

**S B**

**119**

SENATE COMMITTEE REPORT

FURTHER

FIN

2/8/89

DATE TURNED INTO OFFICE

3/8/89

Mr. President:

Resources

Committee considered

SB 119

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; efd

and recommended

- replace with \_\_\_\_\_ CS \_\_\_\_\_ )  same title
- or adopt \_\_\_\_\_ CS \_\_\_\_\_ )  new title
- attached amendment(s) and  technical title change (HB only)

Resources letter of intent adopted

do pass

do not pass

no recommendation

individual recommendations

further referral to \_\_\_\_\_

FISCAL NOTE(S)  zero  fiscal impact  appropriation no FN  
 new  updated  previous  
 same as previous fiscal note(s) published \_\_\_\_\_

MEMBERS SIGNING DO PASS

Ardis Stangor  
 \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_  
 \_\_\_\_\_

OTHER RECOMMENDATIONS

Richard Stinson no rec  
Yvette do not pass  
Donna no rec  
Rick Halford DO NOT PASS

Julio Fabrenberg do Pass  
 Chairman signature and recommendation

Committee Backup attached

# Alaska State Legislature

## Senate Resources Committee

Senator Bettye Fahrenkamp, Chairman

Senator Jay Kerttula, Vice Chairman  
Senator Dick Elhason  
Senator Steve Frank  
Senator Rick Halford  
Senator Arliss Sturgulewski  
Senator Fred Zharoff



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

### SENATE RESOURCES COMMITTEE LETTER OF INTENT FOR SB 119

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

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

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

# STATE OF ALASKA

## DEPARTMENT OF REVENUE

STEVE COWPER, GOVERNOR

STATE OFFICE BUILDING  
P.O. BOX SA  
JUNEAU, ALASKA 99811-0400

March 8, 1989

The Honorable Bettye Fahrenkamp  
Alaska State Senator  
Box V  
Juneau, AK 99811-3100

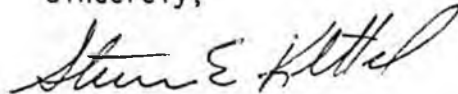
Dear Senator Fahrenkamp:

The Alaska Department of Revenue believes an annual domestic disclosure spreadsheet can be an important tool in insuring fair administration of the corporate tax as it would be revised by the SB 119. Our attorneys advise, however, that sufficient authority already exists in AS 43.20 (Alaska Net Income Tax) for the Department to issue regulations to implement these requirements. We therefore have no objection to deleting the language referring to the spreadsheet on page 2, lines 2 and 3 of SB 119. I have enclosed a copy of the bill with this revision marked.

Assuming that this bill were adopted in its current form, applying only to multinational corporations with foreign parents, the Department might not find it necessary to adopt regulations requiring the spreadsheet. If the spreadsheet were required we would not anticipate that more than a dozen or so taxpayers would have to file it. Indeed, we would intend to ask for the spreadsheet only from firms with a substantial nexus within Alaska, and in most of those cases would only require information readily available from filed state and federal tax returns, plus property, sales and payroll factor information for each state in which the taxpayer or affiliated corporation does business.

I would reiterate that the above applies if water's edge filing is restricted to firms with foreign parents. Should the bill be extended to all multinational corporations, fair administration of the law might require a much more extensive domestic disclosure spreadsheet from substantially more taxpayers.

Sincerely,



Steven E. Kettel  
Director  
Income & Excise Audit Division  
(907) 465-2320

SEK:lr  
89-76



Official Business


# Alaska State Legislature

## Senate

### Finance Committee

Pouch V  
State Capitol  
Juneau, Alaska 99811

SB 119

TO: Senator [redacted] amp   
FROM: Senator Rick Uehling, Co-Chairman  
Senate Committee on Finance  
DATE: April 9, 1990  
RE: CSSB 119 (Fin), Unitary Tax Bill

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

I am enclosing a synopsis of CSSB 119 (Fin) for your review.

SYNOPSIS OF CSSB 119 (Finance)

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

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

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

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

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

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

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

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

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

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

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

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

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

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



FEB 28 1990

ASSOCIATED GENERAL CONTRACTORS of ALASKA

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

February 22, 1990

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

Dear Senator Uehling:

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

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

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

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

Sincerely

ASSOCIATED GENERAL CONTRACTORS  
OF ALASKA

*F. Michael Swalling*  
F. Michael Swalling  
President



JAN 29 1990

Anchorage • Star of the North  
Chamber of Commerce

January 23, 1990

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

Reference: Senate Bill 119

Dear Rick:

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

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

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

Sincerely,  
ANCHORAGE CHAMBER OF COMMERCE

Dave Harbour  
Chairman

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

JAN 7 1990

**XEROX**

December 28, 1989

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

**RE: Senate Bill 119**

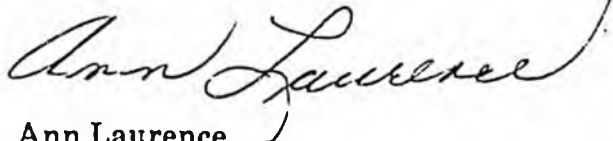
Dear Senator Uehling:

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

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

Sincerely,

**XEROX CORPORATION**



Ann Laurence  
Alaska Manager

AL:eg



ALASKA STATE CHAMBER OF COMMERCE

October 16, 1989

Regional Office:  
501 H Street, Suite 405  
Anchorage, Alaska 99501  
(907) 278-2722  
FAX 278-0643

Representative Fran Ulmer  
P.O. Box V  
Juneau, AK 99811

Re: Finance Subcommittee on Unitary Tax

Dear Representative Ulmer:

The Alaska State Chamber of Commerce had hoped to have a representative appear personally before your Unitary Tax subcommittee at its Monday, October 16 meeting, but that is not possible. We do, however, wish to provide these written comments for consideration by the subcommittee.

At its meeting in February, 1989, the Board of Directors of the State Chamber considered the issues surrounding the current proposals to amend Alaska's laws relating to the unitary tax. The current proposals (Senate Bill 119 and House Bill 281) would permit certain corporations doing business on a worldwide basis to file their corporate tax returns using a water's edge method of reporting. The Chamber supports the concept of water's edge rather than the existing worldwide combination for multinational corporations. However, the Chamber is concerned that the present bills provide the ability to use the water's edge reporting method only to multinational corporations with foreign parents, and in turn discriminates unfairly against domestic multinational corporations. Accordingly, the Board of Directors voted in February, 1989 to support changes in the proposed legislation to include multinational corporations with U.S. parents.

Thank you for the opportunity to provide these comments.

Cordially,

  
George Katz  
President

GK/el



# ALASKA MINERS ASSOCIATION, INC.

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

October 10, 1989

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

Dear Governor Cowper:

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

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

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

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

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

Sincerely,

Curtis McVee  
Executive Director



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

6900 Arctic Blvd  
Anchorage, Alaska 99515

April 28, 1989

Senator Rick Uehling  
Pouch V  
Juneau, Alaska 99811

Re: Senate Bill 119

Dear Senator Uehling:

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

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

Truly yours,

---

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

HCH:lp  
R4:89

FLUOR DANIEL

APR 27 1989

Fluor Daniel Alaska, Inc.  
700 West 5th Avenue, Suite 300, P.O. Box 176680  
Anchorage, Alaska 99519-6680  
907 276-2636

April 24, 1989

Senate Finance Committee  
Pouch V  
Juneau, Ak 99811

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

Gentlemen:

PROPOSED SENATE BILL 119  
An Act Relating to Corporate Income Taxes

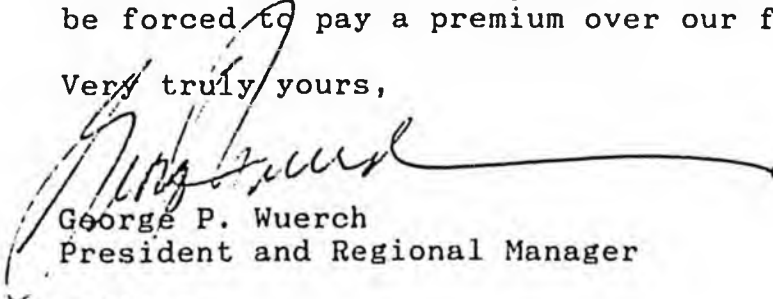
Fluor Daniel Alaska, Inc. is Alaska's largest engineering and construction company. It is a wholly owned subsidiary of the world wide Fluor Corporation which has a long history of work in Alaska.

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

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

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

Very truly yours,

  
George P. Wuerch  
President and Regional Manager

GPW:jnr

9114A.115

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

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

January 30, 1989

SENATE JOURNAL

p. 239

SB 119

The Senate Special Committee on International Trade and Tourism considered SENATE BILL NO. 119 (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). Senator Szymanski, Chair, signed "do pass." Senators Zharoff and Sturgulewski signed "no recommendation." Senator Halford signed "do not pass yet."

Previous fiscal note published 1/17/89 from Department of Revenue and previous zero fiscal note published 1/17/89 from Department of Commerce and Economic Development accompanied the bill.

SENATE BILL NO. 119 was referred to the Judiciary Committee.

SB 119

The Judiciary Committee considered SENATE BILL NO. 119 (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) and a majority of the committee reports it back without recommendation. Senator Faiks, Chair, and Senators Pearce, Rodey and Halford signed "no recommendation." Senator Szymanski signed "do pass."

Previous zero fiscal note published 1/17/89 from Department of Commerce and Economic Development applies to the bill. Previous fiscal note published 1/17/89 from Department of Revenue applies to the bill.

SENATE BILL NO. 119 was referred to the Resources Committee.

SB 119

The Resources Committee considered SENATE BILL NO. 119 (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). Senator Fahrenkamp, Chair, and Senator Sturgulewski signed "do pass." Senators Eliason and Frank signed "no recommendation." Senators Kerttula and Halford signed "do not pass." The committee further attaches a Letter of Intent.

Letter of Intent  
for  
Senate Bill No. 119

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

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

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

Previous fiscal notes.

SENATE BILL NO. 119 was referred to the Finance Committee.

March 26, 1990

SENATE JOURNAL

p. 3027

SB 119

The Finance Committee considered SENATE BILL NO. 119 (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) and recommended it be replaced with

CS FOR SENATE BILL NO. 119 (Finance), entitled:  
"An Act relating to the water's edge method of calculating income taxes for certain corporations other than corporations engaged in the production of oil or gas from a lease or property in the state or in the transportation of oil or gas by regulated pipeline in the state; and providing for an effective date."

Senator Uehling, Co-Chair, signed "do pass." Senators Duncan, Zharoff, Frank and Pearce signed "no recommendation."

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

SENATE BILL NO. 119 was referred to the Rules Committee.

STATE OF ALASKA  
1990 LEGISLATIVE SESSION

BILL VERSION: CS SB 119 (Finance) (a)

PUBLISH DATE: 3/26/90

FISCAL NOTE

REQUEST:

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

Agency Affected: Revenue

BRU: Income & Excise Audit

Components: Operating

EXPENDITURES/REVENUES: (Thousands of Dollars)

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

FUNDING: (Thousands of Dollars)

GENERAL FUND	484.4	441.4	441.4	441.4	441.4	441.4
FEDERAL FUNDS	0	0	0	0	0	0
OTHER	0	0	0	0	0	0
<b>TOTAL</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>

POSITIONS:

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

ANALYSIS: (Attach a separate page if necessary)

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

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

Distribution (by preparer):

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

Prepared by:  
 Steven E. Kettel  
 Alaska Department of Revenue

Fiscal Note Analysis

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

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

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

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

## FISCAL NOTE

**REQUEST:**

Revision Date: \_\_\_\_\_  
Title: Unitary Tax  
Sponsor: Rules Committee  
Requestor: Governor

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

**EXPENDITURES/REVENUES: (Thousands of Dollars)**

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

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

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

**POSITIONS:**

FULL-TIME						
PART-TIME						
TEMPORARY						

**ANALYSIS : (Attach a separate page if necessary)**

Prepared by: Willis F. Kirkpatrick, Director Phone: 465-2521  
Division: Banking, Securities and Corporations Date: 01/09/1989  
Approved by Commissioner: Larry Mercurieff Date: 01/09/1989  
Agency: Dept. of Commerce & Economic Development

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

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

No fiscal impact is  
expected through 1996.

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
<b>OPERATING</b>						
PERSONAL SERVICES	-	-	-	-	-	-
TRAVEL	-	-	-	-	-	-
CONTRACTUAL	-	-	-	-	-	-
SUPPLIES	-	-	-	-	-	-
EQUIPMENT	-	-	-	-	-	-
LANDS & STRUCTURES	-	-	-	-	-	-
GRANTS, CLAIMS	-	-	-	-	-	-
MISCELLANEOUS	-	-	-	-	-	-
<b>TOTAL OPERATING</b>	-	-	-	-	-	-
<b>CAPITAL</b>	-	-	-	-	-	-
<b>REVENUE</b>	0	( 60.0)	( 60.0)	( 60.0)	( 60.0)	( 60.0)

FUNDING: (Thousands of Dollars)

GENERAL FUND	-	-	-	-	-	-
FEDERAL FUNDS	-	-	-	-	-	-
OTHER	-	-	-	-	-	-
<b>TOTAL</b>	-	-	-	-	-	-

POSITIONS:

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

ANALYSIS: See attached analysis.

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

*Carl Meyer, for*

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

Approved by Commissioner: Hugh Malone  
Agency: Department of Revenue

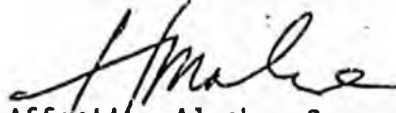
*H Malone*

Date: January 9, 1989

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

SB 119 (a)  
1/17/89

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



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

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

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

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

### FISCAL NOTE

**REQUEST:**

Revision Date: \_\_\_\_\_

Title: Unitary Tax

Sponsor: Rules Committee

Requestor: Governor

Agency Affected: Commerce & Econ. Dev.

BRU: Division of Banking, Securities  
and Corporations

Components: \_\_\_\_\_

**EXPENDITURES/REVENUES: (Thousands of Dollars)**

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

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

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

**POSITIONS:**

FULL-TIME						
PART-TIME						
TEMPORARY						

**ANALYSIS :** (Attach a separate page if necessary)

Prepared by: Willis F. Kirkpatrick, Director

Division: Banking, Securities and Corporations

Phone: 465-2521

Date: 01/09/1989

Approved by Commissioner: Larry Mercurieff *Sam*

Agency: Dept. of Commerce & Economic Development

Date: 01/09/1989

Distribution (by preparer):

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

## Alaska Unitary Statement

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

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

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

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

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

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

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

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

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

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

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

\_\_\_\_\_ 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.

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

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

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

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

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

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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:

*Sec 2*  
*(1)*  
*(A)*

(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;

*Sec 2*  
*(1)*  
*(B)*

(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;

*Sec 2*  
*(4)*

(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

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(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:

*existing  
lang  
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sec 2*

(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

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

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

*Sec 2*  
*(8)(3)*  
Sec. 43.20.051. DEFINITIONS. "Foreign corporation" means a corporation created or organized outside of the United States, the District of Columbia, the commonwealth of Puerto Rico or any possession of the United States.

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

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## ANALYSIS OF I.B.M.'S UNITARY TAX PROPOSAL

The following is a technical explanation of IBM's proposed bill, which would apply the water's edge method to multi-national corporations with both domestic and foreign parents. Many of the provisions of I.B.M.'s proposal are identical to those of the Governor's bill (SB 119). This analysis focuses on the differences.

### TAXABLE INCOME -- Sec. 43.20.031.

DEFINITION. Subsection (a) of Sec. 43.20.031 requires that taxable income shall be determined in accordance with Sec. 63 of the Internal Revenue Code (IRC). Alaska law currently does not contain any express definition of taxable income. Up until 1980, the law did define taxable income according to the IRC definition. The definition apparently was repealed unintentionally in 1980 as a consequence of the personal income tax repeal. A definition is required to eliminate an ambiguity in the law and to support the intent to limit taxation to the water's edge. SB 119 contains no definition of taxable income.

EXCLUSIONS. Subsection (b) of Sec. 43.20.031 excludes 80% of foreign dividends, 100% of IRC Sec. 78 dividend gross-up, and 80% of foreign royalties.

The federal government imposes income tax on a residence principle. Income of foreign subsidiaries owned by domestic corporations is not included in the tax base until it is repatriated in the form of dividends or royalties paid to a

domestic corporation. However, double taxation of repatriated foreign source income is eliminated through the foreign tax credit.

States, including Alaska, impose income tax on a source principle. That is, states are limited by the U.S. constitution to taxation of income arising within the state's borders. For corporations that do business within and without the state, the state's portion of the total income is derived through an apportionment formula. 1/ Theoretically, the use of a worldwide apportionment basis will limit the attribution of income to a state through the apportionment formula because worldwide factors are included in the denominator. On a water's edge basis, however, both income and factors are limited to the water's edge. Therefore, unless foreign source income of companies included in the water's edge is specifically excluded, the apportioned total income will include foreign source income, which the state is prohibited from taxing.

Sec. 78 gross-up is fully excluded, because this is "fictitious income." It is included in federal taxable income solely for U.S. tax purposes as part of the mechanics of the foreign tax credit. Neither this income nor the workings of the foreign tax credit are applicable for state tax purposes

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1/ Typically, states use a three factor formula in which the property, payroll and sales within the state are divided by the total property, payroll and sales of the unitary corporate group. The resulting percentage is then applied to total corporate income to determine the income appropriately attributed to the state.

(although a few states have their own version of a "foreign tax credit").

Foreign dividends and foreign royalties likewise would be fully excludable for the aforesaid reasons. However, certain U.S. expenses, although deducted from (reducing) taxable income, for example research and development expenses, may be partly attributable to the excludable foreign income. In recognition of this, the bill provides for only an 80% exclusion. Subsection (c) of this section further clarifies that no further expense attribution should be made.

The second sentence of subdivision (b) clarifies that these exclusions -- foreign dividends, foreign royalties and Sec. 78 dividends -- apply only to payments received by members of an affiliated group included in a combined Alaska return, from related companies, defined as 50% owned.

AFFILIATED GROUP DEFINITION -- Sec. 43.20.073.

Our bill includes the same corporations in the affiliated group as the governor's bill. The only difference is the exclusion from the group of "80/20" corporations.

80/20 corporations are corporations incorporated in the U.S., but which conduct business primarily overseas. For numerous non-tax reasons, such as foreign prohibitions against incorporating, import restrictions, foreign exchange requirements, etc., many multi-nationals are forced to organize this way in order to facilitate operating in certain foreign counties. Clearly, the preference would be to establish foreign subsidiary

corporations in these countries, in which case they would be excluded from the water's edge. There is no reason to include these essentially foreign corporations in the water's edge, simply because of a method of operation imposed by foreign requirements. There is no tax motivation for this type of organization, and there should be no undue tax consequence resulting from the necessity to operate in this manner.

FOREIGN CORPORATION DEFINITION -- Sec. 43.20.051.

As a result of the extending the water's edge method to U.S. corporations, income received from foreign corporations requires special treatment. Therefore, it becomes necessary to define "foreign corporation." Sec. 43.20.051 defines such a corporation to be one "created or organized outside of the United States, the District of Columbia, the commonwealth of Puerto Rico, or any possession of the United States."

All other provisions of our bill are identical to the Governor's bill.

**OFFICE OF THE GOVERNOR  
DIVISION OF POLICY**

**Box AD, Juneau, Alaska 99811-0164**

**Phone (907) 465-3568**

**Fax (907) 465-3767**

Gregg K. Erickson  
Senior Economist

4 March 1989

James Merle Carter  
Organization for Fair Treatment of International  
Investment  
Wilmington, DE 19897  
by telefax to 302/575-2952

Dear Mr Carter:

The legislation you testified on last Monday, SB 119, is at least temporarily stalled in the Senate Resources Committee. The chairman appears to be concerned about the spreadsheet requirement. Since the only public testimony received on this point was from you, I suggest that we try, as quickly as possible, to reach accommodation so that the bill can move forward. The legislative session in Alaska is limited to 120 days, almost half of which have elapsed. The bill must yet move through two other committees in the Senate, and indications are that the House of Representatives intends to give the bill a close inspection.

The Alaska Department of Revenue believes an annual domestic disclosure spreadsheet is an essential tool in insuring fair administration of the corporate tax as revised by the SB 119. On the other hand, the Department does not anticipate that every taxpayer filing a water's

edge report would have to file the spreadsheet. Indeed, it is my understanding that they intend to require the spreadsheet only from firms with a substantial nexus within Alaska. I also understand that in most cases the spreadsheet would only require information readily available from filed state and federal tax returns, plus property, sales and payroll factor information for each state in which the taxpayer or affiliated corporation does business. Finally, it is my understanding that sufficient authority already exists in AS 43.20 (Alaska Net Income Tax) for the Department to issue regulations to implement these requirements.

With these points in mind, would you be agreeable to an amendment simply dropping the spreadsheet reference? The Governor's Office would suggest this to the chairman by letter, noting that the authority to issue all necessary regulations, including regulations requiring the domestic disclosure spreadsheets, is amply provided elsewhere in statute.

We appreciated your testimony in favor of the bill and hope we can work together to deal with what I believe is a relatively peripheral issue. I will be available to discuss this by phone Monday afternoon, your time (4 hours ahead of Alaska).

Sincerely,

cc: Steve Kettel, Director, Income, Excise and Audit  
Division, Department of Revenue.  
Mary Halloran, Director of Policy, Office of the  
Governor.

# SIC SourceSet

Date Collected: Oct. 3, 1988 Filing Code: FINANCE, PUBLIC Taxation (Corporate)

Source of Information: City & State, September 26, 1988

## California tax still irritates Great Britain

By RODD ZOLKOS ..

New changes in California's unitary system of corporate taxation probably won't satisfy the system's most vocal critics: the British government.

Most of the changes included in a bill that went to Gov. George Deukmejian in mid-September are simply technical corrections in the existing unitary tax law, which has brought the state hundreds of millions of dollars in tax revenue in recent years.

British government and business leaders have complained for years about California's system, which taxes the worldwide, rather than in-state, earnings of multinational companies. Other nations, including Japan, have also complained, but none has been as vocal as the British.

California passed legislation in 1986 that changed the system, allowing corporations to opt out of the worldwide taxing system and accept a "water's edge" method of taxation instead. The revision was expected to provide corporations with about \$230 million in annual tax relief.

But British officials contend that an "election fee," which must be paid to switch systems, a 10-year election period and other restrictions make it difficult for many

companies to switch.

Under the worldwide system, the international profits of a multinational company doing business in California are taxed based on the percentage of its payroll, property and sales in the state.

Under the water's edge tax, only the U.S. earnings of a corporation are taxed, based on the size of California operations.

The election fee companies must pay to opt for the water's edge tax is 0.03% of corporate property, payroll and sales in California. Funds raised through the election fee — about \$50 million annually — are used to finance state infrastructure improvements.

The bill recently sent to Mr. Deukmejian would reduce the election period to five years from 10, but would make no changes in the election fee.

"The current bill is actually more of a technical cleanup bill. It does make some substantive changes, although not great," said Anthony Moss, budget analyst in the California Department of Finance. "I suppose this bill is not going to make (the British) very happy."

Said Richard Pratt, economic counselor at the British Embassy in Washington: "The position of the British government is that we are opposed to unitary taxation in prin-

*Continued on Page 25*

ciple because it is unfair and inconsistent with the internationally accepted method of taxation. We welcome the movement made in 1986 in California, and we remain concerned about the election fee, which we regard as unfair."

Mr. Pratt said that he had no figures on the extent of British investment in California, but that it is substantial.

"The British are the largest single foreign investor in the United States," he said. "California is a major part of that market. We would consider ourselves a major player in the California economy."

British officials believe one prob-

lem with unitary taxation is that it can result in a company being taxed in California even if its operation in the state makes no profit. A company's investment in operations in another country could also end up increasing taxes in California.

"The British have been very keen to remove this thorn in our otherwise very happy trading relationship," Mr. Pratt said.

British officials tried, but failed, to include a clause addressing unitary taxation in the current U.S.-British tax treaty.

During the summer, a British parliamentary delegation warned that California companies could be subject to retaliation in the United Kingdom if the state doesn't make further changes in its unitary tax system.

## The Tax Side

■ FLORIDA LAWMAKERS ANNOUNCE WORLDWIDE UNITARY REPEAL AGREEMENT In Florida, state Senate President Harry Johnston and House Speaker James Harold Thompson say they have crafted an agreement to repeal use of the worldwide unitary method of calculating corporate income taxes at a special session set for Dec. 6. The legislative leaders say they have business approval for a plan to boost the corporate tax rate from 5 percent to 5.5 percent to replace the revenue to be lost by repeal. Florida lawmakers adopted worldwide unitary in 1983 after business waged a long battle against a general corporate rate hike.

Now, the state's large corporations seem willing to see the rate rise as a substitute for worldwide unitary. Ron LaFace, an attorney representing IBM, Xerox and Coca-Cola in the battle against worldwide unitary, said he was very pleased with the proposed solution.

Under the compromise, the state would continue to tax the profits from foreign sales of Florida companies' goods, which the state has been doing only since the worldwide unitary was adopted. However, the state would stop taxing dividends from foreign subsidiaries, another practice it began with adoption of worldwide unitary.

Although some critics say a general rate hike to replace use of worldwide unitary requires small businesses to shoulder some of multinationals' tax burden, Speaker Thompson denies the charge. A corporate tax boost would not hurt small businesses because they "don't show that much of a profit because they translate profits into higher salaries for directors," Thompson said.

01/17/89

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

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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

01/17/89

Selection=>

PF1	PF2	PF3	PF4	PF5	PF6	PF7	PF8	PF9	PF10	PF11	PF12
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BASIS	Journal Text										

01/17/89

corporations and does not consider income from their non-American operations.

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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

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January 17, 1989

\_SB 119 cont'd\_

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

Sincerely,

/s/  
Steve Cowper  
Governor

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27 February 1989

Honorable Betty Fahrenkamp  
 Chairman, Special Committee on International  
 Trade and Tourism, Judiciary, Resources and  
 Finance, Senate of the State of Alaska

ORGANIZATION FOR  
 FAIR TREATMENT OF  
 INTERNATIONAL  
 INVESTMENT INC

Wilmington, DE 19897  
 Tel. (302) 575-3738  
 Fax. (302) 575-2952

S.B. 119

My name is James Merle Carter, speaking on behalf of "Organization for Fair Treatment of International Investment," called "OFTII." OFTII is composed of 20 domestic companies whose principal shareholders are foreign based multinationals. A written list of members who support limiting combined income reporting for State tax purposes to the "water's edge" of the U.S.A. has or shortly will be provided to your Committee. You will recognize most of the names as affiliated with major, mostly European Common Market, companies that have invested in the United States. The industries represented include automotive, chemicals, electronics, food products, metallurgy, and pharmaceuticals. OFTII members employ more than 100,000 citizens of the U.S.A. in manufacture and distribution of products manufactured in the U.S.A. as well as distribution of imported products. A great deal of foreign developed technology has been brought into the U.S.A. by OFTII members and thousands of highly skilled jobs have been created or preserved by OFTII members' investments and operations.

For many years, by treaty and by internal laws, the United States and all of its major foreign trading partners have agreed on the "arm's length principle" for taxing international trade. This principle is embodied in the Internal Revenue Code. A great many States of the United States, by contrast, use the combined income, formula method to apportion taxes among intrastate operations of commonly controlled, "unitary," groups of companies. Combined income apportionment works well enough where there are common accounting standards; a common currency; similar social welfare systems; similarities in production standards and productivity; and fairly consistent definitions of what is taxable, what is deductible, what is capital investment and what is current expense. When all or even most of these factors differ markedly, combined income apportionment doesn't work at all. As we have seen from the California experience, application of combined income apportionment to worldwide income leads to endless frustration on the part of taxpayers and tax collectors; endless litigation; and a strong sense among the business community that investment in such a State must be minimized in order to minimize tax compliance costs which can equal or exceed the amount of tax. Even California, after years of wrangling, has now gone to an elective water's edge procedure. No State and not even the United States federal government has the resources to determine taxable income correctly under worldwide, combined income, formula apportionment. No foreign multinational is prepared to invest the enormous sums of money that are required to adjust and restate accounts, investments, profits, payroll, and currency fluctuations to produce a reasonably uniform and equitable allocation of taxable income to the proper nation. As a result, the attempt to use a worldwide, combined method degenerates into

Directors: Harry Cortess, Chairman • Ned W. Bandle • Robert E. Dillon • Donald J. Kupray • Leonard D. Levin • Alan Spitzer

taxation by intimidation and negotiation, "horse trading" if you will, because no one has the ability to produce mathematically reasonable and economically feasible results. In the recent Barclay's Bank case in California, now on appeal from a State Superior Court ruling that the method violates the U.S. Constitution when applied to a foreign based multinational, California's own accounting expert, Professor John K. Shank, stated unequivocally that a foreign based multinational simply could not comply with the technical requirements of worldwide, combined income, apportionment and would be required to negotiate California income taxes with the assessors based on approximations.

I am not aware of OFTII members' experiences with Alaskan income taxation, but I do not think many of our members presently have significant investments in your State. I can express the view on behalf of OFTII that use of worldwide, combined income, apportionment by any State will be viewed as a major impediment to investment. That isn't to say that investments may not be made for economically compelling reasons; but given a choice, a foreign based multinational would certainly look first to a State that limits combined income apportionment for taxation to operations within the United States. Alaska, at present, is the only remaining State not to utilize some form of water's edge reporting for State income tax purposes. Ladies and gentlemen, you are urged to abandon that invidious distinction and take a large step toward achieving rationality and fairness in your tax laws.

A modification to the spread sheet requirement of S.B. 119 should be considered by your Committee. A spread sheet is expensive to produce. An annual filing is probably not going to be very helpful to the revenue department. It is strongly recommended that the spread sheet be required only every third year, similarly to the requirement recently adopted by California for those who elect "water's edge." A second modification is also recommended to eliminate the requirement for companies that do not have significant investments in Alaska or employ only a few people in Alaskan operations. A small sales office for goods manufactured outside the State does not justify filing a spreadsheet, the cost of which may well run higher than the tax liability itself. Where the apportionment fraction to Alaska is small from the outset, many taxpayers are indifferent to whether water's edge or worldwide combined income apportionment is applied.

The opportunity to address your Committee is appreciated. If you have questions, I shall be pleased to try to answer them.

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AKZO America, Inc.  
 Alcan Aluminum Corp  
 Allied-Lyons North America Corp.  
 BASF America Corp.  
 BATUS, Inc.  
 Elf Aquitaine, Inc.  
 Fosco Minnep  
 Gold Fields American Corp.  
 Hoechst Celanese Corp.

ICI Americas Inc.  
 M&C-Hennessy U.S. Corp.  
 Nestlé Holdings Inc.  
 Siemens Capital Corp.  
 Sony Corporation of America  
 Thorn EMI (USA) Inc.  
 Unilever United States  
 Volvo of America Corp.



BY FACSIMILE

27 February 1989

ORGANIZATION FOR  
FAIR TREATMENT OF  
INTERNATIONAL  
INVESTMENT INC

Wilmington DE 1989  
Tel (302) 576-3738  
Fax (302) 576-2952

Honorable Bettye Fahrnkamp  
Chairman, Committee on Resources,  
Senate of the State of Alaska

S.B. 119

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 Sony Corporation of America  
 Thorn EMI (USA) Inc.  
 Unilever United States  
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**Sadami (Chris) Wada**  
Senior Vice President  
Government Affairs

February 27, 1989

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

Before  
Senate Committee on Resources  
Chairwoman Bettye Fahrenkamp  
Alaska State Senate

By

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

U.S. Advisor to  
The Council for Better  
Investment in the U.S.  
of KEIDANREN

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

In closing, Madame Chairwoman Bettye Fahrenkamp and members of the Senate Committee on Resources, I would like to express my appreciation for the opportunity to testify before your committee in support of the Senate Bill No. 119, which would change a world-wide combination to the water's edge combination for Alaska State tax purpose.

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## ANALYSIS OF I.B.M.'S UNITARY TAX PROPOSAL

The following is a technical explanation of IBM's proposed bill, which would apply the water's edge method to multi-national corporations with both domestic and foreign parents. Many of the provisions of I.B.M.'s proposal are identical to those of the Governor's bill (SB 119). This analysis focuses on the differences.

TAXABLE INCOME -- Sec. 43.20.031.

DEFINITION. Subsection (a) of Sec. 43.20.031 requires that taxable income shall be determined in accordance with Sec. 63 of the Internal Revenue Code (IRC). Alaska law currently does not contain any express definition of taxable income. Up until 1980, the law did define taxable income according to the IRC definition. The definition apparently was repealed unintentionally in 1980 as a consequence of the personal income tax repeal. A definition is required to eliminate an ambiguity in the law and to support the intent to limit taxation to the water's edge. SB 119 contains no definition of taxable income.

EXCLUSIONS. Subsection (b) of Sec. 43.20.031 excludes 80% of foreign dividends, 100% of IRC Sec. 78 dividend gross-up, and 80% of foreign royalties.

The federal government imposes income tax on a residence principle. Income of foreign subsidiaries owned by domestic corporations is not included in the tax base until it is repatriated in the form of dividends or royalties paid to a

domestic corporation. However, double taxation of repatriated foreign source income is eliminated through the foreign tax credit.

States, including Alaska, impose income tax on a source principle. That is, states are limited by the U.S. constitution to taxation of income arising within the state's borders. For corporations that do business within and without the state, the state's portion of the total income is derived through an apportionment formula. 1/ Theoretically, the use of a worldwide apportionment basis will limit the attribution of income to a state through the apportionment formula because worldwide factors are included in the denominator. On a water's edge basis, however, both income and factors are limited to the water's edge. Therefore, unless foreign source income of companies included in the water's edge is specifically excluded, the apportioned total income will include foreign source income, which the state is prohibited from taxing.

Sec. 78 gross-up is fully excluded, because this is "fictitious income." It is included in federal taxable income solely for U.S. tax purposes as part of the mechanics of the foreign tax credit. Neither this income nor the workings of the foreign tax credit are applicable for state tax purposes

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1/ Typically, states use a three factor formula in which the property, payroll and sales within the state are divided by the total property, payroll and sales of the unitary corporate group. The resulting percentage is then applied to total corporate income to determine the income appropriately attributed to the state.

(although a few states have their own version of a "foreign tax credit").

Foreign dividends and foreign royalties likewise would be fully excludable for the aforesaid reasons. However, certain U.S. expenses, although deducted from (reducing) taxable income, for example research and development expenses, may be partly attributable to the excludable foreign income. In recognition of this, the bill provides for only an 80% exclusion. Subsection (c) of this section further clarifies that no further expense attribution should be made.

The second sentence of subdivision (b) clarifies that these exclusions -- foreign dividends, foreign royalties and Sec. 78 dividends -- apply only to payments received by members of an affiliated group included in a combined Alaska return, from related companies, defined as 50% owned.

**AFFILIATED GROUP DEFINITION -- Sec. 43.20.073.**

Our bill includes the same corporations in the affiliated group as the governor's bill. The only difference is the exclusion from the group of "80/20" corporations.

80/20 corporations are corporations incorporated in the U.S., but which conduct business primarily overseas. For numerous non-tax reasons, such as foreign prohibitions against incorporating, import restrictions, foreign exchange requirements, etc., many multi-nationals are forced to organize this way in order to facilitate operating in certain foreign countries. Clearly, the preference would be to establish foreign subsidiary

corporations in these countries, in which case they would be excluded from the water's edge. There is no reason to include these essentially foreign corporations in the water's edge, simply because of a method of operation imposed by foreign requirements. There is no tax motivation for this type of organization, and there should be no undue tax consequence resulting from the necessity to operate in this manner.

FOREIGN CORPORATION DEFINITION -- Sec. 43.20.051.

As a result of the extending the water's edge method to U.S. corporations, income received from foreign corporations requires special treatment. Therefore, it becomes necessary to define "foreign corporation." Sec. 43.20.051 defines such a corporation to be one "created or organized outside of the United States, the District of Columbia, the commonwealth of Puerto Rico, or any possession of the United States."

All other provisions of our bill are identical to the Governor's bill.

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

Testimony in support of  
SB-119  
Of Alaska State Senate  
To modify  
The Worldwide Unitary Tax  
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By

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

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

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

\*\*\*\*\* end \*\*\*\*\*

f. SB 119

By: Don Lowell  
Introduced: 01/12/89

POSTPONED JAN 19 1989

RESOLUTION NO. 89-002

A RESOLUTION REQUIRING SEPARATE ACCOUNTING

WHEREAS, the State of Alaska has lost hundreds of millions of dollars since "separate accounting" was repealed in 1981; and

WHEREAS, "separate accounting" requires the oil industry to pay taxes on profits made in Alaska; and

WHEREAS, "separate accounting" will give multi-national corporations the incentive to do business in the State of Alaska; and

WHEREAS, "separate accounting" will help assure the State of Alaska receives its fair share of oil revenue profits.

NOW, THEREFORE, BE IT RESOLVED that the Fairbanks North Star Borough Assembly urges the Governor and the Legislature to reinstitute "separate accounting" as the method of corporate taxation in the State of Alaska.

BE IT FURTHER RESOLVED that copies of this resolution shall be sent to the Honorable Steve Cowper, Governor, State of Alaska and all members of the Interior Delegation of the Alaska State Legislature.

PASSED AND APPROVED THIS \_\_\_ DAY OF \_\_\_\_\_, 1989.

\_\_\_\_\_  
Presiding Officer

ATTEST:

\_\_\_\_\_  
Clerk of the Assembly

THE  
COUNCIL  
FOR  
BETTER  
INVESTMENT  
IN THE U.S.

In an effort to adjust to the changing international business environment, Japanese companies have been increasing their direct investments abroad, particularly in the U.S. According to the 1987 statistics of the Ministry of Finance, Japanese investment in the U.S. amounted to 1316 cases, approximately \$147 billion in value. This registered a 44.1% jump over the previous year.

Currently, Japan is the third largest investor in the U.S., after Great Britain and the Netherlands in cumulative total. We believe these trends are a positive factor for the continued expansion of U.S.-Japan economic relations. But since the tempo is so intense, we are bound to cause economic, social and political impacts on the hosting local community and the national economy. The causes for concern include lack of awareness about regional practices, mores and the culture as well. When maladjustment snowballs, seeds for negative sentiments will grow.

With such concerns in mind and in order to minimize potential and emerging problems, the Council for Better Investment in the U.S. (CBIUS) was organized by leading members of the Keidanren\* on April 6, 1988.

*\*Note: a brief explanation of the Keidanren follows.*

## INTRODUCTION



**Eisshiro Saito**  
Advisor, CBIUS  
Chairman, Keidanren  
Director and Honorary Chairman  
Nippon Steel Corp.



**Akio Morita**  
Chairman, CBIUS  
Vice Chairman, Keidanren  
Chairman, Sony Corp.



July 25, 1988

Mr. Akio Morita  
 Vice Chairman, Keidanren  
 Japan Federation of Economic Operations  
 1-9-4 Otemachi, Chiyoda-ku, Tokyo 100

Dear Mr. Morita:

I certainly welcome the formation of your council and wish it great success in its endeavors. As you know, the United States has a long history of enjoying the benefits of foreign investment. For example, a significant portion of the financing for railroad construction in our country in the last century, a vital element in that period's economic expansion, was provided by foreigners. We know the positive impacts from foreign direct investment are many, including:

- increased efficiency in the use of capital;
- transmission of new management techniques and production methodologies;
- improved understanding of host and home countries' economic systems and concerns; and
- strengthened economic relationships

It is important for both our countries, and for the world generally, that the international climate for direct investment flows be open. The United States has long argued that increased openness on the part of developing countries to direct investment could significantly improve their economies.

However, sometimes concerns are expressed in both home and host countries over potential negative implications of such investments. In the United States, the recent sharp increase in foreign direct investment inflows has tended to heighten those feelings of concern in some quarters. In my personal view, these fears are substantially overblown. Organizations, like yours, aware of these sensitivities, can be effective in minimizing the frictions that may occasionally arise in connection with Japanese business expansions in the United States. This would certainly be an important achievement, and you have my wholehearted support.

Sincerely,

*Mike Mansfield*  
 U.S. Ambassador to Japan

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# OBJECTIVES

The purpose of the CBIUS is fourfold:

- heighten the awareness of Japanese investing firms about concerns of the hosting local community and the nation.
- encourage and support the integration of the investing firms into American society and the local community.
- assist the member companies in their efforts to cope with legal and administrative problems, related to direct investment at state and federal levels.
- help Japanese subsidiaries in gaining the support of their headquarters and facilitate smoother adaptation to the business environment in the U.S.

---

# ACTIVITIES

## (1) MEETINGS

Meetings were held to discuss difficulties encountered by Japanese subsidiaries, related to management, recruiting, and others:

- updates on recent trends in Japanese direct investment in the U.S.
- advice on how to interact in community relations.
- case studies of successful and unsuccessful ventures to grasp ingredients for success and reasons for failure.
- comparative analyses of American and Japanese lifestyles and living environments, including the American educational system and potential areas for adjustment, necessary for families moving to the U.S.
- enhancement of the awareness level as to the diverse and multi-faceted nature of American society, including minority issues among Japanese investors.





## (2) SEMINARS

The following are some seminars sponsored by the CBIUS:

June 1988:

- "Investment Environment of the State of New Mexico"
- "Investment Environment of the State of California"
- "The Importance of Community Relation Activities in the U.S."

July 1988:

- "Harvard Seminar on International Management and Investments"

August 1988:

- "The U.S./Japan Bilateral Session: A New Era in Legal and Economic Relations"

October 1988:

- "Osaka Seminar on Community Relation Activities in the U.S."

### (3) MISSIONS

The CBIUS sent a delegation to Alaska and Hawaii in September 1988 to investigate the investment environment and learn the realities of doing business there. A series of investment-related missions were also sent by Keidanren to various states beginning four years ago, covering 23 states in 1984, 16 states in 1986, and five states last year.

The delegations were sent to learn from and exchange views with members of the federal government and state legislature, mayors, leaders of the states and municipalities, business communities and Japanese companies operating in the U.S.



### (5) SURVEYS

We survey our member companies regarding the nature of their business and investment, locations, scale, goals and problems.

By studying actual cases, we strive to follow up the activities and efforts of our member firms and probe into the diverse difficulties they face. In this way, we can assist them in concrete ways, rather than merely pursuing abstract aspirations.

### (4) NEWSLETTERS

The CBIUS newsletters update our member companies on our activities and future programs, featuring articles on topics of common concerns, including:

- U.S. legislation and regulatory developments related to foreign direct investment.
- Summaries on meetings with visiting U.S. officials, lawyers, and consultants focusing on advice to problems and their possible solutions.
- Articles by and summaries on interviews with business leaders and government officials of Japan on U.S.-Japan investment relations.

We are also planning to introduce specific examples of community activities by our member companies so that others can learn and follow.

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# OFFICIALS

**Chairman:** Akio Morita  
Vice Chairman, Keidanren  
  
Chairman and Chief Executive Officer  
Sony Corporation

**Advisor:** Eishiro Saito  
Chairman, Keidanren  
  
Director and Honorary Chairman  
Nippon Steel Corporation

**Acting Chairman:** Yoh Kurosawa  
Deputy President  
The Industrial Bank of Japan, Ltd.

**Treasurer:** Tetsuya Horie  
Deputy President  
The Long-Term Credit Bank of Japan, Ltd.

**U.S. Advisor:** Sadami (Chris) Wada  
Senior Vice President  
Sony Corporation of America

**Secretariat:  
(Keidanren)** Katsuhiko Fujiwara  
Director  
International Economic Affairs Dept.  
  
Yoshio Nakamura  
Senior Assistant Director  
International Economic Affairs Dept.  
  
Atsushi Yamakoshi  
Staff Economist  
International Economic Affairs Dept.

---

TOTAL MEMBERSHIP:  
245 corporations (as of November 15, 1988)

---

## STEERING COMMITTEE MEMBERS

Akio Morita	Chairman, CBIUS	Toshio Yamazaki	Corporate Advisor, Mitsubishi Corporation
Yoh Kurosawa	Acting Chairman, CBIUS	Yasunari Ohta	Vice President, Mitsubishi Real Estate Co., Ltd.
Seiki Tozaki	Counselor, C. Itoh & Co., Ltd.	Eiichi Hori	Managing Director, Mitsui & Co., Ltd.
Yoshitoki Chino	Chairman, Daiwa Securities Co., Ltd.	Shozo Shimizu	Executive Vice President NEC Corporation
Yusaku Onaga	Executive Director, Fujitsu Limited	Masaru Shidara	Senior Managing Director Nippon Life Insurance Co. Ltd.
Masataka Nishi	Executive Vice President & Director, Hitachi, Ltd.	Tetsuo Arakawa	Executive Vice President Nissan Motor Co., Ltd.
Hideo Sugiura	Advisor, Honda Motor Co., Ltd.	Yoshihiko Wakumoto	Vice President & Deputy Group Executive, Corporate International Staff Group, Toshiba Corporation
Shoichi Ohori	Managing Director, Kajima Corporation	Ken-ichi Kato	Director, Toyota Motor Corporation
Yuzaburo Mogi	Managing Director, Kikkoman Corporation	Sejiro Nishizaki	Senior Managing Director Yoshida Kogyo K.K.
Asa Jonishi	Statutory Auditor, Kyocera Corporation		
Tetsuya Horie	Deputy President The Long-Term Credit Bank of Japan, Ltd.		

## KEIDANREN

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 members and 921 corporate members, as of September 1988.

The Keidanren is headed by internationally-acknowledged leaders of the Japanese business community and plays an increasingly influential role to achieve the ends mentioned above.

THE COUNCIL FOR BETTER INVESTMENT IN THE U.S.

Keidanren Bldg., 1-9-4 Otemachi  
Chiyoda-ku, Tokyo 100, Japan

Phone: (03) 279-1411

Fax: (03) 279-1888

Telex: 2223188 KDR TOK J

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**ICI Americas Inc.**

Law Department  
General Section  
Wilmington  
Delaware 19897  
Telephone (302) 575-3000  
Fax (302) 575-2952

March 6, 1989

Gregg K. Erickson  
Senior Economist  
Office of the Governor  
Division of Policy  
Box AD, Juneau, Alaska  
99811-0164

BY FACSIMILE (907) 465-3767

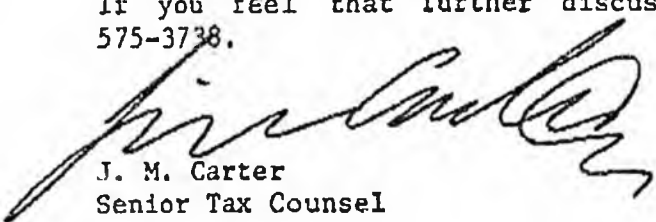
Senate Bill 119

Thank you for your letter of 4 March respecting the spreadsheet issue in the subject bill.

The view expressed last Monday was intended to call attention to a potentially troublesome problem. As you may know, remedial legislation was required in California after 18 months to correct the original spreadsheet provisions. To be sure, the California legislation was more detailed and the implementing regulations promised to be far more onerous than anything suggested in your letter. It is regretted if OFTII's testimony gave the impression that removal of the spread sheet provision was a sine quo non of support for SB 119.

Needless to say, all businessmen would like to make life as easy for themselves as possible and OFTII members are no exception. We do support the Bill, however, and welcome your suggestion of removing the reference to the spreadsheet. This seems an eminently satisfactory solution to the legislative problem. We ask that OFTII and others be given the opportunity to comment on any spreadsheet regulations proposed by the Department of Revenue under AS 43.20.

Your courtesy in inviting our further response to this issue is appreciated. If you feel that further discussion would be useful, please call (302) 575-3738.



J. M. Carter  
Senior Tax Counsel

030689VAB101

SEARS, ROEBUCK AND CO.

SEARS TOWER  
CHICAGO, ILLINOIS 60684

January 26, 1989

Mr. Jerry Reinwand  
159 South Franklin  
Juneau, Alaska 99801

Dear Jerry:

At Chuck McKenney's request, I have set forth below Sears concerns associated with either the passage of a state sales tax or unitary tax reform in Alaska. Enclosed for your information is a memorandum I prepared which detailed the problems we perceived with Alaska Substitute H.B. 20, a 1987 legislative proposal for a state sales tax. Each of the points outlined in the memorandum should be considered and addressed in any legislation on this subject. Several additional points should also be mentioned. First, the exemption for advertising materials should be extended to all direct mail catalogs, circulars and the like to offset the unfavorable decision issued by the U.S. Supreme Court in the D.H. Holmes case. Second, the law should provide an exemption for transactions between affiliated companies. This is becoming a more common feature as sales tax bases are broadened. Third, any proposal to require taxes to be paid by an electronic funds transfer method should be carefully analyzed to insure the taxpayer has viable options of payment and is not subjected to burdensome requirements associated with its payments. Finally, if a state sales tax is to be enacted, state law should be examined to determine if the current locally imposed taxes can be state administered and required to have a uniform tax base. This would simplify taxpayer compliance and ease tax administration by the state.

Our main concern with any unitary tax reform is the domestic disclosure spreadsheet. If the goal of Alaska is to follow the California model, several points should be stressed. First, the spreadsheet should only be required by those taxpayers electing water's-edge combination. Second, a spreadsheet should only be filed every three years unless there is a significant change in the taxpayer's business activities. Third, taxpayers should not be required to create and furnish tax information on the spreadsheet for the five states which do not impose a corporate income tax (Nevada, South Dakota, Texas, Washington and Wyoming). Finally, the spreadsheet should not be due until six months after the extended due date of the Alaska return. Each of these changes, if adopted, would help to alleviate some of the time associated in preparation of the spreadsheet.

You should also be aware that the domestic disclosure spreadsheet itself is still a troublesome item. The schedules proposed by California, Idaho and North Dakota all require an inordinate amount of information much of which is repetitive and irrelevant. We would, therefore, favor the spreadsheet being limited to a disclosure of only that information readily available from filed state tax returns such as tax liability, factors, income and the method for apportioning or allocating income. Any other information is more appropriately considered during an audit.

If you have additional questions on either of these issues, please feel free to contact me directly at (312) 875-9021. I would appreciate being kept apprised on the developments on these and other tax issues of interest to Sears.

Sincerely,

SEARS, ROEBUCK AND CO.



Marc S. Weinstein  
Senior Tax Attorney  
Tax Department 970

MSW:jc

cc: James F. Buresh, D/970  
Terrell E. Schroeder, D/970  
Charles P. McKenney, D/980F-W

Enclosure

## Annotated Table of Contents

### Basic source materials.

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

### Materials advocating elimination of the worldwide unitary tax system.

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

### Briefing materials provided by the Department of Revenue.

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

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

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

Annotated Table of Contents, *page 2*

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

Materials prepared by the Staff Working Group on Unitary Taxation.

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

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

Summary & Sectional Analysis

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

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

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

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

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

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

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

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

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

## INTRODUCTION AND REFERENCE OF SENATE BILLS

SB 119

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

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

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

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

Governor's transmittal letter dated January 16:

Dear Senator Kelly:

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

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

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

SB 119 cont'd

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

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 Sturgulowski, Roday and Zharoff, entitled:

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

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

FISCAL NOTE

REQUEST:

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

Agency Affected: Revenue  
BRU: Income and Excise Audit  
Components: \_\_\_\_\_

EXPENDITURES/REVENUES: (Thousands of Dollars)

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

FUNDING: (Thousands of Dollars)

GENERAL FUND	-	-	-	-	-	-
FEDERAL FUNDS	-	-	-	-	-	-
OTHER	-	-	-	-	-	-
<b>TOTAL</b>	-	-	-	-	-	-

POSITIONS:

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

ANALYSIS: See attached analysis

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

Phone: (907) 465-2320  
Date: November 18, 1988

Approved by Commissioner: Hugh Malone  
Agency: Department of Revenue

Date: November 18, 1988

Distribution (by preparer):

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

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

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

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

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

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

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

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

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

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

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

Mitsuru Misawa

Industrial Bank of Japan, Ltd.

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

Japan's direct investment in the United States is increasing steadily, having reached a balance of \$3 billion at the end of 1982 (which is equal to 36 percent of Japan's total investment worldwide). However, the future of this trend is now clouded by the system of a worldwide unitary taxation adopted by California and twelve other states.<sup>1</sup> 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.<sup>2</sup> 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<sup>3</sup> visited a total of twenty-four states, including several where unitary taxation is applied.<sup>4</sup> 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.<sup>5</sup>

## The Consequences of Unitary Taxation on Japanese Corporations

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

ited sales within the state. This situation prevails even when a subsidiary is performing poorly in California.<sup>6</sup> 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.<sup>7</sup> In this period, the corporation paid \$3.5 million to the state of California on a net income of \$22 million. However, with the imposition of unitary taxation, tax liabilities were recalculated to include corporate income earned throughout the world. Thus, the state levied an additional amount of \$21 million inclusive of interest accrued during an alleged delay in payment. Altogether, the state tax paid exceeded net income. In this case, the grievance against unitary taxation on the part of Kyocera Corporation appears to be justified.<sup>8</sup>

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,<sup>9</sup> 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.<sup>10</sup>

## 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.<sup>11</sup>

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.<sup>12</sup> 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.<sup>13</sup> 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.<sup>14</sup> 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.<sup>15</sup>

**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.<sup>16</sup> 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 justifiable because the assessment of tax on multinational business activities presupposes a knowledge of intragroup dealings. In practice, however, several problems could arise. As a separate legal entity, the foreign parent firm of a U.S. subsidiary is not entirely free to furnish the kind of information required by this proposed approach. It should also be remembered that different states employ different taxation principles and procedures. The synopsis listing of tax payments to each and every state is, there-

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

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

### Conclusion

The initiative for satisfactory settlement of this issue rests with each of the state governments and legislatures concerned. Having fully appraised the adverse effects of unitary taxation on direct investment in the United States, I would like to see 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

**L**ISTEN. 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 compa-

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

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

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

#### Worldwide Combined Reporting Method

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

3

#### Water's Edge Reporting Method

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

3

#### Separate Accounting

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

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

With a *water's edge* approach, only U.S. widget activities would be used in calculating state tax liability. Fair market value would be used to determine the value of raw materials extracted in Alaska and "sold" to the manufacturing division in Taiwan and the value of finished widgets shipped from Taiwan to be sold out of Washington. If the corporation earns \$50,000 from U.S.

multinational corporations.

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

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

States. Donald Fitzgerald, partner in charge of tax work in the Los Angeles law firm Manatt, Phelps, 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

## Water's edge and the foreign dividend dilemma

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

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

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

The dilemma:

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

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

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

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

annually due to the revision—a fraction of its estimated \$4.1 billion annual corporate tax take. Further, it expects that decline to be more than offset by property, income and sales taxes from new investment the change should spawn.

Nonetheless, the revision came only after intense lobbying and teeth gnashing within the state and pressure from the Reagan Administration. And a pair of not-so-gentle nudges from California's worldwide reporting-free neighbors to the north, Oregon and Washington.

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

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



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

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

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

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

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

- That states still using worldwide reporting should abandon it in favor of a water's edge approach;

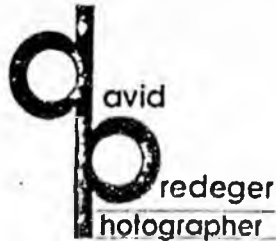
- That the federal government should assist states in monitoring compliance with water's edge reporting;

- That a competitive balance be maintained among U.S.-based multinationals, foreign-based multinationals and purely domestic corporations.

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

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

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

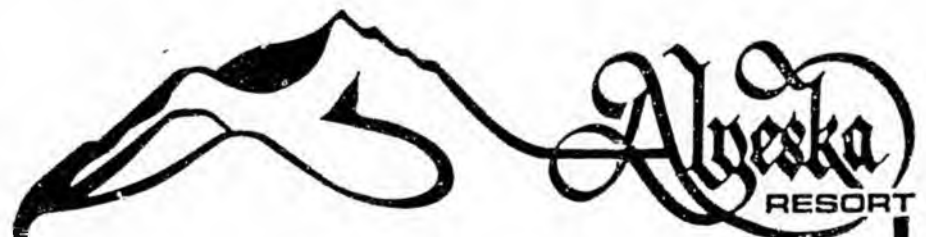
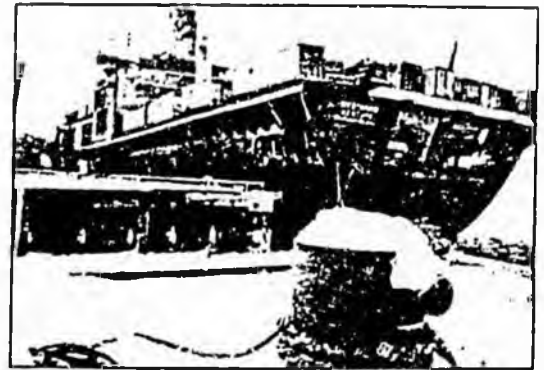


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ment's total revenues, and like state revenues in general, it's come almost exclusively from the oil industry.

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

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

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

ments 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 Roloids whenever someone brings up the issue of changing the tax structure?

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

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

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

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

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

Companies providing pipeline transportation are taxed on assets and sales.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

**"IT SEEMS LIKE** we often forget who our friends really are," he says. "The state has seemed to treat foreigners like they're on the other side of a competitive game. The Japanese, Koreans and Taiwanese have more of a holistic view of things. They figure they need help with fishing and 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 Proebger

*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 ~~spreadsheet~~ 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~~ Minnesota's Commissioner of Revenue viewed 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% 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

~~Utah's Income Tax Bureau Chief,~~ Utah'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;~~ 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 mind 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 cost 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;~~ 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 man-



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

***REVIEWING THE OPTIONS***

Briefing for Governor Steve Cowper  
and senior state officials

prepared by

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

A. SUMMARY OF THE ISSUE

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

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

B. NEED FOR BRIEFING AT THIS TIME

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

C. AGENCY INVOLVEMENT

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

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

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

D. THE STATE POLICY CONSIDERATIONS

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

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

E. THE APPROACH TO THE ISSUES

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

## SECTION ONE

### Summary

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

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

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

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

## DEFINITION OF TERMS

### *1. Unitary Business*

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

### *2. Combination (or combined report)*

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

### *3. Worldwide Combination*

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

### *4. Domestic Combination*

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

### *5. Water's Edge Apportionment*

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

### *6. Separate Accounting Method*

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

### *7. Apportionment Factor*

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

### EXAMPLES

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

#### Facts

Company A: Coal mining operation in Alaska.

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

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

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

#### *Separate Accounting*

Company A would file its tax return in Alaska and report only those receipts and costs related to its 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*

Alaska Taxable Income = Total Apportionable Income X

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

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

Total Apportionable Income X

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

**MODIFIED APPORTIONMENT FORMULA FOR PIPELINE  
COMPANIES**

Total Apportionment Income X

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

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

Total Apportionment Income X

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- - it may result in double taxation of the same income unless all countries adopt the method.
- - it may interfere with international trade and impede new investment in the United States.
- - foreign based corporations may have a greater income distortion since they have a greater proportion of foreign to U.S. activities.
- - it departs from the international norm of arm's length or separate accounting.
- - it gives rise to foreign threats of retaliation against U.S. based companies.
- - it is administratively burdensome for corporations and 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.

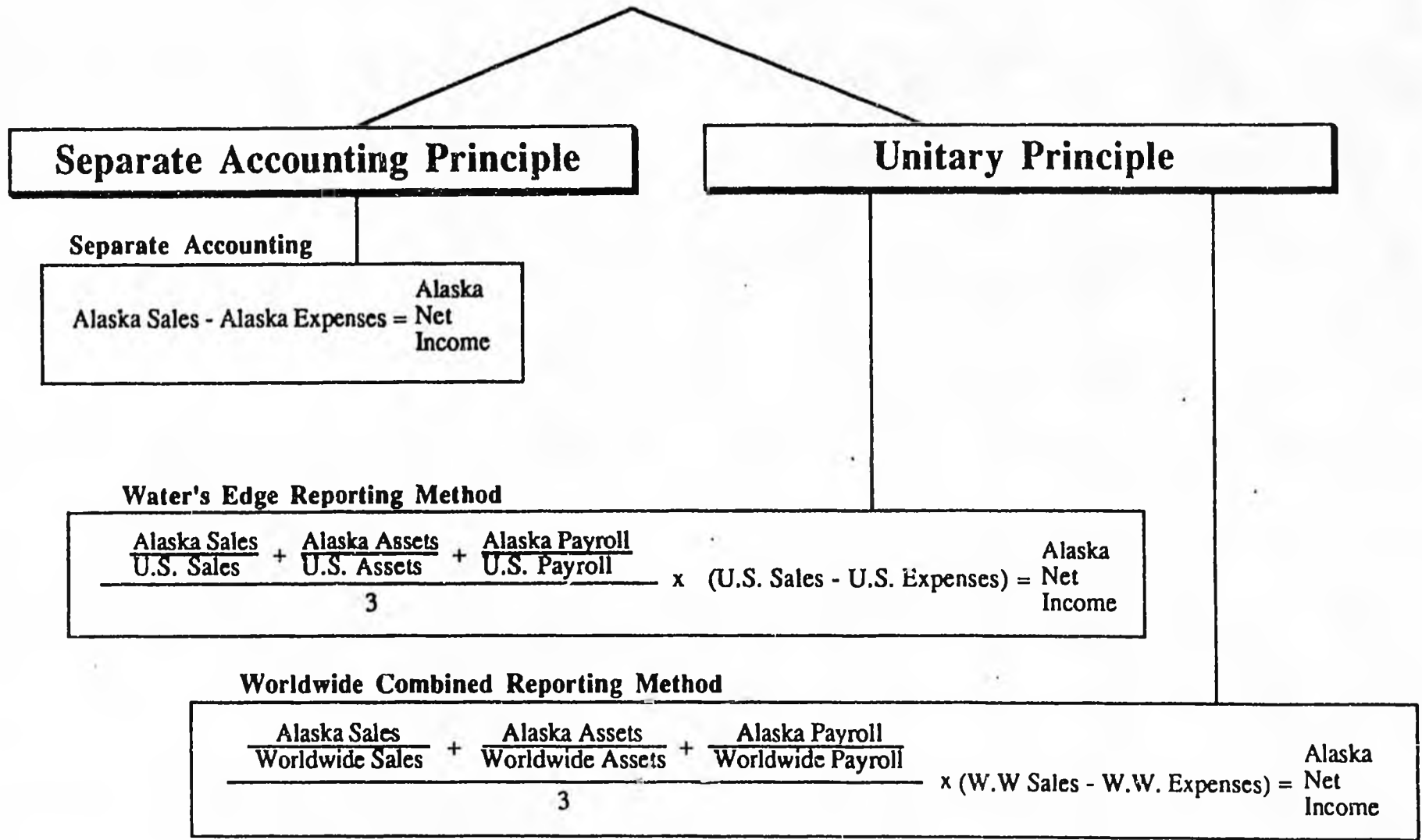
#### FACTORS FAVORING WORLDWIDE APPORTIONMENT

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:



No. 113 / October 1988

— BIMONTHLY —

# KEIDANREN

## on Japanese Economy **REVIEW**

### in This Issue:

#### Strengthening the Multilateral Free Trade System

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

#### Japanese Direct Investment In U.S. Gains Momentum

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

#### Investment from Japan Essential to Diversification of State Economies

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



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

# Investment From Japan Essential to Diversification of State Economies

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

By Hideo Ishihara

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

### 1. Background and Purpose

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

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

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

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

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

### 2. Impressions of the States Visited

#### (1) General Impressions

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

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



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

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

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

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

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

welcomed.

## (2) Impressions in Each State

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

### 1) Alaska

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

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

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

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

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

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

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

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

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

## 2) Hawaii

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

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

that would promote the development of the state economy.

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

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

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

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

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

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

## 3. Future Prospects

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

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

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

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

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

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

#### 4. Acknowledgements

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

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Japan National Tourist Organization

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

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

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

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

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

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

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

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

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

**September 1988**

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

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

*Since then Keidanren has grown into a nationwide body with 120 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.*

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

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

By

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

U.S. Advisor to  
The Council for Better  
Investment in the U.S.  
of KEIDANREN

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

\*\*\*\*\* end \*\*\*\*\*

ATTACHMENT A

Draft List of Possible Options

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

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

-----millions-----

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

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

2. **Water's edge for all corporate taxpayers.** Would also remove the psychological barrier said to deter foreign investment. Likely to have little impact on current non-petroleum corporate tax revenue (i.e.  $\pm$  <\$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 <sup>oil</sup> 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	2.00
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: (Collections/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	148.6	36.0
86	2679.4	133.0	15.0
87	1741.3	95.7	14.0
88*	1716.1	110	15

\*Forecast.

ATTACHMENT E

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

