions of a chemical distribution business and photo album fabricator. In 1987 the OEDD developed projections of the economic spinoffs resulting from direct foreign investment. This forecast, which has not been updated, predicted as many as 12,000 secondary jobs, presuming final direct employment of 6,900.

The fundamental question is whether these dollars and jobs can be directly attributed Oregon's retreat to a domestic combined reporting system. Some announcements of new investment plans preceded the actual repeal of worldwide combination and a number followed directly on its heels. More have followed. Rich Carson is convinced that they would not have happened absent the repeal. He however cautions that, in his opinion, other states will not be able to replicate Oregon's experience due to the unique circumstances of the episode. A number of factors favored Oregon in capturing investment that would have been made at this time in any case. The Pacific coast location placed it high on the list of locations sought by Japanese firms and it is adjacent to a major U.S. market and high tech center, California. Real estate prices are substantially lower than those in California, its prime rival for Japanese investment. Oregon has an excellent higher education system and a stable, highly educated work force, a prerequisite for high tech investment. A base of domestic U.S. suppliers and related industries already existed in the budding "Silicon Forest" outside Portland. Oregon's timing was perfect, repeal taking place at the peak of expansion in the electronics industry. Oregon also at about the same time sharply reduced worker's compensation insurance rates and streamlined land-use regulations to favor large industrial sites (Business Week, [illegible]). Additionally, individual Japanese investors have been receiving substantial inducements from local and state government and business (Wall Street Journal, July 21, 1987). It does not seem unreasonable to suggest that the surge in foreign investment in Oregon is due to a variety of factors, of which the repeal of worldwide combination may been the final [illegible] in a very enticing [illegible] for investors.

3. Indiana - When Sony was on the verge of constructing a plant in Indiana, it became concerned that its worldwide earnings might be subjected to state taxation. Although Indiana had pursued worldwide combination in a only few isolated instances in which the state felt a multinational had misrepresented its income sources, it clarified its law to allay Sony's fears and the plant

was built. Foreign investment [illegible] was not affected in Indiana as a result of the issue, the fact that Sony chose it as an investment site and then worked to get its tax law clarified suggests as much.

6. Colorado - Five months after Colorado dropped worldwide combination, Texas Instruments, a domestic multinational, announced the impending construction of a defense electronics plant costing $200 million and eventually employing 3,000 people. The firm said that the repeal was a "major factor" in its decision. Several other domestic multinationals have also responded positively to the change. A modest change in foreign investment in Colorado has been detected to this point. The Colorado International Trade Office (CITO) has noted that a number of Japanese research and development, warehousing, and sales offices have located in the state recently, although the volume of investment has thus far been small. No major manufacturing enterprises have yet to come in, though this prospect was the basis of the repeal lobby's campaign to end worldwide reporting (Madsen, pers. com., 1987). CITO has compiled no figures on investment and employment. The Colorado Springs Chamber of Commerce did provide some incomplete data on foreign investment, citing three firms (one in fiber optics and two in semiconductors) that have opened facilities slated to employ about 550 people at buildout. Additionally, the chamber asserts that the retreat from worldwide reporting was too late to prevent the decisions by six major multinationals (Japanese and West German) to select other states, cancel investments altogether, or to phase down existing Colorado operations. One cancelled project was budgeted at $130 million (Reeves, pers. com., 1987). However, information available from other sources indicates that at least one of the investments that went to another state was decided on the basis of other factors as well as tax policy (see subsequent discussions on the Kyocera decision [illegible] in Washington). Many in the economic development sector in Colorado believed that the state simply missed the initial wave of investment captured by states like Oregon which acted more quickly (Colorado Business Magazine, July 1986).

7. Utah - An ironic and pointed anecdote with broader implications emerges from the debate in Utah. U.S. Steel was a leader in the effort to convince the state legislature that worldwide combination created a poor business climate. In the midst of the debate, however, U.S. Steel

... announced the impending closure of its major steel manufacturing operation in Utah. Shortly thereafter,

> U.S. Steel and a Korean company, Pohang Steel, announced that they had entered into an agreement to participate in a joint venture. And where will the new operation have its headquarters? Why, in California, the leading practitioner of worldwide combination. (MTC, May 1986)

Several officials in the Utah economic development sector confirm that no significant foreign investment has occurred since the state went to a water's edge system. Greg Gillet, a development specialist with the Division of Business and Economic Development, International Section, indicated that some European and Japanese firms that previously wouldn't even discuss investment in Utah are doing so now (pers. com., 1987). His testimony was that worldwide reporting had acted as a perceived barrier (particularly for Japanese and Korean electronics companies); now that this barrier has been removed, market factors will determine whether foreign investment does occur. Utah's primary problems are that it is far from the West Coast and from financial centers. Nor does it have a significant existing market or supply advantage in any of the industries currently drawing capital from active foreign investors (McDonald, pers. com., 1987).

8. New Hampshire - The level of foreign investment in New Hampshire is relatively low (about 3% of the over 2100 manufacturing firms there are foreign owned), according to the New Hampshire Division of Industrial Development (NHDID). Some basic, albeit sketchy, direct information on trends in foreign investment was provided by the NHDID. It has been aggregated to show total foreign investment and Japanese investment as of February 1986 (prior to repeal) and April 1987 (post repeal). Unfortunately, no analysis of this data exists, so the causes of the sharp drop in employment over the period are unknown. The figures are most interesting in that the number of jobs has fallen by a quarter in just over a year, while facility space has climbed modestly. Increases in automation or efficiency are suggested, on the one hand, but the decline in the number of foreign companies also must have had some impact. Local officials state that some businesses had moved in while the state embraced worldwide combination and no appreciable change in [illegible] looking closely at their own employment data). At the time of the repeal, no testimony was offered to the legislature by corporations with specific plans to locate or expand in New Hampshire once repeal was effective.

Senator Fatke
December 1[illegible], 1987

New Hampshire Foreign Investment

Total Foreign Manufacturers*
1986 - 253
1987 - 235 (-7.1%)

Total Employees of Foreign Manufacturers
1986 - 10,084
1987 - 7,549 (-25.1%)
Employees of Japanese Manufacturers
1986 - 2,399
1987 - 1,752 (-27.0%)

Total Space Occupied by Foreign Manufacturers
1986 - 4,466,205 sq. ft.
1987 - 4,78[illegible],300 sq. ft. (+7.[illegible]%)
Space Occupied by Japanese Manufacturers
1986 - 622,000 sq. ft.
1987 - 653,800 sq. ft. (+5.1)

Source: NHDID, 1987.
* Foreign parents fell from 74 in 1986 to 70 in 1987.

9. California - California embraced worldwide reporting during the 1930s and since then has become the center of foreign investment in the United States. Prior to the state's adoption of the water's edge option, California claimed 43% of all Japanese investment in the U.S. (Business Week, Sept. 15, 1986). It also ranked in the top three states for Canadian and European holdings and employees, according to federal data. California achieved that position in spite of the worldwide requirement because it represents the largest single market in the U.S., has a skilled and well educated work force, an enticing environment, and is the U.S. center of the high technology industry.

California has been at the center of the controversy for several years. In 1984, Akio Morita, the chair of Sony, said that as soon as California repealed worldwide combination, there were 120 Japanese corporations ready to invest $1.4 billion in California, creating 11,000 jobs. The business journals were fond of quoting the Kyocera anecdote as evidence that California's tax system was discouraging new investment. Kyocera, then ready to increase beyond its existing U.S. capacity to manufacture ceramics for integrated chip assemblies, chose to open a new plant in

Washington state rather than expand its San Diego facility. Only one of the journals (Business Week, Aug. 27, 1984) noted that, in addition to the fact that Oregon had repealed worldwide combination, other factors led to Kyocera's decision. No real estate was available near the San Diego plant and electricity, labor, and land were all cheaper in Washington, in addition to still other attractions discussed in the concluding paragraphs of this section. So, while the unitary tax issue was cited as the primary motivation to select Washington, it is unlikely that, absent other favorable economic factors, the same choice would have been made.

As noted in the previous section, California's water's edge option is not designed to entice corporations to take advantage of it. It will not be available until the 1988 tax year and the first elections will not be made until 1990 when 1989 returns are due. The effect it will have on the California economy is as yet unknown. The Office of Economic Research (OER) of the California Department of Commerce measures foreign investment in the state, but its data is two or three years out of date. The OER does not expect to be able to measure any change for another three or four years and even then is not sure it would be possible to link any new foreign investment directly to the provision of the water's edge option. Sony did announce a $30 million dollar expansion of a San Diego plant immediately after the repeal passage, but OER believes that Sony would have expanded eventually in any case. Foreign investment had not abated during the years of controversy over worldwide combination because the state had so much else that attracted foreign business (Dudan, pers. com., 1987).

10. Idaho - Until the end of [illegible], Idaho will adhere to worldwide reporting, so information on foreign investment prompted by the tax change does not yet exist. No prospective analysis of the effect of the change was undertaken by the State of Idaho, nor did business groups offer any testimony as to their intentions. It was basically a "business climate" issue for the latter and an effort to bring the state into line with the trend away from worldwide combination on the part of the former. The Idaho International Trade Division, in existence only six months, noted that there was, at present, little foreign investment in the state (Whitwell, pers. com., 1987). Idaho has also recently established a flight [illegible] which will help [illegible] Pacific Rim corporations. New contacts have been made with some Asian countries, but no concrete products are in the works. [illegible] make comparisons to new patterns of investment.

11. Montana - In 1985, the Montana Council on Economic Development, a joint public/private body, recommended that the state retain worldwide combination (in effect since 1967), even if it hindered foreign investment. By 1987, the council had reversed its position, labelling worldwide combination a "red flag" that marked the state as having an unfavorable business climate. It did not base that change on the belief that limiting taxable income to the U.S. would draw foreign investment, however (Yeager, pers. com., 1987). The Council staff could offer no evidence of any potential increase in foreign business activity (the repeal will not take until the end of 1987). The Keidanren (the pre-eminent Japanese economic association) did threaten that no investment would take place so long as worldwide reporting was in place, but there has never yet been any appreciable Japanese investment in Montana. Resource extraction companies were not prominently involved in the repeal effort (Miller, pers. com., 1987). No commitments, specific or otherwise, on new investment were made by any of the participants in the debate.

12. North Dakota - Given that North Dakota's law will not take effect for over a year, it is far too soon to note any foreign investment trends. As in other states, the repeal was seen primarily as a move to bring the state in line with the tax policies of other states and eliminate the perception that North Dakota was an "anti-business state". North Dakota's Economic Development Commission has predicted little if any change in the present minimal level of foreign investment as a consequence of the initiation of the water's edge option (Torkelson, pers. com., 1987).

IV. Foreign Investment: An Overview

The major national organization supporting the movement to [illegible] worldwide combination was the Committee on State Taxation (COST), an office of the Council of State Chambers of Commerce. COST was present from Illinois in [illegible] to Montana in 1987. Although much of the general testimony before most legislatures considering reform of worldwide reporting focused on the barrier to foreign investment it presented, COST now affirms that there is no hard evidence to prove that it substantially hindered investment or that its repeal has spurred new investment (Walker, pers. com., 1987). The Working Group established by the U.S. Department of Treasury to consider alternatives to worldwide reporting heard no evidence that demonstrated a negative impact on overseas investment in the U.S. ([illegible], 1986). A number of state

officials interviewed for this inquiry noted that the argument that a repeal of worldwide combination would spur foreign investment has been downplayed recently. Detractors have, instead, concentrated on the "tax climate" approach in their testimony before state legislatures.

The evidence available concerning the economic effect of worldwide combination repeal, at this early juncture, is simply incomplete and uncertain. The majority of states have too recently modified their approach for any meaningful evidence to have developed. Only Oregon has attempted to gather any direct information and, while that presents a positive picture of the consequences of repeal, the other factors intrinsic to Oregon's success suggest that other states will be unlikely to duplicate the results. The Oregon data and individual examples from other states indicate that foreign high technology ventures are the most likely to be sensitive to the worldwide reporting issue and to respond favorably to its modification. It is abundantly clear that the presence or absence of a worldwide combined reporting system, however, is not the sole determinant of foreign investment; other economic factors must favor such investment, market factors, some of which are not responsive to public policy and others of which may be influenced by public policy. California would have had a strong foreign sector with or without worldwide reporting. New York, which has a reputation as a high tax state, is a national center for foreign investment. Oregon's repeal of worldwide combination was a superbly timed final move that enabled it to exploit a number of positive elements that were already attracting Japanese investors.

Apart from the meager statistical data, it is manifestly clear that multinational corporate management, in general, is strongly opposed to worldwide combination. There is a long list of pronouncements condemning it and asserting that states employing it will be avoided. A survey of Fortune 1000 chief executive officers indicated that 54% of their companies would consider relocating to another state in response to a worldwide reporting requirement (Cost, 1984). [illegible] individual location and relocation decisions have been explicitly or implicitly linked to the existence of a worldwide unitary tax in one state or another. In most of these cases, the tax issue was but one of a series of [illegible] affecting business decisions, but in some it appears as though it may have been the prime motive for a particular decision. No exhaustive analysis of such decisions is available and would be difficult to accomplish for [illegible] reason. Any attempt to measure the weight of the unitary issue, in comparison to other economic factors, would be [illegible] subjective. For

example, was the Kyocera decision to open a plant in Washington primarily due to the burden of the California tax? That is what the company maintains, but the other costs of business in California (real estate, labor, etc.) were higher than in Washington state. Even the tax issue is more complex. Washington has no income tax at all and $3.5 million in Washington state grants and loans and an additional package of incentives offered by county and city governments surely had some influence on Kyocera's decision (as did the fact that Kyocera had an active research relationship with the University of Washington). A joint venture between Sharp Microelectronics (Japanese) and RCA considered four states for the location of a $200 million semiconductor plant. Two states without a corporate income tax, one of which had just repealed worldwide combination, and one employing worldwide combination were in competition. Washington, which provided $10 million in incentives, won the plant. What, if anything, the other competitors offered was not a matter of record. In many of the cases spotlighted by the media and proponents of repeal, additional economic factors such as these are significantly present. Without access to the corporate boardroom, it is nearly impossible to determine which elements were more important than others in specific decisions.

One can find very few public revenue officials who will affirm that repeal of worldwide combination has had any real effect on foreign investment in their state. Public economic development and trade agencies mostly believe that it has positively influenced foreign investors. Very few multinational corporation officers, on the other hand, were other than completely negative about the damage wrought by worldwide reporting. Perception is colored by perspective in each case. Only occasionally has the opposition of small businesses and domestic enterprises to repeal been publicized. These sectors feared that the loss of the worldwide unitary tax base would adversely affect their bottom line. In some states, where tax rates have been adjusted to attempt to compensate for lost revenues, they have been proven to be right. In California, mostly domestic oil companies have fought repeal, while multinationals have pushed it. Chevron, a domestic multinational, complains that the current law creates an "uneven playing field" due to the application of the unitary reporting principle to Chevron's foreign subsidiaries and not to those of its foreign competitors. Shell, a foreign multinational, estimates that it will be more expensive for them to elect water's edge than to stay with worldwide combination (The Oil Daily, September 15, 1986).

In sum, it may be imprudent to place too much faith in the power

of a move away from worldwide combination, in and of itself, to significantly alter the level of foreign investment in Alaska. The evidence of the efficacy of repeal elsewhere is mixed. Most of the response has come from the high tech sector, not an industry likely to be important in Alaska in the near future. Certainly, in instances in which all the other elements needed for a successful investment are in place, the absence of worldwide reporting or the option to elect water's edge reporting may be the final positive factor needed. On the other hand, if an investment is so marginal that state tax policy is the difference between its success and failure, the project may be so unstable that its long term viability and the likelihood it will truly contribute to the state's economy should be closely scrutinized. It should be recalled that in some cases in which repeal or absence of worldwide reporting was identified as the deciding issue in investment, state and local governments [illegible] more than the tax revenues foregone as a consequence of repeal by providing substantial incentive packages. These costs should also be included in the balancing of costs and benefits, both public and private.

NEW JAPANESE CORPORATE INVESTMENT IN OREGON (Revised: August 12, 1987)

Company	Status	Contact	Product	Initial Investment	Potential Investment	Initial Employment	[illegible]
Dailron	Announcement (12-10-86)	J. Howells (503) 620-2879	Measuring Instruments	-0-	-0-	5	[illegible]
Epson America	Grand Opening (6-10-86)	M. Tomita (503) 645-1118	Terminal Printers	$ 16 million	$ 60 million	200	[illegible]
Fujitsu America	Ground Breaking (6-25-85)	K. Krause (503) 681-7300	Disk Drives	30 million	100 million	200	[illegible]
Fujitsu Micro-electronics	Announcement (6-12-86)	T. Saito (619) 565-4419	Wafer Fabrication	30 million*	130 million	400	[illegible]
Kambara	Grand Opening (3-18-87)	S. Watanabe	Photo Albums	1 million	1 million	25	[illegible]
Mitsubishi Metal	Plant Purchased (9-8-86)	S. Meyers (415) 365-6600	Silicon Wafers	33 million	33 million	270	[illegible]
NEC America	Grand Opening (5-30-86)	K. Kawakami (503) 648-5000	Fiber Optics & Mobile Phones	30 million	300 million*	300	[illegible]
Nippon Kokan	Announcement (12-18-86)	M. Maruiwa (213) 624-0651	Polycrystalline Silicon	60 million	140 million	100	[illegible]
Tokyo Kogyo Kasei	Grand Opening (6-19-86)	M. Isono (503) 283-1681	Chemical Distribution	600,000	600,000	10	[illegible]
Toyo Tanso	Plant Leased (6-87)	J. Honbo (503) 254-0674	Graphite Products	5 million	20 million	50	[illegible]
Ushio	Grand Opening (6-6-87)	S. Kuniharu (213) 329-1960	Halogen Lamps	4 million	10 million	30	75
			TOTAL	≈$203.6 million	≈$794.6 million	≈1,590	[illegible]

*Estimate by the Oregon Economic Development Department is based on site capacity, existing employment and investment.

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Introduced: 1/17/89 go00179s
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).

MEMORANDUM. State of Alaska
Department of Law

TO: Greg [redacted]
Seni[redacted] Analyst
Offi[redacted]t & Budget

DATE: November 9, 1988

FILE NO: 773-89-0017

TEL NO: 465-3600

SUBJECT: Equal Protection

Dick

FROM: Richard D. Monkman
Assistant Attorney General

You have requested a brief analysis of equal protection issues relating to the Governor's proposed amendments to the corporate income tax, AS 43.20 (the unitary tax bill). Your concern is that because the bill provides disparate tax treatment to foreign and domestic corporations, it could be [illegible] on equal protection grounds.

Legislatures have "especially broad latitude in creating classifications and distinctions in tax statutes." Regan v. Taxation with Representation of Washington, [illegible] U.S. 540, 547 (1983). The corporate income tax does not [illegible] any fundamental interest, or contain a suspect classification (e.g., race or religion). Under the federal constitution, therefore, the only equal protection question is whether the proposed tax is "rationally related" to a legitimate state interest. Exxon v. Eagerton, 462 U.S. 176, 195-96 (1983). The state's interest in this proposed legislation is to encourage foreign investment in Alaska, by changing a tax provision which has discouraged foreign investment. The proposal appears rationally related to its goal; and encouraging investment is a legitimate state interest. There is no equal protection problem under the federal constitution.

The same conclusion results under the more complex, three-step equal protection analysis required by the Alaska Constitution. Alaska Pacific Assurance Company v. Brown, 687 P.2d [illegible] 1984). First, the importance of the cons[illegible] interest involved must be examined. As the Alaska Supr[illegible] recently recognized,

> The interest involved here, freedom from disparate taxation, lies at the low end of the continuum of interests protected by the equal protection clause.

Atlantic Richfield Co. v. State, Dep't of Revenue, 705 U.S. 418, 437 (Alaska 1985), appeal dismissed, 474 U.S. 1043, rehearing denied, 475 U.S. 1062 (1986) ("ARCO").

03-002

Second, the validity of the statute's purpose must be analyzed in light of the interest impinged. ALPAC, 687 P.2d at 269. The purpose of this proposed statute is stated forthrightly in section 1: "to promote foreign investment in the state." Tax statutes are frequently used to direct and encourage specific economic activity by taxpayers. Removing this perceived roadblock to productive foreign investment in Alaska is a valid governmental interest which can only be accomplished through a change in the tax statutes.

Last, the means chosen by the Legislature will be examined in light of the interest at stake (the "freedom from disparate taxation") to assure that the means chosen are "sufficiently related to the goals of the statute." Id.; ARCO, 437 P.2d at 437. The goal of the statute is to encourage foreign investment by changing a tax reporting method which has met with hostility among foreign investors and which has, we are told, discouraged foreign investment in the state. The means chosen appear sufficiently related to the goal of the proposed statute to pass this test.

The Alaska equal protection test is commonly referred to as a "sliding scale," with the degree of judicial scrutiny applied varying directly with the importance of the constitutional interest at stake and the amount of discrimination between similarly situated, but differently treated, classes of persons involved. The constitutional interest here is, the Supreme Court has told us, "at the low end." ARCO. And, as I understand the Department of Revenue's analysis, the fiscal impact of this proposal will be minimal -- the "disparate treatment" of domestic versus foreign corporations under the proposal, in dollar terms, will not be great. Thus, there does not appear to be an equal protection problem with this statute.

As a matter of insurance rather than necessity, howe[illegible] that section 1 of the draft bill be expanded to e[illegible] between the proposed tax change and increased fore[illegible] in Alaska. The present statement of purpose is ad[illegible] brevity but, striving to be concise, it is somewhat obscure.

RDM:jf

cc: Mary Halloran, Director of Policy, OMB
Royce Weller, Assistant Commissioner, Dep't of Revenue
Steve Kettel, Director of Audit, Dep't of Revenue

TAX EXEMPTIONS, DEDUCTIONS, CREDITS, AND SPECIAL TREATMENTS

	Business Inventory	Goods in Transit	Industrial Fuels and Raw Materials	Industrial Machinery and Equipment	Energy and Fuel Conservation Measures	Investment Tax Credit	Job Creation Tax Credit	Pollution Control Equipment	Property Tax Abatement	Research and Development	Sales and Use Exemption	Corporate Income Tax Incentives
Alabama	X	X	X	X				X	X			
Alaska	X	X			X	X						
Arizona	X	X		X	X			X				
Arkansas		X	X	X				X	X			
California	X	X	X	X	X		X	X		X		
Colorado	X		X	X	X	X	X	X	X			
Connecticut	X	X	X	X	X		X	X	X			
Delaware	X	X		X								
Florida	X	X	X	X	X	X	X	X	X			
Georgia	X	X	X	X	X			X				
Hawaii		X	X	X	X			X	X			
Idaho	X	X	X	X	X	X	X	X				
Illinois					X			X	X		X	
Indiana		X	X	X	X	X	X	X	X	X		
Iowa	X	X	X	X	X		X	X	X			
Kansas		X	X	X	X	X	X				X	
Kentucky		X	X	X				X				
Louisiana		X			X		X		X			
Maine	X	X	X	X		X	X	X	X	X		
Maryland	X	X	X	X	X		X	X	X	X		
Massachusetts	X	X	X	X	X	X		X	X	X		
Michigan	X	X	X	X		X		X	X			
Minnesota								X			X	X
Mississippi	X	X	X	X					X			
Missouri			X	X		X	X	X	X			
Montana	X	X			X	X	X	X	X			
Nebraska	X	X	X	X	X			X				
Nevada	X	X	X					X				
New Hampshire	X			X	X			X	X			
New Jersey	X	X	X	X	X			X	X	X	X	
New Mexico	X	X	X	X								
New York			X	X	X	X		X	X	X		
North Carolina	X	X	X	X	X			X				
North Dakota	X	X	X		X		X		X			X
Ohio		X	X	X	X	X	X	X	X			
Oklahoma		X	X	X	X	X	X	X	X			
Oregon	X	X	X		X			X				
Pennsylvania	X	X	X	X		X	X	X	X	X		
Puerto Rico												
Rhode Island	X	X	X	X	X	X		X	X	X		
South Carolina	X	X	X	X	X		X	X	X			X
South Dakota		X	X	X	X				X			
Tennessee	X	X	X	X	X	X		X	X			
Texas		X		X	X				X			
Utah	X	X	X	X	X			X				
Vermont	X		X	X	X			X	X	X		
Virginia	X	X	X	X	X	X	X	X	X	X		
Washington	X	X	X	X	X					X		
West Virginia			X	X	X	X		X		X		
Wisconsin	X	X	X	X	X	X		X		X		
Wyoming	X	X	X	X				X				
STATE TOTALS	35	42	41	42	37	20	19	40	31	14	4	3

DIRECT FINANCIAL INCENTIVES

	Revenue Bond Financing/ State Issued	Revenue Bond Financing/ Locally Issued	Revenue Bond Guarantees	Umbrella Bonds	Grants[1,2]	Loans and Loan Guarantees[1,3]	Customized Industrial Training[1]	Enterprise Zones	Equity or Venture Capital Corporations[1,4]
Alabama		x			x	x	x	x	
Alaska	x			x		x			
Arizona		x						x	
Arkansas		x	x			x	x	x	
California	x	x			x	x	x	x	
Colorado		x					x	x	
Connecticut	x			x	x	x	x	x	x
Delaware	x	x				x	x	x	
Florida		x				x	x	x	
Georgia		x					x	x	
Hawaii	x					x	x	x	
Idaho		x					x		
Illinois	x	x		x	x	x	x	x	x
Indiana	x	x			x	x	x	x	x
Iowa		x		x	x	x	x		x
Kansas		x					x	x	
Kentucky	x	x		x		x	x	x	
Louisiana		x			x	x	x	x	
Maine	x	x	x	x	x	x		x	x
Maryland	x	x	x	x	x	x	x	x	
Massachusetts	x	x	x			x	x		x
Michigan	x	x			x	x	x	x	x
Minnesota		x			x	x		x	
Mississippi	x	x			x	x	x	x	
Missouri	x	x	x	x	x	x	x	x	x
Montana	x	x		x		x	x		x
Nebraska	x	x		x			x		
Nevada	x	x		x		x	x	x	
New Hampshire	x	x				x			
New Jersey	x		x		x	x	x	x	
New Mexico		x			x		x		
New York	x	x	x	x	x	x	x	x	x
North Carolina		x			x	x	x		x
North Dakota		x	x				x		
Ohio	x	x			x	x	x	x	
Oklahoma		x			x	x	x	x	
Oregon	x	x		x	x	x		x	x
Pennsylvania		x			x	x	x	x	
Puerto Rico	x					x	x		
Rhode Island	x		x		x	x	x	x	
South Carolina		x		x		x	x	x	
South Dakota		x				x	x	x	
Tennessee		x					x	x	
Texas		x				x	x	x	
Utah		x			x			x	
Vermont	x	x			x	x	x	x	
Virginia	x	x		x		x	x	x	
Washington		x							
West Virginia	x	x				x	x	x	
Wisconsin		x			x	x	x	x	x
Wyoming		x		x		x			
STATE TOTALS	27	45	9	16	25	40	42	38	13

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 $27 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 fru[illegible] 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.

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 out [illegible] waii is Japanese, and Japa[illegible] sitors account for one-third [illegible] e total revenue from touris[illegible]

Thus Japan ma[illegible] a conspicuous presence [illegible] vaii, as compared with o[illegible] ates of America. Regarding [illegible] ese investment in the state, [illegible] eaction was generally favorable [illegible] t in a few cases, and most peop[illegible] met expressed hope that inv[illegible] ent would be expanded. Gov[illegible] or 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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Shimogyo-ku, Kyoto
Tel. (075) 371-5649

Japan National Tourist Organization

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.
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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 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

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
日本興業銀行常務取締役
1-3, 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
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

Members:

Satoshi OGIHARA
Manager, Business Planning Dept.
International Operations
Fujitsu Limited
荻原 諭
富士通海外事業本部業務部企画担当部長
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業務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管理室長
6, Kanda-Surugadai 4-chome, Chiyoda-ku,
Tokyo 101, Japan

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Energy Group Administration Office
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宮川 尚三 (アラスカのみ参加)
日商岩井エネルギー部門統括管理室長
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 1
Chiyoda Corporation
福田 信一郎
千代田化工建設営業第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
12-24, Nishi-Azabu 4-chome, Minato-ku,
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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 (随員)
経団連国際経済部調査役
9-4, Otemachi 1-chome, Chiyoda-ku, Tokyo
100, Japan

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A.B. Laffer Associates

1825 Lomita Boulevard, Suite 100, Lomita, California 90717
(213) 534-6260

February 7, 1989

Senator Jan Faiks
Judiciary Chairman
Alaska State Legislature
Post Office Box V
Juneau, Alaska 99811

Dear Senator Faiks:

The worldwide combined method discourages investment in Alaska by multinational corporations.

Replacing the worldwide combined apportionment with some form of water's edge method will increase Alaska's competitiveness and will likely attract new multinational corporations. Therefore, the move to a water's edge reporting method is desirable in Alaska's case. However, it is unfortunate that the existing legislation attempts to single out only foreign corporations. This feature of the bill may be the result of undue attention being paid to the "static" revenue effects of the bill.

Proponents argue that the worldwide unitary method increases state corporate income tax revenues. While this may be true in a static sense, the worldwide unitary method increases the cost of doing business in the state and thus increases the incentive to avoid the worldwide unitary tax by locating elsewhere. Presumably the move to a water's edge method is an attempt to increase the state's competitiveness. If successful, new business will locate in the state and tax revenue and overall employment in the state will increase.

The overall "static" revenue impact of the switch to a water's edge apportionment is not very large. In fiscal year 1987, corporate profits paid by non-petroleum companies were only $20.5 million, or 1.1 percent of the total general fund unrestricted revenues. According to the *Legislative Digest*, the static revenue losses will be $65,000 if the water's edge is applied to foreign firms and $5 million if domestic firms are included. Yet, viewed in the context of the state revenues, the "static" revenue losses of $5 million will be an insignificant amount of the unrestricted state revenues. In contrast, the damage to the economy in terms of forgone employment and tax revenue gains (from "domestic" companies that are now being prevented from locating in Alaska because of the worldwide combined reporting method) could very well exceed the $5 million static revenue losses.

From an incentive/economic efficiency viewpoint, it does not make any sense to treat differentially companies that want to locate in Alaska. Differential tax treatment, however, may be appropriate for different industries depending on the characteristics of the industry. One example is the oil industry, the treatment of which we have discussed in detail in our study, "Promoting Economic Growth in Alaska."

Sincerely,

Victor A. Canto

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 [illegible] 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.

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

1 For this purpose, the payment is deemed to be received
2 from a corporation that is part of the unitary business if
3 the payments are received by a member of an affiliated
4 group included in a combined Alaska report from a
5 corporation in which the recipient owns 50 percent or more
6 of the stock of such corporation.
7 (c) Dividends and royalties taxable under (b) of
8 this section are in lieu of any expense attribution for
9 income excluded under (b) of this section.
10 (d) In computing the tax under this chapter, the
11 taxpayer is not entitled to deduct any taxes based on or
12 measured by net income.
13 (e) An affiliated group of corporations may make or
14 the commissioner may require them to make a consolidated
15 return for the taxable year in place of separate returns.
16 For purposes of calculating the amount of tax payable by
17 the group under a consolidated filing, 26 U.S.C. 1501 -
18 1552 (Internal Revenue Code), as amended, apply.
19 (f) A corporation that is a member of a group of
20 unitary corporations that collectively has income from
21 business activity taxable both inside and outside the
22 state,or income from other sources both inside and outside
23 the state, shall determine its income from sources in this
24 state by use of the combined method of accounting provided
25 under AS 43.20.073.
26

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424 North Franklin Street
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* 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

1
2 imposes an income tax at a rate lower than 90 percent of
3 the federal tax rate on the federally defined income tax
4 base, and 50 percent or more of sales, purchases, or
5 payments of income or expenses, exclusive of payments for
6 intangible property, of the corporation are made directly
7 or indirectly to one or more members of a water's edge
8 group and that conducts no significant economic activity.
9 * Sec. 4. AS 43.20 is amended by adding a new section to
10 read:
11 Sec. 43.20.051. DEFINITIONS. "Foreign corporation"
12 means a corporation created or organized outside of the
13 United States, the District of Columbia, the commonwealth
14 of Puerto Rico or any possession of the United States.
15 * Sec. 5. This Act is retroactive to tax years beginning
16 after December 31, 1988.
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Cheryl ✓
Chris ✓
Mark
Kelly ✓
*a professional reading slip.

Alaska Legislative Digest

An Inside View of Alaska Policy

Business Office: 344-2455
3037 South Circle
Anchorage, AK. 99503

January 28, 1989
No. 3/89

Environmentalist Maneuver On Resolving 6(i)

Mining 6(i) --Watch 'Reclamation'

Reclamation of state lands involved in mining operations may emerge as an issue in the complex "6i" mineral leasing legislation, now before Resources Committees in both House and Senate. State DNR officials have briefed legislative committees on the proposed administration bills, and committee members appear ready to tackle the complex issue of setting up a new mineral leasing, royalty and rental system for state lands. So far other proposals to deal with the issue, a bill put forth by the Alaska Miners Association and a different version to be offered by environmental groups, have not appeared. Environmental groups hope to maneuver into a position to push reclamation requirements.

The "6i" issue developed when community and environmental groups challenged the state's existing mining claim system, arguing that it violates Section 6i of the federal Alaska Statehood Act, which requires that Alaska lease its lands in any disposal for mineral purposes.

Mineral 'In Character'

Miners are said to be in basic agreement with the administration bill, with possible exception of a more restrictive definition of state lands "of mineral character," to which a new leasing system would apply. *(Continued page 8)*

Problems For Unitary Tax

There's grumbling already over the governor's unitary tax bill, heard last week in the Senate International Trade Committee. The bill, presented as a measure promoting international investment in Alaska, discriminates against major U.S. companies (not including oil) that do business in Alaska. IBM, for example, is voicing its displeasure with the measure.

What the governor's bill does is allow foreign-owned subsidiaries doing business in Alaska to use 'water's edge' accounting of corporate income, for purposes of computing their Alaska corporate income tax. U.S.-owned companies, meanwhile, would continue to pay tax using their worldwide income as a base. Oil and gas companies, foreign or domestic, are also are intentionally excluded from the bill. (Continued on page 7)

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School Debt, The Big Debtors: A list of who pays what .... Page 5

A School Endowment ? Gov. Cowper's proposal for School Endowment .... Page 2

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TAGS Gas Line: Rival Projects Spar at Anchorage Hearing .... Page 2

House Finance ELF Bill: House Finance offers ELF Revision .... Page 2

. . . Status Of Bills . . .

Key Senate Bills Introduced

--SB-130, Approp Alaska Power Authority, Bradley Lake Intertie (Uehling) .... To L&C & FIN
--SB-131, Railbelt Economic Recovery Fund (Uehling) .... To SA & FIN
--SB-132, Spl. Appropriation Railbelt Recovery Fund (Uehling) ... . To SA & FIN
--SB-134, Practice Acupuncture (Duncan) .... To HESS, :L&C, FIN
--SB-139, Retroactive Extension Term Task Force Guiding & Game (by RSC).............. To RSC & FIN
--SB-140, Re: Big Game Guiding, Reg. Game & Marine Mammals (by RSC) .... To RSC & FIN
--SB-141, Payment Municipal, School Construction Debt (Kerttula) .... To CRA, HESS, FIN
--SB-142, Revising Port Authority Law For Cities (Duncan) .... To TRANS & L&C

Key Senate Committee Action

--SB-48, Extending Life Older Alaskans Commission (SA 'do pass') .... To FIN
--SB-94, Limiting Liability Certain Acts of National Guard (SA 'do pass') .... To JUD
--SB-42, Re: State Marine Parks (CRA 'do pass') .... To RSC
--SB-87, Use of Housing Assistance Loan Funds (CRA CS) .... To FIN
--SB-95, Authorizing Combined Sales Tax w/Borough Incorp Elect (CRA 'do') .... To RULES

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School Debt Load

(Related story page 3) This is a list of state aid for school debt reimbursement estimated for FY-90. This is only the 'state share' paid for keyed to a mix of years when debt support varied between 80% /100%.

We have added current year ADM (pupil daily attendance) to show the distortion in obligation for some districts that has occurred due to rapid growth in the 1980s. Note that Anchorage, with 38,685 ADM and $25-million in debt support is almost the same as Kenai with 8,000 ADM for $24.4-million. Remember, these figures are for 'state support.' What they mean is that, on the local payment side, Kenai is laying out virtually as many local dollars for school debt payment as Anchorage.

School District	State Debt $$$	ADM
Anchorage	$25.0-million	38,685
Kenai	$24.4-million	8,232
Mat-Su	$20.5-million	8,430
Fairbanks	$13.7-million	13,188
North Slope	$ 7.1-million	1,237
Juneau	$ 6.1-million	4,588
Kodiak	$ 3.3-million	2,273
Valdez	$ 3.0-million	690
Ketchikan	$ 2.7-million	2,498
Sitka	$ 2.2-million	1,607

New Unitary Tax . . . .

(Continued from page 1) Foreign companies, particularly Idemitsu-Kosan, Ltd., now developing the Wishbone Hill mine north of Palmer, have complained that using worldwide income as a base for state income tax imposes heavy accounting burdens and other problems, with little net revenue effect. Two other companies prominent in Alaska that would be benefitted by the bill are Canadian-owned Cominco Alaska, developing the Red Dog Mine, and British-owned RTZ Corp., new owner of the Greens Creek Mine near Juneau.

Switching to "waters' edge" (meaning U.S. only) income would solve the problem. It is a change most U.S. states have already made. But the administration bill applies only to foreign companies. U.S.owned multinationals, including U.S. mining companies, would continue to pay on a worldwide basis. Reportedly, the tax bill was written to include only foreign firms so as to have as little adverse revenue effect as possible, an estimated $65,000 loss. If domestic non-petroleum companies doing business in Alaska were allowed to use water's edge, the revenue loss would be about $5 million.

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

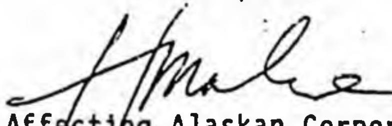
Approved by Commissioner: Hugh Malone H Malone
Agency: Department of Revenue

Date: January 9, 1989

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

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.

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

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

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

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