

HB 12

SENATE FINANCE COMMITTEE REPORT

DATE: 5/17/91

FURTHER:

DATE TURNED INTO OFFICE: 5-19-91

The Finance Committee considered CS HB 12 (RULES) (efd del)

"An Act relating to the water's edge method of calculating income taxes for certain corporations."

and recommended:

- replace with _____ CS _____
- or adopt _____ CS _____
- attached amendment(s)
- _____ letter of intent adopted
- same title
- new title
- technical title change (HB only)

- do pass
- do not pass
- no recommendation
- individual recommendations
- further referral to _____

ATTACHES NEW FISCAL NOTE(S):

APPROVES PREVIOUS:

- fiscal note(s) Dept/Date: _____
- zero fiscal note(s) _____

- fiscal note(s) Dept/Date: DOR 13.0
- zero fiscal note(s) DOR 13.0

appropriation-no fiscal note

SIGNING DO PASS:

OTHER RECOMMENDATIONS:

[Signature]
[Signature] (DO PASS)

[Signature] NO REC
[Signature] NO REC
 Al Adams - DO NOT PASS

1. *[Signature]* NO REC
 2. *[Signature]* DO NOT PASS
 Co-Chairs: Signatures and Recommendations

FISCAL NOTE

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

STATE OF ALASKA
 1991 LEGISLATIVE SESSION

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 | 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)

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:

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: William F. Pierchinger Phone: (907) 465-2320
 Division: Income and Excise Audit Division Date: March 12, 1991

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

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

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.

	<u>FY92</u>	<u>FY93</u>	<u>FY94</u>	<u>FY95</u>
<u>Personal Services</u>				
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
<u>Travel</u>				
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
<u>Contractual</u>				
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
<u>Supplies</u>				
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
<u>Equipment</u>				
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	<u>\$13.0</u>	<u>\$47.5</u>	<u>132.6</u>	<u>\$130.6</u>

COMMITTEE COPY

FISCAL NOTE

STATE OF ALASKA
1991 LEGISLATIVE SESSION

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

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

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

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

POSITIONS:

FULL-TIME	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 *Glenn A. Olds* Spec Asst
Agency: Department of Commerce & Economic Development Date: 2-28-91

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

CS FOR HOUSE BILL NO. 12 (RULES)(efd del)
IN THE LEGISLATURE OF THE STATE OF ALASKA
SEVENTEENTH LEGISLATURE - FIRST SESSION

BY THE HOUSE RULES COMMITTEE

Amended: 5/14/91
Offered: 5/13/91
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."

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.

5-19-91
Susan
Burke

COMPARISON OF WORLDWIDE, WATER'S EDGE AND DEPARTMENT
OF REVENUE FISCAL NOTE METHODS

WORLDWIDE:

AK property, payroll, sales $\frac{1,000,000}{1,000,000,000}$ = .001
Worldwide prop., payroll, sales

Worldwide net income = \$500,000,000

Alaska net income = \$500,000 (\$500,000,000 x .001)

WATER'S EDGE:

AK property, payroll, sales $\frac{1,000,000}{500,000,000}$ = .002
U.S. prop., payroll, sales

U.S. net income = \$250,000,000

Alaska net income = \$500,000 (\$250,000,000 x .002)

DEPARTMENT OF REVENUE FISCAL NOTE METHOD:

AK property, payroll, sales $\frac{1,000,000}{1,000,000,000}$ = .001
Worldwide prop., payroll, sales

U.S. net income = \$250,000,000

Alaska net income = \$250,000 (\$250,000,000 x .001)

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: Senator Pat Pourchot
Co-Chair, Senate Finance Committee

May 17, 1991

From: Representative Tom Moyer *TM*

Re: HB12, An Act relating to the water's edge method of calculating income taxes for certain corporations; and providing for an effective date.

Pending referral by the Senate president, I would like to request the Senate Finance Committee to hear HB 12 as soon as possible because of the short time remaining in the legislative session. The House voted 34-5 to approve the bill, it was approved by the Senate Labor and Commerce Committee today and it has been waived by the Senate Judiciary Committee. It is vitally important for at least one Alaska economic development project that the bill be passed this session.

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, 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 from across Alaska and within the legislature. 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.

Attached are materials about the bill and I am happy to provide additional information or testify about the legislation at your convenience.

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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

Questions About House Bill 12, relating to the water's edge tax

• What is the purpose of HB12?

The bill would change Alaska's corporate income tax system to encourage additional investment to Alaska and increase the state's share of the international marketplace.

• How does HB12 work?

The bill would replace Alaska's corporate unitary tax with a so-called "water's edge" tax system for both foreign and domestic owned companies. Under a unitary system, all the activities of a corporation worldwide are subject to taxation in Alaska. Under this water's edge proposal, the domestic activities would be subject to Alaska taxes as well as 20 percent of the dividends and royalties from foreign income.

• Why make the change?

Alaska remains the only state with a unitary system on the books. Since 1984, 11 states have altered their worldwide unitary tax system, including such leaders in international trade as California, Florida and Oregon. International corporations dislike the unitary tax because they consider it double taxation and are reluctant to invest in states which have unitary tax systems. Alaska in April earned a "D" from the Corporation for Enterprise Development, a private research group, for economic performance, in part for lack of diversity.

• What's the cost of changing from unitary to water's edge?

The Alaska Department of Revenue estimates an initial annual revenue loss of between \$500,000 and \$3 million. In addition, the Department estimates it would need an additional auditor. However, bill supporters believe the new investment the change would attract to Alaska would offset any revenue loss. As economist Gregg Erickson told the House Finance Subcommittee: "There is a correlation between corporate income taxes and business location decisions, and perceptions by businesses about a jurisdiction's taxing attitude also affect those decisions."

-MORE-

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• Who supports the bill?

The bill is supported by many businesses and business groups including the Anchorage, International and Alaska State Chambers of Commerce, Alaska Miners Association, Associated General Contractors of Alaska, IMB, Xerox and Keidanren, the Japan Federation of Economic Organizations.

U.S. Sen. Frank Murkowski told a joint session of the Alaska Legislature in March: "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."

• What is Barclays and what's the connection to HB12?

Barclays refers to a 1990 California Court of Appeals decision holding that, as applied to foreign-based unitary groups, the California worldwide combined reporting method of corporate income taxes violates the foreign commerce clause of the U.S. Constitution. The case should have no direct bearing on Alaska until it reaches the U.S. Supreme Court. But if Barclays is upheld by federal courts, Alaska's current unitary tax could be found unconstitutional. That's why Section 2 of the bill was added in House Finance and appears in the Rules CS.

• Does the bill result in a tax on the cruise ship industry?

No. The Finance CS did propose to remove a federal tax exemption for the cruise ship industry. However, the Rules CS dropped this provision because its applicability may have been broader than initially intended and the fiscal impact was impossible to calculate in a relatively short period. Additionally, the administration is addressing the issue in a more comprehensive form.

• Why doesn't HB12 apply to oil and gas companies?

This is an economic development incentive bill. The sponsors feel that oil and gas companies operating in Alaska pay adequate taxes and especially after the 1989 Economic Limit Factor change, feel a change in the tax structure for those companies is not necessary at this time. Several court cases including the 1985 separate accounting case in Arco v. Alaska upheld the right of Alaska to impose different tax methods to different industries in the state. Alaska applied a standard apportionment formula before 1977 and a modified formula after 1981. The oil and gas industry has not asked to be included or excluded from HB12.

*--By Representative Tom Moyer
May 14, 1991*

Point of View



By Rep. Tom Moyer

DUMP ALASKA'S UNPRODUCTIVE UNITARY TAX

Alaskans are justifiably proud of the notion, "We don't care how they do it Outside." But when it comes to changing Alaska's tax system to attract new business, we should follow the lead of every other state in the nation.

Alaska remains the only state with an antiquated corporate income tax system that discourages investment and gives the state an unfriendly reputation in international business circles.

We can convince our trading partners we're serious by replacing Alaska's unitary corporate income tax with a so-called "water's edge" system. I believe the change will attract additional investment and new companies to Alaska and bolster our standing as a legitimate player in the world market.

That's why I've introduced legislation to do exactly that. House Bill 12 would replace our unitary tax. Under the current system, all the income of a corporation, regardless of where it is earned, is totaled. Alaska then calculates its share by determining the company's payroll, property and sales in Alaska.

International companies dislike the system because they consider it double taxation and because it permits Alaska auditors to snoop through the books of a firm's entire worldwide operations.

Studies show that a favorable tax climate is a

significant factor in a company's decision to move or open an operation in a new locality. Investors from Japan and elsewhere have been warning state officials since the mid-1980s that they have cold feet about Alaska because of our unitary tax system.



In its place, HB12 would institute a water's edge tax structure under which only the domestic activities of a corporation — whether foreign or U.S.-based — would be subject to taxation. Generally, a corporation would be subject to the water's edge tax if 20 percent or more of its average property, payroll and sales are within the U.S.

It would not apply to oil and gas companies, which the state historically has opted to tax differently from other corporations.

Since 1984, 11 states, including the leaders in international trade such as California, Florida and Oregon, have moved to water's edge systems. Although difficult to quantify, trade officials from some of those states say changing to a water's edge tax system helped attract new business and investment.

Alaska Sen. Frank Murkowski told the legislature in March: "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

Continued on Page 5

Moyer

Continued from Page 4

doing business in our part of the world."

HB12 doesn't do everything for everyone. The Alaska Department of Revenue estimates the change could cost the state between \$500,000 and \$3 million in lost revenues. However, supporters, including the Hickel administration and its revenue department, believe any revenue loss will be offset by the new investment this change is likely to bring to Alaska.

This tax change has been pending before the legislature at least since 1987. A recent legal development makes the need for it even more timely.

A California appeals court last year, in a case known as "Barclays," ruled that its worldwide unitary tax violates the equal protection doctrine and that California could be liable for refunds.

Continued on Page 6

Moyer

Continued from Page 5

Although it doesn't now affect Alaska, the ruling could be a harbinger to which we should pay attention.

HB12 is widely supported in the Alaska business community by groups from the Alaska State Chamber of Commerce, Alaska Miners' Associa-

tion and Anchorage Economic Development Corporation to companies such as IBM and Xerox.

Despite the bill's popularity among some, its path through the legislature is uncertain because tax bills are complicated and attract scrutiny. Legislators need to hear that this change is a necessary one.

Tom Moyer is a state representative from Fairbanks.

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.



ALASKA MINERS ASSOCIATION, INC.

501 W. Northern Lights Blvd., Suite 203, Anchorage, Alaska 99503 FAX: (907) 278-7997 Telephone: (907) 276-0347

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
4341 B. Street
Anchorage, Alaska 99503
(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



GREATER PALMER CHAMBER OF COMMERCE

March 14, 1991

Representative Tom Moyer
P O Box V
Juneau, AK 99811

Dear Representative Moyer:

Our Board of Directors has reviewed House Bill No. 12 per your request to Sara Horner, immediate past president.

The decision was made to support the Alaska State Chamber of Commerce position on this legislation. They feel the legislation will be good for Alaska.

We appreciate your requesting our input.

Sincerely

Delores Prickett
Executive Director

cc: Rep. Larson & Carney
Sen. Kerttula & Menard

RECEIVED MAR 22 1991

April 1, 1991

21688/01012

TO: House Finance Committee Members

FROM: Brian W. Durrell *BWD*

RE: Water's Edge Tax Legislation

What is Barclays'? 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., 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' case, the Alaska Supreme Court upheld the use of the separate accounting

Memorandum to House Finance Committee Members
April 1, 1991
Page 3

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)



ANCHORAGE
ECONOMIC
DEVELOPMENT
CORPORATION

Proposal to Reform Alaska's Worldwide Unitary Method of Taxation

Executive Summary

GOAL: To reform Alaska's worldwide unitary method of taxation by adopting a "water's edge" combined method that applies equally to domestic and foreign multinational corporations.

PROBLEM: Alaska is the only state that requires worldwide unitary taxation. In addition, no country in the world uses this method of taxation. Why? Worldwide unitary taxation can distort a company's taxation relationship to states and cause double taxation of income earned in another governmental jurisdiction.

BENEFITS: A reform of the worldwide unitary system should make Alaska a more attractive place to invest if it is applied equally to domestic U.S. and foreign corporations.

ACTIONS: The AEDC will support and recommends your support of the committee substitute for Senate Bill 119 (Finance) which was approved 14 to 5 by the Senate in the 1990 session. The bill, to be reintroduced, provides for a "water's edge" combined reporting method of taxation for both domestic and foreign multinational corporations.

UNITARY TAX
 The following are examples of
 unitary & illustrate the typical
 distortion produced by unitary

		<u>Unitary Principle</u>			
		<u>Seperate Acctg.</u> <u>(arm's length)</u>	<u>Domestic</u> <u>(water's edge)</u>		<u>Worldwide</u>
			<u>High</u>	<u>Low</u>	
SALES	<u>In-state</u> Everywhere		$\frac{100}{1000} = .10$		$\frac{100}{2000} = .05$
Property	<u>In-state</u> Everywhere		$\frac{200}{4000} = .05$		$\frac{200}{6667} = .03$
Payroll	<u>In-state</u> Everywhere		$\frac{120}{2000} = .06$		$\frac{120}{3000} = .04$
Average Factor			.07	.07	.04
Income			40	40 + 30	100
Apportioned Income			2.80	4.90	4.00
Distortion				75%	43%

2-17-91

Fairbanks Daily News-Miner, Fai

'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 corporation's 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 Legislature 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 project 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 examined 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

(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

formula

— 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 15 years.