5-13-91

HB

12

Official Business

Alaska State Legislature

House of Representatives

Committee on Rules

P. O. Box V
Juneau, Alaska 99811

Phone:
(907) 465-3764
465-3765

MEMORANDUM May 10, 1991

TO: ALL RULES COMMITTEE MEMBERS

FROM: REPRESENTATIVE JOHNNY ELLIS, CHAIR
HOUSE RULES COMMITTEE

HOUSE RULES COMMITTEE MEETING
8:00 A.M.
CAPITOL, ROOM 208
MONDAY, MAY 13, 1991

AGENDA: HB 12 - CORPORATE INCOME TAX REPORTING METHODS

COMMITTEE NAME

DATE ____________ JOINT ____________

TAPE # ____________ JOINT ____________

TIME CALLED TO ORDER ________ am/pm TIME ADJOURNED ________

ROLL CALL:	PRES	ABST	TIME ARRVD	JOINT MEMBERS PRESENT:
Martin	✓		8	Vapor[illegible]
Gruss	✓		Before 8	Mackiel
Taylor	✓		8:04	
Davidson	✓		8:05	
Greenberg			8:06	
Donley			8:08	

AGENDA:

BILL NO.	SHORT TITLE	ACTION TAKEN
31		Gruss – we adopt, No objection
		Martin moved
247		Joined by Mackie

OTHER:

SPECIAL ANNOUNCEMENTS:

COMMITTEE NAME: HOUSE RULES COMMITTEE

DATE May 13, 1991

JOINT

TAPE # 4

JOINT

TIME CALLED TO ORDER 8:10 am/pm

TIME ADJOURNED

ROLL CALL:	PRES	ABST	TIME ARRVD	JOINT MEMBERS PRESENT:
Donley	X		8-	Rep Mocpue
Martin	X		8	D. Damour
Ellis	X		8	Fran Ulmer
Grussendorf	X		8:05	John Lindbeck
Davidson	X		8:09	Jeannie Smith
Taylor	X		8:15	Jim Nordlund
Gruenberg		X		K. Brown

AGENDA:

BILL NO.	SHORT TITLE	ACTION TAKEN

OTHER:

SPECIAL ANNOUNCEMENTS:

STATE OF ALASKA
THE LEGISLATURE
LEGISLATIVE AFFAIRS AGENCY
LEGISLATIVE REFERENCE LIBRARY

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Copies of minutes listed below were originally included in this file. The minutes are available on the STAIRS database CMPR. In order to save space copies of minutes have not been left in the files.

Mary Van Nimwegen

House Rules 5-13-91 8:00 am

(7)

HOUSE COMMITTEE REPORT

Date Referred: 5/1/91 FURTHER REFERRALS:

Date of Committee Action: 5-13-91

The RULES Committee considered: HB 12

HOUSE BILL NO. 12
"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."

RECOMMENDATIONS: [ ] the same title
be replaced with CS HB 12 (Rules) [ ] a new title

[ ] have attached amendments(s)
[ ] do pass
[ ] do not pass
[ ] no recommendations
[X] individual recommendations
[ ] additional referral to the ______ Committee

ADOPTS: ______ letter of Intent

ATTACHES NEW FISCAL NOTE(s): (Dept)
[ ] fiscal impact ______
[ ] zero fiscal note ______

APPROVES PREVIOUS: (Dept/Date)
[X] fiscal note(s) 3/20/91 Rev.
[X] zero fiscal note(s) 3/20/91 Comm. Econ. Devp.

SIGNING/DO PASS	DP	OTHER RECOMMENDATIONS	DNP	NR	AM
[signature]		[signature]	✓		
		[signature]		✓	
		[signature]		✓	
		[signature]	✓		

[signature]
CHAIRMAN'S SIGNATURE

Sponsor: Rep. Moyer

TITLE FOR HB 12

"An Act relating to the water's edge method of calculating income taxes for certain corporations; relating to the determination of net income subject to state income tax from the operation of a ship or water transportation carrier for a foreign corporation; and providing for an effective date."

REPRESENTATIVE TOM MOYER

DISTRICT 19 • 119 N. CUSHMAN ST., SUITE 203 • FAIRBANKS, AK 99701 • (907) 456-8161

International Trade & Tourism, Chair • State Affairs, Vice Chair • Resources, Member

JS/JN

MEMORANDUM

To: Representative Johnny Ellis
Chairman, House Rules Committee

April 30, 1991

From: Representative Tom Moyer TM

Re: CSHB12 (Finance), An Act relating to the water's edge method of calculating income taxes for certain corporations; relating to the determination of net income subject to state income tax from the operation of a ship or water transportation carrier for a foreign corporation; and providing for an effective date.

With this memo, I would like to request the Rules Committee to schedule for floor action at your earliest convenience HB12. The bill is designed to attract foreign investment to Alaska by replacing Alaska's unitary tax, widely considered a barrier to foreign investment, with a so-called "water's edge" tax system. Under the bill, only the domestic activities of a foreign or international corporation would be subject to Alaska taxes and oil and gas companies would be exempt.

The bill has received broad support in the three earlier committees of referral. It is backed by a number of Alaska business groups including the State Chamber of Commerce, Alaska Miners' Association, Anchorage Economic Development Corp., a host of private companies doing business in the state as well as the Hickel administration. As you'll recall, a similar version of this bill passed the state Senate last year.

I am happy to provide any additional information should you need it.

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HOUSE RULES COMMITTEE MEETING

CAPITOL, ROOM 208
MONDAY, MAY 13, 1991

AGENDA:

HOUSE BILL NO. 12
"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."

I N D E X

I. MEMO DATED MAY 10, 1991 TO REP. ELLIS, RE: PROPOSED RULES CSHB 12

II. PROPOSED VERSION CSHB 12(RULES)

III. CSHB 12(FINANCE)

IV. CSHB 12(ITT)

V. MEMO TO HOUSE FINANCE COMMITTEE MEMBERS FROM BRIAN W. DURRELL RE: WATER'S EDGE TAX LEGISLATION

VI. POSITION PAPER RE: HB 12 DATED 2/28/91

VII. FISCAL NOTE - HB 12

VIII. FAIRBANKS DAILY NEWS ARTICLE 2/17/91 - HB 12

I

REPRESENTATIVE TOM MOYER

DISTRICT 19 • 119 N. CUSHMAN ST., SUITE 203 • FAIRBANKS, AK 99701 • (907) 456-8161
International Trade & Tourism, Chair • State Affairs, Vice Chair • Resources, Member

MEMORANDUM

To: Representative Johnny Ellis May 10, 1991
Rules Chairman

From: Representative Tom Moyer TM

Re: HB12, relating to the water's edge method of calculating income taxes for certain corporations.

You have asked for an explanation of the differences between the House Finance CS of this bill and the proposed Rules CS.

The only difference is the Rules CS would eliminate a provision (Section 3) that would exempt the federal exclusion for calculating income taxes for foreign-based ships or other water transportation carriers. In effect, the Finance CS would require cruise ships and other foreign vessels that operate in Alaska to pay Alaska corporate income taxes. The reason for the change is that Governor Hickel plans to introduce a corporate income tax bill that would include this provision and also apply to international air carriers.

The proposed Rules CS includes other positive changes made in the House Finance Committee, such as language (Section 2) that expresses legislative sentiment about a recent California Appeals Court decision that could affect Alaska's corporate income tax system in the future.

As sponsor of this bill, I believe the proposed Rules CS best accomplishes the original intent of this legislation.

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CS FOR HOUSE BILL NO. 12 (RULES)

IN THE LEGISLATURE OF THE STATE OF ALASKA

SEVENTEENTH LEGISLATURE - FIRST SESSION

BY THE HOUSE RULES COMMITTEE

Offered:
Referred:

Sponsor(s): REPRESENTATIVES MOYER, Brown, Koponen, Ellis

A BILL

FOR AN ACT ENTITLED

1 "An Act relating to the water's edge method of calculating income taxes for certain
2 corporations; and providing for an effective date."
3 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:
4 * Section 1. PURPOSE. It is the purpose of the addition of AS 43.20.073, added by sec. 3 of this
5 Act, to promote investment and trade opportunities in the state.
6 * Sec. 2. LEGISLATIVE INTENT. The amendments to the Alaska Net Income Tax made by this
7 Act are not intended to reflect a determination or conclusion by the legislature as to the assertion that
8 the imposition of the worldwide combined reporting method directed for use by certain taxpayers by
9 AS 43.20 violates the foreign commerce clause of the United States Constitution.
10 * Sec. 3. AS 43.20 is amended by adding a new section to read:
11 Sec. 43.20.073. AFFILIATED GROUPS. (a) A corporation that is a member of an
12 affiliated group shall file a return using the water's edge combined reporting method. A return
13 under this section must include the following corporations if the corporations are part of a unitary
14 business with the filing corporation:

1 (1) an affiliated corporation that is eligible to be included in a federal consolidated
2 return under 26 U.S.C. 1501 - 1505 (Internal Revenue Code) if the corporation's property,
3 payroll, and sales factors in the United States average
4 (A) 20 percent or more; or
5 (B) under 20 percent, if the corporation does not meet the requirements
6 of 26 U.S.C. 861(c);
7 (2) a domestic international sales corporation; in this paragraph, "domestic
8 international sales corporation" has the meaning given in 26 U.S.C. 992(a);
9 (3) a foreign sales corporation; in this paragraph, "foreign sales corporation" has
10 the meaning given to the term "FSC" in 26 U.S.C. 922(a);
11 (4) a corporation, regardless of the place where the corporation was incorporated,
12 if the corporation's property, payroll, and sales factors in the United States average 20 percent
13 or more;
14 (5) a corporation that is incorporated in or does business in a country that does
15 not impose an income tax, or that imposes an income tax at a rate lower than 90 percent of the
16 United States income tax rate on the income tax base of the corporation in the United States, if
17 (A) 50 percent or more of the sales, purchases, or payments of income or
18 expenses, exclusive of payments for intangible property, of the corporation are made
19 directly or indirectly to one or more members of a group of corporations filing under the
20 water's edge combined reporting method;
21 (B) the corporation does not conduct significant economic activity.
22 (b) When computing taxable income for a corporation under (a) of this section, the
23 following amounts shall be excluded:
24 (1) 80 percent of dividend income received from foreign corporations;
25 (2) an amount treated as a dividend under 26 U.S.C. 78;
26 (3) 80 percent of the royalties accrued or received from a foreign corporation.
27 (c) In (b)(1) and (3) of this section, a payment is considered to be received from a
28 corporation that is part of the unitary business if the payment is received
29 (1) by a member of an affiliated group included in a water's edge combined
30 report filed under this section; and
31 (2) from a corporation in which the recipient owns 50 percent or more of the

1 stock of the corporation.

2 (d) Dividends and royalties taxable to a corporation using the water's edge combined
3 reporting method are in lieu of an expense attribution for income excluded under (b) of this
4 section.

5 (e) The department may require a corporation that files under (a) of this section to file
6 a report under AS 43.20.065 - 43.20.071 prepared without regard to this section if the corporation
7 or an affiliated corporation

8 (1) fails to comply with regulations adopted under this chapter, including domestic
9 disclosure spread sheet filing requirements; or

10 (2) does not provide information that is requested by the department that is
11 necessary for the department to audit the taxpayer's corporate return in a reasonable period of
12 time.

13 (f) This section does not apply to taxpayers subject to AS 43.20.072 engaged in

14 (1) the production of oil or gas from a lease or property in the state; or

15 (2) the transportation of oil or gas by regulated pipeline in the state.

16 (g) In this section,

17 (1) "affiliated corporation" means a member of an affiliated group to which the
18 taxpayer filing a return under (a) of this section belongs;

19 (2) "affiliated group" means a group of two or more corporations in which 50
20 percent or more of the voting stock of each member of the group is directly or indirectly owned
21 by one or more corporate or noncorporate common owners, or by one or more of the members
22 of the group;

23 (3) "foreign corporation" means a corporation created or organized outside of the
24 United States, the District of Columbia, the Commonwealth of Puerto Rico, or a possession of
25 the United States;

26 (4) "water's edge combined reporting method" means a reporting method in which
27 the only corporations besides the taxpayer that may be included in the return are the corporations
28 listed in (a) of this section.

29 * Sec. 4. This Act applies to tax years beginning after December 31, 1991.

30 * Sec. 5. This Act takes effect immediately under AS 01.10.070(c).

CS FOR HOUSE BILL NO. 12 (FINANCE)

IN THE LEGISLATURE OF THE STATE OF ALASKA

SEVENTEENTH LEGISLATURE - FIRST SESSION

BY THE HOUSE FINANCE COMMITTEE

Offered: 5/1/91
Referred: Rules

Sponsor(s): REPRESENTATIVES MOYER, Brown, Koponen, Ellis

A BILL

FOR AN ACT ENTITLED

1 "An Act relating to the water's edge method of calculating income taxes for certain
2 corporations, and to the determination of net income subject to state income tax from the
3 operation of a ship or water transportation carrier for a foreign corporation; and
4 providing for an effective date."

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

6 * Section 1. PURPOSE. (a) By setting aside the exclusion from gross income of the income earned
7 by foreign corporations from vessel operations, it is the purpose of AS 43.20.030(h), added by sec. 3 of
8 this Act, to establish a uniform policy relating to the taxation of water transportation carriers, domestic
9 or foreign, subject to the apportionment of business income under AS 43.20.071.
10 (b) It is the purpose of the addition of AS 43.20.073, added by sec. 4 of this Act, to promote
11 investment and trade opportunities in the state.
12 * Sec. 2. LEGISLATIVE INTENT. The amendments to the Alaska Net Income Tax made by this
13 Act are not intended to reflect a determination or conclusion by the legislature as to the assertion that

1 the imposition of the worldwide combined reporting method directed for use by certain taxpayers by
2 AS 43.20 violates the foreign commerce clause of the United States Constitution.
3 * Sec. 3. AS 43.20.030 is amended by adding a new subsection to read:
4 (h) For purposes of determining the net income of a foreign corporation from the
5 operation of a ship or water transportation carrier, the provisions of 26 U.S.C. 883(a)(1) do not
6 apply. The taxpayer shall calculate gross income taking into consideration income derived from
7 the operation of a ship or water transportation carrier, and the provisions of AS 43.20.071 apply
8 to the determination of income subject to taxation by the operation of this subsection.
9 * Sec. 4. AS 43.20 is amended by adding a new section to read:
10 Sec. 43.20.073. AFFILIATED GROUPS. (a) A corporation that is a member of an
11 affiliated group shall file a return using the water's edge combined reporting method. A return
12 under this section must include the following corporations if the corporations are part of a unitary
13 business with the filing corporation:
14 (1) an affiliated corporation that is eligible to be included in a federal consolidated
15 return under 26 U.S.C. 1501 - 1505 (Internal Revenue Code) if the corporation's property,
16 payroll, and sales factors in the United States average
17 (A) 20 percent or more; or
18 (B) under 20 percent, if the corporation does not meet the requirements
19 of 26 U.S.C. 861(c);
20 (2) a domestic international sales corporation; in this paragraph, "domestic
21 international sales corporation" has the meaning given in 26 U.S.C. 992(a);
22 (3) a foreign sales corporation; in this paragraph, "foreign sales corporation" has
23 the meaning given to the term "FSC" in 26 U.S.C. 922(a);
24 (4) a corporation, regardless of the place where the corporation was incorporated,
25 if the corporation's property, payroll, and sales factors in the United States average 20 percent
26 or more;
27 (5) a corporation that is incorporated in or does business in a country that does
28 not impose an income tax, or that imposes an income tax at a rate lower than 90 percent of the
29 United States income tax rate on the income tax base of the corporation in the United States, if
30 (A) 50 percent or more of the sales, purchases, or payments of income or
31 expenses, exclusive of payments for intangible property, of the corporation are made

1 directly or indirectly to one or more members of a group of corporations filing under the
2 water's edge combined reporting method;
3 (B) the corporation does not conduct significant economic activity.
4 (b) When computing taxable income for a corporation under (a) of this section, the
5 following amounts shall be excluded:
6 (1) 80 percent of dividend income received from foreign corporations;
7 (2) an amount treated as a dividend under 26 U.S.C. 78;
8 (3) 80 percent of the royalties accrued or received from a foreign corporation.
9 (c) In (b)(1) and (3) of this section, a payment is considered to be received from a
10 corporation that is part of the unitary business if the payment is received
11 (1) by a member of an affiliated group included in a water's edge combined
12 report filed under this section; and
13 (2) from a corporation in which the recipient owns 50 percent or more of the
14 stock of the corporation.
15 (d) Dividends and royalties taxable to a corporation using the water's edge combined
16 reporting method are in lieu of an expense attribution for income excluded under (b) of this
17 section.
18 (e) The department may require a corporation that files under (a) of this section to file
19 a report under AS 43.20.065 - 43.20.071 prepared without regard to this section if the corporation
20 or an affiliated corporation
21 (1) fails to comply with regulations adopted under this chapter, including domestic
22 disclosure spread sheet filing requirements; or
23 (2) does not provide information that is requested by the department that is
24 necessary for the department to audit the taxpayer's corporate return in a reasonable period of
25 time.
26 (f) This section does not apply to taxpayers subject to AS 43.20.072 engaged in
27 (1) the production of oil or gas from a lease or property in the state; or
28 (2) the transportation of oil or gas by regulated pipeline in the state.
29 (g) In this section,
30 (1) "affiliated corporation" means a member of an affiliated group to which the
31 taxpayer filing a return under (a) of this section belongs;

1 (2) "affiliated group" means a group of two or more corporations in which 50
2 percent or more of the voting stock of each member of the group is directly or indirectly owned
3 by one or more corporate or noncorporate common owners, or by one or more of the members
4 of the group;
5 (3) "foreign corporation" means a corporation created or organized outside of the
6 United States, the District of Columbia, the Commonwealth of Puerto Rico, or a possession of
7 the United States;
8 (4) "water's edge combined reporting method" means a reporting method in which
9 the only corporations besides the taxpayer that may be included in the return are the corporations
10 listed in (a) of this section.
11 * Sec. 5. This Act applies to tax years beginning after December 31, 1991.
12 * Sec. 6. This Act takes effect immediately under AS 01.10.070(c).

CS FOR HOUSE BILL NO. 12 (ITT)

IN THE LEGISLATURE OF THE STATE OF ALASKA

SEVENTEENTH LEGISLATURE - FIRST SESSION

BY THE HOUSE SPECIAL COMMITTEE ON INTERNATIONAL TRADE AND TOURISM

Offered: 2/19/91
Referred: Labor and Commerce, Finance

Sponsor(s): REPRESENTATIVES MOYER, Brown, Koponen, Ellis

A BILL

FOR AN ACT ENTITLED

1 "An Act relating to the water's edge method of calculating income taxes for certain
2 corporations other than corporations engaged in the production of oil or gas from a lease
3 or property in the state or in the transportation of oil or gas by regulated pipeline in
4 the state; and providing for an effective date."

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

6 * Section 1. It is the purpose of this Act to promote investment and trade opportunities in the state.
7 * Sec. 2. AS 43.20 is amended by adding a new section to read:
8 Sec. 43.20.073. AFFILIATED GROUPS. (a) A corporation that is a member of an
9 affiliated group shall file a return using the water's edge combined reporting method. A return
10 under this section must include the following corporations if the corporations are part of a unitary
11 business with the filing corporation:
12 (1) an affiliated corporation that is eligible to be included in a federal consolidated
13 return under 26 U.S.C. 1501 - 1505 (Internal Revenue Code) if the corporation's property,

VI

1 payroll, and sales factors in the United States average

2 (A) 20 percent or more; or

3 (B) under 20 percent, if the corporation does not meet the requirements

4 of 26 U.S.C. 861(c);

5 (2) a domestic international sales corporation; in this paragraph, "domestic

6 international sales corporation" has the meaning given in 26 U.S.C. 992(a);

7 (3) a foreign sales corporation; in this paragraph, "foreign sales corporation" has

8 the meaning given to the term "FSC" in 26 U.S.C. 922(a);

9 (4) a corporation, regardless of the place where the corporation was incorporated,

10 if the corporation's property, payroll, and sales factors in the United States average 20 percent

11 or more;

12 (5) a corporation that is incorporated in or does business in a country that does

13 not impose an income tax, or that imposes an income tax at a rate lower than 90 percent of the

14 United States income tax rate on the income tax base of the corporation in the United States, if

15 (A) 50 percent or more of the sales, purchases, or payments of income or

16 expenses, exclusive of payments for intangible property, of the corporation are made

17 directly or indirectly to one or more members of a group of corporations filing under the

18 water's edge combined reporting method;

19 (B) the corporation does not conduct significant economic activity.

20 (b) When computing taxable income for a corporation under (a) of this section, the

21 following amounts shall be excluded:

22 (1) 80 percent of dividend income received from foreign corporations;

23 (2) an amount treated as a dividend under 26 U.S.C. 78;

24 (3) 80 percent of the royalties accrued or received from a foreign corporation.

25 (c) In (b)(1) and (3) of this section, a payment is considered to be received from a

26 corporation that is part of the unitary business if the payment is received

27 (1) by a member of an affiliated group included in a water's edge combined

28 report filed under this section; and

29 (2) from a corporation in which the recipient owns 50 percent or more of the

30 stock of the corporation.

31 (d) Dividends and royalties taxable to a corporation using the water's edge combined

1 reporting method are in lieu of an expense attribution for income excluded under (b) of this
2 section.
3 (e) The department may require a corporation that files under (a) of this section to file
4 a report under AS 43.20.065 - 43.20.071 prepared without regard to this section if the corporation
5 or an affiliated corporation
6 (1) fails to comply with regulations adopted under this chapter, including domestic
7 disclosure spread sheet filing requirements; or
8 (2) does not provide information that is requested by the department that is
9 necessary for the department to audit the taxpayer's corporate return in a reasonable period of
10 time.
11 (f) This section does not apply to taxpayers subject to AS 43.20.072 engaged in
12 (1) the production of oil or gas from a lease or property in the state; or
13 (2) the transportation of oil or gas by regulated pipeline in the state.
14 (g) In this section.
15 (1) "affiliated corporation" means a member of an affiliated group to which the
16 taxpayer filing a return under (a) of this section belongs;
17 (2) "affiliated group" means a group of two or more corporations in which 50
18 percent or more of the voting stock of each member of the group is directly or indirectly owned
19 by one or more corporate or noncorporate common owners, or by one or more of the members
20 of the group;
21 (3) "foreign corporation" means a corporation created or organized outside of the
22 United States, the District of Columbia, the Commonwealth of Puerto Rico, or a possession of
23 the United States;
24 (4) "water's edge combined reporting method" means a reporting method in which
25 the only corporations besides the taxpayer that may be included in the return are the corporations
26 listed in (a) of this section.
27 * Sec. 3. This Act applies to tax years beginning after December 31, 1991.
28 * Sec. 4. This Act takes effect immediately under AS 01.10.070(c).

BOGLE & GATES

MEMORANDUM

April 1, 1991 21688/01012

TO: House Finance Committee Members

FROM: Brian W. Durrell BWD

RE: Water's Edge Tax Legislation

What is Barclays[1]? It is a recent California Court of Appeals decision holding that, as applied to foreign-based unitary groups, the California "worldwide" combined reporting method ("WWCR") violates the foreign commerce clause of the U.S. Constitution. A unitary group is a group of corporations with common ownership that have attributes of functional integration, centralized management and economies of scale. A foreign-based unitary group is one in which the parent corporation is based in a country other than the U.S. By contrast, a unitary group with a parent corporation based in the U.S. is known as a domestic-based unitary group. A WWCR method is one which taxes a portion of a unitary group's income no matter where it was earned in the world. The California Court of Appeals is an intermediate appellate court. Its decision was appealed by the California Franchise Tax Board to the California Supreme Court which has accepted the appeal. A ruling is not expected from the California Supreme Court for at least a year. Its decision - no matter what it is - is expected to be appealed to the U.S. Supreme Court.

What effect does Barclays have on Alaska? Barclays will have substantial persuasive weight to any Alaska court which may be presented with the issue of the constitutionality of Alaska's WWCR as applied to foreign-based unitary groups. Only a decision of the U.S. Supreme Court, however, would be controlling upon an Alaska court addressing this issue. Barclays appears to impact equally Alaska's income tax imposed both upon foreign-based non-oil & gas and foreign-based oil & gas unitary groups. Both are currently taxed under WWCR. It is important to note that domestic-based unitary groups are unaffected by Barclays. In fact, an earlier U.S. Supreme Court case, Container Corp.[2], held that California's WWCR was constitutional as applied to domestic-based unitary groups. We have no data as to the number of non-oil & gas foreign-based unitary groups doing business in Alaska. Upon inquiry, we have learned that perhaps as few as three oil & gas foreign-based unitary groups do business in Alaska, with the most significant being BP.

Would Barclays' effect be retroactive? If Alaska's corporate income tax method is unconstitutional, any affected taxpayer could demand a refund for any open year, so long as the tax was paid under protest. A year is generally open if the return was filed within the prior three years or the tax was paid within the prior two years.

How does HB 12 address that effect? HB 12 is a bill that would change the method of reporting from a WWCR to a "water's edge" combined method. A water's edge method taxes only income earned within the "water's edge" of the U.S. The bill applies equally to foreign-based and domestic-based unitary groups. The bill does not apply to corporations engaged in the production or transportation of oil & gas. The water's edge method of reporting does not affect business activities that are wholly foreign. Therefore, the water's edge method of reporting does not violate the foreign commerce clause of the U.S. Constitution.

What is the difference between worldwide and water's edge combined reporting? Combined reporting must include some method of allocating a portion of the unitary group's income to Alaska for income tax purposes. The portion is usually determined by comparing the amounts of three factors - sales, property and payroll - within the State to the amounts found throughout the entire world (i.e., worldwide) or within the bounds of the U.S. (i.e., water's edge). Each of the three factors is reduced to a fraction, the numerator of which is, for instance, the sales in Alaska. Under the worldwide method the denominator would be the sales of the unitary group throughout the world. Under the water's edge method, the denominator would be just the sales of those members of the unitary group which conduct substantial activity within the water's edge of the U.S. Under the worldwide method, the average of the three factors' fractions would then be multiplied by the worldwide income of the unitary group. Under the water's edge method, the average of the three factors' fractions would then be multiplied by just the income of those members of the unitary group which conduct substantial activity within the water's edge of the U.S. The tax generated from the water's edge method is not necessarily less than the tax generated from the worldwide method. The tax difference will vary on a case by case basis, but in many cases the tax from a water's edge method will be greater than the tax from a worldwide method. Which method produces the greater amount of tax depends upon whether a unitary group's foreign or domestic activities are more profitable.

Must HB 12 address the income tax upon oil and gas companies? The differing methods of taxation for oil & gas corporations and, under HB 12, for non-oil & gas corporations do not appear to create a constitutional problem. In the ARCO[3] case, the Alaska Supreme Court upheld the use of the separate accounting

method of reporting for oil & gas corporations despite the claim that it violated the equal protection clause because other corporations were taxed under a different and (arguably) more favorable method. The different methods of reporting occasioned by HB 12 would almost certainly withstand an equal protection challenge. The oil & gas industry does not appear to be concerned with HB 12. The industry's fear of separate accounting appears to have kept it from advocating any change to the method in which the State taxes oil & gas corporations. Therefore, HB 12 need not address the method of taxation for oil & gas unitary groups. However, the likely impact of Barclays upon the current method of taxing foreign-based oil & gas unitary groups may mean that the issue of constitutionality should be addressed.

cc: David P. Harlow

1. Barclays Bank International Limited v. Franchise Tax Board, 275 Cal. Rptr. 626 (Cal. Ct. App. 1990)

2. Container Corp. v. Franchise Tax Board, 463 U.S. 159, 103 S.Ct.2933, 77 L.Ed.2d 545 (1983)

3. Atlantic Richfield Company v. State of Alaska, 705 P.2d 418 (Alaska 1985)

Department of Commerce & Economic Development / POSITION PAPER

House Bill 12: An Act Relating to the Water's Edge Method of Calculating Income Tax

The Department of Commerce and Economic Development supports passage of House Bill 12 and its objective to promote investment and trade opportunities in the state. Accomplishment of this goal is dependent on numerous factors. These amendments to the current unitary tax are an important step to help foster a favorable international business climate for Alaska.

Major resource development projects must compete for international investment dollars. Limited access and infrastructure, climate, small work force, distance to markets, land status, and regulatory issues are among the numerous factors which have bred an extremely cautious attitude towards investment in this state. The worldwide unitary taxation method unique to Alaska is perceived by foreign and domestic corporations with international holdings as a further disincentive to investment in Alaska.

This administration has clearly stated its intent to promote economic diversification as a primary objective to compensate for pending revenue declines. Amending the unitary tax structure to the more common water's edge method will help demonstrate to the international business community that the Alaskan Legislature is willing to work cooperatively with the administration in this effort to reduce disincentives for Alaskan investments.

Passage of this bill may be timely from an international perspective. Major mineral development, for example, relies totally on international investors. Many mineral rich countries, such as Canada, South Africa, and Australia, are just beginning their national debates on aboriginal rights and resource regulation. Alaska's twenty-year struggle with these issues is behind us. The ground rules for development have been laid. The additional certainty that Alaskan taxes will not be based on worldwide income will be an additional incentive for potential investors.

We recognize that other states have not been able to precisely measure the economic growth that resulted from this amendment to tax law. This inherent imprecision in economic projections is cited by critics of the bill as a good reason to maintain the status quo.

Psychology also plays an important role in business decisions. The Department of Revenue's initial rough estimates indicate a $1-3 million annual revenue loss from passage of HB 12. We believe this is a small price to pay for the business incentive it provides and anticipate that these losses, which assume no increase in economic activity in the state, will be compensated by an expansion in the state's industrial base.

[signature] Spec. Asst II

Glenn A. Olds, Commissioner

Date: 2-28-91

GAO/DM/dgl9013D
022891a

VII

FISCAL NOTE

STATE OF ALASKA
1991 LEGISLATIVE SESSION

No. 2
Bill Version: CSHB 12 (FIN)
(H) Publish Date: 3/20/91

Revision Date: March 12, 1991
Title: An act relating to the water's edge method of taxation
Sponsor: Representative Moyer
Requestor:

Department Affected: Department of Revenue
BRU: Revenue Operations
Component: Income and Excise Audit

COMPONENT SERIAL NO. | 1 | 1 | 1 | 3 |

EXPENDITURES/REVENUES: (Thousands of Dollars)

OPERATING	FY 92	FY 93	FY 94	FY 95	FY 96	FY 97
PERSONAL SERVICES	0.0	0.0	63.8	63.8	63.8	63.8
TRAVEL	0.0	30.0	34.8	39.3	39.3	39.3
CONTRACTUAL	13.0	15.0	17.0	17.0	17.0	17.0
SUPPLIES	0.0	2.5	2.5	8.0	8.0	8.0
EQUIPMENT	0.0	0.0	14.5	2.5	0.0	0.0
LANDS & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	13.0	47.5	132.6	130.6	128.1	128.1
CAPITAL	0.0	0.0	0.0	0.0	0.0	0.0
REVENUE	(500.0 - 1500.0)	(1000 - 3000)	(1000 - 3000)	(1000 - 3000)	(1000 - 3000)	(1000 - 3000)

FUNDING: (Thousands of Dollars)

	FY 92	FY 93	FY 94	FY 95	FY 96	FY 97
GENERAL FUND	13.0	47.5	132.6	130.6	128.1	128.1
FEDERAL FUNDS						
OTHER						
TOTAL	13.0	47.5	132.6	130.6	128.1	128.1

POSITIONS:

	FY 92	FY 93	FY 94	FY 95	FY 96	FY 97
FULL-TIME	0.0	0.0	1.0	1.0	1.0	1.0
PART-TIME						
TEMPORARY						

Estimate of current year impact:

ANALYSIS: Attach a separate page for analysis.

ATTACHED

Prepared By: Cliff Moerchinger
Phone: (907) 465-2300
Division: Income and Excise Audit Division
Date: March 12, 1991

Approved by Commissioner: Lee E. Fisher
Agency: Department of Revenue
Date: 3-12-91

Distribution (by preparer): Legislative Finance, Legislative Sponsor, Requestor, OMB, & Impacted Agency(ies).

Rev 10/90

COMMITTEE COPY

Fiscal Note Analysis, CSHB12
Income and Excise Audit Division
Prepared by Bill Floerchinger
March 12, 1991

The proposed legislation mandates the use of a water's edge method of accounting under the income tax law for non-oil and gas taxpayers. The legislation would be effective for tax years beginning in calendar 1992. Returns would be due in calendar 1993 and audits would begin in FY94. The data below shows the timing for the various cost components required to administer the proposed legislation.

	FY92	FY93	FY94	FY95
Personal Services				
1 Revenue Auditor IV, Anchorage	$0.0	$0.0	$63.8	$63.8
Total Personal Services Costs	$0.0	$0.0	$63.8	$63.8
Travel				
Training, 5 @ $10.0	$0.0	$30.0	$10.0	$10.0
Management Review, 4 @ $.5	$0.0	$0.0	$2.0	$2.0
12 Audits completed @ $1.9	$0.0	$0.0	$22.8	$22.8
9 Appeals completed in Anchorage @ $.5	$0.0	$0.0	$0.0	$4.5
Total Travel	$0.0	$30.0	$34.8	$39.3
Contractual				
Printing and Advertising Costs	$13.0	$13.0	$13.0	$13.0
Telecommunications, Centrex	$0.0	$2.0	$4.0	$4.0
Total Contractual	$13.0	$15.0	$17.0	$17.0
Supplies				
Office supplies, Computer supplies, Audit Manuals and References	$0.0	$2.5	$2.5	$8.0
Total Supplies	$0.0	$2.5	$2.5	$8.0
Equipment				
2 Wang PC Computers, Cable Hookup	$0.0	$0.0	$7.5	$2.5
2 Laptop Computers	$0.0	$0.0	$7.0	$0.0
Total Equipment	$0.0	$0.0	$14.5	$2.5
TOTAL COSTS	$13.0	$47.5	132.6	$130.6

COMMITTEE COPY

FISCAL NOTE

No. 3

STATE OF ALASKA
1991 LEGISLATIVE SESSION

Bill Version: CSHB 12 (FIN)
(H) Publish Date: 3/20/91

Revision Date: ______
Department Affected: Commerce & Economic Dev.
Title: An Act Relating to the Water's Edge Method of Calculating Income Tax
BRU: Banking, Securities & Corporations
Component: ______
Sponsor: Rep. Moyer
Requestor: ______
COMPONENT SERIAL NO. ______

Expenditures/Revenues: (Thousands of Dollars)

OPERATING	FY 92	FY 93	FY 94	FY 95	FY 96	FY 97
PERSONAL SERVICES						
TRAVEL						
CONTRACTUAL						
SUPPLIES						
EQUIPMENT						
LAND & STRUCTURES						
GRANTS, CLAIMS						
MISCELLANEOUS						
TOTAL OPERATING	0	0	0	0	0	0
CAPITAL	0	0	0	0	0	0
REVENUE	0	0	0	0	0	0

FUNDING: (Thousands of Dollars)

	FY 92	FY 93	FY 94	FY 95	FY 96	FY 97
GENERAL FUND						
FEDERAL FUNDS						
OTHER						
TOTAL	0	0	0	0	0	0

POSITIONS:

	FY 92	FY 93	FY 94	FY 95	FY 96	FY 97
FULL-TIME	0	0	0	0	0	0
PART-TIME						
TEMPORARY						

Estimate of current year impact: ______

ANALYSIS: (Attach a separate page if necessary.) This bill proposes to amend the method of computing corporate Net Income Tax payable to Alaska. Definitions for the corporation's "affiliated groups" and criteria for determining the U.S. taxable income are given. Corporations producing or transporting oil and gas are not subject to the water's edge method. The purpose of the bill is to promote investment and trade opportunities in the state.

Prepared By: Willis F. Kirkpatrick, Director
Phone: 465-2521
Division: Banking, Securities & Corporations
Date: 2/27/91
Approved by Commissioner: Glenn A. Olds
Agency: Department of Commerce & Economic Development
Date: [illegible]

Distribution (by preparer): Legislative Finance, Legislative Sponsor, Requestor, OMB, & Impacted Agency(ies)

Rev 10/90
DM/dg19012D/022891a

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2-17-91

Fairbanks Daily News-Miner, Fai

VIII

'Water's edge' tax stands to benefit state coffers

State Rep. Tom Moyer, D-Fairbanks, is moving quickly this legislative session to re-write state corporate income tax laws in ways he believes will attract more foreign companies to invest here.

Moyer introduced HB 12, with Rep. Niilo Koponen, D-Fairbanks, and two others as co-sponsors, to change the corporate income tax reporting formula from the "worldwide combined" method used here for almost two decades to a "water's edge" formula.

You don't have to be a tax attorney to appreciate the difference, although it would help. The whole issue revolves around

Fred Pratt

how a political jurisdiction like the State of Alaska should determine how much of a multinational corporation's income comes from operations in just our state.

The worldwide combined method offers a simple approach. It totals all of a corporations income, then calculates a share for Alaska by taking into account the corporation's property, payroll and sales in Alaska.

Prudhoe Bay oil companies like this because their payroll and sales in Alaska are very small, relative to other areas, so their corporate income tax payments here were quite low in comparison to the huge profits they made from oil produced here. This led the Legislature in 1977 to adopt a "separate accounting" formula just for oil companies, aimed at taxing a more accurately calculated estimate of their real Alaska income.

This wasn't popular among the oil companies and they challenged the constitutionality of separate accounting. In 1981, while the challenge was still in court, a group of Anchorage Republicans took over the leadership of the State House and repealed the separate accounting law.

The U.S. Supreme Court eventually ruled separate accounting was constitutional, but by then Alaska had already gone back to worldwide combined, at the cost of many millions of dollars a year.

But during this same time most other states were following Alaska's lead of 1977 and changing all corporate income tax to "water's edge," which is basically an easier form of separate accounting. It's more complicated than worldwide combined, because it has to calculate a multinational corporation's earnings just from Alaska, stopping at our "water's edge," but it's more fair and it keeps Alaskan revenue agents out of a foreign corporation's other books.

By the late 1980s Alaska was the last state to still use worldwide combined corporate income tax reporting. A change we pioneered is used by everyone but us.

In 1988 a bunch of Republicans in the Alaska Legislalture hired Arthur B. Laffer, the economist whose teachings guided Ronald Reagan in developing "Reaganomics," to tell us how we could change our tax codes to help business. Laffer's champions in Juneau were rather shocked when he told them one of the best and fastest changes they should make was to scrap worldwide combined accounting.

"The worldwide combined method discourages investments in Alaska by foreign corporations," Laffer flatly stated. "For example, the Idemitsu Company has postponed development of the Wishbone Hill coal deposit because it believes the cost of the porject will be too high if their taxes are computed using worldwide combination. Foreign corporations are reluctant to have their books on operations outside the United States examiend by auditors from Alaska."

Laffer noted that in Fiscal Year 1977 non-oil corporate income taxes in Alaska totaled only $20.5 million, or 1.1 percent of the state's total general fund revenues. " . . . the way many

(See PRATT, Page B-6)

PRATT: Changing formula

(Continued from Page B-1)

businesses are avoiding Alaska's relatively high unitary tax is by not locating in Alaska," Laffer said. "The only businesses locating in Alaska will be those that cannot do business elsewhere.

"Aside from natural resource processing firms, the state's continued use of a worldwide-combined unitary tax will discourage non-resource processing multinational corporations from locating in Alaska," Laffer predicted.

The problem with fixing this is that too many people like to play with the solution. Former Gov. Steve Cowper tried to push a "water's edge" bill through last year that would have only applied to foreign corporations, leaving U.S. multinational corporations under the higher tax formula.

HB 12 still has some problems. One has to consider the fairness to small Alaska corporations who won't get some tax breaks allowed large outside competitors, and there may be some problem with excluding the oil companies from the deal.

But when Moyer brought HB 12 out for its first hearing last week, it drew support from the Anchorage Chamber of Commerce, the Alaska State Chamber of Commerce, the Alaska Miners Association, and the Anchorage Economic Development Corp.

The Department of Revenue reported that the change would cost at most $3 million a year in lost revenue and require hiring four new auditors, certainly a cheap price to pay for a even a hint of foreign interest in Alaska.

■ Free-lance journalist Fred Pratt has been covering Alaska business and politics for the past 18 years.

HOUSE COMMITTEE REPORT

(11)

Date Referred: March 20, 1991

FURTHER REFERRALS:

Date of Committee Action: 4.29.91

The FINANCE Committee considered: HB 12

HOUSE BILL NO. 12 CORPORATE INCOME TAX REPORTING METHODS

"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."

RECOMMENDATIONS:
be replaced with CS HB 12 (Fin) [ ] the same title [X] a new title

[ ] have attached amendments(s)

[ ] do pass

[ ] do not pass

[X] no recommendations

[ ] individual recommendations

[ ] additional referral to the ______ Committee

ADOPTS: ______ letter of Intent

ATTACHES NEW FISCAL NOTE(s): (Dept)

[ ] fiscal impact ______

[ ] zero fiscal note ______

APPROVES PREVIOUS: (Dept/Date)

[X] fiscal note(s) REVENUE 3-20-91

[X] zero fiscal note(s) DCED 3-20-91

SIGNING DO PASS	DP	OTHER RECOMMENDATIONS	DNP	NR	AM
Fran Brown	✓	Eileen P. MacLean		✓	
[illegible]	✓	[illegible]			
Ramona L. Barnes		[illegible]		X	
Ronald L. [illegible]	X	[illegible]		✓	
		[illegible]	X		[illegible]
		do not pass unless amended			
		[illegible]		X	
		Mike Navarre		X	

Mike Navarre Eileen P. MacLean
CHAIRMAN'S SIGNATURE

Alaska State Legislature

HOUSE OF REPRESENTATIVES

Official Business

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

April 23, 1991

To: House Finance Committee

From: Representative Kay Brown
Chair, Subcommittee on HB12

The Subcommittee on HB12 requested the attached draft committee substitute. Note that the bill title was broadened in order to accommodate a change relating to taxation of international cruise companies. The following is a discussion of major issues discussed by the subcommittee and changes made in the proposed committee substitute.

I. Impact of HB12 on Revenues

The Department of Revenue informed the subcommittee that it would be unable, in the time allowed, to provide an analysis of how revenues would be affected if the Water's Edge method of taxation were applied to the oil and gas industry. Department representatives said such an analysis would take several months. As a result, the subcommittee made no changes to provisions that would apply the bill only to non-oil and gas corporations. The subcommittee, however, recommends that the full committee request such an analysis from the Department of Revenue and that it be reviewed during the interim.

II. Legal Issues

The Department of Law informed the committee in writing that it could foresee no legal problems with treating the oil and gas industry differently than other corporations, so long as there is a legitimate public interest to do so. The Department of Law memorandum is attached. As you may recall, there was testimony before the full committee on this bill regarding the affect on Alaska of the recent "Barclays' decision." The California Court of Appeals ruled that the worldwide method of apportionment, when applied to foreign-based unitary groups, is unconstitutional. The Department of Law sees no

reason for the legislature to try and change the law while the case is still in the courts. The subcommittee added a section to the bill, Section 2, that states the legislature, by passage of HB12, is making no admission regarding the constitutionality of the worldwide apportionment tax method.

III. Cruise Industry

The subcommittee discussed current corporate income taxes and how they relate to the cruise industry. The Department of Revenue, in answer to questions from the subcommittee, reported that the international cruise industry now pays no corporate income tax. The Department of Law has for the past 10 months been reviewing the Alaska tax code and its applicability to cruise companies. That review is not yet complete. International cruise industry representatives argue that they are excluded from state corporate income tax by section of the US tax code regarding exclusions from taxation due to treaties. The subcommittee recommends that the legislature clarify the situation with a new Section Three to HB12. It states that the tax exemption granted in the U.S. Code does not apply in Alaska. The subcommittee asked the Department of Revenue to estimate tax revenues that will result from this provision. The department was also asked to report to the legislature on how the cruise industry is taxed in other states.

If you have any questions or comments, please contact me.

C.C. Representative Tom Moyer
Commissioner of Revenue Lee Fisher

7-LS0237\G
Chenoweth
4/19/91

CS FOR HOUSE BILL NO. 12 ( )

IN THE LEGISLATURE OF THE STATE OF ALASKA

SEVENTEENTH LEGISLATURE - FIRST SESSION

BY

Offered:
Referred:

Sponsor(s): REPRESENTATIVES MOYER, Brown, Koponen, Ellis

A BILL

FOR AN ACT ENTITLED

1 "An Act relating to income taxes imposed on certain corporations; and providing for an

2 effective date."

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

4 * Section 1. PURPOSE. (a) By setting aside the exclusion from gross income of the income earned
5 by foreign corporations from vessel operations, it is the purpose of AS 43.20.030(h), added by sec. 3 of
6 this Act, to establish a uniform policy relating to the taxation of water transportation carriers, domestic
7 or foreign, subject to the apportionment of business income under AS 43.20.071.

8 (b) It is the purpose of the addition of AS 43.20.073, added by sec. 4 of this Act, to promote
9 investment and trade opportunities in the state.

10 * Sec. 2. LEGISLATIVE INTENT. The amendments to the Alaska Net Income Tax made by this
11 Act are not intended to reflect a determination or conclusion by the legislature as to the assertion that
12 the imposition of the worldwide combined reporting method directed for use by certain taxpayers by
13 AS 43.20 violates the foreign commerce clause of the United States Constitution.

14 * Sec. 3. AS 43.20.030 is amended by adding a new subsection to read:

1 (h) For purposes of determining the net income of a foreign corporation from the
2 operation of a ship or water transportation carrier, the provisions of 26 U.S.C. 883(a)(1) do not
3 apply. The taxpayer shall calculate gross income taking into consideration income derived from
4 the operation of a ship or water transportation carrier, and the provisions of AS 43.20.071 apply
5 to the determination of income subject to taxation by the operation of this subsection.
6 * Sec. 4. AS 43.20 is amended by adding a new section to read:
7 Sec. 43.20.073. AFFILIATED GROUPS. (a) A corporation that is a member of an
8 affiliated group shall file a return using the water's edge combined reporting method. A return
9 under this section must include the following corporations if the corporations are part of a unitary
10 business with the filing corporation:
11 (1) an affiliated corporation that is eligible to be included in a federal consolidated
12 return under 26 U.S.C. 1501 - 1505 (Internal Revenue Code) if the corporation's property,
13 payroll, and sales factors in the United States average
14 (A) 20 percent or more; or
15 (B) under 20 percent, if the corporation does not meet the requirements
16 of 26 U.S.C. 861(c);
17 (2) a domestic international sales corporation; in this paragraph, "domestic
18 international sales corporation" has the meaning given in 26 U.S.C. 992(a);
19 (3) a foreign sales corporation; in this paragraph, "foreign sales corporation" has
20 the meaning given to the term "FSC" in 26 U.S.C. 922(a);
21 (4) a corporation, regardless of the place where the corporation was incorporated,
22 if the corporation's property, payroll, and sales factors in the United States average 20 percent
23 or more;
24 (5) a corporation that is incorporated in or does business in a country that does
25 not impose an income tax, or that imposes an income tax at a rate lower than 90 percent of the
26 United States income tax rate on the income tax base of the corporation in the United States, if
27 (A) 50 percent or more of the sales, purchases, or payments of income or
28 expenses, exclusive of payments for intangible property, of the corporation are made
29 directly or indirectly to one or more members of a group of corporations filing under the
30 water's edge combined reporting method;
31 (B) the corporation does not conduct significant economic activity.

1 (b) When computing taxable income for a corporation under (a) of this section, the
2 following amounts shall be excluded:
3 (1) 80 percent of dividend income received from foreign corporations;
4 (2) an amount treated as a dividend under 26 U.S.C. 78;
5 (3) 80 percent of the royalties accrued or received from a foreign corporation.
6 (c) In (b)(1) and (3) of this section, a payment is considered to be received from a
7 corporation that is part of the unitary business if the payment is received
8 (1) by a member of an affiliated group included in a water's edge combined
9 report filed under this section; and
10 (2) from a corporation in which the recipient owns 50 percent or more of the
11 stock of the corporation.
12 (d) Dividends and royalties taxable to a corporation using the water's edge combined
13 reporting method are in lieu of an expense attribution for income excluded under (b) of this
14 section.
15 (e) The department may require a corporation that files under (a) of this section to file
16 a report under AS 43.20.065 - 43.20.071 prepared without regard to this section if the corporation
17 or an affiliated corporation
18 (1) fails to comply with regulations adopted under this chapter, including domestic
19 disclosure spread sheet filing requirements; or
20 (2) does not provide information that is requested by the department that is
21 necessary for the department to audit the taxpayer's corporate return in a reasonable period of
22 time.
23 (f) This section does not apply to taxpayers subject to AS 43.20.072 engaged in
24 (1) the production of oil or gas from a lease or property in the state; or
25 (2) the transportation of oil or gas by regulated pipeline in the state.
26 (g) In this section,
27 (1) "affiliated corporation" means a member of an affiliated group to which the
28 taxpayer filing a return under (a) of this section belongs;
29 (2) "affiliated group" means a group of two or more corporations in which 50
30 percent or more of the voting stock of each member of the group is directly or indirectly owned
31 by one or more corporate or noncorporate common owners, or by one or more of the members

1 of the group;

2 (3) "foreign corporation" means a corporation created or organized outside of the
3 United States, the District of Columbia, the Commonwealth of Puerto Rico, or a possession of
4 the United States;

5 (4) "water's edge combined reporting method" means a reporting method in which
6 the only corporations besides the taxpayer that may be included in the return are the corporations
7 listed in (a) of this section.

8 * Sec. 5. This Act applies to tax years beginning after December 31, 1991.

9 * Sec. 6. This Act takes effect immediately under AS 01.10.070(c).

STATE OF ALASKA

DEPARTMENT OF LAW

OFFICE OF THE ATTORNEY GENERAL

WALTER J. HICKEL, GOVERNOR

REPLY TO:

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April 18, 1991

Honorable Kay Brown
Chair, House Finance Subcommittee on HB 12
Alaska House of Representatives
P. O. Box V
Juneau, Alaska 99811

Re: HB 12 - Water's Edge Apportionment

Dear Representative Brown,

You have asked us to address certain questions regarding House Bill 12, which would enact a water's edge apportionment method for certain Alaska corporate taxes. Specifically, you have asked about the application of the equal protection doctrine for taxation purposes, and the impact of a California Court of Appeals decision, Barclays Bank International v. Franchise Tax Board, 275 Cal.Rptr. 626 (Cal.App. 1990), review granted, 278 Cal.Rptr. 836, 806 P.2d 308 (Cal. 1991), on Alaska tax methods. Our short answer is that we do not see a serious constitutional problem in HB 12; a more detailed discussion follows.

In Atlantic Richfield Co. v. State, 705 P.2d 418 (Alaska 1985), the Alaska Supreme Court considered the oil companies' equal protection challenge to the separate accounting method of taxation. The court upheld the taxation method under both Federal and state analysis. The court found that the interest involved, "freedom from disparate taxation," lies at the low end of the continuum of interests protected by the equal protection clause, that taxing the oil companies differently from other businesses to rectify a perceived inequity was a valid state purpose, and that the use of separate accounting was sufficiently related to the legislative purpose. Id. at 437. This was sufficient to uphold the tax under state equal protection analysis. Under a Federal analysis, separate accounting was found to have a rational relationship to the state's legitimate interest of correcting a perceived inequity. Id.

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From the above it can be deduced that, while the equal protection clause of the Federal and state constitutions do apply to taxation methods, a method will not be found unconstitutional so long as it is reasonably related to and furthers a legitimate state interest. Classification is not unconstitutional if any state of facts reasonably can be conceived that would sustain it. Allied Stores of Ohio, Inc. v. Bowers, 358 U.S. 522, 528 (1959). Thus, the disparate treatment of oil and gas taxpayers under the bill likely would withstand challenge.

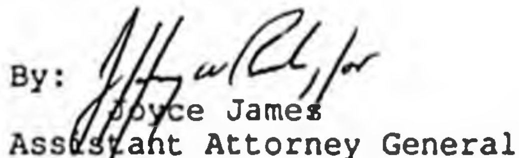
In addition, so long as the worldwide method used for oil and gas corporations is not clearly unconstitutional under current case law, it does not need to be changed. To the extent that the Barclays case invalidates worldwide apportionment, it is not binding in this state until it is affirmed by the United States Supreme Court or adopted by our own supreme court. Of course, were this to eventually happen, any taxes paid under protest (AS 43.10.210) would need to be refunded to the taxpayer if the taxpayer ultimately prevails in having the tax declared unconstitutional. Principal Mut. Life Ins. v. Div. of Ins., 780 P.2d 1023, 1030 (Alaska 1989).

Finally, we are unaware of any set of circumstances related to worldwide or water's edge apportionment that would give rise to potential liability to Mental Health Trust advocates.

We hope this addresses your concerns. If we may be of further assistance, please advise.

Sincerely,

CHARLES E. COLE
ATTORNEY GENERAL

By: 
Joyce James
Assistant Attorney General

JJ:prm

WALTER J. HICKEL, GOVERNOR

DEPARTMENT OF REVENUE

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

April 26, 1991

The Honorable Kay Brown
Chair, House Finance Sub-Committee on HB12
Alaska State Legislature
Capital Room 513
P.O. Box V
Juneau, Alaska 99811

APR 29 1991

Re: HB 12 - Cruise Ship Question

Dear Representative Brown:

We have made an attempt to estimate the revenue impact of amending Alaska law to very specifically exclude IRC Sections 883 and 894. Taxpayers such as those engaged in the cruise ship industry have taken the position that those sections are incorporated into Alaska law. The Income & Excise Division has taken a contrary view and the Department has not yet officially considered the question. Unfortunately, our efforts to quantify the tax involved have not been successful as the necessary information is simply not available.

The problem is that the Internal Revenue Code in Section 883 provides that the gross income derived by a foreign corporation from the operation of a ship or ships is not included in gross income. Similarily, Section 894 provides that income subject to a United States treaty obligation is not to be included in gross income. Therefore, unlike other items that are shown as subtractions from income, the income in question is not reported as income on either the United States or Alaska income tax returns. This is similar to the treatment for interest on state and local bonds which generally is not included in gross income.

Shipping income would be reflected in book income. The federal tax return does contain a schedule for reconciling book and taxable income for those corporations included in the return. However, the precise nature and breakdown of the income shown on the reconciliation cannot always be ascertained from the return detail. In our review, we were unable to identify any income from shipping operations. That is not surprising since the foreign corporations with the shipping operations would not generally be filing with any related United States corporations.

Foreign corporations are generally subject to United States tax on gross income derived from sources within the United States or otherwise effectively connected with the conduct of a trade or business in the United States. Therefore, since the shipping and treaty income is not a part of federal gross income, there is no requirement that it be reported.

04-04LH

A state unitary tax return would include all income from foreign and domestic corporations within the unitary business. A taxpayer may then show various subtractions from that income on the return. For instance, a taxpayer would show as a deduction the interest on obligations of the United States that are taxable at the federal level but which are not subject to state taxation. However, where a taxpayer uses the Internal Revenue Code to exclude an item of income from the tax base, as is the situation here, it will not be reflected anywhere on the Alaska return.

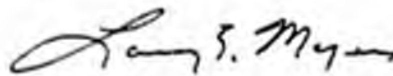
We would have a similar problem in trying to determine an apportionment factor to the tax base. The apportionment factor would be based on property, payroll, and sales. Since we are dealing with transportation property and personnel that do not remain in one location, this would require that the mobile property and personnel be allocated among the taxing jurisdictions. The regulations of the Department provide generally for a "port day" methodology in this situation. For example, the value of the cruise ship would be reflected in the numerator of the property factor in the ratio that the Alaska port days bear to port days everywhere. That information is not available except upon audit.

The above provisions of the IRC have application beyond just the cruise ship industry. However, the exclusion for shipping income was narrowed in 1987 to remove controlled foreign corporations. A controlled foreign corporation is any foreign corporation that is more than 50% owned by United States shareholders. Nevertheless, this illustrates that a tie-in to the federal provisions in this area leaves a great deal of uncertainty and makes Alaska subject to wholly unrelated federal policy considerations that are reflected in the tax code in laws such as Sections 883 and 894.

I have attached information as you requested concerning how other states treat this issue. It can be assumed that the majority of other states that incorporate federal taxable income have the same problem.

I hope that these explanations satisfy your request. I am sorry that we could not generate the numbers that the sub-committee is interested in. We appreciate the consideration that you and the sub-committee have given to this important legislation.

Sincerely,



Larry E. Meyers
Director
Income and Excise Audit Division

LEM:CM
91-77

Enclosure

cc: Lee E. Fisher, Commissioner
Representative Fran Ulmer

1991 Multistate Corporate Tax Guide

Volume I
Corporate Income Tax

WILLIAM A. RAABE, PhD, CPA
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Conformity to Federal Rules for Determining Taxable Income and Income Tax Rates

The Internal Revenue Code (IRC) is typically the starting point for computing state corporate taxable income. State statutes may specifically adopt the IRC as the starting point or they may adopt provisions of the IRC without designating it as the actual starting point. In either case, the state corporate taxable income is directly impacted by the federal statutes in most states after which specific state modifications are made.

The adoption of the IRC may be current or as of a specific reference date. A state that adopts the current IRC automatically incorporates any changes in the federal statutes into its own state statutes. The adoption of the IRC as of a specific reference date requires periodic updates to the state statutes for conformity to the IRC. For those states where a specific reference date applies, annual legislation is almost automatic to accomplish state statutory updates. In the latter case, care must be taken to consider the differences that may arise as the result of the delayed adoption of federal statutory provisions.

A complete tie-in to the IRC by the states would simplify tax administration and compliance. However, two primary considerations prevent this situation from occurring. First, the state's judiciary might consider a complete tie-in to be an unconstitutional delegation of legislative power to Congress. Second, state legislatures typically like to review amendments to the IRC before they are adopted for state tax purposes.

A complete tie-in also carries with it political issues. State legislators fear possible federal economic coercion of the states. Traditionally, there has been an underlying suspicion of federal interference in state activities that could lead to a state's loss of control over its own tax policy. Specific problems revolve around an absence of common goals in the state and federal tax laws. A state's tax policy tends to be responsive to regional needs, which are necessarily subordinated at the federal level. Federal tax policy is motivated by broader concerns.

The effects of federal tax changes on state revenues are often difficult to predict. This was particularly true of the extensive revisions included in the Tax Reform Act of 1986 and continues to be true to a lesser extent with more recent federal tax legislation. Some states respond quickly with legislation affecting state tax laws and other states defer any response until the impact of the tax changes are more fully known. The states face a difficult problem in evaluating the effect of federal tax legislation on state revenues. States will continue to evaluate how closely to conform to the IRC. A state's budgetary objectives as well as objectives related to economic development and social concerns will always be emphasized over conformity.

The following chart indicates whether the state follows the IRC for determining gross income and deductions and the respective date of adoption of federal tax statutes. Some states use final federal taxable income as the starting point, while others use federal taxable income before special deductions (e.g., dividends-received or net operating loss deductions). The chart also includes selected tax rate information and related state statutory citations.

Trends

As indicated by the charts, most states adopt the IRC as the starting point for computing state corporate taxable income. Fewer and fewer states depart from the use of federal income as the starting point. For example, Wisconsin recently revised its statutes to consider federal taxable income as the starting point for state taxable income, and California recently enacted tax legislation that incorporates much of the IRC, bringing the California State income tax calculation in closer conformity to the IRC.

Many states indicated current references to the IRC as amended to date. Other states adopt the federal tax rules as of a specific date which may reflect judicial or political considerations or possibly a desire to review the impact of the federal provisions before adopting them as part of the state tax calculation.

The tax rates and methods of applying them vary from state to state. Many states have a single rate flat-tax. There are also numerous states that have a graduated tax ranging from 2 brackets to a total of 10 brackets in the state of Alaska. Several states have indicated changes to their tax rates or adopted surtaxes in response to revenue and budgetary concerns.

Conformity to Federal Rules for Determining Taxable Income and Income Tax Rates

	Does State Computation of Taxable Net Income Start with a Figure from Federal Form 1120?	*Date of Adoption of Federal Income Tax Rules*	*Tax Rates*	*State Statute(s) That Apply in These Areas*
Alabama	Yes. Starts with taxable income before special deductions	Various	5% of Alabama taxable income	Ala. Code §§40-18-31, 40-18-33, 40-18-34
Alaska	N/R	N/R	N/R	Alaska Stat. §§43.20.011, 43.20.021
Arizona	N/R	N/R	N/R	Ariz. Rev. Stat. Ann. §§43-102, 43-1101, 43-111
Arkansas	No	N/A	$ 0-3,000: 1% 3,001-6,000: 2% 6,001-11,000: 3% 11,001-25,000: 5% 25,000 or more: 6%	Ark. Stat. Ann. §26-51-205
California	Yes. Starts with taxable income before special deductions	Various	9.3%; except for banks and financial institutions, which are taxed at 10.668%	Cal. Rev. & Tax Code §§23151, 23501, 24271
Colorado	Yes. Starts with taxable income after special deductions	Current	$0-50,000: 5%. A surcharge tax of 5.2% for taxable income in excess of $50,000 is in effect until 7/1/91	Colo. Rev. Stat. §39-22-30
Connecticut	Yes. Starts with taxable income before special deductions	Current	11.5%; net income base; a 20% surtax for years beginning on or after 1/1/89; 0.0031 per capital base for years beginning after 1/1/89; $250 minimum tax	Conn. Gen. Stat. §§12-214, 12-217
Delaware	Yes. Starts with taxable income after special deductions	1901(5) and 1903(a) of 30 DEL C.	8.7%	Del. Code. Ann. tit. 30 §1902
District of Columbia	No	1986 Code was approved 10/22/86	10% plus 5% surtax	D.C. Code. Ann. §§47-1803.2, 47-1807.2
Florida	Yes. Starts with taxable income after special deductions	1/1/90	5.5% (regular tax) for all taxpayers	Fla. Stat. §§220.11, 220.12

Georgia	Yes. Starts with taxable income after special deductions	1/1/90	6%	Ga. Code Ann. §48-7-21
Hawaii	No	January 1, 1990 for the amendments made as of December 31, 1989 to the Internal Revenue Code Sections operative for the state	4.4% on first $25,000 5.4% on next $75,000 6.4% above $100,000	Haw. Rev. Stat. §235-2.3, 235-71
Idaho	Yes. Starts with taxable income after special deductions	1/1/90	8%. With $20 minimum for each corporation that is required to file	Idaho Code §§63-3022, 63-3025
Illinois	Yes. Starts with taxable income after special deductions	Current	7.3% for taxable years ending 7/1/89 through 6/30/91. 6.5% thereafter. 1.5% for S corporations	Ill. Rev. Stat. Ch. 120, Para. 2-201(b), 2-203
Indiana	Yes. Starts with taxable income after special deductions	1/1/90	3.4% of adjusted gross income, plus supplemental net income tax at 4.5%	Ind. Code §§6-3-3-2, 6-3-1-3.5
Iowa	Yes. Starts with taxable income after special deductions and before NOL	1/1/90	$ 0-25,000: 6% 25,001-100,000: 8% 100,001-250,000: 10% 250,000 or more: 12%	Iowa Code §422.33
Kansas	Yes. Starts with taxable income after special deductions	Current	$ 0-25,000: 4.5% 25,000 or more: 6.75%	Kan. Stat. Ann. §§79-32, 110, 79-32, 138
Kentucky	No. See KRS 141.010 and 141.0101 for definition of gross and net income and deductions	12/31/89	$ 0-25,000: 4% 25,001-50,000: 5% 50,001-100,000: 6% 100,001-250,000: 7% 250,000 or more: 8.25%	Ky. Rev. Stat. Ann. §§141.010, 141.040
Louisiana	Yes. Starts with taxable income before special deductions; modifications do exist.	1/1/87	$ 0-25,000: 4% 25,001-50,000: 5% 50,001-100,000: 6% 100,001-200,000: 7% 200,000 or more: 8%	La. Rev. Stat. Ann. §§47-287.12, 47-287.61
Maine	Yes. Starts with taxable income after special deductions	12/31/89	$ 0-25,000: 3.5% 25,001-75,000: 7.93% 75,001-250,000: 8.33% 250,000 or more: 8.93%	Me. Rev. Stat. Ann. tit. 36 §5200

Conformity to Federal Rules for Determining Taxable Income and Income Tax Rates *(continued)*

	Does State Computation of Taxable Net Income Start with a Figure from Federal Form 1120?	*Date of Adoption of Federal Income Tax Rules*	*Tax Rates*	*State Statute(s) That Apply in These Areas*
Maryland	Yes. Starts with taxable income after special deductions	Current	7%	Md. Tax-General Code Ann. §§10-105, 10-304
Massachusetts	N/R	N/R	N/R	Mass. Gen. L. Ch. 63 §§30, 32, 39
Michigan	Yes. Starts with taxable income after special deductions	1/1/87	2.35%	Mich. Comp. Laws §§7.558(3), 7.558(31)
Minnesota	Yes. Starts with taxable income before special deductions	12/31/86	9.8%	Minn. Stat. §§290.01, 290.06
Mississippi	No. Taxpayer can begin with line 28 and make state adjustments, but is not required to do so	N/A	$ 0-5,000: 3% 5,001-10,000: 4% 10,000 or more: 5%	Miss. Code Ann. §27-7-5
Missouri	Yes. Starts with taxable income after special deductions	N/R	5%. However, for all tax years beginning on/after 1/1/90 but not after 12/31/91, tax is as follows: $ 0-100,000: 5% 100,001-335,000: 6% over 335,000: 6.5%	Mo. Rev. Stat. §§143.071, 143.441
Montana	Yes. Starts with taxable income before special deduction	State code annotated §§15-31-113 and 15-31-114	6.75%; a 5% surtax is imposed for tax years beginning after 12/31/89; 7% for water's-edge elections	Mont. Code Ann. §§15-31-113, 15-31-121
Nebraska	Yes. Starts with taxable income after deductions	Current	$ 0-50,000: 5.17% 50,001 or more: 7.24%	Neb. Rev. Stat. §§77-2734.02, 77-2734.04
Nevada	Nevada Does Not Impose a Corporate Income Tax.			
New Hampshire	Yes. Starts with taxable income before special deductions	Current	8%	N.H. Rev. Stat. Ann. §§77-A:1, 77-A:2

New Jersey	Yes. Starts with taxable income before special deductions and the NOL	Adopted by reference N.J.S.A. 54:10A-4(k)	9%. A surcharge of .417% is in effect and is annually reviewed	N.J. Rev. Stat. §§54:10A-4, 54:10E-4, 54:10E-5, 54:10A-5
New Mexico	N/R	N/R	N/R	N.M. Stat. Ann. §§7-2A-2, 7-2A-5
New York	Yes. Starts with taxable income before special deductions	Current	9% on income; 8% graduated rate for small businesses. Also, surtax of 15% in fiscal 1991 and 1992; 10% in 1993	N.Y. Tax Law §§208, 210
North Carolina	Yes. Starts with taxable income before special deductions	1/1/90 under proposed/introduced legislation	7%	N.C. Gen. Stat. §§105-130.2, 105-130.3
North Dakota	Yes. Starts with taxable income after special deductions	Perpetual except for safe harbor leases, foreign sales corporations (formerly domestic international sales corporations), and certain adjustments for depreciation	$ 0-3,000: 3% 3,001-8,000: 4.5% 8,001-20,000: 6% 20,001-30,000: 7.5% 30,001-50,000: 9% 50,000 or more: 10.5%	N.D. Cent. Code §§57-38-01.3, 57-38-30
Ohio	Yes. Starts with taxable income before special deductions	Statute refers to IRC as amended, not a specific adoption date	Greater of: (a) $ 0-50,000: 5.1% Over 50,000: 8.9% or (b) 5.82 mils multiplied by net worth; a surtax of 0.11% on the first $50,000 and 0.22% over $50,000 of net income or 0.00014 of net worth is imposed through 1992	Ohio Rev. Code Ann. §§5733.04, 5733.04.1, 5733.06
Oklahoma	N/R	Current	6%	Okla. Stat. tit. 68 §§2353, 2355
Oregon	Yes. Starts with taxable income after special deductions	Federal effective date, or tax years beginning on or after 1/1/89	6.6% of apportioned income	Or. Rev. Stat. §§317.010, 317.259, 318.020
Pennsylvania	Yes. Starts with taxable income before special deductions	1971	8.5%	72 Pa. Cons. Stat. §§7401, 7402
Rhode Island	Yes. Starts with taxable income before special deductions	Current	9% effective 1/1/89	R.I. Gen. Laws §§44-11-2, 44-11-11

Conformity to Federal Rules for Determining Taxable Income and Income Tax Rates *(continued)*

	Does State Computation of Taxable Net Income Start with a Figure from Federal Form 1120?	*Date of Adoption of Federal Income Tax Rules*	*Tax Rates*	*State Statute(s) That Apply in These Areas*
South Carolina	Yes. Starts with taxable income after special deductions	12/31/88	5%	S.C. Code Ann. §§12-7-230, 12-7-415
South Dakota	South Dakota Does Not Impose a Corporate Income Tax.			
Tennessee	Yes. Starts with taxable income before special deductions	Federal rules not specifically adopted. T.C.A. 67-4-805 uses federal taxable income before NOL and special deductions as starting point for excise tax base	6% on all income	Tenn. Code Ann. §§67-4-805, 67-4-806
Texas	Texas Does Not Impose a Corporate Income Tax.			
Utah	Yes. Starts with taxable income before special deductions	Federal rules not adopted	5%; $100 minimum	Utah Code Ann. §§59-7-102, 59-7-107, 59-7-201
Vermont	Yes. Starts with taxable income after special deductions	Current	5% to 8.25%	Vt. Stat. Ann. tit. 32 §§5811, 5832
Virginia	Yes. Starts with taxable income after special deductions. The NOL Deduction cannot create or increase a net operating loss, i.e. F.T.I. cannot be reduced below zero by a NOLD	Current	6%	Va. Code Ann. §§58.1-400, 58.1-402
Washington	Washington Does Not Impose a Corporate Income Tax.			
West Virginia	Yes. Starts with taxable income after special deductions	Current	9.30%	W. Va. Code §§11-24-4, 11-24-6
Wisconsin	Yes. Starts with taxable income before NOL and special deductions	12/31/89, with certain exceptions	7.9%	Wis. Stat. §§71.26, 71.27
Wyoming	Wyoming Does Not Impose a Corporate Income Tax.			

Legend:
N/A. Not applicable
N/R. Not reported

Alaska State Legislature

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House of Representatives
Committee on Finance
P.O. Box V, Juneau, Alaska 99811

4/15/91

TO: ALL HOUSE FINANCE COMMITTEE MEMBERS

FROM: REPRESENTATIVE NAVARRE Mike

RE: HB 12- AN ACT RELATING TO THE WATER'S EDGE METHOD OF CALCULATING INCOME TAXES... (UNITARY TAX BILL)

Attached is an article from the April 15, 1991 issue of NEWSWEEK Magazine. This article, The Corporate Shell Game, details the approach that many foreign corporations are utilizing in their global efforts to avoid and/or evade taxes. The approach is termed "transfer pricing". Put simply, subsidiaries - with internal transactions - use "transfer pricing" to shift their profits to low tax jurisdictions. This is graphically demonstrated by the article's inset: Who's Got the Profits?

Not only is the Federal tax structure subject to major revenue leakage, the article further points out its added administrative difficulties and costs.

These are many of the same problems presented by HB 12, and they must be addressed by the Committee before we pass the measure out.

RECYCLED

The Corporate Shell Game

How multinational firms use 'transfer pricing' to evade at least $20 billion in U.S. taxes

For taxpayers battling their 1040 forms and legislators peering into the black hole of the federal budget deficit, there's good news: the Internal Revenue Service, armed with fresh troops and new legal tools, is setting out to mine a mother lode of $25 billion in unpaid taxes. But there's also a catch: nobody expects much more than a trickle of new revenue to come from it.

The mother lode is unpaid business taxes, largely from foreign corporations doing business in the United States. In effect, like street-corner artists hiding peas under walnut shells, such companies play games with their profits. By manipulating the prices charged among their own subsidiaries, the multinationals can concentrate profits in countries with low corporate rates and thus get away with a smaller total tax bite (chart). The bottom line is that most foreign corporations operating in the United States pay little or no tax to Washington.

Tax loss: All told, the Treasury's loss is enormous. At hearings last summer before the House Oversight Subcommittee, chairman J. J. Pickle of Texas said he had heard estimates ranging up to $30 billion. IRS Commissioner Fred T. Goldberg Jr. said that was "on the high side," but conceded that the agency should be doing better. Michigan tax experts James Wheeler and Richard Weber calculate that foreign-based multinationals dodge $20 billion in U.S. taxes every year. And that's not considering U.S.-based companies, many of which also find ways to tuck away profits in tax havens. They usually do it on a smaller scale, since it's harder for them to dodge the IRS.

The corporate shell game has been going on for at least 30 years, ever since multinational operations became a significant factor in the corporate world, and there have been periodic attempts to crack down. The latest was prompted last summer, when the IRS published a table showing that foreign-based companies sold $543 billion worth of goods and services in the United States in 1986, but claimed to have net losses of $1.3 billion on that trade. That year was an aberration: before and since, overseas companies in the United States have actually reported net profits, albeit tiny ones. But the 1986 "loss" was riveting. "That tore it," says Ronald Pearlman, former chief of staff of the congressional Joint Tax Committee, now practicing law at Covington & Burling. Congress voted a stiff new 20 percent fine and gave the IRS broader power to subpoena records from parent companies overseas. The tax agency also got to expand its overworked international staff and dangle a small salary premium to recruit talent.

Abuses in pricing across borders—"transfer pricing," in corporate jargon—are illegal, if they can be proved. Corporations dealing with their own subsidiaries are required to set prices at "arm's length," just as they would for unrelated customers. And there's no question that abuses can be enormous. In its biggest known victory, the IRS made its case that Japan's Toyota had been systematically overcharging its U.S. subsidiary for years on most of the cars, trucks and parts sold in the United States. What would have been profits from the United States had wafted back to Japan. Toyota denied improprieties but agreed to a reported $1 billion settlement, paid in part with tax rebates from the government of Japan.

But such triumphs are rare, and the hurdles are mountainous. For one thing, small armies of accountants are needed to sift through corporate records in several countries, even if access is granted—by no means a sure thing. In one case, an agent who requested a specific document was sent 40 boxes of papers, without an index. Trained economists must rule in each case whether costs were realistically allocated. And since real-world cases are usually far more subtle than simple illustrative anecdotes, there is room for years of legal maneuvering over disputed facts, accounting practices and business judgments.

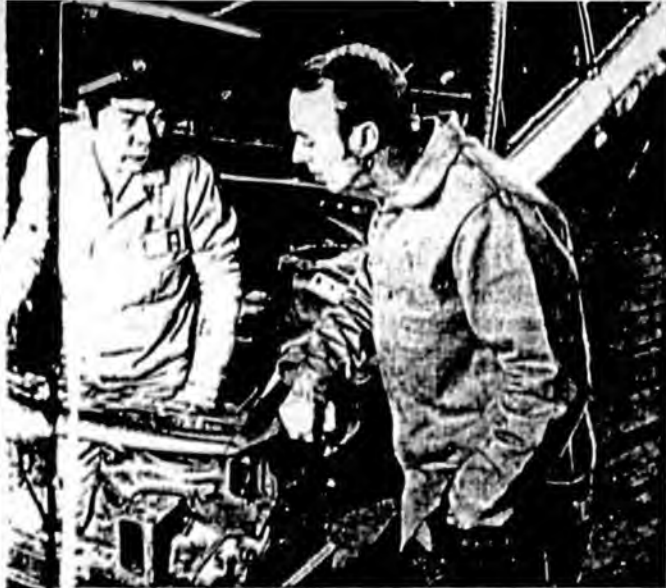
Who's Got the Profits?

By using tax havens and "trick" pricing, a corporation could slash its U.S. tax bill by transferring profits to low-tax countries. This typical transaction follows one trail.

Germany

An item is manufactured at a cost of $80. It is then sold to an Irish subsidiary for $80.

Tax Rate: 48% Tax Paid: $0



PHOTOS BY LOUIS PSIHOYOS—MATRIX

BOB CRANDALL—PICTURE GROUP

Dodge ball: *Toyota workers (above), Westinghouse researcher (left), Goldberg*

Some abuses are blatant. One foreign manufacturer, for instance, sold TV sets to its U.S. subsidiary for $250 each, but charged an unrelated company just $150. Most cases are nowhere near as clear. What if the set sold outside has a slight change in the casing? Which subsidiary gets charged for shipping and insurance? In one current case, the IRS says Japan's Yamaha forced Yamaha Motor Corp., U.S.A., to overstock motorcycles and all-terrain vehicles in the early '80s, and then made the subsidiary pay for discounts and promotions to unload the excess inventory. The result, says the tax agency, was that Yamaha Motor U.S.A. paid only $5,272 in corporate tax to Washington over four years. Proper accounting would have shown a profit of $500 million and taxes of $127 million, the agency says. But Yamaha argues that the IRS case ignores the colossal reality of the 1982 recession, which caught the company just as unprepared as its U.S. competitors. The U.S. Tax Court is mulling the case.

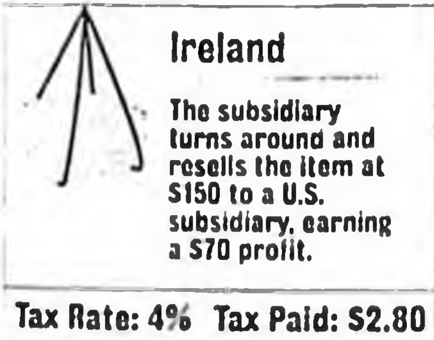
American-based multinationals have also been accused of squirreling profits away. Tax agents find it easier to monitor their books, since they're all in this country and follow SEC standards; as Wheeler explains it, "It's the difference between examining the head and several arms of an octopus, rather than just one tentacle." Even so, he thinks the U.S. multinationals could easily account for an additional $5 billion in lost taxes on profits dubiously allocated to tax havens. Wheeler and Richard Weber say they've found one case that is suggestive: Westinghouse Electric managed to book 27 percent of its 1986 domestic profit in Puerto Rico, where its final sales are tiny. To spur the Puerto Rican economy, Washington has set the corporate-tax rate there at zero. (Westinghouse says the accounting is proper, since its "highest-profit products are made in Puerto Rico.")

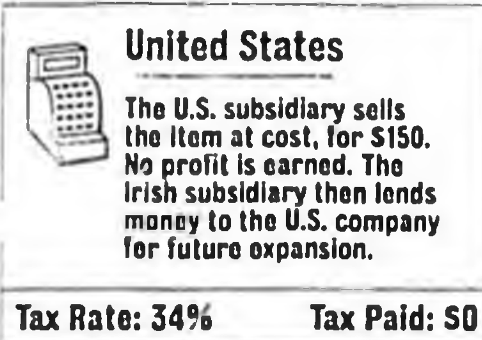
The IRS professes to be delighted with its new powers and loaded for bear. "We've been outmanned and outgunned in the past," says Steven Lainoff, chief IRS lawyer for international enforcement. "Now we've got the tools and people to really attack this problem." But that is at least questionable. The new fine, for instance, stipulates a 20 percent penalty for any company whose transfer pricing results in underpayment of $10 million or more in taxes. Experts call that a crude weapon that may well fail to stand up in court; even the IRS initially objected to it. And in testing their new subpoena powers in foreign countries, IRS agents will be under the scrutiny of tax people there, who stand to lose any taxes that Uncle Sam succeeds in claiming. The prospects for litigation are wearying.

When it comes to litigation, the IRS may also find little comfort in its expanded international staff (to 700 from 550) or its big-city salary premiums of 8 percent over government standards. The agency is now eight years behind in merely auditing multinationals; corporate officials who make a decision may well be dead or transferred when the tax people finally show up to question it. And in competing for legal and accounting talent, the IRS is still severely outmatched. Senior partners in private tax practice routinely get $500,000 to $1 million a year. Goldberg recalls ruefully that when he took office as IRS commissioner in 1989, his new salary of $80,000 was just what his former firm was paying newly fledged lawyers fresh out of school.

Bad record: All told, it's not surprising that when the IRS does bring a case, it frequently loses. Thomas Field of Tax Analysts says the agency typically settles for just 10 cents on the dollar of its initial claims against foreigners, and the IRS doesn't dispute that. At one major multinational firm, the head of taxes says he tries to do the right thing. "But there's no way the IRS is going to find chinks in our armor," he says. "We're just too smart and way too well prepared."

If the new reforms don't bear fruit, Pickle and Senate Finance Committee chairman Lloyd Bentsen say they are ready to propose something else. Ideally, that might be a whole new approach to international taxes, one that ignores the details of transactions and focuses on allocating shares of the total profit. Most U.S. states have similar laws, essentially basing corporate taxes on what percentage of a company's employees, sales and assets are located in the state. In the long run, reforming international taxes along those lines may be inevitable. But any such attempt would be formidably complicated; few major foreign countries would welcome an overhaul of the entire structure, which in effect would require unanimous consent. For the foreseeable future, the corporate shell game goes on.





LARRY MARTZ with RICH THOMAS

February 6, 1991

H B 12
POSITION PAPER
DEPARTMENT OF REVENUE

House Bill No. 12 would mandate the use of a water's edge method of accounting under the income tax laws for non-oil and gas taxpayers. The bill would be effective for tax years beginning in 1992.

All domestic and foreign corporations at least 50% owned, directly or indirectly, by a common parent may be engaged together in the conduct of a unitary business. Under current law, all such unitary corporations would be included in a worldwide unitary combination. Each corporation with a taxable nexus in Alaska would then be required to file an Alaska income tax return.

HB 12 would limit the corporations that could be included in the unitary combination. Generally, only those domestic and foreign corporations whose United States property, payroll, and sales average 20% or more of the total of such factors both in the U.S. and foreign jurisdictions could be included in the combination. It is not entirely clear whether each of the three factors must average 20% or more or whether it is simply the average of the three. From an administrative standpoint, either will require an additional audit inquiry, especially as to those corporations that are close to the 20% threshold.

HB 12 would also exclude from income 80% of all dividend income from foreign corporations, all dividend gross-up, and 80% of all royalties from foreign corporations. Expenses associated with the 80% excluded from income may not be disallowed as the 20% subject to tax is deemed to be compensation for the expenses related to the 80%. The stated purpose of the bill in Section 1 is to "promote investment and trade opportunities in the state" and, presumably, the intent is to attract those taxpayers who oppose the worldwide combined reporting method.

However, the exclusion of dividends and royalty has absolutely nothing to do with use of either worldwide or domestic water's edge combination. Exclusion of income is a separate issue and the exclusion could just as well have been for any other item of income. Further, since this income is not excluded from the tax base of oil and gas taxpayers under AS 43.20.072, serious constitutional questions might arise under AS 43.20.072. We would not want to jeopardize the tax revenues under AS 43.20 by allowing a deduction to non-oil and gas companies that is not allowed to the oil and gas companies. The Department of Law should review this provision.

A state tax exemption for foreign dividends and royalty could well favor foreign over United States investment. That is because, unlike foreign income, domestic income is subject to both federal and state tax before being paid out as a dividend. The provision could thus have an effect opposite from that intended.

The dividend and royalty exclusion might well also result in an increased effective tax burden on purely domestic and small businesses. That is because these taxpayers are taxed on 100% of their federal tax base while the larger taxpayers with multinational operations will be taxed on less than 100% of their federal tax base. Smaller established Alaska businesses would not receive this tax break.

Multinational corporations have the opportunity to arbitrarily shift income between jurisdictions under all accounting methods other than the worldwide combined reporting method. Under the Internal Revenue Code, Sec. 482 is designed to prevent that shifting of income. A copy of Sec. 482 is attached as Exhibit A. This section is designed to determine if related parties have charged an arm's length price. An October 18, 1988 Treasury discussion draft on "A Study of Intercompany Pricing" concludes that 482 pricing audits require large commitments of audit resources. The California experience certainly affirms that observation. See Exhibit B. A move to water's edge will mean application of 482 in Alaska audits. Therefore, a change to water's edge will require substantial additional staff to administer.

According to a report to the Commissioner of Internal Revenue and the Assistant Attorney General by the Special Counsel for International Taxation on January 12, 1981, the provisions of the tax law applicable to international transactions, and specifically Sec. 482, are among the most complex in the Internal Revenue Code and are among the most difficult to administer. See Exhibit C. In 1990, the House Ways and Means Oversight Subcommittee held hearings on Sec. 482 and the problem of federal tax avoidance due to transfer pricing. Testimony indicated potential underpayment of federal taxes as high as $50 billion. A former IRS auditor testified that obtaining appropriate information was extremely difficult, of little assistance in determining an arm's length price, and that the so-called arm's length standard exists only in a world of "smoke and mirrors" where no one knows what it means and it doesn't work where the market place is controlled. See Exhibit D. That testimony is consistent with the views of a former attorney in the Office of International Tax Counsel of the Treasury Department printed in the February 17, 1986 issue of Tax Notes. See Exhibit E. Further, House Majority Leader Richard Gephardt testified in the hearings that competitiveness suffers when foreign controlled corporations do not pay their fair share of taxes.

A June 8, 1989 Research Report to the Alaska State Legislature (a copy of the report to Research Request 89.165 is attached as Exhibit F) contains the following quote from Montana's director of Revenue:

> It struck me that the changes in the tax laws that we've seen now in the last two or three years in a number of

> states, moving away from worldwide to water's edge, have served to substantially increase the cost of compliance for both taxpayers and tax agencies. We have reduced the tax base in a number of states, we have moved the states away from uniformity, have shifted the tax burden, and we have looked for an economic boom that has not happened. Therefore, I have to wonder if somewhere down the road, we are going to have to re-invent worldwide unitary.

That statement suggests that despite claims to the contrary, foreign investment is not withheld from a state simply because of tax policy. See Exhibit G. Markets, not tax policy, apparently influence investment. The state has yet to receive any stated commitment to increased jobs and investment in return for a change in the tax policy.

The substantial weight of authority is that taxes do not play a major role in business locational decisions and also are not a major influence on state economic growth. See Exhibits H and I. A nationally recognized expert on job growth, David Burch, a professor at the Massachusetts Institute of Technology, has stated that

> "taxes are to economic development what race is to schools. It is irrelevant. The important thing is the quality of the schools. And the quality of economic development is not related to tax policy." See Exhibit J.

Under the circumstances, it would be difficult to justify supporting this legislation. Action on this legislation should be deferred until further study is performed to determine the validity of the assumption that water's edge will promote investment and trade in Alaska. That is a question the administration is interested in pursuing. However, at present we are skeptical and certainly not convinced there is anything to be gained by changing from worldwide to the water's edge.

Further, the expressed policy of the administration is to reduce the size of government. This legislation would be counter to that policy because of the additional cost to the state to administer the income tax provisions under water's edge as compared to worldwide combination. We must be convinced before we can support this legislation that other factors, such as increased investment and employment opportunities as a direct result of the legislation, will offset the revenue losses and the increase to the cost of state government.

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ALL OTHERS ADMITTED IN ALASKA

M E M O R A N D U M

TO: House Finance Committee: Representatives MacLean, Navarre, Boyer, Brown, Jacko, Koponen, Larson, Ulmer, Barnes, R. Phillips, and Sharp

FROM: Robert Blasco and Mary Nordale RPB

DATE: April 26, 1991

RE: House Bill 12

==

Enclosed for your review is information regarding the economic benefit derived by the state as a result of the multi-faceted operations of Holland America Lines Westours, Inc. By its own operations and aligned businesses and industries, Holland America stimulates economic health and growth throughout most of the state. In addition to the stimulus Holland America provides to the economy, Holland America already pays $3.4 million in taxes to the state, not including taxes paid in local communities.

The present draft of HB 12 would eliminate a long standing tax exemption afforded foreign vessels. The exemption would be contrary to federal law and presents significant legal questions. Equally important, should the state begin to tax foreign vessels, Holland America will be forced to review its services to Alaska, and potentially relocate those services in other ports. It can be expected that Holland America would limit its operations in Alaska so as not to incur this additional burden.

We would be happy to speak with you at your convenience. Please do not hesitate to contact one of us if you have questions or would like additional information.

Enclosure
RPB:MAN:na

Holland America Line
Westours Inc.

1990 ALASKA ECONOMIC IMPACT BY HOLLAND AMERICA WESTOURS AND ITS PASSENGERS

Alaska is the third most popular cruise destination after the Caribbean and the Mediterranean. The Alaska market is currently estimated to represent 7 percent of the entire North American cruise industry. Over the next decade, the Alaska cruise market is forecast to grow at 6 to 8 percent annually.

The number of cruise passengers carried to Alaska by Holland America Line, one of the largest operators in the Alaska market, has grown from 16,000 in 1983 to 101,000 for 1990, including Alaska cruise passengers and Alaska and Canadian Rockies cruisetour passengers.

Holland America Westours and its subsidiaries, Gray Line of Alaska and Westmark Hotels and Inns, employed a total of 2,343 people in 1990. All of the year-round employees are Alaska residents, as are 89 percent of the seasonal workers. The company also does business with 1,050 vendors around the state. In addition, Holland America Westours spends nearly $14 million annually in advertising to promote Alaska tourism and distributes nearly 2.5 million Alaska brochures to consumers and travel agencies across the United States and Canada.

Cruise- and cruisetour-related contributions to the Alaska economy by Holland America Line and Windstar Sail Cruises directly and their passengers indirectly in 1990 amounts to an estimated $89,453,514 statewide. The breakdown follows:

Estimated passenger spending (Includes cruisetour, Gray Line of Alaska and Westmark Hotels)	$35,978,727
HAL-W direct spending (Includes taxes, rent, fuel, food/beverage, utilities, equipment, local advertising, contributions, capital projects/ maintenance, other tour operators, air transportation)	37,363,459
Estimated crew spending	1,416,000
HAL-W statewide payroll	14,695,328
Total direct and indirect impact	$89,453,514
Total estimated statewide economic impact (using commonly accepted economic multipliers)	$242,275,476

[illegible]
Seattle, WA [illegible]
206-281-3535
Telex: [illegible] HALW SEA
FAX: [illegible]

Holland America Line
Westours Inc.

March 27, 1991

Rep. Mike Navarre
Co-Chairman
House Finance Committee
P.O. Box V (MS 3100)
Juneau, Alaska 99811

Dear Representative Navarre:

House Bill No. 12, the so-called "Water's Edge Act", makes the State of Alaska a far more hospitable place for business and undoubtedly, will encourage both the expansion of Alaska enterprises and the establishment of Alaska offices by businesses headquartered elsewhere. Personally, and on behalf of Holland America Line, I support the bill.

In reviewing the bill, I did note two potential problems that result from other statutes within the Alaska income tax act. First, the bill may require that a business that derives income excluded under federal tax laws join in the filing of an Alaska unitary return. Even though this company would add nothing to the unitary taxable income subject to apportionment, other statutes would require that its property and payroll be included in the unitary apportionment factors.

To avoid this unanticipated loss of revenue to the state, I propose that all foreign corporations which derive income which is entirely excluded from federal taxable income, be excluded from the Alaska unitary income tax return.

The second change that I propose will codify an existing regulation which permits foreign corporations to claim certain deductions to derive taxable income. If a foreign corporation does not derive income which is "effectively connected with a United States trade or business", federal statutes deny the corporation any deductions and impose a tax on the company's gross income.

Under existing Alaska statutes and House Bill No. 12, such a corporation could, under certain circumstances, be required to join in the filing of a unitary income tax return. Since Alaska has adopted the Internal Revenue Code for the purpose of determining taxable income, this corporation's gross income would, absent other authority, be included in the unitary base.

The Department of Revenue currently has a regulation that permits a corporation in this situation to claim deductions. However, it is my opinion that this regulation is not authorized by existing statutes. The amendment I propose closely follows this regulation,

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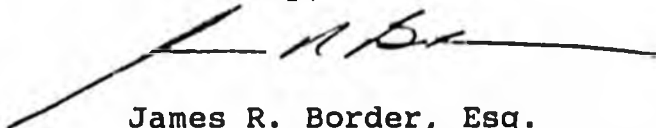
with some changes to ease its administration and to make it work more equitably.

The specific amendments to the bill, together with a detailed technical explanation are attached. If there is any additional information that I can provide or if I can be of assistance in any way, please do not hesitate to contact me.

Sincerely,



James R. Border, Esq.
Corporate Director - Taxation

PROPOSED AMENDMENTS TO HOUSE BILL NO. 12

I. INELIGIBLE FOREIGN CORPORATIONS - EXCLUSION FROM UNITARY RETURN

Subparagraph (g) of AS 43.20.073, page 3 of the bill, beginning on line 21, is amended to read:

(3) "foreign corporation" means a corporation created or organized outside of the United States, the District of Columbia, the Commonwealth of Puerto Rico, or a possession of the United States, provided however, a "foreign corporation" does not include any corporation subject to the internal revenue laws of the United States if all of such corporation's income is excluded pursuant to the provisions of the Internal Revenue Code adopted as part of this chapter in AS 43.20.021(a) or excluded pursuant to any treaty to which the United States is a party;

II. ALLOWANCE OF DEDUCTIONS TO FOREIGN CORPORATION REQUIRED TO JOIN IN A UNITARY RETURN

On Page 3 of the Bill, Line 27, a new "Section 3" is added to read:

*Sec. 3 AS 43.20.036 is amended by redesignating subsection (j) as subsection (d) and adding a new subsection to read:

(e) For purposes of calculating the tax payable under this chapter, a foreign corporation required to join in the filing of a unitary return is entitled to the same deductions as a domestic corporation.

(1) A corporation permitted deductions under this paragraph may elect to report as its taxable income either:

(A) income reported in its financial statements prepared in accordance with generally accepted accounting principles;

(B) earnings and profits as determined under tit. 26 USC; or

(C) taxable income that would have been reported if the foreign corporation had used the same rules as a domestic corporation for the calculation of allowable deductions.

(2) An election under this paragraph:

(A) must be made for all members of the unitary group that are not required to file a federal income tax return which encompasses all of their income, unless approval is obtained from the department to exclude particular members from the election; and

(B) the election is binding for all subsequent years unless prior approval is obtained from the department to rescind the election.

On Page 3 of the Bill, Lines 27 and 28, former Sections 3 and 4 are redesignated as Sections 4 and 5, respectively.

EXPLANATION OF THE PROPOSED AMENDMENTS TO HOUSE BILL NO. 12

I. INELIGIBLE FOREIGN CORPORATIONS - EXCLUSION FROM UNITARY RETURN

Through Alaska Statutes § 43.20.021(a), the State has adopted specific sections of the Internal Revenue Code (tit. 26, USC). Included in the sections adopted are several which exclude certain classes of gross income derived by foreign corporations from income taxation. This amendment recognizes that, by adopting the Internal Revenue Code by reference, Alaska also excludes these specific items from gross income for Alaska income tax purposes.

Without this amendment, certain foreign corporation which derive income which is technically from United States sources but excluded pursuant to the Internal Revenue Code, would have to join in the filing of a unitary return, adding nothing to the group's taxable income subject to apportionment.

Since these income elements are excluded from gross income they would not enter into the calculation of taxable income or the sales apportionment factor. However, if included in a unitary return, the property and payroll information of these entities could be used in the determination of the combined apportionment factors. If the entities conduct significant business abroad as required by these exclusion sections, this will serve to disproportionately allocate income outside the State. For example, see the rules applicable to financial organizations contained in 15 AAC 20.610, excluding from the apportionment factors all tax exempt receipts but including all property and payroll.

This amendment addresses only those situations where a foreign corporation is required to file a tax return and the income is excluded by statute or treaty. To the extent that a foreign corporation is required to join in the filing of a unitary return under this bill, but has not been required to file a federal income tax return, its income is determined as under prior law and regulations, with the amendments offered below.

II. ALLOWANCE OF DEDUCTIONS TO FOREIGN CORPORATION REQUIRED TO JOIN IN A UNITARY RETURN

The redesignation of paragraph (j) is a clerical amendment.

New paragraph (e) permits foreign corporations which are part of a unitary group to deduct expenses which relate to the income required to be reported. Under the Internal Revenue Code, many of these corporations are not permitted any deductions and therefore, the Alaska income tax could operate to tax these entities on a gross income basis.

For example, assume that the only income corporation derives are royalties from the use of a patent in the United States. For federal income tax purposes, the corporation is subject to a 30% tax on the gross income it receives. Pursuant to 26 USC 882(c)(1)(A), this corporation would not be permitted any deductions against this income, even those deductions which directly relate to its production.

If the tax due by this corporation has been withheld by the payor, it is not required to file a United States income tax return. If the corporation's tax liability is not satisfied by withholding, it must file an income tax return and remit the tax due.

If this corporation is required to join in the filing of an Alaska unitary return, all of its gross income, including the royalties, are considered. However, the incorporation of the Internal Revenue Code in AS 43.20.021(a) includes the disallowance of deductions to which this corporation is entitled under 26 USC 882(c)(1)(A). Thus, this corporation would be subject to Alaska income tax on its gross income rather than its taxable income.

This problem is currently addressed by regulation 15 AAC 20.300(c) which states, in relevant part:

> The total unitary income subject to apportionment is the business income, as defined in AS 43.19.010 of the unitary business, which is the sum of (1) for income of a unitary business that must be reported as income under the Internal Revenue Code, the taxable income under chapter 1 of Subtitle A of the Internal Revenue Code of 1954, as amended ...; and (2) for income of the unitary business which is not required to be reported as income under the Internal Revenue Code, the income reported for financial statement purposes, plus taxes, based on or measured by net income that were deducted, less dividends received from that corporation included in the unitary business, except that (a) a corporation may elect to report this income as the income is reported on the "Information Return With Respect to a Foreign Corporation" filed with the Internal Revenue Service: (b) if the taxpayer makes the election under (a) of this paragraph (i) the election must be made upon the filing of a return under AS 43.20; (ii) the election must be made for all members of the unitary group that are not required to report income under the Internal Revenue Code unless approval is obtained from the department to exclude particular members from the election; and (iii) the election is binding for all subsequent years unless prior approval is obtained from the department to rescind the election; (iv) the taxpayer may use any method of depreciation allowed under Sec. 167 of the Internal Revenue

Code (26 U.S.C. Sec. 167) as that section read on June 30, 1981; and (v) the taxpayer may take the cost depletion deduction allowed under Sec. 611 of the Internal Revenue Code (26 U.S.C. Sec. 611).

As drafted, this regulation presents several difficulties. First and foremost of these is the lack of statutory authority for the alternative methods of accounting permitted foreign corporations. The regulation addresses the difficulties inherent when entities which do not file federal income tax returns are included in a unitary return. However, statutory authority for this is required.

The second problem is that the methods of accounting under subparagraph (2), both mandatory and elective, are limited to entities which receive income which is not required to be reported under the Internal Revenue Code. As pointed out above, whether or not certain types of income are "required to be reported" by a foreign corporation depends on whether or not adequate income taxes were withheld. The adequacy of withholding is solely within the control of the payor and can not be controlled by the corporation to be included in the unitary return.

If sufficient taxes are withheld to satisfy a foreign corporation's tax liability, its taxable income would be determined pursuant to subparagraph (2) of the regulation. On the other hand, if the same corporation's federal income tax liability is not satisfied by withholding, its income is "required to be reported" and its taxable income would be determined under subparagraph (1). This being the case, there is no justifiable reason for any difference in the methods of accounting available to entities which are similarly situated except for the actions of the withholding agent.

The third problem is a byproduct of the adoption of the Internal Revenue Code through AS 43.20.021(a), the unitary method of taxation in general, subparagraph (1) of this regulation, and the dual tax systems applicable to foreign corporations under federal law. If a corporation is required to report income to the Internal Revenue Service, its taxable income for Alaska purposes is determined under subparagraph 1 of the regulation. Under the facts of the above example, "taxable income" reported under chapter 1 of Subtitle A of the Internal Revenue Code will be the company's gross income, no deductions permitted.

Since the State imposes a "net income" tax, the deductions which give rise to income to be included in an Alaska unitary income tax return should be permitted. Alaska has no comparable "gross income" tax on earnings derived from Alaska sources and therefore, modifications to the federal scheme are required to achieve an equitable result.

The department's regulation attempts to address the problems faced by foreign corporations that are required to join in an Alaska unitary return. The amendment generally follows the department's existing regulation with the following changes to alleviate the problems outlined above.

1. The corporations to which the elective methods of accounting are available is expanded to include all foreign corporations. This will avoid any disparate treatment of similarly situated corporations.

2. A third method of accounting is made available to these corporations, the use of taxable income under United States tax principles. This change is made to accommodate those foreign corporations which are required to report income to the Internal Revenue Service on the basis of "taxable income". Essentially, this codifies subparagraph (1) of the regulation and makes this method of accounting available to all corporations.

3. The election to use financial statement income is changed to incorporate United States generally accepted accounting principles (GAAP). Due to the lack of uniformity in accounting methods internationally, GAAP is designated as the financial accounting method to be used.

4. The previously existing election to use income reported on "Form 5471" is changed to "earnings and profits". Earnings and profits determined under United States tax laws are reported on this form and it appears that this is the "income" to which the regulation alluded. However, GAAP income is also disclosed on this form.

   The amendment clarifies the prior regulation and provides that earnings and profits can be used by foreign corporations which are not controlled foreign corporations required to file Form 5471.

5. The amendment omits the references to the Internal Revenue Code of 1954 since 26 USC is now known as the Internal Revenue Code of 1986.

6. The amendment deletes the restriction on methods of depreciation contained in the regulation. The depreciation methods permitted foreign corporations are limited under current law. Assets used predominately outside the United States are not allowed either the shorter lives or accelerated methods permitted assets used in the United States. This being the case, the requirement that taxpayers continue to use methods determined under 1981 federal tax laws increases the

complexity of the administration of Alaska law and unnecessarily burden taxpayers.

WALTER J. HICKEL, GOVERNOR

DEPARTMENT OF REVENUE

OFFICE OF THE COMMISSIONER

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April 2, 1991

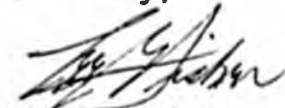
The Honorable Mike Navarre
Alaska State Legislature
P.O. Box V
Juneau, AK 99811

RE: HB 12 - Water's Edge Tax Legislation

Dear Representative Navarre:

As promised in my earlier letter I am forwarding, a copy of Attorney Brian Durrell's letter of April 1, 1991 and his proposed comments to the House Finance Committee.

Sincerely,



Lee E. Fisher
Commissioner

LEF:mll
Enclosure

91-52

04-02LH

BOGLE & GATES

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21644-01012

April 1, 1991

VIA FACSIMILE 465-2389

Mr. Lee Fisher
Commissioner
Department of Revenue
P.O. Box S
Juneau, Alaska 99811-0400

Re: Water's Edge Tax Legislation

Dear Lee:

Attached is a copy of the memo that you suggested I prepare. I hope that you find the memo useful and appropriate to share with members of the House. I have arranged my schedule so that I will be available to testify on HB 12 before the House Finance Committee in Juneau this Wednesday. Please advise me whether in your opinion my testimony would be helpful.

As David Harlow may have advised you, we have a few amendments that we believe should be made to the current version of HB 12. I would like an opportunity to discuss these amendments with you prior to the hearing. If you agree with the amendments, you are likely best suited to facilitate their introduction. Please advise me if you will have time Wednesday morning to meet and discuss these matters.

I look forward to working with you on this matter.

Very truly yours,

BOGLE & GATES

Brian W. Durrell

Attachment(s)
cc: David Harlow (w/attch.)

BOGLE & GATES MEMORANDUM

April 1, 1991 21688/01012

TO: House Finance Committee Members

FROM: Brian W. Durrell BWD

RE: Water's Edge Tax Legislation

What is Barclays[1]? It is a recent California Court of Appeals decision holding that, as applied to foreign-based unitary groups, the California "worldwide" combined reporting method ("WWCR") violates the foreign commerce clause of the U.S. Constitution. A unitary group is a group of corporations with common ownership that have attributes of functional integration, centralized management and economies of scale. A foreign-based unitary group is one in which the parent corporation is based in a country other than the U.S. By contrast, a unitary group with a parent corporation based in the U.S. is known as a domestic-based unitary group. A WWCR method is one which taxes a portion of a unitary group's income no matter where it was earned in the world. The California Court of Appeals is an intermediate appellate court. Its decision was appealed by the California Franchise Tax Board to the California Supreme Court which has accepted the appeal. A ruling is not expected from the California Supreme Court for at least a year. Its decision - no matter what it is - is expected to be appealed to the U.S. Supreme Court.

What effect does Barclays have on Alaska? Barclays will have substantial persuasive weight to any Alaska court which may be presented with the issue of the constitutionality of Alaska's WWCR as applied to foreign-based unitary groups. Only a decision of the U.S. Supreme Court, however, would be controlling upon an Alaska court addressing this issue. Barclays appears to impact equally Alaska's income tax imposed both upon foreign-based non-oil & gas and foreign-based oil & gas unitary groups. Both are currently taxed under WWCR. It is important to note that domestic-based unitary groups are unaffected by Barclays. In fact, an earlier U.S. Supreme Court case, Container Corp.[2], held that California's WWCR was constitutional as applied to domestic-based unitary groups. We have no data as to the number of non-oil & gas foreign-based unitary groups doing business in Alaska. Upon inquiry, we have learned that perhaps as few as three oil & gas foreign-based unitary groups do business in Alaska, with the most significant being BP.

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Would Barclays' effect be retroactive? If Alaska's corporate income tax method is unconstitutional, any affected taxpayer could demand a refund for any open year. A year is generally open if the return was filed within the prior three years or the tax was paid within the prior two years. Additionally, any year in which an assessment has been made and appealed by the taxpayer will generally be open. The taxpayer's right to claim a refund for a closed year would turn upon whether the state of Alaska could have foreseen, at the time the tax was imposed, the unconstitutionality of the worldwide combined reporting method. Since the date of the Barclays decision, November 30, 1990, (and perhaps even earlier) its likely that the State should have been able to foresee the constitutional problem.

How does HB 12 address that effect? HB 12 is a bill that would change the method of reporting from a WWCR to a "water's edge" combined method. A water's edge method taxes only income earned within the "water's edge" of the U.S. The bill applies equally to foreign-based and domestic-based unitary groups. The bill does not apply to corporations engaged in the production or transportation of oil & gas. The water's edge method of reporting does not affect business activities that are wholly foreign. Therefore, the water's edge method of reporting does not violate the foreign commerce clause of the U.S. constitution.

What is the difference between worldwide and water's edge combined reporting? Combined reporting must include some method of allocating a portion of the unitary group's income to Alaska for income tax purposes. The portion is usually determined by comparing the amounts of three factors - sales, property and payroll - within the State to the amounts found throughout the entire world (i.e., worldwide) or within the bounds of the U.S. (i.e., water's edge). Each of the three factors is reduced to a fraction, the numerator of which is, for instance, the sales in Alaska. Under the worldwide method the denominator would be the sales of the unitary group throughout the world. Under the water's edge method, the denominator would be just the sales of those members of the unitary group which conduct substantial activity within the water's edge of the U.S. Under the worldwide method, the average of the three factors' fractions would then be multiplied by the worldwide income of the unitary group. Under the water's edge method, the average of the three factors' fractions would then be multiplied by just the income of those members of the unitary group which conduct substantial activity within the water's edge of the U.S. The tax generated from the water's edge method is not necessarily less than the tax generated from the worldwide method. The tax difference will vary on a case by case basis, but in many cases the tax from a water's edge method will be greater than the tax from a worldwide method. Which method produces the

greater amount of tax depends upon whether a unitary group's foreign or domestic activities are more profitable.

Must HB 12 address the income tax upon oil and gas companies? The differing methods of taxation for oil & gas corporations and, under HB 12, for non-oil & gas corporations do not appear to create a constitutional problem. In the ARCO[3] case, the Alaska Supreme Court upheld the use of the separate accounting method of reporting for oil & gas corporations despite the claim that it violated the equal protection clause because other corporations were taxed under a different and (arguably) more favorable method. The different methods of reporting occasioned by HB 12 would almost certainly withstand an equal protection challenge. The oil & gas industry does not appear to be concerned with HB 12. The industry's fear of separate accounting appears to have kept it from advocating any change to the method in which the State taxes oil & gas corporations. Therefore, HB 12 need not address the method of taxation for oil & gas unitary groups. However, the likely impact of Barclays upon the current method of taxing foreign-based oil & gas unitary groups may mean that the issue should be addressed, perhaps through the enactment of some form of a "backstop" tax.

cc: David P. Harlow

1. Barclays Bank International Limited v. Franchise Tax Board, 275 Cap.Rptr. 626 (CalApp 1990)

2. Container Corp. v. Franchise Tax Board, 463 U.S. 159, 103 S.Ct.2933, 77 L.Ed.2d 545 (1983)

3. Atlantic Richfield Company v. State of Alaska, 705 P.2d 418 (Alaska 1985)

C:\DOCS\FISHER.MEM

WALTER J. HICKEL, GOVERNOR

DEPARTMENT OF REVENUE

OFFICE OF THE COMMISSIONER

P.O. BOX S
JUNEAU, ALASKA 99811-0400
PHONE: (907) 465-2300
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March 26, 1991

The Honorable Mike Navarre
Co-Chair House Finance Committee
Alaska State Legislature
P.O. Box V
Juneau, AK 99811

RE: HB 12 - Unitary tax legislation

Dear Representative Navarre:

In response to your letter of March 22, 1991, I must start with an apology for the confusion you have experienced. Simply stated, it was caused by my inability to pay sufficient attention to this Bill and the related fiscal note when it originally was brought to my attention by Carl Meyers, the Acting Director of Income and Excise Audit Division.

At that time Carl briefed me in a completely one-sided presentation which had its roots in the attitude of the prior administration. I told him that I expected the new administration would support the "water's edge" concept.

Several events and items with higher priority then took my attention and while I do not fault Carl for testifying as he did, he knew that he was taking a position that was going to be reversed. I regret that this has caused a problem for you.

The wording in the February 6, 1991 position paper is a throw-back to Hugh Malone's position in prior years. The fiscal note reflecting four new positions was challenged by me and Assistant Commissioner Floerchinger, resulting in the revised fiscal note dated March 20, 1991. There are no legislative amendments of which I am aware. The only important events that have transpired to cause this reversal are Governor Hickel's election and my appointment. We are pro-development and view the "water's edge" concept as being in keeping with our philosophies.

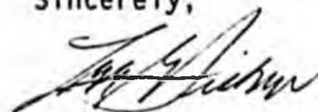
04-D2LH

The issue you raise in regards to oil and gas companies and the Barclay case is better addressed to an attorney such as the author of the Bogle & Gates memo. Your question has caused me to contact that firm's managing partner, Brian Durrell. He is preparing a short response intended to remove concerns about the oil and gas industry. I will convey it to you immediately upon receipt at DOR.

My only new information on this issue is a recent conversation with one of my former partners, resident in Portland, Oregon. He placed me in touch with my counterpart in the Oregon administration. This gentleman is mailing me a copy of their statute and a brief overview of the simplified methodology used by Oregon.

I am troubled by the fact that Alaska is the only remaining state to use the concept of world wide accounting. What do we know that is unknown to all other jurisdictions?

Sincerely,



Lee E. Fisher
Commissioner

LEF:mll
91-43

cc: D. Max Hodel
Chief of Staff

Alaska State Legislature

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House of Representatives

Committee on Finance
P.O. Box V, Juneau, Alaska 99811

March 22, 1991

The Honorable Lee Fisher
Commissioner
Department of Revenue
11th Floor
State Office Bldg.

Dear Commissioner Fisher:

As you are aware HB 12- " An Act relating to the water's edge method of calculating income taxes..."- currently resides in the House Finance Committee. This is an important piece of legislation; it deserves a very careful review.

I have reviewed some of the file materials relating to this measure. Frankly, I am more than a bit confused by the documentation that has been submitted by your Department on this subject. To help clear up my concerns, and before this measure comes before the full committee, I would like a written response to the questions listed below:

1. Why has the Department submitted two, and very different, fiscal notes to a bill that has undergone very little change since its introduction? Your original fiscal note, dated 2/7/91, addresses the need for four new positions by FY 95. The most recent fiscal note, dated 3/20/91, declares a need for only one new position within the same time period. What specific legislative amendments have caused you to so drastically modify you initial fiscal note?

RECYCLED

2. Your Deparment's February 6, 1991 POSITION PAPER is very critical of this legislation. In fact, it states that "... at present we are skeptical and certainly not convinced there is anything to be gained by changing from worldwide to the water's edge." In contrast, before the House Labor and Commerce Committee you testified in support of HB 12. What has transpired to cause the Department to do a complete reversal?

3. In the same PAPER your Department concluded that "... Action on this legislation should be deferred until further study is performed to determine the validity of the assumption that water's edge will promote investment and trade in Alaska...". Is your reversal in position based on some recently concluded study on this issue? If so, please forward a copy to my office.

4. During your confirmation hearing you referenced Bogle & Gates' February 20, 1991, memo as a very good analysis of the Water's Edge issue. Among its many points, this memo advises the legislature to revise the bill to comply with the California Barclays case. In this case the California Court of Appeals found that the worldwide unitary method of taxation, at least as it applies to multinational corporations with foreign parents, unconstitutional. The issue being, states need to move away from worldwide if they are to avoid constitutional problems. If this is the case, would we not also be required to adopt a similar approach for all taxpayers--oil and gas taxpayers included? How could we comply with this advice if we restrict water's edge to non-oil and gas taxpayers, while requiring all multinational oil and gas taxpayers--including those with foreign parents--to file under worldwide apportionment? What are your thoughts and position?

Thank you,

Representative Mike Navarre
MN/rw

ADDRESS OF
SENATOR FRANK H. MURKOWSKI
TO
THE LEGISLATURE OF THE STATE OF ALASKA
March 26, 1991

NEW WORLD ORDER

I began today by pointing out three major events addressing us in 1991. The first was the war in the Gulf, and the second is the New World Order. President Bush embraced this idea to pull allies together during the Persian Gulf crisis. The new world order also entails multilateral cooperation on economic issues.

Alaska is positioned perfectly to play a key role in the new economic world order. As cooperation and interdependence grow, so will opportunities for Alaskans.

Basic is the need to attract outside capital -- that is the only way to guarantee long-term economic growth. The legislature should discard Alaska's outdated unitary tax system. By attracting capital we will fulfill our potential as a natural jumping-off point for corporations doing business in our part of the world.

KEIDANREN

<JAPAN FEDERATION OF ECONOMIC ORGANIZATIONS>
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March 1, 1991

The Hon. Walter Hickel
Governor of Alaska
P.O. Box A
Juneau, Alaska 99811-0101
U. S. A.

Dear Governor Hickel:

We are very pleased to know that Alaska legislature is now deliberating an amendment of the worldwide unitary taxation in Alaska.

We have opposed the worldwide unitary taxation because it hampers foreign companies' willingness to make investment. I have attached herewith the materials expressing our position including the paper dated September 7, 1988, which was prepared by Keidanren Investment Mission to your state and used for the discussion during their stay there.

We are looking forward to the progress of deliberation in Alaska legislature toward the abolishment of the worldwide unitary taxation, and would appreciate your initiative in encouraging this movement.

Sincerely yours,

Kazuo Nukazawa
Managing Director

Attachment

September 7, 1988

On the Worldwide Unitary Taxation

Keidanren Investment Mission

Alaska is the only remaining state in the U.S. which still maintains the worldwide unitary taxation. Keidanren Investment Mission urges Alaska to abolish its worldwide unitary taxation.

Under the worldwide unitary taxation, all the income of a corporate group is combined and subject to taxation on the basis of the property, payroll and sales of not only the subsidiary concerned, but also the subsidiary's parent company and all other subsidiaries of the parent, regardless of their location.

(2)

We oppose the worldwide unitary taxation for the following reasons.

1) It results in taxing the foreign-source income of foreign entities beyond the jurisdiction of the individual state, causing what amounts to double taxation and giving rise to arbitrary application of the tax.

2) It deviates from international customs and practices on taxation based on separate accounting.

3) It requires an inordinate amount of time and cost to translate documents, convert figures, and revise their financial statements to meet complicated requirements for disclosure of information.

We consider that these factors hamper foreign companies' willingness to invest in the state that applies the worldwide unitary method of taxation.

Thus, the existence of the worldwide unitary taxation in the State of Alaska provides the negative image to the general investment climate.

Keidanren Investment Mission is not supposed to be involved in direct business talks, but to report on the state's overall investment climate to its members, consisting of 915 major corporations and 120 leading associations in Japan. The worldwide unitary taxation issue will be an essential part of the mission's report.

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No. 17 March 1984 KKC Brief KEIZAI KOHO CENTER Japan Institute for Social and Economic Affairs

How U.S. States Can Lose Business Investment

Keidanren Statement on Worldwide Unitary Taxation

In February 1984 Keidanren (Japan Federation of Economic Organizations) sent a delegation to the United States to urge abolition of the worldwide unitary method of taxing corporate income that has been adopted by more than 10 states. Under worldwide unitary taxation, all the income of a corporate group is combined and subject to taxation in a state. Stated more specifically, taxation of the income of a subsidiary located in a particular state in the United States is calculated on the basis of the property, payroll, and sales of not only the subsidiary concerned but also the subsidiary's parent company and all other subsidiaries of the parent, regardless of their location. This constitutes the extraterritorial application of law by the local state, and it also results in double taxation. Furthermore, companies are forced to spend an inordinate amount of time and money to translate documents, convert currency figures, and revise their financial statements to meet complicated requirements for disclosure of information.

Below is a summary of the position paper distributed in the United States by the Keidanren delegation. Unless states eliminate worldwide unitary taxation, it warns, Japanese companies will channel their investments elsewhere. And if this tax method spreads to other parts of the globe, it will be the United States and its multinational corporations that will be hurt the most.

We regret that more than 10 states in the United States have adopted the unitary method of taxation to tax the worldwide income of multinational enterprises, because this impedes Japanese investment in the United States just at the time that positive steps by the Japanese business community have been increasing. Worldwide unitary taxation results in taxing the foreign-source income of foreign entities beyond the jurisdiction of the individual state, causing what amounts to double taxation and giving rise to arbitrary application of the tax. It also deviates from international agreements on taxation based on separate accounting.

These factors hamper foreign companies' willingness to invest in those states that apply the worldwide unitary method of taxation. We are concerned that some of our member companies are reconsidering their investments or refraining from investing in states with unitary taxation.

We would like to reiterate President Reagan's statement on international investment, which we fully support: "Both home and host country economies benefit from an open international investment system. . . . The United States welcomes foreign investment and accords foreign investors the same fair, equitable and nondiscriminatory treatment it believes all governments should accord foreign investment."

Keidanren has surveyed its member companies on their experience with the worldwide unitary tax now being implemented in more than 10 U.S. states and has examined the issue in the light of the views stated above. We have concluded that we oppose the worldwide unitary tax for the following reasons.

Worldwide unitary taxation oversteps the tax jurisdiction of the state and results in double taxation

Beyond tax jurisdiction

In practice, the worldwide unitary tax method imposes tax on the foreign-source income of entities residing outside the state and even outside the United States by combining the income of all corporations in the group to which the resident corporation belongs and apportioning it to each geographical area. This constitutes the extraterritorial application of law by the local state, and does not reflect the actual state of transactions. For example, the U.S. subsidiary of a Japanese company usually has nothing to do with the income that the parent company earns from transactions with its subsidiaries located in Southeast Asia or Europe. But under the worldwide unitary taxation system, part of the income earned from such transactions will be apportioned to the state in which the U.S. subsidiary has its domicile, even though the U.S. subsidiary was not involved in earning this income.

We have difficulty understanding why a state has the authority to tax income totally unrelated to that

state, especially when the state in turn provides none of the benefits normally furnished to a taxpaying entity, such as infrastructure and workers' education and training programs. The power to impose taxes derives from the general benefits and protection that a government provides to taxpayers and their property. Where no such benefits exist, the power to tax is not clear. Therefore, a tax authority is empowered to tax only within its proper jurisdiction or territorial boundaries. Tax jurisdictions must be respected, for a government's taxing of income beyond its jurisdiction contradicts international practices and allows unreasonable taxation.

Inevitable double taxation

Under the system of separate accounting, corporate group members not doing business in the United States are taxed on the income they earn outside the United States by the local authorities where they are domiciled or doing business. Double taxation is inevitable when the profits of foreign corporations are included in the income earned in a unitary state. Furthermore, bilateral tax treaties cannot relieve such corporations from double taxation, because the federal government has no authority over local taxes.

Corporation A reports, "Even though our U.S. subsidiary operated at a deficit in 1976 and 1977, it was still taxed under the worldwide unitary method. After turning a profit in 1978, its income under the worldwide unitary method was estimated to be 8.4 times higher than its income under the system of separate accounting, and a tax totaling 93 times the amount under the separate accounting system was imposed."

Corporation B states, "Even though we recorded a loss in the 1980 fiscal year, we were assessed tax totaling 294 times the minimum amount."

The sum of the tax burden of Corporation C from 1979 through 1982 by the worldwide unitary method gives the corporation an effective tax rate of 101%, which means that all its profits have been siphoned off by the state.

Corporation D reports, "We were charged penalties amounting to 14 times our tax according to the separate accounting system in fiscal 1981, 42 times in fiscal 1982, and 21 times in fiscal 1983."

Corporation E says, "After several years of paying taxes according to the system of separate accounting, we were suddenly told that our taxes had to be calculated by the worldwide unitary method. Now we must pay additional taxes and interest ranging from 4 to 35 times the tax we paid in previous years."

Corporation F reports, "In 1981 we received notice that we were being assessed for additional taxes as far back as 1969. The interest was so high that we ended up having to pay four to five times the tax amount we had previously paid under the separate accounting system."

The taxable income that serves as the base for calculating the additional tax has already been taxed in Japan, where the parent company is domiciled. For a state to tax the same income again is a clear case of double taxation.

Particularly during the initial period of an investment, the unitary tax method tends to result in double taxation, especially when the local operation is in the red. Corporation G therefore makes it a policy to estimate a higher tax rate than normal when it starts up new projects in states where worldwide unitary taxation has been adopted.

In the case of the Caterpillar Tractor Company, worldwide combined reporting reduced its state taxable income. Such undertaxation, however, does not justify the overtaxation of others. Two wrongs do not make a right.

Worldwide unitary taxation is impractical

Vague concept

Fair and just taxation is the fundamental principle of modern taxation and is indispensable in obtaining the confidence of taxpayers in the tax system. In this regard, it is important that the procedures for calculating taxable income be set forth clearly. The procedures should also induce in both taxpayers and the authorities a willingness to abide by the system. A tax system that does not have clear procedures and relies on the arbitrary judgment of tax authorities is deficient and inappropriate.

Under the unitary tax method, arbitrary treatment by tax authorities is inevitable because there is no clear definition of a "unitary business." Some states apply a "three unities" test, in which they assess the unities of ownership, use, and operation. Ownership aside, the definitions of "use" and "operation" are very vague.

For instance, Corporation H was judged to be part of a unitary business by mere reason of its holding more than 50% of the stock of a U.S. subsidiary, even though the unities of use and operation were absent. There was no exchange of raw materials or goods between the Japanese parent and the U.S. subsidiary, no centralization of managerial and supervisory functions on the part of the parent, and no financing or loan guarantees provided to the subsidiary by the parent.

In unitary taxation, the total income of a corporate group is generally distributed among the group's member companies giving equal weight to the three factors of property, payroll, and sales. No recognition is given to the fact that these three factors do not carry equal weight in the incomes of many multinational enterprises.

Also, when income is apportioned by these three factors, the higher the level of these factors are, the more income is apportioned to that company. Such levels are higher in the United States than in the developing countries, so states with a worldwide unitary tax are apportioned more income than are the developing countries. But the economic and political risks are much higher in the developing countries than in the United States. Investment will not be made where the risks are great unless the anticipated return is higher than that of an investment in the United States. Apportioning income by the three-factor formula gives no consideration to this fact.

Bank I reports, "Our California subsidiary employs 4,000 people and is contributing to the economic welfare of that state. However, its payroll factor is more than twice as large, and in some years even four times as large, as its sales and property factors. Because of this, its income apportionment is abnormally high."

The more broadly the unitary tax is applied in the economically diverse areas of the world, especially with regard to the value of property, payroll, and sales, the greater will be the negative impact of this irrational and ambiguous method of taxation.

We must also point out that the broader the application of the unitary tax method, the greater the potential for instability of state revenues due to ambiguity. Although the worldwide unitary tax method may enable states to collect income tax from corporations domiciled in the state that have earned no income in a particular year, if the combined income of a unitary business shows a loss, it will result in a tax reduction or refund even if the corporation domiciled in the state turned a profit. This instability of revenue will be greatly compounded as the unitary concept spreads to vastly diverse areas of the world. Our members report that because of this unpredictability, tax authorities tend to implement unitary taxation in an arbitrary manner.

Corporations J and K report that worldwide unitary taxation is applied in some years but not in others. And many other Keidanren member corporations say that they were being taxed only on the combined incomes of the U.S. subsidiary and Japanese parent, but suddenly and without any notification as to which companies were to be considered part of their unitary business, the state tax authorities informed them that they would have to combine the incomes of all affiliated companies.

Intolerable paperwork and costs

It is desirable that tax payment procedures be made as simple as possible. Tax methods that require an inordinate amount of expense and effort in relation to the amount of tax to be paid or that are likely to lead to frequent disputes should not be adopted.

The worldwide unitary method of taxation is both troublesome and costly because of its complicated concept of taxation and computation of taxable income. State tax authorities and companies alike have difficulty calculating tax amounts by the correct procedures. As a result, arbitrary judgments by the tax authorities prevail, and taxpayers are forced to carry out costly, time-consuming procedures in order to comply.

"We have to revise financial statements that were prepared in Japan to comply with the U.S. standards of accounting and tax code," complains Corporation J. "In addition, we also have to explain in detail in English the differences between the Japanese and U.S. accounting methods. This is an enormous task." Corporation A adds, "Individual adjustments in the values of property and sales also create a lot of work."

Corporation L says, "It takes time to collect information from foreign subsidiaries outside the United States in order to comply with the worldwide unitary method of taxation. Adjusting special allowances and depreciation allowances so that they comply with U.S. accounting standards is extremely time-consuming."

Bank I reports, "The California state tax authorities told us that we had to calculate the amounts in the bad-debt reserves of the parent bank and affiliated banks by the California method. The paperwork, which involved going back a number of years and computing these amounts, was tremendous."

When state tax authorities unilaterally decide that foreign-source income should be included in taxable income, it is the companies that are responsible for providing any evidence to the contrary. However, it is impossible for companies to provide such evidence because of all the effort and money that must be put into deciding which companies are part of the unitary business, computing taxable income, and apportioning worldwide income. This is especially true for such multinationals as trading companies, which have numerous subsidiaries all over the world.

Corporations E and L report, "Even though we object to unitary taxation, arguing with the tax authorities would only cost us more. Instead, we get our tax reduced by negotiating with them." A number of companies also report that when the rate of penalty was raised, they paid the additional tax assessed, but registered a protest so that they will be able to claim a refund if their claim is upheld.

Worldwide taxation is detrimental to the sound development of capital exchange

Negative impact on investment

It is desirable that taxation have as neutral an effect as possible on corporate decisions where the

KKC Brief

worldwide unitary tax is being enforced. However, the managements of corporations domiciled in unitary states are caught in a dilemma of being unable to estimate their taxes or formulate a business strategy because the connection between their business performance and the amount of tax they must pay has been severed. Moreover, if the tax authorities arbitrarily change the tax calculation method, the willingness of corporations to invest will be severely hampered. Japanese companies are in fact becoming reluctant to invest in states that have adopted the worldwide unitary tax method.

According to Corporation C, "No state is 'safe' to invest in, because the worldwide unitary tax can be adopted so readily."

Corporation F reports, "We decided not to invest in California because it has a worldwide unitary tax, and set up operations in Alabama instead."

Corporation M says, "We had been considering investing in Oregon, but dropped it in favor of North Carolina."

Corporation N is considering pulling out of California.

Corporations F and J report, "We would like to expand our facilities in California, where we already have a factory, but we probably will not."

Corporation A says, "We place top priority on investing in those states that do not apply the worldwide unitary method of taxation."

Corporation D says, "In the future we will have to rethink our investment strategy because more than ten states have been applying the worldwide unitary tax."

Corporation O says, "We have been audited in the past, but we were never notified that we would be taxed on a worldwide unitary base. However, we are concerned about the possibility of being taxed unreasonably by the worldwide unitary method, so from now on we will consider new investments only in nonunitary states."

Corporation P asserts, "We are not making new investments in states that have been applying the unitary method of taxation."

Many Keidanren member companies regard the worldwide unitary method of taxation as a negative factor in deciding where to make their future investments.

Confusion in the international tax system

Because nations have grown more economically interdependent and international transactions have rapidly increased, it is necessary that efforts be made to harmonize nations' tax methods. The United States and other OECD member countries have worked hard toward this goal, the result being the establishment of an internationally accepted system. Tax treaties based on this system have been concluded among OECD nations to avoid taxing the same income twice in the recognition that double taxation has the effect of distorting the flow of goods, services, and investments. Such efforts have contributed greatly to the expansion and development of the world economy.

Under these circumstances, it is most regrettable that a concept of taxation that differs so greatly from internationally accepted principles and discourages the further expansion of trade and investment is being applied in the United States, a nation that should be the main pillar of the free economic system. Worldwide unitary taxation not only brings to naught the efforts that nations have persistently devoted to the important issue of eliminating double taxation. If developing nations follow suit in implementing worldwide unitary taxation, the framework of international taxation that has been built up so far will collapse, and the development of international trade and investment will come to a complete halt with the ensuing scramble to collect as much tax as possible. If this should happen, the United States, which has more multinationals than any other country, would suffer the most damage.

KEIDANREN (Japan Federation of Economic Organizations) is a private nonprofit economic organization representing all branches of economic activity in Japan. While maintaining close contact with economic sectors at home and abroad, Keidanren 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. As of January 24, 1984, Keidanren's membership numbered 117 associations and [illegible] corporations. The association members include trade associations and regional economic organizations. The corporate members are leading Japanese enterprises and foreign companies operating in Japan.

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KKC BRIEF is an occasional publication of the Keizai Koho Center, issued several times a year. It provides, in a concise format, news on the activities and views of Keidanren (Japan Federation of Economic Organizations) and other private Japanese economic organizations, as well as information on particular industries and the Japanese economy in general.

KEIZAI KOHO CENTER (Japan Institute for Social and Economic Affairs) is a private nonprofit organization that works in cooperation with Keidanren to provide information on the Japanese economy.

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FEB 22 1991

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21684-01012

February 20, 1991

The Honorable David Finkelstein
House of Representatives
P. O. Box V
Juneau, Alaska 99811

Re: **Proposed Water's Edge Tax Legislation (HB12)**

Dear Mr. Finkelstein:

At the request of Mr. David Harlow, General Reporter of the Commission on Taxation of the International Chamber of Commerce, we send to you the attached final policy statement of the Commission on Taxation with respect to proposed water's edge tax legislation in Alaska.

As you will see from the attached policy statement, the International Chamber of Commerce strongly urges the Alaska State Legislature to enact legislation changing the State's method of corporate income taxation from a "worldwide unitary" method to a "water's edge" method of taxation. Representative Tom Moyer has already introduced a bill to enact the change. The bill, HB12, is essentially the same as the Senate Finance Committee substitute bill for SB119 from the last legislative session.

Since the close of the last session, an important court decision was issued by the California Court of Appeal, Barclays Bank of California vs. Franchise Tax Board, Court of Appeal, Third District (Nov. 30, 1990). In Barclays, the court found that the worldwide unitary method of taxation, at least insofar as it applies to multinational corporations with foreign parents, is unconstitutional under the foreign commerce clause of the United States Constitution. It is believed that the Barclays opinion, because of its reasoning, will have strong influence in any U.S. federal or state court that addresses the issue. With minor revisions designed primarily toward complying with the holding in Barclays, the International Chamber of Commerce endorses the enactment of legislation similar to HB12 in Alaska.

Mr. David Harlow, in his capacity as an officer of the International Chamber of Commerce, will be making a special trip to Juneau from his office in London to deal with this important matter. Mr. Harlow will be available during March 11 through 15 to meet with members of the legislature and the administration to discuss the importance of enacting a water's edge method of taxation.

Should you have any questions concerning this matter prior to Mr. Harlow's visit, feel free to contact the undersigned.

Very truly yours,

BOGLE & GATES

Brian W. Durrell

Enclosure(s)

cc: David Harlow

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Policy and Programme Department
15.01.1991 DC

Document No 180/319 REV.
Original nd

COMMISSION ON TAXATION

PROPOSED WATER'S EDGE LEGISLATION IN ALASKA

Statement on Unitary Taxation

1. The International Chamber of Commerce (ICC) is an international organisation representing the business community worldwide. With 7,000 members comprised of companies and business associations in more than 100 countries, the ICC works to promote the principles of a free market economy, and a fair and open system of international trade and investment.

2. The ICC has over many years consistently opposed the use of worldwide unitary method of taxation ("worldwide unitary"). Worldwide unitary conflicts with the established principles of taxation as practised federally and internationally and acts as an impediment to the free flow of international trade and investment. The ICC has long advocated its removal and, in its place, the secure provision for international business of the unconditional right to be taxed by the States in accordance with internationally accepted principles, as is the case for federal purposes.

3. The US Treasury Secretary (at the time James A. Baker III) wrote to the Chairman of the US Senate Finance Committee (at the time The Honourable Bob Packwood) on 5th March 1986 in connection with proposed Federal legislation in this area. The body of the letter is attached as an Appendix to this statement. There have been some changes in the law and the position of individual States since the letter was written.

   The ICC has previously endorsed the strong condemnation of the use of worldwide unitary in Part II of the letter.

4. In the view of the ICC, a satisfactory, universal and lasting solution is only likely to be found through federal legislation. Even so the ICC seeks to encourage States to introduce 'water's edge legislation' (taxing multinationals only on income derived from the territory of the United States). Such legislation should not reach out beyond the United States to tax companies, by the use of worldwide unitary, on income earned outside the United States by them or by non-US companies in the same affiliated group.

5. Whilst the fact that California has clearly recognised the strength of the case against

In particular:

(1) It does not grant an unconditional right to be taxed on the water's edge basis. Instead it makes the right to elect water's edge subject to a number of undertakings and conditions.

Most seriously, the water's edge basis is only available to a company which contracts with the State for a five year period, on an evergreen basis, to pay an annual fee calculated as a percentage of its California payroll, property and sales.

(2) The State retains the power, in a range of circumstances in which normally a financial penalty would be the appropriate sanction (and in which indeed the State does in addition impose the customary financial penalties), to disregard a company's water's edge election with retroactive effect and to subject it mandatorily to worldwide unitary.

The protection afforded by the Californian legislation is thus hedged about the conditions and uncertainty. The door is left open to the mandatory reimposition of worldwide unitary. Further, payment (the annual fee) is demanded as the price for being taxed on a basis consistent with that practised federally and internationally, rather than on a basis (worldwide unitary) which has been so widely and powerfully condemned by the federal government, by the major trading partners of the US and by international business, both US and foreign, for the reasons already mentioned.

The ICC would discourage Alaska from legislating on the Californian model.

6. The ICC urges that the boundary in water's edge legislation be drawn so as to exclude foreign corporations whose nexus with the United States is slender, or even non-existent. Instead the water's edge boundary should be drawn on a basis compatible with the permanent establishment approach, thus clearly confining the State's taxing powers to income derived from the territory of the United States. This would put the foreign investor at the State level on the same basis as that already existing at the Federal level.

7. ICC notes the unanimous decision of the Californian Court of Appeal of November 1990 holding that California's unitary tax method of worldwide combined reporting as applied to foreign-based unitary groups, is unconstitutional under the foreign commerce clause of the United States Constitution and finds it difficult to distinguish the position in Alaska from that in California.

8. In concluding, the ICC warmly welcomes the positive initiative which has been taken in Alaska by the introduction of SB119 followed, in substitution, by the Senate Finance Committee Substitute Bill. It hopes that the Alaskan legislature will be able to resolve the worldwide unitary problem for the foreign investor in Alaska during the forthcoming session.

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APPENDIX

I. Description of Current State Corpororate Income Tax Practice

When a corporation (or related group of corporations) operates across state or national boundaries, competing tax claims of the jurisdictions in which the corporate group operates are resolved by identifying the income attributable to each jurisdiction. Two different taxation methods are in use for making this determination: separate accounting and worldwide unitary combination.

Separate accounting is the method of taxation in use generally throughout the world and is employed by the federal government. Under separate accounting, taxable income is determined separately for each individual corporation. Any improper income or profit shifting between related corporations for tax avoidance purposes is corrected by requiring "arm's length" pricing in related party transactions. That is, flows of goods and services between related or commonly-owned corporations are required to be valued at prices corresponding to those that would govern transactions between unrelated entities operating at arm's length. Under the separate accounting method, double taxation between jurisdictions is relieved either through exemption from tax by the residence jurisdiction (usually the place of incorporation or management control) of income derived in the source jurisdiction (the place the income is earned), or by the residence jurisdiction granting a credit for taxes paid to the source jurisdiction. The United States federal tax law used the latter approach.

The alternative method, worldwide unitary combination, is currently used by seven states (Alaska, California, Idaho, Montana, New Hampshire, North Dakota, and Utah) to determine a multinational enterprise's state corporate tax liability. Under this approach, the business income of all individual companies in the commonly controlled enterprise which operate in the same general line of business (the "unitary business") as the corporation or corporations subject to the state's taxing jurisdiction is aggregated, regardless of (i) whether the other individual companies are foreign or domestic; (ii) whether the other individual companies have a tax nexus with or presence in the state in question; and (iii) whether the income of the other individual companies would be treated as derived from foreign or domestic sources under federal tax rules or generally accepted international taxation principles. A share of the aggregated income of the worldwide unitary group is then assigned or apportioned to the taxing state on the basis of a formula which is intended to measure how much of the activity of the unitary business (and hence its income) is attributable to the taxing jurisdiction.

The apportionment formula generally used is based on relative amounts of payroll, property, and sales. If, for example, 25 percent of the payroll, property, and sales of the unitary group is located in the taxing jurisdiction, then 25 percent of the group's aggragate income from the unitary business

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would be apportioned to that state. Because the apportionment formula is considered to assign the appropriate amount of income to a particular state, no further measures are taken to relieve any multiple taxation of the same income which may arise from the use of different income sourcing rules by other taxing jurisdictions.

Under the worldwide unitary method, dividends paid by one corporation to another within the unitary business group are eliminated as intercorporate transfers. Under separate accounting, in contrast, intercorporate dividends are recognised explicitly as a flow of income from the dividend-paying corporation to the dividend-receiving corporation. A "water's edge" limitation on the unitary method, i.e., excluding foreign corporations, would respect the separate entity status of related domestic and foreign corporations. It therefore gives rise to the question of how dividends received by a U.S. corporation that is a member of a "water's edge" unitary group from a foreign corporation that is not a member of the "water's edge" group should be treated for state tax purposes. The question of state taxation of foreign-source dividends is thus inextricably linked to the issue of worldwide unitary taxation and, as described below, is therefore addressed in the proposed legislation.

Under present law, state taxation of intercorporate dividends, foreign and domestic, exhibits a range of practice. Though dividends from a domestic corporation income tax, most of these states also grant a dividends-received deduction, frequently the 85 percent or 100 percent deduction allowed under federal law. As at the federal level, the effect of this treatment is largely to exempt dividends paid by a domestic corporation from state corporate income taxation. Dividends received from a foreign corporation are subject to varying treatment, ranging from full allocation (and thus taxation) to the recipient's commercial domicile, to apportionment, to either full or partial exemption. Unlike the federal government, no state alleviates international double taxation of foreign dividends by allowing a foreign tax credit.

II. Reasons for Administration Opposition to Worldwide Unitary Taxation

It has been the longstanding policy of the United States to favor the separate accounting method for allocating income among nations for purposes of taxation. This policy is embodied in the Internal Revenue Code and is a central feature in our bilateral tax treaties. Separate accounting is also the international standard. The model tax treaties published by the Organisation for Economic Cooperation and Development ("OECD") and the United Nations ("UN") specify that transnational income is to be taxed on a separate accounting basis. Thus, continued state worldwide unitary taxation is directly in conflict with federal and internationally accepted practice and impedes the ability of the federal government to pursue this policy in its international dealings.

During the debate over worldwide unitary taxation, foreign governments have repeatedly petitioned the federal government to act to curb state use of the worldwide unitary method. Diplomatic notes articulating the problems caused by state worldwide unitary taxation have been received from virtually every developed country in the world, including Canada, the United Kingdom, Germany, France, Belgium, the Netherlands, Italy, Switzerland, Japan, and Australia. The United Kingdom, in July, 1985, adopted anti-unitary retaliatory legislation that would permit the U.K. government to effectively increase the U.K. tax on dividend distributions from U.K. subsidiaries to their U.S. parent corporations operating in worldwide unitary states. If implemented, this legislation would clearly violate the U.S.-U.K. bilateral income tax treaty. This legislation, by virtue of a provision which makes possible the retroactive imposition of heavy penalties, was having an adverse effect on the willingness of U.S. companies to repatriate earnings of their U.K. subsidiaries to the United States. (The U.K. has now agreed to defer implementation of this legislation for the time being.) The adoption of this legislation by the U.K. illustrates that state worldwide unitary taxation is clearly adversely affecting the United States' foreign economic relations.

Foreign governments and businesses that are subject to worldwide unitary taxation argue that this method of computing state tax gives rise to double taxation of foreign income. They also contend that worldwide unitary taxation is administratively burdensome, particularly for foreign owned companies. These results are inevitable as long as a few states rely on a method of measuring income that is different from the approach used by the rest of the world.

Theoretically, if all jurisdictions, domestic and foreign, were to adopt a uniform unitary method of taxation, and apply it consistently, there would be no double taxation as the formula would not apportion the same income to more than one jurisdiction. The problem, however, arises from the fact that combined reporting on a worldwide unitary basis is a distinctly minority practice. In an environment in which separate accounting is the generally accepted rule, state taxation on a worldwide unitary basis creates a clear risk of double taxation. Because labor costs, property values, and profitability can vary greatly among countries, an income measurement system based on formula apportionment is in open conflict with the international standard of separate accounting. This is because formula apportionment assumes all parts of a unitary business are equally profitable whereas separate accounting acknowledges that individual corporations can earn different rates of return. Double taxation will result if the relative profitability of the investment in the unitary tax state is less than that of the affiliated overseas operations that are taxed abroad on a separate accounting basis.

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State use of the worldwide unitary method also creates administrative burdens for taxpayers. There are substantial costs associated with collecting and converting accounting data generated by the various foreign affiliates of the unitary group to a form consistent with U.S. standards. These burdens can be particularly acute for foreign-owned companies which are not required to keep data under U.S. tax and financial accounting rules on their non-U.S. operations for any other purpose.

The use of the worldwide unitary method by some states may also inhibit and distort the international flow of investment capital. In the words of one foreign government, "the (unitary tax) method can chill international investment and decrease efficient allocation of resources and employment opportunities. In particular, the unitary method can impede foreign entry into the United States market." Consequently, according to a group of foreign governments, worldwide unitary tax constitutes "... a serious obstacle to the further development of our trade and investment relationships." (Note signed by the Ambassadors of fourteen of our major trading partners). The United States is strongly committee to encouraging the free movement of international direct investment capital across national boundaries. State use of the worldwide unitary method is unacceptable because it can adversely affect this clearly articulated federal policy. The United States, as the country hosting the largest amount of foreign direct investment, has gained enormously from the inflow of foreign investment. If the use by some of our states of the worldwide unitary method inhibits the flow of capital, the economic well-being of the country as a whole would suffer. Some states may be in a position in which their use of the unitary method causes foreign investors to turn away from the United States altogether (rather than shift investments to other U.S. states).

In September 1983, in response to complaints raised by both the U.S. and foreign business community and foreign governments over the Supreme Court decision in Container Corp. v. Franchise Tax Board, President Reagan asked then Treasury Secretary Donald Regan to establish and chair a Worldwide Unitary Taxation Working Group. This group was composed of representatives of the federal government, state governments, and the business community and was asked to provide recommendations suitable for resolving the issues raised by worldwide unitary taxation.

At its final meeting on May 1, 1984, the Worldwide Unitary Taxation Working Group agreed on three principles that should guide state taxation of the income of multinational corporations:

Principle 1: "Water's edge" unitary combination for both U.S. - and foreign-based companies.

Principle 2: Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability.

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Principle 3: Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses.

While the first and third principles were to be adopted voluntarily on a state-by-state basis, Principle 1, in particular, represented a clear recognition by the Working Group that the separate accounting method was superior to the worldwide unitary method in the international context. The Administration was very hopeful that the state would be able to resolve the worldwide unitary problem along the lines advocated by the Working Group on a voluntary basis without resort to federal legislative intervention.

Since the adoption of the Working Group Report some states have changed their laws to conform to the Working Group principles. Florida, Colorado, Indiana and Oregon have ceased taxing on a worldwide unitary basis. A Massachusetts court decision imposed limitations on that state's use of the worldwide unitary method and the state legislature has to date refrained from taking any action that would permit application of that method in the face of the judicial decision. However, seven other states continue to use the worldwide unitary method. In particular, efforts in California to enact legislation limiting worldwide unitary taxation have foundered in the past two legislative sessions, most recently when the California legislature adjourned for the year in September, 1985 without taking action on the issue.

In transmitting the report of the Working Group to the President, Secretary Regan indicated that he would recommend restrictive federal legislation if substantial voluntary progress had not been made on the worldwide unitary issue at the state level by July 31, 1985. That date has long since passed. We now believe that the time has come for Congress to act to finally resolve this serious international economic problem.

III. State Taxation of Foreign-Source Dividends

The taxation of foreign-source dividends is directly related to the issue of worldwide unitary taxation. A limited resolution of the worldwide unitary issue - such as an agreement by states not to impose worldwide unitary tax but with no restriction on the taxation of foreign-source intercorporate dividends - would cause other serious problems. In effect, this would be a "foreign only" situation, freeing foreign-owned multinationals from the yoke of worldwide unitary taxation while subjecting U.S. based multinationals to full taxation on their foreign dividend income. Such a "foreign only" solution, if adopted, would disadvantage domestically controlled businesses. The Working Group's third principle recognises the need for competitive balance for domestic multinationals, foreign multinationals, and purely domestic businesses. That principle requires that legislation restricting state unitary taxation also address the question of equitable state taxation of foreign-source dividends. Unrelieved state taxation of foreign dividends is not consistent with Principle 3.

Unrestricted state taxation of foreign dividends would subject domestic businesses to serious double taxation of foreign income. Federal tax policy has long been characterised by its commitment to avoid international double taxation. Indeed, the United States has been a leader in a worldwide effort to establish taxing rules under treaties and commonly accepted principles that minimise international double taxation. If a clear federal policy is not to be undercut by state action, states must comply with this policy of eliminating double taxation and therefore be limited to taxing some equitable portion of foreign source dividends.

The legislation does not mandate that any specific method of dividend taxation be imposed on the states. In our view, arguments of state fiscal sovereignty strongly indicate that states should have leeway to tailor their own systems of taxation to the extent that they do not cause serious foreign commerce difficulties by resulting in systematic overtaxation and double taxation of U.S. business in contravention of established federal and international policy. The legislation therefore provides in broad terms for the equitable taxation of dividends and suggests certain guidelines that states could follow in satisfying that standard. As an illustration of the flexibility of the approach, the legislation would accept as appropriate the treatment of dividends in such states as Colorado, Oregon, Florida and Illinois, states which have been intimately involved in the worldwide unitary tax controversy.

IV. Information Reporting and Other Federal Assistance

States have legitimately contended in the Working Group and elsewhere that they lack the resources and ability to monitor adequately transactions between members of a water's edge unitary group and related foreign companies outside that group. The Treasury Department agreed with recommendations of the Working Group to provide appropriate federal assistance to the states in order to assure proper working of the separate accounting method. The Working Group suggested that an annual information return be filed with the Internal Revenue Service by multinational companies. This return would in turn be shared with the states and with multistate audit agencies and would provide states with some assurance that corporations had allocated and apportioned the appropriate share of the corporation's income to each state. The report would also identify those related companies with which serious income shifting would be most likely to arise. In the summer of 1985, the Treasury Department published for comment a draft of legislation implementing this reporting system. Section 3 of the bill is based upon that draft after taking into account the many comments received from affected businesses and the various states. We believe that the information reporting system provided for in the bill is an integral part of the solution to the worldwide unitary problem.

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In order to provide states with greater assistance the Treasury Department also indicated in the Working Group an intention to increase the resources devoted to the IRS's administration of tax laws applicable to foreign operations of multinational companies. I urge your assistance in approving the increased budget appropriations that are being requested for this purpose.

Will it attract foreign investment?

Changes in Alaska's "unitary" tax: Pro and con

Legislation changing Alaska's "unitary" corporate income tax to allow domestic and foreign corporations to use "water's edge" accounting for state income taxes is now in House Labor and Commerce, having passed earlier from its initial committee, House International Trade and Tourism. HB-12, sponsored by Rep. Tom Moyer of Fairbanks, is being pushed mainly to enhance foreign investment in Alaska by removing what many see is a disincentive in the state corporate income tax, although the tax advantages incurred would be shared with domestic U.S. as well as foreign corporation. The bill passed the Senate last year, but failed in the House. Essentially, the bill permits multinational U.S. corporations or foreign-owned U.S. subsidiaries, except oil and gas producers, to pay their Alaska income tax based on a pool of income earned in the U.S. (with tax jurisdiction stopping at 'water's edge.') Under current Alaska law, domestic and foreign-owned corporations must use their world-wide income as a base for income taxes. Many states once had state income tax laws similar to Alaska's, but have repealed them at the urging of foreign companies looking to invest in the U.S. Alaska is the last state requiring income tax to be based on worldwide income.

Unitary tax was a big problem in states like California

This was a much more serious problem in states like California, where hundreds of foreign firms have domestic operations. In Alaska, for foreign companies doing business in the state, the issue seems to involve both principle and practicality. As for principle, foreign corporations just don't like the prospect of state auditors poking through their worldwide books. For practicality, the sheer cost of compliance — translating Japanese into U.S. accounting standards, for example — often exceeds the amount of income tax due the State of Alaska, some Japanese firms have complained. As it was originally introduced last year, the bill to allow use of 'water's edge' accounting would have applied only to foreign-owned companies. Domestic corporations would have still been required to use world-wide income. That was changed in Senate Finance Committee last year, so that both U.S. and foreign corporations can base their Alaska tax on U.S. income. HB-12, as it was introduced this year, is similar to the bill that passed the Senate last year.

While it is being sold as a bill that will encourage foreign investment in Alaska (by removing the disincentive of requiring world-wide income reporting) the bill will reduce state corporate income taxes by an estimated $1 to $3 million, the Department of Revenue estimates. *Proponents of HB-12 in its expanded form argue the small revenue loss will be more than offset by new foreign investment, jobs and taxes paid to the state treasury.* But some critics doubt that: Alaska is in a different league, they say, than states like California, Oregon or Washington, who compete with each other for foreign investment, mainly in manufacturing. Foreign firms come to Alaska mainly for natural resources, the presence of which weigh more heavily in the investment decision than the unitary tax.

Is discriminatory effect a constitutional issue?

Another potential problem is a constitutional one. Oil companies are not being allowed to use 'water's edge' accounting, under the bill. Alaska's supreme court, in the ARCO "separate accounting" decision, approved use of a different formula (separate accounting vs. the traditional 'appotionment' method) for a different class of taxpayers, like oil producers, under special circumstances. But discriminating among taxpayers required to use the same formula (oil and non-oil companies now use apportionment) could run afoul of the constitution, some people argue. *One feature that troubles Dept. of Revenue, which in the end will support the bill, is the exclusion of 80 percent of dividends earned by a foreign subsidiary of the U.S. company, or of 80 percent of any royalty earned by an overseas franchisee. That leaves 20 percent of dividends and royalties to be included in U.S. taxable income.* Revenue feels there's no basis for the 80-20 split, and that the share of foreign dividends or royalties including in the U.S. pool of income could be larger than 20 percent.

DIVISION OF LEGAL SERVICES

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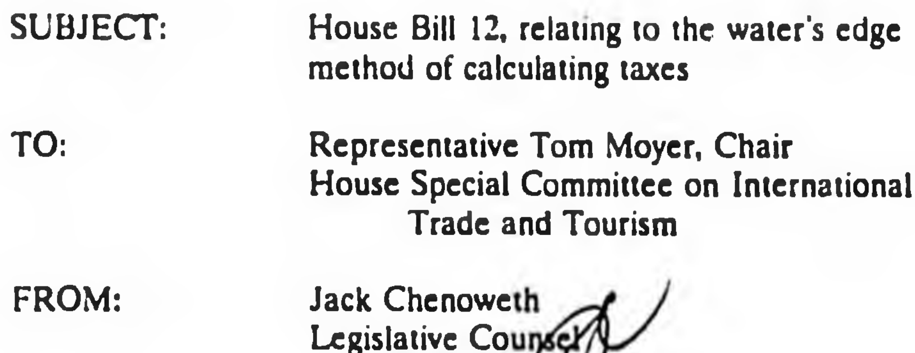

M E M O R A N D U M — February 13, 1991

SUBJECT: House Bill 12, relating to the water's edge method of calculating taxes

TO: Representative Tom Moyer, Chair
House Special Committee on International Trade and Tourism

FROM: Jack Chenoweth
Legislative Counsel

This is by way of response to several comments and questions made during the course of Monday's testimony on House Bill 12.

I

Representative Robin Taylor and Carl Meyer, speaking for the Department of Revenue, raised the possibility that the legislation is unconstitutional. Their comments about the constitutional implications of the measure went to whether proposed AS 43.20.073(f), exempting from the proposed water's edge modifications the income taxes imposed on oil and gas producers and pipeline transporters, would pass muster when examined against the equal protection clauses of the Alaska and federal constitutions.

I am satisfied that the Alaska Supreme Court's decision in Atlantic Richfield Company v. State, 705 P.2d 418 (Alaska 1985), cited by Susan Burke in her testimony, puts their concerns to rest. In that decision, the court upheld the separate accounting method of the oil and gas corporation income tax (imposed, until 1982, by AS 43.21) against a constitutional challenge on various grounds. The tax, you may recall, substituted a different methodology, separate accounting, for the formula apportionment method then generally in place to ascertain the taxable income of production and pipeline transportation companies for the period 1978-1981. Against the taxpayers' assertions to the contrary, the court specifically found that the tax did not violate state and federal equal protection.

The court's analysis under state equal protection involved a three-step process:

> First, in order to ascertain the appropriate level of review, the nature of the constitutional interest affected must be identified. Next, the validity of the statutes' purpose must be analyzed in light of the interest impinged. Lastly, the means chosen must be examined, also in light of the interest, to insure that they are sufficiently related to the goals of the statute.

Atlantic Richfield, at 437 (citations omitted). Examining the constitutional interest affected, the court declared that the taxpayers' asserted right to be free of "disparate taxation" was to be found at the low end of the continuum of interests deserving of the guarantees of equal protection. As to the Oil and Gas Tax statutes' purpose, the court found evidence that the legislature had passed the measure "to rectify a perceived underestimation of oil production and pipeline transportation income that occurred with the application of the apportionment formula." Id. The differential treatment of the oil companies, the court said, was an attempt "to prevent disparate treatment," and the court determined that the corrective effort embodied in the Oil and Gas Tax served a valid purpose. Id. On the final point, the relationship between the means chosen and the goals of the legislation, the court found the necessary correlation, noting that the choice of a different method of taxation "more fairly represented the extent of the business activities of the oil companies in Alaska." Id.

Under the court's federal equal protection analysis, it declared that the imposition of the tax affected no fundamental interest nor did it contain a suspect classification. Absent these factors, federal equal protection analysis requires only that the tax distinction shall have been rationally related to a legitimate state interest. The court then observed:

> The rational basis standard is particularly easy to meet in the area of taxation. The United States Supreme Court has stated that "[l]egislatures have especially broad latitude in creating classifications and distinctions in tax statutes." Regan v. Taxation with Representation of Washington, 461 U.S. 540, 547, 103 S.Ct. 1997, 2002, 76 L.Ed.2d 128, 138 (1983). [Alaska's] Oil Tax clearly bore a rational relationship to the state's goal of correcting a perceived inequity in the tax structure.

Atlantic Richfield, at 437.

Would HB 12, establishing a water's edge method of taxation but incorporating an exception or exclusion for oil and gas producers and pipeline transporters, survive similar analysis?

It is uncontroverted that Alaska is the only state that continues to levy a worldwide combined tax under which all the income of a corporation is combined and taxed, regardless of the location of the taxpayer's affiliates. Perceived inequity in the tax structure--in this case, the perception expressed to legislators by foreign companies, particularly, to the effect the state's current worldwide combined tax method overreaches and discourages foreign investment in the state--is, like the separate accounting initiative of the Oil and Gas Tax of a decade ago, a principal motivating factor underlying HB 12.

Under state equal protection analysis of the proposed tax and its exemption or exclusion, the court would examine (1) the importance of the right involved, (2) the validity of the exemption's purpose, and (3) the relationship between the means chosen and the objectives of the proposed statute.

First, as it did in Atlantic Richfield, I assume that the court would readily find that the water's edge exception or exclusion for certain producers and pipeline transporters--the inability of these taxpayers to use the water's edge method--would fall at the low end of the spectrum of interests for which the state's equal rights clause provides protection.

Justification of the validity of the exemption's purpose is relatively more difficult, albeit possible. First, unlike the circumstances underlying the challenge to the Oil and Gas Tax discussed in Atlantic Richfield, perceived underestimates of taxpayer income do not motivate this proposed tax change. Rather, the committee heard from Ms. Burke, Ron Garzini, and Scott Hawkins, among others, about the need to diversify the state's economic and revenue base away from its heavy dependency on exploration for and production of crude oil. The witnesses have all suggested that the legislature ought to establish a climate more conducive to foreign investment in the state's other resources. As I understand the measure's purpose, you and your committee are seeking to amend state tax policy in an attempt to find a balance between attracting additional foreign investment by eliminating what has been identified as a principal obstacle to encouraging foreign corporations to do business in the state--the state's worldwide combined method of taxation--without risking a substantial loss of revenue from the state's major revenue source, the income tax paid by the oil and gas producers, at a time when state finances should be stabilized. Moreover, while the water's edge initiative is an attempt to remove what you perceive as a major barrier to entry of foreign investment into the state particular for, especially, the development of renewable resources, there is no evidence to suggest to you and the committee that the exploration and production of oil and gas in place or its transportation to ports and markets is significantly limited by the state's continued reliance on the worldwide combined method. In short, you and the committee are apparently satisfied that current tax policy may be a real barrier to entry of new capital and methods that might expand interest in recovery and development of many state resources, but the continued levy and collection of the

income tax on oil and gas producers using the worldwide combined tax method has not discouraged--does not seem to be a factor to discourage--continued exploration and development activity by that industry.

The third point--the relationship between the choice of method and the objectives of the statute--is eminently defensible: in recent years, the water's edge approach has been the preferred method of tax modification put in place by states to diminish the broad administrative reach of the worldwide unitary tax system previously imposed, and is more nearly consistent with federal efforts to encourage the states to shift toward a separate accounting approach to taxation of international activities.

Clearly, the exemption of the proposed water's edge levy of the taxable activities of certain oil and gas producers and pipeline transporters that would meet the requirements of state equal protection would also meet the rational basis test of federal equal protection analysis set out in Atlantic Richfield.

For these reasons, it is, in my judgment, more likely than not that the measure proposed--incorporating as it does an exclusion for oil and gas producers and pipeline transporters--would be found to meet the tests of equal protection.

II

The Department of Revenue's representative questioned the inclusion of proposed AS 43.20.073(b), excluding, for purposes of water's edge computation, 80 percent of the dividend and royalty income received by the taxpayer's foreign affiliates. In other words, 20 percent of the taxpayer's dividend and royalty income from its foreign subsidiaries is taxable. As I understand, the department suggests elimination of the provision, thereby making all dividend and royalty income from the taxpayer's foreign operations subject to taxation under water's edge.

The portion of my December analysis discussing proposed AS 43.20.073(b) sets out the rationale for inclusion of the provision. Its retention or elimination--and the determination of the actual amount of the exclusion--is a policy call, but as I understand, elimination or substantial reduction of the percentage excluded may raise a question as to whether the state has provided even-handed treatment as between foreign-based and domestic-based multinationals subject to the tax.

III

The representative of the Department of Revenue suggested that the bill should give attention to any affected provisions of the Multistate Tax Compact, AS 43.19, to which the state is a party.

The text of the Multistate Tax Compact is set out in AS 43.19.010. Paragraph 18 of article IV of the compact provides:

> If the allocation and apportionment provisions of this Article do not fairly represent the extent of the taxpayer's business activity in the state, ... the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> (a) separate accounting;
>
> (b) the exclusion of any [one] or more of the factors;
>
> (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
>
> (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

What the "tax administrator" may require, so, too, it seems to me, may the legislature by law. Consequently, this paragraph, in my view, provides sufficient authority for the state to make any adjustments to its taxation practices consistent with the compact without the necessity of cross-referencing the provisions of the compact into the substantive change and without the necessity of amending the compact (AS 43.19) to incorporate specific exceptions.

IV

Finally, the department's representative raised a question about the computation and application of the three-factor formula set out in proposed AS 43.20.073(a) at p. 1, line 13-p. 2, line 1, and at p. 2, line 10. Mr. Meyer was uncertain whether each of the three factors--property, payroll, and sales--determined under the affiliated corporation's tax return needed to meet the threshold 20 percent or whether the threshold would be satisfied by an average of the three factors.

The measure contemplates an averaging of the factors. In both instances, at the lines cited, the threshold speaks in terms of the "factors ... average." I see no uncertainty on the point. If the department believes clarification is necessary for proper administration of the tax provision, the committee should ask the department to prepare and submit suggested language.

*

If the committee considers an amendment or committee substitute, I would ask consideration of one additional provision.

As was mentioned in Monday's hearing, proposed AS 43.20.073(e) establishes a "default" or "penalty" imposable against a taxpayer who files a water's edge return but

who fails to file necessary supporting information. The commissioner may require the taxpayer who fails to provide the information to "file a worldwide combined report." See page 3, line 4. Nowhere else in AS 43 do the statutes refer to "worldwide combined report." For clarity, then, the committee should consider changing the reference to "a report under AS 43.20.065 - 43.20.072 made without regard to this section" or, alternatively, add a definition of "worldwide combined report" to the short list of definitions set out in subsection (g).

*

I trust this is responsive on the points requested.

JBC:pl
91-077.plm

ALASKA MINERS ASSOCIATION, INC.

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February 8, 1991

Representative Tom Moyer
P.O. Box V Mailstop 3100
Juneau, AK 99811

RE: HB 12 Unitary Tax

Dear Representative Moyer:

We have reviewed HB 12 regarding Unitary Tax and we support passage of this bill.

The Alaska Miners Association has supported the intent of this bill in past years including Senate Bill 119 in the previous legislature which passed in the Senate on a vote of 14 to 5.

We feel that this bill will help to remove some of the roadblocks that discourage investment in Alaska. This bill will provide an encouragement to both domestic and foreign corporations to locate in Alaska. This will in turn help to diversify our economic base.

Sincerely,

Steven C. Borell, P.E.
Executive Director

Xerox Corporation
[illegible]41 B Street
Anchorage, Alaska 99[illegible]3
(907) 561-8200

February 7, 1991

XEROX

Honorable Tom Moyer
Representative
Alaska State Legislature
Juneau, Alaska 99801

Dear Mr. Moyer:

The Xerox Corporation supports increased business investment in the state. Accordingly, House Bill 12 applied equally to both domestic and foreign corporations should make Alaska a more attractive place to invest. We definitely recommend its passage.

Sincerely,

XEROX CORPORATION

Ann Laurence
Manager, Xerox Alaska

Larry Imhof
Manager, Xerox Alaska

January 23, 1990

The Honorable Fran Ulmer
House Finance Committee
P.O.Box V
Juneau, AK. 99811

Reference: House Bill 281

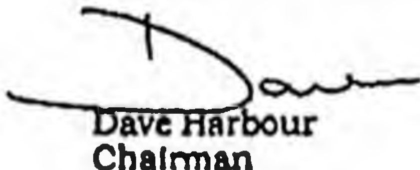
Dear Fran:

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 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

437 E Street, Suite 300, Anchorage, Alaska 99501-2365 (907) 272-2401 FAX (907) 272-4117
Founded 1915

R.E.D.C. TEL NO:907-[illegible] JAN 24.90 13:01 No.004 P.03

ALASKA STATE CHAMBER OF COMMERCE
Regional Office
501 B Street, Suite 405
Anchorage, Alaska 99501
(907) 278-2722
FAX 278-6643

October 16, 1989

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 Krusz
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.

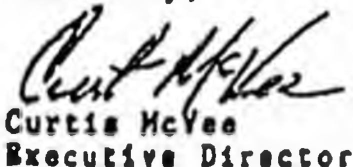
Last year the Alaska Miners Association presented testimony on Senate Bill No. 119 concerning reporting methods for corporate income tax. We supported the bill, but with an amendment which puts our domestic multi-national corporations on the same tax footing as foreign corporations.

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

FEB 28 1990

ASSOCIATED GENERAL CONTRACTORS of ALASKA

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

February 22, 1990

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

Dear Senator Uehling:

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

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

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

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

Sincerely

ASSOCIATED GENERAL CONTRACTORS
OF ALASKA

F. Michael Swalling
President

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

XEROX

December 28, 1989

Representative Fran Ulmer
House Finance Committee Member
P.O. Box V
Juneau, Alaska 99811

RE: House Bill 281

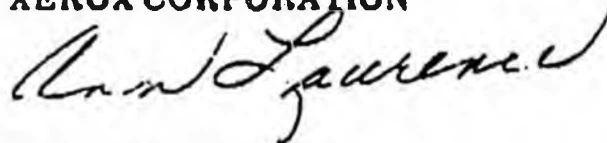
Dear Representative Ulmer:

It is our understanding that House Bill 281 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

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

5900 Arctic B...
Anchorage, Alaska 995...

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

H.E.D.C.
FROM FLUOR DANIEL ALASKA 4.24.1989

bcc: Don Langworthy

FLUOR DANIEL

April 24, 1989

Senate Finance Committee
Pouch V
Juneau, Ak 99811

Attention: Senator Rick Uehling, Co-Chairman
Senator Johne 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.116

The Ship Creek Opportunity

A Panel Discussion

550 West 7th Avenue • Suite 1130 • Anchorage, AK 99501 • Telephone (907) 258-3700 • FAX (907) 258-6646

PREFACE

On February 7, 1991, the Anchorage Economic Development Corporation (AEDC) held a pre-proposal conference for the Ship Creek Waterfront Development Project. The two-hour conference provided general information on the Anchorage waterfront project and specific economic reports from specialists in real estate, international trade, tourism and architecture.

The baseline document for the project is the AEDC's Request for Proposal which was printed and distributed in December, 1990. Developers who had received the RFP and who sought more information on the project were in attendance at the pre-proposal conference both physically and electronically by means of a telephone conference call arranged by the AEDC.

The agenda for the meeting, handouts from the participants and other current information on the project is included at the end of this report.

Anyone interested in more information about the Ship Creek Waterfront Development Project should contact the AEDC at 550 West 7th Ave., Suite 1130, Anchorage AK 99501 or at (907) 258-3700.

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General

AEDC Board Chairman Ron Duncan introduced panelists and outlined the program for the two-hour session. He described the Ship Creek Waterfront Development an excellent example of the type of project the AEDC was created to foster. It involves significant public and private interest, new jobs and economic expansion in the tourism industry, one of Anchorage's growth targets.

Alaska Railroad Perspective

The project area was briefly described by Marvin Yetter, Alaska Vice President for Finance and Real Estate. The area is a clean industrial zone which has been used primarily for freight storage. It already attracts over half of the 800,000 tourists who visit Alaska annually. The Alaska Railroad seeks to attract year-round visitor business. Tax exempt financing is expected to be available from the Alaska Railroad Corporation.

Local Government

Anchorage Assembly Member Heather Flynn described the local government's commitment to the area and to the project. Within the Ship Creek basin there are two zones: the industrial port area and the project area for the Ship Creek Waterfront Development Project. The creek itself is the dividing line between the industrial and the commercial zones. The project is supported both by the public sector and by the private sector.

The Ship Creek RFP

The Alaska Railroad has been quite supportive of commercial development of its property since the railroad was transferred to the State of Alaska in 1985. AEDC staff member Tyler Jones described the Ship Creek RFP as being designed to respond to the development community's creative ideas for the area. The project is the best available opportunity to create a convenient and focused international visitor attraction that will become the prime jumping-off place for visitors to the 49th State.

Components of the Deal

AEDC President Scott Hawkins summarized the six components of the RFP offering: 120 acres of fully assembled downtown waterfront ground under a single owner; environmental protection; tenants on the ground covering ground rent payments; capital improvement credits; infrastructure grants; and tex exempt financing.

The Economic Opportunity

The Anchorage economy has recovered from the 1986-88 recession and shows strong signs of continued growth. Alaska's growth rate since the late 1960s has been triple the national average. Alaska's and Anchorage's global location are becoming appreciable commodities, particularly for global transportation concerns like Federal Express and United Parcel Service, both of which have established international air cargo hub facilities in Anchorage.

Commercial Real Estate

Real estate occupancy has increased in all areas, real estate broker Chris Stephens reported. In the Anchorage business community there is a sense of optimism and a sense that economic recovery has taken place. Compared to other cities hurt in the mid-80s recession, Anchorage's market was never as overbuilt. All our buildings were occupied at one time or another. Consequently, for Anchorage rates to return to amortization values we need only regain the economic strength we had in 1986.

International Trade

The acting director of the Alaska Office of International Trade, Ginna Brelsford, said the administration of Gov. Walter J. Hickel considers the timing excellent for an innovative and challenging project like the Ship Creek Project. It conforms well with Gov. Hickel's "owner state" strategy for development of Alaska.

Tourism

Katelyn Carrigan of the Alaska Department of Commerce reported that of the 820,000 visitors to Alaska in 1990 over half came to Anchorage. The Ship Creek Project has all five of the "five A's of tourism success:" attractions, accommodations, access, advertising and attitude.

The Site

John Burns, architect for the Alaska Railroad's Original Townsite project within the Ship Creek Project Area, explained why, if Ship Creek is such a good idea, the opportunity is still available. He explained it as a convergence of changes: a new and ambitious railroad leadership, a cooperative Municipality of Anchorage and a strong interest within the private sector to locate in and develop the Ship Creek area.

CONFERENCE PARTICIPANTS

Ron Duncan, Chairman
Anchorage Economic Development Corp. Board of Directors

Marvin J. Yetter, Vice President
Alaska Railroad Corp.

Heather Flynn, Anchorage Assembly Member

Tyler Jones, Transportation Projects Director
Anchorage Economic Development Corporation

Scott Hawkins, President
Anchorage Economic Development Corporation

Chris Stephens
Jack White Company

Ginna Brelsford, Acting Director
Alaska Office of International Trade

Katelyn Carrigan
Alaska Office of International Trade

John Burns
Burns & Peterson Architects

TELECONFERENCE PARTICIPANTS

Michael Whalen
Callison Partnership

Bill Price
Northwest Properties

Jean Gorton
Trillium Corporation

Dave Taylor/Larry Nielson
Skinner Development Company

Tandy Lofland
Intergroup Development Company

Bob Baron
Enterprise International Development Corporation

Keiko Kameda
Frontier West Properties

Hudson Brett/Chris McDonald
Brett & Company

CONFERENCE ATTENDEES

Roy Whitten
West Cook Inlet

Robert T. Griffin
Anchorage Port Commission

Tim Wiepking
Municipality of Anchorage

John Klepac
Sverdrup Corp.

Mike Stone
KPMG Peat Marwick, Anchorage Economic Development Corp. Board of Directors

Ed Musgrove
ECI Hyer

Mary Ann Keller
ECI Hyer

Bill Blessington
Municipality of Anchorage

Betty Adkison
University Area Community Co.

Greg Branch
Anchorage School District

Ted Trueblood
Tryck, Nyman & Hayes

John G. Burns
Burns & Peterson Architects

William Elmer
Reid Middleton, Inc.

Steve Agni
Development Managers

Karen Skurig
National Bank of Alaska

INTRODUCTION

MR. DUNCAN: Good afternoon. I'm Ron Duncan, President of GCI and Chairman of the Board of Directors of the Anchorage Economic Development Corporation. Now that we have our communications links to the Lower 48 we're ready to get under way with the pre-proposal conference for the Ship Creek Waterfront development project.

As AEDC Board Chairman it's my pleasure to moderate this discussion of the Ship Creek Project. The Ship Creek Project is a wonderful example of what the AEDC was designed to do: bring together different interests in support of economic development and job formation. In this case the players include the Municipality of Anchorage and the administration of Mayor Tom Fink; the Alaska Railroad Corporation, represented today by Marvin Yetter, Vice President for Finance and Real Estate; the Port of Anchorage and numerous private concerns which favor expansion of our community's commercial offerings and tourism amenities.

Today we intend to do three things: first we'll listen to a few minutes of history and background on the project. Then we will hear from a panel of specialists who will present their impressions of the Ship Creek Project from their special vantage point. Finally we will entertain and respond to questions about the project from anybody in the audience or any of those with us by conference call.

The first segment of the meeting will provide general background information on the project. Marv Yetter, the vice president for finance of the Alaska Railroad, will describe the Railroad's view of Ship Creek. Then we'll hear from Heather Flynn, one of the members of the Anchorage Assembly, the equivalent of our city council for some of you in the Lower 48. Heather will discuss the Ship Creek project committee, of which she is a member, and the links between the Ship Creek project and the Municipality, through both the assembly and the administration. Tyler Jones, who is the staff person on the AEDC responsible for the Ship Creek project, will run briefly through the RFP and the process of developer selection. Then Scott Hawkins, president of AEDC, will discuss the nature of the proposed deal that will be available to the successful developer.

At that point we will break for questions from the people on the conference phone and from those here in Anchorage. We'll take a short break before continuing on with the second half of the meeting. The second half will be a panel discussion concerning the economic opportunity at Ship Creek Point. That discussion will be moderated by Scott Hawkins. He will introduce the panel at that time.

Just one note on protocol before I turn this over to Marv. Because we're on a conference phone system, and we're trying to record this meeting to create a record of it, we request during the question and answer period and during the panel discussion period that only one person at a time speak. We will poll each of the conference call participants individually for questions. If there are multiple people talking at once, the phone will cut out the conference call participants, they won't be able to hear effectively, and we'll have a difficult time with the transcript.

With that I will turn it over to Marv Yetter, the vice president for finance of the Alaska Railroad.

ALASKA RAILROAD PERSPECTIVE

MR. YETTER: My name is Marv Yetter. I'm vice president of finance at the Alaska Railroad Corporation. One of the areas I manage, in addition to the administration/finance area, is the real estate area.

Before I get into the Ship Creek project, let me give you a little bit of background on the Alaska Railroad and what the last six years have brought the Railroad and Alaska.

Many of you recall from reading some of the material that the State of Alaska bought the Alaska Railroad in January of 1985. The citizens of the State of Alaska are the stockholders. They're the only stockholders. The railroad corporation operates as a private, independent corporation most of the time, and we try to maintain autonomy from the State of

Alaska. In the transfer the State-owned Alaska Railroad received about 40,000 acres of land, three deep-water ports (Whittier, Seward, and Anchorage) and about 550 miles of track right-of-way. Our rail bed and right-of-way in Alaska covers an area that includes about two-thirds of the State's population. We also received numerous major buildings, including a historic railroad depot and a lot of junk.

During the last six years the Alaska Railroad spent $81 million investing in capital upgrades, all in the area of freight and passenger service. We financed that from our profits, and through some bank borrowing. We have about $24 million in debt at this time. Through this six-year period we've been able to average a rate of return of about 10-1/2 percent, close to 11 this year. We've been able to do this, thankfully, during one of Alaska's worst recessions. Don't ask me how we did it; we're still trying to figure it out. One thing you may hear is that we don't pay taxes. You could say, "Well, that's how you do it," and that's not correct. We don't pay taxes, but if we did pay taxes our tax bill would be about $1.2 million to $1.5 million each year. We actually give about three million dollars a year in dividends back to the State in free use of our facilities, properties and right-of-ways. We charge the private sector for those services.

We spent the early years overhauling the freight and passenger business. Now we've been looking at the real estate side, and we're ready to start major development. The Ship Creek waterfront development, as you've all heard, is 120 acres of prime waterfront land that we're concentrating on in this first phase.

A couple unique things about this 120 acres. We only have three small leases on it today. Most of it's used for car storage -- new car storage, not junkyards. Environmentally I like to call it virgin. Our lawyers have a problem with that, but I think it's in pretty good shape compared to what you would find in most industrial properties. Most of the acreage has been unused for many years. Some of it is tidelands that will be filled. We feel that it's pretty good property from an environmental standpoint.

The Railroad has funded a Coastal Zone Management study of the area that's going to be completed probably in the next two months. So within two months that study should be done, which will outline the uses in the tidelands portion of the property.

In looking for a master developer to assist us, we've done a lot of research from the standpoint of what we thought Anchorage and the Railroad would like to see on the waterfront next to downtown. Because we're a winter city environment

The Railroad has already secured a few good major tenants in the project area. We feel we've made a good start at redeveloping the area even before we get the major developer selected.

We want to be very careful that whatever we do here has advantages for the community during the shoulder seasons and during the off months. During our four or five summer months we have enough traffic in the project area that we feel just about anything would work. But we want to concentrate on year-round attractions, such as an aquarium or a planetarium, or some similar special attraction that would bring people to the area in the off season. It could be tied to the University of Alaska and to the local school district to be used as an educational medium in the wintertime. But in the summertime it would be a fine tourist attraction.

The Railroad has already secured a couple of good major tenants in the project area. One is ourselves. We're in the process of receiving and reviewing bids on a new Railroad headquarters building. It will be about a 38,000-square-foot building on one of the arterials in the project area, Warehouse Avenue. Glacier Brewery's brew-pub/microbrewery project is also scheduled to begin construction in the spring. Another office building on Warehouse Avenue will be hopefully leased by that time. These three projects will completely change the use of a street that's about a half mile long. Today there's 50 employees on Warehouse

Avenue. Two years from now when the Railroad's office building is completed and the other two facilities are completed, there'll be 400-500 employees on Warehouse Avenue. We feel we've made a good start at redeveloping the area even before we get the major developer selected.

There are many positive attributes to this project from the Railroad's standpoint. Our railroad depot in the center of the project area handles about 450,000 passengers in a four-month period in the summer. Most of these are tied into the tour companies like Princess Tours, via cruise ship from Whittier and Seward. There is also Anchorage's local traffic.

The Railroad would like to participate as an equity owner in some of the proposed projects. We also have rent credits available, and may have rent abatement, depending on the situation.

The infrastructure is being handled by state grants. This includes streets, sidewalks, curbing, lighting and those kind of things. Last year the State funded a grant for $2.5 million for some street extensions, lighting, a new bridge over Ship Creek and a footbridge. This year we've requested $10 million.

We have preliminary word from our bond counsel that tax exempt financing will be available for a project of this nature. We have a regular $10 million annual cap that we use with banks today to arrange tax-exempt financing. But it appears we will have available a tax-exempt bonding capability. That has to be approved by our board of directors and the state legislature, of course, but if the project makes sense the approvals shouldn't be a problem. We feel the high probability of tax-exempt financing is a big plus.

LOCAL GOVERNMENT PERSPECTIVE

MS. FLYNN: I'm Heather Flynn. I'm a member of the Anchorage Assembly and I want to talk to you just a little bit about our committee process and structure. However, I first want to give you just a little bit of Local Government 101.

We have a community here which is about half again the size of the entire state of Rhode Island, and about two-thirds the size of the state of Connecticut. We are bounded on the east by some of the most fantastic mountains you've ever seen. I can look out the window and see a 20,000-foot mountain to the north, and, of course, to the west and coming around to the north is what you're interested in, a whole bunch of water.

We feel the high probability of tax-exempt financing is a big plus.

We have about a quarter of a million people here, a strong mayor form of government, and 11 elected assembly members from six different districts. We are a unified government. We're called a unified city and borough, but for those of you from New York, we're not like New York boroughs. Our borough is something akin to a county, but not quite. We have a single government and we also have a single taxing authority. That means you don't go out for levies every other month like you do in most places. In fact, we don't have to go out for levies at all. That's one small advantage we have.

A little bit about our planning process as well. We have, of course, a planning department which is just now completing a unified plan which integrates transportation, commercial, industrial and recreational opportunity as it deals specifically with the land that you are looking at, as well as some additional lands.

If you are looking at your map, there's a very natural division along Ship Creek. To the north is the traditional industrial port area. To the south is the area we are addressing today, the more people-oriented and the less industrially-oriented area.

The Ship Creek Project Committee process began several months ago with a three representatives: Marv Yetter from the Railroad, AEDC Board of Directors member Ken Gain, and myself, representing the Municipality of Anchorage. We since added Mayor Tom Fink to the committee.

The proposal went through many drafts, and the committee had input from more people than you can possibly believe. We feel it has the support of the entire community of Anchorage. The committee process is so dedicated and so tight that the most highly ranked proposal must receive unanimous approval from all four committee members in order for it to go forward.

This is a project with heavy commitments from not only the public sector, but also from the private sector. This is a very unique opportunity in that sense. We have a remarkable collection of opportunity here. We have land, land which is free and clear, most of it belonging to the Railroad, some of it under lease by the Municipality. In addition to that, it is in a fantastic setting. It's a very beautiful area. The basic infrastructure is in place: there are roads, and there are utilities. There is a plan for, and, indeed, a financial plan, for upgrading both the roads and the utilities, and that will be primarily at public expense. In addition, as Mr. Yetter has indicated to you, we are one of the few places left on the face of the earth, and certainly in this country, where there is bonding and financial capacity which makes this project much more financially feasible.

This is an opportunity for a real coordinated development with a great deal of support from the entire community here in Anchorage, from the state legislature in session in Juneau right now, and certainly from the private community, which is very well represented in this room today.

RFP SUMMARY

MR. JONES: I would like to do a quick run-through on the request for proposal. For those who have had their copy for awhile, this may seem redundant. We'll try to make it brief. For those who are newcomers to the process, this'll be too brief, and we'd like you to raise any questions you might have about it with us later, so that we can make you comfortable with the document and explain it in all the detail you'd like.

Generating the request for proposal, as has been stated by previous speakers, has been a long effort of various enterprises to put together a collective and cooperative development plan for this area. This area is the origins of Anchorage, Alaska. The name Anchorage is derived from the actual anchorage for marine vessels that existed at the mouth of Ship Creek shortly after the turn of the century when the Alaska Engineering Commission was building the Alaska Railroad. The Ship Creek basin has been under the control of the Alaska Railroad in its federal and its state manifestations since then.

The request for proposal is designed to respond to the development industry's ideas. It is our goal to satisfy the developer's interest in new information, and to bring to the table a qualified master developer for the project.

The inland half of the project area has been filled over the years. The waterfront half of the project is approximately one-third filled and ready to receive additional fill.

The transfer of the Railroad from the federal government to the State of Alaska has been addressed previously. The change in the demeanor of the Railroad toward development, toward expansion of economic activity in the state, has been quite striking in the period since the transfer.

The development of the project area, in particular, has had three phases. Originally with the development of the Alaska Railroad the original townsite area was for freight sheds, transfer structures, transfer activities, and track. Since then, in the early 1980s, the Port of Anchorage, an agency of the Municipality, acquired an interest in the waterfront portion for port expansion, and more recently there have been commercial plans, as reflected in the request for proposal, along the banks of Ship Creek, particularly near the Ship Creek dam, which is at the east end of the project area. The Ship Creek property that we're looking at today has the capacity to serve as a site for a

mixed-use development without having to satisfy the port's marine industrial requirements as once suggested by the Port's 1983 Master Plan.

In 1988, the Municipality received a concept plan for the Ship Creek project. The plan set out the mixed-use and commercial project concept. More recently, as has been described in some detail, the Municipality, the Railroad, the Economic Development Corporation, and assorted private interests have generated an overall redevelopment plan, which is reflected in the request for proposal.

The Municipality is engaged in ongoing work to resolve all planning and zoning issues. The coastal zone plan, which Mr. Yetter referred to, is in the process of being completed. It follows a lengthy period of environmental concern over the project area that is now being resolved. Additionally, the Municipal planning department is conducting a process of waterfront zoning and planning which is expected to be resolved in the next couple of months.

The request for proposal is designed to respond to the development industry's ideas. It is our goal to satisfy the developer's interest in new information, and to bring to the table a qualified master developer for the project. The RFP is organized to help people understand the area, its history and its potential.

The selection criteria in the request for proposal also reflect the submission requirements. Since the selection criteria spell out the percentage and ratings that the developers must consider, I will cover that exclusively at this time. Two of the criteria are rated at 40 points each of 100 total points. Those are the concept plan and the developer's qualifications and experience. The concept plan element is intended to determine the mix of uses proposed by a developer, to identify project economics, to lay out a marketing plan and strategy for the project, to include a design proposal, and to deal with the responsiveness to the request for proposal in detail. The project committee is not taking a bottom-line approach to the project exclusiv[illegible]. The members are interested in long-ter[illegible]nefits of the project to the community. W[illegible] paying special attention to those proposals that suggest new economic activities for Anchorage.

In particular, we anticipate that there is international interest in visiting Alaska that has not been brought to Alaska in quite the scope or scale we imagined yet. Ship Creek is the best opportunity to create that focused or invented attraction for Alaska to be a jumping-off place for the scenic 49th state. The Ship Creek Basin has its own attractions that can be packaged into an exciting project, for that matter, which would be attractive to an international tourist. These include our huge tidal range of roughly 30 feet, beluga whales in the summer, and king and silver salmon which spawn in the creek, and for which sportfishing is allowed, and bald eagles in the area.

The Ship Creek Basin has attractions that can be packaged into an exciting project which would be attractive to international tourists.

The developer's experience and qualifications are standard elements for any RFP response. The Ship Creek Project Committee is looking at breaking down the experience and qualifications category to developer experience, private design experience, financial capability of developer, the organization and management approach, and the qualifications of the key personnel.

Finally, the last two items in the request for proposal's criteria section is the investment schedule, and the gross revenue sharing plan. These are rated at 10 points each, and need to be clearly understood by proposers. We are interested in private and public investment schedules, and also in the percentage that a developer intends to pay out of project gross revenue to the lessor.

Proposals are due on August 1, 1991. They will be reviewed and ranked by the project committee. We will be negotiating a contract with the recommended proposer at that time, and recommending that contract's approval by the Alaska Railroad board of directors, and the Municipality of Anchorage. The schedule requires approvals by year's end.

DEVELOPER CULTIVATION

MR. HAWKINS: I'm Scott Hawkins, president of the Anchorage Economic Development Corporation. First, I'd like to just run down our view of what is being offered to developers.

First and foremost is 120 acres of fully-assembled downtown/waterfront ground under a single ownership. Second is environmental protection. You'll see in the appendices to the RFP that although this has been utilized as a light industrial area in the past, the Railroad has accepted the liability for any environmental cleanup costs that may arise in the future that would have occurred prior to the developer taking control of the ground.

Third, there do exist tenants on the ground now. We understand that over time the developer will probably wish to move those tenants to other locations, but what it does provide is interim cash flow which will help defray the carrying costs of the ground in the early developmental stages. Fourth are capital improvement credits that, as investment is put in place, credits against the ground rent, which again makes the project more forgiving in the early developmental stages.

Fifth are infrastructure grants. I'd like to elaborate a little bit that the Economic Development Corporation, with the support of both the City and the Railroad, is asking the Alaska legislature to appropriate this year a sum of approximately $10 million to be used for access and tidelands fill, and to a lesser extent utilities, but I think the bottom line is that there's a very good chance that at least $10 million in infrastructure, in addition to what's already been put in place in the area, may very well be available even before the developer takes control of the ground.

The final thing that is being offered is financing potential. The Railroad, of course, has the capacity to do the tax-exempt financing. In addition to that, we do have an industrial bonding authority here in Alaska called the Alaska Industrial Development and Export Authority. AIDEA has also expressed an interest and a willingness to participate in the project. So from our point of view that's what's being offered.

In terms of the developer cultivation process, I'd like to observe a couple of things. As it currently stands, the process is wide open. Any developers that feel that they would qualify and would offer a responsive proposal are free to submit one. All proposals will be accepted. We do, however, maintain the right at some point to amend the RFP process, if necessary, to limit the number of developers that we're working with. That's an option that remains open, but as of this time and, I guess, for the foreseeable future, the process will remain wide open.

What is being offered to developers is 120 acres of fully-assembled downtown/waterfront ground under a single ownership, environmental protection, tenants on the ground, capital improvement credits, infrastructure grants and financing.

The AEDC maintains files on potential participants. Those that are interested in participating in one component of the development, but may not be interested in taking on the whole thing, may wish to be associated with other developers. We will maintain files and make those files available to other developers interested in partnership approaches. We also intend to serve as a facilitation resource, putting people, firms, and other project players, together with others to help facilitate specific proposals.

Finally, we are available, ready and willing, for questions, feedback, input, response to ideas, and any other assistance that we can provide to help make easier the process of putting together your proposal.

We're looking for final proposals August 1. Our goal as a development corporation in this

whole process is to have one or more solid responsive proposals involving substantial private investment and job creation at that time. That will give us approximately four months to put the development agreement together and have it ratified by the end of the year. The drop-dead date on this project is the end of 1991. In assembling the ground for this project, the AEDC has put together two lease option agreements which we currently hold and which we intend to assign to the successful respondent. Those lease options expire on December 31. If there is not a development agreement in place and ratified at that time, and if those lease options are not assigned to the successful respondent by that time, then we have to go back to square one. I don't know that we'd have to start the process over, but it would certainly complicate things; the commitments that we have in place now would no longer be binding commitments.

FINANCING Q&A

QUESTION: Would it be possible for us to get some further parameters or details about the tax-exempt financing? I think that's going to be a key issue for anybody involved in the process. What types of projects apply, what sort of debt and equity ratios are sought, what other qualifications in terms of the borrower might exist? Are such regulations in existence now for the tax-exempt financing that you mentioned, or are they being developed? I might want to get a little more educated on that.

MR. YETTER: Yes, we can respond to that. The regulations are not in place. We have not had to use any bonding capability to this point because our $10 million tax-exempt bank financing that the Transfer Act allows has been adequate. We haven't had to use any more than that in any particular year. The rates that we were getting through that method were as low from the banks as we could get in the bonding process, so we have not used that. However, we can put those parameters and procedures together.

We have been informed by our bond counsel that all types of development in this area can be considered. We have a very broad authority, we feel, at this time. But we'll confirm that.

MS. FLYNN: We can send them AIDEA statutes and regulations. That's all easy to put together.

We have been informed by our bond counsel that all types of development in this area can be considered. We have a very broad authority

MR. HAWKINS: I'd like to elaborate on it a little bit. This will be the first time that the Railroad's tax-exempt financing authority under the Railroad Transfer Act has been utilized. We'll be breaking new ground. For that reason there aren't any institutional parameters in place as of yet, or even any precedent, for that matter. It's pretty wide open.

MR. YETTER: Let me give you an example of why we haven't had to use anything like that until now. Right now in a 13-month period, essentially, we can do $20 million of tax-exempt financing. We can do 10 million through 12 months, and in January turn around and do another 10 million. So the Alaska Railroad Corporation has a capability right now in that short period of time to do $20 million. So we just have not had to consider other types of financing.

MS. FLYNN: On behalf of the Municipality, of course, we have port revenue bonds. We also have General Obligation bonds, some of which have been spent. It's not envisioned at this point that the available five-plus million dollars in the balance of that bonding capacity will be made available to this project, but please do understand that we have an exceptionally good bond rating. Anchorage is certainly in a position where we can do general obligation bonds, as well as directly port-related revenue bonds.

QUESTION: What do you foresee as the means of title conveyance of the land itself? Will everything in the future as far as individual projects be on long-term ground leases, or is there a possibility of fee ownership?

MR. YETTER: It basically will be a ground lease. We have the capability to have a 35-year lease with two 35-year options, so that's 105 years. We have on occasion written into a lease a first option to purchase if the Railroad was sold. But it would essentially be a ground lease.

ECONOMIC OPPORTUNITY PANEL

MR. HAWKINS: We're ready to get started with the panel discussion on the economic opportunity at Ship Creek. I'll give you a quick briefing on the Anchorage economy, what makes it tick, where it's been and some general observations about it. Then we'll move to other folks who can give you some perspective on commercial real estate, international trade, tourism and site specific information.

After me will be Chris Stephens, who is a commercial real estate broker with the Jack White Company, one of the Jack White Company's principal commercial agents. Chris has handled a large volume of sale and lease transactions and is an acknowledged expert in the commercial real estate field here in Anchorage. He's also got a banking background, is a columnist for the Anchorage Daily News, and we're happy to have him to tell you about the real estate perspective as far as where the Anchorage market is.

After Chris, we'll go to Ginna Brelsford, the Acting Director of the Alaska Office of International Trade within the State Department of Commerce and Economic Development. She will give you some perspective on the international interests in Alaska, particularly those involved with tourism-related developments of late.

Following her will be Katelyn Carrigan with the Alaska Office of International Trade. Katelyn will give you some perspective on international tourism and tourism in general. John Burns with Burns & Peterson Architects will conclude the panel presentations by giving you some perspective on the redevelopment of the Ship Creek Basin. John has been the principal architect on what development has occurred at Ship Creek so far. In fact, it's been his brain child, essentially, that launched this process to begin with.

In terms of the economic perspective, I'd like to first just make some general observations. Alaska and Anchorage in particular over the long term reflect a high-growth economy. The growth of Alaska since the early 1960's, since statehood, has averaged about triple the national average in terms of its rate of growth. It is a small economy, and it could be characterized, I guess, as a frontier type of economy. As such its rate of growth could be expected to be greater than the national average. The economic base of Anchorage is really made up of two essential things. One is natural resources, and the other is location.

The growth of Alaska since the early 1960's has averaged about triple the national average.

Under resources we have the petroleum industry, easily the largest single industry in Alaska. We have a growing minerals industry, which includes gold, as well as some of the base metals. We have some of the largest mining operations in the world under way in Alaska right now.

Of course, Alaska is easily the leading fish and seafood-producing state in the union. Fisheries is a major part of the economic base. And, finally, tourism is a large and rapidly growing component of the economy. That comprises the resources.

From the standpoint of location, many people in the world don't think of Alaska as being centrally located. They see it on the edge of maps, sometimes even down in a little box where it's not even supposed to be. But when you look at a globe, Alaska's location comes into perspective very quickly. It's because of our location vis-a-vis the Soviet Union, and vis-a-vis the Pacific Basin that Alaska has had large military bases and populations. The Army settled Anchorage in the 'teens. The military buildup before and during World War

II doubled Anchorage's population. Since the 1940s the military has been a substantial part of the economic base here because of our proximity to the Soviet Union and Pacific Asia.

More recently, private industry has recognized Alaska's unusual location as well. We have two major air cargo hubbing operations under development right now, one by the Federal Express Corporation, the other by United Parcel Service. They are taking advantage of our location as an air crossroads on the air routes. Anchorage's location within the state has made it a headquarters city.

Since the 1960s the economy would have to be characterized as historically cyclical. Now, we have had our ups and downs. Those ups and downs, however, tend to run counter to the national trend. I prepared a graph which shows the growth of Anchorage employment since 1970 compared to U. S. GNP growth. It documents that Anchorage tends to run countercyclical to the national average. What that means is that as the U. S. economy has turned down in recent months, Anchorage is entering its third year of economic recovery. We're two years into the recovery that followed our slump in the mid-1980s.

The recession was a severe one. It began in 1986, ended about the middle of 1988, or at least it stabilized in the middle of '88. The economy during that time downsized by approximately 10 percent, as measured by population and employment. As I said, the economy stabilized in late 1988 and turned the corner and began growing again in early 1989. In fact, that growth shows up as coming back fairly strong in the early months of 1989, and then when we had the Exxon Valdez tragedy in March of 1989, the oil spill cleanup impact associated with that further accelerated the recovery, at least temporarily.

Total employment here in Anchorage will reach its pre-recession peak again this year. We're almost back to our 1985 levels as of right now. The growth in our first two years of recovery has been moderate, and it continues to be moderate, and we have not really seen any actual impacts here in Anchorage of the recent situation in the Middle East. Our growth at this time is not being driven by events in the Mideast. What it has been driven by is renewed oil field activity, continued development in the mining industry, which really resurged just in the past two or three years. We're seeing some further growth in our military presence here in Anchorage as the U. S. pulls back on some of its forward commitments on the Pacific Rim. We're seeing that the Pentagon is pulling back to U. S. soil. Alaska is the beneficiary of that pullback in terms of economic impact.

In the business community in Anchorage there is a sense of optimism. There's a sense that the readjustment has taken place.

Just in the past 18 months we've seen substantial air cargo-related development as it pertains to international air cargo hubbing, sorting and customs clearance. We've also observed some light manufacturing growth as our cost structure has dropped relative to the U. S. average. Finally, it's been just continued, consistent growth in the tourism industry, military expansion and some recent growth in state government which has driven the recovery for the last couple of years.

In terms of an economic outlook for our basic industries, the outlook for private basic industry development is very bright, particularly in the tourism industry. You'll hear a little bit more about that shortly. During the 1990s our state government will be downsizing as the surplus revenue from the Prudhoe Bay oil field gradually declines during the 1990s. We will be looking for private basic economic development to fill that gap for state government and for the economy.

I'd have to say that in the business community here in Anchorage there is a sense of optimism. During the mid-1980s recession the business community was hammered fairly hard, as you can imagine in the context of a 10-percent drop in population and employment. But there's a sense now that the readjustment has taken place, the petroleum industry and some of the other basic industries are coming back, the petroleum industry in particular has adjusted to where it can develop

fields in the new lower oil price environment that we're in, and there is a sense of optimism out there.

COMMERCIAL REAL ESTATE MARKET

MR. STEPHENS: I'll give a very brief overview of the commercial market in Anchorage. During the question and answer session if you want specific information I can give it then, or perhaps at another time. But right now I want to give you a feel as to where the commercial market is now and where it's going.

The commercial real estate market in Anchorage is bigger than you might think for a city of 250,000, if you're not familiar with Anchorage. We are the commercial hub for the state of Alaska and as a result we have a larger commercial sector than a city of this size would warrant anyplace else. So our commercial market I think you'll find is perhaps more like that of a city of 350 or 400,000, perhaps, rather than the population size we have now.

Our market certainly was hurt tremendously in the crash that we experienced in 1986. I know some of you are familiar with the Anchorage market, and are aware of the downturn that we had. Paralleling the economy, we are now on a definite recovery. We have increased occupancy across the board in all areas and we're beginning to see our lease rates beginning to inch up significantly.

To give you some idea, I think in the Class A office market you would say it's probably 10 percent vacancy overall, or 10 to 12 percent vacancy. It's as low as five-percent vacancy in our midtown area, which if you're familiar with office real estate, that's a very, very low vacancy rate. In industrial, I think it's more like a 12-percent vacancy. Retail has a substantially higher vacancy right now, probably overall 18 to 20 percent, but a year ago it was 30 percent. That sector is beginning to come back also.

I'm going to talk about Class A office rates in particular. Class A rates here on the top end will run from $1.50 to $2.00. It's interesting that replacement for Class A I would say is 2.35 to 2.50, so you can see we're substantially below amortization rates at this time. Industrial rates are running between 45 and 60 cents. Industrial here is with the tenant paying their own utilities. Replacement in the industrial is probably about 85 cents. Retail strip centers are running a dollar or less. Replacement's about $1.60. The malls run around 2.50 a foot. In the malls I think vacancy is only about 10 percent.

Compared to other cities that were hurt in the crash, our market was never overbuilt to the extent that theirs were. For us to get our rates back to an amortization value, we only have to get our economy really back to where it was.

The recovery that I'm seeing is from businesses coming to Anchorage, as a matter of fact. I also see tremendous expansion in some of the cases of expanding existing business.

You'd be interested from a broker's standpoint in selling and leasing real estate that the first people to recognize our recovery was not the Alaskan. It was primarily people outside of the state. I think we were so traumatized by the downturn we didn't recognize the recovery when it started to happen. But we have had a large number of West Coast investors coming up from Seattle, California, Hawaii, and investing. They started in 1987, some of them, and in 1988. We also have some foreign investors. There's some Hong Kong money here, we've got some Canadian money coming in, and I think some others, so there have been people outside the state of Alaska recognizing opportunity coming in buying primarily developed properties at bargain basement prices. We are also beginning to see them pick up undeveloped pieces of land now.

An interesting difference that Anchorage has compared to other cities that were hurt in the crash -- for example, Denver, Dallas, Hous-

ton, Oklahoma, and so forth -- is that our market was never overbuilt to the extent that theirs were. As a result, all the buildings that we have were occupied at one time or another pretty much. So for us to get our rates back to an amortization value, we only have to get our economy really back to where it was. We don't have to go beyond where we were before. I think in those other cities that I mentioned they're going have to go a lot further to absorb the space that they have available.

I think one of the obvious keys is the availability of financing with the Ship Creek project. It's been talked about already so I'll just touch on it. As we get back to amortization value on rents and people start looking at additional development, the biggest stumbling block is going to be finance. The history of Alaska has been one of a shortage of capital, a shortage of money for development. The only time that I'm aware of that we didn't have that problem was the early 1980s. Those who participated then were hurt so badly that a lot of them say they're not going to come back.

For the Ship Creek development that means a developer should be able to come on line and take advantage of the market opportunity, while the rest of the market, because financing is not available, won't be able to come in as quickly. That's going to provide a significant advantage to whoever's here first. Ship Creek has the potential of doing that.

Also, at Ship Creek, because it's a redevelopment project, the public services are in place to a large degree in that area. In the light industrial zones in South Anchorage, those utilities are not in place. The roadways aren't in place, the power, sewer and water are not in place. So the differential in development costs will give some significant advantage to Ship Creek.

In summary, with our market recovering the timing for this project is good. Financing is a very key factor, and I think the redevelopment opportunity adds greatly to the Ship Creek potential.

INTERNATIONAL TRADE

MS. BRELSFORD: Before I get into what the international trade situation is here in Anchorage, I'd like to lay out some of the political and international trade elements of Alaska's landscape. Anybody who's going to bid on a project of the magnitude and diversity of this type of project inherently takes on a number of risks. I would like to say that I'm here today explicitly to lend the support from the State Commerce and Economic Development International Division to this specific project.

The perspective for Alaska and the international scene is nothing short of extraordinary. We have seen our state exports triple within the last three years.

Allow me to set the political stage, as I understand it. It is early in a new State of Alaska political administration. As Assemblywoman Heather Flynn mentioned, this project presents a remarkable collection of opportunities. From a state perspective there couldn't be a more exciting time to be involved in an innovative and challenging project like the Ship Creek waterfront development effort.

Governor Walter Hickel took over the governorship of Alaska this past December. You may have seen him last weekend on the Good Morning, America television show. He's been a speaker at the National Press Club in Washington, he's a familiar figure in Washington, having served as secretary of the interior under President Nixon, and the Sunday New York Times featured him two weeks ago. All this exposure tends to focus on his particular view and vision of Alaska which has a lot to do with opening it up to responsible development. A project like the Ship Creek Project fits into the new administration's view quite nicely.

Governor Hickel is carving out a strategy for development of Alaska that reflects Mr. Hawkins' previous comments concerning our strategic location. The fact that we sit halfway between Asia and Europe and the

Lower 48 places us in a very, very unique position, not only for transportation and air cargo types of development, but for international tourism. It's much easier to get on a plane and fly from Anchorage to Tokyo. You get off in five hours. Try to go from here to the Lower 48 and you're eight, 10 or 12 hours away, and lord knows how many missed planes in between. So the comfort factor alone, due to our excellent commercial airline connections and direct flights, is a significant contributing factor to Alaska's international environment.

Probably the cornerstone of Governor Hickel's vision for Alaska, and, therefore, the political climate that any respondent to this RFP would encounter at some level, has to do with the very strong commitment to something called an owner state. This is not to try to pick up where the Soviet Union's failures have left off. It's a very different perspective. It has to do with the terms of Alaska's statehood a mere 32 years ago and some very serious fiduciary responsibilities included in the executive powers of this state. It has to do with the way land is developed and our wealth is managed.

There is now an opportunity and a hospitable environment here in Alaska. Those of you who invest abroad or deal with foreign investments, know that in foreign affairs the first question you always look at besides the general economics is the political climate. What's the host environment? How many various bureaucracies and machinations am I going to have to go through on a political level that may or may not have anything to do with an economic level? Asking these questions in Alaska at this time leads one to conclude that this is the right time for investment in Alaska.

In terms of our foreign affairs, we can now see an international picture when before we limited our perspective to development to the domestic arena. Alaska's been on the forefront of setting its own foreign economic policies since the early 1960s. Sometimes Washington likes that, and sometimes they don't, but that's the way that it is.

Beginning in the 1960s we opened an office in Tokyo, Japan, 20 years before any other state developed a foreign office. It was primarily in reference to fish and fisheries, but tourism and air cargo are fast gaining on that track. In 1965, that office opened. It was followed by, 20 years later, an office opening in Seoul, Korea, and Taipei, Taiwan.

We've taken the opportunity with this project to use our foreign offices to seek foreign direct investment in the Ship Creek Project. Many offshore firms may be interested in this project. I'm pleased to report that the Anchorage Economic Development Corporation was delivered a file of over 100 potential investment firms yesterday from our Tokyo office, with more to follow from some Scandinavian contacts and other Asian entities.

Governor Hickel is carving out a strategy for development of Alaska that reflects our strategic location. We sit halfway between Asia and Europe and the Lower 48.

We've seen a notable escalation in foreign investment in the state of Alaska. Again, it's primarily in terms of fisheries, timber, tourism and mining.

I think that one of the points or themes that tends to run through a lot of our marketing efforts abroad is that Alaska is maturing. You don't start a state in 1958 and not have some startup problems, some identity problems. Now what we have is a rather sophisticated environment where people have learned to deal with foreigners, and to figure out ways to host them here, and to market ourselves abroad with a great deal of success. Seibu Corporation has purchased Alyeska Ski Resort, for example. To illustrate another point that's been brought up before, the State has exhibited a strong commitment to investing in infrastructure for the Seibu project. It's a good case study.

Seibu employs roughly 75 people full time in Alyeska, a short drive from Anchorage. Another 175 are seasonal or part time. Seibu itself invested seven million dollars in the resort, and has plans to spend an additional $50 million. I might add that the Alyeska Resort is close enough to any development that would

occur on the Ship Creek waterfront that you might see some very nice tourism tie-ins: People come in to Anchorage for the Ship Creek project, and get on a bus and go down to one of the world's greatest outdoor ski facilities. The hotel there is expected to create roughly 250 full-time, year-round jobs. Tax revenues generated by the resort were not available to us. However, we have seen a number of other advantages to the state from this area. Its presence, as I mentioned, has made Alaska a very attractive tourism destination site. The resort provides first class recreational opportunities. Hotel and tram development mean construction jobs. The expected influx of Japanese skiers means more resort employment and improved area ski facilities as well.

We've seen charter flights from both Korean Airlines and JAL, that bring literally planeloads of tourists destined for Alaska. We'd like to see that expanded to planeloads of skiers in the winter.

Alaska does have a number of investment incentives. We've got the Alaska Railroad Corporation bonding authority that you've heard about. We've got the industrial development and export authority --AIDEA-- that has been referred to, which is a publicly-held state corporation which assists in securing long-term financing at moderate interest rates.

The perspective for Alaska and the international scene is nothing short of extraordinary. Without trying to overdo it I have to acknowledge that we have seen our state exports triple within the last three years. That's a fairly phenomenal growth pattern by any measure. So it's with a great deal of interest and support that we are represented here today.

TOURISM POTENTIAL

MS. CARRIGAN: Tourism is Alaska's shining star for the future. Historically the visitor industry in Alaska has been one of the most resilient and stable sectors of the Alaska economy. From its beginnings in the late 1800s until the early 1950s, tourism grew at a slow and somewhat sporadic rate with new attractions, delivery modes, and infrastructure improvements creating irregular increases in the number of visitors to the state. As these new attractions came on line, new businesses were established, cementing tourism's place in the Alaska economic mix. By 1959, few would have predicted the extent to which tourism would color the new state's economic picture.

In 1990, 820,000 people visited Alaska. Over 50 percent of them visited the Anchorage area to enjoy the sights and activities this area has to offer.

The establishment of the state's cooperative marketing program with the private sector, and a significant increase in the level of commitment by the State of Alaska to promote Alaska as a destination in the '70s and early '80s, accelerated the growth of the industry. By the mid-'80s, tourism had become one of Alaska's three largest industries, topped only by the petroleum and fisheries industries. Worldwide Alaska's growth has paralleled tourism expansion. Advances made in transportation and communication have, in effect, shrunk the size of the world. Estimated to generate more than two trillion dollars in revenues, tourism will become the world's largest business activity by the year 2000.

In 1990, 820,000 people visited Alaska. Over 50 percent of them visited the Anchorage area to enjoy the sights and activities this area has to offer, such as Portage Glacier, Alyeska Ski Resort, and the Columbia Glacier. Anchorage is a hub for many tourism activities. Sportfishing enthusiasts use Anchorage as a jumping-off point before going to the Kenai Peninsula, or Bristol Bay to indulge in the world-class fishing opportunities there. Climbers interested in challenging Mt. McKinley, or those interested in viewing the wildlife in Denali National Park, usually start their venture in Anchorage, and Anchorage is also the gateway to Alaska for Asians who visit Fairbanks in the winter and spring to view the aurora borealis dancing in the sky.

Currently, Alaska's primary consumer market for Alaska's tourism opportunities is

the continental United States, specifically the West Coast states. Approximately 92 percent of Alaska's visitors are domestic, and statistics show this market will remain strong for years to come. The remaining eight percent of our visitors come from overseas, with Japan and German-speaking Europe delivering nearly half of the total overseas visitors. Overall in recent years, in terms of percentage growth, overseas markets have shown a larger growth trend than those domestically, and we hope that that will continue upward.

The Division of Tourism's five-year strategic plan calls for emphasis on overseas markets. In recent years, foreign currencies have risen in value, travel restrictions have been eased, and residents of economically booming countries have spent more of their income on travel, creating a frenzy of promotional and development activities by destinations throughout the world. Alaska's efforts to develop overseas markets have been focused on Japan and German-speaking Europe, with secondary markets including Australia, Korea, Taiwan, and Britain.

When discussing overseas tourism promotion, the primary problem the State of Alaska faces is the lack of international air seats on flights to Anchorage. Alaska is well-known domestically and abroad for its beauty, wildlife, vast, open space, and moderate temperatures in the summer. Direct flights can fly from Tokyo to Alaska in the same amount of time it would take for that same flight to fly from Tokyo to Hawaii, and from Alaska to Europe is actually about the same amount of time, from five to seven hours.

As mentioned, the lack of air seats is the first stumbling block, but as most economists will tell you, this problems is demand driven. If there is a demand, the seats will be allotted. The Division of Tourism is currently working with wholesalers in Japan and Korea on charter flights to Alaska. In fact, there has been a total of nine successful 747 charter flights from Korea over the past two summers, and plans are on for an additional five this upcoming summer.

The Ship Creek development project is a development in which creativity can play a major role, especially in terms of what this project can do for the tourism industry in adding another attraction to the Anchorage area. Although development projects will not be the primary force for bringing people to Anchorage, it will enhance their stay dramatically while here. Made in Alaska shops, tours of a brewery, marine viewing facilities, boat-launching access, and other ideas you may put into your plan are all attractions for visitors and locals alike. There is also a need for a new first-class hotel in Anchorage, and if added to this project, would not only enhance the project, but would keep visitors in the area of Ship Creek using the other facilities.

You might ask yourself why this opportunity is still available. The answer is that we are at a conjunction of several significant changes in the elements of the project.

In the tourism industry when you talk about development, reference is always made to the five A's of tourism success: attractions, accommodations, access, advertising, and attitude. Alaska, and getting more specific, Anchorage and the Ship Creek project, have all the makings for a successful tourism development. In terms of attitude, the mystique and wonderment of Alaska is real. The State of Alaska, the private sector within Alaska, and local convention and visitor's bureaus will continue to promote Alaska as a destination for years to come. The 1990s will be a decade of both risk and opportunity for Alaska tourism. Travel will become the world's largest business activity by the year 2000, giving Alaska the opportunity for significant tourism growth. Competition will be stiff and unparalleled, but the State will focus for the future on promoting Alaska as a destination. The State is extremely committed to that proposition.

I encourage you to join us in promoting investment in the Ship Creek development project.

PROJECT SITE OPPORTUNITY

MR. BURNS: Since I'm batting cleanup there's a number of things I'd like to touch on. As the architect planner involved with this project over the last two to three years for the Railroad, I'm gratified to see it come this far this fast. I'd like to touch on a couple of aspects that I believe are of interest to the developers here, or listening to this panel.

I would expect after the encouraging presentations that preceded me you might ask yourself why this opportunity, if it's so wonderful, is still available. The answer is that we are at a conjunction of several significant changes in the elements of the project.

A number of years ago our firm was starting to do a project here in Anchorage called the Coastal Trail. We had to deal with the federal railroad, and the federal railroad was less than interested in things like pedestrian trails, public access, and the like. Then the State bought the railroad, and we have seen a very dramatic turnaround in their interest as a member of the community, and as an owner of substantial properties throughout Alaska.

So first of all we've had an awakening of interest on the part of the Railroad. Second, at the same time we entered our economic downturn. Essentially Sleeping Beauty has come awake here in the 1990s. Our economy is up, the interest remains high on the part of the City, on the part of the Railroad, and on the part of the public, Now is the first time that all these things have come together.

There is substantial documentation of the public interest. The Municipality has funded many studies for projects such as trails, greenbelt projects, parks at Ship Creek Point, and so forth. The public has expressed its support by supporting the General Obligation bond for the original Ship Creek project, and I really can't overemphasize the comprehensive extent of the support that you would find if you came here to pursue this project.

Moving to a couple of physical items that merit attention, the area is effectively physically part of downtown. Anchorage is organized by several north-south arterials, and then has major crossing east-west collectors that organize it into the midtown-downtown segments. What we have been doing over the last several years is essentially creating this area as the northernmost flank of downtown, with the benefit of the physical attraction of Ship Creek as a boundary.

The economy is, in fact, strong, and quite substantial for a community of our size. We enjoy several aspects of being a small city, one aspect being that this particular project would become the terminus of one of four east-west bike trail systems crossing the Municipality, and is within extremely short walking distance of the majority of the downtown hotels. It's just a very accessible and desirable location.

As we have looked at this project for two years we've anticipated certain kinds of uses. Among those uses are probably a hotel for which there is documented demand; a combination of retail, destination retail, general retail for office space, and recreational opportunity both in terms of physical adult features; parks; and natural amenities for the residents of Anchorage themselves. Anchorage is clearly not overbuilt in any of the categories I've mentioned.

The availability of financing this project and its emergence from very low land value make it a tremendous opportunity economically for a developer with vision.

GENERAL Q & A

QUESTION: I've got two questions for Chris Stephens. How many full floors are available in Anchorage right now, number one. And number two, what do you anticipate the annual absorption to be for 1991 and 1992?

MR. STEPHENS: At this moment there are two full floors available in Anchorage, one in the NBA building, and one in Peterson Tower. For absorption for the next two years we're at five percent in Class A. I don't know how you can get any fuller than that, and I think in the next 12 months we're going to hit zero, and then the rates are going to respond, obviously, and depending on financing, we'll see where we go from there.

QUESTION: I would like to add my thanks for the presentation; it's very well done. And a question: are there any proposed density,

height, or other kinds of restrictions that are on the site?

MR. BURNS: I'll speak to that. We have drafted, or had drafted over 18 months ago, an outline of some covenants for the original core district. It is intended that they be considered in that district, and perhaps, as we go forward, with the balance. However, they are not finalized at this time, and we, frankly, have not presumed to finalize them, knowing that we might well have a master developer with some important thoughts for us.

There is a current height limitation that would speak to three or four stories, for several reasons. If you're familiar at all with Anchorage, our earthquake activity up here is subject to interpretation as to how severe it might be based upon the soils that you are sitting on. This area is generally a fill area. Deeply below it is some of the Bootlegger's Cove clay that is involved in the region, and, frankly, four stories is a very conservative of avoiding any special engineering for the district. Greater height could be entertained with some proper engineering.

MR. JONES: One thing that we've stressed in the request for proposal, which has the concurrence of the Municipality and the Railroad Corporation, is the establishment of site criteria, covenants, restrictions and limitations is intended to wait for the recommended development proposal. We want to know what the successful developer proposes, and then make that satisfactory to the community in whatever ways zoning and planning and engineering require. But it's key to know what people want to build, notwithstanding our natural limitations.

MR. BURNS: To perhaps bring it a little more specifically to an answer, you should be aware that the current zoning is I-2, which has few limitations, certainly, but the proposed zoning is in two districts, one waterfront related, and the other through the bulk of the district would be B-2, which is the designation in Anchorage essentially for downtown. So it opens up the possibility of some fairly reasonable densities, and I think a lot of flexibility for the suggestions that you might make.

QUESTION: In talking about the proposed zoning, does the Anchorage Economic Development Corporation have zoning authority, or is that retained by the City?

MR. JONES: That is a function of the Municipality of Anchorage. They are in the process of completing a waterfront land use task force report, which is intended to include zoning recommendations. Among those recommendations is the creation of a new mixed commercial zoning classification for this area, and that is one of the aspects which is sort of in suspended animation awaiting developer responses to the RFP.

In the absence of further questions from our telephonic participants as well as those present, we'll conclude this conference. A printed record of this conference will be supplied participants and others interested in the project. Thank you for your participation.

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CORPORATION

SHIP CREEK WATERFRONT DEVELOPMENT

PRE-PROPOSAL CONFERENCE - FEBRUARY 7, 1991- 2 P.M.

ALASKA RAILROAD CORP. CONFERENCE ROOM

Introduction - Ron Duncan, Chairman
Anchorage Economic Development Corp. Board of Directors

Alaska Railroad Corp. Perspective - Marvin J. Yetter, Vice President
Alaska Railroad Corp.

Ship Creek Project Committee Report - Anchorage Assembly Member Heather Flynn

Summary of Request for Proposal - Tyler Jones, Transportation Projects Director
Anchorage Economic Development Corp.

Developer Cultivation Process - Scott Hawkins, President
Anchorage Economic Development Corp.

Questions and comments

Economic Opportunity at Ship Creek - Panel Discussion

Scott Hawkins, moderator
Economic trends

Chris Stephens, Jack White Company
Commercial Real Estate Market

Ginna Brelsford, Director, Alaska Office of International Trade
International interests in Alaska

Katelyn Carrigan, Alaska Department of Commerce
International tourism in Alaska

John Burns, Burns & Peterson Architects
Redevelopment of the Ship Creek Basin

Questions, comments, discussion

550 West 7th Avenue • Suite 1130 • Anchorage, AK 99501 • Telephone (907) 258-3700 • FAX (907) 258-6646

Developer Cultivation Process

A. What is being offered

- 120 acres, fully assembled
- Downtown/waterfront location
- Environmental protection
- Existing tenants - interim cash flow
- Capital improvement credits
- Infrastructure grants
- Financing vehicles (ARRC & AIDEA)

B. Cultivation Process

- Process is Open; all proposals accepted
- AEDC will maintain files on potential participants
- AEDC will serve as a facilitation resource
- AEDC is available to developers for questions, feedback and input, and any other assistance we can provide.

C. Final Proposals by August 1

D. Goal Is To Have One or More Solid, Responsive Proposals Involving Substantial Private Investment and Job Creation.

Economic Trends

A. Introductory Comments

B. General Observations

- Alaska and Anchorage high growth areas
- Economic base of Anchorage: resources and location
  - Resources: petroleum, minerals, fisheries, tourism
  - Location: military, air transport, headquarters
- Economy historically cyclical
- Tends to run counter to national trend

C. Entering Third Year of Economic Recovery

- Recession was severe, oil related
- Economy downsized approximately 10% from 1986 - 1988
- Stabilized in 1988; began growing in 1989
- Oil spill clean-up accelerated recovery temporarily
- Employment should reach pre-recession peak again this year
- Growth has been moderate in pace, not influenced by mideast
- Growth has been driven by:
  - Renewed oilfield activity
  - Renewed mining activity
  - Growth in military presence
  - Air cargo development
  - Growth in tourism
  - Some light manufacturing

D. Economic Outlook

- Basic industries look bright - especially tourism
- State government to downsize
- Sense of optimism

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Anchorage Employment Growth vs. U.S. GNP Growth 1970 - 1990

Percent Change

Anchorage Employment

U.S. GNP
(in 1982 Dollars)

20
15
10
5
0
-5
-10

70 72 74 76 78 80 82 84 86 88 90

Source: AK Dept. of Labor and *Statistical Abstract of the United States.*

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Anchorage Employment
1970 - 1990

Thousands

120
100
80
60
40
20
0

70 72 74 76 78 80 82 84 86 88 90

Source: AK Dept. of Labor

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Alaska's Travel Outlook, 1990 and Beyond

Alaska Visitors Association
40th Annual Convention

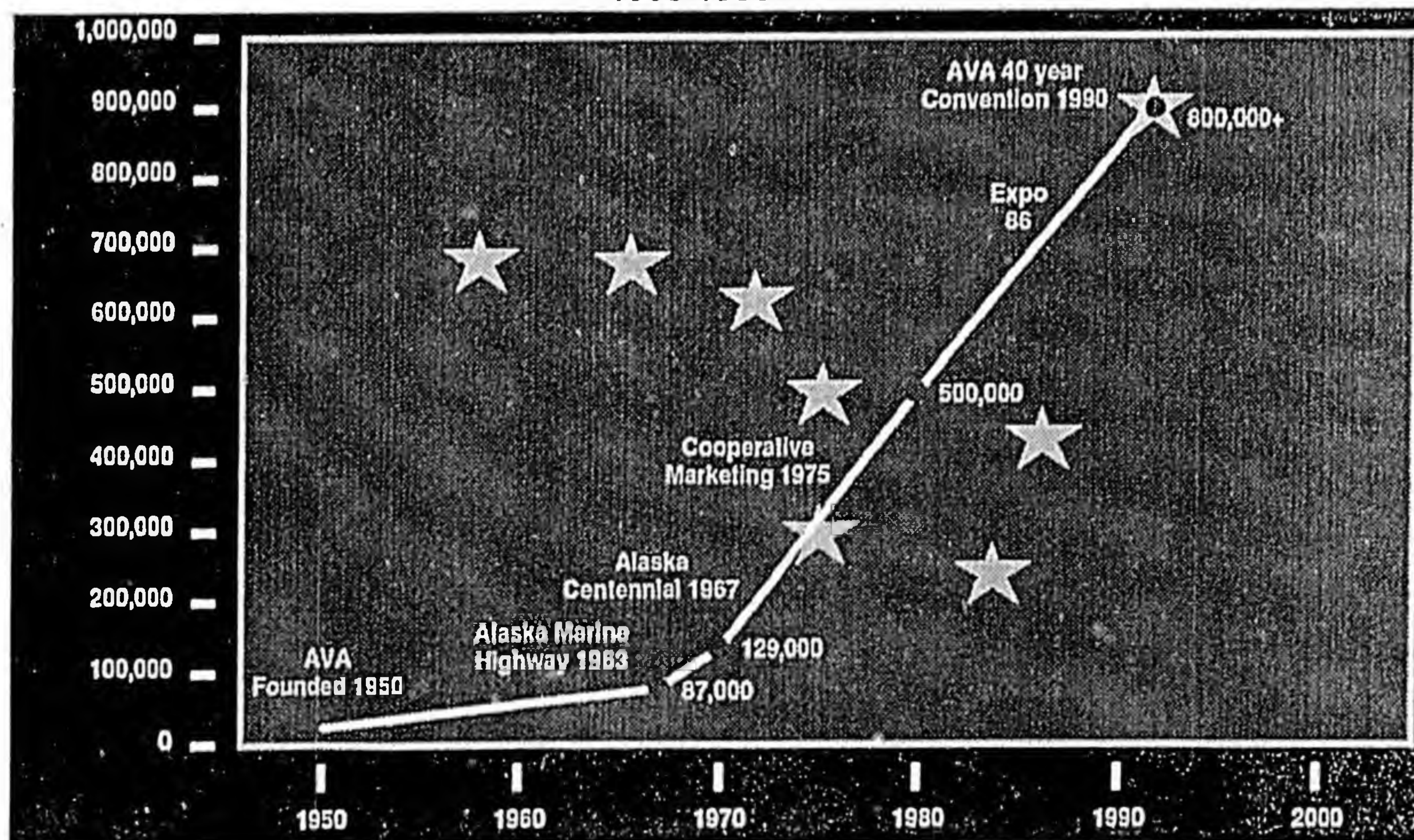
Juneau, Alaska
October 12, 1990

Presented by the

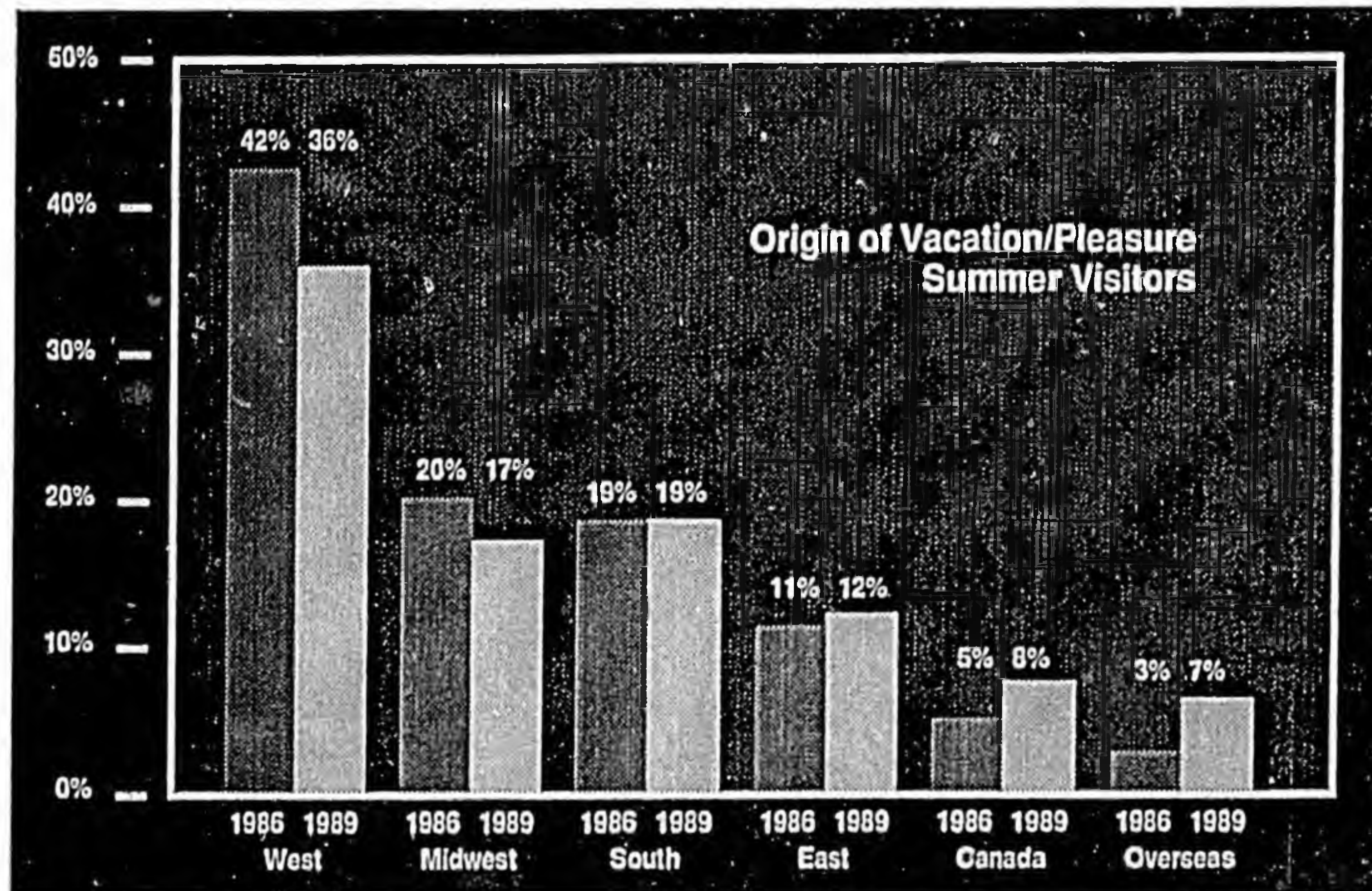
Forty Years of Progress

Alaska Visitor Growth

1950-1990



Where Are They From?



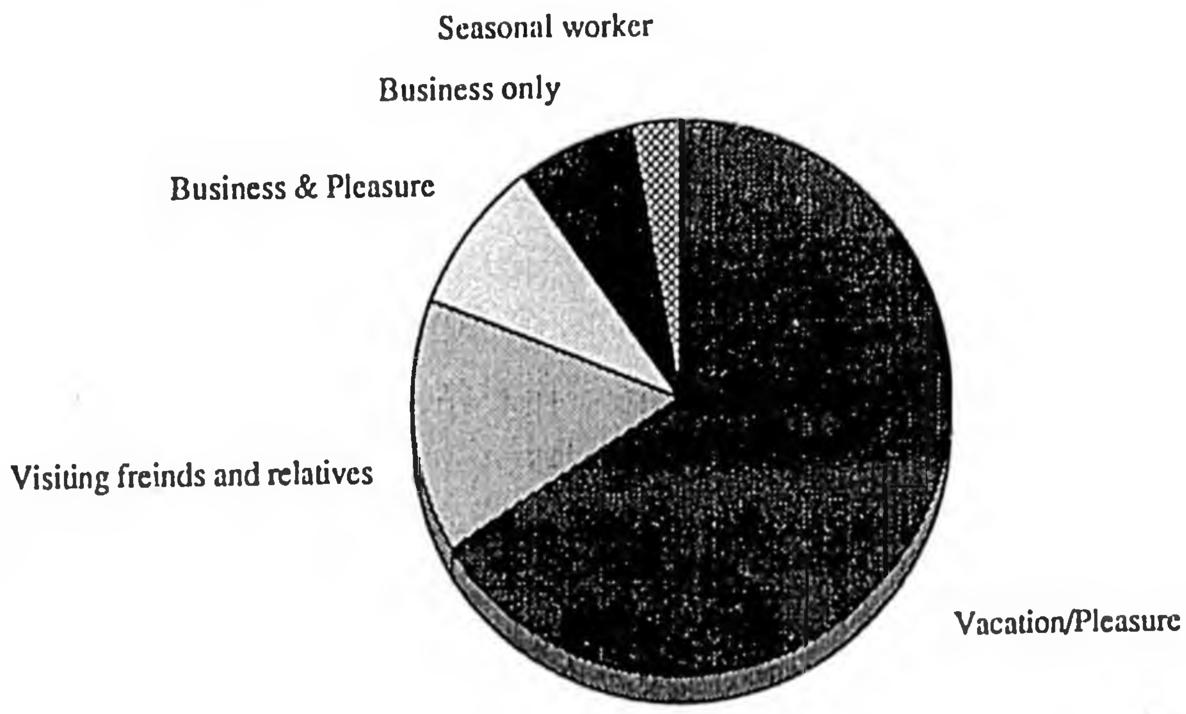
- Europeans account for over 60% of all Overseas Vacation/Pleasure visitors

Who Spends The Most Among Vacation/Pleasure Visitors?

Type of Visitor	Spending per person per trip
Average Vacation/Pleasure Visitor	$ 619
Germans/Swiss/Austrians	1,483
Other Package Tour Visitors (includes fishing)	1,459
International Air Users	1,194
Ferry Users	963
Cruise/Tour Package Visitors	944
Japanese	942
Independents buying Instate tours	867
Domestic Air Users	814
Southerners	794

Visitors to Alaska in 1990

Full Year	820,000
Summer	590,000



[Sec. 481(d)—Repealed]

Amendments

P. L. 96-471, § 2(b)(3):

Repealed Code Sec. 481(d), effective for dispositions made after October 19, 1980, in taxable years ending after that date. Prior to repeal, Code Sec. 481(d) provided:

"(d) EXCEPTION FOR CHANGE TO INSTALLMENT BASIS.—This section shall not apply to a change to which section 453 (relating to change to installment method) applies."

[Caution: Code Sec. 482, as amended by P.L. 99-514, applies to tax years beginning after 1986.]

[Sec. 482]

SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

Amendments

P.L. 99-514, § 1231(e)(1):

Act Sec. 1231(e)(1) amended Code Sec. 482 by adding at the end thereof a new sentence to read as above.

The above amendment applies to tax years beginning after December 31, 1986. However, see Act Sec. 1231(g)(2)-(4), below.

Act Sec. 1231(g)(2)-(4) provides:

(2) SPECIAL RULE FOR TRANSFER OF INTANGIBLES.—

(A) IN GENERAL.—The amendments made by subsection (e) shall apply to taxable years beginning after December 31, 1986, but only with respect to transfers after November 16, 1985, or licenses granted after such date (or before such date with respect to property not in existence or owned by the taxpayer on such date).

(B) SPECIAL RULE FOR SECTION 936.—For purposes of section 936(h)(5)(C) of the Internal Revenue Code of 1986, the amendments made by subsection (e) shall apply to taxable years beginning after December 31, 1986, without regard to when the transfer (or license) was made.

(3) SUBSECTION (f).—The amendment made by subsection (f) shall apply to taxable years beginning after December 31, 1982.

(4) TRANSITIONAL RULE.—In the case of a corporation—

(A) with respect to which an election under section 936 of the Internal Revenue Code of 1986 (relating to possessions tax credit) is in effect,

(B) which produced an end product form in Puerto Rico on or before September 3, 1982,

(C) which began manufacturing a component of such product in Puerto Rico in its taxable year beginning in 1983, and

(D) with respect to which a Puerto Rican tax exemption was granted on June 27, 1983, such corporation shall treat such component as a separate product for such taxable year for purposes of determining whether such corporation had a significant business presence in Puerto Rico with respect to such product and its income with respect to such product.

Amended 1954 Code by substituting "Secretary" for "Secretary or his delegate" each place it appeared. Effective February 1, 1977.

[Sec. 483]

SEC. 483. INTEREST ON CERTAIN DEFERRED PAYMENTS.

[Sec. 483(a)]

(a) AMOUNT CONSTITUTING INTEREST.—For purposes of this title, in the case of any payment—

(1) under any contract for the sale or exchange of any property, and

(2) to which this section applies,

there shall be treated as interest that portion of the total unstated interest under such contract which, as determined in a manner consistent with the method of computing interest under section 1272(a), is properly allocable to such payment.

[Sec. 483(b)]

(b) TOTAL UNSTATED INTEREST.—For purposes of this section, the term "total unstated interest" means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of—

(1) the sum of the payments to which this section applies which are due under the contract, over

and separate orientations on each other's organizational structure, philosophy, and procedures.

Since the training, we have successfully completed over 40 cases under the joint procedures. None have reached impasse. An unexpected benefit of the agreements is the tendency of taxpayers to cooperate with us both once they realize that the federal and state authorities are no longer stumbling over each other. In the past, failure to reach agreement often resulted in neither taxing authority being effective, with the taxpayer or third party creditors reaping the benefits. We now have effective alternatives.

Growth

Our successes have encouraged us to explore new cooperative opportunities. We resumed discussions this May on real estate redemptions and joint bankruptcy motions. These areas offer further opportunities for increasing revenues and strengthening taxpayer compliance. In closing, we wish to reiterate our belief that the keys to an enduring, productive federal-state relationship are finding common ground for mutual benefit and demonstrating a genuine interest in the other agency's success.

AUDITS USING IRC SECTION 482 APPROACH

KATHY SOMMERS
Manager, International Audit Section
California Franchise Tax Board

I think everyone will re-dily agree that §482 is one of the most difficult code sections to apply in practice. The section itself is amazingly short, containing only two sentences. The first sentence states that the Commissioner can allocate items of income and expense between commonly controlled entities to prevent evasion of tax or to clearly reflect income. The second sentence, added with the Tax Reform Act of 1986, states that the compensation received by the transferor of an intangible asset must be commensurate with the income stream generated by the intangible. This is the new so-called super royalty provision. Before discussing §482 audit concerns, it would be beneficial to consider the reason this section is needed.

Background

In any setting other than the worldwide unitary method of taxation, multinational corporations have both the incentive and the opportunity to shift income from high to low tax jurisdictions. Under the worldwide unitary method, the income of related corporations that are part of a unitary business is combined to determine the total income of the unitary corporate group. A share of this combined income is then assigned or apportioned to the taxing jurisdiction on the basis of relative levels of business activity of the combined group. Since the income attributable to the taxing jurisdiction is determined by reference to the combined income of the group, there is no opportunity for shifting of income.

The alternative to combined reporting is separate accounting. The separate accounting method determines the income of related corporations on a corporation-by-corporation basis and does not take into consideration the income of related corporations not doing business within the taxing jurisdiction. The separate accounting method allocates income among related corporations according to the "arm's-length" principle. Under this principle, the prices or charges on transactions between related parties should be the same as if the transactions occurred between unrelated parties. The opportunity to arbitrarily shift profits under the separate accounting method can be demonstrated by the following example.

Assume that a foreign company manufactures personal computers for a per unit cost of $500. The computers are then sold to the company's U.S. subsidiary for $2,000 each, which resells them in the U.S. market for $3,000 each. In this example, the parent will have earned $1,500 per unit and the subsidiary will have earned $1,000 per unit. By only changing the intercompany transfer price the parent can shift the group's profits to whichever jurisdiction it prefers. For example, if the parent charged the subsidiary $3,000 each for the computers, the foreign parent would report per unit profits of $2,500 and the subsidiary would report no profits.

For tax purposes, the intercompany transfer price can obviously have a significant impact on the overall tax liability of the group. If the U.S. can only tax the subsidiary and it pays $3,000 per unit, it has no income to tax. If the effective tax rate is significantly higher in the U.S. than it is in the foreign country, the related group's total tax liability can be reduced by the parent overcharging its subsidiary.

Section 482 and the Issues

It is this arbitrary shifting of profits that §482 is aimed at preventing. The objective of a §482 audit is to determine if the related parties have charged an "arm's-length" price, and if not, what the "correct" price should be. This is commonly referred to as transfer pricing. The IRS considers transfer pricing issues to be the most difficult audit specialty in the Service. Typically, only the most experienced agents are

selected to work on these cases. Economists, engineers, industry specialists, and other experts must also participate in the audits because of the significant amount of nontax knowledge needed to perform the detailed functional analysis vital to the determination of an appropriate transfer price. Based on discussions with international examiners (IE's), the IRS typically spends about 3,000 audit hours on a pricing case. In comparison, based on California's experience, even the most complicated unitary audits rarely take more than a 1,000 hours to complete, and typically take only 300 to 400 hours. Add on the substantial hours spent on pricing cases at the appeals and litigation levels, coupled with the often limited success in court, and it becomes clear that pricing audits represent a very speculative and resource-intensive proposition.

The five most significant transfer pricing issues relate to interest on loans, use of property, performance of services, transfers of intangible property, and transfers of tangible personal property. Audits involving interest and use of property are comparatively easy to perform. The regulations under §482 provide clear-cut methodologies or safe haven rules for resolving the pricing issue.

With respect to services and transfers of tangible and intangible personal property, the §482 regulations rely heavily on finding comparable transfer prices or transactions. In the case of services and intangibles, there is little or no guidance in the regulations for determining what the arm's-length price should be in the absence of direct comparable transactions with unrelated third parties. With respect to transfers of tangible property, the regulations set forth three detailed pricing methods, with a priority of use. These methods, which also rely on finding comparable transactions, are the comparable uncontrolled price method (CUP), the resale price method, and the cost plus method. If none of these methods can be used, the regulation calls for the use of some "other appropriate method"—the so-called "fourth method". There is no guidance in the regulations in terms of how to construct another appropriate method. In practice, the fourth method has included profit splits, rates of return, and customs valuations.

It should be noted that in spite of the rigid hierarchy of rules set forth in the regulations, the trend in the more recent §482 cases has been to use CUP whenever possible; however, if a CUP cannot be found, the courts skip over the intermediate methods and go right to the fourth method. The method favored by the courts in the more recent cases has been profit split.

Both taxpayers and the government agree that the practical problems encountered in applying the current §482 regulations are unacceptable. As a result of the growth and increasing sophistication of multinational corporations, both groups have for some time criticized the regulations as largely unworkable in the modern economic climate. The search for comparables is a complicated, resource-intensive burden. Further, comparables are difficult to find, especially in the case of unique, high-profit intangibles. The failure of the regulations to provide guidance in the absence of comparables creates unacceptable levels of uncertainty and significant administrative burdens for both taxpayers and the government. Taxpayers, the IRS, and the courts have been forced to devise ad hoc fourth methods to resolve pricing disputes.

Because of these concerns, the Tax Reform Act of 1986 amended §482 to add the commensurate-with-income standard with respect to intangibles. Congress also directed IRS to make a comprehensive study of the intercompany pricing rules and to consider whether the existing regulations under §482 needed to be modified. On October 18, 1988, Treasury issued an approximately 200-page discussion draft entitled "A Study of Intercompany Pricing" (commonly referred to as the "White Paper"). The White Paper is a generally well-considered analysis of the problems in the §482 area, and should be read by those interested in intercompany pricing issues. It proposes a new system of intercompany pricing rules, putting heavy emphasis on the role of intangibles in intercompany pricing.

Study of Intercompany Pricing

Although the White Paper is merely a discussion draft and taxpayers do not have to follow its recommendations, it is a clear indication of Treasury and IRS thinking in this area. It will undoubtedly be the basis for regulations implementing the commensurate-with-income standard. One important conclusion of the White Paper is that the IRS needs more complete and timely information from taxpayers on intercompany pricing. It recommends that taxpayers be required to document their pricing at the same time they file their returns, report their methods of pricing on their returns, and make the documentation available to IE's within a reasonable time after request. It also recommends that IRS economists and counsel become more involved in the audits and that IE's more aggressively pursue noncompliant taxpayers by making more use of the administrative summons and §982 (access to foreign documents) procedures. Some commentators have called these recommendations incredibly unreasonable and overly burdensome. It seems doubtful, however, that Treasury and IRS will back down too much in this area.

The White Paper also concludes that the commensurate-with-income standard is merely a clarification of prior law and is consistent with the arm's-length principles. Based on this conclusion, it argues that the standard should not increase the incidence of double taxation. The legislative history of the 1986 Act indicates that Congress enacted the commensurate-with income-standard because of concerns that the existing rules had not focused appropriate attention on actual profits generated by the intangible in situations where comparables do not exist. As is the case with the current pricing standards, application of the commensurate-with-

income standard will require a detailed functional analysis of the respective entities so that the income generated by the intangible can be allocated on the basis of the relative economic contributions of the related parties.

A further important conclusion reached by the White Paper is that intercompany prices may have to be periodically adjusted to reflect substantial changes in the profit attributable to the intangible, or change in the activities and risks borne by the related parties. In order to implement the commensurate-with-income standard, the White Paper suggests important changes to the existing rules of the §482 regulations. The regulations applicable to services and tangible and intangible property will probably be completely rewritten. The resale price and cost plus methods will probably be deleted, as will the rigid hierarchy of rules contained in the current regulations applicable to tangible property. The White Paper approach would coordinate the rules for services, tangible, and intangible property, recognizing that all three types of transfers are often bundled into a single economic transaction. It recommends four alternative methods, each applicable under a prescribed fact pattern. Those methods are exact comparables, inexact comparables, basic arm's-length return (generally referred to as the ballroom method), and profit split analysis. The first two methods look to an arm's-length price, while the second two methods look to an arm's-length rate of return.

The White Paper states that the ballroom method should have wide application and will probably be the appropriate method for most manufacturing affiliates and many marketing affiliates. The White Paper recommends that the exact comparable method have priority over all other methods. However, there would be no priority among the other methods although each method is designed to be used under a specific fact pattern. Therefore, the determination of which method applies would be based on the underlying facts and circumstances.

The White Paper also considers and rejects several proposed safe harbor methods, most notably several profit split approaches. While not totally rejecting the possibility that useful safe harbors could be developed, the White Paper generally concludes that no safe harbor has yet been proposed that would be useful without being subject to potential abuses. The White Paper also rejects, without much discussion or analysis, the possibility of a formula or unitary approach as opposed to the arm's-length separate accounting method.

Criticism of the White Paper

While there seems to be general acceptance that the current system has to go, there is a good deal of controversy over the White Paper recommendations. Commentators and major U.S. trading partners such as Japan, Canada, and Britain, have disagreed with the conclusion that the commensurate-with-income standard, particularly the periodic adjustment provision, is consistent with the arm's-length principle and therefore will not increase the incidence of double taxation. International acceptance of these conclusions is probably requisite to the successful adoption of the key recommendations set forth in the White Paper. Pricing cases are often resolved by negotiations between the U.S. and foreign government competent authorities. A serious potential for disputes with treaty partners over the proper allocation of income would exist if the commensurate-with-income standard were perceived as a violation of the arm's-length standard. As a result, negotiations with the major trading partners will undoubtedly be a high priority for those working on regulations implementing the commensurate-with-income standard. Obtaining a bilateral solution to this problem may seriously delay the regulations.

The proposed ballroom method has also drawn a lot of criticism. The main criticism is that ballroom is not a method, but simply another name for "contract manufacturing", the current "aggressive" IRS examination and litigation position with respect to foreign manufacturing subsidiaries. Commentators argue that contract manufacturing/ballroom relies on industry statistics, an approach which has been expressly rejected by the courts in a number of cases. Although Treasury and IRS initially seemed unmoved by this criticism, the recent tax court decision in *Bausch & Lomb* (92 TC No. 33, Dec. 45,547), which soundly rejected the IRS' contract manufacturing argument, will undoubtedly force them to be more responsive to the criticism. Although there probably are cases where ballroom is an appropriate method, it is unlikely that the method will have the wide application suggested by the White Paper. This may leave profit split analysis as the primary method for resolving pricing cases.

While on the surface it might seem that profit split would solve the major difficulties in this area, neither the White Paper analysis nor the recent court cases applying a profit split approach provide much guidance on how to determine the appropriate profit split. For example, in the *Bausch & Lomb* decision, the court rejected the testimony of the expert witnesses for both the taxpayer and the government and determined the appropriate royalty rate based on "our best judgment" that Bausch & Lomb's Irish subsidiary would have been willing to accept as little as 50 percent of the projected profits from its manufacturing activities. This "best judgment" approach was also used by the court in the *Lilly* case. As noted by the Court of Appeals in the *Lilly* decision, no unassailably precise methodology exists for determining the appropriate profit split. The court stated that "these judgments must rely largely on intuitions informed by an understanding of the business in which the affiliated companies are engaged." It is one thing for the courts to determine an appropriate profit split using "our best judgment" but it is quite another for a taxpayer or an auditor to hope to sustain their "best judgment" in the absence of any empirical data or documentation.

Noticeably missing from the White Paper analysis is any serious discussion of inbound pricing problems and issues.

In light of the well-publicized settlement of the Japanese auto company cases last year for over $600 million in U.S. taxes, this is pretty astounding. The study seems to have been overly influenced by outbound transfer pricing problems and the outcomes of the *Lilly* and *Searle* pharmaceutical cases. Indeed, the new super royalty provisions and White Paper recommendations will very likely provide foreign taxpayers with an opportunity to reduce their U.S. taxes on inbound transfers of intangibles.

Issues for States

So where does all of the above leave the states? The potential for the arbitrary shifting of income between taxing jurisdictions is obviously an important issue at the state level. Only a small handful of states still require the use of the worldwide unitary method. In California, for example, legislation passed in 1986 provides taxpayers with an election to file on a domestic only, or so-called water's-edge, basis for income years beginning on or after January 1, 1988. If it does anything, the White Paper reaffirms that pricing audits present enormous practical problems and involve very speculative and very large commitments of audit resources. It certainly offers very little encouragement in this area. Anyone who had hoped that the White Paper would solve the §482 application problems should be pretty disheartened. To a large extent the White Paper merely prescribes what has become IRS practice in pricing audits: contract manufacturing and profit split. The search for comparables, the most difficult and time-consuming part of transfer pricing examinations, was largely skimmed over by the White Paper.

Whether it is a search for a comparable price, a search for a comparable rate of return, or a search for an appropriate profit split, a detailed functional analysis—the most time-consuming and resource intensive aspect of §482 audits—is still required. As discussed above, such an analysis requires a considerable amount of expertise and nontax knowledge on the part of the auditor, coupled with the assistance of economists, engineers, and industry specialists. The federal government has experienced some difficulty in retaining and recruiting such resources. To retain this kind of expertise is even more difficult for the states, given their necessarily smaller resources and tax base.

Clearly, §482 audits represent a tremendous resource burden for the states. However, while the states will necessarily have to be highly selective in choosing potential audits, from a tax policy perspective it would be difficult to simply ignore the issue. Because of these resource problems, one imperative requirement in developing a viable international audit program at the state level is establishing a working relationship and channel of communication with the Internal Revenue Service. The states should obviously rely on the IRS international audit program as much as possible. However, while some reliance can be placed on the IRS' program to police potential pricing abuses between U.S. corporations and their foreign affiliates, from the states' perspective the federal program is limited in certain respects, specifically with regard to both the number of taxpayers subjected to a detailed examination and the applicability of the federal audit results for state purposes.

Further, even applying the results of IRS audits will not be easy. While the IRS does provide Revenue Agent's Reports to the states, such reports do not contain the kind of detail needed to make the appropriate adjustment at the state level. The international examiners' report and underlying audit workpapers will need to be obtained from the IRS. Coordination with all of the IRS regions and districts to obtain such information may be a major undertaking.

Franchise Tax Board Activities

In response to the passage of California's water's-edge legislation, the Franchise Tax Board has established an International Audit Program to plan and implement a §482 audit program. The IRS has provided invaluable assistance in establishing this program. Initially, we participated in a two-week training course on international issues conducted by the IRS. The training, although helpful, was fairly basic and was not primarily devoted to transfer pricing, the most important issue in the international program. Therefore, we requested and received advanced international issues training from the IRS. Approximately 20 to 30 of our more experienced auditors and staff counsel have attended the five-week training course provided by the IRS to new international examiners. About a dozen of these people have also attended the more advanced three-week course given to IE's after a year of on the job training. Selected auditors have also been permitted, under the information exchange program, to observe international audits in progress.

Using the IRS courses as a starting point, we are in the process of developing our own international issues training course, modified to address unique issues raised by the California legislation. We have established an Industry Specialization Program (ISP), patterned somewhat after the federal ISP. Special industry teams have been established, comprised of individuals with extensive audit knowledge and experience in designated key industries. The special industry teams will audit taxpayers in their respective industry, develop training materials, and provide assistance and training to other auditors working on cases in the industry. It is hoped that with this program we will be able to develop in-house expertise in important industries. Management also anticipates a need to recruit outside experts in this field.

We are also making a concerted effort to keep open a channel of communication with IRS to enable exchanges of information on international issues on a fairly consistent basis. For example, IRS has agreed to provide us with copies of the International Program Digests. These digests are published periodically by IRS and discuss innovative audit techniques developed by IE's, unusual issues which have

arisen during the course of field examinations, and suggestions for resolving those issues. The IRS has also provided us with a copy of a training class on financial statement analysis for international examiners developed by Prof. Wheeler, a highly regarded commentator in the international area and the government's expert accounting witness in the *Lilly* case. Using the Wheeler class as a basis, we plan on providing our staff with a class in financial statement analysis.

Because of the invaluable assistance the IRS has provided us, we make a concerted effort to find ways to assist their compliance efforts. We have on occasion, for example, provided agents in the Western Region with access to copies of state returns in instances where they were having difficulty obtaining the federal return from the service center. On a quarterly basis, we also provide magnetic tape data to the Western Region on foreign incorporated taxpayer filings in the state. Finally, although it is difficult at this point to assess how large our International Audit Program will become, we do anticipate conducting some transfer pricing audits with respect to tangible and intangible goods. From California's perspective, relying solely on the federal government to police this area is simply not a viable option in light of the fiscal implications of transfer pricing abuses.

In conclusion, we believe it is possible, with the assistance of IRS, for a state to develop a meaningful international audit program. Only time will tell how successful California's efforts have been.

WHAT CONSTITUTES INCOME DERIVED FROM WITHIN A STATE FOR PERSONAL INCOME TAX PURPOSES?

JAMES W. BRUCE
Assistant Chief Counsel
Pennsylvania Department of Revenue

Introduction

During my flight to Portland, I nodded off and had a dream. I dreamt that all of the states I was flying over were going to assess me for their fair share of my income. As I look over this group, I have to assume you are here either because you also have had this frightful nightmare or because you are a tax administrator from one of these states. For those of you who are here for reassurances, I will give you what I can.

First, the bad news. The Supreme Court in its 1920 *Shaffer v. Carter* decision made it clear that a state may impose an income tax on "incomes accruing to nonresidents from their property or business within the state or their occupations carried on therein" and thus subject a nonresident to a duty to pay taxes *to the extent of* his property held or his occupation of business carried on therein.

The good news is that a state's right to tax nonresidents is limited in extent. Of course, both taxpayers and revenuers have been trying to find a yardstick to measure property, occupation, and business "extents" for 69 years.

Related Matters

Nexus Arising from Residency. First, before we start trying out our yardsticks, let me step back. Again, according to the U.S. Supreme Court, a state has authority to impose a tax on an individual that is apportioned to the ability of the individual to bear it when the economic interest realized bears a direct legal relationship to protection afforded to the recipient of the income by the state in his person, in his right to receive the income, and enjoyment of it when received.

By definition, that economic interest and that protection are each incident and attendant to the other if you are dealing with a domiciliary. Thus, you do not need a property yardstick, business yardstick, or occupation yardstick if you are dealing with a domiciliary.

The Supreme Court was not suggesting, however, that domicile is a necessary condition of a state's authority to tax an individual on income from intangibles and property and income-producing activity outside that state. It suggests only that the individual's connection with that state must show that the economic interest of that individual realized by the receipt of income or represented by the power to control or enjoy that income must bear a direct legal relationship to the protection afforded to the recipient of the income by the state, in his person, in his right to receive the income, and in his enjoyment of it when received.

In applying these abstract concepts to particular individuals, every state has struggled to define exactly what evidence is primary, fundamental, and determines "residence." The results are not pretty. Because each state has its own rules and interpretations, taxpayers end up being either a resident of more than one state or a resident of none or somewhere in between. Reciprocal agreements and tax credits help—in masking the symptoms if nothing else. Probably no perfect solution exists but achieving some degree of uniformity between the states would be a good start.

Estates, Trusts and Beneficiaries. Every trust and estate seems to have earnings comprised primarily of interest, dividends, and gains derived from intangible personal prop-

Tax Havens and Their Use By United States Taxpayers - An Overview

A report to the
Commissioner of Internal Revenue
the
Assistant Attorney General (Tax Division)
and the
Assistant Secretary of the Treasury (Tax Policy)

Submitted by:
Richard A. Gordon
Special Counsel for
International Taxation

January 12, 1981

Publication 1150 (4-81)

Fraudulent use has also included forming sales companies that are structured to appear to deal only with unrelated parties but that in fact are dealing with related parties, forming corporations to appear to be banks, hiding the fact of ownership of tax haven corporations, the use of a Cayman Islands corporation by a United States person to hide corporate receipts and corporate slush funds.

Tax havens may be used to commit crimes that violate tax as well as other laws. The most serious fraudulent use of this kind is by narcotics traffickers to accumulate or launder large sums. Often phony shelter schemes violate securities as well as tax laws. Shell banks established in St. Vincent have been used to defraud United States banks and other businesses.

The provisions of the tax law that apply to international transactions in general and to tax haven transactions in particular are among the most complex in the Internal Revenue Code. The two most important provisions affecting tax haven transactions are subpart F, which taxes United States shareholders of a United States controlled foreign corporation on certain categories of income, and section 482, which authorizes the Commissioner to reallocate income among related entities to properly reflect their income. Both of these provisions are primarily transactional in nature, that is, each separate transaction must be analyzed to determine its tax effect. Also, the foreign personal holding company provisions and the foreign trust provisions may apply.

The proper administration of subpart F and §482 often requires IRS access to detailed books and records which are not always available. The complexity coupled with information gathering problems makes the law in this area extremely difficult to administer.

Income tax treaties with tax havens are often used by residents of nontreaty countries to achieve a reduction in United States tax. The United States has a large and growing network of income tax treaties mostly with other high tax countries, but about 16 treaties are with tax havens. Many of the tax haven treaties are the result of the extension of the old United States-United Kingdom treaty to former United Kingdom colonies. The treaty with the Netherlands Antilles is in force as a result of the extension of the United States-Netherlands income tax treaty. United States treaties with Luxembourg, the Netherlands and Switzerland were independently negoiated.

There is significant use of tax haven treaties for investment in the United States. In 1978, 43 percent of the gross income paid to all nonresidents of the United States was paid to claimed residents of tax havens. Forty-six

Multistate Tax Commission

RESOLUTION URGING THE FEDERAL GOVERNMENT TO ADDRESS THE TRANSFER PRICING ISSUE

WHEREAS, in 1983 the federal government established a Worldwide Unitary Taxation Working Group, whose members consisted of representatives of multinational businesses, the states and the federal government to develop voluntary, cooperative solutions to disputes concerning state use of the worldwide unitary combination apportionment method of determining the taxable income of multinational corporations; and

WHEREAS, in an effort to resolve the controversy over the use of the arm's length method versus the worldwide unitary method of accounting, the state members of the working group agreed to support "water's edge" unitary combination if certain conditions were fulfilled, including specific improvements in federal tax compliance and cooperation with the states; and

WHEREAS, the majority of states previously employing the worldwide method of accounting have implemented water's edge combination methods; and

WHEREAS, the federal government has not fulfilled the commitments it made in the worldwide working group for improving federal tax administration in the transfer pricing area and for increasing cooperation and support for the states; and

WHEREAS, recent hearings by a House Ways and Means Subcommittee chaired by Rep. J.J. Pickle revealed that the federal government may be losing up to $50 billion annually in revenue due to uncorrected transfer pricing abuses; and

WHEREAS, the estimate of federal revenue losses attributable to transfer pricing abuses does not include the state revenue losses that result from the same abuses; and

WHEREAS, the states are largely dependent on the federal government to correct these transfer pricing abuses and to determine the proper share of the income of multinational corporations to be assigned to the United States; and

NOW THEREFORE BE IT RESOLVED, that the Multistate Tax Commission respectfully urges Congress, the Department of the Treasury, and the Internal Revenue Service to address effectively the problem of substantial under reporting of income earned in the United States by multinational corporations, and

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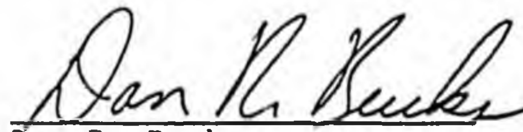
BE IT FURTHER RESOLVED, that the Multistate Tax Commission respectfully urges the federal government to fulfill the commitments it made in the Report of the Worldwide Unitary Taxation Working Group to increased federal compliance efforts and assistance to the states with respect to correcting transfer pricing abuses, and

BE IT FURTHER RESOLVED, that the Multistate Tax Commission requests the Executive Committee to review the federal response to evidence of widespread transfer pricing abuses, to communicate to all appropriate federal officials the interests and concerns of the states concerning these problems, and to recommend such further measures as it deems appropriate to resolve these issues.

Adopted this 31st day of August, 1990, by the Multistate Tax Commission.

Attest: 
Dan R. Bucks
Executive Director

Legislative Update
Hearings On Transfer Pricing
By The
House Ways And Means Oversight Subcommittee

July 10 & 12, 1990

EXECUTIVE SUMMARY

The House Ways and Means Oversight Subcommittee held two days of hearings on the problem of federal income tax avoidance due to transfer pricing by foreign-controlled U.S. subsidiaries. The hearing focused in three areas: 1) defining the extent of the problem of underpayment under Code Section 482; 2) solutions to non-compliance with strong emphasis on the need for more resources for the IRS; and 3) non-compliance creating competitiveness problems between U.S.-controlled and foreign-controlled U.S. subsidiaries.

These subsidiaries pay inflated prices for goods purchased from overseas parents as a means of reducing their taxable profit. The Oversight Subcommittee just completed a nine month investigation of 36 foreign-controlled companies in the automobile, motorcycle and electronics equipment industries to study underpayment of federal taxes. The results of the investigation found that over half of the 36 companies investigated paid little or no federal income tax. These same companies had more than $35 billion in retail sales in the U.S. in 1986. Potential underpayment by foreign-controlled U.S. companies is estimated to run as high as $50 billion.

It is interesting to note there was little discussion of the need to look at alternative methods to the arm's-length standard. The IRS is committed to the use of the arm's-length standard to enforce Section 482. However, one former IRS employee testified that arm's-length would never work even with adequate funding and information.

LEGISLATIVE UPDATE
HEARINGS ON TRANSFER PRICING
BY THE
HOUSE WAYS AND MEANS OVERSIGHT SUBCOMMITTEE

July 10 & 12, 1990

Background:

Representative J.J. Pickle (D,TX), chairman of the Oversight Subcommittee of the House Ways and Means Committee conducted two days of hearings on the problem of non-compliance with Code Section 482 by U.S. subsidiaries of foreign-controlled companies. Briefly, Section 482 gives the IRS the authority to distribute, apportion, or allocate gross income, deductions, credits, or allowances between related entities in order to prevent tax evasion. Section 482 is intended to prevent the artificial transfer of taxable income (such as transfer pricing) to foreign affiliates outside the U.S. The IRS uses the arm's length standard to measure compliance.

The Hearings:

The hearings focused on the problem of transfer pricing practices used by some foreign-controlled U.S. companies. These U.S. subsidiaries pay inflated prices for goods purchased from overseas parents as a means of reducing their taxable profit. The Oversight Subcommittee just completed a 9 month investigation of 36 foreign-owned companies in the automobile, motorcycle and electronics equipment industries to study underpayment of U.S. income taxes.

The results of the investigation found that over half of the 36 companies investigated paid little or no federal tax. These same companies had more than $35 billion in retail sales in the U.S. in 1986. Potential underpayment by foreign-controlled U.S. companies is estimated to run as high as $50 billion.

Witnesses:

Witnesses from the Treasury Department and the IRS dominated the two day hearing. Those witnesses included: IRS Commissioner Fred Goldberg; Ken Gideon, Assistant Secretary of the Treasury for Tax Policy; other high level IRS officials, IRS field agents, and former IRS Commissioners Lawrence Gibbs and Roscoe Egger. Other witnesses included Stuart Brown, Deputy Chief of Staff for the Joint Committee on Taxation; Michael Lane, Deputy Commissioner,

U.S. Customs Service; Barbara McLennan, Deputy Assistant Secretary, International Trade Administration; Frank Sailer Deputy Assistant Secretary, International Trade Administration; Michael Granfield, Associate Vice-Chancellor, UCLA; and James Wheeler, Professor of Accounting, University of Michigan. Several members of Congress testified including Senator Jesse Helms (R,NC), House Majority Leader Richard Gephardt (D,MO), and Representatives David Bonior (D,MI) and Duncan Hunter (R,CA).

Testimony:

IRS Commissioner Fred T. Goldberg, Jr. was the dominant witness on the first day of the hearing. His testimony, aided by numerous graphs and tables requested by the subcommittee, established that in 1987 U.S.-controlled domestic corporations reported net income (less deficit) as a percentage of total receipts of 3.1 percent, while foreign-controlled domestic corporations had a 0.9 percent net income as a percentage of total receipts for the same period.

Goldberg repeatedly asserted that the aggregate data did not conclusively establish a pattern of wide-spread abuse by foreign companies of the arm's-length pricing standard under Section 482. He stated that the figures might be skewed by a disproportionate number of start-up companies which typically do not show a net profit. Rep. Pickle reminded the Commissioner that all of the 36 companies investigated were well-established corporations.

Goldberg's testimony highlighted four main areas of concern:

1. The IRS budget must be increased to allow expanded enforcement efforts;

2. Congress should allow the IRS to directly obtain independent experts without the burdensome authorization requirements currently imposed on the Service;

3. Pending legislation (H.R. 4308) should be passed to further assist the IRS in obtaining taxpayer information; and

4. Locality-based pay (pay scales tailored to the cost of living in a particular location) should be implemented as a means to recruit and retain qualified personnel.

The remainder of the first day of testimony raised many of the same issues addressed by Commissioner Goldberg. Stuart Brown, Deputy Chief of Staff of the Joint Committee on Taxation, frequently referenced a pamphlet issued by the JCT for the

hearings.[1] The pamphlet briefly addresses formulary apportionment as an alternative to the arm's-length standard. While the unitary or formulary approach is described in the publication as one which, "...having certain disadvantages of its own, avoids numerous allocation problems of present law", both the Treasury Department and the OECD (Organization for Economic Co-operational Development) are quoted in the document, dismissing this alternative because it is "necessarily arbitrary" and disregards market conditions. Aside from this written report, none of the witnesses at the hearings raised the issue of formulary apportionment or world-wide combination as an alternative to the arm's-length standard.

The conclusion of nearly every witness was that Section 482 will work if the IRS is able to obtain the necessary information from the taxpayer. Various obstacles to gathering the information were described. In most instances, the records or documents sought by the international examiner were exclusively controlled by the foreign company which either flatly refuted IRS authority to review the documents, or which employed various tactics to indefinitely delay the examiner from receiving the information. Even when the records and documents were obtained, IRS representatives testified that the information was frequently written in a foreign language and had to be translated. In several cases the companies utilized foreign accounting methods which could not be reconciled with generally accepted accounting principles.

The IRS representatives maintained that these problems are the primary impediment to a successful implementation of Section 482. In addition, the Service is handicapped by a lack of funds from competing with taxpayer representatives, such as the "Big Six" accounting firms, in retaining top-flight economic and legal experts to assist in the development and prosecution of the cases.

However, a former IRS examiner testified that in her experience, obtaining the information was not only extremely difficult, but of almost no assistance in determining what the arm's-length price of a transaction should be. She stated that the arm's-length standard exists in a world of "smoke and mirrors" where no one knows what the phrase means and that market place assumptions clearly do not work where the market place is controlled. She indicated that in one situation the only value of the information gathered was that it "froze" the facts for litigation purposes, but it did not tell her what the arm's-length price should be. She also testified that IRS managers are often more concerned with closing cases than with raising or resolving difficult issues such as transfer pricing. It was the "lack of consistency and integrity" in administering Section 482 that contributed to her decision to leave the IRS.

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[1]Joint Committee on Taxation, Present Law and Certain Issues Relating to Transfer Pricing (Code sec. 482) (JCS-22-90), June 28, 1990.

The first day of testimony concluded with Michael H. Lane, Deputy Commissioner, U.S. Customs Service, reporting on the Service's enforcement program, Operation RAP (Rebate and Adjustment Program). This operation targeted foreign corporations suspected of overstating the cost of insurance and freight which are "nondutiable" charges. The Customs Service faces many of the same difficulties as the IRS in determining what constitutes an arm's-length transaction between related companies in the area of import duties.

Ken Gideon, Assistant Treasury Secretary for Tax Policy was the key witness at Thursday's hearing. Mr. Gideon disagreed that transfer pricing is widespread among foreign-controlled U.S. companies. He suggested that other factors may account for low profitability including start-up expenses and the skill of management. At one point, Rep. McGrath (R,NY) asked Mr. Gideon if the arm's-length method is working. Gideon ducked the question by saying if the IRS had the data, arm's-length would work. He also suggested that taking action away from arm's-length enforcement could encourage U.S. investment abroad as well as invite foreign retaliation.

House Majority Leader Richard Gephardt's testimony focused on the competitiveness issue created when foreign-controlled corporations do not pay their fair share of federal income taxes. He has introduced H.R. 4308, the Foreign Tax Equity Act, which would enhance the ability of the IRS to investigate tax returns of foreign-controlled U.S. subsidiaries, extend reporting requirements for open tax years, and extend the statute of limitations for up to 6 years. Rep. David Bonior (D,MI), a cosponsor of H.R. 4308, provided similar testimony.

The hearing closed with a panel of witnesses including James Wheeler, accounting professor from the University of Michigan, who suggested that a new alternative minimum tax (AMT) could be a solution. Michael Granfield, Vice-Chancellor, UCLA, supported establishing a "Blue Ribbon" panel to review the whole Section 482 area. Chairman Pickle also supported the idea of establishing some type of commission or working group to study the problems associated with Section 482.

Prepared by:

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Multistate Tax Commission

REVIEW

Former Treasury Insider Debunks Claims that an International Arm's-Length Norm Exists

by Eugene F. Corrigan
General Counsel, MTC

The U.S. Treasury Department and many multinational corporations have long insisted that the arm's-length method of attributing income on a geographical basis is the normal internationally recognized method and that it works well. This country's state tax administrators have disputed such claims and have received support from IRS career staff personnel who must deal with the problems to which the arm's length method must theoretically be addressed; but such personnel cannot come forth and publicly oppose the position of their superiors in Treasury.

Solomon himself would have great difficulty in making sense out of, and trying to live with, the variety of tax systems and tax practices to which international businesses must submit around the world and within this country. On the other hand, the legitimacy of concern over such difficulties should not blind one to the facts concerning either American or foreign tax practices.

That the arm's-length method does not work well can be established by anyone who takes the time to discuss it with IRS auditors. Absent such diligence, a mere review of the manner in which the method is supposed to be applied should make transparently clear the fact that the procedure *cannot* work, as indeed it *does not*. (See the series of three McCray articles on the subject starting in the November issue of the MTC *Review*, continuing in the February issue, and concluding in this issue.) IRS staff auditors, a 1972 Conference Board study, a 1973 Treasury study, a 1976 article in the Harvard Law Review, a 1980 *Journal of Taxation* article, and a 1981 GAO report have all confirmed the fact that IRS auditors must, and do, utilize formulary apportionment to accomplish results which they cannot reach by means of arm's-length adjustments alone.

Now comes new and unanticipated support for unitary apportionment from a former attorney in the Office of International Tax Counsel of the Treasury Department. Stanley Langbein served in that capacity from 1978 to 1980. In the February 17, 1986 issue of *Tax Notes*, he reviews the history of the development of what he calls the "radical" arm's-length method, analyzes the manner in which the federal government applies it, concludes that it is unworkable both theoretically and practically, demonstrates that the arm's-length method is not the international norm, maintains that unitary apportionment represents the true norm in most instances, and advocates both governmental and business support for unitary apportionment as the most widely-used, most effective and most practical means of attributing income on a geographical basis. Indeed, he recommends that the federal government itself adopt that regime. His article is entitled "The Unitary Method and the Myth of Arm's Length."

He thinks that, where comparable uncontrolled prices (CUPs) are available, they should take primacy in income calculations; but that, since they are

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available and useful in only an extremely limited number of instances and primarily with respect to intermediate product transactions, the unitary method must remain available. He believes that the states would greatly strengthen their hand if they would amend their statutes to allow a taxpayer to make a CUP election to determine income on the basis of such transactions. This would ensure fairness to the taxpayer under those circumstances in which unitary apportionment might really produce an unfair result; but the limited number of such circumstances would protect the states against what he calls "the evisceration of the revenue base" which, he says, characterizes the separate enterprise arm's-length system.

Langbein attributes the popularity of the arm's length method with the multinationals to the fact that it establishes a presumption of correctness on the part of a return as filed and places upon the government the burden of establishing otherwise, a burden which is heavy since the taxpayer itself initially is the sole possessor of pertinent materials and information. On the other hand, he says that the unitary method places upon the taxpayer the burden of establishing that the unitary results are unfair and unreasonable. He believes that the burden is properly placed in the latter instance except under those circumstances in which it is appropriate to give precedence to comparable uncontrolled prices.

Langbein contends that, in the mid-1960s, Treasury first began its efforts to foist upon the world a "radical" arm's-length system which has not worked, and that Treasury and the multinational business community are now falsely claiming that that system is the international norm. Treasury thus fell into the trap of quoting itself as proof for its assertions. While such over-statement may have been understandable as part of its efforts to establish *some* norm, its effect has been to box Treasury into an unfortunate position; a position in which Treasury finds itself unable to admit, as a matter of theory, to a practice in which its staff engages on a regular basis. Langbein concludes that a true international norm would give primacy to CUP's in those few instances in which they are pertinent and available, and would then rely on the unitary system of formulary, or fractional, apportionment in nearly all remaining matters. He contends that this would not only be theoretically respectable but would accurately reflect current international and federal practice.

He also states flatly that pending federal legislation aimed at prohibiting the states from using the worldwide unitary method "should be shelved." (Hearings on that legislation, S. 1974, are expected in May.) He maintains that British retaliation against U.S. firms, because of continued use of the method by the states, would constitute a clear violation by the British of the U.S.-U.K. double taxation convention. And he says that it would be appropriate for the U.S. to retaliate against such retaliatory measures by enacting the Symms-Baucus Bill (S. 1845).

Excerpts from Article by Stanley I. Langbein

In a long and complex review of the history of the development of the arm's-length method, Stanley Langbein's *Tax Notes* article sets forth a series of perceptive observations, statements of historical fact, knowledgeable opinions, and constructive recommendations. The following are some of its highlights:

1. "I believe that the [arm's length] method is unsound in theory. . . [and] has problems, perhaps fatal problems in practice."

2. No definable or enforceable arm's-length standard exists as an international norm. "Therefore, I do not believe [that] the state unitary systems offend any international norm." (p. 642)

3. The U.S. "first embraced and then promoted a radical arm's-length notion" in the form of the arm's-length method. (p. 643)

4. The section 482 regulations provide for the "radical comminution of shared factor relationships" under which "different components of an integrated enterprise share a factor of production. . . in connection with the several functions of the components." (p. 645)

5. Even when Assistant Treasury Secretary Surrey first sought to internationalize the radical arm's-length regime twenty years ago, he was proposing it as an alternative to a regime which was "void of rules. . . . What he attacked was not formulary systems, but the fiscal 'no man's land' which the area at that time constituted." The internationalization effort "was not conceived as an attack on formulary methods, or as involving real contradistinction between separate-enterprise and formulary-unitary rules. . . [Professor Surrey] never used the 'arm's length' system as a stick to beat 'formulary' systems. . ." (p. 647)

6. Treasury spokesmen seeking to internationalize the arm's-length method in the 60s "tended quite typically to speak in tones which created the impression that (1) 'arm's length' was the standard adopted 'everywhere'; and (2) that the categories and provisions of the American system constituted something of a science, that they related almost to a naturally occurring set of phenomena, which had to be deeply studied to be understood. Both of these impressions, of course, embodied substantial untruths." (p. 648)

7. "The 'new' [1965] section 482 regulations were an experiment, which involved certain radical departures from prior theory and practice. It was immediately obvious to their sponsors that they could not work, under existing legal authority, without international cooperation. So those sponsors sought to export, to internationalize the standard. In undertaking this, they embraced a rhetorical device, assimilating the standard they sought to impose to a generally defined standard; and, by dint of shadings and generalizations, assimilating other, different approaches utilized elsewhere to the same general definition. This accomplished, they then sought to transform the general definition into their particular system, and thus to persuade the international community that conformance to the general definition required basic conformity to their particular system. . . But the only concrete achievement has been the adoption of the system, administratively but explicitly, by one foreign country, and a series of hortatory, general agreements among administrators to principles based on the system. That does not establish any international norms. . ."

"In short, the international norm is what it ever was: the use of comparable prices when they are available, and some blend of intuitive, informal ad hoc methods when they are not—primarily an examination of the reasonableness of the profit of the component in question, or a fractional division of the integrated entity's profit." (p. 653)

8. The lack of comparable uncontrolled prices "drives any arbiter of the matter—an examining agent, or, in the litigation context, the judge—to abandon the rules of law directing use of the single component method and to seek a method which justifies a definite assignment of the entirety of the combined income. Most often this is a fractional [formulary apportionment] method." (p. 654)

9. "When the single component methods are abandoned, as to make sense of the system they must be, there is nowhere to go but back to fractional methods. This means that arm's length, defined as an antithesis of fractional apportionment, not only is not a norm. It is not even meaningfully a concept." (p. 655)

10. The 1981 GAO report "expressly suggested, as one of its major conclusions, that the Treasury seriously consider adopting a unitary method along the lines of the state systems by amendment to the regulations under section 481." (p. 657)

11. Among the major objections to the section 482 regime are: (1) that it creates uncertainty. . .; (2) that it creates great administrative and litigation burdens. . .; (3) that it creates the potential for overtaxation (double taxation). . .; (4) that it creates the potential for undertaxation (double nontaxation). . .; and (5). . .that it establishes a legal regime with nominal laws which are not enforced. . . ." (p. 657)

12. "[T]he tendency to generate skewed results is inherent in the underlying idea of a 'separate enterprise' or 'arm's length' system. The Tax Director of International Business Machines has recently stated in these [*Tax Notes*] pages that 'economic reality is arrived at' by recognizing 'the fact that companies consist of separate profit centers which are separately managed.' But the 'arm's length' and 'separate enterprise' approaches do not ask how the prudent business manager allocates profits among divisions, subsidiaries, components; the manager does not necessarily construct hypothetical market transactions. To cast the rules on how a manager would divide profits uses a *separate accounting* method, but not a separate enterprise standard; it is rather a *unitary* method which uses separate accounting." (p. 663)

13. "[T]he undertaxation potential of a 'separate enterprise' standard, dependent as it necessarily is upon 'single component' methods, is simply too great for any set of administrative or international rules to counteract. The logic of the system, and the rules [that] that logic generates, appears to mandate undertaxation, and that inevitably generates tax minimizing opportunities for businesses which their managers in many circumstances will not be able responsibly to decline to take." (p. 665)

14. "I do not think [that] the longstanding antipathy of the international business community to fractional methods, even if those methods increase taxes in the short run, and expose the businesses to additional international information reporting, is altogether wise." (p. 666)

15. "In sum, I believe [that] the difficulties [that] the United States 'arm's length' system has encountered are not failures of implementation, but grow out of an inherent conceptual defect in the 'separate enterprise' standard. That standard implies the use of 'single component methods,' which in turn generate the 'continuum price problem.' This sets the system oscillating back and forth between multiple taxation and base evisceration, and makes uncertainty, administrative burdens, and a world of rules without clear application inevitable. The salvation of the system is the resurrection of a fractional approach." (p. 666)

16. "[W]here there are not comparable transactions—a method must be sought which is fair, but which will not attempt the pointless task of localizing the nonlocalizable factor, to which by inference is attributable a major portion of the earnings of the entire enterprise. Fractional methods. . .fill this bill." (p. 670)

17. "[T]he method of using comparable prices, when demonstrably available, and fractional methods, otherwise, is the true, descriptive, prescriptive, and theoretically desirable *substantive* international norm. . ." [The international norm is] "formulary apportionment, because of the

predominance of formulary features, invariably as expense allocation measures and because, given that comparable prices are ordinarily available in only a trivial range of cases, its status as a backup method does not mean that it is other than the method most frequently used." (p. 670)

18. "[T]he unitary system is very close to the true international norm. In substance it differs only in not starting with comparable uncontrolled prices. But comparable uncontrolled prices exist in only a trivial range of cases anyway. . . so this deviation should as a practical matter not be of great concern." (p. 670)

19. A basis for major corporate concern is the fact that "the application of the fractional system. . .constitutes a reporting *obligation* and constitutes a basis for *compulsory information disclosure*. . . [and that the] unitary method. . .sets forth determinate, universally applicable criteria which leave little [room] for conjecture, or manipulation." (p. 670)

20. The separate enterprise standard even when backed up by the franctional standard, as in the case of the "fourth method" used so widely in applying section 482 arm's-length adjustments, is preferable to the multinationals because it lets the taxpayer "report on the basis of single component methods without penalty, and thus place on the audit and litigation process the entire burden of avoiding wholesale base evisceration." (p. 670)

21. "[T]he arm's length system is a formula for undertaxation of international income. . . [and there exists] the suspicion that the concomitant of 'separate enterprise' is massive worldwide base evisceration. . ." (p. 671)

22. "[T]he state unitary methods. . . simply offend no norm." (p. 671)

23. "[F]ormulary methods are inevitably used, whatever the *nominem* given the overall system—fractional methods are the real, rather than the nominal, norm." (p. 671)

24. The states would greatly strengthen their hand if they would "amend their statutes to provide a 'CUP election' to taxpayers. . .to determine income on the basis of comparable uncontrolled transactions on *intermediate product transactions* only." Made available under a strict standard of comparability such as that nominally used by the federal system so that the use of third party transactions would be confined to cases of commodities or other properties which are regularly traded on an open market; and made available subject to the requirement that the taxpayer making the CUP election identify on his return the comparable uncontrolled transactions which from the basis for his allocation, such an amendment might well insulate the state systems from the attacks to which they have been subject, and with a minimal revenue cost. "It would be difficult to distinguish such a statutory regime from the regime mandated by Article 7 of the OECD Model. . . . The CUP elections will be available in relatively few cases, so that the revenue loss. . . should be containable. (p. 671)

25. S. 1974 "should be shelved." (p. 672)

26. "The federal government negotiates the conventions, participates in the discussions of international organizations, and has written the regulations that embrace the radical 'separate enterprise' notion. It did this without state participation. . . [I]f the federal government. . .feels it necessary to secure to foreign governments and their nationals the benefit of a bargain the federal government thinks the foreign governments made, it can do so by funding the amount necessary to make them whole. . .This amount could be determined by a. . .direct federal. . .foreign tax credit. . .for the state tax on that portion of the base determined under the unitary method over that determined under whatever 'arm's length' method the federal government wants to permit the state to use." (p. 672)

27. "As to the threat of United Kingdom retaliation, I am thoroughly comfortable with the Symms-Baucus bill, and other proposals, which would retaliate in turn against the threatened retaliation. The Gryllis Amendment [in the House of Commons] would clearly violate the double taxation convention with the United Kingdom; the unitary methods clearly do not violate the convention, whatever the state of international norms." (p. 672)

28. "I believe [that] it is none too early to start thinking of ways to dismantle the 'separate enterprise' notion at both the federal and international levels. . . [N]ational legislation needs to move toward a 'unitary' method." (p. 672)

29. "The United States has spent the last 20 years as the apostle of the 'new' arm's length system, which it is not extreme to say the United States has to a substantial extent forced upon the world. . . [A]t some point we must be candid with ourselves and the international community about the nature of our experience with the comminution of shared factor relationships, the creation of income and the single component methods. At a minimum we should address whether the progressive degeneration of procedural principles and method priorities in the cases is evidence that the use of fractional methods in the absence of comparable prices is inevitable regardless [of] whether one calls one's system a 'separate enterprise' approach or not." (p. 673)

ALASKA STATE LEGISLATURE
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June 8, 1989

MEMORANDUM

TO:

ATTN:

FROM: Ginny Fay
Legislative Analyst

RE: Alaska's Unitary Corporate Taxation: Alternatives and Impacts on Revenues
Research Request 89.165

You requested information on 1) unitary corporate tax laws in Alaska and other states, 2) alternatives to the method of tax collection currently used in Alaska, and 3) the source of Alaska's revenues and impacts on these revenues of changing Alaska's tax law. Specifically, you asked this agency to update House Research Agency Memoranda 85.012, 85.014, and 85.047. To answer your questions, the first part of this memorandum provides an overview of state corporate taxation. This is followed by information on alternative tax methods. The final section identifies sources of Alaska revenues and the potential impact on revenues of changes to Alaska's corporate tax method.

Background

The form of corporate taxation commonly known as unitary tax is based on the concept that the most equitable and efficient method of determining corporate income subject to state taxation is formula apportionment. Under unitary taxation, the total income of a corporation or of an affiliated group of corporations engaged in a unitary (related) business activity is apportioned among states, usually based on the portion of corporate payroll, property, and sales attributable to each state. This apportioned income is the taxable income subject to the respective state's tax rates. Approximately 45 states (including the District of Columbia) currently use some form of the unitary tax to apportion corporate income for state income tax purposes. Alaska currently taxes corporate income by using a form of the unitary tax called worldwide combined reporting.

In recent years, the unitary tax principle has come under considerable attack--largely as a result of efforts to apply scientific exactness to a concept which is relatively broad and is, by its nature, impervious to exactness.[1] In applying the unitary tax principle in the context of corporate income taxation, the courts have focused on whether a state was making a reasonable effort to effect a fair division of the income of a multi-state taxpayer.[2] Toward this end, the U.S. Supreme Court avoided endorsing any particular method of unitary apportionment as *the* preferred method. In *Container*, the Court noted that variations on the theme of unitary apportionment can be acceptable as long as those variations "are logically consistent with the underlying principles motivating the unitary approach." The fact that another approach, such as separate accounting, might produce a different result is irrelevant: adherence to reasonable principles is the standard against which the courts have measured tax methods.

All states that use the unitary tax must determine the corporate income that is to be apportioned. Alaska is the only state that uses a method called worldwide combined reporting. Worldwide combined reporting totals all of the income from all subsidiary and affiliated corporations engaged in a unitary business even if they are located outside of the United States.[3] Other states use a waters edge approach which apportions only the income earned by the unitary business within the United States.

During the 1980s, worldwide combined reporting has been criticized by the United States government and both foreign and domestic multinational corporations. The federal government opposes worldwide combined reporting because of fear of 1) state interference in foreign trade and 2) reprisal by foreign nations whose multinational corporations are taxed by states using this method. Because states' application of worldwide combined reporting to domestic multinational corporations has been upheld by the Supreme Court, federal action to date has been limited to persuading states to stop using this version of the unitary tax.

Domestic and foreign multinational corporations oppose the use of worldwide combined reporting because they do not believe that states have the right to tax business activities that occur outside the United States. In addition, these corporations claim that state taxation of foreign activities constitutes

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[1]Gene Corrigan, "A Unitary Primer," Multistate Tax Commission, Volume 1988, Number 1, May 1988, p. 1.

[2]*Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159,169 (1983).

[3]Alaska uses a modified formula apportionment method for computing taxable income of oil and gas corporations. For information on apportionment formulas, see House Research Agency Memoranda 85.012 and 89.303.

double taxation because this income is taxed by foreign governments. Foreign multinational corporations have been especially vocal in their criticism of worldwide combined reporting.

Alternatives to Worldwide Combined Reporting

In 1984, eleven states used worldwide combined reporting. As a result of federal government opposition and the threats of economic reprisal by foreign corporations, ten states have changed taxing methods. The degree to which states have backed-off taxing foreign income varies considerably as a result of inconsistency in states' definitions of "waters edge." Alternatives to worldwide combined reporting include:

- worldwide combined reporting for domestic corporations with an alternative tax levied on foreign multinational corporations;
- a waters edge method that includes foreign source dividends in taxable income and includes 80/20 corporations within the definition of waters edge;[4]
- a waters edge method that excludes foreign source dividends from income and excludes 80/20 corporations from the definition of waters edge; and
- separate accounting.

Worldwide Combined Reporting that Excludes Foreign Multinationals. This alternative allows United States subsidiaries of foreign corporations to pay an alternative tax rather than a tax based on income apportioned using worldwide combined reporting. Although many types of alternate taxes could be devised, state representatives on the 1984 unitary tax task force recommended that the tax be based on in-state property, payroll, and sales and that the tax rate be based on the tax paid by firms in the same industry conducting unitary business in the state.

Proponents of this option claim that it would reduce the threat of foreign retaliation against U.S. corporations. In addition, this option is claimed to be a fair way to exclude foreign multinational corporations from worldwide combined reporting while protecting the competitive advantage of U.S. multinational corporations and domestic business. This option would also protect state revenues and be relatively easy to implement. Opponents, however, do not view this alternative as an adequate alternative to worldwide combined reporting because corporate income tax rates based on industry

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[4]These corporations are U.S. based corporations that have 80 percent or more of their business activity occurring outside of the United States.

classification would not change tax liabilities of foreign corporations. Critics also claim that U.S. based multinational corporations may pay higher taxes than foreign corporations on similar income.

This alternative is similar to Senate Bill 119, introduced by Governor Cowper in the 1989 legislative session. The governor's bill, which applied to nonpetroleum corporations, would exempt foreign multinational corporations from worldwide combined reporting and tax them with a waters edge approach. Because the bill would result in a competitive disadvantage for domestic corporations, it was stridently opposed by U.S. industry and made little headway in the legislature.

Waters Edge Combination Including Dividends and 80/20 Corporations. This alternative to worldwide combined reporting includes limiting the unitary group to the waters edge and including all foreign source dividends in the calculation of income, and treating all 80/20 corporations as if they were within the waters edge. Only dividends generated by foreign subsidiaries that are significantly related to the activities of the unitary group would be included in income of domestic multinational corporations.

Supporters of this option claim that it would reduce foreign criticism of states' application of worldwide combined reporting and it would result in equitable taxation of all taxpayers. Proponents claim that even though worldwide income of domestic multinational corporations is taxed (through taxation of dividends) by the states, while worldwide income of foreign multinationals is not, foreign government taxation of dividend income repatriated to the home country of the parent corporation equalizes any inequities. Opponents of this option disagree and claim that this method of taxation would put U.S. multinationals at a considerable competitive disadvantage in the world economy. Furthermore, opponents claim that fully taxing foreign source dividends is identical to taxing the income of their foreign subsidiaries and yields the same result as worldwide combined reporting.

Waters Edge Combination Excluding Foreign Dividends and 80/20 Corporations. This alternative to worldwide combined reporting limits the income of the unitary group to those corporations within the boundaries of the United States. However, this option excludes all or at least a high percentage of foreign source dividend income, depending on the particular option chosen. In addition, 80/20 corporations are considered to be foreign corporations and are excluded from the unitary group. This option is generally favored by both foreign and domestic multinational corporations. Foreign multinational corporations and governments support this alternative because it eliminates worldwide combined reporting. Domestic multinational corporations like this option because it keeps them competitive in the world economy by not taxing foreign source dividends. Opposition comes mainly from state governments that fear a serious erosion of their tax base if foreign source dividends and 80/20 corporations are excluded from taxation.

Separate Accounting. This alternative to worldwide combined reporting would completely eliminate the use of the unitary tax. States would tax corporate taxpayers only on the income earned in the state and each corporation would be treated as a separate entity for tax purposes (as opposed to a unitary group). This method is also called "arm's length accounting" because all transactions between related corporations are assumed to occur as if no special relationships exist (such as a subsidiary corporation supplying a parent corporation) so that prices are fair market values.

In general, business leaders would like to have all states determine taxable income by using separate accounting because it uses information directly related to traditional accounting income. Opponents, which include many states, claim separate accounting makes states vulnerable to manipulation of income to reduce tax liabilities by corporations that do business in more than one state. However, under the separate accounting method Alaska imposed on the petroleum industry under AS 43.21, revenues from the corporate income tax were considerably higher than under either the standard apportionment formula applied before 1977 or the modified formula used after 1981.[5]

Attachment A provides information on how states using the waters edge unitary approach to corporate taxation treat foreign-source dividends (i.e., the first three alternatives discussed above). In summary, California's approach best represents the first option of providing an alternative tax to foreign multinational corporations. Another ten states would fit under the second option which taxes foreign-source dividends. Nine states partially exempt foreign dividends; 14 fully exempt foreign dividends; and 11 fully exempt dividends if a corporation meets specified conditions, i.e., 34 states' corporate taxation method is similar to the third option.

Alaska Revenue Sources and Relationship to Unitary Taxation

The revenues that the State of Alaska collects fall into one of three categories:

- unrestricted revenues go to the general fund to be appropriated for any purpose,
- restricted revenues are received for specific purposes, and
- special fund revenues are received by statutorily established funds such as the International Airport Fund.

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[5]For information on the formulas used for corporate taxation in Alaska, see House Research Memoranda 85.012 and 89.303.

Table 1 shows the contribution to total state revenues of each of these types of revenue in FY 88.

TABLE 1
CONTRIBUTIONS TO TOTAL STATE REVENUE BY TYPE OF REVENUE, FY 88
(Millions of Dollars)

TYPE OF REVENUE	DOLLAR CONTRIBUTION	PERCENT OF TOTAL
Unrestricted Revenue	$2,305.8	63.7
Restricted Revenue	475.2	13.1
Special Funds	836.4	23.1
TOTAL	$3,617.4	100.0

Source: Alaska Department of Revenue, "Revenue Sources," Fall 1988.

Table 2 provides a breakdown of unrestricted revenue by source. As mentioned previously, unrestricted revenues are the only source that allow legislative discretion in appropriation.

TABLE 2
SOURCES OF UNRESTRICTED REVENUES, FY 88
(Millions of Dollars)

REVENUE SOURCE	REVENUE	PERCENT OF TOTAL
Corporate Income Tax	$181.4	7.9
Gross Receipts Tax	58.5	2.5
Severance Tax	818.7	35.5
Property Tax	96.2	4.2
Sale/Use Tax	51.8	2.2
Licenses and Permits	28.3	1.2
Intergovernmental Receipts	8.9	0.4
State Resource Revenues[a]	843.9	36.6
Facilities Related	32.3	1.4
Service Related	7.5	0.3
Other	16.4	0.7
Special Settlements[b]	161.9	7.0
TOTAL	$2,305.8	100.0

[a]Includes $694.8 million in royalty income, $132.6 in investment earnings, and $6.0 million in rents. Petroleum resource revenues are shown in more detail in Table 3.

[b]Outer Continental Shelf "8(g)" or Dinkum Sands settlement partial payment.

Sources: Alaska Department of Revenue, "Revenue Sources," Fall 1988.

Table 2 indicates that the largest contributions to state unrestricted income are derived from petroleum producers. In fact, the various petroleum revenues account for 85 percent of all state unrestricted revenues--this proportion has not changed since our earlier memorandum on FY 83 revenues.

Table 3 provides a breakdown of the contribution to FY 88 unrestricted revenues by the various petroleum revenue sources.

TABLE 3
CONTRIBUTION OF PETROLEUM REVENUE SOURCES
TO STATE UNRESTRICTED REVENUES, FY 88
(Millions of Dollars)

SOURCE OF REVENUE	CONTRIBUTION	PERCENT OF TOTAL
Corporate Income Tax	$158.0	8.1
Severance Tax	818.7	42.0
Royalties	694.8	35.6
Property Tax	96.2	4.9
Bonus Sales	5.6	0.3
Rents	5.7	0.3
Intergovernmental Receipts	8.7	0.4
Special Settlements	161.9	8.3
TOTAL	$1,949.6	100.0

Source: Alaska Department of Revenue, "Revenue Sources," Fall 1988.

Description of Unrestricted Revenue Sources

Corporate Income Taxes. Alaska Statute 43.20 imposes a unitary income tax on the entire corporate income derived from sources within Alaska, and apportions this income under graduated rates. In FY 88, the corporate income tax generated a total of $181.4 million, of which $158.0 million, or 87 percent, was collected from petroleum corporations.

Gross Receipts Taxes. A variety of taxes are collected under this general heading. A business license tax of $25 is assessed annually on any business operating in the state. The license fee for each state and national bank, trust company and savings and loan association is seven percent of net income. In FY 88, a total of $1.4 million was collected from this source.

In addition to the business license tax, gross receipts taxes are levied on various seafood production activities. Taxes on commercial fishing (AS 43.75) include a raw fish tax of 4.5 percent of the value of salmon canned at shore-based canning facilities, a three percent tax on the value of all other fish canned by shore-based facilities and a five percent tax on the value of fishery resources processed by floating processors. Developing commercial fisheries are taxed at lower rates. In FY 88, these taxes contributed $22.5 million to state revenues.

Salmon enhancement taxes (AS 43.76) are levied on limited entry fishing permit holders within qualified regional aquaculture associations. Rates are two or three percent of the value of the salmon caught, depending on the vote of the aquaculture association. In FY 88, total Salmon Enhancement Tax receipts were $5.8 million. In effect, this is a pass-through program, since the legislature appropriates these tax revenues to the regional associations from whose members they were collected.

A seafood marketing tax (AS 16.51) is levied on seafood processors at a rate of 0.3 percent of the ex-vessel value of seafood products purchased (over $50,000) in Alaska. Revenue in FY 88 was $2.7 million. Similar to the Salmon Enhancement Tax, these revenues are passed through to fund the Alaska Seafood Marketing Institute (ASMI).

Insurance premium taxes (AS 21.09, AS 21.33, AS 21.34, and AS 23.33) are levied on gross premiums (less certain deductibles) at various rates ranging from 0.075 to 3 percent depending on the type of insurance. In FY 88, revenue from these taxes totaled $25.6 million.

Severance Taxes. Oil production taxes are levied upon oil producers for all oil produced from each lease or property in the state, less any part of production exempt from taxation (AS 43.55). The tax is 15 percent of gross value (except 12.25 percent for the five-year period following commencement of new oil production after June 30, 1981) adjusted by the Economic Limit Factor (ELF) for mature oil fields. The ELF, however, was repealed effective January 1, 1989.[6] Gross value is calculated as the sales price minus transportation costs at the point of production. Gas production taxes (AS 43.55) are levied at the greater of a rate of $0.64 per thousand cubic feet of taxable gas or ten percent of the gross value of taxable production calculated at the point of production, multiplied by the ELF. During FY 88, $816.4 million was collected in oil and gas production tax revenues.

The oil and gas regulation and conservation tax (AS 43.57) is levied upon oil and gas producers at the rate of four mills per barrel (oil) and four mills per 50,000 cubic feet (gas) of oil and gas removed or sold from each lease or property in the state,
less any tax exemptions. Gross value is calculated as for the production taxes. This tax contributed $2.3 million to state revenues in FY 88.

Property Taxes. The oil and gas property tax (AS 43.56) is levied at 20 mills on the full and true value of taxable property used in oil and gas production and exploration. If a municipality levies a property tax against the same

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[6]The actual effective date on HB 118, Chapter 25 SLA 89, is August 6, 1989, with a retroactive effective date of January 1, 1989. The ELF, nowever, was in place during FY 88.

property as the state, a state credit is given for the tax paid to the municipality. Oil and gas property taxes generated $96.2 million in FY 88.

Sales and Use Taxes. Fuel taxes (AS 43.40) are levied at the rate of four cents per gallon for aviation fuel and 2.5 cents per gallon for jet fuel, eight cents per gallon for gasoline and diesel fuel, and five cents per gallon for marine fuel. Sixty percent of the revenues from aviation fuel taxes are returned to municipalities that operate municipal airports. Gross receipts from fuel taxes contributed $33.6 million to state revenues in FY 88.

Alcoholic beverage taxes (AS 43.60) are assessed based on alcoholic content: malt beverages (one percent or more of alcohol) $0.35 per gallon, wine (21 percent or less alcohol) $0.85 per gallon, hard liquor (more than 21 percent alcohol) $5.60 per gallon. Contributions from this tax are shared with political subdivisions of the state. The FY 88 gross revenue from this source was $11.9 million.

Cigarette taxes (AS 43.50) are levied at the rate of eight mills for each cigarette imported into or acquired in the state; this is equivalent to 16 cents per pack. Two and a half mills are dedicated to school construction and 5.5 mills are paid to the general fund. In FY 88, the cigarette tax generated $8.7 million, of which $2.7 million was dedicated to school construction and $6.0 million was deposited into the general fund. Those revenues were from the sale of over 54 million packages of cigarettes, down from 62 million packs in FY 87. The 1989 legislature increased the undedicated portion of the cigarette tax to 12 mills per cigarette, resulting in a total tax of 29 cents per pack.

In addition, the Cigarette Tax Act requires annual licensing by the Department of Revenue of the following: cigarette manufacturers ($5), distributors and wholesale distributors ($50), vending machine operators ($25), and others who import cigarettes into Alaska ($25). These license fees generated $3,225 in FY 88, the majority from $25 licenses.

Licenses and Permits. Business license taxes on alcoholic beverage licenses, commercial fishing licenses, professional and occupational licenses, and various regulatory permits contributed $8.6 million (including the alcoholic beverage fees mentioned above) in FY 88.

Nonbusiness license taxes include receipts from hunting, trapping, and sports fishing licenses, and motor vehicle instruction permits, title transfers, registration fees, and drivers' licenses. In FY 88, these fees totaled $19.7 million.

Investment revenues include the investment earnings from the state's various investment portfolios and interest on bank deposits. Investment earnings totaled $132.6 million in FY 88.

State Resource Revenues. State royalty payments (AS 38.05) include royalties from minerals and oil and gas. Depending on the type of resource, royalty payments can be taken in kind. Revenues from royalties are apportioned between the permanent fund and the general fund. General fund royalty revenues totaled $594.8 million in FY 88.

Other revenue sources within this category are state property sales ($3.8 million), resource bonus sales ($5.6 million), state rental revenues ($6.0 million), and the sale of resources not classified as minerals such as gravel and timber ($1.1 million).

Facilities-related charges include receipts from airports, the ferry system, food services, and other state facilities. These charges totaled $32.3 million in FY 88.

Service-related charges include receipts from statutory inspection fees, the court system, and other state service charges. These fees totaled $7.5 million in FY 88. Another $16.4 million was collected in miscellaneous revenues.

During FY 88, a special settlement of $161.9 million was paid to the general fund. The money was 49.5 percent of the $322.9 million Outer Continental Shelf (OCS) "8(g)" or Dinkum Sands revenue sharing settlement. Fifty percent of the settlement was paid to the Permanent Fund and 0.5 percent to the Public School Fund. The FY 88 figure also reflects $2.1 million in TransAlaska Pipeline Settlement (TAPS) receipts owed to the general fund.

Revenue Implications of Changing Alaska's Corporate Income Tax

While a recent U.S. Supreme Court case, *Shell Oil Company v. Iowa Department of Revenue*, upheld states' use of unitary tax apportionment to calculate taxes owed by multistate and multinational corporations, the determination of a consistent form of the unitary tax still remains to be decided.[7] There are two significant cases whose outcomes are likely to affect Alaska's use of worldwide combined reporting.

In the first case, the U.S. Supreme Court has agreed to decide *Franchise Tax Board of the State of California v. Alcan Aluminum* (No. 88-1400). The hearing for Alcan, a Canadian company, is to determine whether the firm has standing to sue in federal courts over disputed taxes. If the plaintiff prevails, the case will likely go back to lower courts. In this case, Alcan is challenging California's relatively recent changes in corporate taxation. Under pressure from foreign firms, California legislators moved to repeal their worldwide

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[7]"Supreme Court Approves State's Unitary Tax," *Oil & Gas Journal*, November 14, 1988, p. 30, and "Iowa Wins Tax Fight with Shell," *Governing*, January 1989, p. 15.

combined reporting form of the unitary tax, but faced opposition from U.S. multinational corporations on the grounds that the result would be better tax treatment of their foreign competitors. The compromise in California was to drop worldwide combined reporting for companies that complied with a variety of requirements but to leave it for those which did not.[8] These cases are likely to answer a number of unresolved issues regarding the uniformity of treatment of foreign-source dividends and 80/20 corporations by the waters edge and the worldwide combined reporting approaches to taxation.

In a parallel case, a California state court ruled that California's use of worldwide combined reporting during the tax years 1970 through 1973 was contrary to the national policy favoring waters edge taxation, as expressed by the executive branch of the federal government.[9] The case is under appeal.

In summary, there are three reasons most often stated for considering a change from worldwide combined reporting:

- worldwide combined reporting reduces the ability of the state to attract foreign investment,
- the federal government strongly discourages state use of worldwide combined reporting, and
- there is potential for the application of worldwide combined reporting by foreign multinational corporations to be declared unconstitutional by the U.S. Supreme Court.

The remainder of this section analyzes these reasons and discusses implications to Alaska of changing the corporate income tax structure.

Effect on Foreign Investment. This is the most important reason that several states have recently changed from worldwide combined reporting to a waters edge approach. The verdict on whether these changes have affected foreign investment, however, is not clear. John LaFaver, Montana's director of Revenue, who moderated a panel on unitary taxation at the Multi-State Tax Commission in 1988, said

> it struck me that the changes in the tax laws that we've seen now in the last two or three years in a number of states, moving away from worldwide to waters edge, have served to substantially increase the cost of compliance for both taxpayers and tax agencies. We have reduced the tax base in

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[8] *State Policy Reports*, May 1989, p. 12.

[9] California Superior Court; Gardner, J.; *Colgate-Palmolive Co. v. Franchise Tax Board*, No. 319715, December 12, 1988.

> a number of states, we have moved the states away from uniformity, have shifted the tax burden, and we have looked fo, an economic boom that has not happened. Therefore, I have to wonder if somewhere down the road, we are going to have to re-invent worldwide unitary.

This conclusion is confirmed by surveys that indicate that state tax treatment is, at best, ranked fourth among corporate factors regarding the location of manufacturing plants in the U.S.[10] A foreign corporation that wishes to invest in a state by constructing a manufacturing plant will try to find a location that offers cheap land and utilities, a skilled labor force, low living costs, and cheap access to suppliers and markets. As long as the particular location can offer these basic benefits, one location is not very different from another. It is this inter-changeability that makes states fearful of foreign threats of economic reprisal.

Foreign corporations that wish to invest in resource extraction have a more limited choice; they must go to the resource location. Because it is so expensive to do business in Alaska, foreign investments are usually relatively large in scale and have high potential profitability to offset the high cost and risks. In this investment climate, the type of taxes levied by a state are probably a secondary consideration.

A related question is the impact of worldwide combined reporting in deterring the development of Alaska as a manufacturing state. It seems unlikely that Alaska will be able to compete in the near future with other states for manufacturing that does not depend on natural resources. Alaska would have trouble competing with other locations based on the criteria mentioned above.

Federal Action to Ban the Use of Worldwide Combined Reporting. It is quite clear that the federal government opposes the use of worldwide combined reporting. At this point, however, there is little action to ban worldwide combined reporting because all states except Alaska have moved to waters edge taxation.

U.S. Supreme Court Action. As mentioned previously, the next chapter on the application of unitary taxation is likely to be written by the U.S. Supreme Court. Based on the outcome of current lawsuits, Alaska may have little choice but to change its corporate tax law.

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[10] Larry C. Ledebur and William W. Hamilton, "The Failure of Tax Concessions as Economic Development Incentives," in *Reforming State Tax Systems*, ed., Steven D. Gold, National Conference of State Legislatures, December 1986. Attachment B is a copy of this article.

Alaska Revenue Implications. From a revenue standpoint, Alaska's corporate income tax accounted for $181.4 million, or 7.9 percent of state unrestricted revenues in FY 88. Of this $181.4 million, $158.0 million (87 percent) was paid by petroleum companies. Petroleum corporations in Alaska include foreign multinational, U.S. multinational, and U.S. domestic corporations. Therefore, any change in corporate tax law is likely to result in a shakeup of the petroleum industry. The $23.4 million in nonpetroleum corporate income taxes was one percent of Alaska's FY 88 unrestricted revenues. A change in the corporate tax structure would affect the tax liability of nonpetroleum corporations, but the impact on state revenue is about 1/10th of one percent.

According to information from the Office of the Governor and oil industry officials, the oil industry does not have a problem with Alaska's use of worldwide combined reporting. The oil industry considers worldwide combined reporting preferable to separate accounting.[11] Because of problems related to the shifting of income to minimize tax liabilities, returning to separate accounting might not be in Alaska's long-term best interest. Given these considerations, there is little compelling reason for Alaska to change corporate taxation of petroleum corporations unless required to do so as a result of court decisions.

It is extremely difficult to determine the revenue impacts of changes to corporate tax laws. Before changing its tax law, the State of California spent two years and $1.0 million to analyze the effects--and their results were off by $250 million.[12] The Alaska Department of Revenue (DOR) indicates that they are not able to determine the revenue impact of applying waters edge taxation to petroleum corporations in Alaska. However, the DOR estimated (in the fiscal note for SB 118) that applying waters edge unitary taxation to foreign multinational corporations would not decrease state revenues by more than $60,000 and would be revenue neutral. The DOR also concluded that applying the waters edge unitary approach to all nonpetroleum corporations would cost approximately $3 to $4 million annually in foregone tax revenues. As a result of this potential loss in revenues, the governor's bill would apply only to foreign corporations.

Given the potential benefits of modifying Alaska's tax structure--pacifying foreign criticism, encouraging foreign investment, complying with federal government opposition to the use of worldwide combined reporting, and

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[11]Specific industries and corporations vary in their position on corporate income tax treatment based on how changes will affect their tax liability in a particular state. For example, petroleum corporations prefer worldwide combined reporting over separate accounting in Alaska but take the opposite position in California.

[12]Steve Kettel, director, Alaska Department of Revenue, Income and Excise Tax Division, personal communication, February 7, 1989.

providing equal competitive footing to U.S. multinational corporations--a $3 to $4 million cost is relatively low. It should be noted, however, that many states expect increases in personal income tax revenues--resulting from employment growth--and increase in sales tax revenues--from increased economic activity--to offset corporate tax losses. Alaska currently lacks both of these vehicles for offsetting losses.

With no state personal income tax or sales tax, Alaska currently has a very narrow tax base--taxes on the petroleum industry account for 85 percent of unrestricted revenues. The 13 cents per pack cigarette tax increase passed in House Bill 80 during the 1989 legislative session is expected to increase state revenues by approximately $4 million annually--enough to offset the expected decrease in nonpetroleum corporate income taxes. Similarly, repeal of the ELF is expected to result in an annual increase in state revenues of over $150 million. Reinstating the personal income tax at about 1.9 percent would raise about $217 million annually in revenue and a one percent state sales tax would raise $49 million annually. Therefore, because of the options available to offset any tax losses, modification of the state corporate income tax is more a public policy question than a revenue question.

* * *

I hope this answers your questions. If you would like additional information, please do not hesitate to call.

Attachments

ATTACHMENT A
State Treatment of Foreign-Source Dividends

STATE TREATMENT OF FOREIGN-SOURCE DIVIDENDS

Jean A. Walker, Committee on State Taxation

	Exemption			Treatment of Balance		
	Exempt	Conditional	Partial	Allocate	Apportion	Statute(s)
ALABAMA				X		§§40-18-34, 40-18-35(14), Reg. 810-3-31.02
ARIZONA	X					§43-1122(8), L. 1985, c. 109, eff. for taxable years beginning from/after 12-31-83
ARKANSAS		If 95% ownership of payor.			X	§84-2003(2)(j)
CALIFORNIA 1)					X	§§24271, 24402
2)		If more than 50% ownership of payor, 75% exclusion of base period dividends (greatest amount of dividends received in any one of 1984, 1985 or 1986 income years); exclusion of foreign dividends in excess of base period amount dependent upon increase or decrease in foreign payroll factor.			X	§24411, L. 1986, c. 660, eff. for tax years beginning on/after 1-1-88
COLORADO			Amount of exclusion of all foreign-source income dependent upon election of federal foreign tax deduction or credit.		X	§39-22-303, §39-22-305(10), L. 1985, H. 1010, eff. for tax years beginning on/after 1-1-86
CONNECTICUT	X					§12-217(a)(B)
DELAWARE	X					§1903(a)(2)
FLORIDA	X					§220.13(1)(b)2.a, ch. 84-549, Laws of Florida, eff. for tax years beginning on/after 9-1-84
GEORGIA	X					§48-7-21(b)(9)
HAWAII					X	§235.7(c)
IDAHO 1)					X	§63-3022
2)			85% exclusion.		X	§63-3027C, L. 1988, c. 342 (HB 669), eff. for tax years beginning 1-1-88
ILLINOIS		If 80% ownership of payor.	Otherwise, 85% exclusion.		X	§2-203(b)(2)(O), L. 1982, P.A. 82-1029, eff. for taxable years ending on/after 12-31-82
INDIANA 1)					X	[illegible]5(b)
2)		If 80% ownership of payor.	Otherwise, 85% exclusion if ownership of payor is less than 80% but at least 50%, or 50% exclusion if less than 50% ownership of payor.		X	[illegible], L. 1987, P.L. 383, eff. for [illegible] years beginning after 12-31-87
IOWA					X	§422-35
KANSAS 1)					X	§79-32,138
2)			80% exclusion.		X	§79-32,138(c)(vi), L. 1987, c. 386, eff. for taxable years beginning after 12-31-87
KENTUCKY	X					§141.010(12)(b)
LOUISIANA				X		§§42.A, 63, 242(1)(d), 243.A(4)

	Exemption			Treatment of Balance		
	Exempt	Conditional	Partial [illegible]	Allocate	Apportion	Statute(s)
RHODE ISLAND					X	§§44-11-11, 44-11-12
SOUTH CAROLINA 1)		If 80% ownership of payor.		X		§12-7-700(15), repealed L. 1985, S351, eff. for tax years beginning after 12-31-84; §12-7-1120(2)
2)				X		§§12-7-415, 12-7-430 [illegible] L. 1985, S351, eff. for tax years beginning after 12-31-84; §12-7-1120(2)
TENNESSEE		If 80% ownership of payor.			X	§67-2704(b)(2)(A)
UTAH			50% exclusion.		X	§59-13-5(2)(d), L. [illegible], c. [illegible] ([illegible]), eff. for tax years beginning on/after [illegible]
VERMONT					X	§5811(18) [illegible]
VIRGINIA		If 50% ownership of payor.		X		§58-151.032([illegible]) [illegible]
WEST VIRGINIA 1)	X					§11-24-6(c)(3) [illegible] 1985, [illegible], [illegible] to taxable years beginning before 7-2-87
2) 3)	X					§§11-24-4, 11-24-7(a)([illegible]). §11-24-6(c)(10), L. 1988, [illegible] 4475, eff. for taxable years ending after 7-1-88
WISCONSIN		If 80% ownership of payor.			X	§71.04(4)
DISTRICT OF COLUMBIA					X	§47-1810.1

Worldwide Combination States*

ALASKA					X	§43.20.0[illegible]

*Dividends between combined corporations are eliminated from income, thus the indicated treatment of [illegible] [illegible] only to dividends received by members of the combined group from corporations not included in the combination.

ATTACHMENT B

Larry Ledebur and William W. Hamilton, "The Failure of Tax Concessions as Economic Development Incentives," in *Reforming State Tax Systems*, ed., Steve Gold, NCSL, December 1986

The Failure of Tax Concessions as Economic Development Incentives

by

Larry C. Ledebur

William W. Hamilton

On October 7, 1985, the *Washington Post* reported:

> **Chrysler, Mitsubishi Set Joint U.S. Venture**
> Chrysler Corp. and Mitsubishi Motors Corp. last night signed a $500 million agreement to build 180,000 subcompact cars a year in the United States, beginning in 1989, according to industry sources. . . .
>
> The plant is to be built in the Bloomington-Normal, Ill. area, according to the Associated Press . . . . To attract the plant, the AP reported, the state of Illinois and Bloomington-Normal offered the automakers about $10 million worth of land, $20 million in local real estate tax breaks over 10 years and various other incentives valued conservatively at more than $100 million.
>
> The joint venture between Chrysler and Mitsubishi is expected to yield 2,500 production jobs and 9,000 jobs in related industries when the plant is operating on two shifts, the sources said.

Announcements such as that of the Chrysler-Mitsubishi joint U.S. venture have ripple effects throughout state legislatures and other state bodies involved in economic development policy and programs. The clear implication of the article is that the new facility was "attracted" to the Bloomington-Normal area because of the package of incentives offered by the state and locality. As a consequence of this type of informati[illegible] misinformation, states and local governments have joined the race to provide broad and expensive packages of industrial assistance.

Since 1975, state subsidies/incentives to business have proliferated. States now offer a broad array of incentives to firms locating, expanding, or agreeing to remain in their jurisdictions. These include loans, loan guarantees, direct interest subsidies, land write-downs, tax-exempt financing, and equity and near-equity investments, and in a few cases, outright grants (Table 1).[1] The centerpiece of most state industrial finance programs, however, is tax concessions in the form of exemptions, deductions, credits, and abatements.[2] This array of state and local subsidies to industry has been described as a "well-stocked candy store."[3]

This rapid proliferation of state and local programs testifies to the widespread belief among policymakers and practitioners that an arsenal of development incentives is considered critical to inter-jurisdictional, interstate, and regional competition for industry and jobs. Despite the creativity demonstrated by state and local governments in providing sophisticated financial assistance packages to firms involving both public and private funds, subsidization of private enterprise to achieve public objectives remains a malnourished art form. The effectiveness of interstate business incentives in exerting any significant influence on firm location decisions, however, is undemonstrated.

Table 1.

State Industrial Incentives

Incentive	Number of States
Grants	4
Debt Instruments	
Direct Interest Subsidies	3
Loans	
Direct State Loans	21
Private Development Credit Corporation	17
Industrial Revenue Bonds	
State-Issued	22
Locally Issued	45
General Revenue Bonds	4
Umbrella Bonds	10
Loan Guarantees	11
Industrial Revenue Bond Guarantees	11
Equity and Near-Equity Financing	
State-Chartered Equity/Venture Capital Corporations	8
Tax Exemptions, Credits, Deductions, and Special Treatment	
Job Creation Tax Credits	19
Investment Tax Credits	23
Property Tax Abatements	31
Business Inventory	35
Goods in Transit	43
Research and Development	43
Pollution Control Equipment	37
Industrial Fuels and Raw Materials	45
Energy and Fuel Conservation Measures	41

Source: William Hamilton, Larry Ledebur, and Deborah Matz, *Industrial Incentives: Public Promotion of Private Enterprise* (Washington, DC: Aslan Press, 1985), pp. 4-5.

musts" center on proximity to markets and supplies, labor conditions and costs, and amenities. "Ease in obtaining environmental permits" is the only "must" directly amenable to government action in the short term.

A survey of influences on plant location decisions in Michigan produced similar results (Table 3). Among the most important factors are access to markets and suppliers, local cost considerations, and labor supply and quality. Local property taxes are important, ranking fifth. Tax concessions, on the other hand, ranked 16th among the 23 most important influences.

Finally, a 1981 survey of 500 of the 1,000 largest U.S. industrial corporations assessed the importance of factors in locating plants in the continental United States (Table 4). In this study, "state and local attitude toward taxes and business and industry" (i.e., tax structures and rates) ranked fourth in order of importance. "Financing inducements" ranked 15th, with 77 percent of the responding firms indicating that these inducements were "fairly" (29 percent), "quite" (32 percent), or "extremely" (16 percent) important. It appears, therefore, that some forms of financial incentives, although not necessarily tax concessions, are important in the site location decisions of a majority of large corporations in the United States.

Table 2.

Influences on Plant Location Decisions-National Plant Openings in All Industries

Factors Viewed as "Musts"	Percent of Plants Citing Factor
Favorable labor climate	76%
Proximity to market	55
Attractive place for engineers/managers to live	35
Proximity to supplies, resources (including energy)	31
Low labor rates	30
Proximity to existing facilities or division/company	25
Ease in obtaining environmental permits	17

Source: Roger Schmenner, "Location Decisions of Large Firms: Implications for Public Policy," *Commentary*, January 1981.

Table 3.

Influences on Plant Location Decisions Michigan (Establishment Weighted)

Criterion	Total Sample
Access to markets	1
Land, building, rent cost	2
Labor cost	3
Skilled labor pool	4
Local property taxes	5
Transportation	6
Specialized suppliers	7
Quality of living	8
Raw materials	9
Energy	10
Qualified professionals	11
State taxes on business	12
Financing and capital	13
Labor/management relations	14
Unemployment compensation cost	15
Tax incentives	16
Attitude of state government	17
Crime rates	18
Workers compensation cost	19
Licensing and state regulations	20
Water	21
State and local government services	22
Access to universities	23

Source: Patricia A. Braden and Susan R. Rideout, "Location Decision-Making in Export-Oriented Business and Industry" (Ann Arbor: Division of Research, Graduate School of Business Administration, University of Michigan, 1978), p. 111-13.

Recent Experience

Three examples of site selection decisions of major corporations that received national attention, Microelectronics and Computer Technology Corporation (MCC), General Motors' Saturn Plant, and Volkswagen, provide additional evidence on the possible role of tax concessions.

Both MCC and General Motors were vigorously courted by states and cities, many of which offered extremely generous packages of financial incentives to attract the new facilities. After

Pennsylvania and Ohio off against one another to obtain the best possible deal from Pennsylvania. The state responded by offering increasing costly tax concessions to lock up the decision. The characterization of this spectacle as "the Rabbit that ate Pennsylvania" is descriptive.

Summary of Existing Evidence

There appears to be little or no evidence that tax concessions play a major or even significant role in the site selection processes of firms. The business facility location decision-making process is complex and driven primarily by economic considerations beyond the capacity of state and/or local governments to affect, particularly in the short term.

This dichotomy between the belief of many policymakers and practitioners in the efficacy and need for tax concessions and the findings of existing research literature is paradoxical. It appears that what are "good business practices" for state and local governments and sound public policy are in conflict with what is viewed as "good" or "expedient" politics.

Tax structures and rates and forms of financial incentives, other than tax concessions, however, do appear to be important considerations in the site selection process of corporations. This suggests that states (and localities) (a) should be concerned about the effects of taxes on the competitiveness of businesses in their jurisdictions, and (b) should consider more cost-effective industrial incentives if seeking to offer firms financial assistance to influence their behavior to achieve some specified public purpose.

Cost-Effectiveness of Industrial Incentives

Cost-effectiveness, for present purposes, is defined as the ratio of actual benefits received by the assisted firm to the real cost of the assistance to the administering government. Use of this measure would permit state and local governments to identify the benefit derived by the firm per dollar of public expenditure and to allocate scarce development resources to their most cost-effective uses.

Actual benefit to the firm of any form of public assistance is the difference between operating costs in the absence of the govern[illegible] in the presence of this assistance." The

The major offsetting cost is the loss of tax benefits for which the firm would have been eligible in the absence of the development incentive or tax-offsets. Firms pay both state and federal corporate income taxes on net revenues, the effective rate of tax ratio varying with the level of profitability and the tax policies of the state. An incentive treated as revenue for tax purposes is directly taxed, reducing the benefits to the firm of the assistance. For example, if a firm's marginal tax rate under current federal rates is 46 percent, the actual value of a dollar of public assistance to a firm making a profit is 54 cents. Incentives that reduce operating costs of firms that otherwise would be tax deductible if incurred by the firm from its own resources decrease the value of assistance in the same manner. For example, forms of assistance that subsidize depreciable assets such as a plant and its equipment reduce the amount of depreciation deductible from the firm's income.

Costs to government of development incentives include direct outlays and revenues forgone. When the subsidy involves a flow of government commitments over time, as in the case of tax abatements, the present value of the cost is determined by discounting the time stream of direct costs. The net cost to government, however, may be less than the gross outlay because subsidies increasing firm revenues or reducing operating costs also raise the tax liability of the firm.

A minimum condition of sound state and/or local government business practice in providing incentives to business is that the ratio of benefits received by the firm from the assistance exceed the cost to the administering government. There appears to be no justification for providing assistance to private firms from public coffers where government costs are greater than private benefits.

Some will argue that measuring only direct benefits to firms in terms of effects of assistance understates the real value of the incentive. This line of argumentation takes two tacks. First, there are benefits to a community or state of the location or expansion of economic activity that are not readily quantifiable (such as the image of the business climate, importance of the facility as a turnkey or catalyst in the economic development process, contributions to the community, and so on). Second, the baseline measurement ignores secondary benefits generated through the employment and income multiplier processes as new incomes are spent and respent in the economy.

The logic of these arguments cannot be denied. The first category of benefits, however, is essentially intangible and, in the absence of quantification, can be used to justify almost any undertaking. While these intangible benefits should be recognized, past

high-technology manufacturing, (3) wholesale supply, and (4) a business supply service industry. Two primary findings emerged.

- Although numerators and denominators of the cost-effectiveness ratios varied widely across type of tax concession, firm size, and industry, none of the ratios exceeded one; i.e., *in no case were the tax concessions cost-effective.*
- In every case, even where tax concession ratios approached unity, there is always some more cost-effective instrument for pursuing the public purpose.

The importance of tax incentives lies primarily in psychological effects on businesses. They often are viewed as measures of a jurisdiction's business climate and willingness to work with business to improve their operating environment. This viewpoint argues that state and local governments should offer a small set of tax concessions that are relatively inexpensive in terms of tax revenues forgone.

Cost-effective industrial incentives are those that leverage investment from commercial lending and investing institutions. Among these are loan guarantees, direct interest subsidies, and incentives targeted to nondepreciable assets.

Loan guarantees to small businesses are the most cost-effective of all industrial incentives evaluated. At a default rate of 22 percent, the cost-effectiveness ratio of this form of assistance to small firms is 0.79. This ratio is highly sensitive to the ex-post default discount rate. Estimates indicate that default rates can be as high as 40 percent before loan guarantees are no longer a cost-effective instrument of industrial finance.

Conclusion

State and local governments' rush to provide tax concessions to business is paradoxical in the absence of any substantive evidence that these incentives influence firm decisions and behavior in ways that contribute to the public purpose. Proliferation of tax incentives occurs, in part, because of the failure of researchers to effectively communicate the inadequacies of concessions as tools of public policy and the penchant of policymakers to dismiss research as being "academic" and not an accurate representation of the [illegible] legislators voting

against business tax concessions risk being labeled "antibusiness," a pejorative reference, presumably entailing political risk. But it also occurs because business has learned to play the game, and to play it well. Site location decisions are made primarily on the basis of considerations that lie beyond the capacity of state and local governments to influence. Once the decision is made, however, many businesses appear quite willing to pressure state and local governments for tax breaks and to play governments off against one another to increase their leverage in obtaining reductions in their tax liabilities. Where these tax concessions are granted, businesses are subsidized for undertaking actions that are in their own financial self-interest and that would have been undertaken in the absence of public assistance.

Throughout the United States, state and local governments are being subjected to pressures to provide special tax concessions in the name of "economic development." Subnational governments must become increasingly sophisticated in dealing with these issues and develop the capacity to sit at the bargaining table with industry as informed, equal partners. Two initial steps are necessary. First, state and local governments should understand the cost-effectiveness of various tools of government for assisting business enterprise. Second, they should establish a consistent decision-making framework and guidelines for evaluating the desirability of awarding incentives to firms and avoid the trap of making these decisions on an ad hoc case-by-case basis.

Nine basic guidelines are recommended to the state and local governments as central pillars in a decision-making framework:

(1) The primary responsibility of local government is to provide the level and quality of public services and public infrastructure consistent with the preferences and requirements for basic welfare of its citizens, and to ensure the revenue base necessary to this end.

(2) The appropriate concern of local government is the overall tax structure, its capacity to generate necessary revenues, equity in the distribution of tax burdens between citizens and businesses, and the effect of business taxes on the competitiveness of the local business environment.

(3) Subsidization of business enterprise lies beyond the conventional scope of responsibilities of local government and should be considered only in exceptional circumstances in which the essential welfare of the jurisdiction is at issue.

(4) Revenues forgone through tax concession should be regarded as costs to the local government no less real than direct expenditures.

(5) Industrial subsidies should not be awarded to businesses for actions undertaken in pursuit of their own financial self-interests.

(6) Local government should establish overall policies on industrial subsidies and avoid operating on an ad hoc or case-by-case basis. These policy guidelines should be overriden only in exceptional circumstances.

(7) Industrial incentive programs should operate within carefully specified budget constraints. All too often incentive programs are administered with no clear account of their costs, especially those resulting from off-budget programs and tax expenditures. Adherence to budget constraints encourages the careful targeting of resources and the use of the most cost-effective instruments to achieve public development objectives.

(8) Jurisdictions should use the most cost-effective instrument for accomplishing their purposes. In most cases, there will be little justification for using less effective incentives. Two possible exceptions to this general rule can be identified. First, the use of limited tax concessions with firms considering relocation from other jurisdictions or relocation to another jurisdiction may be justified because of the psychological dimensions of concessions to businesses. Even in these cases, jurisdictions will want to ensure that they are not being "blackmailed" by the possibility or threat of relocations simply to "sweeten" a move that the firm would undertake in any case. Second, in some cases, jurisdictions might be justified in using an incentive of lesser cost-effectiveness that delivers a higher effective value to the firm in order to achieve the necessary leverage with the firm.

(9) Cost-effectiveness ratios should be used to rank applicant firms and determine priorities for allocating limited state and local industrial development resources. These ratios measure the efficiency of state expenditures in providing financial assistance to firms. They are, therefore, the appropriate reference for guiding decisions on allocating industrial development resources.

Notes

1. For information on state industrial incentives and recent innovations, see William Hamilton, Larry Ledebur, and Deborah Matz, *Industrial Incentives: Public Promotion of Private Enterprise* (Washington, D.C.: Aslan Press, 1985), and Deborah Matz, *An Analysis of Innovative State Economic Development Financing Programs* (Washington, D.C.: National Association of State Development Agencies, 1985).

2. *Exemptions* exclude particular items or actions from taxation. *Deductions* reduce the base upon which a tax is computed. *Credits* are subtracted from the tax due, thereby reducing the actual tax payment. *Abatements* are reductions in, or forgiveness from, taxes (usually property taxes) provided for a specified period of time. For a more detailed discussion of forms of tax concessions, see *Industrial Incentives: Public Promotion of Private Enterprise*.

3. John Gray and Dean Spina, "State and Local Industrial Location Incentives—A Well Stocked Candy Store," *Journal of Corporation Law*, Spring 1980, pp. 517-687.

4. U.S. Office of Management and Budget, *Managing Federal Assistance in the 1980s* (Washington, D.C.: Office of Managment and Budget, 1980).

5. Lester Salamon, "Rethinking Public Management: Third Party Government and Changing Forms of Government Action," *Public Policy*, Summer 1981, pp. 255-275.

6. For reviews of these studies, see Larry C. Ledebur and David W. Rasmussen, "State Development Incentives" (Urban Institute Report, May 10, 1983); and George A. Reigeluth and Harold Wolman, "The Determinants and Implications of Communities Changing Competitive Advantages: A Review of Literature" (Urban Institute Report, January 9, 1979).

7. Michael Kieschnick, *Taxes and Growth: Business Incentives and Economic Development* (Washington, D.C.: Council of State Planning Agencies, 1981).

8. Roger Vaughan, *The Urban Impacts of Federal Policies: Vol. 2, Economic Development* (Santa Monica: The Rand Corporation, June 1977).

9. Roger Schmenner, "The Location Decisions of Large, Multi-Plant Companies," mimeographed, 1980.

10. Conclusions of Barry M. Rubin and C. Kurt Zorn, "Sensible State and Local Economic Development," *Public Administration Review*, March/April 1985, pp. 333-339. As sources supporting these conclusions, the authors cite Michael Wasylenko, "The Location of Firms: The Role of Taxes and Fiscal Incentives," in *Urban Government Finance*, ed. Roy Bahl (Beverly Hills, California: Sage Publications, 1981), pp. 155-190.

11. Jerry Jacobs, *Bidding for Business* (Washington, D.C.: Public Interest Research Group, 1979).

12. Roger W. Schmenner, *Making Business Location Decisions* (Englewood Cliffs, N.J.: Prentice-Hall Inc., 1982).

13. Calculation of the value of benefits to firms requires identification of the flow of gross benefits from the incentive, the appropriate discount rate to compute present values of flows accruing over time, and any offsetting costs of accepting the assistance.

public expeditures argues for extreme caution in weighing these factors.

Secondary income and employment benefits can be quantified. The cost-effectiveness model can build in income and employment multipliers. Application of the expanded model, however, has demonstrated that projects that are not cost-effective in terms of direct benefits to the recipient firm seldom become cost-effective even when secondary benefits are included. Further, multipliers used by state and local governments are, at times, somewhat unrealistic. Absurdly large multipliers have been used to justify projects that otherwise would not meet a reasonable test of benefits to costs. Therefore, one should be cautious in the application of secondary benefit tests of cost-effectiveness.

Calculating the cost of development incentives is complicated by the multilevel structure of the U.S. federal system. Changes in tax revenues resulting from incentives—both positive and negative—may accrue to both state and federal governments, and the full public sector cost of a development subsidy is the combined federal and state cost. For example, the most cost-effective instrument of industrial finance available to state and local governments, by far, is industrial development bonds. Costs of IDBs are borne by the federal government in the form of tax expenditures resulting from the tax-exempt nature of these bonds. The cost to the state is a relatively modest tax expenditure, while the benefits to the firm may be great. This situation results in a low (that is favorable) cost-to-government/benefit-to-firm ratio from the state and local government perspective. Consequently, use of IDBs has proliferated. Inclusion of federal tax expenditures in the IDB cost-effectiveness calculations, however, reduces the effectiveness of this instrument below several other tools of industrial finance.

Cost-effectiveness ratios for selected interest subsidies, subsidies for production inputs, and state and local tax abatement are presented in Table 5. Cost-effective incentives will have ratios of less than one. Negative ratios indicate the most cost-effective incentives. A general principle emerging from this table is that the federal system diminishes the cost-effectiveness of many forms of development incentives. Whenever a form of assistance raises profits or lowers costs, the aided firm faces an increased income tax liability. Since the federal government receives most income tax revenues, the states, in effect, subsidize the federal government when they assist business firms.

Tax concessions are not cost-effective. State and local government rev[illegible]es forgone through tax expenditures are greater than [illegible] firms. It is unlikely that any form of tax concession can be cost-effective. One application of the cost-effectiveness methodology examined the benefits to firms and cost to governments of business income taxes, property taxes, and employment tax credits in one state. The cost-effectiveness of these tax concessions was examined for large and small firms in four industries: (1) capital-intensive manufacturing, (2) labor-intensive,

Table 5.

Cost-Effectiveness Ratios for Selected Development Incentives

Incentive	Cost to Government/Benefit to Firm		
	Federal	State	Combined
Low-Profit Firms[a]			
Interest Subsidies			
Industrial revenue bonds[b]	2.01	0.18	2.19
Subsidized direct loan	−0.33	1.47	1.14
Loan guarantee[c]		0.79	.079
Subsidized Production Inputs			
Equipment	−1.11	2.36	1.25
Land	−0.58	1.58	1.00
Plant	−1.40	2.40	1.00
Tax Abatement	−0.42	1.42	1.00
High-Profit Firms[d]			
Interest Subsidies			
Industrial revenue bonds[b]	2.24	0.25	2.49
Subsidized direct loan	−0.84	1.82	0.98
Subsidized Production Inputs			
Equipment	−0.53	1.71	1.18
Land	−0.58	1.58	1.00
Plant	−1.40	2.40	1.00
Tax Abatement	−0.85	1.85	1.00

Notes: a. Low-profit firms face a federal corporate income tax rate of 20 percent and an average state corporate income tax of 5 percent. The combined tax rate is 24 percent under the assumption that states do not allow the deduction of federal income taxes.

b. Industrial revenue bonds are federally funded via tax expenditures.

c. Assumes a default rate of 22 percent.

d. High-profit firms face the maximum federal corporate tax rate and an average state corporate income tax of 5 percent. The combined tax rate is 48.7 percent under the assumption that states do not allow the deduction of federal income taxes.

Source: David Rasmussen, Marc Bendick, and Larry Ledebur, "A Methodology for Selecting Economic Development Incentives," *Growth and Change*, Vol. 15, January 1984, pp. [illegible]

Table 4.

Fortune Survey
Comparative Importance of Factors in Locating Next Mainland U.S. Plant

(1981 Rank Order) 1981 Rank Factor Figures in ( ) are 1976 ranks	Weighted Score* 1981	1976	Notable Changes
1. Productivity of workers (1)	82	82	
2. Efficient transportation facilities for materials and products (1)	79	82	
2. Community receptivity to business and industry (3)	79	80	
4. State and/or local attitude toward taxes on business and industry (5)	77	79	
5. Availability of energy supplies (3)	75	80	−5
6. Ample area for future expansion (8)	71	70	
7. Costs of property and construction (6)	70	71	
7. Availability of skilled workers (11)	70	65	+5
7. Quality of life for employees (n/a)	70	n/a	
10. State and local posture on environmental controls and processing of environmental impact reports (6)	69	71	
11. Water supply (9)	66	68	
11. Calm and stable social climate (14)	66	62	+4
13. Adequate civic waste treatment facilities (14)	63	62	
14. Availability of technical or professional workers (22)	62	53	+9
15. Financing inducements (23)	61	51	+10
15. Fiscal health of state and/or city (12)	61	63	
15. Proximity to customers (12)	61	63	
15. Availability of unskilled or semi-skilled workers (10)	61	66	−5
19. State and/or local personal income tax structure (17)	60	60	
20. Proximity to raw materials, components, or supplies (16)	59	61	
20. Proximity to services (17)	59	60	
20. Efficient transportation facilities for people (20)	59	55	+4
23. A growing regional market (20)	57	55	
24. Availability of clerical workers (24)	49	47	
25. Personal preferences of company executives (26)	42	36	+6
26. Proximity to other company facilities (25)	37	37	

n/a: not asked.

*Weighted Score: Respondents were asked to rate each of 26 possible factors as to their importance in locating the company's probable next new plant. The rating scale had five points, ranging from "extremely important" to "not at all important." For ease of interpretation, the answers were presented in the form of "weighted scores" so that if every respondent had said "extremely important," the weighted score would be 100, and if every respondent had said "not at all important," the weighted score would be 0.

Source: Fortune Market Research Survey, *Why Corporate America Moves Where* (New York, N.Y.: Time, Inc., 1982), p. 9.

national site selection processes, MCC chose Austin, Texas, and General Motors announced its intention to locate in Springhill, Tennessee. In neither case did tax concessions play a role in the site selection process. The state of Texas and city of Austin made a commitment to provide ongoing support to the state's education system, a commitment benefiting all firms and residents, and to assist employees in locating satisfactory housing. The Saturn decision was made on the basis of traditional location factors, primarily access to market, labor quality and costs, and local amenities.

The Volkswagen case provides an unfortunate example of corporate behavior in the site selection process. Most knowledgeable observers agree that Volkswagen made its decision primarily on the basis of access to market, access to resources and supplies, and labor considerations. Having made, but not announced, the decision to locate in Pennsylvania, the corporation proceeded to play

The United States Office of Management and Budget, after a two-year study, concluded:

> The relative effectiveness of different forms of assistance such as grants, loans, and risk assumption for meeting different types of program objectives has not been systematically reviewed, in public literature. In the light of the scope, magnitude and importance of assistance as a tool of national leadership, much more needs to be known.[4]

The significance of this deficiency in the literature has been emphasized by Lester Salamon:

> The widespread use of tools like loans, loan guarantees, social regulation, insurance, government corporations, tax incentives, various types of grants and others—many of which involve the pervasive sharing of governmental authority with a host of "third parties" ... has significantly altered the practice of public management. ... To come to terms with the new reality, it will be necessary to change the unit of analysis in public management and implementation research from the individual programs or agencies to the generic tools of government action and to develop a systematic body of knowledge about the dynamics and characters, the distinctive "political economies," and resulting advantages and disadvantages of different tools through which the public sector now acts.[5]

Existing Evidence

Variations in business tax liabilities among states and municipalities are unlikely to play a major role in business site selection, location, or relocation decisions. Existing studies, with a striking degree of consistency, have failed to demonstrate a significant relationship between taxes and location decisions of business firms.[6]

Studies

> No empirical analysis has been able to find a significant relationship between local taxes and economic development.[7]

> Only 3.3 percent of the new firms [in a survey], none of the expansions, and 6.3 percent of the new branch plants indicated they would have located in another state in the absence of tax incentives.[8]

> Tax levels are either not applicable or of low concern to the typical relocating plant. ... [O]nly about a quarter to a third of the relocating plants actually move to new locations with lower property tax rates. The bulk, 40 to 50 percent, move within the same taxing jurisdiction or to locations in towns with similar tax rates. Another quarter move to jurisdictions with higher property tax rates.[9]

> Despite the perception among policy makers that taxes matter and, therefore, a good incentive package should contain tax concessions, the overriding conclusion from previous research is that taxes do not play a significant role in a firm's choice of location among regions. Research also has shown that the other nontax controllables contained in state and local industrial incentive packages play little or no role in a firm's interregional choice of location. But as the geographical area diminishes, the importance of taxes and fiscal incentives increases. Transportation, energy, labor cost and market differentials tend to decrease as the area under consideration diminishes, making taxes a more significant locational determinant.[10]

Further, it has been argued that the availability of special subsidies for business has increased to the point that most states now offer standard types of business location incentives.[11] To the extent that this is the case, the usefulness of these subsidies in affecting interstate cost differentials is "washed out."

Surveys

Corporations do not identify tax concessions as significant factors in location, relocation, or expansion decisions. Roger Schmenner, in a far-reaching examination of determinants of behavior of large firms, identified the most important influences in national [illegible] (Table 9).[12] The seven co[illegible]ons viewed as

	Exemption: Exempt	Exemption: Conditional	Exemption: Partial	Treatment of Balance: Allocate	Treatment of Balance: Apportion	Statute(s)
MAINE. 1)					X	§5102.8
2)			1989: 10% exclusion. 1990: 20% exclusion. 1991: 30% exclusion. 1992: 40% exclusion. 1993: 50% exclusion.		X	§5200-A, Subd. 2. G; §5244, L. 1988, c. 841, eff. for taxable years beginning in 1989
MARYLAND		If 50% ownership of payor.			X	§280A(c)(5)
MASSACHUSETTS 1)	X (Unless less than 15% ownership of payor.)					§38(a)(1)
2)			95% exclusion.		X	§38(a)(1), L.1988, ch. 202, eff. for tax years ending on/after 12-31-88
MINNESOTA 1)	X					§290.21 Subd. 4(e), L. 1984, c. 502, eff. for taxable years beginning after 6-30-85
2)			80% exclusion.		X	§290.21 Subd. 4(a), L. 1987, c. 268, eff. for tax years beginning on/after 1-1-87
3)			80% exclusion if 20% ownership of payor, otherwise 70% exclusion.		X	§290.21 Subd. 4, L. 1988, c. 719, eff. for taxable years beginning after 12-31-87
MISSISSIPPI					X	§§27-7-15(1), 27-7-15(4)(1), 27-7-23(c)(2)(B)
MISSOURI	X					§143.431, *Union Electric Co. v. Coale*, 347 Mo. 175 (1940)
MONTANA 1)					X	§15-31-113(1)
2)			80% exclusion.		X	§15-31-3__, L. 1987, c. 616, eff. for tax years beginning after 12-31-87
NEBRASKA	X					§77-2716(7), L. 1984, LB 1124, eff. for taxable years beginning on/after 1-1-84
NEW HAMPSHIRE 1)					X	§§77-A:1.III(a), 77-A:1.VI
2)			Amount of exclusion determined by formula modified to include payor's foreign dividend-related property, payroll and sales.		X	§77-A:3.II(b), L. 1986, c. 153, eff. for tax years beginning after 6-30-86
NEW JERSEY		If 80% ownership of payor.	Otherwise, 50% exclusion.		X	§54:10A-4(k)(1)
NEW MEXICO					X	§§7-2A-2.M & N
NEW YORK		If 50% ownership of payor.	Otherwise, 50% exclusion.		X	§§208.9(a)(1) & (2) and (b)(2)
NORTH CAROLINA				X		§§105-130.7, 105-130.4(f)
NORTH DAKOTA 1)					X	§57-38-01.8
2)			1989-1994: 50% exclusion or, if at least 25% increase in "threshold activity", 70% exclusion. 1995: 70% exclusion.		X	L. 1987, H.B. 1064, effective for tax years beginning after 12-31-88
OHIO	X					§5733.04(I)(2)
OKLAHOMA				X		§2358.A.4.b
OREGON			80% exclusion.		X	§317.267(2), c. 1, Oregon Laws 1984, eff. for tax years beginning on/after 1-1-86
PENNSYLVANIA	X					§§7401(3)1.(A) & (B)

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Reforming State Tax Systems

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LEGISLATIVE AFFAIRS

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December 1986

generous tax deal, and because the evidence suggests pretty clearly that these offers are not major determinants of the location decision, that the state that dares to turn its back on this game is likely to attract favorable attention.

I commend this to you as food for thought.

. . . The states should stress the uniform, equal, predicatble and certain application of taxes to all businesses.

NOTES

1. Gray C. Cornia, William A. Testa, and Frederick D. Stoker, *State Local Fiscal Incentives and Economic Development*, (Urban and Regional Development Series No. 4), Academy for Contemporary Problems, Columbus, June 1978.

2. George W. Morse and Michael C. Farmer, *Tax Abatement Location Investment Effects: Does the Ohio Reinvestment Area Tax Exemption Really Work?* (Report ESS 605), Department of Agricultural Economics and Rural Sociology, The Ohio State University, Columbus, November 1983.

Frederick D. Stocker is a Professor of Economics and Public Administration at Ohio State University. This paper was originally presented at the Western States Association of Tax Administrators meeting in Boise, Idaho, on September 17, 1984.

The State 'Unitary Tax' Dispute

by Congressman Byron Dorgan

Most of the major newspapers in the United States have printed stories and editorials in the past year on the subject of a "unitary tax" dispute, an issue that has divided the U.S. and some of its allies and has reached all the way to the Oval Office in the White House.

The controversy is shrouded in the language of tax lawyers and corporate attorneys, but the dispute is really simple.

Some state governments, including the state that I'm from (North Dakota), require a corporation doing business in that state to report for income-tax purposes on a unitary worldwide combination basis.

Simply put, that means a corporation doing business all around the globe, and also in North Dakota, is asked to report to North Dakota a portion of its total income for the purpose of allowing North Dakota to compute the income-tax liability it owes the state.

That portion of income attributable to North Dakota is computed by requiring the corporation to report its payroll, property and sales in North Dakota and compare that to its payroll, property and sales everywhere else. These three fractions then are applied to the total income of that corporation, and that is the piece of the income pie attributable to North Dakota as a tax base.

Some Corporations have become very upset with that approach. They believe states are attempting to tax foreign income. That, of course, is not the case. The states are only attempting to tax a fair percentage of the total corporation's income as measured by the corporation's activity in that state.

The corporations say the state should use something called the "arm's-length method" of computing a corporation's state income tax. This method is similar to the old shell game at the carnival. You only get to look at one portion of the corporation's financial picture. The result is corporations price-transfer their profits around and play the shell game to avoid paying their state-tax liability. That's why they like this method.

Some corporations headquartered in Great Britain have been especially active in trying to convince the British government that they are being mistreated when they do business here.

All of that is pure nonsense. There is not a shred of evidence anywhere that the state governments, using the unitary worldwide combination approach, have overreached and are attempting to require more than an appropriate share of a corporation's tax base to be reported to the states for income-tax purposes.

Let me repeat—there's not a single credible instance that I know of in which injury to those corporations has been demonstrated, and I don't believe it ever will be, because the issue is pure myth.

When I was tax commissioner for the state of North Dakota, I learned very quickly that the problem is not that the states are overreaching to try to tax income that does not belong to them. The problem is that too many of the multinational corporations are underreporting their income and avoiding scandalous amounts of state income taxes.

Byron L. Dorgan, a Democrat from Bismarck, is North Dakota's U.S. representative. This article was originally published in The Denver Post, Oct. 13, 1984.

Multistate Tax Commission

REVIEW

A New York Perspective on Tax Incentives

The Role of State Tax Incentives in Attracting and Retaining Business

*by Richard D. Pomp**

Chief Justice Marshall once wrote that the power to tax involves the power to destroy. This essay examines the 1985 version of that statement: whether the power not to tax involves the power to create. More specifically, are state tax incentives an efficient strategy for attracting and retaining businesses and their employees?

States, municipalities, and big businesses are currently playing a high stakes game. The premise of this game is that a healthy state economy can be created (or maintained) by providing tax incentives that affect a business's locational decision.[1] If a state does not meet the going ante in terms of incentives, it runs the risk that a business will locate in areas offering greater inducements. It is a high stakes game that pits neighbor against neighbor, North against South. If tax incentives are the new ammunition in the latest war between the states, as some commentators have claimed, then the courtship of General Motors for its Saturn plant must be the most recent battle.[2]

The use of tax incentives is not new. Tax policymakers and theorists have concerned themselves with the impact of taxes on business activity and employment since governments began levying taxes. From the early years of the Union, state governments have sought to influence the character and pace of economic activity with tax policy, direct expenditures, public relations, and regulations.[3] During years of slow growth, states have increased their efforts to attract industry and to stimulate employment and income.

New York has actively used its tax laws in an attempt to attract and maintain businesses and their employees by adopting tax credits and other special provisions. Although these provisions may be cost-effective, the State has never demanded a rigorous or systematic evaluation either prior to or after their adoption. This failure is perhaps understandable because it is during periods of slow growth that the temptation and pressure to adopt these provisions without adequate research is greatest.[4]

In order to provide for an informed debate over the use of such provisions, and more generally to analyze the effect of New York's overall business tax structure, the Staff of the Legislative Commission on the Modernization and Simplification of Tax Administration and the Tax Law (Tax Study Commission) undertook a comprehensive study of these issues.[5] The Staff first reviewed over 30 years of research on the factors that influence where a business locates.[6] This body of learning suggests that locational decisions are extremely complex and that state business taxes are just one of innumerable factors that vary among jurisdictions. The majority of studies conclude that state and local business taxes do not significantly influence most business locational decisions.[7]

The Staff then attempted to determine whether this conclusion was valid regarding New York taxes. Are the State's business taxes out-of-line with those of other states so that studies on locational decisionmaking are not valid for New York? To answer this question, the impact of the corporate, sales, and property taxes on the after-tax rates of return of representative manufacturing firms was evaluated.[8] A computer model was used to simulate a representative manufacturing firm's

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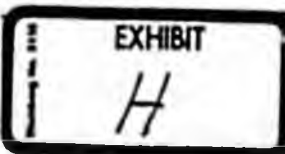

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profits over a period of time both in New York and in a variety of other locations in the United States. Simulations were made under existing law and under a number of possible changes. These simulations provided a basis for evaluating the impact of the State's overall tax structure on the after-tax rates of return of various manufacturing firms and the impact of the State's investment tax credit, the employment incentive credit, the recently repealed job incentive credit, and the double-weighted receipts factor, as well as changes in the corporate tax rate, the adoption of the federal rules on depreciation (ACRS), and the adoption of a so-called throwback rule.[9] Comparisons were made between New York and seven other states. The results of these simulations were consistent with the conclusions drawn from the literature review.

The combination of three decades of research and analysis and the microsimulations conducted specifically for New York suggest that changes in business taxes cannot be viewed as an effective means of influencing business locational decisions.[10] Interstate differences in corporate, sales, and property taxes among the states do not seem to have a large impact on after-tax rates of return. The reason why changes in the State's business taxes are unlikely to be a successful policy can be summarized as follows.

First, innumerable factors are important to a business in its decision about where to locate. Depending on the type of business at issue, the locational decision can be influenced by plant or site availability,[11] access to financing, access to and cost of transportation,[12] quality[13] and cost of labor,[14] proximity to markets,[15] the cost of utilities,[16] proximity to supplies,[17] proximity to other company facilities,[18] the regulatory environment, the quality of a state's schools, colleges and universities,[19] the cost of housing,[20] the level and quality of public services,[21] and the range of other amenities that enter into the general quality of life offered.[22]

Second, taxes are one of the many costs of doing business and the magnitude of these other costs may easily swamp the amount of state taxes involved. For example, a Staff analysis of those corporations which allocate their income for purposes of the State franchise tax—a group that pays approximately 70% of the corporate tax revenues—indicated that their labor costs in New York are 53 times as large as their State corporate tax payments. A 2% wage differential is equivalent in its effect on profits to a 106% corporate tax differential. For a labor-intensive corporation, a few pennies difference in the hourly wages paid to employees might reduce its costs by more than any conceivable tax savings that would result from locating in one state rather than another.[23]

Third, state and local tax payments are deductible for purposes of the federal corporate income tax. The effect of this deduction, the so-called federal offset, is to reduce both the absolute burden of state and local taxes and differences in burdens among the states. For example, consider a corporation subject to 46% federal corporate marginal tax rate. Assume that this corporation is deciding whether to move from State A to State B. Taxes would be $200 in State A but would only be $100 in State B—a $100 difference. After taking into acount the federal offset, however, the out-of-pocket cost of state taxes is $108 in State A and $54 in State B. The net difference in taxes between A and B is reduced to $54 ($108-$54), from $100 ($200-$100).[24]

Fourth, differences in state and local taxes may reflect differences in the level and quality of state and local public goods and services, and these goods and services also affect business locational decisions. Low taxes are not necessarily attractive to businesses if they mean that the firm will have to supply, at its own expense, what is supplied through the public sector in other states or other jurisdictions. Furthermore, if low taxes mean inferior schools, a state may lack the educated and literate labor force that is essential to certain types of businesses.[25] Of course, not all public goods and services are equally important to businesses.

Fifth, to the extent that tax rate differentials are capitalized, their impact will be reduced. For example, low property taxes in one jurisdiction might mean that land sells there for a higher price than it would sell for in another jurisdiction having higher property taxes. In other words, land located in a high-property tax jurisdiction may sell for less than an equivalent parcel of land in a low-tax jurisdiction, assuming that differences in taxation are not reflected in differences in public services, which might also be capitalized.[26]

Sixth, most relocating companies plan to stay at their new site years longer than any group of elected officials is likely to be in office. Consequently, current tax levels, special concessions, or special features of the tax law may not be a reliable basis upon which to make a multi-million dollar investment. What one group of legislators might grant today by way of concession another might eliminate tomorrow, especially if financial conditions change significantly. Fiscal stability and predictability may be more important than special concessions.[27]

Seventh, a state tax incentive that is granted by way of incorporating a similar federal provision may have no impact on a firm's decisionmaking if the future of the federal provision itself is in jeopardy. For example, states have been urged to adopt the federal provisions on depreciation (ACRS) in order to provide a tax incentive to businesses. Because the U.S. Treasury has proposed eliminating ACRS, it is highly unlikely that any business would make a major investment decision on the basis of whether a state had adopted ACRS.[28]

Eighth, state tax incentives may contain their own seeds of destruction. If incentives are effective at all, a state will gain only a short-lived advantage over other states because the latter can be expected to adopt similar ones.[29] A tax incentive that is adopted by all states is equivalent to no incentive at all, except that tax revenue is needlessly lost. In reality, however, states

are afraid of letting any other state obtain an advantage, and thus tax incentives are often adopted without evaluating the results that occurred elsewhere.

Ninth, some executives charged with the locational decision may be uninformed about the existence of tax incentives. For example, one researcher found that most firms were unaware of whether tax incentives even existed when making their locational decisions. In the case of those firms which were aware, only a small portion claimed that they would have located in another state in the absence of the incentives. Further, most firms making new investments did not even consider locating in any state other than their final choice.[30]

. . . the weight of the evidence indicates that business tax incentives cannot play a significant role in attracting or maintaining firms.

Finally, there are relatively few footloose firms that can be affected by tax incentives.[31]

Because the weight of the evidence indicates that business tax incentives cannot play a significant role in attracting or maintaining firms, their use probably results in a needless loss of State revenue. Unfortunately, the New York Legislature, like most legislatures, is unaware of the ongoing cost of various special provisions in the tax law. Aside from an initial revenue estimate that is sometimes made when a tax incentive is proposed the Legislature has not requested an annual accounting. Yet such costs can increase dramatically.

As an illustration, consider that no revenue estimate accompanied either the adoption of the New York investment tax credit (ITC) in 1969 or the related employment incentive tax credit (EIC) in 1975.[32] By 1982, however—the most recent year for which data is available—$136 million of ITCs were claimed, with $133 million of unused investment and employment tax credits carried forward into 1983. Indeed, the amount of unused credits carried forward into 1983 exceeded the total amount of credits claimed in 1980. Moreover, in 1982 two corporations used nearly 40 percent ($57 million) of the total amount of ITCs and EICs used. Overall, from 1970 to 1982 more than two-thirds of a billion dollars of ITCs and EICs have been claimed. This rapid escalation in cost and the marked concentration of these credits have occurred without a full accounting to the Legislature.

In effect, tax incentives are tantamount to a spending program that is implemented through the tax system. For example, in lieu of enacting the ITC the State could have adopted an explicit spending program. Rather than filing a form claiming an investment tax credit with the Tax Department, the taxpayer could have filed the same form with a different agency, perhaps the Commerce Department. The Commerce Department would then have issued a check to the taxpayer, instead of the current approach in which the corporation receives an implicit check through a reduction in its tax liability.

By choosing a tax incentive over an explicit spending program, the State surrenders control over the amount it expends each year on the ITC and the EIC and abdicates its responsibility for financial accountability. In a conventional direct spending program, the State appropriates a specific amount of funding. The appropriated amount represents the State's maximum revenue exposure and presumably reflects a Legislative judgment about the costs and benefits of that program relative to other programs competing for funding. Tax incentives, however, are more like an entitlement program, in which any taxpayer that meets the stated criteria qualifies for the benefit. The State cannot control the total expenditure in advance and the program has unpredictable financial consequences for the budget.

The lack of control over the cost of tax incentives is exacerbated by the Legislature's failure to review these credits in the same manner it reviews other spending programs. Direct subsidy programs are reviewed annually through the Legislative appropriation process. Using the tax system to implement a program to encourage capital investment avoids this process. Indeed, no published information is even available to facilitate periodic review. For example, until a report by the Staff of the Tax Study Commission, there was no publicly available document indicating the annual amount and distribution of ITCs or EICs claimed by corporations.[33] But the need for this evaluation may be greater in the case of a spending program that is implemented through the tax system than in the case of an explicit spending program. In the former case, the details are often buried in the technical and abstruse language that exemplifies the tax law. Furthermore, in periods when the budget is scrutinized in order to ferret out any possible waste, and painful decisions are confronted regarding the provision of services, the tax system escapes this same degree of fiscal vigilance. Tax incentives thus avoid the traditional cost-benefit analysis that is applied to other governmental programs.

In addition to the explicit loss in revenue, tax incentives impose inevitable administrative costs and result in "leakage" as taxpayers pursue aggressive tax planning techniques to qualify for the special benefits. These problems are not unique to the State. A recent example of possible abuse of the federal investment tax credit involves a major accounting firm. In a civil complaint, the Justice Department alleged that this firm engaged in a pattern and practice of misclassifying property that was clearly unqualified for the investment tax credit. For example, it was alleged that the firm encouraged its clients to classify concrete block walls as portable plug-in panels and to classify immovable industrial heating units as unit heaters so that they would not appear as buildings or structural components of buildings, which are ineligible for the federal ITC.[34]

Continued on page 4

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Indications exist suggesting that taxpayers are abusing the State ITC and EIC. For example, when the amount of EIC claimed by a corporation in 1980 was matched by a computer against the maximum amount of EIC that could have been claimed legitimately, it appeared that nearly one-half of the corporations claimed an EIC that was too high. These apparent errors involved about three-fourths of the value of the total EICs claimed in 1980, over $30 million.[35]

Tax incentives also raise serious questions of equity. The State's investment and employment tax credits, for example, raise four different sets of equity considerations. First, over 97 percent of all corporate filers do not benefit from the ITC and over 99 percent do not benefit from the EIC, yet they indirectly bear the costs of these credits through higher rates. By contrast, these credits have allowed nearly 4,000 corporations, including some of the largest corporations in the State, to pay the $250 minimum tax.

Second, even though the ITC and EIC are claimed primarily by manufacturers, the benefits are highly skewed. In 1982, less than 16 percent of all manufacturers claimed an ITC and less than six percent claimed an EIC. Two corporations received 40 percent of all the credits used in 1982 and ten corporations received 50 percent.

Third, corporations receiving an ITC pay lower taxes than do equivalent firms that are not investing in assets qualifying for the credit. If such corporations are competitors, the State has provided one group of firms with an "edge" over another. To take just one example, a corporation manufacturing or processing frozen gourmet dinners receives an ITC on its qualifying assets, whereas a fast foods restaurant is ineligible for the credit. If the credit is reflected in the price of the final product, frozen gourmet dinners have received a subsidy from the State while corporations producing a competing product have not. These haphazard effects are inevitable whenever the tax system is used to subsidize certain activities or investments over others. Since such effects are neither obvious nor easily traceable, they are unlikely to represent a conscious industrial policy by the State.

Fourth, most tax incentives favor capital rather than labor. Consequently, their effect might be to lower employment. An investment tax credit, for example, lowers the cost of capital relative to labor, which encourages businesses to shift from the use of labor to the use of capital, and can result in a decline in employment. In addition, much new equipment tends to be labor saving (e.g., robotics). Indeed, the more successful the ITC might be at inducing investment the less successful it might be at creating jobs. The New York data is consistent with this supposition.[36]

In addition to these problems, state tax incentives are inherently wasteful. Because of the federal offset, a state may forgo $2 in revenue yet a corporation may, after taking into account the increase in its federal corporate income tax, receive barely more than $1. The difference between what a state forgoes and what the corporation receives inures to the benefit of the federal government—revenue sharing in reverse.[37]

Most tax incentives are also wasteful because their benefits are available to corporations whether they alter their behavior or not. To illustrate, a corporation receives the State investment tax credit for all of its qualifying purchases, including those which it would have made anyway. No attempt is made to limit the credit to investments in excess of those which would have occurred in any event.[38]

In addition, New York, like all other states, does not require that any tax savings from the use of an incentive be invested within the State. For example, not only does a corporation receive the ITC for investment that it would have made anyway, but it is then free to use such savings to finance activities in other states or to increase its dividends. Indeed, a recent study of the U.S. corporate income tax indicates that corporations receiving the largest amount of tax incentives actually reduced their investment and increased thier dividends.[39]

Why, despite the evidence to the contrary, has it become an article of faith in some quarters that a state can affect locational decisions through changes in its business taxes? One common explanation is that business taxes are one of the few aspects of the economic milieu that a legislature can directly control. Transportation costs, the cost of labor, the price and availability of real estate, climatic conditions, and so forth are less susceptible to state intervention. A business seeking a reduction in its costs is likely to focus its political activities on tax relief—an area in which the legislature at least has the power to act.[40] Indeed, some corporate officials view themselves as having an obligation to the shareholders to pursue all possible tax incentives.[41]

From a legislature's viewpoint, taxes are one of the few costs of doing business that can be reduced and no doubt for this reason the temptation to do so is great. And, because legislatures may never demand an annual accounting of the cost of the various special provisions they have enacted, tax incentives may appear to be less costly than direct spending programs aimed at economic development. Moreover, legislators do not wish to be perceived as being opposed to jobs or economic development or as having the blood of a runaway plant on their hands. In addition, no state desires other states to get a jump on it. It is not surprising, therefore, that tax incentives are easy to legislate if only because they give lawmakers a feeling of having done something constructive.

A more cynical view is that tax incentives may allow some legislators to accomplish indirectly what they cannot do directly—lower taxes on business. Indeed, from a business lobbyist's perspective, the combination of high nominal rates and a narrow tax base may be preferable to low nominal rates and a broad base. A high nominal rate provides an effective club that can be waved in order to persuade a legislator to support some arcane change in the tax law. One of a lobbyist's

standard tools—the incantation of "business climate" and "economic development"—depends on high nominal rates for maximum impact.

Many New York legislators are aware of the substantial body of research indicating the ineffectiveness of tax incentives but nonetheless view such measures as symbolic of a favorable business climate. No easy way exists of evaluating this position because there is no acceptable definition or measurement of "business climate." Many considerations affect a corporation's view of New York's business climate, and the issues important to one corporation—energy costs or transportation facilities—may be unimportant to another.[42] There is little doubt, however, that the level of taxes compared with the level and quality of public services is one factor that shapes a business's perception. Firms that avail themselves of various tax incentives and receive the level of public services that they desire probably have a favorable view of the State's business climate and of its tax law. For other corporations, the level of taxes rather than the level and quality of public services may shape their perceptions. Whether this view is shared by all corporations, however, is problematic. For the 91.3 percent (379,000) of all corporate taxpayers in 1982 that did not utilize the double-weighted receipts factor, or did not benefit from the lack of a throwback rule, or did not benefit from any of New York's special credits, but bore the burden of the forgone tax revenue through higher rates,[43] the tax law may simply be viewed as a complicated morass of special provisions benefiting their competitors.[44] Such corporations may feel that the State's business climate would be improved if these various provisions were eliminated with a correlative reduction in tax rates. As economists remind us, no "free lunch" exists. Revenue that is lost through wasteful tax provisions results in a combination of lowered services and higher taxes than would otherwise result and these effects must be considered by policymakers when evaluating tax incentives.

Commentators caution that the role that taxes play in a particular firm's perception of a state's business climate must be placed in perspective. Zoning regulations, construction permits, the attitude of those public officials with whom a firm most often deals, the speed with which telephone calls are returned from the public sector, the degree of government regulations and restrictions, the way businesses are treated by a tax department's auditors, the level of civility that characterizes interaction with government personnel, the amount of "red tape" that exists, the number of forms and permits that must be filled out, and the governmental assistance offered to a new firm and its employees in relocating all contribute to perceptions of business climate. Perceptions of business climate are also based on intangibles and imponderables that defy analysis or quantification (*e.g.*, personal reasons of executives).

In this vein, a leading researcher suggests that:

> . . . states and localities should concentrate on helping their manufacturers with the physical items which go into selecting a plant's location, constructing it, and starting it up. States and localities should stand ready to offer the interested manufacturer (i) speedy and accurate information about potential sites, (ii) help in securing necessary environmental or zoning permits, and (iii) timely help with the roads, sewerage, water, waste treatment, and labor training which can make a real difference to the smooth start-up of a new manufacturing facility. I remain convinced that the industrial growth of the South has had more to do with Southern hospitality than with Southern tax rates. The regional differences in the use of such assistance as labor training suggests that supply does seem to create at least some of its own demand in these matters.
>
> Recently there has been a rise in expediting mechanisms to counter the stifling effect that large bureaucracies have on industrial decision-making. Some cities and states have sponsored ombudsmen to guide businesses through the red-tape mazes. Such programs have received uniformly positive reactions. Such expediting is highly valued by many large companies, and explains, in part, the favorable opinions they have of the industrial development programs of North Carolina, South Carolina, Nebraska, and elsewhere. It is difficult for the average businessperson to know how to secure quick rulings on zoning variances, building permits, environmental standards and regulations, parking regulations, and tax assessments and abatements. The more government can cut the red tape, the more industry it can expect to retain. This exceedingly useful function could be promoted even more than it has been.[45]

To the extent that business taxes contribute to perceptions of business climate, some researchers argue that a state is better off with a broad tax base and low nominal rates than with a high nominal rate coupled with numerous special provisions. On the one hand, such differences should not matter. The sophisticated tax manager of a corporation is likely to be more interested in the "bottom line" liability and less concerned with what the nominal rates might be. On the other hand, the tax manager of a corporation that is considering a number of expansion sites, including New York, may not be involved in compiling the initial list identifying which of the 50 states merit further consideration. Such a list may be compiled by persons such as the division general manager who might not be involved in preparing the state tax returns for the corporation. A state with a high nominal tax rate but having favorable allocation formulae, tax credits, or

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favorable rules on defining taxable income may be eliminated from consideration as an expansion site in favor of a state having a lower nominal rate but a less desirable tax law. Whether a state obtains the same advantages when it indirectly lowers business taxes by adopting special provisions rather than when it directly lowers visible tax rates is a fundamental and critical question.[46] In terms of improving its business climate, a state may be better off eliminating most or all of its special provisions and using the increased revenue to lower rates.[47]

One commentator has concluded that:

> State tax policy should be designed so as to emphasize stability, predictability, and uniformity in state business taxation. The business tax climate is impaired more than anything else by tax policies that seem to single out particular industries or activities for special treatment, either favorable or punitive, creating a situation in which everything seems to be up for grabs. Tax concessions to specific firms or industries are to be avoided. On the contrary, state policy should emphasize the evenhanded application of the tax structure to businesses of all kinds.[48]

Whatever the perceptions are of New York's business climate, work by the Staff of the Tax Study Commission indicates that the State's business tax structure is generally in line with that of other states. Moreover, the effects of a range of policy options that were simulated, which included rather dramatic changes in the State's franchise tax, did not alter New York's ranking among the sites studied and were probably too insignificant to alter New York's attractiveness.[49]

Perhaps in recognition of the competitiveness of the State's *business* tax structure, attention has recently turned to the role played by New York's *personal* income tax. The effects of a state's personal income tax on the location of a business has not yet been studied with any rigor, primarily because the issue is not as susceptible to the kind of analytical tools that are applied to business taxes. The research discussed above covered only the corporate, sales, and property taxes and therefore its findings cannot be extrapolated to the State's personal income tax.

This essay . . . concludes that using business taxes as a significant part of an economic development strategy is virtually certain not to have the impact that proponents expect.

The conclusions and findings of the Tax Commission's research on New York, which are consistent with a substantial body of economic analysis, seriously question the emphasis the State has previously placed on the relationship between business taxes and economic development. In the past, it has been assumed that a change in the business allocation formula, the introduction of an investment tax credit, the adoption of ACRS, the ability to allocate income to other states even if such income is not taxed by these other states, and similar special tax provisions, would significantly affect a business's locational decision. Like many issues that state policymakers confront, the question of the influence of taxes on the business locational decision cannot be definitively and conclusively answered. Knowledge in this area is and will remain imperfect, which, unfortunately, describes many of the other areas that policymakers are asked to address. Confronted with the lack of perfect information, policymakers should respond by determining the direction in which the bulk of the evidence points.

Clearly, a substantial body of evidence suggests that state business taxes are unlikely to affect significantly the locational decisions of firms. Businesses are not flocking to Mississippi, Louisiana, or Arkansas—low tax states. Conversely, Route 128 developed at a time when Massachusetts's unofficial sobriquet was "Taxachusetts." Apparently, low taxes do not inevitably attract firms any more than high taxes necessarily repel them. Of course, in some cases state and local taxes may be the determinative factor in a locational decision. It is also possible that taxes matter more for some types of firms than for others, and that the mix of taxes might also be important. For some businesses, an adverse tax picture reinforces other disadvantages that a state has. What the research suggests, however, is that these situations are infrequent and should not be the "tail that wags the dog."[50] This finding should not be misinterpreted, however, as an invitation for a state to increase cavalierly its taxes on business—at some point, deleterious effects can be expected.

The policy implications seem clear. Those who advocate using the tax system to influence business locational decisions, a position that is seemingly inconsistent with over 30 years of research, should have to support their case with a rigorous and periodic cost-benefit analysis. Because of the revenue and inequities at stake, the burden of proof should be on such advocates. Ironically, programs costing a few million dollars receive more scrutiny than tax incentives like the ITC and EIC, which cost more than the budgets of most State agencies.

De-emphasizing the use of business tax incentives as a tool for attracting and maintaining businesses should be viewed as a way of eliminating waste, inefficiency, and inequity in the tax system and is not tantamount to abandoning any meaningful program of economic development or to damaging the State's business climate. To the contrary, the money that would be raised from eliminating ineffective and inequitable provisions in the tax code could be used to finance rate reductions in the corporate and personal income taxes, to supplement existing State programs, or to fund new ones. Money raised from eliminating provisions that cannot survive a cost-benefit analysis could be used for human resource development, job

training, research and technological development, providing capital to finance growth and development, improving the State's infrastructure, and energy and natural resources management. To encourage economic growth, money is probably best spent on programs that increase the birth rate of local companies and the encourage the expansion of small, local companies. This essay does not address the specific merits of these programs, but only concludes that using business taxes as a significant part of an economic development strategy is virtually certain not to have the impact that proponents expect.

NOTES

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1. *See State Taxation Policy* (ed. M. Barker 1983), p. xiii-xv.

2. See note 27 *infra*.

3. *See* M. Kieschnick, "Taxes and Growth: Business Incentives and Economic Development," p. 155 in *State Taxation Policy supra* note 1 at 155; S. Kanter, "A History of State Business Subsidies," *Proceedings of the National Tax Association—Tax Institute of America*, (1977) p. 148. Massachusetts granted the first tax incentive in the country in the 17th century. *See* R. Pomp, S. Kanter, K. Simonson, and R. Vaughan, "Can Tax Policy Be Used to Stimulate Economic Development," 29 *Amer. L.R.* 207, 222 (1980). New Jersey granted a tax exemption to a manufacturing company established by Alexander Hamilton in 1791. *See Fortune*, March 5, 1984, p. 112.

4. A survey by the Advisory Commission on Intergovernmental Relations found that support for business tax incentives is strongest when economic growth has been slowest. *See* "State Tax Incentives: How Effective Are They?" CUED *Commentary*, Jan. 1980, p. 3.

5. The Staff's work is summarized in a Report by the Staff of the Legislative Commission on the Modernization and Simplification of Tax Administration and the Tax Law, Interstate Business Locational Decisions and the Effect of the State's Tax Structure on After-Tax Rates of Return of Manufacturing Firms (December 31, 1984).

6. Nearly all of the research was conducted on the locational decisions made by existing firms that were expanding, establishing branch operations, or moving from one site to another. Little research has been conducted on the effect of state taxation on new business formation, although intuitively it would seem that state taxes would be less important than other factors, such as school and family ties and availability of financing.

7. Kieschnick, *supra* note 3 at 187 discusses numerous weaknesses in some of the existing empirical literature. His more carefully conducted research is consistent, however, with much of existing literature.

8. The Staff did not address the effect of local taxes on the location of businesses within the State—for example, whether a property tax abatement offered by Jurisdiction A is likely to be cost-effective. Any impact the personal income tax or payroll taxes might have on business locational decisions was also not addressed.

9. By using after-tax rates of return of representative manufacturing firms in selected industries a number of problems that mark other studies of comparative tax burdens were avoided. *See* Report of the Staff of the Legislative Commission on the Modernization and Simplification of Tax Administration and the Tax Law, Interstate Tax Comparisons: Introduction and Overview (1985), Kieschnick, *supra* note 3 at 190-198. Staff Report, *supra* note 5 at 31-36.

10. State tax incentives typically favor capital investment (e.g., the investment tax credit or the adoption of a depreciation regime like ACRS). These incentives can increase the level of investment in a state in two independent ways: by encouraging existing firms to invest more than they otherwise would or by encouraging firms to locate (or remain) in a state. Such incentives, however, are rarely defended as tools for increasing the level of investment in a state except through their impact on attracting new businesses. The simulations described in the text which included doubling the rate of the State's ITC, as well as eliminating it entirely, suggest that tax incentives cannot be seriously defended as a cost-effective means of increasing the level of investment by existing firms. For a further discussion, see Staff Report, *infra* note 28 and Staff Report, *infra* note 32.

11. The red tape involved in site assembly may be a much greater investment barrier than the price of land. *See* R. Vaughan, *State Taxation and Economic Development* (1979), p. 25.

12. Transportation costs affect both the revenue a firm receives from its sales and the prices it pays for its inputs. Availability of transportation linkages, such as the ease with which trucks can make deliveries and collections, or the proximity of a railroad spur, shipping pier, or major airport, can also be critical for some activities. Cities like New York, which have traditionally housed a large number of small firms whose products are fairly transportation intensive, suffer from inadequate access to rail transportation and inconvenient access to truck routes. *See id.* 24.

13. Because training labor is expensive, businesses are attracted to areas that have a ready supply of skilled labor. Labor that is priced low relative to its skill was a major factor in the development of manufacturing in the South. *See id.* 24. Skilled labor also appears critical to attracting technology-oriented firms. *See* note 19 *infra*.

14. The cost of labor may be a major consideration in competitive labor intensive industries, for example, apparel, leather, furniture, and consumer electronics. Another labor consideration is whether the workforce is likely to be unionized. *See* R. Schmenner, *Making Business Location Decisions* (1982), p. 37. A company with seasonal needs for labor has to be located in an area with a large labor pool. *See* Vaughan, *supra* note 11 at 24.

15. A site near established markets may be essential for industries such as printing, plastics fabrication, paper conversion, and can manufacturing, which involve commodities that have a low value-to-weight ratio and thus have transportation costs that are a high percentage of the selling price of the goods. *See* Schmenner, *supra* note 14 at 37.

16. One of the factors cited by Bankers Trust for transferring part of its operations from New York to New Jersey was the lower cost of utilities, an important consideration presumably because of the large amount of electricity needed to run the company's computers. *See New York Times*, April 29, 1983, p. B3. Energy costs are commonly mentioned as one of the reasons why the banking and insurance industries are relocating part of their operations outside of New York City. *See New York Times*, March 2, 1982, p. D23; December 23, 1981, p. D14. State and local taxes, of course contribute to the cost of energy. The price and availability of office space is another factor contributing to the movement of firms from New York City to less dense regions, both within and without the State.

17. For example, paper mills typically locate near a supply of trees and water; fruit and vegetable processors are usually located near farms; and petrochemical complexes must be close to pipelines. *See* Schmenner, *supra* note 14 at 37.

18. Some manufacturing plants operate as satellites to a base or main plant and cannot be located too far from the main plant without stretching the lines of support too taut. Schmenner, *supra* note 14 at 37. Savin Corporation decided to build a plant in Union, New York because four of its feeder plants were already in the area. According to the corporation's senior vice president, "the choice wasn't made because of tax considerations." *Wall Street Journal*, July 1, 1980. Nonetheless, the State's Commerce Commissioner chose to describe Savin's decision as "a splended example" of the drawing power of tax incentives. *Id.*

State officials responsible for economic development have an institutional interest in exaggerating the impact of tax incentives. When Church and Dwight built a new plant in Ohio, one economic development official claimed: "The tax incentive was the keystone of the deal." The corporate comptroller, however, stated that: "The tax abatement was a nice kicker at the end, but we chose Ohio mainly because of its strategic location for distribution and market growth." *Wall Street Journal*, June 30, 1978, p. 1.

19. High-tech companies, which are being wooed by many states today, are especially sensitive to the existence of prominent universities having graduate-level technical programs that produce a pool of potential employees. A recent example involves Microelectronics and Computer Technology Co., a joint venture of 12 major companies, including Control Data, Digital Equipment, Honeywell, RCA, and Sperry, which was courted by fifty-seven cities. According to the president of Microelectronics in selecting Austin, Texas for its site the corporation emphasized "the output of technical people in the area," particularly electrical engineers and computer scientists with advanced degrees—and "not who's holding a gold watch to get you to come." *Wall Street Journal*, May 12, 1983. *See also* note 20 *infra*. The existence of high quality graduate programs no doubt explains the presence of high-tech firms along Route 128 in Massachusetts and in the "Silicon Valley" in California. But *see infra*.

According to recent reports, sweeping changes in educational policies are being pursued throughout the South by a growing number of persons who assert that the ability of their states to attract growth industries increasingly hinges on the educational depth of the work force. Many of these changes are being financed by increased taxes. *New York Times*, March 20, 1982, p. 26.

The Alabama Governor's Task Force on Economic Recovery expressed a similar concern: "Alabama's traditional combination of low taxes and minimum services no longer constitutes a sound basis for progress. . . . Today the premium is on the elements which support technology—the educational system, engineering resources, communications reseach." *New York Times*, June 14, 1983, p. A19.

Florida recently increased its budget for education by $227.8 million through a variety of tax increases. The Florida Governor supported the tax increases with the slogan, "Education Means Business." *New York Times*, January 11, 1984.

This phenomenon is not limited only to the South. When voters approved the first Dayton, Ohio public school tax in twelve years, they were described as acting in part from a concern for jobs. *New York Times*, June 14, 1983, p. A18. Business executives in California have also called for tax increases to finance educational reforms. Business leaders fear that the poor quality of public education in California is undermining the ability of their companies to compete with foreign countries, especially Japan, which are perceived to have better education systems. *New York Times*, April 23, 1983, p. 7.

20. The high cost of housing in the Silicon Valley is apparently making it increasingly difficult for companies to attract employees and is causing some corporations to move to lower cost areas. *Wall Street Journal*, May 11, 1983, p. 37. The cost of housing played a role in the selection of Austin, Texas by Microelectronics and Computer Technology Co., *supra* note 19. "The biggest economic factor was the cost of private housing. Taxes didn't play a significant role in our decision. . . . The governor of Texas put together a statewide task force of bankers, industrialists, educators and political figures . . . and they did some clever things to reduce the hassles of relocating—such as getting bank commitments for mortgage money below FHA rates and starting a job placement center for spouses." *USA Today*, August 24, 1983, p. A8.

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21. Improvements in the level and quality of public services, such as a state's infrastructure, will benefit many firms, both large and small. By comparison, tax incentives tend to accrue to a small percentage of large firms.

22. According to one of the leading researchers on locational decision-making, corporations visit a potential site in order to gather information about the community—its attractiveness as a place to live and raise a family, its housing, schools, medical facilities, cultural and recreational activities, and its civic pride. Schmenner, *supra* note 14 at 20.

23. Many studies have concluded that regional differences in labor costs, construction costs, and energy costs are generally too large to be offset by differences in tax levels. *See, e.g.*, Cornia, Testa, and Stocker, State-Local Fiscal Incentives and Economic Development, Urban and Regional Development Series No. 4, Academy for Contemporary Problems (1978).

24. To the extent that other costs of a business are also deductible, the relative differentials between such costs and taxes would be unchanged.

25. *See supra* note 19; C. Tiebout, "A Pure Theory of Local Expenditures," 54 *J. Political Economy* (1956), p. 416.

26. *See* W. Oates, "The Effects of Property Taxes and Local Public Services of Property Values: An Empirical Study of Tax Capitalization and the Tiebout Hypothesis," 77 *J. of Political Economy* (1969), p. 957.

27. Roger Smith, Chairman of General Motors, whose Saturn plant has been sought after by nearly every governor, stressed that "tax breaks can't make a silk purse out of a sow's ear." According to Smith, "we're going to be in business for the long term . . . you've got to look at more than just what the great big cookie is that's coming in on the plate." *Detroit Free Press*, March 18, 1985, p. 1A. Consistent with this philosophy, the first state GM eliminated as a site for the Saturn plant was Florida, a state that is perceived as having an extremely favorable tax climate (e.g., no personal income tax, no estate tax, a double-weighted receipts factor, as well as its recent elimination of worldwide combined reporting). *See also text* accompanying *infra* note 48.

28. For a fuller discussion, see Report by the Staff of the Legislative Commission on the Modernization and Simplification of Tax Administration and the Tax Law, The Article 9-A Franchise Tax: Should New York Adopt ACRS? (December 31, 1984). The issue of whether a state should adopt the federal rules on ACRS also illustrates a significant difference in perspective between federal and state tax law. When the Congress enacts special tax provisions designed to encourage investment, it is indifferent to where within the United States such activity occurs. A particular state does not share this perspective, however. If state law mirrors federal measures designed to encourage investment regardless of where it occurs, a state may lose revenue to support investment occurring beyond its borders, the benefits of which may not sufficiently rebound to that state. If the policy question is phrased as whether a state should adopt a tax incentive that results in a loss in revenue for investments made in other states, most officials would answer with a resounding "No." Yet, if New York were simply to adopt the federal rules on ACRS, as has been vigorously proposed by many persons, a corporation would receive the benefits of the faster depreciation for investment occurring both within and without the State. Indeed, most of the revenue loss that New York would experience from adopting ACRS would actually be attributable to investments made in other states. *See id.* In order to minimize this revenue loss, a state that wished to adopt ACRS should limit it only to in-state investment, which is the approach New York recently adopted. Even this approach, however, does not ensure that the resulting loss in revenue will be cost effective. *See id.*

29. For example, shortly after New York adopted its double-weighted receipts factor Massachusetts and Connecticut adopted similar provisions. *See* Report by the Staff of the Legislative Commission on the Modernization and Simplification of Tax Administration and the Tax Law, The Article 9-A Franchise Tax: The Double-Weighted Receipts Factor (May 1985).

30. Kieschnick, *supra* note 3 at 325. Moreover, some economists argue that business accounting and organizational structures can reduce the effectiveness of a tax incentive. Tax incentives operate at the overall company level by reducing the final tax. But the problem that generated the need for a tax incentive is often focused at the plant level, where the plant manager is faced with the decision to purchase equipment that would otherwise be unprofitable without the tax incentive. Consider, for example, the investment tax credit (ITC). Unless the tax savings at the overall level are allocated within the company to the particular plant, that plant manager might be saddled in the company's books with a high pre-ITC cost for the equipment. *See* Surrey, Warren, McDaniel & Ault, *Federal Income Taxation* (1972), Vol. 1, p. 271 at n. 21. Further, the plant manager or other persons in charge of purchasing equipment may be unaware of the credit. A staff member of Minnesota's Taxation Committee expressed a similar sentiment: "We've learned that accountants are better at discovering tax breaks than managers." *See* D. Frey, Economic Development Tax Incentives: A Staff Perspective, Paper Presented at the National Conference of State Legislatures, July 22, 1984.

31. *State Taxation Policy*, *supra* note 1 at 89.

32. The EIC can only be claimed by those firms which have claimed ITC. For a complete discussion, see Report by the Staff of the Legislative Commission on the Modernization and Simplification of Tax Administration and the Tax Law, The New York State Investment and Employment Tax Credits (March 11, 1985).

33. *See id.* The federal government annually publishes a supplement to the budget which estimates the cost of various tax incentives. *See* Budget of the United States Government, Special Analysis G. A few states publish a similar analysis.

34. *See* "Ernst & Whinney Faces Civil Charges for Deceptive ITC Studies," *Tax Notes*, March 22, 1982, p. 770.

35. *See* Staff Report, *supra* note 32 at 56.

36. *See id.* at 30-33, 35-36.

37. A reduction in the rate of the franchise tax would also have the effect described in the text. A state program that was structured to provide a tax-free benefit to a corporation would not have such an effect, provided that the program did not reduce a cost that a business would have otherwise incurred.

38. *See* Staff Report, *supra* note 32 at 36-37.

39. The study compared the investment patterns of 238 profitable non-financial corporations with the federal taxes they paid in 1981, 1982, and 1983 and concluded that "evidence that the billions of dollars the federal government spends each year on tax incentives to encourage investment have failed to achieve their purpose is overwhelming." *See* The Failure of Corporate Tax Incentives: A Study of Three Years of Growing Loopholes and Lagging Investment, Citizens for Tax Justice (1985), p. 4. The study found that the 50 lowest-taxed corporations had an average tax rate of minus 8.4 percent (i.e., they received tax refunds or sold their excess tax benefits) but *reduced* their investment by 21.6 percent. By contrast, the 50 corporations with the highest tax rates *increased* their investment over the same period by 4.3 percent while paying 33.1 percent of their profits in federal income taxes. Moreover, although the low-tax companies cut back on their new investment, they increased their dividends at a pace more than 30 percent greater than the high-tax companies.

40. The pressure exerted on some states to repeal worldwide combined reporting provides a recent illustration. *See also* note 41 *infra*.

41. A spokesman for General Motors, for example, stated that the reason the corporation asked Baltimore for a tax abatement (in addition to non-tax benefits that were already granted) was that "we'd be very irresponsible to our shareholders not to request it." *See* New York State Comptroller, Fiscal Research Report, Tax Concessions for Business Development (January 1981), p.3.

Michael Barker's description of the role of business is more cynical:

> In virtually every state, businesses and their trade associations make an annual pilgrimage to the state capital, pleading for additional tax reductions or the creation of special investment incentives. Armed with studies and charts, they attempt to show why the state is suddenly in danger of losing jobs to other, more attractive areas. Usually, they stress that the tax reductions being advocated pose no long-term threat to the state's treasury and that prompt action on tax reductions will provide such a stimulus to private taxable activities that the changes will pay for themselves, producing no net loss in state or local revenues. But the alternative is always clear. Without action, disaster looms. The state's business climate will be severely damaged. Investment capital will flow elsewhere. Existing businesses will wither and die. Workers will go jobless. Tax revenues will fall as industry stagnates. Business interests will support other, more responsive candidates. A blight will move across the face of the land.

That such efforts continue to prove successful in the complete absence of any empirical evidence that state or local taxes play an important role in guiding business investment decisions is not surprising. Business lobbies are powerful in state capitals. What very few numbers do exist concerning the impact of taxes on business investment decisions have usually been furnished by the very people seeking tax relief. *State Taxation Policy supra* note 1 at xiii-xiv.

42. Various groups attempt to measure a state's "business climate." One well known attempt by Alexander Grant has been described as lacking rigor and scientific methodology. *See* Wheeler, Interstate Differences in Tax Costs to Corporations: A Look at Some Accounting Studies, in *Michigan's Fiscal and Economic Structure* (Brazer & Laren eds., 1982). Professor Wheeler notes that the Alexander Grant study "does not claim to be, nor should it be construed to be, using scientific methodology in that a whole host of internal and external validity problems exist." *Id.* 252. The Grant study has been criticized for counting the same variable twice, relying on poor data sources, and improperly measuring the factors used. *See* Biermann, "The Validity of Business Climate Rankings: A Test," *Industrial Development*, March/April 1984), p. 17.

Attempts to measure a state's business climate often suffer from the problems encountered in measuring a state's tax burden: most business climate studies are not industry-specific and are thus too general to be very useful. Disparate industries are likely to have very different impressions of a state's business climate and a general study that ranks various aspects of doing business in a state cannot reflect the priorities of every sector of the economy.

Fantus Corporation contends that business climate studies are inappropriate and unusable in the site selection process. *See* Biermann, *supra*. Fantus described the Grant study, *supra*, as "a tremendous disservice for states and industries because it is so misleading. . . the ranking is subjective and uses general data that are misleading because they don't come to grips with the specific needs of companies in specific locations." *Id.* 23.

43. The North Carolina director of industrial development stated: "Existing industries in most cases pay for incentives, and we don't burden our industries with that. We treat everybody equally." *Wall Street Journal*, June 30, 1978, p. 17.

44. "Tax subsidies tend to provide windfalls to large, well-established companies and have little meaning for new small companies that offer the greatest potential for local economic development." Jack Faucett Associates, *Effectiveness of Financial Incentives on Investment in the Economic Development Administration's Designated Areas*, Economic Development Administration, U.S. Department of Commerce (June 1976), p. iii.

45. Schmenner, *supra* note 14 at 58. Some persons have argued that tax concessions should be viewed in terms of their announcement effect—that the businessman is a hero who is admired and loved by the citizenry. Southern policymakers are often described as accomplished practitioners of this stroking policy. *See* Shannon, "State Income Taxes—Living with Complexity," *National Tax Journal* (1977), p. 339-340. Schmenner's recommendations would seem to serve this purpose.

In discussing the psychological effects of investment incentives on business climate, one economist concluded, " Unfortunately, about all one

can do about such matters is to note their existence and our inability to say anything definite about them." Bird, *Tax Incentives for Investment: The State of the Art* (1980), p. 49 n. 10.

46. A 1979 survey conducted for the Chemical Bank asked the question: "If you had to choose between general tax relief and State assistance and incentives for business, which should be emphasized to improve the State's business climate?" Of the 898 businessmen questioned, 76% chose general tax relief. *See* New York State Comptroller, Fiscal Research Report, Tax Concessions for Business Development (January 1981), p. 4.

47. One representative of a prominent Massachusetts lobbying group was reported as stating that he would prefer an outright cut in the state's corporate income tax rate, but since that was hard to obtain, "tax incentives will have to do." Another lobbyist who was instrumental in the adoption of the Massachusetts job creation tax credit stated that his organization fully intended the credit to be a "gift" to companies to "compensate" them for the State's high tax rates. *See* Harrison and Kanter, The Great State Robbery (Working Papers for a New Society, Spring 1976), p. 57.

As this essay goes to press, Stanley Fink, Speaker of the New York State Assembly, is planning to introduce a bill that would eliminate many of the special provisions in the New York corporate tax, coupled with a dramatic reduction in the rates. His bill would reduce (or leave unaffected) the taxes paid by 99 percent of the corporations in the state. Speaker Fink's proposals are philosophically similar to those being proposed by the U.S. Treasury Department for reforming the federal corporate income tax.

48. Stocker, "A Fiscal Strategy of Ohio Economic Development," LII *Bulletin of Business Research* (May 1977).

49. The simulations conducted actually understate New York's attractiveness for four reasons. First, the State's tax law has extremely favorable rules on the taxation of dividends, interest, and capital gains. These rules were not simulated because only income from manufacturing activities was modeled.

Second, the manufacturing firms that were simulated were assumed to have a pattern of sales that would magnify and exaggerate the impact of adopting more stringent changes in the taxation of corporations. For example, the firms modeled were those which would experience nearly the greatest decline in after-tax rates of return if a throwback rule were introduced, or if a single-weighted receipts factor were adopted. The overall decline in after-tax rates of return which would actually accompany these changes, even though modest, were nonetheless overstated.

Third, the computer model assumes that an out-of-state firm would expand in New York through a branch rather than through a new subsidiary. If a combined report is filed, the tax consequences will be identical regardless of whether the out-of-state firm expands through a branch or through a subsidiary. If a combined report is not filed, however, very different tax consequences can result. By creating a subsidiary for its New York operations, an out-of-state corporation can achieve even more favorable tax results than those indicated in the Staff Report, *supra* note 5. Using orthodox tax planning techniques, the subsidiary can reduce its New York taxable income through payments to its parent (or other related corporations) for goods or services, such as legal fees, accounting fees, advertising expenses, stewardship costs, and interest. These expenses would be deductible as costs of doing business and thus reduce the corporation's New York taxable income. If the payee is subject to a lower tax rate than the payor, a net savings results. The creation of a branch in New York would not allow this same flexibility and thus the simulations understate the competitiveness of the New York tax structure.

Fourth, all other states were assumed to have adopted the federal ACRS rules on depreciation. To the extent that some of these states have decoupled, the simulations make New York appear less attractive than it is.

50. Theoretically, if only a few firms were influenced by a tax incentive to locate (or remain) in New York, the resulting benefits might still outweigh the various costs and inequities that are identified in the text. Evaluating the benefits generated when a firm is induced to locate in New York involves a complex set of issues: Are the kinds of firms or investments attracted by tax incentives consistent with the long term interests of the State? Will the new corporation's employment, investment, and environmental policies comport with the needs of the local community? Will the new firm bring its own work force or absorb local unemployed persons? Will profits by the firm be invested locally or outside the State? Will raw materials and other inputs be purchased from local firms or from out-of-state firms? What services, such as water, transportation, and waste disposal will be required by the new firm and how will these be financed?

Once the benefits have been quantified, they can be compared to the costs of the tax incentive to see whether the incentive was a sound policy or whether there were more cost efficient means of achieving the same goals. Although quantifying the benefits generated by a new firm is exceedingly complex, some commentators have concluded that the types of businesses most likely to be attracted by tax incentives pay low wages, offer poor working conditions, and provide unstable employment. *See* R. Vaughan, *supra* note 11 at 94 (citing Harrison and Kanter).

MTC Annual Meeting Covered Wide Range of Tax Subjects

Representatives of twenty-eight states and of many businesses attended the Commission's Eighteenth Annual Meeting. This year's meeting consisted of programs on Sales and Use Taxes, Enforcement Efforts, Property Taxes, Corporate Income Taxes, and National Taxes.

SALES AND USE TAXES

Untaxed Mail Order Sales from Out-of-State

Plight of the In-State Retailer

The first program addressed the burgeoning mail-order problem which faces the states. Arthur Wheeler, Executive Director of the North Dakota Retailers' Association, lamented the fact that so many sales are made into his state by out-of-state mail order sellers whom his State cannot require to collect and remit applicable use tax. Since the State cannot effectively enforce the payment of the tax by each individual buyer (it does not even receive any information with respect to such sales from the sellers), the result is, according to Wheeler, "an unrecognized form of tax relief for out-of-state direct marketers." In-state sellers must, he pointed out, collect and remit sales tax with respect to each sale of the same items as those which such out-of-state sellers market tax-free. He said that the same situation prevails across the country. Many mail order sellers can be required to collect and remit the tax by virtue of the fact that they have a jurisdictional nexus in a state, i.e. they have sufficient contacts with the state to allow the State to impose the collection and remittance requirement on them. Thus, Sears Roebuck is subject to that requirement in all states because of the fact that it has at least one store in each state. However, under a 1967 U.S. Supreme Court decision in *National Bellas Hess v. Illinois Department of Revenue*, sellers who operate solely through the mails or have similarly minimal contacts with a state cannot be subjected to that State's tax collection jurisdiction.

Wheeler referred to proposed federal legislation which has been drafted by state tax administration officials for the purpose of extending the jurisdictional reach of the states to enable them to impose the collection requirement upon such out-of-state direct marketers. That proposal would cause the requirement to trigger when the seller exceeded a certain threshold level of sales into a state. Wheeler objected to the exemption of such sales below the threshold level, saying that that would still be unfair to in-state sellers and to buyers from in-state sellers. (It appears likely, however, that the tax collection requirement could apply to all sales, including those below the threshold, but

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UNITARY TAX REVIEW. ECONOMIC IMPACTS

THE ROLE OF TAXATION
IN STATE BUSINESS CLIMATE

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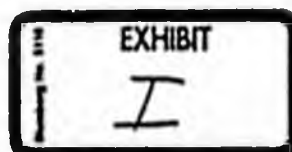

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THE ROLE OF TAXATION IN STATE BUSINESS CLIMATE

Introduction

Tax policy is one of the most difficult and publicly scrutinized issues that state policymakers encounter. Legislators must balance many concerns when deciding upon tax questions. Undoubtedly, they seek to keep the level of taxation reasonable while also addressing demands and needs for public spending. The fairness and efficiency of taxation are other important considerations in tax policy. Lawmakers pursue tax fairness by attempting to tailor tax burdens to the taxpayer's ability to pay and by taxing individuals and businesses in similar circumstances under the same rules. Furthermore, since taxes can distort economic decision-making and lead to a less efficient allocation of resources, this consequence of tax policy must also be weighed.

In recent years, another issue has come to dominate tax debates in state capitols. Legislators and public officials have been warned that their tax system is the key to their economic fortunes -- if their tax system is not competitive with those of other states, then businesses will chose to invest and create jobs in those states where taxes are lower and tax incentives for business investment are greater. Since private business investment generates most employment and income growth, the competitiveness of state tax systems is largely a question of how differences in state and local taxes effect business investment and location decisions . Consequently, the effect of taxes on business location and investment decisions is the primary subject of this paper. Since it dominates tax policy debate in many states, policymakers need to understand how taxes may shape economic development and the results of empirical research on this question. Special attention to this issues is not meant to imply that competitiveness should be the major consideration in making tax policy. Tax competitiveness is only one characteristic that legislators need to consider alongside traditional concerns of adequate and stable revenue sources, tax fairness and economic efficiency.

This paper is divided into five sections. The first section discusses the potential effect of taxes on business investment and job growth. In the second section, the specific effects of different types of taxes are outlined. The next two sections summarize and critique empirical studies of taxes and economic development, first focusing on the cost impact of taxes and then looking at the indirect effects of taxation on population. Finally, the conclusions of the paper are presented.

1.0 Taxes and Economic Growth: The Major Issues

1.10 The Role of Different Business Investment Decisions in Job Creation

Business investment decisions are the motor behind state job and income growth. Different regions and states experience varying economic conditions, largely based upon their particular pattern of business investments.[1] One recent study suggests that plant closing rates vary far less than job replacement rates by region and therefore, the rate of new job creation is a more significant factor in economic growth.[2] Since job creation results from several kinds of business investment, the importance of taxes and other factors will vary with the type of investment involved.[3] Thus, state policy-makers need to know which investment decisions are the largest contributors to economic growth and which are most sensitive to tax considerations. Current research suggests that investments which are the largest sources of new jobs are the least likely to be affected by tax considerations while the investment type that is most sensitive to taxes is a relatively insignificant source of job growth.

Job generating investment decisions can be grouped into four categories:

(1) starting a new business;
(2) expansion at an existing site (with or without adding new facilities);
(3) opening a new branch plant; and
(4) relocating a plant or business.

Several studies indicate that on-site expansion is the most important source of new jobs while business relocations are relatively unimportant. Roger Schmenner's census of employment and investments at 410 of the nation's largest corporations during the 1970s uncovered that 60% of national job growth at these firms resulted from on-site expansions, net of contractions. Another 36% of employment gains were from new branch plant employment in excess of job loss from plant closings. Employment growth at relocating plants accounts for only 4% of the national job creation by these large companies. Results for the Sunbelt were different, with new plant employment being the largest source of new jobs. Since these findings apply only to large firms, they do not measure employment from

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[1]See Roger W. Schmenner, Making Business Location Decisions (Englewood Cliffs, New Jersey:Prentice-Hall, Inc., 1982), pp. 164-199; and Candee S. Harris, "The Magnitude of Job Loss from Plant Closings and the Generation of Replacement Jobs: Some Recent Evidence," The Annals of the American Academy of Political and Social Science 475 (September 1984), pp. 15-27 for a detailed analysis of this issue.

[2]See Harris, pp. 23-25.

[3]See Harold Wolman, Components of Employment Change in Local Economies: A Review and Critique of the Literature (Washington, D.C.: The Urban Institute, 1979), pp. 22-29, which discusses how the causes behind different sources of job creation are likely to vary by investment type.

two of the three most important job generating business investment decisions – the start-up of a new business and on site expansion – typically do not involve this type of site selection and, therefore, taxes are unlikely to be a location factor. Entrepreneurs typically start their business where they work and live; they do not search out the optimal location.[7] This location may be necessary for access to expertise at a university or to be close to a major customer. Alternatively, the entrepreneur may simply be choosing to stay in an area that is known and liked. Furthermore, corporate profit and property taxes are a minor concern for new firms since they usually are not profitable in the initial years and do not have substantial assets. Consequently, tax costs are likely to be quite small.

Expansion at an existing site is also insensitive to taxes. In many cases, expansion at an existing site may simply involve adding employees, a shift and some equipment, rather than new construction. Since, in this case, expansion does not require a new site, alternative sites, including their tax consequences, are unlikely to be considered and evaluated. When on site expansion does involve new construction and additional facilities, it is likely that the advantages of remaining at the same site (lower land costs and economies of scale) and the problems of dividing up operations will either preclude a search for an alternative site or outweigh cost savings at other sites. Detailed studies of business location decisions indicate that on site expansion is the most frequent expansion route chosen by companies.[8]

Relocation of an existing business or facility and establishing a branch plant are the two situations where tax considerations will matter most. These decisions are likely to involve information gathering and comparison of alternative sites, especially when the firm is large. When different sites are compared, the tax costs at each site may be estimated and considered in evaluating the costs and benefits of different locations.

Interstate tax differences, however, are irrelevant for most relocations since most firms relocate over a small distance. One study estimated that 80-90% of all relocations are short distance moves and are primarily motivated by space considerations.[9] Even among large Fortune 500 companies most plant relocations are short-distance. Since "the interstate, inter-regional [illegible]cation is a rare event,"[10] differentials in tax rates among states are [illegible] influence most business

[7]This point is made by Eva Mueller and James M. Morgan, "Location Decisions of Manufacturers," American Economic Review 52 (March 1962), pp. 204-217; and by Wolman pp. 23-25.

[8]See Roger W. Schmenner, Summary of Findings: The Manufacturing Location Decision: Evidence from Cincinnati and New England (Cambridge, Massachusetts: Harvard Business School, March 1978), p. 2.

[9]See Schmenner (1978), p. 9.

[10]Schmenner (1982), p. 179.

is perhaps the most important determinant of business location and employment growth.[13] Thus trends in population growth and migration partly influence business location since they determine the distribution of consumer demand. Access to markets is likely to be most important for industries that produce goods with low value to weight ratios and where transportation costs are large.[14] A location close to customers can also be important for firms that supply intermediate products to other industries. When supplier firms need to regularly share information with customers, observe and understand their operations and meet tight scheduling requirements, proximity may be a determining factor in location.

Supply of production factors. Labor, materials, land and energy are necessary inputs for production. Any plant must have an adequate supply of these resources to be profitable. Labor is generally the most important factor, representing the largest single cost and value component for most industries. Consequently, a plant must be located in an area where there is a sufficient supply of workers and where the required mix of skills is available. For firms that require highly skilled labor such as engineers, computer programmers, or scientists, the supply of skilled labor can be a major location factor. Similarly, technology-based operations may need a location that provides access to research, training and expertise at a university. While raw material supplies are not generally a major location factor, they are important for resource based industries such as paper, food processing and oil.[15] Energy and land availability are less important issues since they are generally available nationwide. However, land and space considerations can influence the choice of suburbs over central cities for manufacturing plants.

Production and Distribution Costs. Labor and transportation costs are generally the most important location cost factors. Several studies indicate that a large share of manufacturers is sensitive to transportation costs.[16] A study that simulated labor, transportation, tax and energy costs for manufacturing industries across the continental United States found that labor and transportation costs greatly exceed tax and energy costs for virtually all industries at the 2 digit SIC code.[17] The location of facilities that serve a national or large regional market will be affected by the cost of transporting goods to consumers, and will thus be influenced by the distribution of population. Labor costs are a consideration for

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[13]See Vaughan (1977), pp. 49-53 and (1982), pp. 21-23.

[14]Schmenner (1982), p. 37.

[15]Schmenner (1982), p. 37.

[16]See Vaughan (1982), p. 23.

[17]See Barry M. Rubin and C. Kurt Zorn, "A Comparative Analysis of Interstate Variation in Manufacturing Industry Business Costs" Center for Urban and Regional Analysis, School of Public and Environmental Affairs, Indiana University, 1983.

of industrial concentration.[23] Location in a industrially developed and diversified economy may also benefit firms that rely on specialized business services and a range of labor force needs.

Relationship to Other Plants and Operations. When a firm establishes a new branch plant, it must consider how this plant fits into its existing operations. The relationship of a new branch plant to other plants will depend on a firm's organization and multiplant manufacturing strategy. Schmenner outlines four possible strategies:

(1) a product plant strategy where a plant or a few plants produce a product for the entire domestic market;

(2) a market area plant strategy where a plant produces a product or product line for an entire regional market;

(3) process plant strategy where a plant is assigned a specialized stage in the production process for a more complex product; and

(4) general purpose plant strategy where a plant can take on a broad range of responsibilities with an assignment to a product, market area or process for a set period of time depending on changing conditions.[24]

Process plant strategies are most likely to require plant locations that are close to and closely related to other plants, while each market area plant will be placed in a separate region. The direct and logistical costs of moving people and materials between plants can be significant and may lead firms to cluster plants within one area, especially for firms following a process plant strategy.[25]

Local Characteristics. A number of local conditions, some of which are not directly related to demand, cost or supply issues, are important in business location decisions.[26] The quality of life in an area can influence the decision of where to site a plant or corporate headquarters. Firms are likely to prefer an area with good recreational and cultural amenities, good schools and less congestion and pollution. Quality of life consideration may be weighed heavily for plants that must attract and retain a more mobile, professional workforce.[27] Several factors that shape the local quality of life depend on public goods and services, e.g., recreation facilities and education. Local attitudes and leadership may also be considered.

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[23]ACIR, p. 37.

[24]See Schmenner (1982), p. 11-12 for a discussion of the classification.

[25]Schmenner (1982), p. 39.

[26]See Vaughan (1977), pp. 77-79 on these location factors.

[27]Schmenner (1982), p. 38.

Two important economic trends provide a compelling explanation for why the Sunbelt grew faster than the Frostbelt since World War II. The first trend is the substantial shift in population from the Northeast and Midwest to the South and Southwest. This pattern of population shapes business locations in many ways. It has greatly increased consumer demand in these regions and shifted the locus of plants that serve national markets southward. It has also increased the labor supply for businesses in these regions. Secondly, U.S. industry has undergone a process of decentralization that has been reinforced by the shifts of population southward and the development of a large interstate highway system. With industry highly concentrated in the Northeast and Midwest at the end of World War II, the greater growth in the Sunbelt is understandable as part of a decentralization process. As industry expanded during this period, it spread plant locations throughout the nation partly in response to a more decentralized population, partly to take advantage of better access to markets and materials provided by a national highway system, and partly to reduce vulnerability to disruptions from labor stoppages, weather and natural disasters that were greater when production was centralized in one or two regions.[29]

1.30 The Potential Effect of Taxes on Business Investment

Direct Effect on Business Costs. State and local taxes may affect businesses in several ways and these effects can vary with the scope of the geographic region considered. Taxes may directly affect businesses by increasing their costs. If all other costs are the same, then a higher tax bill will reduce profits and lower a firm's rate of return. Since state and local taxes differ across jurisdictions, businesses will face lower tax bills in some states than in others. A business could increase its profit rate by making its plant investments in the lower tax state, assuming revenues and all other costs are not affected. Theoretically, this potential consequence of taxes could, over time, result in greater levels of investment and employment in states with lower taxes than in states with higher taxes.

The investment impact of tax differentials is far more complicated than this simple hypothesis for several reasons. First, the crucial "ceteris paribus" assumption (everything else being equal) is not true. Non-tax costs vary considerably across states and are generally more significant than taxes. Second, a tax collected from a business is not necessarily paid by the business's owners. A firm may be able to shift taxes, such as sales and property taxes, forward to consumers or backward to factor suppliers. If the cost of taxes is not ultimately paid by the firm, then profits will not be affected. While the ultimate tax incidence question has been well researched, no clear conclusions have been reached.[30] Third, differences in property tax rates may be offset by their capitalization in land value, thus

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[29]The role of decentralization in the post war pattern of business investment and employment growth is discussed by several authors. See Mueller and Morgan, p. 14; and Schmenner (1982), pp. 167-172.

[30]For discussions of tax incidence see Kieschnick, p. 5; and Lester Thurow, The Impact of Taxes on the American Economy (New York: Praeger Publishers, 1971), chapter 4.

certain population groups. These incentives attempt to use taxes to make the desired action economically advantageous through the value of tax savings. To be effective, a tax incentive must actually cause a firm to take a desired action it would not otherwise take rather than provide a windfall benefit to firms that would have acted the same way without the incentive. To be an efficient expenditure of public dollars, the public benefits generated by those firms which acted due to the incentive must exceed the foregone tax revenues from all business who use the incentive.

Interregional and Intraregional Effects. As mentioned earlier, the influence of tax costs on business investments may vary depending on the geographic area. Since access to markets and resources, the nature of the labor force, labor costs, transportation costs, energy costs and other business location considerations vary enormously between major regions of the United States, we would expect the impact of different tax bills to be less significant across regions. However, within the same state, among bordering states and within metropolitan areas, where major business factors are fairly similar, the variation in taxes may take on more significance. Similarly, people may be more likely to locate based on tax considerations when the underlying climate, economic conditions and quality of life is similar within an area. Therefore, we might expect the potential influence of taxes, both directly and indirectly, to be greater within regions than across regions. This evaluation of the evidence on the effect of taxes on economic growth, therefore, will consider separately the impact between regions and the impact within a state or metropolian area.

The Importance of Federal Taxes. State and local taxes interact with federal taxes as they influence economic decisions. Since federal taxes are significantly greater than state and local taxes, federal tax policy is an important constraint and influence on the potential effect of state and local taxes on business investment. The ability of businesses to deduct state and local taxes from their income for federal purposes reduces the actual cost of these taxes and the magnitude of differentials between jurisdictions.[33] With most corporations now paying a federal marginal tax rate of 46%, each $100 of state and local taxes paid reduces federal tax liability by $46 and thus is actually an effective tax of only $54. Thus, federal deductibility will reduce a $100 tax differential between two states to a $54 differential. Although federal deductibility does not change the relative difference between taxes across states, it does alter the size of the state and local tax bill and thus the importance of taxes in comparison to other location costs. Federal deductibility also significantly reduces disparities in personal income taxes among states and thus mitigates the potential impact of these taxes on population migration.[34]

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[33]See Herman B. Leonard. Unchecked Balances: The Quiet Side of Public Spending (New York: Basic Books, 1986), p. 134.

[34]See ACIR, pp. 19 and 22.

2.0 The Potential Effects of Major State and Local Taxes

It is the variation in state and local taxes across jurisdictions that potentially affects business and individual location decisions, altering the distribution of economic growth. States and localities, however, vary not only in their level of taxes but in the tax mix they employ. Two states with similiar overall tax burdens may have very different tax structures; one state may rely heavily on sales and property taxes while the other largely depends on corporate and personal income taxes. Since the myriad studies on taxes and economic growth use a variety of tax burden measures, it is important to consider how particular taxes may influence economic growth before evaluating their results. This section discusses the relevance of overall tax burden, and the four major state and local taxes– property, sales, personal income and corporation income – to the debate.

2.10 Overall Tax Burden

The most common way to compare taxes across states is to use an aggregate measure of total tax burden. Per capita tax revenues and tax revenues as a share of personal income are the two most common measures of total tax burden. Since fees are also used to finance government services, it is appropriate to include both tax and fee revenue (usually called own source revenue) in these figures. Many studies rely on these indicators. The Grant Thornton state business climate ranking uses state and local taxes per $1000 of personal income as its tax burden measure. Two recent studies of interstate effects of taxes on business investment and employoyment growth also use overall tax burden.[35]

Aggregate tax measures, however, do not accurately reflect the tax burdens that matter to businesses and individuals. Firms should be interested in taxes that are direct costs to them. A high tax burden due to a large sales tax for which goods and equipment used in manufacturing are exempt (a fairly common exemption) should not matter to a manufacturing business. Similarly, we would not expect high taxes to discourage individuals from moving to or remaining in a state if the major tax was an oil severance tax and energy costs were a small share of income. Alaska is a good example of this problem. Alaska has the highest overall tax burden per $1000 of personal income. However, since most of its revenues come from oil severance taxes, the taxes paid by a married couple in Alaska are the lowest in the nation.[36]

Different taxes, tax bases, and rates across states, as well as the complication of tax incidence and capitalization, make it difficult to get accurate data on the actual tax burdens for corporations and individuals. Therefore, overall tax burden

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[35]See B. Benson and R. Johnson, "Capital Formation and Interstate Tax Competition;" and Michael Wasylenko, "The Effect of Business Climate on Employment Growth: A Report to The Minnesota Tax Study Commission," 28 June 1984, cited in Netzer, p. 25.

[36]See ACIR, Significant Features of Fiscal Federalism, 1985-86 Edition (Washington, D.C.: ACIR, 1986), pp. 52 and 128.

2.30 Corporate Income Taxes

In 1984, forty-five states collected $15.5 billion in corporate income taxes, representing only 3.1% of state and local revenues nationwide. Corporate tax rates and tax bases, like the personal income tax, vary to a large extent across states. Top rates range from 2.35% in Michigan to 11.5 % in Connecticut. There are also differences in depreciation schedules, investment tax credits and the allocation of income for multistate firms.[41]

Since corporate income taxes are a cost to businesses that directly reduce their profits and rate of return, variation in this tax is expected to influence business investment and location. Firms in states with high corporate income taxes might invest less, while those in low tax states might have a higher rate of investment. Similarly, firms considering new plant investments or relocations would favor states with lower corporate income taxes. This effect will differ by type of firm since the effective tax is lessened by depreciation write-offs, investment credits and the like. Furthermore, new firms and firms with unstable profits should be less influenced by corporate tax rate differences since their tax liabilities will be less and can be offset with loss carry-forwards. The potential economic impact of the corporate income tax also may be overshadowed by property tax rate differentials. A study by the Federal Reserve Bank of Boston found that, on average, corporate income taxes accounted for 20% of the state and local taxes paid by a firm while property taxes were 43% of the total. Therefore, differing property tax burdens, which are large both within and across regions, may have a more significant effect that interstate variation in corporate income taxes.[42]

2.40 Sales Taxes

Forty-five states had general sales taxes in 1984 that generated $62.6 billion in revenue. The sales tax is the most important single tax for state governments, accounting for 18.9% of revenues in 1984. For combined state and local revenues, sales taxes represent 13.9% of revenues. While the variation in state sales taxes is limited, ranging from 3 to 7.5%, the sales tax base varies enormously. States differ in exemptions for consumer goods (clothes, food, etc.), consumer services, business services, and materials and equipment used in manufacturing. In addition to these variations, local sales tax add-ons are very common. Over six thousand local government units in twenty-nine states collect sales taxes.[43] Consequently, the sales tax burden can vary a lot both between and within states.

Sales taxes can impose a cost on businesses. However, the sales tax's burden on business, and thus its effect on investment, is reduced due to widespread

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[41]See ACIR (1986), pp. 40, 48 and 103 for data on state corporate income taxes.

[42]See Vaughan (1982), pp. 73 and 76.

[43]Data on sales taxes is from ACIR (1986), pp. 48, 49, 92 and 94.

property wealth per capita. Consequently, cities may have higher property tax rates while appearing to have a lower level of services valued by businesses. In this manner, variation in tax rates and services within a region can have a reinforcing effect. This situation can be ameliorated through state aid that helps equalize localities' ability to provide services or their property tax rates, or by metropolitan tax base sharing.[47]

Property tax differentials are likely to affect business and residential location only to the extent that they are not capitalized in land values. While reserach on this issue is not conclusive, there is some evidence that capitalization of tax differentials does occur.[48] To the extent that property tax rates are not capitalized, businesses investments and individual residency would be expected to shift toward low property tax jurisdictions. This effect should be greater for more capital intensive firms. Property taxes, by raising the cost of investments in plant and equipment, may also reduce these investments and lower the capital to labor ratio. Since property taxes generally support services valued by businesses, the impact of property tax differentials may well be offset by differences in the benefits firms receive from these services. Areas with lower property tax burdens may also impose more user fees, further reducing the actual variation in business costs.

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[47]See Vaughan (1982), chapter 4 on this issue.

[48]Vaughan (1977), p. 78; Leonard, p. 135; and Netzer, p. 27.

3.0 The Direct Impact of Taxes as a Business Cost

3.10 The Relative Size and Variation of State and Local Tax Burdens

The direct impact of state and local taxes on business location decisions depends both on the variation in effective tax (and fee) costs across jurisdictions and the size of tax cost differentials in comparison to variations in other costs and location factors. While the theoretical effect of each tax may differ, it is not the variations in these particular taxes that matter, but rather the variation in the sum total of taxes incurred by businesses. A review of data and studies indicates that there is substantial variation in business tax bills across states. However, these measures often do not accurately reflect tax costs and overstate the extent of variation in the net tax costs since they do account for the benefits received from government services, tax incidence and tax capitalization.[49]

Measures of overall tax burden provide a rough indication of the extent of tax variation. In 1984, the per capita state and local tax burdens ranged from $866 in Arkansas to $4704 in Alaska. If we exclude Alaska because of its high costs and unique tax structure, the range is $866 to $2504, almost three to one, with 47 states within a range of 2 to 1. Measuring tax burden as a share of personal income, the variation in overall tax burdens was similar. The range from the state with the highest to the lowest burden was three to one, with 48 states within a range of 1.8 to 1.

Since businesses face a specific set of taxes and do not pay the average tax burden, several studies have looked at interstate differences in the particular taxes paid by firms. Three approaches have been taken. Some studies estimate the total amount of taxes initially paid by businesses in a state and then compare it to total business income, profits or capital stock in that state. While this approach is informative about the taxes paid by business as a whole, it does not reveal actual differences in taxes for specific firms or classes of firms due to the highly aggregated data employed. This measure is also very sensitive to the year chosen for comparison since business income fluctuates from year to year with the business cycle. Other studies construct a typical manufacturing firm or typical firms in several industries and then estimate the taxes collected from these typical firms in each state. Both approaches, however, ignore the interaction of federal tax deductibility and do not measure the marginal cost of taxes for new investments. Despite these problems, both kinds of analysis are better indicators of the variation in state and local taxes paid by businesses than overall tax burden.

These studies, while somewhat mixed in their results, do indicate that a large degree of variation in business taxes exists and that the variation appears greater for manufacturing firms than for all business. Wheaton's analysis of tax burdens for all business and manufacturing firms in the continental U. S. in 1977 found

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[49]For a good discussion of the problems with various measures of tax burdens as indicators of business tax costs, see Stephen Brooks, Robert Tannenwald, Hillary Sale and Sandeep Puri, The Competitiveness of the Massachusetts Tax System (Boston: Massachusetts Special Commission on Tax Reform, 1986), pp. 4-27.

relatively small increase in wage costs can have a large impact on profitability. For example, a 5% increase in wages for a firm with moderate wage costs can reduce profits by over 16%.[56] Legislative staff in New York estimated that a 2% wage differential is equivalent in its effect on profits to a 106% differential in corporate taxes.[57] Thus, a 20% difference in wage costs among states would overwhelm even a 500% difference in tax bills.

Rubin and Zorn's study of interstate cost difference for 20 manufacturing industries shows that absolute tax differences are far less than those for labor and transportation costs. While estimated tax costs might vary by 6 to 1, the actual cost difference was usually a matter of a few thousand dollars.[58] Labor costs, on the other hand, generally varied by less than 2:1, but these variations represented tens of thousands if not hundreds of thousands of dollars in annual costs.[59] Similarly, in most industries the transportation cost differentials across states were at least tens of thousands of dollars.[60] In each manufacturing sector, transportation and labor costs were far greater than tax costs, by multiples ranging from 5 to 50.

3.20 Survey Studies

One way of studying the role of taxes in business location decisions is to survey the corporate executives who make these decisions. Most of the early studies of this issue were done through mail and personal interview surveys of business executives. A number of states have also commissioned such studies to

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[55](_continued)
Michigan. See also Leonard, p. 136 for data on the greater size and variation of business costs other than taxes.

[56]Assume initial annual sales of $1 million, wages of $333,000, 10% profit margin and total taxes equal to 60% of profits. Before tax profits are $100,000 and after tax profits are $40,000. A 5% increase in wages raised the wage bill to $349,650 and reduced gross profits to $83,350. After tax profits are $33,340 (83,350 X .40). The change in profits is $6,660 or 16.6%.

[57]See State of New York Legislative Commission on the Modernization and Simplification of Tax Administration and the Law, "Interstate Business Locational Decisions and the Effect of the State's Tax Structure on After-Tax Rates-of-Return of Manufacturing Firms," Staff Working Paper, 1983, p. 76.

[58]See Rubin and Zorn, Table 2A, pp. 30-31.

[59]Rubin and Zorn, Table 4A, pp.49-50.

[60]Rubin and Zorn, Table 1A, pp. 16-17.

factor was personal reasons or chance.[62]

Roger Schmenner's research included interviews with executives at dozens of the nation's largest U.S. firms. He concluded that:

> In none of the more than 80 interviews I have had with key location decision makers in, mainly, large companies have I heard that state or local levels of taxation have been the most significant determinant of a plant's location. Almost every company takes a look at taxes; indeed, tax costs are one of the costs of a new site which can be quantified and presented in the documentation that supports the project's formal capital appropriation request. Nevertheless, taxes themselves are merely a minor consideration, capable of altering the decision in favor of a particular site only if almost all other factors are equal.

Taxes, according to Schmenner's interviews, are more likely to be a consideration when a high rate for a very visible tax "pushes" a firm away from a potential site.[63]

In another analysis, Schmenner looked at how the tax bill changed for relocating firms. If lower taxes were an important factor in firm location, then taxes at a new site should be lower than taxes at the old site. Overall, Schmenner found that the likelihood of moving to either a lower tax or higher tax site was about equal. For plant relocations studied in New England and Cincinnati, slightly more than one quarter moved to a site with lower property taxes, almost half found a new site with the same property taxes and one-quarter located at a new site with higher taxes. Furthermore, firms with higher capital to labor ratios, which would be expected to be more sensitive to property tax rates, were not more likely to settle in low tax jurisdictions.[64] Schmenner did find that multiplant firms in Cincinnati and long distance movers from New England were likely to choose new sites with lower taxes. However, this pattern did not hold true for long distance moves by Fortune 500 firms.[65]

Michael Kieschnick conducted a mail survey of firms concerning investments they made in 1979 in 11 states offering employment or investment incentives through their tax codes. Investments in creating a new firm, expansion of an existing plant and establishment of a new branch plant were analyzed separately. Business and personal taxes were rated as an insignificant or moderate factor by

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[62]See Mueller and Morgan, pp. 207-210.

[63]Schmenner (1982), p. 46.

[64]Roger W. Schmenner, "Industrial Location and Urban Public Management," in Arthur P. Solomon, Editor, The Prospective City (Cambridge: The MIT Press, 1980), pp. 460-461.

[65]Schmenner (1982), pp. 47-51.

mixed, a few studies suggest that tax considerations may be weighed more heavily by larger firms and firms locating new branch plants. The few studies that look at the tax impact of actual location decisions also support the view that reducing tax costs is not a motivating factor in location choices.

3.30 Evidence from Interregional Econometric Studies

A second, increasingly common way to analyze the relationship between taxes and economic growth is through econometric studies that use a statistical method known as multiple regression. These studies attempt to statistically explain the relationship between business investment (or other measures of state economic growth) and various causal factors using historical data. Econometric studies have several advantages over survey studies. First, econometric analysis is based on the actual behavior and experience of firms and states rather than the subjective opinions of surveyed executives. Second, these studies can provide a more precise measure of the role of taxes in states' economic performance by controlling for the contribution of non-tax differences between states. With the inclusion of non-tax factors in econometric models, the variation in these factors is used to explain differences in economic growth and a better estimate of the separate effect of taxes can be obtained. Thus, econometric studies hold the promise of using empirical evidence to elucidate the importance of tax factors in business investment.

There are, however, potential problems with econometric studies, which warrant caution in their interpretation. First, a study must include all the factors that determine business investment or economic growth to successfully control for the influence of non-tax factors. This task is difficult since so many state characteristics shape economic growth and some factors – for example, the talent of a state's population – are very hard to measure. When an important controlling factor is inappropriately omitted, the impact of this omitted factor may be partially attributed to factors included in the study, overstating or understating their effect. Second, when a statistical relationship is uncovered, the underlying causality between a factor and economic growth may not exist or may be in the opposite direction than presumed. In the first case, the revealed correlation is spurious--a result of a chance relationship in the data or a unique historical situation rather than underlying causality. In the second case, causality exists but it runs in the opposite direction than assumed in the study. For example, a statistical relationship between lower tax rates and greater economic growth may mean faster growth increases tax revenues, leading to lower tax rates – rather than lower tax rates leading to more growth.

3.31 Study Summaries

In the past several years, several studies have been conducted to relate differences in economic growth among states to differences in tax levels and other factors. These studies employ a number of economic growth measures including new firm formations, branch plant locations, employment growth, personal income growth and business investment. Most often, the study focus is on the manufacturing sector of the economy, although a few studies look at broader

Workers' compensation and unemployment insurance rates variables often indicated a positive effect. Bartik concludes that his estimated effect of taxes on location is small.[74]

The remaining studies have involved much more aggregate measure of economic growth based on employment, business investment and personal income. Since these studies are not based on actual business location decisions and use aggregate data, they are less precise and may hide the effects that appear with micro level data. Three studies have analyzed the impact of state and local taxation on employment growth. Plaut and Pluta studied how manufacturing growth from 1967-1972 and 1972-1977 was related to four location factors -- access to markets, cost and availability of production factors, climate and environment and business climate and taxes. Three growth measures were used: employment, value added and capital stock. Their results did not demonstrate any strong or consistent negative affect from the taxation factors. While adding the tax variables as a group improved the model's ability to predict employment growth and capital stock growth, no such result occurred for value added. Corporate tax, personal income tax and sales tax variables were all statistically insignificant. A state's overall tax effort was found to have a negative and statistically significant effect while the property tax variable and education expenditures were significant with a positive effect on growth. The authors concluded that "differences in overall industrial expansion can still be best explained largely by traditional market factors."[75]

Neuman's study was based on relative employment growth for 13 separate manufacturing industries during 1957-1965 and 1965-1973. This model used just three factors to explain growth -- corporate tax rates, unionization rates and the presence of a right to work law. Furthermore, the corporate tax data was based on the ten years prior to the period of employment growth, since Neuman argued that the tax effect was a lagged one, i.e., businesses are slow to see tax differentials and respond to them. The corporate income tax variable had a negative effect and was statistically significant for 5 of the 13 industries. Neuman also found that the tax effect was greater for more capital intensive and faster growing industries. Neuman concluded that his results were consistent with Carlton because the impact of taxes may vary by industry.[76] However, Neuman's results seem problematic due to his failure to control for most non-tax factors that affect state employment growth. His use of a lagged tax variable is also questionable since it assumes that businesses are more concerned with the past level of taxation than with present or future taxes when making investment decisions.

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[74]See Timothy J. Bartik, "Business Location Decisions in the United States: Estimates of the Effects of Unionization, Taxes and Other Characteristics of States," Journal of Business and Economic Statistics, 3, No. 1 (January 1985), pp. 14-22.

[75]See Thomas R. Plaut and Joseph E. Pluta, "Business Climate, Taxes and Expenditures, and State Industrial Growth in the United States," Southern Economic Journal July 1983, pp. 99-119.

[76]See Robert J. Neuman, "Industry Migration and Growth in the South," The Review of Economics and Statistics 65, No.1 (February 1985), pp. 76-85.

effect. Since their study is based on relative tax levels, it is difficult to translate actual tax changes into changes in relative position, especially since states may respond to tax reductions in other states.[79]

Kieschnick used 1977 data to analyze the impact of taxes on a state's share of gross national investment for 13 manufacturing industries. Two tax variables were used – an estimate of the actual taxes paid by a hypothetical firm for each industry and a state's rank in an ordering of tax burdens for each industry. Other factors in the model included average wage levels, labor productivity, energy costs, unionization rates, population growth and density, income levels, industry concentration, climate and welfare expenditures. Kieschnick's results did not show any strong impact of taxes on investment. The variable for taxes paid was significant for 2 of the 13 industries, but the estimated effect was positive in one case. The tax rank variable was significant for five industries, with a positive effect estimated for one industry. However, when the tax effect was statistically significant, its size was very small.[80]

The final study of taxes and capital investment was done by Papke using data from 20 states and 20 industries. New capital investment per production worker in a year was related to taxes and several variables that controlled for energy costs, wage costs, industry concentration, and labor productivity. Tax differentials were measured as the after-tax rate of return on investment for each industry and state, derived by a computer simulation model. Thus taxes are not included directly, but rather through their estimated effects on investment profit rates. The estimated effect of the after-tax rate of return variable was positive and statistically significant. This variable also had the greatest impact on investment among factors in the study.[81]

3.32 Analysis and Conclusions from These Studies

Econometric studies of interregional growth fail to provide conclusive evidence concerning the impact of taxes on economic development. Although several studies conclude that higher state and local taxes do deter growth, the case for this conclusion is not strong. The inconsistent pattern of results, several methodological questions and the small impact of most estimated tax effects together mitigate the evidence that taxes are an important factor in business location and growth.

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[79]See Bruce L. Benson and Ronald N. Johnson, "The Lagged Impact of State and Local Taxes on Economic Activity and Political Behavior," Economic Inquiry, pp. 389-401.

[80]See Kieschnick, pp. 74-78.

[81] See Leslie E. Papke, "The Influence of Taxes on the Location of Manufacturing Activity: New Evidence," in James A. Papke, Ed., "Indiana's Revenue Structure: Major Components and Issues, Part II," Center for Tax Policy Studies, Purdue University March 1984.

econometric evidence on taxes and interregional growth supports the conclusions of survey research that tax effects are not a major influence on business location and economic growth.

3.40 Evidence From Intraregional Econometric Studies

Within a state or metropolitan area, taxes may affect business location differently. Since many important location factors, such as wages, availability of labor, market access and energy costs will be similar within a small geographic area, the impact of tax differentials between communities may be amplified. Several studies over the past two decades have employed multiple regression analysis to estimate how taxes influence firm location within a region. Most of these studies analyze business location or investment within metropolitan areas. Intraurban studies have two advantages over the interregional studies. First, since tax differentials across communities in the same metropolitan are primarily due to property tax rates, there is consistency in the tax variable used. Second, since many location factors are the same within an urban area, studies have had to control for fewer non-tax related influences. In addition to property taxes, studies have typically included measures of distance from the central city, transportation access, labor supply, agglomeration, land availability and public services as controlling factors.[83] While no consensus has emerged from these studies, some do conclude that property taxes influence some types of business location with metropolitan areas.

The first study of intraurban business location did not directly measure tax impacts. Moses and Williamson studied expansions and relocations by 2000 firms in the Chicago area between 1950 and 1959. While no tax variable was used, a "dummy" variable indicated whether a location zone was predominantly inside or outside Chicago and served as a proxy for differences in tax rates, zoning policy and other factors between Chicago and its suburbs. Distance from the central city and an agglomeration measure were found to have statistically significant effects, but the tax proxy variable was not statistically significant.[84]

Schmenner used econometric models to predict three measures of business location -- the existing pattern of firm density, changes in firm density and relocations -- in four metropolitan areas during two time periods. In all, sixty regressions were conducted. Two tax variables were used -- effective property tax and income tax rates. The income tax rate was never statistically significant. The property tax variable was significant in only five regressions but with no consistent pattern. Consequently, Schmenner concluded that taxes were an unimportant factor in firm location. He also observed that causation may run two ways. While lower taxes may induce firms to locate in a community, low taxes may

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[83] See Wasylenko (1985), pp. 19-20 for a brief discussion of factors in intraurban firm location.

[84] See Leon Moses and H. Williamson, Jr., "The Location of Economic Activity in Cities," American Economic Review 57 (1967), pp. 211-222.

negative and statistically significant effect for property tax rates.[90] Charney studied the density of manufacturing firms that relocated to communities wthinin the Detroit metropolitan area between 1970 and 1975. Both local property taxes and local income taxes were included as location factors in his model. His results indicated that property tax rates had a large negative and statistically significant effect on relocation destination. The effect was strongest for large firms and nondurable goods producers. No consistent, statistically significant effect was found for income tax rates.[91] In a third study, McGuire explained the building permit value for both new and existing firms over six years in 119 Minneapolis-St. Paul area communities using the property tax rate and four other variables. While the property tax rate had a negative and statistically significant effect in two cases, her results were not consistent. The property tax rate was not significant when building value per land area was used as the dependent variable, and when data for 1976 alone were used. McGuire concluded that there was only qualified support for the hypothesis that taxes matter in firm location and that the extent to which taxes matter is unclear.[92]

No apparent conclusions emerge from studies of intraregional firm location. While four studies concluded that taxes do not matter, three other studies found a strong relationship between property tax rates and firm location or investment within a metropolitan area. One study uncovered qualified evidence that taxes affected commercial and industrial building activiity. It is possible, as Fox and Wasylenko argue,[93] that the studies where taxes do not matter are flawed because they do not account for the supply of industrial space. Studies that control for communities where zoning prohibits industry, therefore, are better designed and provide corroborating evidence that taxes matter.

While this point has some validity, there are important problems that question the conclusions of these studies as well. First, studies that omit communities that zone out industrial land use an imperfect measure of site supply. The actual size and number of avaliable business sites is not included in the model. Thus, densely developed urban communities with existing industrial use, but a shortage of land for expansion or new firms, are innaccurately measured as suppliers of industrial sites. Consequently, the paucity of new business location or investment may be attributed to higher tax rates, when in fact it results from supply shortage. Second, the dependant variables used in several studies raise questions about the

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[90]Cited in Wasylenko (1985), p. 31.

[91]See Albert H. Charney, "Intraurban Manufacturing Location Decisions and Local Tax Differentials," Journal of Urban Economics 14 (1983), pp. 184-205.

[92]See T. McGuire. "Are Local Property Taxes Important in the Intrametropolitan Location Decision of Firms? An Empirical Analysis of the Minneapolis-St. Paul Area." Journal of Urban Economics 18 (1985), pp. 226-234.

[93]See especially Wasylenko (1980), pp. 339-340 and Wasylenko (1985), pp. 29-31.

Several states have used simulation studies to evaluate the competitiveness of their tax system. The advantages of tax simulations and their flexibility in estimating the impact of specific tax law changes make them useful tools in policy analysis. Tax commissions in Hawaii, Indiana, Massachusetts and New York have all used a simulation model to evaluate the competitiveness of their tax system for business investment. With the exception of Massachusetts, the same simulation model -- AFTAX -- has been used by each state.

AFTAX is a simulation model developed by James and Leslie Papke to estimate how taxes affect the after tax rate of return on investments at alternative sites.[95] This model assumes that the pre-tax rate of return is identical at all sites, i.e., all non-tax costs are identical across sites, and then applies federal, state and local tax laws to calculate the after-tax rate of return. Consequently, the results measure how taxes alone affect profitability at varying locations. Federal corporate income taxes, state corporate income taxes, state business franchise fees, state and local sales taxes, and state and local income taxes are all included in the AFTAX model. Representative firms are defined for several manufacturing industries and size classes, and assumptions are made about the location of a firm's sales and plants. The after tax rate of return is then calculated for a variety of situations. First, a baseline estimate of how profit rates vary by site can be calculated. Second, the tax impact of a new investment made at different locations can be simulated. This latter simulation is often run both for "home state" firms and firms based in other states. AFTAX simulations are also used to estimate the impact of particular tax changes and tax incentives on profit rates.

An early application of the AFTAX model compared Hartford, Connecticut to ten sites in nine other states for investments by representative firms in ten industries. When the firm was based in Hartford, the after tax rate of return for a new investment at alternative sites fell within a range of 2-3 percentage points. For some industries, investing in the site with the highest return could boost the return by close to 30% over the site with the lowest return. A simulation to measure the after tax return for home site investment for firms based in each state showed a slightly narrower range of variation.[96]

AFTAX simulations were also used to evaluate the competitiveness of Indiana's tax code. For Indiana based firms, expansion investments in eleven out-of-state sites generally had higher returns than in-state expansion. Across 13 industries, the average out-of-state return is ranged from 7-12% higher than in-state investment. However, in some cases particular sites outside Indiana provided a greater advantage. For example, an electronic components manufacturer which expanded in Cameron, Texas was estimated to earn a return almost 25% higher than

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[95]See Leslie E. Papke and James A. Papke. "Microanalytic Simulation For Analyses of Interstate Business Tax Differentials." National Tax Journal (September 1981), pp. 76-85 for a more detailed description of the AFTAX model.

[96]Papke and Papke, pp. 78-83.

making expansion investments at five sites in Massachusetts and ten sites in ten other states.[103]

The Massachusetts study found that state and local tax differentials resulted in minimal variation in after tax-rates of return. For a hypothetical firm where all sales occurred in its home state, the after-tax rate of return on an expansion investment in all five industries differed by less than 1 percentage point between the site with the highest return (El Paso, Texas) and the one with the lowest return (Bala Cynwyd, Pennsylvania). When the highest and lowest sites are ignored, the after-tax rate of return is virtually the same for all sites.[104] When the hypothetical firm was assumed to have ten percent of sales in its home state and the remaining 90% in states where the firm had no investment, there is a greater spread of returns on the new investment. The largest difference between sites is 2 percentage points, but on average the highest and lowest sites differ by 1.5 percentage points which represents about a 10% difference in after tax returns. Moreover, when the lowest and highest states are omitted, the difference in returns drops to 1 point.[105] Much of the increased variation in returns for this second simulation resulted from a tax law provision relating to the treatment of sales in states where the firm has no income tax liability. However, in practice, this rule is easy to avoid and is rarely applied.

Brooks also simulated the effect of eliminating all state and local taxes. His study included an "empty site" where only federal taxes existed. The after tax rate of return at this empty site, on average, ranged from 10% to 16% higher than the return at the site with the lowest return. Therefore, the maximum impact state and local taxes would have on profit rates was found to be fairly moderate.[106]

While simulation studies found differences in profitability due to state and local taxes, these more precise estimates show far less variation than most other estimates of overall business tax burdens. These four simulation studies all estimate that tax-related differences in profitability from new investments can vary across states by as much as 10 to 30% Other gross measures of business tax burdens have estimated differences of 100% and upward. Thus, simulation model results indicate that variation in profit rates due to state and local taxes are much less than the variation in state and local business taxes themselves. Furthermore, the tax-induced differences in profitability appear modest in comparison with the effect of differences in other factors such as market access, availability of skilled labor, wage levels, transportation costs, and energy costs across states. Thus, evidence from simulations supports other evidence that state and local tax differences are unlikely to exert a major influence on business location decisions.

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[103]See Brooks, et.al., pp. 28-33 and Appendix B for an explananon of the model and his analysis.

[104]Brooks, pp. 39-42.

[105]Brooks, et.al. p.43.

[106]See Brooks, et. al., Tables 2 and 3, pp. 41 and 44.

4.0 The Indirect Effect of Taxes on Population Movement

While the evidence on the direct impact of tax costs generally supports the view that taxes are not a major influence on business location, it is also possible that taxes may indirectly affect economic growth through their influence on population movement. According to this hypothesis, people may choose their residential location in part by the level of taxation, and jobs then follow people to areas with greater population. This theory has been proposed by Wasylenko who argues in two recent papers that personal income taxes affect economic growth by influencing personal location and the availability of labor.[107]

An indirect tax-induced influence on business location is based on two causal relationships. First, population location must shape business location, i.e., jobs must follow people. Second, population location choices must be effected by tax levels. Evidence on these two relationships is reviewed in this section. While empirical studies support the theory that jobs follow people, the limited research on the effect of taxation of residential location is inconclusive.

4.10 Population and Employment Location

The relationship of population and employment location is likely to be a mutually dependent one. Movement of population to an area should attract firms that seek access to consumer markets and a labor force. On the other hand, people are likely to locate where there are greater employment opportunities. However, there is much debate on which effect is larger. Is the tendency of jobs to follow people stronger than the tendency of people to follow jobs? The answer to this question may well depend on the geographic area studied. Within a metropolitan area, where people have relatively good access to jobs throughout the area, the choice of residency may be less dependent on employment locations. However, businesses in the retail, transportation, and service sectors that directly serve consumers, might then follow the pattern of population location. Across regions, individual migration is more likely to be affected by employment opportunities and the tendency of people to follow jobs may be greater.

Several studies of surburbanization indicate that, within a metropolitan area, jobs follow people to a greater extent than people follow jobs. These studies, for the most part, rely on separate econometric models to simultaneously explain population movement with employment shifts and changes in employment location with population movement. The results of the two separate models are then compared to identify which effect is stronger. A 1974 study by Steinnes and Fisher concluded that the location of employment did not have a significant effect on

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[107]See Wasylenko (1985), pp. 19 and 33; and Wasylenko and McGuire (1985).

location.[114] On the other hand, Olvey found that in-migration responded to employment growth, but the effect was twice as high for noncontiguous states than for contiguous states.[115] This latter result suggests that the tendency of people to follow jobs is stronger across regions than within regions.

Despite the difficulty of econometric models to completely control for the many factors that shape population and employment location, the consistency of results in numerous studies over several time periods provides strong evidence that jobs do follow people, both within and across states. With this relationship fairly well established, it is necessary to consider the effect of taxes on population location.

4.20 Taxes and Population Location

Unfortunately, the literature on how taxes affect residential location is fairly limited and has produced mixed results. There is no strong evidence that taxes effect migration across regions and studies of tax-induced intraurban population movement have yielded some conflicting results. The difficulty in obtaining consistent results undoubtedly reflects the complexity of influences on population movement and residential location.[116] Another problem results from the interaction between taxes and population. On the one hand, population growth increases public service needs such as schools, sewers, and police and fire protection which in turn require more taxes. This situation suggests population growth is associated with higher taxes. On the other hand, population growth and associated development of an area may increase the tax base and reduce tax rates and average tax burdens, suggesting a negative relationship between taxes and population growth. In either case, since population growth can affect taxes as well as taxes affecting population location, it is difficult to interpret the meaning of study conclusions. This is particularly problematic since these studies have not used the type of simultaneous models applied to study the interaction of population and employment growth. There have also been no studies that test Wasylenko's hypothesis on the negative effect of personal income taxes on population location.

Carlino and Mills found a negative and statistically significant effect of per capita taxes on county population growth. However, the effect was small and the authors conclude that "public policies, such as taxes, crime rates and Industrial Development Bonds (IDBs) exert little impact on either county population or total

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[114]Cited in Michael J. Greenwood, "Research on Internal Migration in the United States: A Survey," Journal of Economic Literature 13, pp. 397-433; and in Vaughan and Vogel, p. 30.

[115]Cited in Greenwood, p. 420.

[116]For a detailed discussion of factors in population migration, see Vaughan and Vogel, pp. 21-34; and Greenwood. Vaughan and Vogel also discuss what influences residential location choice and suburbanization on pp. 52-84.

decentralization of population in urban areas.[124]

In conclusion, the impact of taxes on population location is unclear. There are too few studies on taxes and interregional population migration to justify any conclusions. For intrametropolitan areas, several studies have found that higher taxes are associated with slower population growth or out-migration. However, other studies do not support these findings. Moreover, these studies do not account for the potential effect of population changes on taxes and do not control for many non-tax factors affecting residential location. Consequently, both the meaning of these results and the relative effect of taxes on population location are unresolved. Thus, there is currently no strong evidence that taxes are an important influence on population location choices either across or within regions, but it is also not possible to conclude that no such effect exists.

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[124]Vaughan and Vogel, p. 84.

5.0 Conclusions

Given the large amount of taxpayers' money at stake in tax incentive programs and general tax deductions aimed at stimulating economic growth, the burden of proof for using tax incentives and reductions to stimulate growth should rest with the advocates of tax concessions. However, the wealth of research summarized in this paper fails to support the position that state and local taxes are an important factor in business location decisions or overall economic development. On the contrary, the weight of evidence lends support to the conclusion that taxes are not a major influence on state economic growth. While studies do not rule out the possibility that taxes influence growth in some circumstances or for some economic sectors, several types of research provide strong evidence that taxes are a minor factor in firm location while other research is inconclusive. Therefore, state policymakers would be wise to ignore the pleas for lower taxes or tax incentives and concentrate instead on other policies with greater promise in fostering economic development.

The following lessons that emerge from this analysis and literature review lend support to a economic development policy that rejects the use of state tax expenditures to stimulate job creation.

- State and local taxes are only one factor among many in complex plant location decisions. Firms consider access to markets, availability of labor and materials, costs, local amenities and integration with other facilities when choosing a plant site. Taxes enter the equation as one part of the cost factor.

- As a direct cost to business, state and local taxes are small and the variation in other costs, such as labor and transportation, overwhelm interregional differences in taxes. When the impact of taxes on profit rates for new investment is measured, fairly modest differences in rates of return are attributable to state and local taxes.

- Business executives themselves, in numerous surveys conducted over three decades, consistently point to factors other than taxes as the major items that they consider whem making location decisions.

- The interstate impact of taxes on economic development is further mitigated by the limited type of business investment decisions where taxes are considered. New business start-ups and on-site expansion, which account for a large share of job growth, are insensitive to tax considerations. Firm or plant relocations are most likely to be influenced by tax costs but account for a very small share of job growth. New branch plant locations are one important source of job creation where taxes are a location factor, although a secondary one. Consequently, interstate tax differentials are irrelevant for investment decisions responsible for a majority of state job creation.

Tax structure: Expert throws cold water on Gardner job-growth argument

Tax reform irrelevant, expert says

MIT prof's view casts doubt on a Gardner job-growth argument

By O. Casey Corr
P-I Reporter

BLAINE — A nationally recognized expert on job growth cast doubt last night on one of Gov. Booth Gardner's favorite ideas by saying tax structure has an "insignificant" impact on economic growth.

Gardner has long argued that Washington state's tax structure retards job growth. That claim is the centerpiece of Gardner's tax-reform campaign.

But David Birch, a professor at the Massachusetts Institute of Technology, said worrying about tax structures is a waste of time.

He spoke before a leadership conference sponsored by the Greater Seattle Chamber of Commerce, at the Inn at Semiahmoo, where some 200 business leaders, elected officials and civic leaders gathered to produce a "firm action agenda" for regional problems.

Birch said there are economic factors far more important than taxes. In King County, it was vital to keep healthy the University of Washington, which he called the "backbone" of the region's economy.

He listed programs to educate or train displaced workers as critical to what he called the "turbulent" modern economy.

Boosting the skills of today's workers is "the number one problem of our nation," Birch said, noting that many job seekers can't fill out the application form.

Conference attendees also heard the results of a survey that concluded that Puget Sound residents are apprehensive about the ill effects of economic growth, but were not ready to end it.

A survey of 651 business people, elected officials

See TAX STRUCTURE Page A12

EXHIBIT
J

HOUSE BILL NO. 12

IN THE LEGISLATURE OF THE STATE OF ALASKA

SEVENTEENTH LEGISLATURE - FIRST SESSION

BY REPRESENTATIVES MOYER, Brown, Koponen, Ellis

Introduced: 1/21/91
Referred: International Trade and Tourism, Labor and Commerce, Finance

A BILL

FOR AN ACT ENTITLED

1 "An Act relating to the water's edge method of calculating income taxes for certain
2 corporations other than corporations engaged in the production of oil or gas from a lease
3 or property in the state or in the transportation of oil or gas by regulated pipeline in
4 the state; and providing for an effective date."

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

6 * Section 1. It is the purpose of this Act to promote investment and trade opportunities in the state.
7 * Sec. 2. AS 43.20 is amended by adding a new section to read:
8 Sec. 43.20.073. AFFILIATED GROUPS. (a) A corporation that is a member of an
9 affiliated group shall file a return using the water's edge combined reporting method. A return
10 under this section must include the following corporations if the corporations are part of a unitary
11 business with the filing corporation:
12 (1) an affiliated corporation that is eligible to be included in a federal consolidated
13 return under 26 U.S.C. 1501 - 1505 (Internal Revenue Code) if the corporation's property,

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1 payroll, and sales factors in the United States average

2 (A) 20 percent or more; or

3 (B) under 20 percent, if the corporation does not meet the requirements

4 of 26 U.S.C. 861(c);

5 (2) a domestic international sales corporation; in this paragraph, "domestic

6 international sales corporation" has the meaning given in 26 U.S.C. 992(a);

7 (3) a foreign sales corporation; in this paragraph, "foreign sales corporation" has

8 the meaning given to the term "FSC" in 26 U.S.C. 922(a);

9 (4) a corporation, regardless of the place where the corporation was incorporated,

10 if the corporation's property, payroll, and sales factors in the United States average 20 percent

11 or more;

12 (5) a corporation that is incorporated in or does business in a country that does

13 not impose an income tax, or that imposes an income tax at a rate lower than 90 percent of the

14 United States income tax rate on the income tax base of the corporation in the United States, if

15 (A) 50 percent or more of the sales, purchases, or payments of income or

16 expenses, exclusive of payments for intangible property, of the corporation are made

17 directly or indirectly to one or more members of a group of corporations filing under the

18 water's edge combined reporting method;

19 (B) the corporation does not conduct significant economic activity.

20 (b) When computing taxable income for a corporation under (a) of this section, the

21 following amounts shall be excluded:

22 (1) 80 percent of dividend income received from foreign corporations;

23 (2) an amount treated as a dividend under 26 U.S.C. 78;

24 (3) 80 percent of the royalties accrued or received from a foreign corporation.

25 (c) In (b)(1) and (3) of this section, a payment is considered to be received from a

26 corporation that is part of the unitary business if the payment is received

27 (1) by a member of an affiliated group included in a water's edge combined

28 report filed under this section; and

29 (2) from a corporation in which the recipient owns 50 percent or more of the

30 stock of the corporation.

31 (d) Dividends and royalties taxable to a corporation using the water's edge combined

1 reporting method are in lieu of an expense attribution for income excluded under (b) of this
2 section.

3 (e) The department may require a corporation that files under (a) of this section to file
4 a worldwide combined report instead, if the corporation or an affiliated corporation

5 (1) fails to comply with regulations adopted under this chapter, including domestic
6 disclosure spread sheet filing requirements; or

7 (2) does not provide information that is requested by the department that is
8 necessary for the department to audit the taxpayer's corporate return in a reasonable period of
9 time.

10 (f) This section does not apply to taxpayers subject to AS 43.20.072 engaged in

11 (1) the production of oil or gas from a lease or property in the state; or

12 (2) the transportation of oil or gas by regulated pipeline in the state.

13 (g) In this section,

14 (1) "affiliated corporation" means a member of an affiliated group to which the
15 taxpayer filing a return under (a) of this section belongs;

16 (2) "affiliated group" means a group of two or more corporations in which 50
17 percent or more of the voting stock of each member of the group is directly or indirectly owned
18 by one or more corporate or noncorporate common owners, or by one or more of the members
19 of the group;

20 (3) "foreign corporation" means a corporation created or organized outside of the
21 United States, the District of Columbia, the Commonwealth of Puerto Rico, or a possession of
22 the United States;

23 (4) "water's edge combined reporting method" means a reporting method in which
24 the only corporations besides the taxpayer that may be included in the return are the corporations
25 listed in (a) of this section.

26 * Sec. 3. This Act applies to tax years beginning after December 31, 1991.

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