

LEGISLATIVE FINANCE - HOUSE / SENATE FINANCE COMM. FILES 8879

SB 119

613

254

S

B

l

l

9

SENATE COMMITTEE REPORT

FURTHER

3/9/89

DATE TURNED INTO OFFICE 3/23/90

Mr. President:

Finance Committee considered SB 119

required reporting methods for corporate income taxes owed by members of an affiliated group whose common parent is a corporation incorporated outside the United States; efd and recommended.

replace with CS SB 119 (Finance) same title
 or adopt CS new title
 attached amendment(s) and technical title change (HB only)
 letter of intent adopted

do pass

do not pass

no recommendation

individual recommendations

further referral to _____

FISCAL NOTE(S) ^{DCEED 1/9/89} zero ^{DOR 3/1/90 (NEW)} fiscal impact appropriation no FN
 new updated ^{437.4 CF} previous
 same as previous fiscal note(s) published (1-3 mil) rev

MEMBERS SIGNING DO PASS

Paul Lehky (NO PASS)
(Co-CHAIR)

OTHER RECOMMENDATIONS

Jim Duncan - No Rec
Frank Stouffer No Rec
Frank No Rec
Leach - NO REC

Chairman signature and recommendation

Committee Backup attached

R/O SFC 3-23-90

STATE OF ALASKA
1990 LEGISLATIVE SESSION

BILL VERSION: CJ SB 119 (Finance)

PUBLISH DATE: _____

FISCAL NOTE

REQUEST:

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

Agency Affected: Revenue
BRU: Income & Excise Audit

Components: Operating

EXPENDITURES/REVENUES: (Thousands of Dollars)

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

FUNDING: (Thousands of Dollars)

GENERAL FUND	484.4	441.4	441.4	441.4	441.4	441.4
FEDERAL FUNDS	0	0	0	0	0	0
OTHER	0	0	0	0	0	0
TOTAL	0	0	0	0	0	0

POSITIONS:

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

ANALYSIS: (Attach a separate page if necessary)

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

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

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

Prepared by:
Steven E. Kettel
Alaska Department of Revenue

Fiscal Note Analysis

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

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

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

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

R/0 SFC 3-23-90

FISCAL NOTE

REQUEST:

Revision Date: _____
Title: Unitary Tax
Sponsor: Rules Committee
Requestor: Governor

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

EXPENDITURES/REVENUES: (Thousands of Dollars)

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

FUNDING: (Thousands of Dollars)

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

POSITIONS:

FULL-TIME						
PART-TIME						
TEMPORARY						

ANALYSIS : (Attach a separate page if necessary)

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

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

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

No fiscal impact is
expected through 1996.

go0179sE
3/1/90
(Uehling)
Bannister
2/27/90

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 meani

CORRECTION

**THIS DOCUMENT
HAS BEEN REPHOTOGRAPHED
TO ASSURE LEGIBILITY**

80173SF
3/1/90
(Uehling)
Bannister
2/27/90

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

water's edge combined report filed under this section; and

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

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

(e) The department may require a corporation that files under (a) of this section to file a worldwide combined report instead, if the corporation or an affiliated corporation

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

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

(f) This section does not apply to taxpayers subject to AS 43.-20.072 engaged in the production of oil or gas from a lease or property in the state or engaged in the transportation of oil or gas by regulated pipeline in the state.

(g) In this section,

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

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

(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).
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28
29
30
31

Alaska State Legislature



Legislative Research Agency

P.O. Box Y
Juneau, AK 99811-3100
Phone: (907) 163-3891
Fax: (907) 163-3351

March 1, 1990

MEMORANDUM

TO: Senator Rick Uehling

ATTN: Carol Horos

FROM: Gordon S. Harrison, Director *(gsh)*

RE: Administrative Burden of Implementing Unitary Tax Change from Worldwide to Water's Edge Method in Colorado and Oregon

At your request, I queried revenue officials in the states of Colorado and Oregon about the administrative impact of implementing a change in the unitary income tax law from the so-called worldwide to water's edge method. Oregon made such a change in 1984 (effective 1986), and Colorado in 1986. My conversations were brief and did not deal at length with the technical details of the laws of these states. Nor did I discuss the revenue impact of the law changes.

Colorado

I spoke with Ted Middle, chief auditor of the Colorado Department of Revenue (303-294-5100). Mr. Middle said that the Colorado law incorporates many innovative provisions; that it is not a conventional formulation of the water's edge approach. Consequently, he foresees a degree of difficulty in implementing the law that would not otherwise exist under a standard approach to the water's edge rule. Specifically, he foresees difficulty with auditing returns because of the peculiarities of the law. The department is only now beginning to audit 1986 returns, so it has not fully assessed the problems it may have. However, the department has not been given more staff to deal with the new law (and this seems unlikely anytime soon), so the outcome of the situation will be fewer audits and less effective enforcement.

The department had to print new forms and instructions; and it has had to promulgate new regulations. The first task was not significant; the second has been. Mr. Middle estimates that he has approximately one full-time equivalent employee working full time on the regulations. Mr. Middle believes that the writing and adoption of regulations would have been a shorter and less complicated process with a more conventional law (for example, model regulations would have been available).

Senator Uehling
March 1, 1990
Page 2

Oregon

I spoke with Richard A. Munn, director of the Oregon Department of Revenue (503-378-3363). He said that the change to the water's edge approach did not have a significant fiscal impact on the department. The department had to print new forms and instructions and adopt regulations, but he characterized these expenses as minor. He also described the Oregon law as unconventional, although it sounded less so than the Colorado law. He said that the law resulted in lower revenues to the state, but did not lower or increase the administrative costs of the department. Like the Colorado department, the Oregon department is just beginning to audit 1986 returns.

Oregon's law applies to all foreign and domestic businesses with interstate activity. It is Mr. Munn's opinion that a law targeting only "foreign parents" would be unconstitutional by the Oregon and U.S. constitutions. Mr. Munn said that the Oregon Department of Revenue has offices in several major U.S. cities. The existence of these offices predates the change from worldwide to water's edge taxation.

I hope this information is sufficient for your needs. If you have any questions, or would like additional information, please call.

Alaska State Legislature

Senate Resources Committee

Senator Bettye Fahrenkamp, Chairman

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



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

SENATE RESOURCES COMMITTEE LETTER OF INTENT FOR SB 119

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

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

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

3/1/90
Susan Burke

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

*/ 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

**/ 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."

3/1/90

2/28/90

SENATOR UEHLING'S TESTIMONY ON SENATE BILL 119

Currently, the Dept. of Revenue requires all multinational corporations doing business in Alaska to include all of their foreign subsidiaries' income in their tax returns, using a method commonly known as "worldwide combination." As originally introduced, Senate Bill 119 establishes a water's edge method for corporations filing state income tax -- in essence, a method that determines Alaska's share of a corporations' taxable income by looking only at the corporations' business operations in the United States. However, the original version of Senate Bill 119 establishes the water's edge method only for multinational corporations with foreign parents. Multinational corporations with U.S parents would still be required to use the worldwide combination method.

The proposed CS would expand the coverage of water's edge reporting to include those domestic multinational corporations. It also includes much more detailed provisions to govern the actual operation of the water's edge method than was contained in the original bill.

You have in your packets letters from a number of varied business organizations and individual businesses expressing support for including domestic multinationals in the bill -- including the State Chamber of Commerce, The Association of General Contractors of Alaska, the Alaska Miners Association, and the Xerox Corporation.

First, the CS contains standard water's edge provisions that are designed to treat all multinational corporations fairly and equally. Its provisions are not tailed to meet the special interests of IBM or any other foreign or domestic multinational. The draft legislation has support within the business community. I am not aware of any opposition whatsoever from the business community to the provisions of the CS.

Senate Bill 119 as originally introduced provides for water's edge reporting only for corporations with foreign parents. There are real problems, however, with limiting the coverage of the bill to corporations with foreign parents.

For one thing, we would be treating corporations that are doing the same kinds of business differently solely on the basis of where the parent happens to be incorporated. For another, we would actually be placing domestic multinationals at a competitive disadvantage. As I have already mentioned, the proposed CS treats all corporations fairly and even handedly, regardless of where the corporation has been incorporated.

The primary reason for eliminating the worldwide method is that all multinational businesses -- both foreign and domestic -- view worldwide combination as being an unfair and oppressive method of taxation. All the other states that previously required the worldwide method have amended their laws to permit some form of water's edge reporting. Alaska is the only remaining state that requires worldwide. As we have heard from both the foreign and the domestic companies that have testified on this bill, a worldwide requirement sends a very negative message to businesses thinking about making investments in Alaska -- the message that Alaska does not want its business.

At a time when we are heavily dependent on the oil industry and looking forward to declining production from Prudhoe Bay, it seems only prudent to take what steps we can to encourage diversified business investment in the state.

There is no question that Alaska's annual revenues from the general corporate income tax would be reduced if we adopt a water's edge method -- the Dept. of Revenue has estimated between \$1 and \$3 million. Even if this figure is accurate, in the large scheme of things, and in the long view -- that does not seem to be too high a price to pay for making Alaska a more attractive place for business investment and development.

LAW OFFICES

LYNCH, CROSBY & SISSON

A PROFESSIONAL CORPORATION

530 WEST 7TH AVENUE, SUITE 100
ANCHORAGE, ALASKA 99501TELEPHONE
AREA CODE 907
276-3222FACSIMILE
(907) 257-9498TIMOTHY M. LYNCH
PETER J. CROSBY
ROD A. SISSON
JAMES BRYAN WRIGHT
MADELOU BLUMJONATHAN A. HATCHER
SUSAN D. MACA
DOUGLAS J. BARKER
KENNETH G. SCHOOLCRAFT, JR.

April 20, 1989

SENT VIA FAX TO 465-4455Senator Rick Uehling
Co-Chairman, Senate Finance Committee
Juneau, Alaska

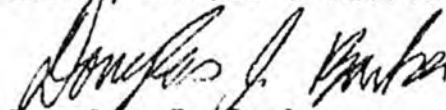
Dear Senator Uehling:

I understand your committee is considering Senate Bill 119. I would like to submit the enclosed testimony in support of Senate Bill 119. I would appreciate it if you could circulate this information to other interested committee members.

Thank you for your help.

Very truly yours,

LYNCH, CROSBY & SISSON


Douglas J. BarkerDJB/wjm:5
Enclosure

LAW OFFICES
LYNCH, CROSBY & SISSONA PROFESSIONAL CORPORATION
650 WEST 7TH AVENUE, SUITE 1100
ANCHORAGE, ALASKA 99501TIMOTHY M. LYNCH
PETER J. CROSBY
ROD R. SISSON
JAMES BRYAN WRIGHT
MADELON BLUMJONATHAN A. KATCHER
BUSAN D. MACK
DOUGLAS J. BARKER
KENNETH J. SCHOOLCRAFT, JR.TELEPHONE
AREA CODE 907
276-3222FACSIMILE
(907) 257-0488

April 20, 1989

SENT VIA FAX TO 465-4455Senator Rick Uehling
Co-Chairman, Senate Finance Committee
Juneau, Alaska

Subject: Testimony in Support of Senate Bill 119

Dear Senator Uehling:

I. INTRODUCTION

By way of introduction, my name is Douglas J. Barker. I am an attorney associated with the firm of Lynch, Crosby & Sisson in Anchorage, Alaska. I am testifying today in support of Senate Bill 119 which will amend Title 43, Section 20, of the Alaska Statutes to enable foreign corporations to pay income tax based on the water's edge method instead of the current worldwide method of tax apportionment. I am testifying on behalf of myself and other Alaskans who seek to decrease the barriers to investment in Alaska and who support the principles of free trade. The views expressed are my own.

My testimony begins with an overview of the current structure of Alaska's unitary tax law which uses the worldwide method of apportionment. The next section reviews the constitutional arguments in favor of a repeal of the worldwide method. The final section summarizes why Alaska's current law, absent repeal, may violate provisions of the Treaties of Friendship, Commerce & Navigation entered into between the United States and its trading partners. I hope that my testimony will encourage the Alaska legislature to enact Senate Bill 119 in the interests of promoting international trade in Alaska.

II. ALASKA'S UNITARY TAX: THE WORLDWIDE METHOD OF APPORTIONMENT

Under Alaska law, the income of foreign multi-national corporations is taxed based on a worldwide method of apportionment. AS 43.19 and AS 43.20.065. The worldwide method requires the foreign corporation to include all worldwide affiliates in a unitary group and then an

LYNCH, CROSBY & SISSON

Senator Rick Uehling
April 20, 1989
Page 2

apportionment formula is applied to the unitary group from which the tax is assessed. The theory behind the unitary concept is that the business activities within the state are an inseparable part of the business conducted outside the state. See, Mathias, The Container Aftermath: The Unconstitutionality of California's Unitary Corporate Tax Concept as Applied to a Foreign Parent Corporation, 25 Santa Clara Law Rev. 633, 635 (1985) (hereinafter "Mathias").

The threshold issue in computing the unitary tax is whether a foreign corporation's subsidiary, doing business in Alaska, is part of a "unitary business". A subsidiary is part of a unitary business if its operations are dependent upon or contribute to the business conducted by the group. See, Moorman Mfg. Co. v. Bair, 437 U.S. 267, 272-73 (1968). See, Rudolph, State Taxation of Interstate Business: The Unitary Tax Concept and Affiliated Corporate Groups, 25 Tax. L. Rev. 171, 197-98 (1970). Assuming the business is unitary, the next determination involves the unitary business' tax base. The tax base includes all the income produced by a unitary business. Mathias, n. 23 at 635. See, Western Auto Supply Co. v. Commissioner of Tax'n., 245 Minn. 346, 71 N.W.2d 797, 804-05 (1955) (tax base includes income from both retail and wholesale operations); Coca Cola Co. v. Department of Revenue, 71 Or. 517, 519, 533, P.2d 788, 792 (tax base includes income from both bottling and syrup production). Once the tax base is computed, Alaska's apportionment formula comes into play. Alaska's apportionment formula is a fraction. Net taxable income is determined from the fraction.

III. FOREIGN COMMERCE CLAUSE ANALYSIS

A. Constitutional Standards Applied to Worldwide Method of Computation

A state's ability to tax a foreign corporation must meet six requirements to meet constitutional muster under the due process clause of the commerce clause of the United States Constitution. Four of the six prerequisites were set forth by the United States Supreme Court (hereinafter referred to as the "Court") in Complete Auto Transit v. Brady, 430 U.S. 274, 279

Senator Rick Uehling
April 20, 1989
Page 3

(1977). State taxes do not offend the federal constitution when:

- (1) A substantial nexus exists between the taxed activity and the state;
- (2) The tax is fairly apportioned;
- (3) The tax does not discriminate against interstate commerce; and
- (4) The tax is fairly related to the services provided by the state.

In Japan Lines v. County of Los Angeles, 441 U.S. 434, 451-452 (1979), the Court added the two additional requirements:

- (5) That the state must not create a substantial risk of multiple taxation; and
- (6) That the tax must not impair federal uniformity in an area in which federal uniformity is essential and, thus, prevent the federal government from "speaking with one voice when regulating commercial relations with foreign governments."

If any one of the six requirements is not satisfied, the state tax is unconstitutional.

The Court has not addressed the issue of whether a state income tax, using the worldwide method of computation, is constitutional as applied to a foreign parent corporation that operates a subsidiary in the state. See, Container Corp. of America v. Franchise Tax Board, 463 U.S. 159 at 189, n. 26, and 195, n. 32 (upholding the constitutionality of California's unitary income tax with regard to a domestic corporation doing business worldwide and specifically reserving the question regarding foreign subsidiaries). However, compelling arguments exist that Alaska's worldwide computation method would not satisfy the fifth and sixth requirements outlined in Japan Lines.

Senator Rick Uehling
April 20, 1989
Page 4

B. Alaska's Tax Results in a Substantial Risk of Multiple Taxation

The problem of multiple taxation arises when a foreign government taxes corporations domiciled in its country and its subsidiaries abroad at full value and a state taxes the same entity in part. Multiple tax burdens alone do not render a fairly apportioned state tax unconstitutional. The inquiry must include an analysis of the context surrounding the imposition of the taxes and the alternatives available to the taxing state. See, Container Corp. at 189.

Alaska's unitary tax leads to double taxation for several reasons. One of the primary reasons is that Alaska's tax differs from the methods used by the United States and by other countries. The United States Government and most trading nations rely on the arms length method or separate accounting method to compute business income tax. See, Ventura, State Unitary Business Taxation: Are Multinational Corporations Being Subjected to an Unconstitutional Tax?, 21 San Diego Law Rev. 879, 879-880 (1984); Report of the OECD Committee on Fiscal Affairs, Transfer Pricing and Multinational Enterprises, 8-9 (1979). Under the federal system of taxation, each separately incorporated business is treated as a distinct taxpayer and the filing of a consolidated return is an election to be made by the business. See, Grumwell, Hirsch & Milton, Worldwide Unitary Tax: Is it Invalid Under Treaties of Friendship, Commerce and Navigation?, 18 L. Pol'y. Int'l. Bus. 695 (1986) (hereinafter cited as "Hirsch"); I.R.C. §11(a) and §1501.

The purpose of the separate accounting method is to allocate to each subsidiary the portion of profit entered if it had dealt at arms length with the other members of the corporate group. See, Ventura at 880; See comment, State Taxation of Multinational Corporations, 50 U. Colo. L. Rev. 499, 501 (1979). The arms length method is preferred because it does not tax a corporation on its worldwide income first and then use that figure to compute an additional state tax. See Ventura at 894. Under the arms-length method, foreign tax credits are used to avoid the problems of double taxation inherent in the unitary system. See Shoup, Taxation of Multinational Corporations, INTERNATIONAL ASPECTS OF U.S. INCOME, 40, 48.

Senator Rick Uehling
April 20, 1989
Page 5

Another reason that Alaska's current law leads to double taxation is because the worldwide method inevitably allocates a higher percentage of tax to the State than other foreign jurisdictions. The allocation is higher because it is based, in part, on Alaska's wage rate which tends to be higher than other countries. In both Container and Japan Line, the court concluded that any state taxing method that inevitably produces a multiple tax is unenforceable. See Container, 463 U.S. at 159; Japan Line, 441 U.S. at 434. Even a de minimus overlap is of great concern in the context of taxing foreign corporations and may serve to invalidate a state's tax. Japan line at 456.

Shell Petroleum is a good example of double taxation. In that case, a corporation was owned 60 percent by the Dutch company and 40 percent by a U.K. corporation. A subsidiary of the corporation, engaged in research in California, lost \$390 million under the separate accounting method from 1973 to 1976. However, by combining the subsidiary with profitable affiliates abroad, the California Department of Revenue concluded that the subsidiary earned \$46 million under the worldwide method. See Hirsch at 5. These same problems would occur in Alaska under similar situations unless the water's edge method is used.

C. Preclusion of Federal Uniformity

Alaska is the last state in the Union which has not made an effort to reform their unitary business income tax in an attempt to comport with the standards of the world community. The tax discourages investment in Alaska and it may subject Alaskan firms to retaliatory action if they attempt direct investment in foreign countries. For example, if an Alaskan firm owned 10 percent or more of a British firm. English law may deny that Alaskan corporation a tax refund to which they would be otherwise entitled, subject them to retroactive penalties and harsh disclosure requirements. See Gorman, California Unitary Tax Reform Law-Retreat to Water's Edge, 11 Suffolk Transnat'l L.J. 105, 109 n. 20 (1987). Absent a change in Alaska's law, the federal government cannot speak with one voice on this issue.

LYNCH, CROSBY & SISSON

Senator Rick Uehling
April 20, 1989
Page 6

D. Inconsistent With Clear Federal Directive

Alaska's current unitary tax may also be inconsistent with a clear federal directive. See Japan Line at 451-452. As mentioned above, all the states operating under the worldwide method have enacted some type of reform to eliminate the problems discussed above. As a result of these changes, it seems unlikely that the federal government would enact federal legislation merely to preempt Alaska law and bring Alaska in line with the rest of that states. However, prior to the reform in California in 1985, Congress considered limiting the states right to tax foreign-based corporations. State Taxation of Foreign Source Income Hearings on HR5076 Before the House Committee on Ways and Means, 96th Cong., 2nd Sess. 141-44 (1980)(hereinafter "House Hearings"). President Reagan also formed a tax force to consider the issue and, in effect, to pressure states into enacting reforms on their own. See *Id.* at 15. These actions infer that a continuation of Alaska's present tax would violate a clear federal policy directive.

IV. FRIENDSHIP, COMMERCE AND NAVIGATION TREATIES

A. Construction Rules for Treaties

Treaties are construed liberally to effectuate the intent of the parties. See Kolovrat v. Oregon, 366 U.S. 187, 192-194 (1961); Nielsen v. Johnson, 279 U.S. 47, 52 (1929); Jordan v. Tashiro, 278 U.S. 123, 127 (1928). If a treaty has two fair, plausible ways of interpretation, courts are to favor the more liberal construction. See Nielsen, 279 U.S. at 52; Asukura v. Seattle, 265 U.S. 332, 342 (1924). Treaties interpretation is not restricted by state laws because treaties are superior to state laws and prevail over inconsistent state enactments. See Nielsen, 279 U.S. at 52. Courts turn to the record of negotiations, diplomatic correspondence and practical construction to determine the meaning of unclear treaty provisions. See *Id.* at 52.

B. Friendship, Commerce and Navigation Treaties Govern State Taxes

Modern Friendship, Commerce and Navigation treaties (hereinafter referred to as "FCN" define the term taxes in a broad manner. The definition of taxes includes, in relevant part, fees, charges, or taxes imposed upon or applied to

Senator Rick Uehling
April 20, 1989
Page 7

income, capital, transactions and activities . . . of whatever nature or denomination. See Treaty of Friendship, Commerce and Navigation, Mar. 27, 1956, United States-Netherlands, art. XI, 8 U.S.T. 2043, T.I.A.S. No. 3942, art. XI; Treaty of Friendship, Commerce, and Navigation, Apr. 2, 1953, United States-Japan, art. XI, 4 U.S.T. 2065, 2071, T.I.A.S. No. 2863. Applying the liberal rules of treaty construction to the definition of taxes in FCN treaties, these definitions seem to encompass state and local taxes. See Hirsch, at 12.

Two cases have raised the issue of whether a unitary tax violates a Treaty of Friendship, Commerce and Navigation entered into by the United States. Shell Petroleum, N.V. v. Graves, 570 F.Supp. 58 (N.D. Cal.), aff'd, 709 F.2d 593 (9th Cir.), cert. denied 464 U.S. 1012 (1983); Complaint in Shiseido Cosmetics (America) Ltd. v. Franchise Tax Bd., No. 336238 (Cal. Super. Ct., Sacramento Cnty., filed Jan. 10, 1986). Based on these cases, the writings of commentators and the language of FCN treaties, several arguments exist that Alaska's worldwide method of taxation violates United States treaty obligations to other countries.

C. Worldwide Method Imposes a Severe Administrative Burden

To determine whether a business is unitary, states may require information regarding the history of foreign affiliates, details of individual businesses, names of customers, revenues, profits, losses, internal management guides and reports filed with government agencies. In the case of large multinational foreign corporations, these documents may have to be gathered from all over the world, translated into English and prepared into the proper form to satisfy state law. See Hirsch, at 8; Tannewald, The Pros and Cons of Worldwide Unitary at 15. The burden also involves preparing different types of returns for the federal government and the state government. See Ventura at 905-907. Foreign corporations also may have difficulty releasing information required by the state because it violates secrecy laws in their home jurisdiction. E.g., Capitol Industries-EMI, Inc. v. Bennett, 681 F.2d 1107 (9th Cir. 1982), cert. denied, 103 S. Ct. 570 (1983); Taxation, 25 Tax Notes 649, 655 (1984).

LYNCH, CROSBY & SISSON

Senator Rick Uehling
April 20, 1989
Page 8

D. Accounting Difficulties

Under current Alaska law, a foreign corporation must satisfy the administrative rules of accounting under the worldwide system to satisfy the state as well as contend with the separate accounting requirements of the arms length method for the foreign government. Domestic corporations do not face the same burden. See House Hearings at 15; See OECD TRANSFER PRICING REPORT, at 8-9; Container Corp., at 159.

E. Worldwide Method Restricts Foreign Investment

Section 413 of the Mutual Security Act of 1954, 68 Stat. 832 provides that the objective of tax and commercial treaties is to encourage and facilitate private investment among nations. See Letter from Secretary of State George P. Shultz to the Governors of Alaska, Idaho, Montana, New Hampshire, California and North Dakota, (Jan. 30, 1986), reprinted in Daily Rep. for Executives (BNA) No. 29, G4-G5 (Feb. 12, 1986). However, the worldwide method discourages foreign investment and thereby violates the spirit of these treaties.

F. Other FCN Provisions that Alaska's Law May Violate

In addition to the possible treaty violations outlined above, Alaska's current law may be contrary to several other treaty provisions. The worldwide method may violate the FCN treaty requirement that a tax may not be imposed on income in excess of that reasonably allocated to its own territories. Dutch FCN Treaty, art. XI. See Hirsch at 13. It may impair the interests of a parent in its enterprises and properties. "Protection against such unreasonable measures is usually standard in FCN treaties." Hirsch at 19 (citing treaties therein). Also, the burden of providing information about affiliates may violate the right to protection from the imposition of requirements on contracting parties, more burdensome than those on companies of the other party. See Hirsch n. 246 at 19.

V. CONCLUSION

In the final analysis, the passage of Senate Bill 119 is important to diversify the Alaska economy and to provide the legal infrastructure to compete with other American states for foreign direct investment. Alaska's needs laws premised on the

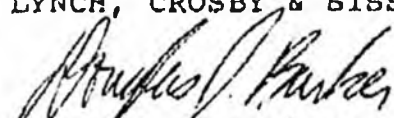
LYNCH, CROSBY & SISSON

Senator Rick Uehling
April 20, 1989
Page 9

principles of free and fair trade to operate in a global economy. By moving to a unitary tax based on a water's edge computation, the Alaska legislature can begin to build the framework to improve Alaska's role in the international marketplace.

Very truly yours,

LYNCH, CROSBY & SISSON



Douglas S. Barker

DJB/src
caf:977

H/21/89
Susan Burke
IBM Amend.

DRAFT #2 (I.B.M.)
11/22/88

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

_____ BILL NO.

IN THE LEGISLATURE OF THE STATE OF ALASKA
SIXTEENTH LEGISLATURE - FIRST SESSION

A BILL

For an Act entitled: "An Act relating to corporate income taxes; and providing for an effective date."

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

* Section 1. It is the purpose of this Act to promote investment in the state.

* Sec. 2. AS 43.20.031 is repealed and re-enacted to read:

Sec. 43.20.031. TAXABLE INCOME OF CORPORATIONS;

DEDUCTIONS; EXCLUSIONS; EXEMPTIONS. (a) Taxable income shall be determined in accordance with Section 63 of the Internal Revenue Code, except as otherwise provided.

(b) In computing Alaska taxable income for a corporation, the following amounts shall be excluded:

- (1) 80 percent of dividend income from foreign corporations;
- (2) any amount treated as a Section 78 dividend under Section 78 of the Internal Revenue Code; and
- (3) 80 percent of royalties accrued or received from a foreign corporation.

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

I.B.M. Amendment

-SUBMITTED BY SUSAN BURKE-

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

7
8 (c) Dividends and royalties taxable under (b) of
9 this section are in lieu of any expense attribution for
10 income excluded under (b) of this section.

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

14 (e) An affiliated group of corporations may make or
15 the commissioner may require them to make a consolidated
16 return for the taxable year in place of separate returns.
17 For purposes of calculating the amount of tax payable by
18 the group under a consolidated filing, 26 U.S.C. 1501 -
19 1552 (Internal Revenue Code), as amended, apply.

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

1
2 * Sec. 3. AS 43.20 is amended by adding a new section to
3 read:

4 Sec. 43.20.073. CORPORATIONS. (a) A corporation
5 that is a member of an affiliated group shall file a
6 return using the water's edge combined reporting method.
7 A return under this section shall include the following
8 corporations if they are a part of a unitary business:

9 (1) affiliated corporations that are eligible
10 to be included in a federal consolidated return as
11 described in Sections 1501 to 1505, inclusive, of the
12 Internal Revenue Code, the average of whose property,
13 payroll and sales factors within the United States is 20
14 percent or more;

15 (2) affiliated corporations that are eligible
16 to be included in a federal consolidated return as
17 described in Sections 1501 to 1505, inclusive, of the
18 Internal Revenue Code, the average of whose property,
19 payroll and sales factors within the United States is less
20 than 20 percent, and that do not meet the requirements of
21 Section 861(c) of the Internal Revenue Code;

22 (3) domestic international sales corporations
23 and foreign sales corporations;

24 (4) any corporation, regardless of the place
25 where it is incorporated if the average of its property,
26 payroll and sales factors within the United States is 20
percent or more; and

CROSS & BURN
CORPORATE CONSULTANTS
424 NORTH FRANKLIN STREET
JUNEAU, ALASKA 99801
(907) 586 2777

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

(5) tax haven corporations.

(b) The department may require a corporation filing under this section to file a worldwide combined report if:

(1) the corporation or any affiliate fails to comply with the domestic disclosure spreadsheet filing requirements as required by the department in regulations;

(2) the corporation does not provide information requested by the department on the operations of a foreign parent necessary for the department to audit the taxpayer's corporation return within a reasonable period of time.

(c) This section does not apply to taxpayers subject to AS 43.20.072 engaged in the production of oil or gas from a lease or property in the state or engaged in the transportation of oil or gas by regulated pipeline in the state.

(d) As used in this section:

(1) An "affiliated group" is a group of two or more corporations, in which 50 percent or more of the voting stock of each member is directly or indirectly owned by a common owner or by common owners, either corporate or non-corporate, or by one or more of the member corporations of the group;

(2) A "tax haven corporation" means a corporation that is incorporated in or does business in a country that does not impose an income tax, or that

Alaska State Bar Association
6000 E. Tudor City Road
324 North Denali Street
Juneau, Alaska 99801
(907) 586-2171

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26

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

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

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

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

ALASKA STATE LEGISLATURE
OFFICE OF THE CLERK
1000 ALASKA STATE HOUSE
JUNEAU, ALASKA 99801
907/586-2777



APR 27 1989

FLUOR DANIEL

Fluor Daniel Alaska, Inc.
900 West 5th Avenue, Suite 300, P.O. Box 196680
Anchorage, Alaska 99519-6680
(907) 276-2636

April 24, 1989

Senate Finance Committee
Pouch V
Juneau, Ak 99811

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

Gentlemen:

PROPOSED SENATE BILL 119
An Act Relating to Corporate Income Taxes

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

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

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

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

Very truly yours,


George P. Wuerch
President and Regional Manager

GPW:jnr

9114A.115



FEB 28 1990

ASSOCIATED GENERAL CONTRACTORS of ALASKA

4041 B STREET • ANCHORAGE, ALASKA 99503
P.O. BOX 240609 • ANCHORAGE, ALASKA 99524-0609
TELEPHONE (907) 561-5384 • FAX (907) 562-6118

February 22, 1990

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

Dear Senator Uehling:

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

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

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

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

Sincerely

ASSOCIATED GENERAL CONTRACTORS
OF ALASKA

F. Michael Swalling
President



JAN 29 1990

Anchorage Star of the North
Chamber of Commerce

January 23, 1990

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

Reference: Senate Bill 119

Dear Rick:

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

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

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

Sincerely,
ANCHORAGE CHAMBER OF COMMERCE

Dave Harbour
Chairman

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

JAN 7 1990

XEROX

December 28, 1989

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

RE: Senate Bill 119

Dear Senator Uehling:

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

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

Sincerely,

XEROX CORPORATION



Ann Laurence
Alaska Manager

AL:eg



ALASKA STATE CHAMBER OF COMMERCE

October 16, 1989

Regional Office:
801 B Street, Suite 405
Anchorage, Alaska 99501
(907) 278-2722
FAX 278-6643

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

Re: Finance Subcommittee on Unitary Tax

Dear Representative Ulmer:

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

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

Thank you for the opportunity to provide these comments.

Cordially,


George Krausz
President

GK/el



ALASKA MINERS ASSOCIATION, INC.

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

October 10, 1989

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

Dear Governor Cowper:

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

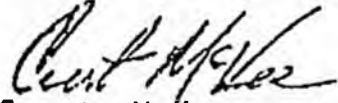
Last year the Alaska Miners Association presented testimony on Senate Bill No. 119 concerning reporting methods for corporate income tax. We supported the bill, but with an amendment which puts our domestic multi-national corporations on the same tax footing as foreign corporations.

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

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

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

Sincerely,


Curtis McVee
Executive Director



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

6900 Arctic Blvd.
Anchorage, Alaska 99515

April 28, 1989

Senator Rick Uehling
Pouch V
Juneau, Alaska 99811

Re: Senate Bill 119

Dear Senator Uehling:

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

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

Truly yours,

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

HCH:lp
R4:89

STATE OF ALASKA

DEPARTMENT OF REVENUE

OFFICE OF THE COMMISSIONER

STEVE COWPER, GOVERNOR

RECEIVED FEB 20 1990

P.O. BOX 5

JUNEAU, ALASKA 99811-0400

PHONE: (907) 465-2300

TELEFAX: (907) 465-2389

February 28, 1990

Denby Lloyd
Special Staff Assistant
to the Governor
Governor's Office
P.O. Box A
Juneau, AK 99811

Dear Mr. Lloyd:

I believe that it is time for the people inside the administration to sit down and review the status of the work on the administration efforts on the changes to the unitary (worldwide) corporate income tax reporting.

The Department of Revenue has been working with the office of international trade (Bob Poe) and various representatives of the interested corporations in an attempt to arrive at a change that would meet the interests of those corporations restricting the reporting requirements that now existing under the worldwide combination method that has been the states policy so far.

The purpose in modifying the worldwide combination approach is to send out a signal that provides assurance that companies doing business here will not be discriminated against, and that we want to encourage people to come. The purpose has not been to tap the general fund to provide a subsidy to very large international business concerns.

The Department of Revenue has been working to arrive at change that would be "revenue neutral"; that is, not result in any significant change in the amount of revenue received by the state. It appears that there is no agreement possible that would allow this. There are ways, but various companies disagree with the particular effects of the reporting methods on their operations.

The latest proposal by IBM forms the basis of a Senate Committee substitute on SB 119. It will cost the general fund perhaps upwards of three million dollars a year, money redirected from the state treasury into the international corporate treasuries. It increases our reliance on petroleum revenue. The IBM bill reduces the diversification in our already narrow tax base. It is a substantial change from the purpose of the original bill introduced by the governor.

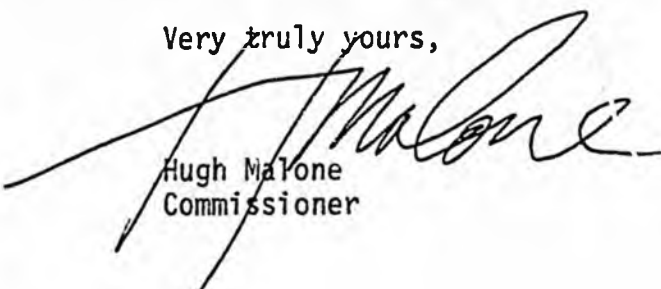
Because of these reasons, I think it is necessary for an administration review to take place. Perhaps it would be preferable for separate legislation to be introduced by the Senate if the IBM approach is to be followed. Perhaps the modifications in the approach that the

Denby Lloyd
February 28, 1990
Page 2

Department has discussed with IBM could be incorporated in the bill (although I really believe that is not something that is likely, since I discussed these issues with the company representative). Or perhaps the IBM proposal is one that, after considering all the alternatives, is somehow seen as being in the interests of Alaskans.

I recommend that we discuss this as soon as reasonably possible. Since the legislation is under active consideration in the Senate, I am as a courtesy, informing the Chairman and members of the Senate Finance committee of my recommendation for the administration review via a copy of this letter.

Very truly yours,



Hugh Malone
Commissioner

cc: Mary Halloran
Bob Evans
Bob Poe
Chairman and Members/Senate Finance Committee

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

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

TAXABLE INCOME -- Sec. 43.20.031.

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

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

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

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

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

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

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

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

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

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

AFFILIATED GROUP DEFINITION -- Sec. 43.20.073.

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

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

SB 119
Modifying the Unitary Tax

Briefing materials
provided to the:

Alaska State Senate
Resources Committee
Senator Bettye Fahrenkamp, Chairman

Office of the Governor
Division of Policy
February 23, 1989

Annotated Table of Contents

Basic source materials.

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

Materials advocating elimination of the worldwide unitary tax system.

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

Briefing materials provided by the Department of Revenue.

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

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

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

Annotated Table of Contents, *page 2*

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

Materials prepared by the Staff Working Group on Unitary Taxation.

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

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

Summary & Sectional Analysis

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Mitsuru Misawa

Industrial Bank of Japan, Ltd.

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

Japan's direct investment in the United States is increasing steadily, having reached a balance of \$3 billion at the end of 1982 (which is equal to 36 percent of Japan's total investment worldwide). However, the future of this trend is now clouded by the system of a worldwide unitary taxation adopted by California and twelve other states.¹ Under unitary taxation, a state government determines a corporation's consolidated income worldwide and allocates its local subsidiary a pro rata income assessed on the evaluation of labor compensation, local assets, and sales proceeds. The validity of this method is open to question.

During his November 1983 visit to Japan, President Reagan was reminded of this problem by Prime Minister Nakasone.² Although the U.S. government is now looking into the matter, Japan's leading businesses are very much concerned about the outcome.

This past June, Keidanren (The Japanese Federation of Economic Organizations) dispatched a high-level unitary tax survey mission to the United States. Representatives from some twenty leading businesses³ visited a total of twenty-four states, including several where unitary taxation is applied.⁴ The purpose of this mission was to meet with government authorities (including governors) and encourage them to either abolish or not adopt unitary taxation. In this paper, I will attempt to summarize the problems that unitary taxation has created for Japanese corporations and then explore possible solutions.⁵

The Consequences of Unitary Taxation on Japanese Corporations

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

ited sales within the state. This situation prevails even when a subsidiary is performing poorly in California.⁶ A newly established subsidiary is rarely profitable as debt service and amortization costs are particularly heavy in the initial years. Yet, even new firms are liable to taxation because of the performance of already well-established parent companies.

For example, Kyocera Corporation, a representative Japanese high-technology firm, paid a total of \$18 million in corporate income tax to the Internal Revenue Service over twelve years from 1972 through 1983.⁷ In this period, the corporation paid \$3.5 million to the state of California on a net income of \$22 million. However, with the imposition of unitary taxation, tax liabilities were recalculated to include corporate income earned throughout the world. Thus, the state levied an additional amount of \$21 million inclusive of interest accrued during an alleged delay in payment. Altogether, the state tax paid exceeded net income. In this case, the grievance against unitary taxation on the part of Kyocera Corporation appears to be justified.⁸

Given these circumstances, Kyocera has suspended its plan to enlarge its plant in San Diego, California. Instead, the firm may consider relocating to the state of Washington which does not impose unitary taxation.

Another well-known electronics firm NEC,⁹ has also suspended additional investment in California and is tentatively planning to invest in an optical fiber telecommunications plant in Oregon, where unitary taxation is expected to be abolished shortly.¹⁰

The Background of Unitary Taxation

The system of worldwide unitary taxation.

CORRECTION

**THIS DOCUMENT
HAS BEEN REPHOTOGRAPHED
TO ASSURE LEGIBILITY**

CORRECTION

**THIS DOCUMENT
HAS BEEN REPHOTOGRAPHED
TO ASSURE LEGIBILITY**

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

Mitsuru Misawa

Industrial Bank of Japan, Ltd.

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

Japan's direct investment in the United States is increasing steadily, having reached a balance of \$3 billion at the end of 1982 (which is equal to 36 percent of Japan's total investment worldwide). However, the future of this trend is now clouded by the system of a worldwide unitary taxation adopted by California and twelve other states.¹ Under unitary taxation, a state government determines a corporation's consolidated income worldwide and allocates its local subsidiary a pro rata income assessed on the evaluation of labor compensation, local assets, and sales proceeds. The validity of this method is open to question.

During his November 1983 visit to Japan, President Reagan was reminded of this problem by Prime Minister Nakasone.² Although the U.S. government is now looking into the matter, Japan's leading businesses are very much concerned about the outcome.

This past June, Keidanren (The Japanese Federation of Economic Organizations) dispatched a high-level unitary tax survey mission to the United States. Representatives from some twenty leading businesses³ visited a total of twenty-four states, including several where unitary taxation is applied.⁴ The purpose of this mission was to meet with government authorities (including governors) and encourage them to either abolish or not adopt unitary taxation. In this paper, I will attempt to summarize the problems that unitary taxation has created for Japanese corporations and then explore possible solutions.⁵

The Consequences of Unitary Taxation on Japanese Corporations

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

ited sales within the state. This situation prevails even when a subsidiary is performing poorly in California.⁶ A newly established subsidiary is rarely profitable as debt service and amortization costs are particularly heavy in the initial years. Yet, even new firms are liable to taxation because of the performance of already well-established parent companies.

For example, Kyocera Corporation, a representative Japanese high-technology firm, paid a total of \$18 million in corporate income tax to the Internal Revenue Service over twelve years from 1972 through 1983.⁷ In this period, the corporation paid \$3.5 million to the state of California on a net income of \$22 million. However, with the imposition of unitary taxation, tax liabilities were recalculated to include corporate income earned throughout the world. Thus, the state levied an additional amount of \$21 million inclusive of interest accrued during an alleged delay in payment. Altogether, the state tax paid exceeded net income. In this case, the grievance against unitary taxation on the part of Kyocera Corporation appears to be justified.⁸

Given these circumstances, Kyocera has suspended its plan to enlarge its plant in San Diego, California. Instead, the firm may consider relocating to the state of Washington which does not impose unitary taxation.

Another well-known electronics firm NEC,⁹ has also suspended additional investment in California and is tentatively planning to invest in an optical fiber tele communications plant in Oregon, where unitary taxation is expected to be abolished shortly.¹⁰

The Background of Unitary Taxation
The system of worldwide unitary taxation

Mitsuru Misawa is Deputy General Manager, International Investment Services Department, of the Industrial Bank of Japan, Tokyo. Dr. Misawa holds the L.L.B. degree from Tokyo University, the L.L.M. degree from Harvard University, the M.B.A. degree from the University of Hawaii, and the Ph.D. degree in business administration from the University of Michigan. He was an official member of the Keidanren Investment Study Mission to the U.S. sent by Keidanren (Japan Federation of Economic Organizations) to investigate the general investment climate in various states for future Japanese investments. Dr. Misawa is the author of articles that have appeared in the *Vanderbilt Journal of Transnational Law*.

represents an attempt to replenish treasuries in several states that are troubled with revenue shortfalls. In southern states such as Georgia and Kentucky, where a balanced budget is a mandatory constitutional requirement, unitary taxation has never been proposed, and their governors have disclaimed any intention to introduce it in the future.¹¹

A number of consumer groups, on the other hand, are adamantly demanding enforcement of unitary taxation to prevent big business from getting away with paying little taxes. Thus, state governments might experience considerable opposition if they withdraw their commitment to unitary taxation.¹² For instance, a government would first have to secure an alternative source of revenues and then convince consumer groups that the tax burden would be equitably shared.

In a recent ruling, the U.S. Supreme Court upheld the constitutionality of unitary taxation.¹³ In this particular case, the corporation, which is incorporated in Delaware and doing business in California, and its overseas subsidiaries constituted a "unitary business." The "formula apportionment" method used by California did not violate the requirement of fair apportionment imposed by the due process clause of the U.S. Constitution.¹⁴ Application of the unitary business and formula apportionment method to overseas subsidiaries did not violate the Foreign Commerce Clause of the U.S. Constitution.

The Arm's-Length Approach

The litigant corporation had undertaken an alternative approach called the "arm's-length" approach, obeying the laws and relevant tax treaties of the U.S. federal government and other national governments under whose jurisdiction the corporation operates subsidiaries. By employing the arm's-length approach, a government imposes taxes only on incomes earned within its jurisdiction — provided that within a group of affiliated firms, each firm is legally treated as an independent entity and that the firms transact

with one another on an arm's-length basis. This ruling, however, leaves the question of foreign parent companies that are operating in the U.S. through U.S. subsidiaries unresolved. It seems worthwhile, therefore, for a Japanese firm like Kyocera to contest this point in court.

Problems for Japanese Corporations

The problems that Japanese corporations encounter with unitary taxation are listed below.

1. Tax Jurisdiction. Tax jurisdiction is considered to be counterbalanced by the benefits and protection provided by the authorities to the taxpayers also under their jurisdiction. Logically, therefore, tax jurisdictions cannot impound incomes accruing to the party outside the tax jurisdiction of the taxing authority. This is widely accepted as an international practice based on justice and equity. It is probably right to infer, therefore, that several states in the United States may not lawfully impose a tax on the foreign-based incomes of foreign corporations.

Although it is true that a group of affiliate firms is interdependent, and the total income of the group represents the fruit of its global activities straddling jurisdictional borders, the method of aggregating worldwide income and then apportioning the total to geographical jurisdictions in accordance with mere business indices is too mechanical to do justice to the complexities of actual business. This point is plain enough in the case of a Japanese corporation, with a U.S. subsidiary, that is gaining profits from the operations of its Southeast Asian and West European subsidiaries. Here, there is normally only a remote possibility for the U.S. subsidiary to contribute anything to the overall profits derived from the Asian or the West European operation. The system of unitary taxation requires, even in this case, the allotment of state tax based on the Asian or the West European operation.

2. Conflicting Taxation Principles. Both the United States and Japan use the arm's-length

approach in taxation, and thus it may be considered the internationally accepted approach. However, the action of some U.S. states in pursuing unitary taxation creates a complex situation for multinational corporations that have to deal with two differing taxation principles.

The arm's-length approach cannot cope with tax evasion effected through transfer pricing within a group of affiliates. In such cases, the tax revenue of the taxing authorities would perhaps suffer a decrease. However, the U.S. and Japan have no appreciable differences in the rates of corporate income taxes, and no merits exist in manipulative transfer pricing.¹⁵

3. Conceptual and Procedural Ambiguities. Conceptually and procedurally, the system of worldwide unitary taxation involves ambiguities, and there is no assurance that the relevant taxing authorities will not adopt an arbitrary stand. To assess the global aggregate income of an affiliate group, the three indices — assets, labor compensation, and sales proceeds — are considered of equal weight. This erroneous assumption is too simplistic to do justice to the complex management of a multinational corporation.

When a Japanese subsidiary constructs a new factory in the U.S., the required site must be purchased at the current price, which is entered on the subsidiary's books as the book value. The parent firm's land holdings in Japan, on the other hand, are recorded at their historical value. This use of asset values inflates the amount of tax liabilities in the United States.

4. Double Taxation. The corporate income of a multinational group is now subject to taxation in either the country of operation or residence. Worldwide unitary taxation — imposing tax liabilities on the foreign income of foreign corporations taxed already under arm's-length taxation — thus entails double taxation.

For example, a Japanese subsidiary in the United States owes tax liabilities to the state government, although, from the viewpoint of

the Japanese parent, tax is being levied on part of the parent's income. The parent cannot claim a tax deduction under Japanese law because the amount in question is levied on its U.S. subsidiary, not on the parent itself. State and local taxes are not covered by the Japan-U.S. tax treaty because the U.S. federal government has no power over them. For this reason, Japanese corporations cannot expect relief from the *ad hoc* consultation procedure set forth in the treaty.

An Alternative: The Water's-Edge Approach. The water's-edge approach to resolving the issue of unitary taxation, which has been advocated by a competent task force in the Treasury Department, appears to be a constructive proposal.¹⁶ This approach recommends that income earned outside the U.S. by a multinational group should be included in the income aggregation only if a number of conditions, which are described below, exist. Thus, the unitary taxation of income from interstate business activities would still remain a problem, but its international application would be theoretically eliminated in many cases.

Even so, there is a catch to this proposal. A wide range of corporations based outside the U.S. would continue to be subject to worldwide aggregation of income. These would include all corporations by which the average of the three indices for a foreign-based corporation amounted to more than 2 percent of the corporate activities (in terms of wages/salaries paid, assets held, and sales registered) to have originated in the United States. Global income assessment would also be applied if either wages/salaries paid in the U.S., or assets held in the U.S., or sales in the U.S. exceeded \$10 million. These provisions would effectively make most Japanese corporations subject to unitary taxation. Further, the same report demands wide-ranging financial disclosure by foreign-based corporations, which might conceivably involve inordinately large costs.

The range of disclosure includes: (1) submission to the state tax authorities of tax-related information concerning the parent

The Keidanren Group (Japanese Federation of Economic Organizations) is composed of the leading business executives in Japan, and operates much like The Business Roundtable in the United States. Maintaining close contact with various economic sectors in Japan and abroad, Keidanren endeavors not only to find practical solutions to economic problems but also contributes to the sound development of the economies of Japan and other countries.

firm; (2) the summarized listing of the amount of taxes paid to each state; and (3) oral explanation in response to a summons from the state tax authorities. To reinforce the legal obligation to respond to summonses, foreign-based firms must deposit a certain amount of money with the authorities. Accordingly, the firms that fail to meet fully these conditions of disclosure would be subject to worldwide unitary taxation.

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

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

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

Conclusion

The initiative for satisfactory settlement of this issue rests with each of the state governments and legislatures concerned. Having fully appraised the adverse effects of unitary taxation on direct investment in the United States, I would like to see those bodies take the constructive steps necessary to create more jobs and encourage economic prosperity within their states. This is the scenario most Japanese corporations strongly hope to see.

References

1

The other states include Massachusetts, Florida, Oregon, and Indiana.

2

Secretary of the Treasury Ragan, who accompanied the president to Japan, stated that in considering unitary taxation, the apprehensions on the part of the Japanese government would be duly considered.

3

The membership included representatives of Nissan Motor Co., Toyota Motor Co., several other manufacturers, the Mitsubishi Corporation, several other trading houses, the Industrial Bank of Japan, and several other banks. The Federation of Economic Organizations is a voluntary association of some 1,000 businesses. It has a considerable influence on public policies and private managerial decision making.

4

California is of strategic importance to most Japanese corporations because approximately 1,000 out of the

3,000 Japanese corporations investing in the U.S. are based in California. This state raises an annual revenue of about \$400 million by — and appears firmly committed to — unitary taxation, according to the Nihon Keizai Shimbun (3 July 1984, p. 4).

5

I am solely responsible for the views herein expressed, which do not necessarily agree with the official standpoints of either the Federation of Economic Organizations or the Industrial Bank of Japan.

6

Apart from a few exceptions, most Japanese subsidiaries in California do not in fact perform better than their parents.

7

Kyocera is a pioneer in ceramic IC packages. It controls 70 percent of the world market for these products. Sales in 1983 was ¥133,230 million.

8

In June 1984, Kyocera deposited \$21 million requested with the judicial authorities and embarked on litigation

against the state government. See the Nihon Keizai Shimbun, 28 June 1984, p. 8.

9

NEC is a major maker of telecommunications equipment, electronic computers, and semiconductors. In the production of semiconductors, NEC is number 2 in the world. Its total sales in 1983 were ¥1,253,588 million.

10

In June 1984, the Keidanren mission met the governor of Oregon, who reconfirmed his commitment to the abolition of unitary taxation. This commitment has been put in writing by the governor and also by several leading members of the state legislature.

11

On this point, the Keidanren mission was very much concerned, and, in its meetings with Governors Harris of Georgia and Collins of Kentucky in June 1984, the mission sounded out their intentions. The governors disclaimed any intention to impose unitary taxation.

12

Following the visit of the Keidanren mission, it seems that some efforts have been made in the direction of the abolition of unitary taxation in California. On the other hand, it is widely acknowledged that its total abolition

cannot readily be attained. Sentiments in the state legislature seem to oppose any concessions to big business at a time when the state is unable to increase the salaries of underpaid schoolteachers. See Nihon Keizai Shimbun, 3 July 1984, p. 6.

13

See *Container Corporation of America v. Franchise Tax Board* (June 27, 1983).

14

See the Constitution of the United States, Article I, Section 8.

15

According to the Ministry of Finance of Japan, the effective rate of corporate taxation is 51.18 percent in the U.S. and 51.35 percent in Japan. If anything, exclusive submission to U.S. jurisdiction would be slightly advantageous for a multinational enterprise.

16

A task force of the Department of the Treasury submitted its report on May 1, 1984, to a working group chaired by the Secretary of the Treasury. The second and third proposals contained in this report advocate the water's-edge approach. Unitary taxation is a prerogative of the various states and the federal government has, therefore, no veto power in this matter.

Walk Softly or Carry a Big Carrot



Alaska's one of only three states that still tax corporations on the basis of worldwide earnings. If the state doesn't want its resources to walk softly in world markets forever, the worldwide reporting requirement may be one of the first big sticks it must drop to attract foreign investment in resource development.

BY PAUL LAIRD

LISTEN. Hear it? No? It's the thundering silence of Alaska's enormous resource and development potential walking softly and carrying a big stick in the international marketplace. So softly, in fact, that many foreign investors haven't been paying much attention.

Truth is, it never seemed to matter much what foreign investors thought about the big stick routine—you know, limited infrastructure and access to remote areas; high labor, construction and real estate costs, and an inhospitable climate. Weather-wise and tax-wise. Love us or leave us alone. Until recently, anyhow. With the steady stream of oil dollars flowing into an Alaskan economy we all knew had outlived the days of boom and bust (say hallelujah!), who had time to listen to those nattering nabobs of negativism preaching diversification or doom?

"The oil boom made us fat, dumb and happy," says Anchorage attorney Robert Breeze, who's been active in international affairs and is a director of the Alaska-Korea Business Council. "Now that it's over, we're starved, more astute and unhappy."

Cheer up: Alaska may have to carry a big carrot instead of a stick if it doesn't want to walk softly in the international arena forever, but the first step toward creating a more favorable foreign investment climate could turn out to be relatively painless yet symbolically significant: repealing the worldwide combined reporting requirement in the state's unitary tax and replacing it with a water's edge approach.

"Going to a water's edge approach alone won't bring more foreign capital into the state," says one foreign trade expert. "Taxes are just part of the package of what goes into a decision to invest in a project. But the worldwide reporting requirement is a major stumbling block. The Japanese and Koreans have as much as told other states that if they have a worldwide unitary tax, they won't invest there unless it's absolutely necessary."

Adds Dan Dixon, director of international affairs in the Alaska Department of Commerce & Economic Development, "The tax structure alone generally doesn't inhibit investment, because a fair and consistent system can be worked into profit-and-loss projections. But the tax system in Alaska is confusing and inherently unfair.

"It sends out a signal of greed, and most of the United States has realized worldwide combined reporting is stupid. It puts us in a rather lonely position when it comes to attracting foreign

investment, and when we're already not competitive in a lot of ways, why add in an onerous tax that doesn't do us any good? We can no longer presume that foreign investors will come here to develop our resources just because we have them. We have to realize we're competing on a global basis with other countries that have the same things."

Unitary taxation is based on the premise that various parts of a corporation engaged in related business activities—divisions, subsidiaries, plants, etc.—contribute equally to produce a single profit or loss. Its goal: to assure that each jurisdiction gets its "fair share" of corporate income when levying taxes.

Unitary tax is determined by calculating the percentage of a company's total business conducted in a given taxing jurisdiction and multiplying its total earnings by that percentage. Assets, sales and payroll commonly are used to determine that percentage. Advantage: The company can't structure its accounting so losses will be weighted toward activities in high-tax jurisdictions while profits are shifted to operations in low-tax states or countries.

If a widget company earns \$100,000 by extracting raw materials in Alaska, manufacturing them in Taiwan and operating its sales division out of Washington, and if 25 percent of the compa-

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

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

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

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

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

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

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

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

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

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

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

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

domino to tumble was California, once the bastion of worldwide unitary taxation. Beginning Jan. 1, multinationals operating in California will have the option of sticking with the existing system of worldwide reporting or paying an annual fee based on California payroll, property and income to switch to a water's edge approach.

"California was literally losing foreign business investment to states without worldwide reporting," says Ken Hansen, a partner in the Sacramento office of Peat Marwick Mitchell & Co. "The Japanese were saying they wouldn't invest any more in California if the worldwide requirement weren't changed, and right after the vote to change the system, Sony announced it would substantially increase its investment in the state."

According to one report, Sony expects its California tax bill to drop by a third when the new system takes effect next year. One Japanese firm relocated to Washington when its California corporate tax actually exceeded its net income from operations in the state. While there's still resistance to some provisions of California's tax bill, foreign investors and governments for the most part seem to feel appeased.

Even with worldwide reporting, the state has captured more than 40 percent of all Japanese investment in the United

Worldwide Combined Reporting Method

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

3

Water's Edge Reporting Method

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

3

Separate Accounting

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

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

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

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

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

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

Water's edge and the foreign dividend dilemma

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

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

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

The dilemma:

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

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

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

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

annually due to the revision—reduction of its estimated \$1.1 billion annual corporate tax take. Further, it expects that decline to be more than offset by property, income and sales taxes from new investment the change should spawn.

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

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

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



Sharon Yesland Interiors
Associate Member ASID

RESIDENTIAL & COMMERCIAL BY APPOINTMENT ANCHORAGE, AK (907) 337-6732

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

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

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

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

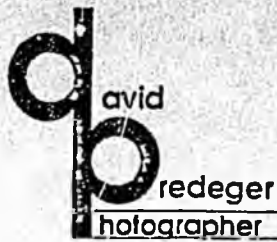
President Reagan resisted pressure to endorse a federal law against the worldwide reporting requirement on the basis that such a law would violate states' rights, but he did appoint a task force headed by then-Treasury Secretary Donald Regan to study the issue. Its recommendations:

- That states still using worldwide reporting should abandon it in favor of a water's edge approach;
- That the federal government should assist states in monitoring compliance with water's edge reporting;
- That a competitive balance be maintained among U.S.-based multinationals, foreign-based multinationals and purely domestic corporations.

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

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

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



6101 Azalea Drive
Anchorage, AK 99516

(907) 345-1338

I will meet your professional
and personal creative needs.
Call for an appointment.

- Brochures
- Annual Reports
- Public Relations
- Photojournalism
- Architectural
- Remote Locations
- Special Events
- Corporate
- Industrial



HELP WANTED

Organize Your Company Or Group Ski Club And Ski Alyeska Free!

- Fantastic Group Rates
- Night Skiing as low as \$9.00 per person
- Lift, lesson and rentals only \$28.00 per person
- Minimum of 20 members required

CALL NOW! 783-2222

Talk to Steve, Jerre or Mark For More Information

JUST 45 MINUTES SOUTH FROM ANCHORAGE TO GIRWOOD
INFORMATION AND RESERVATIONS 783-2222 • SKI PHONE 783-2121

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

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

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

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

ments in development." Promoters of a handful of major resource development projects in Alaska note their negotiations with potential foreign investors haven't reached the point where state tax policy has been a significant issue.

Benefits to Alaska from foreign investment in resource development: shared risk, reliable markets, abundant capital. The state's Dixon maintains

Why oil curdles at the thought of (another) tax change

IN THE MIDST OF LAST YEAR'S MINT-DEBATE OVER whether to reimpose separate accounting on Alaska's oil industry, one long-time state legislator dismissed industry arguments that another change in the tax structure would reinforce business's perception that the state has an unstable tax climate and discourage investment in Alaska. "We've changed taxes nine times on the industry since statehood," he declared.

Is it any wonder the oil industry reaches for its Roloids whenever someone brings up the issue of changing the tax structure?

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

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

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

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

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

Companies providing pipeline transportation are taxed on assets and sales.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

IT SEEMS LIKE we often forget who our friends really are," he says. "The state has seemed to treat foreigners like they're on the other side of a competitive game. The Japanese, Koreans and Taiwanese have more of holistic view of things. They figure they need help with fishing and we need help with some of our other resources; they can't figure out why we want to cut off one hand while we're massaging the other. They see us as quite schizophrenic."

There's debate over why foreign investors find worldwide reporting so onerous. One school of thought: The approach may have limited long-term impact on their bottom lines, but the primary objection is philosophical.



Peat Marwick's Danner: Economic diversification encouraged by a water's edge approach to corporate taxation should benefit Alaska's oil industry in the long term.

Frank Danner, chairman of the Alaska-Korea Business Council and managing partner of the Peat Marwick Mitchell office in Anchorage, says Orientals are "very close with their financial information. They view it as an invasion of privacy, and they don't want to invest where they're not wanted."

He adds foreign investors have "no love for the water's edge approach either" and would prefer separate accounting in which tax liability is calculated by subtracting expenses from sales on a state-by-state basis, "but they accept water's edge."

The other school: The bottom line is still the bottom line, and the goal of any business venture is to recapture initial investment as soon as possible. Any significant investment in developing Alaska's resources almost inevitably will result in substantial losses in the early years. By taxing profits on a worldwide basis, a multinational could find itself losing millions of dollars in Alaska yet paying the state corporate income tax on earnings elsewhere.

Says Calista's Gay, "Business is still business, no matter who's doing it. The investor isn't going to get any return at all until the project is developed and operating, and with some of the projects being looked at in Alaska, that could be as much as 10 years. The most important issue is economics, and investors have to have a way to get over that initial hurdle."

In other states, one of the primary concerns has been the impact of water's edge reporting on state government revenues. According to one study, the average corporate tax setback has been 15 to 25 percent. Oregon projected losing only \$18 million from its 1986-87 biennial budget, though, and there have been no studies of the impact of new investment on water's edge states' economies.

Alaska's Department of Revenue late in 1986 was studying how various tax systems would affect the state budget. Vince Wright, chief of the department's Research Section in Juneau, says an examination several years ago indicated water's edge reporting would have "no material impact."

Unlike other states, Alaska currently has no vehicle to benefit directly from increased investment stemming from a tax change. No state property tax. No personal income tax. No sales tax. While adopting a water's edge approach may not materially reduce state revenues, additional foreign investment may not materially increase them, either.

Nonetheless, worldwide reporting may be one of the big sticks the state will have to be willing to lay down if it's serious about attracting foreign capital to diversify its economy and it doesn't want to walk forever softly in world markets.

Says Peat Marwick's Danner, "I don't know that we get all that much (tax revenue) from foreign corporations anyhow, but with the intense competition for foreign investment, the benefits to the economy outweigh the revenues state government gets from worldwide reporting."

Adds Gay, major foreign investments in Alaska's development will mean "billions of dollars turning over in our economy for years to come. Our future is resource development, and in the longer term, foreign investment will be critical. But we need to send a message now that we want to make Alaska competitive and make it attractive to foreign investors."

Repeal of worldwide reporting may be the loudest and clearest message Alaska can send in the near term to show that it's ready to lay down the big stick and replace it with a carrot.

Water's Edge Combination — Opportunity for Uniformity?

Richard Pinger

Richard Pinger, ~~Director~~ ^{Senior Manager} of Price Waterhouse in Houston, said that an opportunity to achieve uniformity has already been lost because nine states now apply water's edge combination but no two are alike. He said that water's edge is a fairness concept, but that it involves costs. For the taxpayer, the costs are those of return preparation and payment and the costs of compliance.

He said that dividends constitute the most important aspect of water's edge combination, but only for U.S. companies. He said that ~~water's edge plus the inclusion of dividends without including factor relief is worse than worldwide combination.~~

He said that another problem is that of determining which corporations are includable in the combination. Seven of the nine states, he said, include all that are more than 50% commonly owned, one includes only 80% commonly owned corporations and one includes "unitary corporations." Four states include 936 corporations and five include them only partly. He noted other disparities.

Pinger said that eight of the states include at least a part of foreign dividends in the income base; that three provide some form of factor relief; that four states provide for water's edge to be allowed at the taxpayer's election but five require filing on the water's edge basis; that three make an election binding for three or more years; that two impose a fee for electing water's edge; and that only five have regulations.

All of those areas address the tax costs, he said, but the ~~spreadsheet~~ ^{spreadsheets}, which are provided for in the statutes of four of the nine states, ~~will help the states to coordinate costs.~~ He urged that those states be careful to see to it that any information required will be useful and that taxpayer compliance costs be considered. He expressed the hope that the four states would at least be uniform in establishing spreadsheet requirements. He said that this is the area that provides the best opportunity to attain some uniformity

John James

~~Minnesota's Commissioner~~ ^{viewed} the history of his state's use of the unitary method. The state first adopted domestic, but not water's edge, combination as of July 1, 1981. It included U.S. Possession corporations and 931 and 936 corporations and did not recognize the 80/20 concept. Historically, both foreign and domestic dividends were 80% excluded, which continued to be the case under domestic combination. Royalties from foreign subsidiaries were not excluded; nor was there ever any factor relief for intangible or foreign income.

In 1985, the legislature enacted two changes, excluding from the base: 1) 100% of foreign dividends; and 2) 100% of foreign royalties received by 80/20 corporations.

1986 legislation cut the foreign dividend exclusion back to 80% and cut the foreign royalty exclusion for 80/20s to 35%.

1988 legislation phases in various changes which will ultimately result in the following: retention of the 80% exclusion for foreign dividends (70% if the receiving company owns less than 80% of the paying company) with no factor relief; 80% exclusion of royalties received from a foreign subsidiary that is part of the receiving corporation's unitary business (no factor relief); foreign operating corporations, unitary 936s and 80/20s, are effectively treated as foreign corporations so that 80% of their income is excluded and the remaining 20% treated as a fully taxed deemed dividend to the parent corporation (no factor relief). U.S. Possessions corporations are essentially treated as foreign corporations. Intangible operating business income other than that which qualifies for the 80% exclusion is fully included in income subject to factor relief which involves including such income in the sales factor.

James said that ~~worldwide unitary combination is the a~~ ^{propriate approach conceptually}, but that Minnesota has adopted what amounts to water's edge combination. In doing so, it seeks to provide comparable tax treatment for major foreign operations regardless of how organized.

Phil Aldape

~~Minnesota's Income Tax Bureau Chief~~ ^{Chair}, who has also served as Chair of the MTC's Uniformity Committee for the past seven years, ~~said that water's edge combination is not what many people have expected.~~ He said that there had been growing uniformity under the movement toward worldwide combination; that the business community had driven the movement toward water's edge and that, in doing so, it should have expected diverse results.

~~Aldape said that water's edge produces substantial reductions in tax burdens as well as shifts in tax burdens;~~ that purpose of the water's edge movement, at least in the mind of legislators, was to produce an economic boom but that it is too early to determine its effects. He said that uniformity and ease of administration were not foremost in the minds of legislators as they adopted water's edge. He said that uniformity is desirable but that it should not become a means by which to restrict the tax base.

Aldape hoped that the spreadsheet would help the states administer their taxes effectively. He expressed the belief that some multinationals prefer non-uniformity even though many other businesses sincerely yearn for uniformity and consistency among the states; that most multinationals do not want uniformity on the condition of having to comply with spreadsheet requirements. He said that state administrative costs need to be taken into account and that increased uniformity can be helpful to them as well as to many taxpayers.

~~He said that those states which have excluded 80/20s from the base are particularly vulnerable to taxpayer tax avoidance tactics;~~ that Section 482 adjustments are not a practical answer; and that non-combination states are at the mercy of the taxpayer because the states do not have the resources to deal with Section 482 problems.

Nevertheless, he does think that the states should continue to work for uniformity, that it is possible in the water's edge area, and that it is desirable for both the states and n

taxpayers. He said that the four states that have been working on the spreadsheet have been trying to limit the requirements to information that would be necessary, important, and useful and would promote uniformity.

He suggested that current water's edge legislation should remain unchanged for a couple of years. That, he said, would give states and taxpayers alike a chance to evaluate it from state to state; and would increase the chances that any changes to be made in the future would be constructive ones which would enhance uniformity.

Aldape concluded with the comment that uniformity, if it is ever to be achieved, will require a substantial amount of unselfish cooperation between the states and the business community, and that the MTC is uniquely qualified to coordinate that effort.

John LaFaver

Montana's Director of Revenue, who moderated this session, said that, as he listened to the presentations, "it struck me that the changes in the tax laws that we've seen now in the last two or three years in a number of states, moving away from worldwide to water's edge, have served to substantially increase the cost of compliance for both taxpayers and tax agencies.

Therefore, he said, "I have to wonder whether, somewhere down the road, we are not going to have to re-invent worldwide unitary" combination.

Sales Taxation of Services

Ron Shreiner, Wade Anderson, Steve Keene

Ron Shreiner, the South Dakota Revenue Secretary, Wade Anderson, Executive Counsel for the Texas Comptroller, and Steven N. Keene, Director of the New Mexico's Audit and Compliance Division, described the manner in which their states had approached the taxation of services. All agreed upon the importance of taxing this fastest growing segment of the nation's economy. Shreiner and Anderson emphasized the importance of bringing the business community into the legislative process early, implying that Florida's troubles traced to a failure to do so; and Keene thought that Florida had taken the wrong approach in specifying services to be taxed rather than enacting a broad tax on services subject to exemptions.

Walter Hellerstein

Walter Hellerstein, the U. of Georgia law professor who had participated in the drafting of the Florida law, responded that Florida had in fact brought the business community into the process early and that legislative staff members had met endlessly with industry; that the apportionment that had been applied to interstate service transactions had been requested by the business community, which had then turned around and attacked it; that the real reason for the subsequent repeal was that the advertising industry simply did not want to be taxed, and that that would have been true regardless of the approach

taken. He said that most other industries seemed to be willing to accept the tax as one that was needed to solve the state's fiscal problems. He predicted that most of the services which the legislation had addressed would end up being subjected to the tax anyway; but that the process would take longer and would be accomplished incrementally by expanding the base of the present sales/use tax in Florida.

Hellerstein said that some 50% of the GNP now consists of services and that the percentage is increasing. The states, he said, will have to take that into account in shaping their tax systems and will have to broaden their sales and use tax bases.

There is no economic distinction, he said, between the consumption of tangible personal property and the consumption of services. Eliminating the distinction between the two for tax purposes would greatly facilitate administration, and would bring an end to the extensive litigation which has been addressed to the distinction. He said that it would also increase tax neutrality between sales of services and sales of tangible personal property, that it would increase the responsiveness of the sales/use tax to changing economic conditions, and that it might be claimed to reduce regressivity, although he expressed doubt as to the validity of that claim.

Like the other speakers, he referred to special difficulties that are involved in the taxation of services, particularly sales for resale and sales across state lines. But he noted that the sale of services to business, even though the cost is included in the sales price of business products, does not necessarily conflict with current practices in many states with respect to sales of tangible personal property to business. He said that, if sales to business were exempted, the base would be so narrow that much higher rates would be required. Thus, he said, it is not possible to eliminate all pyramiding without making the base too narrow, whether talking about sales of tangible personal property or sales of services.

He noted that Florida had sought to tax consumption rather than performance; that that was consistent with the basic philosophy of treating a sales tax as a consumption tax, and that, in that context, the place where the service is performed is not relevant. This then raises the question as to whether one must apply apportionment with respect to a service that is used simultaneously in many jurisdictions. He thinks that, as a constitutional matter, apportionment is required. Florida considers a credit to be an adequate response to any multiple taxation complaint. Hellerstein said that debate will now center on the question of whether this is true.

He said that the U.S. Supreme Court would address the question in the pending cases of *G.T.E. Sprint v. Sweet* and *Goldberg v. Sweet*, Nos. 87-826 and 86-1101. There, Illinois imposes its tax on all receipts from telecommunication originating in or terminating in Illinois and billed to an Illinois service member, subject to a credit for tax paid on the same transaction and base to another state. He said that, while he believes that the credit deals effectively with the apportionment requirement, there remains the possibility that it will not satisfy Due Process requirements in all circumstances.

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

REVIEWING THE OPTIONS

**Briefing for Governor Steve Cowper
and senior state officials**

prepared by

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

A. SUMMARY OF THE ISSUE

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

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

B. NEED FOR BRIEFING AT THIS TIME

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

C. AGENCY INVOLVEMENT

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

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

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

D. THE STATE POLICY CONSIDERATIONS

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

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

E. THE APPROACH TO THE ISSUES

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

SECTION ONE

Summary

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

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

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

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

DEFINITION OF TERMS

1. Unitary Business

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

2. Combination (or combined report)

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

3. Worldwide Combination

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

4. Domestic Combination

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

5. Water's Edge Apportionment

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

6. Separate Accounting Method

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

7. Apportionment Factor

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

EXAMPLES

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

Facts

Company A: Coal mining operation in Alaska.

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

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

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

Separate Accounting

Company A would file its tax return in Alaska and report only those receipts and costs related to its instate business. Sales between A and B must be determined on an arms length basis for tax purposes even though the companies books and records may report them differently.

Water's Edge Apportionment

Company A and B if unitary, will combine and their combined incomes will be apportioned using the three factor formula. Because Branch A-1 and Company C are not domestic, they cannot combine with the foreign coal mining and sales operations. Some water's edge methods tax the dividends Company C would pay to Company A.

Domestic Combination

Company A and B will combine, including Company A's Australian branch. In some cases, dividends from C may be included in apportionable income.

Worldwide Combination

Companies A, B, and C, including A's Branch, will combine and apportion their entire income. This is the current tax method used by Alaska for both petroleum and non-petroleum taxpayers.

WHAT IS THE UNITARY BUSINESS PRINCIPAL?

More than two dozen states use the unitary method of determining how some corporations figure their income tax, but what exactly is the unitary method? Sometimes it is referred to as a "unitary tax" or a "new tax" on income earned outside the taxing state. It is not a new tax or even a separate tax but a theory or accounting method which some corporations subject to Alaska tax must use to figure out what portion of their income is attributable to Alaska. This method is called the combined income approach. If a unitary group exists, all of the group's income is subject to apportionment based on their use of the state market place. That means that the taxpayer must determine what portion of its income is attributable to Alaska. The amount of tax any company pays to Alaska is determined on the basis of the ratio of its activities in Alaska to its activities everywhere else. The formula method measures the level of business activity conducted in the state. The more or less business in Alaska, as measured by property, payroll and sales factors results in a corresponding reduction or rise in the amount of income subject to tax. The unitary method of taxation is designed to tax corporations based on their actual business relationships rather than the mere form of their relationships.

SECTION TWO

WHAT IS A UNITARY BUSINESS?

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

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

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

HOW DOES ALASKA'S LAW WORK?

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

STANDARD 3 FACTOR APPORTIONMENT FORMULA

Alaska Taxable Income = Total Apportionable Income X

property, payroll and sales in-state
total property, payroll and sales everywhere

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

Total Apportionable Income X

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

**MODIFIED APPORTIONMENT FORMULA FOR PIPELINE
COMPANIES**

Total Apportionment Income X

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

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

Total Apportionment Income X

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

- - it may result in double taxation of the same income unless all countries adopt the method.
- - it may interfere with international trade and impede new investment in the United States.
- - foreign based corporations may have a greater income distortion since they have a greater proportion of foreign to U.S. activities.
- - it departs from the international norm of arm's length or separate accounting.
- - it gives rise to foreign threats of retaliation against U.S. based companies.
- - it is administratively burdensome for corporations and domestic companies may not have access to the information concerning a foreign parent or other subsidiaries.
- - it is difficult to define the parameters of a unitary business which gives rise to taxpayer uncertainty.
- - states apply the concept nonuniformly.

The proponents of the method voice the following concerns on the use of separate accounting or the arm's length method:

- - it fails to accurately measure income and may lead to undertaxation in organizations that are functionally integrated, have centralized management, and share economies of scale.

- - it is administratively burdensome for states and taxpayers because of the millions of transactions that must be reviewed in order to source income among the various jurisdictions and the lack of free access to foreign information.

- - states lack the resources to administer it effectively which can result in the tax burden being shifted away from multinational corporations to smaller domestic companies.

- - the allocation of indirect expenses and the determination of value in intracompany transfers is extremely difficult, can be based on arbitrary criteria, can vary from one company to another, and is nearly impossible to audit in large multinational companies.

- - the rules and level of implementation at the international level are not uniform and it departs from the accepted method of state taxation based on apportionment.

- - it has been criticized by the General Accounting Office for failing to provide consistent, equitable measurement of income.

SECTION THREE

FACTORS AGAINST WORLDWIDE APPORTIONMENT

1. Taxpayers believe it exposes them to double taxation;
2. Taxpayers believe it burdens them with excessive bookkeeping requirements;
3. Distorts international flows of trade and investment;
4. Upsets longstanding agreements among the nations to achieve tax harmony;
5. Limits federal government's ability to conduct consistent international economic policy;
6. Invites retaliation by nation's trading partners;
7. Violates the Constitution.

FACTORS FAVORING WORLDWIDE APPORTIONMENT

1. Prevents corporations from evading taxes by misrepresenting the geographical allocation of their income;
2. Easier to administer than various separate accounting methods;
3. Generally, worldwide apportionment increases a state's corporate income tax revenue.
4. On a domestic basis, apportionment has been court approved.

Figure 1

How Much Income Did A Corporation Earn In Alaska?

Alternative Methods:

Separate Accounting Principle

Separate Accounting

$$\text{Alaska Sales} - \text{Alaska Expenses} = \text{Alaska Net Income}$$

Unitary Principle

Water's Edge Reporting Method

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

Worldwide Combined Reporting Method

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