HB

12

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 Drue Pearce
Chair, Senate Labor and Commerce

May 15, 1991

From: Representative Tom Moyer

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 Labor and Commerce 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 last night and it is vitally important for at least one Alaska economic development project that it be passed this session.

As you know, 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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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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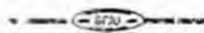

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• Who supports the bill?

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

FISCAL NOTE

STATE OF ALASKA
1991 LEGISLATIVE SESSION

BILL NO. CSHB12

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

	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: Bill Floerchinger
Division: Income and Excise Audit Division

Phone: (907) 465-2320
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

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.

Personal Services	FY92	FY93	FY94	FY95
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

HB 12

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.

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

UNITARY TAX

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

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

SYNOPSIS OF CSSB 119 (Finance)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Offered: 3/26/90
Referred: Rules

go0179sE

Original sponsor(s): Rules/Governor

1 IN THE SENATE BY THE FINANCE COMMITTEE
2 CS FOR SENATE BILL NO. 119 (Finance)
3 IN THE LEGISLATURE OF THE STATE OF ALASKA
4 SIXTEENTH LEGISLATURE - SECOND SESSION
5 A BILL
6 For an Act entitled: "An Act relating to the water's edge method of cal-
7 culating income taxes for certain corporations other
8 than corporations engaged in the production of oil or
9 gas from a lease or property in the state or in the
10 transportation of oil or gas by regulated pipeline in
11 the state; and providing for an effective date."
12 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:
13 * Section 1. It is the purpose of this Act to promote investment and
14 trade opportunities in the state.
15 * Sec. 2. AS 43.20 is amended by adding a new section to read:
16 Sec. 43.20.073. AFFILIATED GROUPS. (a) A corporation that is a
17 member of an affiliated group shall file a return using the water's
18 edge combined reporting method. A return under this section must
19 include the following corporations if the corporations are part of a
20 unitary business with the filing corporation:
21 (1) an affiliated corporation that is eligible to be in-
22 cluded in a federal consolidated return under 26 U.S.C. 1501 - 1505
23 (Internal Revenue Code) if the corporation's property, payroll, and
24 sales factors in the United States average
25 (A) 20 percent or more; or
26 (B) under 20 percent, if the corporation does not meet
27 the requirements of 26 U.S.C. 861(c);
28 (2) a domestic international sales corporation; in this
29 paragraph, "domestic international sales corporation" has the meaning

1 given in 26 U.S.C. 992(a);

2 (3) a foreign sales corporation; in this paragraph,
3 "foreign sales corporation" has the meaning given in 26 U.S.C. 922(a);

4 (4) a corporation, regardless of the place where the corpo-
5 ration was incorporated, if the corporation's property, payroll, and
6 sales factors in the United States average 20 percent or more;

7 (5) a corporation that is incorporated in or does business
8 in a country that does not impose an income tax, or that imposes an
9 income tax at a rate lower than 90 percent of the United States income
10 tax rate on the income tax base of the corporation in the United
11 States, if

12 (A) 50 percent or more of the sales, purchases, or
13 payments of income or expenses, exclusive of payments for intan-
14 gible property, of the corporation are made directly or indirect-
15 ly to one or more members of a group of corporations filing under
16 the water's edge combined reporting method;

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

19 (b) When computing taxable income for a corporation under (a) of
20 this section, the following amounts shall be excluded:

21 (1) 80 percent of dividend income received from foreign
22 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
25 foreign corporation.

26 (c) In (b)(1) and (3) of this section, a payment is considered
27 to be received from a corporation that is part of the unitary business
28 if the payment is received

29 (1) by a member of an affiliated group included in a

1 water's edge combined report filed under this section; and
2 (2) from a corporation in which the recipient owns 50
3 percent or more of the stock of the corporation.
4 (d) Dividends and royalties taxable to a corporation using the
5 water's edge combined reporting method are in lieu of an expense
6 attribution for income excluded under (b) of this section.
7 (e) The department may require a corporation that files under
8 (a) of this section to file a worldwide combined report instead, if
9 the corporation or an affiliated corporation
10 (1) fails to comply with regulations adopted under this
11 chapter, including domestic disclosure spread sheet filing require-
12 ments; or
13 (2) does not provide information that is requested by the
14 department that is necessary for the department to audit the tax-
15 payer's corporate return in a reasonable period of time.
16 (f) This section does not apply to taxpayers subject to AS 43.-
17 20.072 engaged in the production of oil or gas from a lease or proper-
18 ty in the state or engaged in the transportation of oil or gas by
19 regulated pipeline in the state.
20 (g) In this section,
21 (1) "affiliated corporation" means a member of an affili-
22 ated group to which the taxpayer filing a return under (a) of this
23 section belongs;
24 (2) "affiliated group" means a group of two or more corpo-
25 rations, in which 50 percent or more of the voting stock of each
26 member of the group is directly or indirectly owned by one or more
27 corporate or noncorporate common owners, or by one or more of the
28 members of the group;
29 (3) "foreign corporation" means a corporation created or

1 organized outside of the United States, the District of Columbia, the
2 Commonwealth of Puerto Rico, or a possession of the United States;
3 (4) "water's edge combined reporting method" means a re-
4 porting method in which the only corporations besides the taxpayer
5 that may be included in the return are the corporations listed in (a)
6 of this section.
7 * Sec. 3. This Act applies to tax years beginning after December 31,
8 1989.
9 * Sec. 4. This Act takes effect immediately under AS 01.10.070(c).

INTRODUCTION

States have the power to levy taxes in accordance with their own laws, subject to the restrictions imposed principally by the Due Process Clause of the 14th Amendment and the Commerce Clause of the U.S. Constitution. Under the Due Process Clause, a minimal connection must exist between a corporation's activity and the taxing state, and the income attributed to the state for taxing purposes must be rationally related to income-generating values within the taxing state. Under the Commerce Clause, a state is prohibited from adopting a taxing scheme which discriminates against, or places an undue burden on, interstate commerce.

In complying with these restrictions, states impose apportionment methods for determining the income of a multinational corporation within their borders.

WHAT IS UNITARY TAXATION

All states imposing an income tax on the multi-state business activities of a corporation use apportionment generally by a variation of a three factor formula comprised of the average of sales, property and payroll in the state divided by the average of to sales, property and payroll everywhere. Most states apply this formula only to the total U. S. income from business activities conducted by the specific company located in their state. This is generally referred to as the "separate accounting" or "arm's length" method. The "arm's length" method is used for federal income tax purposes, and is the international standard. Some states have adopted the "unitary principle", under which they combine the income of the company located in their state, with the income of all related companies (parent, subsidiaries, and brother-sister corporations). The combined income is then apportioned to these states using a combined factor representing sales, property and payroll of all unitary companies.

There is little consistency between the states in how the unitary principle is applied. Some states, such as New York, use the unitary principle to combine the income and factors of only companies which have "nexus" (are doing business) in the state. Others apply the unitary principle to include in the combination not only companies doing business in the state, but unitary companies which are not doing business in the state. This group either limits the unitary combined group to domestic corporations, or, in the case of Alaska, extends the unitary combination to the worldwide operations of the Corporation.

Worldwide unitary requires a corporation to report its total worldwide income. The worldwide income is apportioned to the state by means of an apportionment formula that uses property, sales, and payroll in the state to property, sales, and payroll worldwide.

The count of states that have historically required worldwide unitary varies, but most commentators have included a dozen states on the list./1. Since the U.S. Supreme Court's decision in Container Corp. of America vs. Franchise Tax Board, /2 all of these states except Alaska, California, Idaho Montana and North Dakota have totally repealed worldwide unitary. California, Idaho, Montana and North Dakota have enacted legislation partially repealing worldwide unitary by permitting taxpayers to elect "water's edge" (limitation of the unitary combination to domestic corporations). The only state which continues to require worldwide unitary is Alaska.

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1. Bureau of National Affairs Daily Tax Report, September 19, 1983, p. G-7 listed 12 states then using worldwide unitary, according to the Multi-state Tax Commission: Alaska, California, Colorado, Florida, Idaho, Indiana, Massachusetts, Montana, New Hampshire, North Dakota, Oregon and Utah.

2. Container Corp. of America v. Franchise Tax Board, 103 S. Ct. 2933 (1983). In this decision, the U.S. Supreme Court upheld California's right to impose worldwide unitary on U.S. multinational corporations as discussed later in this paper; however, the continued validity of this decision is open to some serious speculation.

WHY DID STATES USE WORLDWIDE UNITARY?

On an emotional level, business felt that states used unitary simply to increase tax revenues; states, by contrast, saw worldwide unitary as a weapon against what they perceived as wide-spread cheating by multinational corporations shifting of income from the United States to tax havens. Fortunately, these purely emotional responses on both sides have been ameliorated considerably through the unitary reform process, and the issues have become amenable to a more objective analysis.

For instance, in the Container case, the U. S. Supreme Court had a more reasoned explanation for the unitary principle:

> "One way of deriving locally taxable income is on the basis of formal geographical or transactional accounting. The problem with this method is that formal accounting is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise."

OBJECTIONS TO WORLDWIDE UNITARY

Despite the continued lack of uniform guidance or "bright line" tests, most integrated multinational corporations would concede that they are unitary with their related companies, at least with those engaged substantially in the same line of business. The real question is the necessity and desirability of extending the unitary principle to foreign operations.

It is the very nature of the three factor apportionment formula[3] that income automatically migrates to high price/high wage jurisdictions. When the formula is applied to U.S. operations, the everywhere base is relatively homogeneous and distortions between states is insignificant. However, as a

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3. Most states use an income apportionment method by means of a three factor formula---they assume that their state's proper share of a multi-state income is their state's percentage of in-state property, payroll, and sales compared to the corporation's total domestic (U.S.) property, payroll, and sales.

general rule, wages and prices are substantially lower in foreign countries. Due to these lower costs, foreign operations may also be more profitable. When foreign results and foreign factors are included under the unitary method, the inevitable result is distortion. This distortion is compounded by exchange rate fluctuations and different foreign accounting practices. The following example illustrates typical distortion produced by unitary:

TABLE 1.

	SALES	PROPERTY	PAYROLL	INCOME	APPORTIONED INCOME
DOMESTIC:					
In-State / Everywhere	100 / 1,000	200 / 4,000	120 / 2,000		
Factor	.10	.05	.06		
Income				40	
Average Factor			.07		
	(equals .07 times income of 110)				2.80
WORLDWIDE:					
In-State / Everywhere	100 / 2,000	200 / 6,667	120 / 3,000		
Factor	.05	.03	.04		
Income				100	
Average Factor			.04		
	(equals .04 times income of 100)				4.00
DISTORTION					43%/4

4. The distortion percentage (43%) is calculated by comparing the difference between the domestic apportioned income and the worldwide apportioned income.

In this example, 60% of total income was earned outside of the U.S., but foreign operations employed only 40% of the income-producing factors.[5] This disparity produces a distortion of 43%.

The question inevitably arises, if the unitary group is limited to "water's edge", how should foreign income repatriated in the form of dividends be treated? In the above example, taxation of foreign dividends repatriated, for instance, at a 50% rate would result in:

TABLE 2.

Domestic Unitary Income	40
Foreign Dividends (50% of 60)	30
Total	70
Domestic Factor	X .07
Apportioned Income	4.90

Obviously, including as much as 50 percent of foreign dividends in a "water's edge" method in a corporation's total U.S. taxable income produces even greater distortions than those produced by the "pure" worldwide unitary method.

In testimony on unitary taxation,[6] Robert N. Mattson IBM Assistant Treasurer, has emphasized this point:

> "LET NO ONE MISUNDERSTAND THIS POINT: INCLUSION OF FOREIGN DIVIDENDS IN THE STATE'S TAX BASE IS CLEARLY AN EXPANSION OF THE WORLDWIDE UNITARY TAX AND NOT AN ADOPTION OF A WATER'S-EDGE APPROACH.
>
> My company, along with many others, is rethinking its entire employment and investment strategy in all states using the worldwide unitary method. Just recently, we have ranked our investments by states and have found, for example, that it cost us about five million dollars a year more in income taxes to locate a new plant in California instead of in Texas, Indiana, New York, Ohio, Alabama or 11 other states. In addition business pays only about 20 percent of their state taxes in Corporate income taxes. Taxes other than

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5. Ironically, as foreign productivity increases, or domestic productivity decreases, tax in unitary states increases!
6. Robert N. Mattson Statement, 1984 Congressional Conference on Unitary Taxation, September 14, 1984.

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 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 Legisalture 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.

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

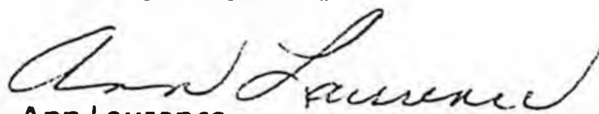
Honorable Tom Moyer
Representative
Alaska State Legislature
Juneau, Alaska 99801

Dear Mr. Moyer:

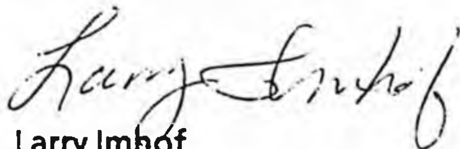
The Xerox Corporation supports increased business investment in the state. Accordingly, House Bill 12 applied equally to both domestic and foreign corporations should make Alaska a more attractive place to invest. We definitely recommend its passage.

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

Delores Prickett
Executive Director

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

RECEIVED MAR 2 2 1991

P.O. Box 45 • Palmer, Alaska 99645-0045 • (907) 745-2880

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, 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)

≪JAPAN FEDERATION OF ECONOMIC ORGANIZATIONS≫
9-4, OTEMACHI 1-CHOME, CHIYODA-KU, TOKYO 100, JAPAN

Cable: KEIDANREN TOKYO
Telephone: 03-3279-1411
Telex: 222-3168 KDRTOK J
Facsimile: 03-3246-2573

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.

We oppose the worldwide unitary taxation for the following reasons.

1) It results in taxing the foreign-source income of foreign entites 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.

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 men.)er corpo tions 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 tha. hey 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

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 832 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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Printed in Japan

ALASKA STATE LEGISLATURE
HOUSE OF REPRESENTATIVES
RESEARCH AGENCY

Pouch Y, State Capitol
Juneau, Alaska 99811
(907) 465-3991

October 25, 1984

MEMORANDUM

TO:

FROM: Jay Livey
Legislative Analyst

RE: Unitary Taxation: An Examination of Alternatives
Research Request 85-012

You asked that we examine the unitary tax laws of Alaska and other states and present alternatives to the method of collection currently used in Alaska. This memorandum responds to your request. It begins with an explanation of the unitary tax and worldwide combined reporting, including supporting and opposing arguments. An explanation of Alaska's current corporate taxation method is followed by a discussion of alternatives to worldwide combined reporting as developed by a national task force. Issues which the task force were unable to resolve are also identified. Four alternatives to worldwide combined reporting are then discussed, and states' experience with the alternatives are examined. The memorandum concludes with an analysis that focuses on the implementation of the options in Alaska.

SUMMARY

Alaska currently taxes corporate income by using a form of the unitary tax called worldwide combined reporting. The unitary tax is based on the concept that the total income of a corporation or of an affiliated group of corporations engaged in a unitary (related) business activity can be apportioned among states based on the portion of total corporate business activities that occur in each state. Business activity in the state is generally measured by the level of corporate payroll, property and sales. This apportioned income is the taxable income subject to particular state tax rates. Approximately forty states currently use some form of the unitary tax to apportion corporate income for state income tax purposes.

All states that use the unitary tax must determine the corporate income that is to be apportioned. Eleven states use a method called world-wide combined reporting to do this. 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. The balance of unitary tax states use a waters edge approach which apportions only the income earned by the unitary business within the United States.

Worldwide combined reporting has recently 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 state interference in foreign trade and fear of 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 of the United States. Also, these corporations claim that state taxation of these foreign activities constitutes double taxation because this income has already been taxed by foreign governments. Foreign multinational corporations have been especially vocal in their criticism of worldwide combined reporting. Recently, several Japanese corporations announced that they would make no further investments in states that used worldwide combined reporting.

As a result of federal government opposition and the threats of economic reprisal by foreign corporations, several states have considered changes to worldwide combined reporting. The following alternatives are discussed in this memorandum:

1. Worldwide combined reporting for domestic corporations with an alternative tax levied on foreign multinational corporations;

2. A waters edge method that includes foreign source dividends in taxable income and includes 80/20 corporations within the definition of waters edge;[1]

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[1] 80/20 corporations are U.S. based corporations that have 80 percent or more of their business activity occurring outside of the United States.

3. A waters edge method that excludes foreign source dividends from income and excludes 80/20 corporations from the definition of waters edge; and

4. Separate accounting.

The corporate tax in Alaska generates approximately $260 million annually, of which $230 million or 90 percent comes from the petroleum industry. It is interesting to note that the petroleum industry in Alaska is comprised of foreign multinational corporations, domestic multinational corporations and largely domestic corporations. This diversity of interest will have to be considered as alternatives to worldwide combined reporting are proposed.

Foreign multinational corporations in Alaska would be likely to support either of the waters edge options or separate accounting. Foreign corporations were instrumental in supporting alternatives to worldwide combined reporting that were adopted in Illinois and Oregon and proposed in California. All of these methods would mean that the worldwide income of these corporations would escape taxation by the states.

Domestic multinational corporations generally support alternatives that repeal worldwide combined reporting, but not at the expense of giving a competitive advantage to foreign multinationals. Domestic multinational corporations generally support a waters edge option if foreign source dividends are excluded from taxable income. Representatives of Exxon noted that their corporation would be opposed to any alternative to worldwide combined reporting that included the taxation of these dividends. This position is consistent with that of domestic multinational corporations that opposed the passage of a bill in California that would have repealed worldwide combined reporting.

Although the Department of Revenue was unable to provide revenue projections for the various alernatives to worldwide combined reporting, revenue would probably decline under all options. A waters edge approach that included foreign dividends in income determination would not effect revenues as much as the other options.

INTRODUCTION

The form of corporate taxation commonly known as the 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. Formula apportionment divides the corporate income of a unitary business among the states in which the corporation does business in proportion to the amount of corporate activity in the

state. Most states determine the level of corporate activity by applying formulas that compare the corporate payroll, sales and property within the state to the total corporate payroll, sales and property.[2] For example, if a state determines that 10 percent of a corporation's business activity (as determined by examining payroll, sales and property factors) occurs within its borders, then 10 percent of the total corporate income is subject to state taxation.

Arguments Supporting Unitary Taxation

Formula apportionment is based on the concept that corporate activity in a state is a better measure of the state contribution to corporate income than accounting income based only on in-state operations. Two arguments are used by proponents of the tax to support this view. First, corporate transactions across state lines can be used to manipulate income to reduce corporate tax liability. Second, the integrated nature of corporate activities makes it difficult and irrelevant to separate in-state activities from the activities of the corporation as a whole.

As an example of the first argument, consider a business that manufactures a product in one state but sells it through a subsidiary corporation located in another state. Both states have contributed to total corporate profit; however, taxable income in both states depends on the price at which the product is sold to the subsidiary. By adjusting this sales price, the corporation can transfer profit between states so that total tax liability is minimized. To accurately determine the corporate income that should be taxed in the manufacturing state, the selling price of the product must be established as if there were no special relationship between the two corporations. This very difficult and expensive pricing process would have to be applied to all interstate corporate transfers for a state to levy the corporate tax efficiently.

The second argument for formula apportionment claims that the use of subsidiary and affiliate corporations does not mask the fact that all the corporate entities may be engaged in related business activities. As long as the corporate activities relate to this unitary business, the contribution that each state makes to the corporate whole is the equitable base upon which to apportion taxable income.

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[2] $$\left[\frac{\dfrac{\text{Payroll In State}}{\text{Total Payroll}} + \dfrac{\text{Property In State}}{\text{Total Property}} + \dfrac{\text{Sales In State}}{\text{Total Sales}}}{3}\right] \times \text{Total Income} = \text{Income Apportioned To State}$$

Much of the controversy surrounding the application of formula apportionment stems from its extension to multinational corporations. The concept of a unitary business has been applied to groups of affiliated corporations doing business in more than one state or nation. Consequently, a group of affiliated corporations performing different functions (manufacturing, distributing, selling) but engaged in the same unitary business are treated as if they were a single corporation. The extension of this concept to all worldwide subsidiaries engaged in a unitary business is known as worldwide combined reporting. Currently, forty-five states apply formula apportionment to domestic corporations and 11 states (including Alaska) use worldwide combined reporting.

Opposition to States Use of Worldwide Combined Reporting

Although some critics of the formula apportionment method maintain that accounting income should be the only basis upon which states should be allowed to tax, most criticism of the unitary tax is reserved for worldwide combined reporting. The most vocal of these critics are domestic and foreign multinational corporations and the United States government.

Multinational corporations claim that state taxation of foreign affiliates and subsidiaries results in double taxation because income is taxed by the foreign nation in which it was earned. Also, multinationals question the basic right of the states to tax activities that occur outside of the borders of the United States. A third criticism claims that the use of the unitary method of formula apportionment, as opposed to traditional accounting methods, causes severe administrative burdens and duplication of accounting and reporting efforts. Many multinationals are also concerned that income distortion occurs because of the factors used to apportion income. Because payroll, property and sales costs in the United States are generally higher than similar costs in other parts of the world, states are able to claim a disproportionate share of the total worlwide income.

The federal government opposes the use of worldwide combined reporting by the states for two main reasons. First, the federal government claims that application of this method of income distribution is a state intrusion into foreign policy considerations that are reserved for the federal government. As a result of this intrusion, the government is not able to establish a consistent policy of taxation with its trading partners. Second, the federal government fears retaliation against United States based multinational corporations by nations whose corporations have been subject to states' application of worldwide combined reporting.

The federal government oposition to worldwide combined reporting is based on policy rather than legal arguments. Several recent United

States Supreme Court cases, most recently Container Corporation versus the Franchise Tax Board of California, have upheld the legality of state use of worldwide combined reporting.

Container presented two issues to the court: the definition of a unitary business and the constitutionality of worldwide combined reporting. On the first issue, the court held that states should be allowed to define unitary business as long as the state decision is "within the realm of permissible judgment." Basically, this means that the Supreme Court did not define "unitary business" but allows states to apply their own definitions of unitary as long as they are based on reasonable criteria.

The court went on to rule that worldwide combined reporting is constitutional because it does not violate either the due process clause or the commerce clause of the United States Constitution. Under the Due Process Clause of the 14th amendment, a minimal connection must exist between the corporation's activity and the taxing state, and the income attributable to the state for taxing purposes must be rationally related to income generating values within the taxing state. The Commerce Clause stipulates that a state is prohibited from adopting a taxing scheme which places an extraordinary burden on interstate commerce.

It is important to note, however, that the Container case involved a foreign subsidiary of a domestic corporation. According to some legal analysts, the constitutionality of applying the unitary tax to foreign-based corporations is an issue that may be litigated in the future. However, until another Supreme Court case determines otherwise or until Congress acts to outlaw the unitary tax, states can legally apply it on both a worldwide and domestic basis.

Alaska Corporate Taxation

According to the Department of Revenue, Division of Audit, the State of Alaska collects about $260 million annually in corporate income taxes. Of this total, approximately $230 million (90 percent) is paid by the petroleum industry. Although projections of future taxes indicate that corporate income tax revenue will increase, the share paid by the petroleum industry is expected to remain at about 90 percent.

Alaska Statute 43.20.065 provides that corporations with income both inside and outside Alaska must apportion their income for tax purposes according to the Multistate Tax Compact. This compact, which has been adopted by 20 states including Alaska (AS 43.19), attempts to provide states with a uniform method of applying corporate income taxes.

Generally, Alaska law requires that all "business income" is subject to apportionment and that an Alaska taxpayer conducting a unitary business

inside and outside the state must combine all income from all members of the unitary group. This combination may be on a domestic or international basis, depending on the particular configuration of the business [15 AAC 20.300 (b)]. For most businesses in the state, income is apportioned using the basic three factor formula. However, the income from four industries--land transportation, airlines, construction and petroleum--is apportioned based on formulas designed specifically for those industries. It should also be noted that business activities related to petroleum production occurring more than three miles offshore are not included as in-state activity for income apportionment.

The starting point for calculating the tax liability of a domestic corporation is consolidated Federal Net Income as reported for federal income tax purposes. Any taxes that are paid by the corporation to state or local jurisdictions and are allowed as federal tax credits must be added back to the federal net income figure. However, any interest income received from federal government obligations (treasury bills or bonds) may be subtracted from federal net income because this is not considered to be business income. Other nonbusiness income items are subtracted from the federal net income total. The result after these adjustments is the Alaska apportionable income.

If the corporation is part of a domestic multinational corporation, these same adjustments are made. In addition, the federal net income of all unitary foreign subsidiaries and affiliates is added. As with the domestic income, all taxes that had been deducted to arrive at the net income figure are added back. However, any dividends received from unitary subsidiaries whose income is already included in the combined income total should be subtracted. The same method is used for multinational corporations that have a foreign parent. In these cases, adjustments can be made for gains or losses from currency fluctuations.

ALTERNATIVES TO WORLDWIDE COMBINED REPORTING

Although we mentioned earlier that some business leaders would like to see all applications of formula apportionment abandoned by the states, most efforts by business and the federal government have been directed toward the repeal of worldwide combined reporting by the states that currently use it. After the Supreme Court declared worldwide combined reporting to be legal in the Container case, a task force of business leaders and state and federal government officials was appointed by President Reagan to develop alternatives to worldwide combined reporting. The task force was able to agree on the following three principles to guide the states in taxing the income of multinational corporations:

1. Foreign and domestic corporations should only be taxed on income that is earned by the unitary group within the "waters edge".

2. Federal administrative assistance and cooperation with the states should be increased to promote full taxpayer disclosure and accountability.

3. A competitive balance between U.S. multinational corporations, foreign multinational corporations and purely domestic businesses should be encouraged.

Waters Edge Unitary Combination. This principle restricts the definition of unitary combination to U.S. corporations included in a consolidated return for U.S. tax purposes. It would exclude foreign subsidiaries and affiliates of domestic multinational corporations and the United States based subsidiaries and affiliates of foreign multinational corporations. This waters edge approach can be contrasted with worldwide combined reporting, which includes all income from all foreign subsidiary and affiliate corporations determined to be part of the unitary business.

Increased Federal Administrative Assistance. In return for the states' agreement to restrict the use of worldwide combined reporting, the federal government would agree to the following activities to assist the states implement alternative taxation policies:

1. The federal government would require corporate taxpayers to file a domestic disclosure spreadsheet that would detail the corporate tax liability and method of calculation for each of the states in which the corporation operates.

2. The federal government would require states to retain a variety of tax and income information that would be made available to state tax auditors.

3. Corporate tax and income information received by the Internal Revenue Service from other nations would be available to the states.

4. The federal government would assist states in their examination of foreign transactions through training of state tax instructors and examination of taxpayer returns as well as increasing federal international auditing resources.

Competitive Balance. This principle promotes the philosophy that state tax policy should maintain the competitive balance among all business taxayers, including foreign multinationals, U.S. multinationals and

purely domestic businesses. Specific arguments relating to competitive advantages under various forms of taxation will be examined as we present alternatives to worldwide combined reporting later in this memorandum. It is important to note, however, that, although the task force adopted this principle, the group made no recommendations as to how competitive balance should be achieved aside from expecting state policies to reflect the principle.

Unresolved Issues

In spite of the consensus reached by the task force concerning these three principles, two important issues relating to foreign dividends and 80/20 corporations were not resolved. It is the treatment of these issues that provides the basic distinctions and controversy among the various alternatives to worldwide combined reporting.

Dividends from foreign subsidiaries. The issue of the taxation of dividends received by U.S. based multinational corporations from foreign subsidiaries becomes critical to states that replace worldwide combined reporting with the waters edge method. Worldwide combined reporting means that the worldwide income of all subsidiary and affiliated corporations that comprise the unitary business are combined to determine the income to be apportioned for state taxation. Under this scheme, there is no need to tax dividends sent to the parent corporation from foreign subsidiaries because the income from which the dividend is paid has already been included in the combined income. However, if waters edge restrictions are applied, foreign source income to the parent corporation will not be included in the income to be apportioned unless dividends are added to the domestic income.

State representatives on the task force presented several arguments for the inclusion of foreign source dividends. Four of these arguments are presented below:

- Dividends paid by any foreign corporation to any other taxpayer are taxable by the state. To exempt dividends paid to U.S. corporations and not those paid to other taxpayers is discriminatory. The exclusion of foreign dividends as taxable income would favor foreign investment because purely domestic businesses are taxed on 100 percent of their income.

- State representatives point out that because the income from which foreign dividends are paid may have already been taxed by a foreign government is no reason to exempt them from state taxation. Both state and federal governments tax incomes of individuals and businesses.

- Foreign source dividends are an important part of the waters edge income of U.S. based multinational coprorations. Expenses incurred by the U.S. parent corporation for research, capital formation and management all contribute to the income of foreign corporations as well as domestic ones. As long as these expenses are deductible for state tax purposes, the foreign source dividend income generated by those expenses should be taxable.

- Excluding foreign dividends would significantly reduce state revenues.

Business representatives cite the following reasons for not including foreign source dividends as part of waters edge income to be apportioned by the states:

- State taxation of foreign source dividends is double taxation because the foreign nation in which the subsidiary is located has already taxed the income from which the dividends are paid. The federal government allows income deductions based on foreign taxes and the states should do the same.

- Taxation of foreign source dividends is an income tax on worldwide income that domestic multinational corporations pay but foreign multinational corporations would not. Domestic multinationals claim that this would put them at a competitive disadvantage with foreign multinational corporations.

- Foreign source dividends should not be taxed by states just to offset revenues lost through the repeal of worldwide combined reporting. Other less offensive methods could be used by states to maintain revenues.

80/20 Corporations. 80/20 corporations are U.S. corporations with at least 80 percent of their property and payroll outside of the United States. The issue surrounding these corporations is their inclusion within the definition of waters edge. State representatives on the task force maintain that all U.S. corporations should be included within the waters edge while business representatives claim that these corporations should be excluded. Generally, the arguments used to support these claims are similar to those used in the dividend controversy and will not be repeated here.

ALTERNATIVES TO WORLDWIDE COMBINED REPORTING--OTHER STATES EXPERIENCE

A number of technical changes could alter the way in which states utilize worldwide combined reporting: examples include applying different weights to the payroll, property and sales factors and redefining unitary. However, this memorandum will concentrate on taxation options that offer significant alternatives to Alaska's current use of worldwide combined reporting. The experience of several states that have recently proposed alternatives to worldwide combined reporting will also be examined. The following four taxation alternatives will be considered:

1. Worldwide combined reporting for domestic corporations with an alternative tax levied on foreign multinational corporations;

2. A waters edge method that includes foreign source dividends in taxable income and includes 80/20 corporations within the definition of waters edge;

3. A waters edge method that excludes foreign source dividends from income and excludes 80/20 corporations from the definition of waters edge; and

4. Traditional separate accounting.

Worldwide Combined Reporting That Excludes Foreign Multinationals

This alternative to traditional worldwide combined reporting allows United States subsidiaries of foreign corporation to pay an alternative tax rather than a tax based on income apportioned using worldwide combined reporting. Athough many types of alternate taxes could be devised, state representatives on the unitary tax task force recommended that the tax be based on in-state property, payroll and sales and 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 retaliation against U.S. corporations recently made by foreign governments. Proponents also claim that this option is a fair way to exclude foreign multinational corporations from worldwide combined reporting while at the same time protecting the competitive advantage of U.S. multinational corporations and purely domestic businesses. This option would protect state revenues and could be relatively easv to implement.

Opponents of this option claim that foreign governments and corporations may not view this alternative as an adequate solution to worldwide combined reporting because a corporate tax based on industry standards

would continue to tax the foreign corporations at current levels. Also, critics maintain that U.S. based multinational corporations may, in some cases, pay higher taxes than foreign corporations pay on similar income. This could occur because domestic multinationals would pay taxes on worldwide combined income while foreign multinationals would choose to pay the alternate tax if it reduced their tax liability. In the cases in which the alternate tax was chosen, U.S. multinational corporations would be at a competitive disadvantage with respect to foreign multinational corporations.

The State of Massachussetts has a taxation policy that is similar to this option. Massachusetts uses worldwide combined reporting to determine income subject to state taxation, but excludes the income of foreign parent corporations. Effectively, the income of foreign multinational corporations is not subject to apportionment, however, the worldwide income of U.S. multinational corporations is subject to apportionment.

According to Nick Metaxas, general counsel for the Massachussetts Department of Revenue, this method of formula apportionment was adopted to avoid potential legal problems resulting from state application of worldwide combined reporting to foreign multinational corporations. Although the U.S. Supreme Court decision in the Container case upheld the constitutionality of states' application of worldwide combined reporting to domestic multinational corporations, Mr. Metaxas expressed doubts that a similar decision would be reached if worldwide combined reporting was challenged by foreign multinationals. Massachusetts' method of applying worldwide combined reporting is designed to reduce the states' vulnerability to such a decision.

Mr. Metaxas noted that opposition to this form of worldwide combined reporting has come from both U.S. multinational corporations and purely domestic corporations in the form of efforts to repeal worldwide combined reporting in favor of a waters edge method. Both of these groups claim that foreign multinational corporations have been given a competitive advantage because portions of the income of these foreign corporations escapes apportionment by the state. However, Mr. Metaxas also points out that it is difficult to determine whether the support of proposals for waters edge are based on problems with the existing tax or because waters edge is more attractive to domestic corporations.

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. Dividends must be generated by foreign subsidiaries that are significantly related to the activities

of the unitary group to be included as part of the income of the domestic multinational.

Supporters of this option claim that it would quiet foreign government and foreign corporation criticism of states' application of worldwide combined reporting. Supporters also claim that this option would result in equitable taxation among all taxpayers. Even though worldwide income of domestic multinational corporations is taxed (through dividends) by the states and worldwide income of foreign multinationals is not taxed by the states, foreign government taxation of dividend income repatriated to the home country of the parent corporation equalizes the apparent inequity. Also, analysts argue that a large portion of the corporate taxes collected by states come from foreign dividends. To exclude this source of state income would put additional tax pressure on purely domestic corporations and individuals.

Opponents of this waters edge option disagree with this conclusion and claim that this method of taxation would put U.S. multinational corporations at a considerable competitive disadvantage in the world economy. They claim that fully taxing foreign source dividends is identical to taxing the income of their foreign subsidiaries and therefore yields similar results to worldwide combined reporting. In fact, some analysts suggest that this method would likely result in higher tax liabilities for some multinational corporations because foreign source income is included in income determination but the factors that produced that income are not included in state apportionment formulas. Additionally, the income that is earned by foreign multinational corporations outside of the borders of United States escapes all state taxation. Therefore, under this option, domestic multinational corporations could pay more tax than foreign multinational corporations with the same level of income.

California, a state that currently uses worldwide combined reporting to determine income subject to apportionment, recently debated a proposal to adopt a unitary tax law similar to this option; including a waters edge limitation to the unitary group, taxation of foreign source dividends and inclusion of 80/20 corporations within the definition of waters edge. The law also gave an option to foreign multinational corporations to pay taxes based on worldwide combined reporting and stipulated that the law was to be in effect only so long as the United States government supported the audit and administration of state taxation policies.

According to Ben Miller of the California Franchise Tax Board, the major supporters of the proposed change were foreign multinational corporations and foreign governments. Japanese corporations were especially vocal in their threats that if California did not replace worldwide combined reporting, the state would be bypassed by these corporations in future investment decisions.

According to Mr. Miller, annual revenue loss to California was estimated to be $200 million if the proposed legislation were passed. However, because California also levies other types of taxes, including property, sales and income taxes, it was assumed by proponents of the bill that this lost revenue would eventually be recouped through increased foreign investment. Mr. Miller was unaware of any analysis that projected future foreign investment in California if the bill were passed.

Opposition to the bill was led mainly by U.S. multinational corporations that feared that the proposed law would put them at a competitive disadvantage with foreign multinational corporations. As discussed earlier in this memorandum, a competitive disadvantage is perceived when the foreign source dividends paid to domestic multinational corporations are included in taxable income to be apportioned by the state. Because the waters edge approach excludes all income of foreign multinational corporations except income earned in the state, domestic multinationals claim they pay more tax than foreign multinationals on similar levels of income earned worldwide.

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 a foreign corporation and are excluded from the unitary group.

This option is generally favored by both foreign and domestic multinational corporations. Foreign multinational corporations and foreign governments support this alternative because it eliminates worldwide combined reporting. Domestic multinational corporations like it for the same reason but also because, in their view, it keeps them competitive in the world economy by not taxing foreign source dividends. Unlike the previous option, this alternative treats foreign subsidiaries of U.S. based multinational corporations and foreign corporations outside of the United States identically, by taxing only their operations within the waters edge.

Opposition to this alternative 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. Revenue analysis done for the states by the Presidential task force on alternatives to worldwide combined reporting supports this conclusion. Opponents of this option also argue that this alternative would shift the tax burden from foreign and U.S. multinational corporations to purely domestic

corporations. This could encourage U.S. corporations to increase foreign investment at the expense of domestic investment.

The State of Illinois recently passed a law that repealed the use of worldwide combined reporting in favor of a taxation policy similar to the option described above. The Illinois law limited unitary combinations to the waters edge, excluded 80/20 corporations and excluded foreign dividends from income if the foreign subsidiary that makes the dividend payment is 80 percent owned by a U.S. based corporation. If the subsidiary corporation is less than 80 percent owned by a U.S. based corporation, then 15 percent of the foreign source dividend is included in the income to be apportioned.

According to Fred Montgomery, Assistant Attorney General for the Illinois Income Tax Division, this tax change was supported by most of the Illinois business community as well as foreign multinational corporations. He noted that even corporations that in the past supported worldwide combined reporting (Caterpillar is the most obvious one) desired this change. As Mr. Montgomery pointed out, as long as foreign source dividends are excluded from income, there is no reason for a multinational corporation to withhold support of a waters edge option.

Much of the support for the repeal of worldwide combined reporting resulted from the hope that this action would encourage more foreign investment in Illinois. Although predictons estimated that Illinois could lose from $100 to $174 million annually as a result of adopting the new method of taxation, the State hopes to earn some of this back through other forms of taxation applied to new investment lured into the state. Illinois also levies sales, property and personal income taxes. Mr. Montgomery also noted that during the debate over Illinois' future taxation policy, there was no clear evidence introduced on either side that defined the true effect of worldwide combined reporting on foreign investment in Illinois.

Oregon has also recently repealed worldwide combined reporting in favor of a waters edge approach. The Oregon law includes only domestic corporations in the unitary group, treats 80/20 corporations as foreign corporations and taxes 15 percent of foreign source dividends of domestic multinational corporations. As in Illinois, support for the bill came from foreign and domestic multinational corporations. According to Tom Everall, Director of Corporate Audit for the state of Oregon, additional support came from the Oregon Department of Economic Development which viewed worldwide combined reporting as an obstacle to attracting foreign investment into Oregon.

Mr. Everall noted that estimates of the annual tax loss to the state were in the $18 million a year range. However, as in Illinois, there was a general perception that this revenue would be recouped through other forms of taxation on the new business attracted to the state.

Mr. Everall did not know of any studies that attempted to estimate the additional investment that would come to Oregon as a result of the new taxation policy. He did acknowledge the heavy lobbying effort of various Japanese corporations and their claims that they would not locate in Oregon unless worldwide combined reporting was repealed. He was unable to conclude to what extent their investment decisions were dependent on the repeal of worldwide combined reporting. He did note, however, that one Japanese corporation that recently announced plans to invest in Oregon because of the repeal of worldwide combined reporting had been doing site reconnaissance in Oregon for the past three years.

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 taxation purposes. This method is also called arms length accounting because for taxation purposes, all transactions between related corporations are supposed to be priced as if no special relationship existed (such as a subsidiary corporations supplying a parent corporation) and the market determined the price.

In general, business leaders would like to have all states determine taxable income by using separate accounting. This method uses information directly related to traditional accounting income and therefore is relatively easy to use. Also, business leaders claim that using this method results in less chance of states taxing more than 100 percent of total profits than if formula apportionment is used. Also, states' use of separate accounting allows the business or corporation more flexibility in developing corporate policies that reduce the tax liability of the company. This method also appeases foreign nations and corporations because it replaces worldwide combined reporting.

Opponents of separate accounting include many states, including those that have chosen to use the unitary tax. Critics of separate accounting claim that it leaves the state vulnerable to manipulation of income by corporations that do business in more than one state. Because income depends upon the cost of goods, related corporations can sell products at less than the market price to shift income to states that have lower tax rates. Developing an audit system to monitor corporate tax returns to detect pricing manipulations is very expensive and inefficient. Moreover, federal auditors provide no assistance because the Internal Revenue Service does not audit transfers between related corporations. As a result of the audit problem, it is generally assumed that most states would lose significant revenue using separate accounting to determine taxable income.

In two of the three states that we contacted, Illinois and Oregon, separate accounting was discussed as an alternative to worldwide combined reporting. However, representatives of both states noted that although separate accounting was desired by some business leaders within the state, most business representatives were willing to support waters edge unitary taxation as long as foreign source dividends were excluded. This position is based on the recognized reluctance of most states' governments to forego the income and administrative efficiency of the unitary tax. According to representatives of the state of California, separate accounting was never seriously considered as an alternative to worldwide combined reporting.

ALASKA ALTERNATIVES TO WORLDWIDE COMBINED REPORTING

In the previous section of this memorandum, we presented several options to the traditional use of worldwide combined reporting. We will now: 1) analyze the reasons other states have given for consideration of alternatives to this method; and 2) discuss the implications to Alaska of implementing the various options to worldwide combined reporting.

Reasons for Replacing Worldwide Combined Reporting

As we discussed the unitary tax with various state and industry representatives, the following three reasons for considering a change from worldwide combined reporting were mentioned most often.

1. Worldwide combined reporting reduces the abilty of the state to attract foreign investment.

2. The federal government strongly discourages state use of worldwide combined reporting.

3. There is a potential for the application of worldwide combined reporting by foreign multinational corporations to be declared unconstitutional by the U.S. Supreme Court.

Effect on Foreign Investment. This issue is without a doubt the most important reason that several states have recently considered alternative taxation to worldwide combined reporting. As mentioned in the previous section of this memorandum, both Illinois and Oregon repealed worldwide combined reporting because they concluded that it would improve their chances to attract foreign investment. Although the repeal of worldwide combined reporting did not pass the California legislature, the legislative proposal was prompted by the fear that worldwide combined reporting was hindering foreign investment in California. In all three of these states, representatives of foreign corporations

and governments were actively lobbying for the repeal of worldwide combined reporting. The most notable example of this effort is Japanese business consortia declarations to avoid future investments in states that use worldwide combined reporting.

Although the threat of foreign corporations withholding investments was a strong incentive for the states that repealed worldwide combined reporting, several state and business representatives noted that Alaska's resource-based economy may not be vulnerable to these threats of economic retaliation.

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 benfits, one location is not very different from another. It is this interchangeability of location that makes states fearful of foreign threats of economic reprisal.

Foreign corporations that wish to invest in resource extraction must go to the resource location. As one oil company representative put it, "we have no choice but to go where the oil is." The investor corporation does not generally have the option of choosing one location over another. Also, 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 costs 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 (in the near future) Alaska will be able to compete with other states for manufacturing that does not depend on natural resources. We mentioned several factors that are usually important considerations in choosing a location for foreign investment including cheap land and utilities, skilled labor, access to suppliers and markets and low living costs. Generally, Alaska would have trouble competing with other locations based on these criteria.

It should also be noted that there was some doubt among both government and business representatives about the actual importance of worldwide combined reporting in decisions by foreign corporations to invest in a state. Although these representatives acknowledged that it was a factor to be considered, it was still only one of many factors that go into an investment decision. There is a feeling among these representatives that foreign corporations are engaged in a media campaign to influence states to repeal worldwide combined reporting. For example, when a recent Japanese corporation announced that it would

invest in Oregon if worldwide combined reporting was repealed, the implication was that the decision was based on the repeal. In fact, that corporation had been doing site location studies in Oregon for years prior to the introduction of legislation to change the tax laws.

Federal Action to Ban the Use of Worldwide Combined Reporting. The second reason mentioned by states for implementing alternative taxation policies is the fear that unless states voluntarily stop using worldwide combined reporting, the federal government will impose a ban on its use. In Treasury Secretary Regan's report to the President on the progress of the task force established to study options to worldwide combined reporting, the Secretary noted that states would be given two years to move away from worldwide combined reporting. If this was not done, he implied that some type of federal government action would be taken to impose repeal on the states that have not complied.

As with the previous question of the impact of worldwide combined reporting on foreign investment, the actual danger of this threat is unknown. There is no doubt that the administration would like to see states impose taxes only to the waters edge, thus eliminating worldwide combined reporting. However, some analysts think that the Reagan administration, which has claimed to stand for states rights, would have trouble dictating tax laws to the states. So far, there has been very little indication on the part of the Congress that this is an issue in which they want to become involved.

Supreme Court Action. The states' use of worldwide combined reporting was found by the Supreme Court to be constitutional in the Container case. However, Container was a domestic multinational corporation and some legal analysts do not feel that the decision extends to state taxation of foreign multinational corporations.

Massachussetts applies worldwide combined reporting to domestic multinational corporations but not to foreign multinational corporations. As a representative of that state reported, this tax policy is to avoid potential legal problems should the courts declare the application of worldwide combined reporting to foreign multinational corporations to be unconstitutional. At this point, it is difficult to assess the chances of the court taking this action. However, there seems to be a consensus among legal analysts that at some point the question of state use of worldwide combired reporting to tax forign multinational corporations will be heard by the Supreme Court.

In summary, the recent action by states to repeal the use of worldwide combined reporting has generally been a reaction to threats of economic retaliation by foreign corporations if the tax was not repealed.

The recent actions in Oregon and Illinois were direct attempts by those states to attract foreign investment. Although many foreign corporations claim that investment in a state is conditional on the repeal of worldwide combined reporting, some analysts maintain that the state tax policy is only one of several important considerations in choosing investment locations. Because Alaska's economy generally depends on resource development rather than manufacturing, threats of economic retaliation do not seem as credible here as in other states. Regardless of Alaska's taxation policy, it is unlikely that Alaska could compete with other states for manufacturing investments. Consequently, the tactic used by foreign multinational corporations in Oregon, the threat of withholding manufacturing investments, may not be critical to Alaska.

The other two reasons that states gave for considering changes in worldwide combined reporting pose more potential than immediate problems. There is currently no action pending in Congress that would hinder state use of worldwide combined reporting. Similarly, the threat of a Supreme Court declaration banning the application of worldwide combined reporting to foreign multinational corporations is years away as the court has not yet agreed to hear such a case.

Implications of Taxation Options for Alaska

We previously identified four options proposed by other states as alternatives to worldwide combined reporting. These options will now be examined in the context of their applicability to Alaska. The four options to be considered are:

1. Modifications to traditional worldwide combined reporting;

2. Waters edge taxation including foreign dividends and 80/20 copororation;

3. Waters edge taxation excluding foreign dividends and 80/20 corporations; and

4. Separate accounting.

As evidenced by the experience of other states, any proposed change in Alaska taxation policy will be opposed or supported depending on the particular self interest of the parties affected. Foreign multinational corporations would likely support any proposal that would repeal worldwide combined reporting. Three of the options that we presented, the two waters edge options and separate accounting, would do this. Illinois and Oregon both adopted waters edge options and both laws had the blessing of foreign multinational corporations. In California, the proposed waters edge option, although it failed to pass, was supported by Japanese business consortia and other foreign multinational corporations.

Foreign multinational corporations would probably support the separate accounting option because this approach would tax only their in-state activities and not their worldwide activities. In addition, separate accounting uses traditional accounting income and therefore the tax information is easier to generate. Foreign multinational attitudes toward alterations in the traditional worldwide combined reporting are more difficult to predict. States using this option would tax foreign multinational corporations using alternate methods that depend upon existing taxes for similar industries. Generally, the uncertainty surrounding the exact nature of the tax and the partial taxation of foreign units would probably make this option less popular than waters edge or separate accounting alternatives.

Domestic multinational corporations, which include oil and gas producers in Alaska, support alternatives that repeal worldwide combined reporting but not at the expense of giving a competitive advantage to foreign multinational corporations. For this reason, domestic multinational corporations support waters edge unitary taxation but only if foreign source dividends are excluded from income and 80/20 corporations are not included in the unitary defininition. Representatives of Exxon corporation noted that their corporation would be adamantly opposed to a waters edge option that taxed foreign source dividends. This position is consistent with the position of domestic multinational corporations that ultimately opposed the bill repealing worldwide combined reporting in California.

It is interesting to note that some corporations' opposition to worldwide combined reporting is not consistent. Oil company representatives told us that although their corporate policy is to oppose worldwide combined reporting, the tax as it is applied in Alaska is not a critical problem because of the extent of their activities in the state. As one representative noted, worldwide combined reporting is a problem in California, but in Alaska it is acceptable and the alternative may be more offensive than the current method.

Several representatives of petroleum producing corporations who did not want to be identified because of the current lawsuit with the state over previous state taxation policies, noted that separate accounting would be difficult for Alaska to implement. One representative noted that because Alaska is primarily a resource extraction state, very few "sales" actually occur in Alaska. Therefore, unless the state closely audited the transfer prices of extracted resources, income could be transferred outside of the state resulting in avoidance of state corporate taxation. Another oil industry representative noted that the state's previous use of separate accounting may have actually hindered investment in the state. It is this separate accounting law that is currently being challenged in the state courts. Until this case is decided and guidelines are established concerning

the implementation of separate accounting, it will be difficult to determine if this option is workable in Alaska.

Conclusion

Corporate attitudes toward the repeal of worldwide combined reporting are fairly straightforward; if the tax change results in a positive contribution to the economic position of a business, then the proposed change is worthwhile. We have mentioned several times that oil companies in Alaska pay 90 percent of the corporate income tax. The domestic multinational corporations in this industry would adamantly oppose any tax change that they perceived as benefitting foreign multinational competitors.

The position of the state is not so straightforward as it must address conflicting objectives. In its role as the collector of revenues to be used to purchase goods and services for residents, the State would oppose several of the options discussed because tax revenue would decline. Although the Department of Revenue was unable to provide a breakdown of corporate income tax revenues between a worldwide combined reporting method and waters edge method, the department was able to predict revenue declines if worldwide combined reporting were repealed. The revenue decline would be more severe if a waters edge option that excluded foreign source dividends were implemented. A separate accounting method would be difficult to implement in light of the current lawsuit concerning Alaska's previous use of this method. If a method of taxation reduced revenues, the state would be faced with the dilemma of increasing other taxes to maintain state revenues or reducing state services.

The State also assumes a role as promoter of economic growth and diversity. In this position, the State must consider the threats made by foreign corporations to ban investments in states that use worldwide combined reporting. Although there is some question among analysts concerning the seriousness of this threat in general, and, especially the magnitude of the threat to Alaska's resource extraction economy, this threat deserves consideration. If the threat of withholding foreign investment is determined to be a deciding factor and worldwide combined reporting is repealed, State revenues would probably decline. If a waters edge method that excluded foreign dividends was chosen, the State would lose considerably more revenues, possibly requiring an adjustment of other taxes or a reduction of services. If a waters edge method that included foreign dividends were adopted, state revenues would be maintained, but domestic multinational corporations in the state would probably oppose the proposal.

We have not enclosed copies of the unitary tax law amendments in Oregon and Illinois, nor the proposed amendment in California. These amendments

only contain the changes in the law and not the complete taxation statute, and therefore, are not self-explanatory. However, the agency has compiled several articles and documents which address the unitary taxation issue in detail. If you have further questions or would like additional information, please do not hesitate to contact us.

JL

ALASKA STATE LEGISLATURE
HOUSE OF REPRESENTATIVES
RESEARCH AGENCY

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October 30, 1984

MEMORANDUM

TO: Representative Joe Hayes

FROM: Jonathan Sherwood, Legislative Analyst

RE: Unitary Taxation in Alaska: Its History and the Effects of Potential Changes
Research Request 85-014

You requested that we examine the history and the use of the unitary tax in Alaska. We were also asked to describe the effects of potential changes to the tax and determine what changes other states have made recently to their own unitary tax laws. This information is to be provided in conjunction with research performed by Mr. Michael Gay, who is to consider the impact of unitary taxation and possible alternatives on Korean investment in Alaska.

This memorandum begins with a brief discussion of unitary taxation and alternatives to the method presently used by Alaska. Then, the history and use of unitary taxation in Alaska is presented. Finally, the effects on Alaska of the changes discussed in the first section are considered.

SUMMARY OF FINDINGS

The two principal features of the unitary method of corporate taxation are: 1) the application of the tax to a commonly owned group of corporations engaged in interrelated business activities, only one of which may operate in the taxing state; and 2) its use of a formula to apportion a taxpayer's income to an individual state based on the portion of the taxpayer's business activity which is located in the state.

States which use worldwide combined reporting define the unitary group to include corporations that operate outside the United States. The waters edge method includes only those corporations which do business in the United States.

The U.S. Supreme court has upheld most challenges to state unitary taxation. While the court has sustained the use of worldwide combined

reporting when applied to U.S. based multinational corporations, it has not ruled on whether states may apply the method to foreign-based multinational corporations.

Worldwide combined reporting is opposed by foreign governments and multinational corporations. Critics claim that it imposes substantial administrative burdens on corporations, results in double taxation of foreign income, and deters foreign investment in U.S. enterprises.

One alternative to worldwide combined reporting is the waters edge-foreign dividend method. This excludes foreign corporations from the unitary group but does count income from foreign-source dividends and U.S. 80/20 corporations (a corporation with 80 percent of its property and payroll outside of the U.S.).

The waters edge-foreign dividend approach is supported by many state officials as the alternative to worldwide combined reporting which best maintains state revenue bases. It is opposed by U.S. multinational corporations who object to having to apportion foreign-source income while foreign-based multinationals do not. An attempt to institute a waters edge-foreign dividend tax in the California Legislature failed because of opposition by U.S. multinational corporations.

Another alternative is the waters edge-no foreign dividend method, which excludes all foreign-source income from apportionment. This method is favored by U.S. multinational corporations. Opponents of this method argue that it substantially reduces state revenue bases and places purely domestic corporations, which must apportion all income, at a competitive disadvantage to multinationals, which apportion only U.S. income. Illinois and Oregon have adopted versions of waters edge-no foreign dividend taxation.

Separate accounting may be used to replace unitary taxation altogether. Transactions between in-state and out-of-state segments of a business are valued as if they occurred between independent companies. Proponents of the method argue that it is more precise than apportionment. Opponents of the method argue that it is difficult both to administer and audit, and that businesses will use the method to shift income to jurisdictions with lower taxes.

Alaska has had a unitary tax since before Statehood. Alaska ratified the Uniform Division of Income for Tax Purposes Act in 1959 and the Multistate Tax Compact in 1970; both measures were intended to increase uniformity to states' corporate income tax laws. Alaska adopted worldwide combined reporting when it implemented the Multistate Tax Compact.

In 1978, the Alaska Legislature enacted legislation to require companies involved in the production and pipeline transportation of oil and gas to use the separate accounting method of taxation. The major petroleum producers in Alaska sued the State over the constitutionality of the new method. The law, AS 43.21, was repealed in 1981 because of fears that an unfavorable court settlement would be too costly should the state continue to collect the tax.

The Alaska Supreme Court has upheld the constitutionality of Alaska's unitary tax on several occasions. A decision is pending on the legality of Alaska's application of the separate accounting method.

The corporate income tax accounted for less than one-tenth of Alaska's unrestricted revenues in FY 84. The petroleum industry accounted for 88 percent of corporate income tax revenues in that year. Any change in Alaska's unitary tax likely would have a small effect on Alaska's total revenues; the major impact could be on the petroleum industry.

Adoption of either of the waters edge methods of taxation could alter the competitive balance among Alaska's major taxpayers because the petroleum industry i comprised of foreign multinational corporations, U.S. multinationals corporations, and mostly domestic corporations. Representatives of petroleum companies expressed relative satisfaction with Alaska's current method of taxation.

Although proponents of waters edge taxation argue that it will encourage foreign investment, state tax policy is only one of several factors affecting a company's decision to invest in a Alaska. Several individuals we contacted stated that state corporate income tax policy was not a significant factor in Alaska s resource development because resource companies must operate in the states which have the resources.

Should Alaska reinstitute separate accounting, it would likely increase revenues from resource producing companies, as was the case under AS 43.21. However, revenues from companies not producing resources might decrease as companies shifted income to states with lower tax rates.

THE UNITARY TAX

When a business operates in more than one state, it can be difficult to determine what portion of the business's income should be attributed to each state. The unitary method of taxation is an approach used by more than forty states to make this determination for the purposes of taxation. The unitary method has two principal features, its use of formula apportionment and its application of the tax to a unitary business.

Using <u>formula apportionment</u>, states determine how much of a taxpayer's income can be attributed to a particular state by comparing the level of income producing activity within the state to the business's total activity. Most commonly, a formula is used to compute the proportion of a business's total payroll, property, and sales which are located within the state. This fraction is then multiplied by the business's total income to determine the amount of the taxpayer's income which is subject to tax in that state.[1]

The alternative to formula apportionment is allocation of income; specific income is assigned to particular states. Some income may be directly allocated without difficulty; for example, income from non-business property may be allocated to the state in which the property is located. Generally, however, when a business which operates in more than one state, at least some income will be produced by interstate business activity. If a state seeks to allocate this income, separate accounting is used. The state treats the portion of the business within its jurisdiction as a separate entity, and transactions with parts of the business outside the state are treated as if they had occurred between two separate companies charging market value for their goods and services. This can be a very time-consuming process, as many transactions are likely to occur between segments of a business in different states. Twenty states use separate accounting, but apply it to certain types of industries, notably construction. In contrast, all forty-plus states which levy a corporate income tax have opted for formula apportionment of at least some income.

The other distinctive feature of the unitary method of tax is that the tax is applied to a <u>unitary business</u>, which may be a single corporation or commonly owned corporations engaged in interrelated business activities. While common ownership is required for groups of corporations to qualify as a unitary business, only one segment of the group needs to be engaged in business activities in the state. If a portion of the commonly owned group is not part of the interrelated business activity, it is not part of the unitary business. However, in many cases, affliated corporations with little direct involvement in each other's operations may be considered part of the unitary business.

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[1] The standard apportionment formula is:

$$\left[\frac{\frac{\text{instate payroll}}{\text{total payroll}} + \frac{\text{instate property}}{\text{total property}} + \frac{\text{instate sales}}{\text{total sales}}}{3}\right] \times \text{total income} = \text{instate taxable income}$$

The intent of requiring corporations to pay tax as a unitary business is to ensure that a group of commonly owned corporations pays the same tax it would if it were a single corporation. Thus, businesses cannot reduce their tax liability simply by redefining their legal structure.

States differ in the way they tax unitary businesses that extend beyond U.S. borders. Alaska and ten other states include all income and all business activity of the unitary business when apportioning income. This approach is referred to as worldwide combined reporting or worldwide combination. The remaining states apportion income based on the business activities of the unitary group within U.S. borders. This method is called the "waters edge" approach.

The Constitutionality of the Unitary Method

Over the last seven decades, the U.S. Supreme Court has ruled on the constitutionality of the unitary method in a number of tax cases. For the most part, the U.S. Supreme Court has upheld the unitary method. However, not every application of the unitary method has been sustained by the court.

Usually, constitutional challenges to the unitary method are predicated on the Commerce Clause and the Due Process Clause of the U.S. Constition. The Commerce Clause gives Congress the power to regulate commerce with foreign nations and among the states; the Due Process Clause prevents the state from depriving any person of life, liberty, or property, without due process of law.

Arguments based on the Commerce Clause claim that a particular unitary tax results in the taxation of the same income in more than one jurisdiction. In the Moorman case, the court ruled that the plaintiff must prove that the apportionment formula in question would result in double taxation if all jurisdictions used that method.[2] If double taxation arises because two jurisdictions use different methods, neither method is necessarily unconstitutional.

Under the Due Process Clause, states are permitted to tax businesses only if there is a connection (or nexus) between the state levying the tax and the business taxed. Beyond the requirement that at least one member of the unitary group do business in the state, the U.S. Supreme Court has declined to elaborate definitive guidelines for determining what constitutes a sufficient connection between the state and business being taxed. However, it has generally accepted state laws which

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[2] Moorman Manufacturing Company v. Bair, 437 U.S. 267 (1978).

consider commonly owned corporations with very limited connections to one another to be unitary.

In addition, under the Due Process Clause, the income apportioned to a state must be rationally connected with the value of the business activity within the state. When challenging the law on these grounds, heavy burden of proof is placed upon businesses to show that the income allocated to a state is grossly disproportionate to the amount of business activity in that state. The court has accepted the fact that formula apportionment is necessarily imprecise; it requires businesses to prove that a particular formula leads to gross distortions.

Another area of litigation involving the unitary tax is the extent to which states have the authority to include foreign business income in apportionment formulas, either by apportioning foreign dividend income under a waters edge approach, or by including foreign income and activities in the apportionment calculations using the worldwide combined reporting approach.

In the Mobil Oil and the ASARCO cases, the U.S. Supreme Court considered whether dividend income received by a taxpayer from a subsidiary outside the state are taxable as income from the unitary business.[3] In Mobil, the court rejected the argument that no dividends are apportionable; Mobil had argued that these dividends should be allocated. In the ASARCO case, the court rejected the argument that all dividends are apportionable. It ruled that for a state to apportion foreign dividend income, the subsidiary must be part of the unitary business.

Only once, in the recent Container case, has the U.S. Supreme Court addressed the constitutionality of worldwide combined reporting.[4] In June of 1983, the U.S. Supreme Court upheld the constitutionality of California's application of worldwide combined reporting to the Container Corporation of America, a U.S. based multinational. However, the court explicitly avoided ruling on whether states may include foreign-based parent corporations in the unitary business for the purposes of apportioning income.

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[3] Mobil Oil Corporation v. Commissioner of Taxes of Vermont, 445 U.S. 425 (1980). ASARCO, Inc. v. Idaho State Tax Commissioner, 50, U.S.L.W. 4962 (1982).

[4] Container Corporation of America v. Franchise Tax Board, State of California, 51 U.S.L.W. 4987 (1983).

It is not certain how the application of worldwide combined reporting to foreign-based multinationals would be treated by the court. In Japan Lines, a property tax case involving strictly international commerce, the Court stated that when states seek to tax the instrumentalities of foreign commerce, the need for federal uniformity and an enhanced risk of double taxation become more significant in the court's deliberations.[5] However, worldwide combined reporting is used to tax income derived from business activities within the state. It is not a direct tax in instrumentalities of international commerce. Therefore, it is not clear whether the more stringent considerations set forth in Japan Lines would be applied to a challenge of worldwide combined reporting by a foreign-based multinational.

ALTERNATIVES TO WORLDWIDE COMBINED REPORTING

The use of formula apportionment and application of the tax formula to unitary business has been sustained by the courts and reasonably well accepted by business and government interests; however, considerable controversy still exists regarding the use of worldwide combined reporting.

In the Container case, several foreign governments submitted briefs in favor of Container's position. The federal government submitted a brief opposing worldwide combined reporting in an earlier case on which the court later deferred. The U.S and foreign governments use the separate accounting method to determine what portion of a multinational corporation's income may be attributed to a particular country; this prevents corporations from paying tax on the same income in more than one country. Many multinational corporations also oppose the use of worldwide combined reporting.

U.S. Treasury Secretary Regan has suggested that he might recommend federal restrictions on state taxation of multinationals if the states do not move toward elimination of worldwide combined reporting in the near future. However, it should be noted that Congress has deferred action on legislation prohibiting worldwide combined reporting for several years and many individuals to whom we spoke indicated that President Reagan supports the states' right to use the method if they so choose.

Following the Container case, President Reagan appointed a task force known as the the Worldwide Unitary Taxation Working Group (hereafter

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[5] Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979).

cited as the Working Group) which was comprised of representatives of multinational corporations, states, and the federal government. According to the Working Group's Final Report, critics of worldwide combined reporting claim that:

> this method of taxation leads to state taxation of foreign source income and is at variance with the internationally accepted separate accounting method for avoiding double taxation. They also contend that simply to lump together income earned in numerous profit centers throughout the world and then divide the result on a formula basis distorts the attribution of income to any particular source or state since in some centers losses are incurred, while in others profits result. Many U.S. based multinationals also contend that distortion occurs because no deduction is allowed for foreign taxes or other payments to foreign governments. Foreign-based multinationals, in particular, contend that use of the method imposes substantial administrative burdens because of the need to translate accounts of their entire foreign operations into U.S. currency and to conform them to U.S. and state accounting rules; they note that there is no other requirement for such reporting by foreign multinationals.[6]

In the remainder of this section, the most frequently suggested alternatives to worldwide combined reporting will be described. In doing so, the merits of the criticisms of worldwide combined reporting will also be considered. Where states have adopted or sought to implement the alternatives presented, their experience is also discussed.

Waters Edge Taxation

Efforts to repeal worldwide combined reporting provisions have generally attempted to replace the method with a waters edge unitary tax. Under this method, separate accounting is used to determine the exchanges of value between domestic and foreign-based corporations within the group, which is how the federal government determines domestic income for federal tax purposes. However, there has been considerable debate as to whether the waters edge method should include foreign source dividends and 80/20 corporations (U.S. corporations with 80 percent of their payroll and property in foreign countries). Because both foreign dividends and income from 80/20 corporations represent foreign-source income, the issues regarding their inclusion are generally the same.

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[6] U.S. Department of Treasury, The Final Report of the Worldwide Unitary Taxation Working Group, August 1984, p. 2.

Water's Edge-Foreign Dividends (Option #2). In the Working Group Final Report, the representatives of state government put forth an option (Option #2 in the report) to apply the corporate income to all segments of unitary businesses which do business in the United States. Foreign corporations which do not do operate in the U.S. are not included in the unitary group when determining either income or the apportionment factors; however, dividend income paid to the unitary business by foreign subsidiaries is counted as income. In addition, 80/20 corporations are also included in the unitary business.

This method eliminates the administratative difficulties of complying with worldwide combined reporting. The income to be apportioned under Option #2 is essentially the income reported for federal tax purposes (although the federal government allows a tax credit on foreign dividend income to offset taxes paid by the foreign subsidiary to foreign governments). In addition, proponents argue that taxing foreign dividend income and income from 80/20 corporations provides an equally competitive environment for U.S. multinationals and purely domestic corporations. Both U.S. multinational and domestic corporations would apportion all income returned to the U.S. State representatives to the working group also identified this approach as the waters edge method that best protects state revenues bases. This method is generally acceptable to foreign-based unitary businesses, as the flow of dividend incomes goes from U.S. subsidiaries to foreign parents and is not subject to apportionment.

However, many U.S. multinational corporations oppose this approach. They believe that taxing foreign dividends puts them at a competitive disadvantage with foreign-based multinationals because foreign-based multinationals would be taxed solely on their U.S. operations while U.S. multinationals would be taxed "on both their U.S. operations as well as their foreign dividends."[7] U.S. multinationals also argue that taxing their dividends amounts to double taxation because their foreign subsidiaries have already paid tax on that income to foreign governments. They note that the federal government provides a tax credit on foreign dividend income for foreign taxes paid by the foreign subsidiary.

Proponents of Option #2 dismiss the double taxation argument. In their view, federal and state taxation is concurrent. Thus, as long as corporations are not taxed on the same income by both the federal government and a foreign government, the double taxation issue is not relevant. Proponents also point out that taxpayers other than corporations must pay tax on dividend income.

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[7] State Approved Report of the Worldwide Unitary Taxation Working Group, June 1984, p. 38.

State representatives to the Working Group made their support of Option #2 contingent on increased federal auditing of the separate accounting used by multinationals for federal tax purposes. They also insisted that the federal government require multinational corporations to submit a spreadsheet which discloses domestic operations by state. The states fear that without greatly increased federal oversight of the pricing of transfers between domestic and foreign members of a unitary business, multinational corporations will shift their income to foreign countries with more favorable tax laws.

In 1984, the California Legislature considered a measure very similar to Option #2; the only major difference was that corporations would have the choice of continuing to use worldwide combined reporting if they so desired. Under the terms of the legislation, the new law did not go into effect until the federal government had substantially implemented several reporting requirements and audit measures similar to those contained in the Working Group report.

According to Ben Miller, with the California Franchise Tax Board (which administers California's corporate income tax), the legislation was supported by Governor Deukmejian, a Republican, and was introduced by Democrats in the State Assembly. California has been the subject of intense pressure by foreign multinationals who cite worldwide combined reporting as a disincentive to further investment in the state.

The California Department of Treasury estimated that the state would lose $270 million in revenue in FY 87 as a result of the change. This estimate did not include possible gains in revenue from other sources resulting from increased economic activity that might be associated with the change. However, Mr. Miller stated trat if such a tax change did bring in new industry and additional jobs, this would require more government services as well as generating additional revenue.

The California legislation failed to pass; it was strongly opposed by several U.S. based multinational corporations. According to Mr. Miller, these corporations argued that the bill would placed them at a competitive disadvantage because they would have to include foreign income in their apportionment, while foreign-based multinationals would not. Mr. Miller questioned this argument, stating that most foreign countries tax foreign dividend income; therefore, there is no real discrimination when looking at the corporations' total tax burden. Legislation introducing some version of waters edge taxation is anticipated during the next legislative session.

Massachusetts uses a method of taxation different from waters edge-foreign dividends, but which produces a similar result: income of foreign subsidiaries of U.S. corporations is apportionable; income of

foreign parent corporations is not. For tax purposes, Massachussetts defines the unitary business as domestic corporations plus all subsidiaries of foreign coporations which operate in the state. Thus, foreign subsidiaries of U.S. corporations are included in combined reporting requirements, but foreign parent corporations are not. Nick Metaxas, General Counsel for the Massachusetts Department of Revenue, believes this method to be preferable to worldwide combined reporting because of the likelihood that the U.S. Supreme Court will find unitary taxation of foreign parent corporations unconstitutional.

Waters Edge-No Foreign Dividends (Option #4). This method applies the waters edge method but exempts foreign dividend income if the U.S. parent corporation owns 80 percent of the foreign subsidiary and provides an 85 percent exemption for foreign dividend income if the parent owns less than 80 percent. In addition, 80/20 corporations are not included in the waters edge unitary group. This removes the objections of most U.S. multinationals to the waters edge approach; indeed, it was put forth by the business representatives to the Working Group (as Option #4 in the Working Group Report). Proponents of this method emphasize that it is similar to federal law in its treatment of foreign source income; essentially, corporations must consider only income from U.S. sources when paying tax in U.S. jurisdictions.

State representatives to the Working Group opposed the exclusion of foreign-source income. They believe that purely domestic corporations are placed at a competitive disadvantage because they must apportion all of their income, while multinational corporations apportion only income earned in the U.S. Furthermore, it is argued that by exempting income earned from foreign investment, this method "would subsidize foreign over domestic investment."[8] In addition, compared to worldwide combined reporting, this method "would substantially reduce state revenue bases."[9]

In 1982, the State of Illinois amended its corporate income tax to institute a waters edge approach very similar to Option #4. Foreign source dividends are treated as in Option #4 and income from 80/20 corporations is excluded. One difference between the Illinois law and Option #4 is that intercompany sales involving 80/20 corporations are excluded from the numerator of the sales factor (not apportioned to Illinois) but included in the denominator (considered part of total sales).

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[8] State Approved Report of the Worldwide Unitary Taxation Working Group, June 1984, p. 43.

[9] Ibid.

The Illinois law also includes a more specific definition of a unitary business than is generally required by court tests. Under the Illinois law, a member of the unitary business must have at least 50 percent common ownership, be in the same business or vertically integrated with other members of the unitary group, and exhibit strong central management, as indicated by central purchasing, financing, marketing, accounting, or other such management functions. If any one of these three conditions is not met, then that segment of the business is excluded from the unitary business.

According to Fred Montgomery, with the Illinois Department of Revenue, the business community in Illinois was divided in its opinion of the new unitary tax initially. Some companies favored the separate accounting method and some preferred worldwide combined reporting, which allowed multinationals to offset U.S. profits with losses in foreign countries. However, he stated that the option chosen was generally perceived as an acceptable middleground position.

Mr. Montgomery stated that at the time of passage, the new law was estimated to reduce corporate income tax revenues by $100-$175 million per year. No attempt was made to estimate what additional revenues might be obtained from personal income, property, and sales tax revenue increases that might result from increased investment in Illinois. Mr. Montgomery stated that, to date, there is no clear evidence that the shift from worldwide combined reporting to waters edge-no foreign dividends has affected the level of economic activity in Illinois.

In June of 1984, the Oregon Legislature met in special session and replaced its worldwide combined reporting provision with the waters edge method similar to Option #4. Under the new Oregon law, which goes into effect in 1986, both foreign and domestic dividend income is subject to an 85 percent deduction before apportionment.

The new law limits the unitary group to those corporations filing a consolidated federal tax return as one taxpayer; foreign corporations are excluded, as they cannot be part of a federal consolidated return. This change increases the common ownership requirement to 80 percent for a unitary relationship to exist. The law also made the definition of a unitary group more explicit and restrictive. A unitary group is:

> "corporations engaged in a single trade or business where there exists a sharing or exchange of value demonstrated by (1) centralized management, (2) functional integration, and (3) centralized administrative services."[10]

According to the Oregon Legislative Revenue Office, the new law will decrease corporate tax revenue by about $18 million in the first biennial budget cycle. This includes $3 million in FY 86 and $15 million in FY 87.

Tom Everall, with the Oregon Department of Revenue, stated that the new law had the support of the governor, the legislature, and most of the business community. The legislation was not perceived as a revenue measure, but as an economic development measure. Policymakers were seeking to diversify the state's economy, which traditionally has been based on timber and agriculture. The governor and legislature particularly wanted to encourage Japanese investment in Oregon, and Japan-based corporations cited worldwide combined reporting as a deterrent to investment. According to Mr. Everoll, Japanese corporations do not like to make public much of the information necessary to file a worldwide combined report.

Following Oregon's repeal of worldwide combined reporting, Fujitsu Ltd., a Japanese multinational corporation, announced plans to locate two plants, costing $170 million, in the Portland area. The company cited the favorable tax climate in Oregon, along with the availability of a highly skilled labor force, an excellent education system, and the pleasant Northwest lifestyle, as reasons for its choice. Other observers have also pointed out that the Pacific Northwest has low power costs and property values with which to attract manufacturing. Tom Everall noted that Fujitsu had devoted considerable resources to selecting a site in Oregon for several years before the law was changed.

It is interesting to note that both the Oregon law and the Illinois law contained provisions restricting membership within the unitary group. waters edge taxation does not benefit domestic corporations who have no international operations. However, domestic companies with interstate operations may be able to benefit from reducing the number of corporations included in the unitary group in much the same way multinational corporations benefit from waters edge taxation.

General Considerations of the Water's Edge Approach. Although it is useful to generalize about the attitudes of corporations towards waters edge taxation, there are exceptions. Whether a particular corporation favors a specific change in the tax law depends on how that law will affect the corporation and the corporation's competition. For example, taxpayers who have substantial business activity in the U.S., but show most of their profits in other countries favor the waters edge approach,

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[10]State of Oregon, Legislative Revenue Office; Research Report RR 4-84; August 7, 1984; p. 2.

as the worldwide combined reporting method would apportion more income to the taxing state. However, if a corporation earns most of its income in the U.S., while operating unprofitable businesses in other countries, worldwide combined reporting spreads their U.S. profits over their entire unitary group, thus reducing the amount of income apportioned to the taxing state.

There is some concern on the part of states that the courts will require states using a waters edge formula to permit multinational corporations to use worldwide combined reporting in circumstances where it permits them to reduce their tax burden. Ben Miller cited this as the reason why California Governor Deukmejian wanted taxpayers to retain that choice when proposing the change to the waters edge-foreign dividends method.

Separate Accounting

Waters edge methods of taxation incorporate separate accounting for transactions between domestic and foreign corporations within a unitary group; some individuals and corporations argue that apportionment should be eliminated completely and taxpayers should use separate accounting for all interstate transactions. Thus, the taxpayer would have to adjust the income received in the state to account for the value of all its transactions between the in-state and out-of-state segments of the business.

Separate accounting is used by some states for some kinds of business activities, including the construction and petroleum industries. Alaska formerly applied a form of separate accounting to petroleum producers. Proponents of separate accounting argue that it is the only way in which income can be properly attributed to in-state business activity. They claim that apportionment effectively averages the profitability of all business operations, ignoring the reality that some operations are more or less profitable than others. Other proponents claim only that it can produce a more accurate estimate of taxable income than apportionment for some industries.

Some companies seek to use separate accounting to reduce their taxes. For example, Amoco sued unsuccessfully for the right to use separate accounting in Alaska. Exxon sued the State of Wisconsin unsuccessfully for the right to use separate accounting to lower its tax burden. However, Exxon also joined in the constitutional challenge of Alaska's separate accounting law--a law which substantially increased its tax liability.

Opponents of separate accounting claim that the task of accurately valuing each transaction between jurisdictions is burdensome. They also

fear that businesses will place improper values on interstate transfers of goods and services within the company. By adjusting these transfer prices, a company can define its income producing transfers as those which occur in states with little or no corporate income tax. A number of state tax administrators I contacted expressed doubts as to whether states could afford the audit effort necessary to ensure that this did not happen.

In addition, some opponents of separate accounting believe that it is not always possible to determine one undisputably correct price for a transfer. As Ben Miller of the California Franchise Tax Board stated, there are "as many ways to divide income as there are people to count it." While opponents of separate accounting acknowledge that the unitary method is an imprecise measure of income; they claim that a precise determination of income using separate accounting is equally unobtainable.

Modifying the Unitary Tax.

Some of the objections to worldwide combined reporting may be addressed without repealing the provision. For example, one alternative (Option #1) proposed by state representatives to the Working Group is to permit the subsidiaries of foreign corporations to pay an alternative tax based strictly on its in-state business activities. The rate of the tax would be based on the rate of tax paid by other unitary companies in the same industry doing business in the state. This would eliminate some of the objections of foreign multinationals and governments while maintaining the competitive position of U.S. business. The business representatives to the Working Group opposed this position, claiming it would provide foreign-based multinational corporations with an alternative for lowering their taxes while providing no relief to U.S. corporations.

Another example of how the unitary method could be modified is factor relief. This term refers to provisions in the unitary tax law which permit businesses to diverge from standard apportionment calculations when they can show that it produces serious distortions. Under factor relief, a business might use the same factors in a weighted formula or substitute some other factor more indicative of business activity. This might reduce the possibility that differences in wage rates and other factors between nations would distort the apportionment. It should be noted that many unitary tax laws already provide state tax officials some discretion in permitting factor relief.

There are numerous other changes to unitary tax laws which might address some of the criticisms to worldwide combined reporting. Whether any such changes are sufficient to satisfy critics is another question.

From the positions taken in the Working Group Report and from other statements made by representatives of multinational corporations, it appears that, at a national level, many U.S. and foreign-based multinational corporations are not likely to be satisfied with alternatives that leave worldwide combined reporting in place.

UNITARY TAXATION IN ALASKA

History of the Unitary Tax in Alaska

Alaska has had some form of a unitary tax since before statehood. In 1959, Alaska became the first state to ratify the Uniform Division of Income for Tax Purposes Act (UDITPA), which was drafted by the National Conference of Commissioners on Uniform State Laws two years earlier. UDITPA established the three-factor apportionment formula (payroll, property, and sales) as the standard for apportioning business income, while allocating all nonbusiness income to particular states. Prior to UDITPA, Alaska had used a factor formula based on gross receipts, payroll, and property.

In 1966, the Multistate Tax Commission was established by several national organizations affiliated with state government in order to promote uniformity in tax law. To this end, the Commission drafted a compact through which state unitary taxes might be applied and administered in a more uniform fashion. Alaska adopted the Multistate Tax Compact in 1970 (AS 43.19) and is one of twenty states belonging to the Multistate Tax Commission.

According to Frederick Boetsch, Director of Petroleum Revenue in the Alaska Department of Revenue, the 1970 legislation adopting the Multistate Tax Compact and the 1972 regulations implementing the compact contained the first provisions for the State to implement worldwide combined reporting. The Multistate Tax Compact also required the apportionment of some types of income which had previously been allocated under UDITPA. At the time, Mr. Boetsch noted, there was a lack of interest regarding the new law on the part of the business community. He recalled that no one appeared to testify when the Department of Revenue held hearings in Juneau on the proposed regulations.

In 1978, the Alaska Legislature changed the way the corporate income tax was levied on businesses engaged in oil and gas production and pipeline transportation. According to the legislative findings in Section 1 of Chapter 110 SLA 1978:

> the method of apportioning income for tax purposes under the "Uniform Division of Income for Tax Purposes" formula embodied in the Multistate Tax Compact (AS 43.19) and AS 43.20.65 does not

> fairly represent the extent of the business activities in this state of multistate corporations engaged in the production and pipeline transportation of crude oil and natural gas in Alaska.

When the Prudhoe Bay oil fields began producing, it became clear that production and pipeline transportation activities were not closely related to the payroll, property, and sales factors used in the standard apportionment formula.

Initially, the proposed new legislation, submitted at the request of Governor Hammond, substituted an extraction factor for the sales factor when computing the tax for oil and gas producers. However, the final version of the legislation created a new corporate income tax, AS 43.21, to be levied against oil and gas production and pipeline transportation. Instead of modifying the unitary apportioment formula, AS 43.21 required businesses to use a separate accounting method whereby the value of the oil or gas extracted would be calculated and certain expenses would be deducted to determine in-state income. The tax assessed against oil and gas production and pipeline transportation businesses was to be "commensurate with the tax that would be assessed against a corporation owning and operating only those assets of the multistate corporation which are in or directly associated with [Alaska]."[11] Businesses paying tax under AS 43.21 were still required to calculate income derived from activities other than oil and gas production or pipeline transportation using the same unitary method as applied to other corportations.

The Atlantic Richfield Company (ARCO) sued the State of Alaska, challenging the constitutionality of AS 43.21. It was joined in the suit by Exxon and Sohio; according to Deborah Vogt, Assistant Attorney General for the Alaska Department of Law, these three companies accounted for about 95 percent of the oil production for the years in question.

In 1981, the Alaska Legislature repealed AS 43.21. and reinstituted the unitary tax for businesses' oil and gas production and pipeline transportation. At the time, there was concern that AS 43.21 might not withstand the legal challenge mounted by the oil companies. This could have resulted in the State of Alaska owing oil companies several billion dollars if the State continued to levy the tax. In his letter of June 23, 1981 to the Legislature, Governor Hammond estimated that, if the law was not changed, the State would have to set aside at least $350 million in FY 82 against the possibility that the State would lose in court.

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[11] Chapter 110 SLA 1978.

However, instead of returning to the three-factor formula used before 1978, new factors were included in the formula as follows:

- for a business engaged in oil and gas production, income is apportioned using a property factor and an extraction factor;
- for a business engaged in pipeline transportation of oil and gas, income is apportioned using a property factor and a sales factor; and
- for a business engaged both in oil and gas production and pipeline transportation, income is apportioned using an extraction factor, a property factor, and a sales factor.

At the same time, the Oil and Gas Properties Production Tax (AS 43.55) was modified. Consequently, the decline in corporate income tax revenues as a result of the repeal of AS 43.21 was substantially offset by increased revenues from the production tax.

The Constitutionality of Alaska's Unitary Tax

On several occasions, Alaska's unitary tax has been upheld by the State Supreme Court. In the Earth Resources case, the court sustained the Department of Revenue's application of the unitary business definition to a vertically integrated group of corporations, only one of which operated in Alaska.[12] In rejecting Earth Resources's argument that its Alaska subsidiary was not part of a unitary business, the Alaska Supreme Court applied the criteria set forth by the U.S. Supreme Court in the F.W. Woolworth case.[13] Under this test, unity exists if a subsidiary derives contributions of income from functional integration, centralization of management and economies of scale.

In the Amoco case, the court upheld the constitutionality of standard, three-factor apportionment formula used by the State.[14] In this case, Amoco Production Company, a subsidiary of Standard Oil Company of Indiana, filed its corporate income tax returns for 1971 through 1974 using its own method of separate accounting. The Alaska Depart-

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[12] Earth Resources Co. of Alaska v. State of Alaska Department of Revenue, 665 P.2d 960 (Alaska 1983).

[13] F.W. Woolworth v. Taxation and Revenue Department, 102 S.Ct. 3128, 73 L.Ed. 2d 819, (1982).

[14] State of Alaska, Department of Revenue v. Amoco Production Company, (Opinion No. 2771, January 6, 1984)

ment of Revenue assessed Amoco's tax based on the traditional three-factor formula unitary method then in effect for oil companies. Amoco argued that because the oil it produced in Alaska was sold in Alaska, it was entitled to invoke a provision in the unitary tax law which allowed for separate accounting if the segment of a business within the state "is so separate and distinct from and unconnected with the part outside that the net income from the part inside can be determined without regard to the part outside."[15]

The Alaska Supreme Court upheld a Superior Court finding that Amoco's Alaska income was not sufficiently separate and distinct from its outside income to justify separate accounting. The Superior Court found that "Amoco's substantial pro-rated overhead charges attributed to the Alaska operation shows heavy dependence on management and technical services performed outside the state."[16]

Currently, the <u>ARCO</u> case challenging the constitutionality of the separate accounting method applied to production and pipeline transportation of oil and gas under AS 43.21 is under consideration by the Alaska Supreme Court. Arguments were presented to the court in September, and a decision should be forthcoming. Should the State lose the case, the three oil companies involved will be entitled to a net refund of $1.8 billion, the difference between total collections and their tax liability for those years using the current, modified apportionment formula.

Deborah Vogt stated that the principle contention of the oil companies in the ARCO case is that out-of-state activities contribute to the production of Alaska oil and that merely subtracting the cost of these activities from the in-state value of the oil produced results in excessive income being allocated to Alaska.

According to Ms. Vogt, this contention applies principles of apportionment to a separate accounting method, which seeks to allocate income. While both apportionment and allocation may be legitimate methods of determining income for tax purposes, they are distinct. Louisiana, Mississippi, and Oklahoma all tax oil companies using procedures similar to the separate accounting method in question, and have filed <u>amicus curie</u> briefs in support of the State's position.

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[15] Alaska Statutes 43.20.060.

[16] <u>State of Alaska, Department of Revenue v. Amoco Production Company</u>, (Opinion No. 2771, January 6, 1984) p. 6.

Present Status of Alaska's Unitary Tax

Currently, the State of Alaska applies worldwide combined reporting to all multijurisdictional businesses operating in Alaska. The standard three-factor formula is used for most kinds of business, with the modified formulas used for oil and gas production and pipeline transportation. In addition, there are special rules for applying the three-factor formula to airlines, land transportation carriers, and construction contractors.

According to Maureen O'Brien, Director of Audit for the Alaska Division of Revenue, relations between the Alaska Department of Revenue and corporate taxpayers have improved over the last few years. Some representatives of major corporate taxpayers expressed similar views. Ms. O'Brien noted that the Audit Division is more likely to permit taxpayers to seek factor relief where the apportionment formula results in distortion and it has become less inclusive when determining which segments of a commonly owned group of corporations belong to the unitary business subject to tax.

In FY 84, Alaska collected an estimated $302 million from the corporate income tax; the petroleum industry accounted for $265 million, or 88 percent of this revenue. The corporate income accounted for less than 10 percent of the estimated $3.3 billion total unrestricted revenues for FY 84. Corporate income taxes paid by businesses outside the petroleum industry accounted for slightly more than 1 percent of unrestricted revenues.

THE EFFECTS OF REPEALING WORLDWIDE COMBINED REPORTING IN ALASKA

Should the State of Alaska consider eliminating worldwide combined reporting, it could replace it with one of the two waters edge methods of unitary taxation or with separate accounting. In this section, the possible effects of such changes will be considered. However, before considering the impact of specific changes, one should realize that because any change in the corporate income tax affects less than one-tenth of Alaska's current revenues, any negative impact on total revenues will be relatively small. Also, most of the impact will likely fall on the petroleum industry, which currently accounts for seven-eighths of the corporate income tax revenues.

The Alaska Department of Revenue is unable to provide us with estimates of the impact to revenue from changes in Alaska's corporate income tax. Where experiences in other states or from previous Alaska laws are applicable, I have included them.

Waters Edge

Revenues. Estimates from other states indicate that a shift from worldwide combined reporting to waters edge taxation would reduce corporate income tax revenues. James Rosapape of the Multistate Tax Commission estimates the change commonly will result in a 15 to 25 percent decrease in corporate tax revenues.

In Alaska, a small number of oil companies account for a large portion of the corporate income tax. Therefore, Alaska's corporate income tax might be more sensitive to effects of a shift to waters edge taxation than states with a more diverse tax base. For example, Sohio, a major taxpayer in the state, is a foreign-based multinational corporation. A shift to waters edge taxation, with or without apportionment of foreign source dividends would presumably exclude a significant portion of its income from apportionment. Exxon, another major taxpayer, is a U.S. based multinational corporation. Moving to a waters edge method which excludes foreign dividends presumably also would exclude significant income from apportionment. Because the apportionment factors would change also, these companies could pay more or less taxes under a waters edge method; however, the impact on Alaska's total corporate income tax revenue might be substantial.

Relative Competitiveness of Business. Opponents of waters edge with apportionment of foreign dividends argue that it favors foreign-based multinationals over U.S. multinational and domestic corporations. Critics of waters edge without apportionment of foreign dividends argue that it favors foreign and U.S. multinationals at the expense of purely domestic corporations. ARCO, Exxon, and Sohio are, respectively, a mostly domestic corporation, a U.S.-based multinational, and a foreign-based multinational. Therefore, changing Alaska's worldwide combined reporting method to a waters edge method could alter the competitive balance among Alaska's major taxpayers.

The oil company representatives to whom I spoke were reluctant to state a company position on any of the alternatives to Alaska's present tax. Although some stated that their company had a general preference for a particular type of taxation, there was general apprehension that a change in Alaska's corporate income tax would have a negative impact.

Most of the individuals whom I contacted stated that their company was reasonably satisfied with Alaska's current application of worldwide combined reporting. One representative of a petroleum company stated that although his company opposes worldwide combined reporting in California and Florida, where it results in a heavy tax burden, it does not believe the system is inequitable in Alaska, where its tax burden is not as significant.

Development Impacts of the Waters Edge Method. All of the states which have recently moved from worldwide combined reporting to waters edge taxation, or have considered doing so, have been seeking to attract investment by multinational corporations. Foreign corporations claim that worldwide combined reporting deters investment within a state. According to a survey released by Akio Morita, chief executive of Sony Corporation, "120 major Japanese corporations would invest $1.4 billion in California" if California repealed worldwide combined reporting.[17] Foreign companies have cited the absence of worldwide combined reporting as a reason for locating manufacturing plants in Washington, Oregon, and Indiana.

It is possible that the State of Alaska might encourage an increase in foreign investment by repealing worldwide combined reporting. However, there are some reasons to question this supposition. First, it is not clear the extent to which state tax laws really play a part in decisions to locate industry. As one author has mentioned, the cost of labor, energy, and real estate are also important factors in these decisions.[18] Ben Miller, with the California Franchise Tax Board, cited proximity to major markets as another factor. Mr. Miller questioned the importance of state tax in the decision making process, noting that California leads the nation in foreign investment even though it uses worldwide combined reporting.

Several individuals also stated that state tax issues were less significant for businesses involved in the extraction of natural resources, perhaps the area of development in which Alaska has the most potential. According to Maureen O'Brien, while manufacturing companies can relocate plants, resource companies cannot relocate resources. As one petroleum company representative stated, "we go where the oil is."

Maureen O'Brien also mentioned that, unlike the states which have gone to waters edge taxation, Alaska has no means other than the corporate income tax for capturing revenue from increased business activity without increasing other state taxes. Most other states have some combination of sales tax, property tax, and individual income tax with which to capture some of the revenue generated by new business activities; Alaska has none. Thus, even if waters edge taxation fostered increased economic activity in Alaska, the State revenues might not experience a comparable increase in revenues.

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[17]"Japanese Companies Start to Flee the Unitary Tax," Business Week August 27, 1984. p.30

[18]Ibid, p. 31.

Separate Accounting

Revenue. It is often the position of state tax administrators that using separate accounting, businesses will attempt to shift income to jurisdictions with little or no taxes. 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 1978 or the modified formula used after 1981.

Should Alaska impose a separate accounting method that taxed the petroleum industry as under AS 43.21, any decrease in revenues from other taxpayers would likely be offset by increased revenues from petroleum taxation. The $30 million collected from other corporate taxpayers in FY 84 is less than one-tenth the $350 million cited by Governor Hammond as the difference between FY 82 collections from the petroleum industry under AS 43.21 and what the State would collect if AS 43.21 was invalidated by the courts. Of course, this assumes that the petroleum industry will continue to account for the majority of Alaska's taxable business activity.

Other Concerns. The issue of competitive balance between U.S. multinational, foreign, and domestic corporations is not generally raised when discussing the advantages and disadvantages of separate accounting. The methods used to allocate income under separate accounting do not distinguish between foreign and U.S. multinationals, or multinational and domestic corporations. Within the petroleum industry, there may be some division of preference. According to Maureen O'Brien, petroleum companies producing oil in Alaska tend to oppose separate accounting, as it attributes more income to the state than apportionment formulas do. Petroleum companies not yet producing like separate accounting, because they have few income producing transactions to allocate to the state.

There is some question about the effects a separate accounting law would have on investment. Where separate accounting laws can be used by corporations to reduce their tax liability, it might have a positive impact on investment. However, one representative of a major petroleum company stated that the method of separate accounting formerly applied to oil companies in Alaska had a negative impact on that company's investment in the state.

Another concern regarding separate accounting is its constitutionality. Alaska's previous separate accounting law is currently being challenged in the Alaska Supreme Court. Should Alaska consider reinstituting a separate accounting law on any or all corporate taxpayers, the pending Alaska Supreme Court decision will presumably offer some guidelines as to what constitutes a legitimate separate accounting method.

CONCLUSION

There are a number of reasons why Alaska might consider the elimination of worldwide combined reporting. Among them is the uncertainty regarding the legality of assessing the tax on foreign-based multinational corporations. The U.S. Secretary of the Treasury has threatened to seek federal restrictions on states' authority to tax international unitary business if the imposition of worldwide combined reporting continues. Potential foreign investors may be deterred from investing in Alaska by its present method of corporate taxation. Also, opponents of the tax question the basic fairness of worldwide combined reporting.

However, in the course of my research, several individuals emphasized the importance of defining clear goals before seeking to change the corporate income tax. No single alternative is universally accepted as a fair and practical solution to the problems of taxing multinational corporations. Each of the solutions discussed in this memorandum will benefit some taxpayers more than others, or benefits taxpayers at the expense of state revenues. Any proposed change to the unitary method will redistribute the benefits and burdens of the Alaska's corporate income tax.

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If you have any questions, or if you would like further information, please do not hesitate to contact us. This agency has compiled several articles and documents which address specific issues of unitary taxation in more detail than provided in this memorandum. We will make copies of these materials available to you or to Mr. Gay, should you so desire.

JS

ALASKA STATE LEGISLATURE
HOUSE OF REPRESENTATIVES
RESEARCH AGENCY

Pouch Y, State Capitol
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November 9, 1984

MEMORANDUM

TO:

FROM: Jay Livey
Legislative Analyst

RE: Alaska Revenue Sources: Relationship to Unitary Taxation
Research Request 85-047

You asked that we describe Alaska's current revenue sources and summarize the relative contribution each source makes to the State. You also asked us to analyze this information in the context of the repeal or alteration of Alaska's corporate income tax.

REVENUE SUMMARY

The revenues that the State collects fall into one of three categories: unrestricted revenues which are paid to the general fund to be appropriated for any purpose, restricted revenues which are received for specific purposes and special fund revenues which are received by statutorily established funds such as the International Airport Fund. Table 1 shows the contribution to total State revenues of each of these types of revenue in FY 83.

TABLE 1
CONTRIBUTIONS TO TOTAL STATE REVENUE BY TYPE OF REVENUE, FY 83
(in millions of dollars)

Type of Revenue	Dollar Contribution	Percent of Total
Unrestricted Revenue	$ 3,631.0	77.3
Restricted Revenue	193.4	4.1
Special Funds	874.3	18.6
TOTAL	4,698.7	100.0

Source: Revenue Sources, FY 1983-1986, Alaska Department of Revenue, January 1984.

As Table 1 shows, unrestricted revenues comprised almost 80% of the total State revenues and almost 90 percent of the State's general fund revenues (the sum of restricted and unrestricted revenue) in FY 83. Table 2 provides a breakdown of unrestricted revenues by source. As previously mentioned, unrestricted revenues are the only source that allow legislative discretion in appropriation. Each of the unrestricted revenue sources is described following Table 3.

TABLE 2
SOURCES OF UNRESTRICTED REVENUES, FY 1983
(in millions of dollars)

Revenue Source	Revenue	Percent of Total
Corporate Income Tax	$ 266.3	7.3
Gross Receipts Tax	46.3	1.3
Severance Tax	1,493.7	41.1
Property Tax	152.6	4.3
Sale/Use Tax	49.1	1.4
Licenses and Permits	25.7	.7
Intergovernmental Receipts	33.3	.9
State Resource Revenues*	1,505.0	41.4
Facilities Related	37.3	1.0
Service Related	10.1	.3
Other	11.6	.3
TOTAL	3,631.0	100

Source: Revenue Sources, FY 1983-86, Alaska Department of Revenue, January 1984

* Includes $1,078 million in royalty income, $36.2 million in bonus payments and $2.5 million in rents. These sources are included in petroleum-related revenues in Table 3.

As Table 2 indicates, the largest contributions to State unrestricted income are derived from taxes on petroleum producers. In fact, the various petroleum taxes account for close to 85 percent of all the State's unrestricted revenues. Table 3 provides a breakdown of the contribution made to FY 83 unrestricted revenues by the various petroleum revenue sources.

TABLE 3
CONTRIBUTION OF PETROLEUM BASED REVENUE SOURCES TO STATE UNRESTRICTED REVENUES, FY 83
(in millions of dollars)

Source of Revenue	Contribution	Percent of Total
Corporate Income Tax	$ 236.0	7.8
Severance Tax	1,493.7	49.4
Royalties	1,078.4	35.6
Property Tax	152.6	5.0
Bonus Sale	36.2	1.2
Rents	2.5	.1
Intergovernmental Receipts	27.2	.9
TOTAL	3,026.6	100

Source: Revenue Sources, FY 1983-1986, Alaska Department of Revenue, January 1984

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DESCRIPTION OF UNRESTRICTED REVENUE SOURCES

CORPORATE INCOME TAXES

AS 43.20 imposes an income tax on the entire taxable corporate income derived from sources within Alaska, and apportions this income under graduated rates and specified conditions. Alaska uses the worldwide combined method of unitary taxation to apportion the income subject to State taxation. In FY 83, the corporate income tax generated a total of $266.3 million, of which $236 million, or 90 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 national and state bank, trust company and savings and loan association is 7 percent of net income. In FY 83, a total of $6.9 million was collected from this source.

In addition to this 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 a shore-based canning facility, a 3 percent tax on the value of all other fish canned by shore-based facilities and a 5 percent tax on the value of fishery resources processed by floating processors. (Developmental commercial fish species are taxed at different rates.) In FY 83, these taxes contributed $20.5 million to State revenues.

Salmon enhancement taxes (AS 43.75) are levied on limited entry permit holders within qualified regional aquaculture associations at a rate of 2 or 3 percent of the value of salmon caught, depending on the action of the aquaculture association. FY 83 revenue from this tax was $2.6 million.

A seafood marketing tax (AS 16.51) is levied on all eligible seafood processors at a rate of 0.2 percent of the value of seafood products purchased in Alaska. FY 83 revenue was $.9 million.

Insurance premium taxes (AS 21.09.210 and AS 21.66.110) are levied on gross premiums (less certain deductibles) at various rates ranging from 3 to 6 percent depending on the type of insurance. FY 83 revenue from this tax totaled $13.8 million.

SEVERANCE TAXES

Oil production taxes are levied upon the producer of oil for all oil produced from each lease or property within the state, less any part of this production exempt from taxation (AS 43.55). The tax is based on either the percentage-of-value amount or the cents-per-barrel amount whichever is greater, multiplied by an economic limit factor.*

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*The economic limit factor is based on a mathematical calculation that relates the production of oil to severance tax revenues. The severance tax formula does not establish a one-to-one relationship between production and revenues. Therefore, only when production approaches the breakeven point (the economic limit) do revenues begin to fall dramatically.

The percentage-of-value amount equals either 12.25 percent or 15 percent of the gross value (sales price less transportation costs) of oil at the point of production depending on the date that the well began producing. The cents-per-barrel amount equals $.60 per barrel of crude oil and $.80 per barrel for all other taxable oil.

Gas production taxes (AS 43.55) are levied on all gas produced from each lease or property, less any part exempt from taxes. The base tax rate for gas is $.64 per thousand feet of taxable gas or 10 percent of the gross value of taxable production calculated at the point of production whichever is greater, multiplied by an economic limit factor. As with oil severance taxation, the economic limit factor relates gas production to revenues in such a way that decreases in production do not necessarily mean corresponding decreases in revenue. During FY 83, $1,493 million was collected from the levy of the oil and gas production taxes.

The oil and gas regulation and conservation tax (AS 43.57) is levied upon oil producers at the rate of one-eighth of one percent of the value of each barrel of oil removed or sold from each lease or property in the state less any exemptions. The value of a barrel of oil is calculated as under the oil production tax. This tax contributed $.7 million to State revenues in FY 83.

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 property as the State, a State credit is given for the tax paid to the municipality. Property tax levies accounted for $152.6 million in FY 83.

SALES/USE TAXES

Fuel taxes (AS 43.40) are levied at the rate of 4 cents per gallon for aviation fuel and 2.5 cents per gallon for jet fuel, 8 cents per gallon for gasoline and diesel fuel and 5 cents per gallon for marine fuel. Sixty percent of the revenues from aviation fuel are returned to municipalities that operate municipal airports. Gross receipts from fuel taxes contributed $36.7 million to State revenues in FY 83.

Alcohol beverage taxes (AS 43.60) are assessed based on alcoholic content: malt beverages (1% or more of alcohol) $.35 per gallon, wine (21% or less alcohol) $.85 per gallon, hard liquor (more than 21%

alcohol) $5.60 per gallon. Contributions from this tax are shared with political subdivisions of the State. The FY 83 gross revenue from this source totaled $10.4 million.

Cigarette taxes (AS 43.50) a e levied at the rate of four mills for each cigarette imported into or acquired in the state. Proceeds from this tax equal to 1.5 mills are deposited in the general fund and the balance goes to the School Fund to be used to rehabilitate and repair school facilities. In addition, the following fees are assessed annually: manufacturers $5, vending machine operators $25, direct buying retailer $25, buyer $25 and distributor $50. The proceeds from these fees are deposited in the School Fund. FY 83 gross revenues totaled $2.0 million.

LICENSES AND PERMITS

Business license taxes derive from levies for alcohol beverage licenses, commercial fishing licenses, professional and occupational licenses and various regulatory permits. (Various statutes impose these taxes.) These taxes contributed $10.8 million dollars to State revenues in FY 83.

Nonbusiness license taxes include receipts from hunting, trapping and sports fishing licenses, motor vehicle instruction permits, title transfers, registration fees, and driver licenses (various statutes). FY 83 contributions from this source of revenue totaled $14.9 million.

INTERGOVERNMENTAL TRANSFERS

This category includes receipts from the federal government on timber sales and mineral rents and royalties. The State's share is a percentage of the proceeds derived from these federal lands (AS 41.15 and Public Law 85-505 Sec. 3). Revenues fron this source are apportioned among the general fund, permanent fund and political subdivisions of the State. In FY 83, this revenue source accounted for $33.3 dollars.

STATE RESOURCES REVENUE

Investment revenues include the investment earnings from the State's various investment portfolios and interest on bank deposits. FY 83 investment earnings totaled $375.8 million.

State royalty payments (AS 38.05) include royalties from hard minerals, 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 general fund. Royalty revenues totaled $1,078.4 in FY 84.

Other revenue sources within this category are state property sales ($6.3 million, resource bonus sales ($36.2 million) state rental revenues ($4.3 million) and the sale of resources not classified as minerals such as timber ($4.0 million).

Facilities-related charges include receipts from airports, the ferry system, food services and other State facilities charges. Total revenue from this source in FY 83 was $37.3 million.

Service-related charges include receipts from statutory inspection fees, the court system and other State service charges. FY 83 revenue from this source totaled $10.1 million.

ANALYSIS OF REVENUE SOURCES

Should the corporate income tax be repealed, the State has the option of foregoing revenue from that source ($266 million in FY 83), collecting the revenue through increases in existing taxes or creating new taxes. If other taxes are increased so that net State revenue is unchanged, it is likely that the share of taxation paid by corporations would change. The amount and direction of change would depend upon the method of apportioning the shortfall among existing taxes.

For example, there are seven sources of unrestricted State revenues attributed to petroleum producers. One of these--intergovernmental transfers--is not directly controlled by the legislature. In addition, bonus sales depend upon the disposition of State resources. After excluding these sources and corporate income, four other means are available to generate additional revenues: severance tax; royalties; property tax and rents. Based on the relative magnitude of revenues each of these contributes to the State, royalties and severance taxes would probably absorb most of the revenue shortfall. As Table 3 shows, the combined revenue from these two sources is about $2.5 billion. Therefore, to replace the $236 million currently collected from petroleum corporations, these taxes would have to be increased by about 10 percent. The actual apportionment of the increase of these taxes among oil producers would depend on the changes made in the taxes as well as the taxpayer activities in the state. Because the major oil producers vary in the extent of operations in Alaska (production vs. exploration vs. transportation, etc.) and in the proportion of worldwide operations that occur in Alaska, replacing corporate income tax revenue with revenues from other taxes will redistribute the tax burden among the oil producers.

The nonpetroleum share of corporate income tax totals approximately $30 million dollars. A comparison of Tables 2 and 3 indicates that approximately $600 million in unrestricted State revenues in FY 83 was not petroleum-related. However, as with oil revenues, not all of the revenue sources that produced this income can be changed to produce more income.

The nonpetroleum revenue source that produces the most revenue is State resource revenues, $388 million. However, approximately $375 million of this is investment revenue and is therefore dependent upon State investments rather than legislative action. Three other revenue sources--intergovernmental receipts, facilities-related receipts and service-related receipts--are either dependent on federal action or are tied directly to State services. Three sources of revenue--gross receipts tax, sales/use taxes and licenses and permits--are directly controlled by the legislature. Between them, these sources produced about $120 million in revenue during FY 83. The implication is that nonpetroleum-related taxes would have to be increased by about 25 percent in order to offset the loss of revenue from the nonpetroleum share of the corporate income tax. Although the total tax collections resulting from this tax revision would probably not be significant, the share of taxes paid by individual business and consumers would change depending upon the specific tax laws adopted. This same shift in the distribution of tax liability would likely accompany the imposition of new taxes.

As you requested, I am also enclosing copies of the recently passed unitary tax laws in Oregon and Illinois and a copy of the law recently proposed in California. I hope this information is helpful. If you have any further questions, please do not hesitate to contact us.

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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 aggregate income from the unitary business

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would be apportioned to that state. Because the apportionment formula is concidered 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.

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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 investement. 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.

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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 worldwide unitary by passing SB35 is to be welcomed, it is unfortunately true that as a solution to the problem of worldwide unitary the Californian legislation is seriously flawed.

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.