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August 14, 1979

The Honorable Mike Gravel
United States Senate
3131 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Dear Senator Gravel:

I am taking this opportunity to inform you of our interim AGSOC work. Currently, we have two contracts in effect. The first of these is with Wilmer, Cutler & Pickering. The scope of their work is as follows:

1. Review federal securities law problems that would be raised by the proposed AGSOC legislation and initiate discussion with the federal Securities and Exchange Commission in accordance with recommendations set forth in Wilmer, Cutler & Pickering memorandum dated November 2, 1978.

2. Review federal tax problems that might arise in implementing the proposed AGSOC legislation including any federal tax problems that might occur upon initial distribution of shares. Initiate appropriate discussions with the Treasury Department and/or Internal Revenue Service and submit a federal tax ruling request if necessary to confirm the federal tax consequences of the AGSOC proposed legislation.

Our second contract is with Louis Kelso, who will provide the following services:

1. Development of potential investment opportunities for AGSOC. Analyze the Alaska economy and its total range of potential investment opportunities and evaluate those investment opportunities for their relative significance to the State's

economy against a criterion of maximum return to stockholders.

2. Analysis, cataloging and evaluation of financing sources. Correlate with each of the findings of Task I (Development of Potential Investment Opportunities for AGSOC) the potential financing sources and estimate the limits of funding available from each source, considering potentially available collateral or security and/or guarantee arrangement and estimate the effects upon interest costs.

We anticipate either extending one or both of these or contracting for further AGSOC research.

Please call if you have any questions or suggestions concerning this interim project.

Respectfully,

Jim Duncan

JD:jp

cc: J. Roderick Heller
Wilmer, Cutler & Pickering
1666 K Street, N.W.
Washington, D.C.

Rep. Terry ~~Miller~~ Gardiner

Rep. Russ Meekins

Rep. Mike Miller

WILMER, CUTLER & PICKERING
1666 K STREET, N.W.
WASHINGTON, D.C. 20006

November 2, 1978

MEMORANDUM

Summary of Recommendations Regarding
Federal Securities Regulation of
General Stock Ownership Corporations

A general stock ownership corporation ("GSOC") that is formed pursuant to the Revenue Act of 1978 potentially will be subject to at least three federal securities laws: (1) the Securities Act of 1933 (the "33 Act"), (2) the Securities Exchange Act of 1934 (the "34 Act") and the Investment Company Act of 1940 (the "40 Act"). The attached memorandum describes the operation of these provisions.

The 33 Act makes it unlawful to sell certain securities unless a registration statement for those securities has been filed with the Securities and Exchange Commission (the "SEC") and prohibits misleading information in registration or sale documents.

The 34 Act requires filing of a registration statement by companies whose securities are widely held, requires periodic reporting to the SEC of financial and other information, and sets forth rules governing the solicitation of proxies allowing one to vote shares of

other investors at an annual meeting or to effect other corporate action requiring a shareholder vote.

The 40 Act requires the registration of companies which primarily invest in the securities of other companies, regulates certain conduct of such companies, and sets disclosure standards for them.

Because of the unique nature of the GSOC, we believe that a special application of the federal securities laws may be warranted.

We propose that representatives of the State, on behalf of a proposed Alaskan GSOC, promptly formulate for presentation to the SEC a program of related applications for administrative exemption from the various federal securities laws, conditioned on the undertaking that a GSOC would comply with disclosure and proxy rules specially tailored to circumstances in Alaska and to the unique nature of a GSOC. In particular, we recommend that the GSOC:

(1) Apply for a "no action" letter from the SEC that the 33 Act does not apply to a GSOC on the alternative grounds that the initial offer and sale of GSOC shares (a) will not be "for value" or (b) will qualify for the intrastate exemption;

(2) Seek a conditional and temporary exemption from the 34 Act and 40 Act patterned after the Alaska Native Claims Settlement Act. Under this proposal a GSOC would be required to provide an annual report to shareholders containing substantially all the information required in annual reports under the 34 Act, but no other information. The annual report required by the Revenue Act of 1978 to be submitted to the Treasury Department might be used for this purpose. The exemption period proposed would correspond with the five-year period when shares of a GSOC are generally nontransferable.

(3) Utilize the five-year exemption period to continue discussions with the SEC concerning the extent to which the unique character of the GSOC warrants special treatment under or exemption from other provisions of the federal securities laws. For example, since the shareholders of the GSOC will be state voters, it may be desirable to explore utilizing the state's ballot process as a proxy machinery. Other problems may require innovative techniques in this case of a corporation owned by a large number of investors who in many cases may be less sophisticated than the usual investor for whom existing proxy and disclosure rules were designed.

We believe that the SEC staff would be receptive to preliminary discussions of the problems raised in this memorandum and that those discussions should be initiated.

WILMER, CUTLER & PICKERING

WILMER, CUTLER & PICKERING
1666 K STREET, N.W.
WASHINGTON, D.C. 20006

November 2, 1978

MEMORANDUM FOR THE
COMMISSIONER OF REVENUE
STATE OF ALASKA

Application of Federal Securities
Laws to General Stock Ownership
Corporations

You have asked our advice with respect to the application of the federal securities laws to the organization and operation of a general stock ownership corporation ("GSOC").

Introduction -- the Nature of a GSOC.

A GSOC is defined in section 601 of the Revenue Act of 1978 (the "Act"). Under the Act, a state is authorized to charter a private corporation whose shares will be owned entirely by individuals who are residents of the state. Although the legislation does not specify whether the shares will be distributed with or without charge, its primary sponsor (Senator Gravel) has stated his intention that the shares will be issued without charge.*/

*/ 124 Cong. Rec. S19,168 (daily ed. Oct. 14, 1978).

It is contemplated that a GSOC will acquire an interest in one or more business enterprises with borrowed funds, perhaps aided by state grants or guarantees. The cash flow from the acquired business interests will be used to repay loans and pay dividends to the residents of the state who are its shareholders.

Under the Act, the GSOC will not be subject to corporate tax; instead the shareholders will be taxed currently on their pro rata share of the corporation's taxable income whether or not distributed. A GSOC will be required to distribute 90 percent of its taxable income each year to its shareholders.

The GSOC legislation was structured with a minimum of federal restrictions in order to provide states with maximum flexibility to organize a GSOC on their own terms. However, the corporate charter must provide that: (1) only one class of stock may be issued; (2) each resident will receive at least one share of the GSOC (unless a resident elects within one year not to receive his share); (3) shares may be owned only by individuals as opposed to legal entities; (4) shares may not be transferred for a five-year period, other than by will or by the laws of descent, except where the shareholder ceases to be a resident of the state; (5) shares may not be transferred to non-

residents; and (6) ownership is limited to ten shares. In addition, a GSOC may not hold a 20 percent or more interest in any subsidiary, may not acquire its business properties from an unwilling seller through the use of the state's power of eminent domain and is required to file an annual report with the Secretary of the Treasury summarizing its operations for the year.

The precise mechanisms by which ownership will be restricted to residents of the chartering state and details of distribution, redemption and trade in shares of the GSOCs will be determined by a state's enabling legislation. Principles of federal constitutional law which may be relevant to choices among the various alternatives will be examined in a separate memorandum. This memorandum addresses the applicability of the federal securities laws to a GSOC and reviews legislative and administrative alternatives by which federal regulation may be avoided or minimized.

Application of the Federal Securities Laws.

There are eight federal statutes which comprise the "federal securities laws."*/ In a variety of ways, each of these statutes appears designed to protect the investing public by regulating the activities of companies that raise capital by sale of their shares to the public, by monitoring the practices of persons in the business of trading in such "securities" or the business of managing the investments of others, and by ensuring public disclosure of accurate and relevant information. At least three of the eight statutes which are administered by the Securities and Exchange Commission (the "SEC" or the "Commission") may apply to a GSOC.**/

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*/ These are the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Investor Protection Act of 1970, and certain aspects of the National Bankruptcy Act.

/ The Trust Indenture Act, regulating trust indentures covering particular types of debt securities, the Securities Investor Protection Act, providing certain protection for customers of brokers and dealers in securities who are forced to liquidate, and certain SEC responsibilities with respect to reorganizations under Chapter X of the Bankruptcy Act have no foreseeable application to the GSOCs. As will be explained infra at 17 n., the Investment Advisers Act and the Public Utility Holding Company Act may become relevant depending on the nature of GSOC operations, and should be explored at the appropriate time.

a) Securities Act of 1933.

i) The statute and its application.

The Securities Act of 1933 (the "33 Act") requires the disclosure of material information concerning companies when securities are sold to the public. The primary disclosure device is the Act's requirement that a company or other seller of securities file a detailed registration statement with the SEC and deliver the prospectus contained therein to prospective investors, in connection with the offer or sale of the securities to them. Registration statements are scrutinized by the SEC staff and must be declared "effective" by the SEC before sales of the securities registered may be made. Misleading or incomplete information in such materials or other selling communications is made unlawful by the antifraud provisions of the 1933 legislation and its implementing rules.*/

There are two reasons why the registration requirement of the 33 Act likely may not apply to a GSOC:

(i) No-sale theory.

The 33 Act's registration requirement is keyed to the sale (or offer for sale) of securities by

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*/ In addition, the 33 Act gives a person acquiring a security covered by a misleading registration statement or oral communication a civil cause of action against the directors of the company and others involved in preparation of the statement or communication.

any issuer. A "sale" is defined as "every . . . disposition of a security . . . for value."*/ If a GSOC issues its shares without charge, it would not appear to be selling (or offering for sale) shares "for value".**/ A no-action letter issued by the SEC in the case of corporations created under the Alaska Native Claims Settlement Act confirms our view.***/ See The Native Alaska Federation of Natives, Inc. (Jan. 28, 1974).****/

(ii) Intrastate offering exemption.

Even if a GSOC were to establish a subscription price for its shares, the GSOC may avoid the

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*/ 1933 Act, §§ 2(3), 4(1), and 5(a) and (c).

**/ It is possible, however, that the SEC could take the position that "value" inures to a GSOC from the ultimate creation of a trading market in GSOC shares. Cf. SEC v. Harwyn Indus. Corp., 326 F. Supp. 943 (S.D.N.Y. 1971).

***/ A no-action letter, although informative, is not an official interpretation by the SEC. It is nothing more than a representation of the SEC staff that, based upon the particular facts involved, they will not recommend to the Commission that it take enforcement action against the party seeking the advice. Thus, while we here and elsewhere discuss no-action letters, we are not talking about formal action by the Commission.

****/ A discussion of the legislative approach to securities laws problems in the Alaska Native Claims legislation is included at pp. 23-26.

registration requirement of the 33 Act if any of the several statutory exemptions from those requirements is applicable.*/ It is quite possible that the distribution of shares in the GSOC can qualify for the "intrastate offering" exemption provided in section 3a(11) of the 33 Act for:

> "any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a . . . corporation, incorporated by and doing business within, such State or Territory."***/

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*/ Although certain classes of securities and certain classes of transactions are exempt from the registration and prospectus delivery requirements of the 33 Act, they remain subject to the antifraud provisions of the 33 Act, including specifically §§ 12 and 17. The exemptions from registration set forth in §§ 3 and 4 of the 33 Act do not relieve an issuer of the registration requirements of the Securities Exchange Act of 1934 (the "34 Act") nor of the duty to comply with the antifraud provisions of that Act. United States v. Tallant, 547 F.2d 1291, 1297 (5th Cir.), cert. denied, 434 U.S. 889 (1977).

**/ 33 Act, § 3(a)(11). Another exemption is set out in § 3(a)(2) of the 33 Act, which exempts "any security issued . . . by any public instrumentality of one or more States or Territories . . . ." This "public instrumentality" exemption would not appear applicable since § 601 of the Revenue Act of 1978 provides that, for purposes of the Internal Revenue Code, "a GSOC shall be treated as a private corporation and not as a governmental unit."

***/ The exemption does not derive from any jurisdictional limit on the SEC's powers, since the federal laws can apply to any transaction using any facility of interstate commerce.

This exemption has become the subject of rule 147, which in an effort to define a "safe harbour" for those seeking the benefit of 3(a)(11) explains the particular elements which make up the exemption.*/ The section and the rule contain nothing to suggest that either is inapplicable to a GSOC, the shares in which can be owned only by residents of the chartering state, and which is unlikely to do business outside the state in question. Accordingly, if the strictures of the section and rule are observed, the securities of a GSOC can be issued without compliance with the registration and prospectus provisions of the 33 Act.

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*/ The SEC's rule (17 C.F.R. § 230.147) provides that an issuer shall be deemed to be doing business within a state if its principal office is there and if it derives more than 80% of its gross revenues from the state, has 80% of its assets there, and intends to use 80% of the proceeds from the issue there. In addition, the rule restricts resale to purchasers who are residents of the state for 9 months after the last sale by the issuer; the GSOC restriction is more severe, never allowing sale to nonresidents. A GSOC might, theoretically, hold more than 20% of its assets outside the state, if it invested in an external project, but this seems unlikely as a practical matter.

ii) Possibilities for legislative exemption.

GSOC sponsors also could seek special legislation to exempt */ shares in a GSOC from the 33 Act by a provision such as that contained in the Alaska Native Claims Settlement Act, 43 U.S.C. § 1625, discussed infra at pp. 23-26. **/ Since the central purpose of the 33 Act

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*/ A blanket legislative exemption -- unlike the exemptions in § 3 of the Act -- might also provide relief from the federal antifraud provisions of the 33 Act. Most states, however, have antifraud regulations which would apply to a GSOC. See, e.g., § 45.55.010 of the Alaska Blue Sky law.

**/ See also the Asian Development Bank Act, which provides that "[a]ny securities issued by the Bank . . . shall be deemed to be exempted securities within the meaning of subsection (a)(2) . . ." of section 3 of the 33 Act. 22 U.S.C. § 285h(a).

As an alternative to a complete legislative exemption, the SEC could be given special rulemaking power to tailor reporting requirements to the unique situation of a GSOC. For example, the Asian Development Bank Act provides:

> "The Bank shall file with the Securities and Exchange Commission such annual and other reports with regard to such securities as the Commission shall determine to be appropriate in view of the special character of the Bank and its operations and necessary in the public interest or for the protection of investors." 22 U. S.C. § 285h(a).

The SEC is given authority in 22 U.S.C. § 285h(b) to suspend operation of the filing requirement. The SEC's regulations with respect to filings by the Asian Development Bank are found at [1978] 1 Fed. Sec. L. Rep. (CCH) ¶ 2025.

is to provide information so that an investor can make an informed decision whether to invest in securities being distributed by an issuer, a statutory exemption from the registration requirements of the 33 Act does not seem unreasonable, especially if the initial distribution of GSOC shares is free. An argument along these lines is even more persuasive if disclosure comparable to that required by the 34 Act, discussed below, is provided to the public once the opportunity to buy and sell GSOC shares shares arises at the end of five years.

b) Securities Exchange Act of 1934.

i) The statute and its application.

Among other things, the Securities Exchange Act of 1934 (the "34 Act"), extends the disclosure obligations of the 33 Act to the trading of securities after their initial distribution. The 34 Act requirements can apply whether the securities are (a) listed and traded on a national exchange or (b) unlisted and sold in the so-called "over-the-counter" market. The criteria which require filing include either (a) a prior 33 Act registration (§ 15(d)) or (b) 500 shareholders and $1 million in assets (§ 12(g)). For securities to which it

applies, the 34 Act requires the filing with the SEC of information on certain registration forms; the information is comparable to that required by the 33 Act. After an initial filing, the 34 Act requires periodic "updating" reports to the SEC of financial and other information. In addition, issuers whose securities are required to be registered under the 34 Act may not solicit proxies (allowing management or anyone else to vote shares of investors at an annual meeting or to effect any corporate action which under state law must be accomplished by shareholder vote) unless they do so in compliance with the proxy rules of the Commission. Beyond stipulating the form and content of the proxy solicitation material, the proxy rules also allow any shareholder to submit proposals for corporate action for shareholder vote. The 34 Act also provides for the registration and regulation of the national securities exchanges and of brokers, dealers and transfer agents involved in the trading of non-exempt securities. Like the 33 Act, the 34 Act proscribes fraudulent or misleading practices in the purchase or sale of securities.

Although there are provisions in the Act for exemption, we do not believe exemption from the above-described 34 Act provisions can be assured without administrative or legislative action.

ii) Possibilities for exemption -- administrative.

No express statutory exemption in the 34 Act appears applicable to GSOC securities.*/ However, the SEC has authority under two separate sections to provide an exemption by administrative action.

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*/ Section 3(a)(12) exempts "municipal securities" from all provisions of the 34 Act except those dealing with registration and regulation of brokers and dealers, registration of securities associations, and regulation of associations of brokers and dealers and clearing agencies. However, the definition of "municipal securities" in section 3(a)(29) of the 34 Act appears to apply only to debt securities and therefore not to shares of a GSOC, as it is limited to "direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State . . . ." The legislative history confirms that state and municipal bonds were the focus of the section. See, e.g., Hearings before the Senate Banking and Currency Comm. on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 (73d Cong.), 73d Cong., 1st Sess. 7543-44 (March 27, 1934). A proposal to substitute "any security issued" for "any direct obligation guaranteed" was rejected. See Hearings before the House Interstate and Foreign Commerce Comm. on H.R. 7852 and H.R. 8720, 73d Cong., 2d Sess. 535 (March 6, 1934). Moreover, it is doubtful whether GSOC shares would be considered as "municipal" since section 601 of the Revenue Act of 1978 provides that a GSOC is a private corporation and not a governmental unit for purposes of the tax laws.

Section 12(h) of the 34 Act provides, in relevant part:

> "The Commission may by rules and regulations, or upon application of an interested person, by order, after notice and opportunity for hearing, exempt in whole or in part any issuer or class of issuers from [the registration, reporting and proxy provisions of the 34 Act] . . . any security of which is required to be registered . . . upon such terms and conditions and for such period as it deems necessary or appropriate, if the Commission finds, by reason of the number of public investors, amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer, or otherwise, that such action is not inconsistent with the public interest or the protection of investors."

The SEC also has authority under sections 3(a)(12) and 23(a) of the 34 Act to declare the securities of a GSOC "exempted securities." Section 3(a)(12) provides that "exempted securities" includes:

> "Such other securities (which may include, among others, unregistered securities, the market in which is predominantly intrastate) as the Commission may, by such rules and regulations as it deems consistent with the public interest and the protection of investors, either unconditionally or upon specified terms and conditions or for stated periods, exempt from the operation of any one or more provisions of this title which by their terms do not apply to an 'exempted security' or to 'exempted securities.'"

Since the anticipated market for the securities of a GSOC will be totally intrastate, the SEC might be convinced to issue some type of conditional or unconditional exemption.*/

iii) Trading Alternatives.

Section 12(g) of the 34 Act will prohibit brokers, dealers and transfer agents from processing trades of GSOC shares in the over-the-counter market unless the securities are registered with the Commission if the securities are not exempted. The traditional mechanisms for creation of a trading market in GSOC shares (the matching of sellers and buyers) thus will not be possible unless exemption from the 34 Act is attained. However, a rule proposed by the SEC provides that persons associated with any issuer of securities shall be deemed not to be brokers solely for performing "the ministerial and clerical work of effecting any transaction" if other tests of the rule are met.**/ Hence, it may be possible even lacking total 34 Act exemption to obtain clearance from the SEC that transfers between sellers and the GSOC and buyers and the GSOC

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*/ Cf. rule 3(a)12-2, 17 C.F.R. § 240.3a12-2, an exemption granted for securities guaranteed and managed by a state or political subdivision.

**/ Proposed rule 3a4-1, as proposed in Release No. 34-13195 (January 21, 1977), [1978] 2 Fed. Sec. L. Rep. (CCH) ¶ 21,152.

priced at a pro rata share of the GSOC's current asset value be facilitated by employees of the GSOC -- as long as those employees do not pursue the matching of buyers and sellers and thereby "make" a market.

iv) Possibilities of exemption -- legislative.

Because any administrative exemption from the 34 Act is within the discretion of the SEC, a legislative exemption may be necessary. There are at least two models for such an exemption. The Alaska Native Claims Settlement Act provides for total exemption from the 34 Act during the period that shares cannot be traded, but also accomplishes in large measure the disclosure function of the 34 Act by requiring that the Corporations send an annual report to shareholders. 43 U.S.C. § 1625.*/ The Asian Development Bank Act "deemed" the securities of the Bank to be exempt within the meaning of section 3(a)(12) of the 34 Act, but also provided for periodic filings with the Commission. 22 U.S.C. § 285h(a).**/

*/ As discussed infra, the exemptions in the Alaska Native Claims Settlement Act only apply until a trading market in the shares commences. Hence, a proposal that the GSOCs be exempt from the 34 Act for the first five years of operation will more likely succeed than a proposal of a permanent exemption.

**/ Similar treatment is given securities of the World Bank. [1978] 2 Fed. Sec. L. Rep. (CCH) ¶ 21,200.

c) <u>Investment Company Act of 1940</u>

i) <u>The statute and its application</u>.

The Investment Company Act of 1940 (the "40 Act") requires the registration of certain companies whose business is principally or entirely investing in the securities of other companies. It also sets forth fiduciary standards for their officers and directors, requires approval by the SEC of certain transactions involving insiders and affiliates of registered companies, provides for shareholder approval of various activities, and otherwise subjects the companies to financial and other disclosure requirements.

A GSOC appears to come within the definition of "investment company" in section 3(a) of the 40 Act, since each GSOC will be a company which "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities"*/ or "is engaged or proposes to engage in the

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*/ The 40 Act's definition of "security" is the broad definition common to the federal securities laws. There may be room to argue that a GSOC's participation in joint ventures is outside the scope of this definition, although the definition specifically includes any "certificate of interest or participation in any profit-sharing agreement . . . or . . . investment contract." Section 2(a)(36).

business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities*/ having a value exceeding 40 per centum of the value of such issuer's total assets . . . ." 40 Act §§ 3(a)(1) and (3).**/ If a GSOC falls within the definition, it is subject to registration and regulation under the 40 Act.

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*/ "Investment securities" are all securities except government securities, securities of an employees' securities company, and securities of a majority-held subsidiary which is not an investment company. Section 3(a).

**/ A GSOC appears to be a closed-end, non-diversified management company under the definitions of sections 4 and 5 of the 40 Act, assuming that shares in a GSOC cannot be redeemed by a resident in exchange for "approximately his proportionate share of the issuer's currrent net assets" so as to create a "redeemable security" within the meaning of § 2(a)(32) of the 40 Act, and that the GSOC will not invest in a great number of projects nor hold less than a 10% interest in the projects in which it invests.

Any non-management person who for compensation advises the GSOC as to investment decisions may be subject to the Investment Advisers Act unless he can meet the tests of section 203(b)(1) of that Act (1) by having all clients residents of the state where he maintains his principal place of business and (2) by furnishing no advice respecting securities traded on a national exchange.

In addition, if a GSOC comes to own or control 10% or more of the voting securities of an electric public-utility company or a gas utility company (or another holding company) it will become subject to registration and regulation under the Public Utility Holding Company Act of 1935, absent successful application to the SEC for an exemption. Under this Act the Commission can limit a GSOC to a single, integrated public-utility system and incidentally necessary

[Footnote continued on following page]

ii) <u>Possibilities for exemption -- administrative</u>.

The 40 Act does contain statutory exemptions. None of them appears to apply to a GSOC. However, the Act does provide that the SEC, on its motion or by application, may conditionally or unconditionally exempt in whole or in part any person, security, or transaction from any provision or regulation of the 40 Act "if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title." § 6(c).

In addition, section 6(d) provides that the Commission "by rules and regulations or order, shall exempt a closed-end investment company from any or all provisions of this title . . ." with or without conditions if certain tests are met. If a GSOC issues its securities without charge, it appears that a GSOC would meet all the tests for this exemption including that "the aggregate sums

[Footnote continued]

business enterprises. The SEC shall exempt a holding company if it and the companies it "holds" operate exclusively or even predominantly in the state of organization under § 3(a)(1) and 17 C.F.R. § 250.2, unless exemption is not in the public interest.

Because of the possible application of the Public Utility Holding Company Act to potential investments of a GSOC, a legislative or administrative exemption from that Act also should be considered.

received by such company from the sale of all its outstanding securities, plus the aggregate offering price of all securities of which such company is the issuer and which it proposes to offer for sale, do not exceed $100,000." Our review of exemptions issued under § 6(d) indicates that it is probable that if such an exemption were granted, the GSOCs would be freed from many requirements of the Act. For example, the GSOC would not be required to follow the usual registration process; instead, it would be required to file with the SEC a statement of its investment policies. Instead of the usual periodic reporting requirements, a GSOC would be required to file semi-annual reports with its shareholders and the SEC.*/

iii) Possibilities for exemption -- legislative

Because of the uncertainty of obtaining an unconditional administrative exemption from the 40 Act, consideration should be given to seeking legislation including a GSOC in the list of companies that statutorily are exempt under section 3(c) of the 40 Act.

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*/ See, e.g., Associated Life Ins. Investors Corp., SEC Investment Company Act Rel. No. 4574 (April 22, 1966); United Life Ins. Sec. Corp., SEC Investment Company Act Rel. No. 4193 (March 17, 1965); I.B.T., Inc., SEC Investment Company Act Rel. No. 3369 (November 28, 1961).

Our Recommendations

a) Questions of Policy.

Opportunities exist to seek administrative or legislative exemption for the GSOCs from SEC regulation. However, the substance of certain federal regulatory provisions governing traditional securities may be desirable in order to promote informed public participation in this new type of private enterprise. A decision should be made at an early stage as to what, if any, federal involvement in GSOC regulation is desirable to further the purposes for which GSOCs were created.

Two goals of the federal securities laws highly relevant to the purposes of the GSOC legislation are:

(1) initial and periodic disclosure of accurate and timely financial and other information to aid the public in making investment decisions and to allow for review of the actions of management; and

(2) a mechanism by which residents can be protected in the exercise of the power given them by state law to participate in control of the investment entity.

The disclosure function is promoted by each of the laws discussed above, but blanket application of these laws to the GSOC may be unduly expensive, burdensome and, in some instances, unnecessary. For example, since the 33 Act is designed primarily to ensure disclosure sufficient to enable an investor to decide whether to invest his funds in the securities of an issuer, the test of disclosure required under the 33 Act and its regulations seems largely irrelevant to the initial distribution of GSOC shares, especially if they are issued without charge. Thus, the disclosure and anti-self-dealing provisions of the 40 Act may be more germane to the GSOCs from their inception. The 34 Act, on the other hand, provides for disclosures to enable an investor to decide whether to buy or sell shares other than in an initial distribution. Since shares may not be transferred for five years (unless a shareholder ceases to be a resident), there should not be any substantial market for GSOC shares during the initial five-year period. Upon expiration of the five-year period, however, disclosure of the kind provided by the 34 Act will become relevant. In spite of the possibilities for exemption, we believe that efforts should be made to disseminate complete and accurate information about a GSOC, its officers and directors, since

dealers in its shares as well as underwriters in its shares remain subject to enforcement action by the SEC, state authorities, and conceivably the Department of Justice, and to civil suit by injured investors if it is determined that fraud was involved in connection with the offer or sale of GSOC shares. It must be recognized that the notion of "fraud" under the securities laws is a very broad concept, and includes not only the dissemination of inaccurate information, but also the failure to disseminate material information necessary in order to make statements not misleading in the context in which they are made. Some courts have found fraud in corporate contexts in which incomplete or misleading disclosures may have arisen through inadvertence, rather than through conscious choice of the persons involved. We believe that disclosure rules specially tailored to the unique nature of the GSOCs could be fashioned to promote these desirable ends at a reasonable cost.

The 34 Act also provides the mechanisms for investor participation in management decisions pursuant to its regulation of solicitation of the votes -- or proxies -- of shareholders. The sponsors should decide how they desire the resident shareholders to exercise the traditional voting powers within the corporation which are given them by operation of state corporate law,

and whether regulation of that method comparable to that provided by the 34 Act and 40 Act is desirable. We believe that protection of shareholder voting rights at a reasonable expense could be accomplished, perhaps through use of the state's ballot process. If the GSOC sponsors agree with the view that reasonable and carefully-tailored regulations designed to promote the ends of disclosure and suffrage should be made a part of the GSOC package, the question remains how to accomplish this end.

b) The Alternative of Legislative Relief.

The Alaska Native Claims Settlement Act, as amended, 43 U.S.C. § 1601 et seq. (the "Settlement Act"), provides an instructive example of a congressional compromise of a range of available options in regulating a unique corporate entity not unlike the GSOC. Under that Act, Congress disbursed federal funds to native peoples of Alaska in settlement of outstanding aboriginal land claims, and authorized the creation under Alaska law of a number of Regional Corporations to administer the funds and oversee land investment on behalf of native residents.

The original legislation, passed in 1971, did not address the question of the applicability of the federal securities laws and regulations to the Regional Corporations, but provided for an annual independent audit of each corporation, the results of which were to be transmitted to each shareholder, to the Secretary of the Interior and to appropriate committees of Congress.*/ As a result, the various Corporations were forced to seek individual administrative relief from the SEC.

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*/ This audit requirement remains in the law as amended. 43 U.S.C. § 1606(o).

An earlier draft of the legislation had, in lieu of the Regional Corporations, provided for two federally chartered corporations, one of which was to handle investments and business functions (the "Investment Corporation"). See Alaska Native Claims Settlement Act, Conference Report, S. Rep. 92-581, 92d Cong., 1st Sess. 41-42 (1971). The Senate bill had provided that those sections of the 40 Act, the Investment Advisers Act, the 33 Act and the 34 Act "relating to public disclosure, reporting, and protection of the interests of stockholders" and "consistent with the purposes of this Act . . ." should be applicable to the activities of the Investment Corporation for 12 years from the date of the Act. However, the Investment Corporation was to be granted statutory authority to apply to the SEC under § 6(c) of the 40 Act for exemption from any provisions of that Act resulting in hardship. In addition, the SEC was to be given explicit rulemaking authority to identify which provisions of any securities laws "consistent with the purposes and provisions of the legislation" would be applied to the Investment Corporation. In addition, the directors were required to prepare an annual report to the SEC including the information required under the ICA and "such additional information" as the SEC would require. Such reports were to be available at the offices of the Corporation, and a summary was to be sent to all shareholders. S. Rep. No. 92-405, 92d Cong., 1st Sess. 20-21, 131 (1971).

In 1975, the Settlement Act was amended to provide for total exemption of the Regional Corporations from operation of the 33 Act, 34 Act and 40 Act for the years during which shares in the Regional Corporations could not be transferred except by divorce, separation or death. 43 U.S.C. § 1625 provides:

> "Any corporation organized pursuant to this chapter shall be exempt from the provisions of the Investment Company Act of 1940 (54 Stat. 789), the Securities Act of 1933 (48 Stat. 74), and the Securities Exchange Act of 1934 (48 Stat. 881), as amended, through December 31, 1991. Nothing in this section, however, shall be construed to mean that any such corporation shall or shall not, after such date, be sub- [illegible] to the provisions of such Acts. Any such corporation which, but for this section, would be subject to the provisions of the Securities Exchange Act of 1934 shall transmit to its stockholders each year a report containing substantially all the information required to be included in an annual report to stockholders by a corporation which is subject to the provisions of such Act."

It should be noted that the SEC argued that 40 Act regulation was necessary for the protection of investors and that the Congress nonetheless decided that the Act as well as 33 Act and 34 Act regulation was unnecessarily burdensome and expensive. One reason Congress noted for its decision was that the lack of sophistication of most native residents of Alaska made the elaborate prospectus as required by SEC rules less likely to be useful than the SEC suggested.

Congress also was moved by the assurance that no trading in the shares would occur. It thus decided that application of the 34 Act was unnecessary while the stock could not be transferred. For the first five years, the GSOCs shares will be similarly restricted. However, in the interest of disclosure to the public of relevant information about the Corporations, Congress required an annual report to share-holders -- but not to the SEC -- containing substantially all information required under the annual reports under the 34 Act.*/

Based on the precedent of the Settlement Act, a legislative proposal could be fashioned. However, any legislative proposal might be subject to political oppo-sition as special legislation for the State of Alaska, would have no guarantee of passage and, indeed, might prove unnecessary if an administrative solution can be forged with the SEC.

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*/ H. Rep. No. 94-729, 94th Cong., 1st Sess. at 17-20 (1975).

c) The Alternative of Administrative Relief.

We propose that representatives of the State of Alaska, on behalf of a proposed GSOC, begin immediate exploration with the SEC of an administrative exemption from the various federal securities laws, conditioned on the undertaking that a GSOC would comply with disclosure and proxy rules specially tailored to circumstances in Alaska and to the unique nature of a GSOC. In particular, we recommend that the State:

(1) Apply for a "no action" letter from the SEC that the 33 Act does not apply to a GSOC on the alternative grounds that (a) the GSOC shares are not issued "for value" or (b) qualify for the intrastate exemption;

(2) Seek a conditional and temporary exemption from the 34 Act and 40 Act patterned after the Alaska Native Claims Settlement Act.*/ Under this proposal the only reporting requirement of the GSOC would be to provide an annual report to shareholders containing substantially all the information required in annual reports under the 34 Act. The annual report required by the Revenue Act of 1978 to be submitted to the Treasury

*/ It might also be wise to seek exemption from the Public Utility Holding Company Act when, if ever, it appears that the investments to be made will fall within the Act's coverage.

Department might be used for this purpose. The proposed exemption period would correspond with the period when shares of a GSOC are generally nontransferable.

(3) Utilize the five-year exemption period to engage in a continuing dialogue with the SEC to determine how the securities laws could usefully be applied to a GSOC after the organizational period. For example, it may be desirable to fashion special proxy rules (perhaps utilizing the state's ballot process) to deal with the unique situation of a corporation owned by a large number of investors who in many cases may be less sophisticated than the average investor for whom existing proxy rules were designed.

We believe that the SEC staff would be receptive to preliminary discussions of the problems raised in this memorandum and that those discussions should be initiated.

WILMER, CUTLER & PICKERING

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September 14, 1979

MEMORANDUM FOR THE LEGISLATIVE
BUDGET AND AUDIT COMMITTEE, STATE OF ALASKA

Subject: Proposed CSSS Senate Bill No. 170: Federal Tax and Securities Laws Issues and Suggested Approaches

You have asked us to review pending legislation[1/] permitting the establishment of an Alaskan General Stock Ownership Corporation ("AGSOC") in conformance with the recently enacted Subchapter U of the Internal Revenue Code.[2/] We have considered issues which may arise under the federal tax and securities laws in connection with this legislation, having previously, in our memorandum of November 2, 1978, for the Alaska Commissioner of Revenue, treated the securities law issues. This memorandum summarizes those issues, identifies optional approaches to resolution of certain problems, and identifies sections of S. 170 which you may wish to consider revising in order to facilitate regulatory approvals. We also propose an

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1/ CSSS Senate Bill No. 170, introduced as amended April 27, 1979. (Hereafter "S. 170").

2/ 26 U.S.C. §§ 1391-97, eff. November 6, 1978.

approach for our presentations to the Internal Revenue Service ("IRS"), and the Securities and Exchange Commission ("SEC") to facilitate the creation and operation of AGSOC in conformity with the federal regulatory provisions administered by those agencies.

I. SECURITIES REGULATION OF AGSOC

Our firm's Securities Law Memorandum of November 2, 1978, indicated that AGSOC will potentially be subject to provisions of three of the federal securities laws: the registration provisions of the Securities and Exchange Act of 1933 (the "1933 Act"); the registration, reporting, and proxy rules of the Securities Exchange Act of 1934 (the "1934 Act"), and the registration, conduct regulation and disclosure requirements of the Investment Company Act of 1940 (the "1940 Act").

S. 170 poses no securities regulation problems beyond those raised in our earlier memorandum.[3/] Because the statute is an adaptation of general corporation law,

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3/ However, we do recommend herein minor modifications to S. 170 to facilitate conformance with the intrastate exemption to the 1933 Act.

it does not deal with most of the subject areas which are likely to concern the SEC: particularly disclosure of risks to potential shareholders, periodic reports on financial condition, the administration of the "ballot" mechanisms, and fiduciary duties of officers and directors. Moreover, our initial approach to the SEC will be made at a time when the final form of the AGSOC has not yet been determined. For example, the question of the appropriate basis for exemption from the registration requirements of the 1933 Act must await a final decision as to whether payment of consideration will be required of Alaska citizens who wish to acquire AGSOC shares.[4/]

4/ We presume that an initial free issuance is preferred if we are able to obtain a ruling from the IRS that a tax will not be imposed upon citizens who receive shares. However, AGSOCA provides in Section 10.50.080 that

> "Shares may be issued without consideration or for consideration fixed by the shareholders before issuance. Consideration for shares shall be fixed by a vote of a majority of the shares voting on the issue."

This provision appears to suggest that AGSOC may charge consideration for shares only after the initial distribution as no shareholders will exist until then to fix the consideration. This point should be clarified if an initial charge for shares is contemplated. If you wish to leave the option open, Section 10.50.075 could be amended to read: "Shares may be issued without consideration or for consideration fixed by the Board of Directors before issuance."

We propose to present to the SEC a briefing memorandum describing the proposed AGSOC as set out in the S. 170 draft offered April 27, 1979, formally requesting a 1933 Act exemption, and requesting the commencement of negotiations to develop a modified form of 1934 Act regulation and a waiver of the 1940 Act's requirements during the first five years of AGSOC existence. We plan a preliminary presentation and discussions with the SEC prior to making detailed requests for rulings on the latter points so that we may involve them in establishing a creative approach to GSOC regulation. We hope to have received preliminary feedback from the SEC before S. 170 is passed in final form.

Provisions of the Securities Act of 1933

We believe, as we indicated in our Securities Memorandum, that AGSOC should not be subject to the registration requirements of the 1933 Act, either on the basis that an initial distribution of shares is not a "disposition . . . for value" within the meaning of Section 2(3) of the 1933 Act, or on the basis of the "intrastate exemption" provided by Section 3(a)(11) of

the same Act. We propose to argue both points to the SEC.[5/]

Even if the AGSOC shares are sold for consideration or if the SEC deems the disposition otherwise to be for value, we anticipate that we will be able to prevail on the theory that its shares are exempt from registration under the 1933 Act by virtue of the intrastate exemption in section 3(a)(11).[6/] The characteristics of offerings the SEC will deem as falling within

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5/ Of course, even if the initial distribution of shares is free of charge and thus falls within a "not for value" exemption to the Securities Act of 1933, any additional issuances which are for value would fall within the registration requirement unless they are otherwise exempt. This would include exchanges of shares for property or services as provided for in S. 170 § 10.50.085.

6/ This section exempts from registration:

> "Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory."

Section 3(a)(11) are described in non-exclusive Rule 147 (17 C.F.R. § 230.147).[7/] The rule requires that both the purchasers of the securities and the issuer have certain characteristics to ensure that both are truly residents of the state and that sales and resales are restricted to state residents. We believe that several minor changes in S. 170 are advisable in that they will bring the AGSOC within Rule 147 and thus simplify our task if the intrastate exemption need be relied on (either for the initial or any later issues).

AGSOC will be an Alaska corporation as required by Rule 147. Its principal place of business will probably be located in Alaska (Rule 147(c)(1)(i) and (2)(iv)), although the latter is not required by S. 170.[8/] We suggest that the legislature consider

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7/ Issuers may avail themselves of the intrastate exemption even if they do not satisfy all the provisions of this rule. 17 C.F.R. § 230.147 (Preliminary Notes, p. 1). If an issue satisfies all of Rule 147's provisions, however, the intrastate exemption will apply.

8/ S. 170 § 10.50.050 requires only that the corporation maintain a "registered office" within the state.

requiring AGSOC to have its principal place of business in Alaska as this would clarify this aspect of compliance with Rule 147.

Rule 147 restrictions on sales and resales to state residents are clearly satisfied by AGSOC.[9/] The basic purpose of Rule 147's limitations on resale is to ensure that securities do not enter the interstate marketplace. It does not appear that the fact that a few shares pass by descent after five years to out-of-state holders or that former residents may retain their AGSOC shares if they leave the state after five years is so inconsistent with those principles as to upset application of the exemption.

Rule 147 also requires that the issuer's business be conducted predominantly within the state in which the securities are distributed.[10/] The gross revenues and

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9/ Subchapter U and S. 170 provide that shares may only be transferred voluntarily or involuntarily to persons who are residents of the state. 26 U.S.C. § 1391(4)(D)(ii); S. 170 §§ 10.50.320(a)(6) & 8(B). The general prohibition against transfers except by descent for five years also helps to meet the Rule 147 requirement that resales in a nine-month period after the initial distribution be restricted to state residents. S. 170 also provides that if the shareholder leaves the state or shares pass by operation of law to a non-resident, the corporation shall repurchase them at book value. S.170, Section 4(c).

10/ The issuer must derive at least 80 percent of its gross revenues from within the State and have at least
[Footnote continued on following page]

asset provisions of the rule will only be applicable to the initial GSOC distribution if AGSOC becomes operational before its shares are distributed.[11/]
The use of proceeds provision will only apply if AGSOC charges for the shares, and it may be satisfied easily by segregating issue proceeds to ensure that they are spent within Alaska. If AGSOC is to acquire an asset prior to share distribution we must know what the asset is to formulate arguments that the asset and its income are "within" the State within the meaning of Rule 147 and section 3(a)(11). AGSOC will presumably be acquiring a minority participation in a joint venture as an asset. If majority control of that venture is in the hands of non-Alaskans, it is arguably not an Alaska asset. Also, income may or may not be deemed derived from within the state -- <u>e.g.</u>, sales of oil to out-of-state corporations may be deemed non-Alaska income. Even if the initial

[Footnote continued]

80 percent of its assets within the State. Rule 147 (c)(2)(i) and (ii). It must also intend to use 30 percent of the net proceeds from sales of the issues in question within the State.

11/ Rule 147 provides that if gross revenues for the most recent twelve-month period are less than $5,000, the proceeds provision is not applicable.

distribution is of shares in a shell company, it will be necessary to examine whether AGSOC revenues can be deemed to arise from the "operation of a business or of real property within the state," with regard to subsequent issues of shares. The legislature may wish to consider so restricting the corporation in its enabling legislation.

S. 170 does not now specifically provide for procedures required by Rule 147 to ensure that the reality comports with the intent of the issuer.[12/] We recommend that the legislature amend S. 170 to provide for adequate legends on share certificates;[13/] and that

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12/ A legend on the share certificates must identify the limitations on resale and warn of the lack of registration, stop transfer instructions must be given to the transfer agent, and purchasers must be required to make written representations as to their residence. Rule 147 (b)(1). The issuer must also restrict sales of shares which are part of the same issue and make appropriate disclosures. *Id.* § (f)(2) and (3). S. 170 does require that eligible individuals apply for shares and that their interest will become void if it is determined that they misrepresented their eligibility. § 10.50.345-360. The SEC may wish to make rules in this regard or examine AGSOC procedures for establishing residency prior to authorizing sale or distribution without registration.

13/ S. 170 § 10.50.105 provides for extremely limited information to be contained on the certificate. We recommend that the legislature amend this section to require disclosure on the certificate of all the restraints on transfer, including the fact that shares are not transferable to non-residents on the certificate.

the AGSOC provide for the application and stop transfer requirements in the articles of incorporation or the by-laws.

The Securities Exchange Act of 1934 and The Investment Company Act of 1940

As was indicated in our firm's Securities Memorandum, AGSOC does not fall within any statutory exemptions to either the 1934 or the 1940 Acts, and without special provision by the SEC, it will be required to register its securities, to file periodic reports, to comply with proxy rules, to comply with disclosure and trading rules under the 1934 Act and to file under and comply with the fiduciary standards of the 1940 Act.

The primary goals of the 1934 Act are to ensure that shareholders have adequate information concerning the financing and operations of registered companies to permit informed investment decisions, to ensure that shareholders have similar information when they are called upon to vote on corporate matters, and finally to ensure that sales and exchanges of shares occur in a free and open fair market exchange. The 1940 Act has similar goals although it additionally imposes certain fiduciary standards upon the management of investment companies because of the risks that it might usurp control of shareholder assets.

S. 170 permits the AGSOC to be run as a fairly conventional private corporation. It is primarily subject to control by the legislature in its initial stages[14/] and it is thereafter subject to governance by shareholders[15/] and the board of directors.[16/] It is unique in other respects: (1) its shareholders, constituting a cross-section of the state's citizens, will be in large measure unsophisticated in the exercise of shareholder rights and investment decisions;[17/] (2) shareholders will have little or no initial equity investment in AGSOC; (3) they will be subject to severe limitations on sales or transfers of their shares, particularly during the first five years

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14/ The legislature must amend the enabling legislation pursuant to § 10.50.640 to control it thereafter.

15/ A vote of shareholders is required to amend the articles of incorporation, § 10.50.375, and to approve certain asset sales.

16/ The directors may create and amend the bylaws, § 10.50.125, and have other standard management powers of corporate directors.

17/ Many shareholders will be minors or other legal incompetents.

after distribution;[18/] (4) ownership of shares will remain unconcentrated by statutory mandate; (5) bars to proxy

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18/ In conformance with Subchapter U, S. 170 provides many restrictions which will make it extremely difficult for a trading market in AGSOC shares to develop. For example, shares may not be transferred, voluntarily or involuntarily, within the first five years after issuance, and they may thereafter only be transferred to "resident individuals of the chartering State." It will not be possible for security brokers or dealers to make a market in AGSOC shares if this section is interpreted to mean such entities cannot hold AGSOC shares. Also, since no individual can own more than ten shares, it may not be feasible to create a trading market funded through transfer fees in a manner comparable to those which exist for other private corporate securities. The legislature should, as we previously recommended, give serious consideration to empowering AGSOC to be its own transfer agent or to the creation of a transfer mechanism for bringing together willing buyers and sellers.

Another potential problem is presented by the involuntary transferor. The AGSOC legislation provides at several points that redemption of shares shall be at book value. It is possible that there will be no or negative book value for the shares at stages during the operation of the corporation, when the carrying value of assets approximates the unamortized acquisition debt. This means that shareholders who leave the state or whose shares pass by operation of law to non-residents during the first five years after issuance may end up being forced to "sell" for far less than what would otherwise be market value. The legislature may wish to consider enabling AGSOC to pay a "fair market value" rather than book value to avoid unfairness.

usage[19] and cumulative voting[20] will limit shareholder power (while simultaneously barring usurpation of it by certain groups) and (6) AGSOC equity will be primarily supplied by loans from large financial institutions in reliance upon state guarantees. The existence of a diffuse, unsophisticated, and passive shareholder population together with a sophisticated and concerned set of creditors provides potential for abuses. S. 170 does not contain provisions which are adequate substitutes for most of the investor protections of the 1934 and 1940 Acts.[21]

19/ §§ 10.50.155 & 175.

20/ § 10.50.160.

21/ For example, because of the large shareholder population involved and the large sums of money which will be sought from financial institutions, this entity may have major impact upon financial markets. The SEC will probably be quite concerned about the contents of disclosures made to potential shareholders because of the lack of sophistication of this group of people compared with other investors in corporate securities. Particular care should be given to disclosure of the rights of minors and incompetents, who will probably compose a significant portion of shareholders. We propose to represent to the SEC that the notices to Alaska residents, the prospectus or other offering circulars, and other explanations of AGSOC made available to the public will contain full disclosure of the risks to shareholders.

In addition, S. 170 has no provision imposing fiduciary duties on officers or directors, other than requirements that loans not be made to officers or directors and

[Footnote continued on following page]

Our briefing memorandum prepared for the SEC will suggest that a modified form of 1934 Act regulation will be adequate to meet these problems during the five years after the initial distribution and that 1940 Act regulation would be unnecessarily burdensome. However, we anticipate that some modifications to S. 170 may be requested by the SEC during the course of these discussions because of the possibilities for abuse.

II. FEDERAL TAXATION OF AGSOC AND AGSOC SHAREHOLDERS

Subchapter U permits the creation of GSOCs by states and generally provides that a GSOC set up in conformance with its requirements will be exempt from federal taxation. 26 U.S.C. § 1392.[22/] Taxation of the income of such corporations occurs at the shareholder level. § 1393. Shareholders also receive investment

[Footnote continued]

that distributions not be made unless there are adequate resources in the corporation. § 10.50.230. It provides for no periodic reports but only that shareholders may receive the most recent financial statements of the corporation upon written request. § 10.50.285.

22/ See generally Joint Committee on Taxation, General Explanation of the Revenue Act of 1978 (H.R. 13511, 95th Cong.; P.L. 95-600)(Joint Committee Print, March 12, 1979, pp. 321-24).

tax credits which would otherwise accrue to the corporation. § 1393(b). The corporation, rather than its shareholders, utilizes net operating losses which it may incur, and these may be carried forward for a ten-year period. § 172(b)(1)(H). The GSOC is required by Subchapter U to distribute 90 percent of its annual taxable income to shareholders,[23/] (§ 1396), but to withhold 25 percent of such distributions for the IRS on behalf of shareholders. § 3402(r). A GSOC must file an informational tax return that identifies all shareholders and the distributions they have received. § 6039B.

Subchapter U permits a state to establish a GSOC between December 31, 1978 and January 1, 1984 by a charter enacted by the state legislature or a state-wide referendum. §§ 1391(a)(2) and (3). For the GSOC to qualify for the benefits of the Subchapter,

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23/ These distributions must be made by January 31 of the year following the taxable year in question. A GSOC must maintain a segregated shareholder income account for purposes of accounting for such distributions. § 1394. At certain points, S. 170 refers to "dividends" rather than distributions. See, e.g., §§ 10.50.115(b), 10.50.140(a) and (b), 10.50.350, and 10.50.360; cf. § 10.50.215. These provisions should be conformed to the Subchapter U language.

its charter must provide for the issuance of only one class of stock, for the issuance of the stock only to "eligible individuals,"[24/] for the issuance of at least one share of stock to each "eligible individual" unless such individual elects not to receive a share, and for certain restrictions on the transfer of shares. *Id*. § 1391(a)(4).[25/] GSOCs may not own more than 20 percent of another company, (§ 1391(a), 1504), and may not obtain investment properties through the exercise of the state's power of eminent domain. § 1391(a)(5).

S. 170 contains the obligatory provisions required by Subchapter U[26/] and generally appears to conform to the statutory standards. However, there are a few respects in which modifications to S. 170 may facilitate conformance of AGSOC with Subchapter U.

24/ Eligible individuals are defined as individuals who are residents of the chartering state during a period between "a date specified in the State's enabling legislation . . . and the date of issuance" of shares. § 1391(c).

25/ Shares may not be transferred for five years except by reason of death or if the shareholder ceases to reside in the state. Thereafter they may only be transferred to individual state residents who may not acquire more than 10 shares. *Id*. § 1391(a)(4)(D).

26/ *See* § 10.50.320(a), which requires AGSOC to set forth in its articles of incorporation Subchapter U's limitations on classes of shares, issuance, and restraints on alienation. S. 170 also requires that AGSOC must qualify under Subchapter U. § 10.50.320(9).

Taxation of Shareholders at the Time of Distribution

Section 102 of the Internal Revenue Code provides that "gross income does not include the value of property acquired by gift . . . ." A gift has been defined as a voluntary transfer of property by one to another without any consideration or compensation therefor. Gray v. Barton, 55 N.Y. 68. The recipients of the shares are not required to do anything in order to be entitled to participate in AGSOC. They need only be residents of Alaska which they already are and will be. It cannot reasonably be argued that the possibility of becoming a shareholder will induce anyone to move to, or remain in Alaska. The recipients only have to be in Alaska to share in the disinterested generosity on the part of the donor. See Commissioner of Internal Revenue v. Duberstein, 363 U.S. 278 (1960).

It must be recognized that the IRS may resist treating the share distribution as a gift. For example, there is precedent for treating amounts as income where the recipient has done little or nothing to acquire the property. See Rev. Rul. 53-61, 1953-1 C.B. 17, holding treasure trove to be income to the finder. See also Cesarini v. United States, 428 F.2d 812 (6th Cir. 1970),

where a taxpayer was required to include in income currency discovered in a used piano bought at auction. The IRS has also held that payments under the Soil Bank Act, 7 U.S.C. § 1801, for refraining from planting crops constitute income. Rev. Rul. 60-32, 1960 C.B. 23. These precedents, which involve some minimal taxpayer activity, or induced inactivity, may be distinguishable in the mind of IRS. They do indicate, however, that there may be some reluctance on the part of IRS to exclude amounts from income, for example, where there is a transfer of property outside the normal family situation.

An alternative argument should also be considered. The receipt of shares by Alaska residents is comparable to a non-taxable transfer payment by a government. Support for the transfer payment analogy is found in the legislative history of Subchapter U.[27/]

In general, the IRS has taken the position that transfer payments such as social welfare payments are not non-taxable, although no statutory authority for it to do so exists. United States v. Kaiser, 363 U.S. 299, 305-14 & App. (1960)(concurring opinion of Mr.

27/ Senator Gravel emphasized the hope that GSOC income could ultimately become a substitute for welfare.

Justice Frankfurter); see, e.g., I.T. 3230, 1938-2 C.B. 136 (unemployment benefits); I.T. 3447, 1941-1 C.B. 191 (social security payments); Rev. Rul. 57-102, 1957-1 C.B. 26 (aid to the blind); Rev. Rul. 72-340, 1972-2 C.B. 31 (job training); Rev. Rul. 36-395, 1976-2 C.B. 16 (home rehabilitation grants).

Rev. Rul. 76-131, 1976-1 C.B. 16, holding that benefit payments under the Alaska Longevity Bonus Act are taxable appears readily distinguishable. Those payments are available to all Alaskans "to provide an incentive to continue uninterrupted residence in the State and under no circumstances is to be considered a form . . . of public relief." The payments by Alaska under this Act must have been sufficient in amount to provide a realistic inducement for persons to remain in the State and are comparable to the Soil Bank Act payments in Rev. Rul. 60-92, supra.

It will, of course, be helpful to a favorable determination by IRS that the value of these shares of AGSOC will be readily perceived to be negligible, or possibly zero. The cost basis for gain on a future sale of the shares by the donee shareholder will be the same as the cost to the donor, i.e., negligible or possibly zero. 26 U.S.C. § 1015. Accordingly, the IRS may

recognize the administrative convenience of not taxing the initial distribution but instead deferring the tax until eventual sale when the entire proceeds will be subject to tax.

Finally, in the event that IRS is unwilling to rule favorably on the tax treatment of the initial stock distribution, consideration may be given to obtaining the opinion of two reputable appraisers, if it can reasonably be anticipated that a conclusion of zero value will be reached. In view of the apparent negligible revenue loss involved, if any, it would be highly unlikely that such appraisal would not be accepted as conclusive of the issue.

Tax Consequences After the Initial Distribution of Shares

Under federal law, AGSOC will become eligible for Subchapter U treatment once it qualifies and so elects. 26 U.S.C. 1392(a). It may revoke its election for a year or more with the consent of the Secretary of the Treasury. *Id.* § 1392(f). S. 170 provides that AGSOC shall be formed in conformance with Subchapter U, (§ 10.50.010), and that its Articles of Incorporation shall set out that it "must qualify" as a GSOC under Subchapter U. § 10.50.320(9). The Articles may be

amended in conformance with Section 10.50.365 et seq. but only if as amended the Articles "contain provisions which would be lawfully contained in original articles of incorporation at the time the amendment is made."

While the matter is not free from doubt, we believe the state legislation is thus more restrictive than Subchapter U,[28/] and requires AGSOC to maintain its election as a Subchapter U entity. We believe it would be preferable to permit a maximum flexibility by allowing the Articles to be amended to drop Subchapter U status under the usual procedure whereby the Board of Directors (or 1000 shareholders) proposes an amendment subject to shareholder approval. § 10.50.375. To accomplish this end, we believe § 10.50.320(9) should be modified[29/] and that the possibility of such a change should be added to the list in § 10.50.370.

28/ AGSOC may also lose its Subchapter U status under federal law by "ceasing to be" a GSOC, 26 U.S.C. § 1392(f), but it would appear that this can only occur by such affirmative actions as passing amendments which do not conform to § 1391(a)(4), acquiring assets through exercise of the power of eminent domain, or becoming a member of an affiliated group (i.e., obtaining a greater than 20% investment in another group).

29/ The phrase "unless any election to so qualify is terminated under section 1392(f) of such Subchapter" would be added to the section.

Tax consequences to individuals holding AGSOC shares are set forth in Subchapter U, and nothing in S. 170 raises questions in this regard. The Internal Revenue Code provides that the IRS may by rule provide for a certification procedure by which AGSOC could be exempt, as to non-taxpayers, from the requirement of section 3402(r) that the GSOC reserve 25 percent of distributions as withheld taxes on behalf of shareholders as if it were their employer. 26 U.S.C. 3402(r). We propose to explore the feasibility of establishing such a procedure with the IRS. While such a procedure is desirable from a social welfare perspective (permitting these individuals to receive full distribution value as soon as possible and removing the burden of filing a federal tax return), a technique will have to be established to minimize administrative burdens upon AGSOC which would have to determine and keep a record of which of its anticipated 400,000 shareholders were taxpayers in any given year.

Summary of Points
To Be Discussed with the IRS

We propose to present a brief memorandum describing AGSOC and S. 170 to officials of the IRS.

The focal point of our discussions will be the tax consequences of the initial distribution of shares. We propose to request a revenue ruling on this point on behalf of the citizen shareholders of the State of Alaska. Consideration should also be given to discussing the following matters with IRS:

(1) Confirmation of our understanding of how Subchapter U will work, including

(a) AGSOC obligations to the IRS;

(b) AGSOC shareholder obligations to the IRS;

(c) The general type of reports IRS will desire from GSOCs and the types of regulations contemplated to be issued for GSOCs.

(2) Confirmation that AGSOC as proposed in S. 170 will be viewed in conformance with Subchapter U, including

(a) That S. 170 is a sufficiently detailed "charter" within the meaning of 26 U.S.C. § 1391(a);30/

(b) That the definition of "eligible individuals" conforms to Subchapter U requirements;

30/ It could be argued that such a charter must contain details of AGSOC governance as currently planned for the Articles of Incorporation.

(c) That charging consideration for shares will not defeat Subchapter U status;

(d) That S. 170 provisions requiring eligible individuals to apply for shares are compatible with Subchapter U status;31/

(e) That secondary issuances of shares will not be considered different classes of stocks in conflict with 26 U.S.C. § 1391(a)(4)(A).

III. CONSTITUTIONAL ISSUES

For purposes of determining who is an "eligible individual, the drafters of S. 170 would begin the mandatory period of state residency on the effective date of the enabling legislation. § 10.50.320(6). Persons who are entitled to receive shares thus must remain residents of Alaska for the entire period from the effective date of S. 170 until the date of issuance of shares.32/ As now defined, the class of eligible individuals is permanently fixed and any later issuances of shares by AGSOC apparently

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31/ The federal legislation states that the GSOC shall provide for the "issuance of at least one share to each eligible individual," 26 U.S.C. § 1391(a)(4)(C). S. 170 makes clear that receipt of a share is dependent upon application by residents in response to state-wide notification procedures. § 10.50.345-360. We will attempt to clarify that the IRS does not deem GSOCs as under a duty to seek out and issue shares to all eligible individuals. Such a view could be fatal to AGSOC's tax-free status.

32/ These individuals are referred to herein as "charter residents."

may only be made to charter residents. We again call to your attention our reasons for questioning this approach, although it appears acceptable under Subchapter U.

First, this restriction of eligible individuals to members of a closed class of persons resident within the state at a fixed point in time may pose significant constitutional problems. See Wilmer, Cutler & Pickering, Memorandum for the Commissioner of Revenue, State of Alaska: Federal Constitutional Issues Presented by Alaska's GSOC (December 15, 1978).[33/] S. 170 exaggerates some of the problems we have previously raised because it also provides that within five years of issuance, shares must be sold back to the corporation if charter residents leave the state or die leaving their shares to nonresidents. This means that the pool of AGSOC shareholders will include only those charter residents who stay within the state for five years (and the small group who move into the state within this period and inherit shares from a charter resident). After five years, right to AGSOC shares seemingly vests in charter residents and their heirs may retain

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33/ (Hereinafter "Constitutional Memorandum"). As we indicated there, such limited eligibility for a government benefit must at least be based upon significant state interests as recited in legislative findings.

AGSOC shares even if they do not reside in Alaska. Establishing a fixed class which excludes Alaska citizens who are born in or move to Alaska after S. 170's effective date from AGSOC share issuances may then appear particularly inequitable in view of the fact that these non-Alaskan heirs will hold shares and receive AGSOC income. Even if later arriving residents may acquire shares from charter residents after the five-year period, there can be no assurance that a market in such shares will exist.

The possible constitutional problems are exacerbated by the fact the residency period to qualify as a charter resident could be lengthy, as AGSOC must be organized and become sufficiently operational to issue shares.[34/] The longer the eligibility period the more difficult it will be to verify compliance with residency requirements. A long residency period will also reduce

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34/ Incorporators must be selected, and an initial slate of directors chosen. The latter are subject to disapproval within 15 days of their nominations which could cause delay. S. 170 § 4(b). The directors must prepare articles of incorporation and bylaws, and there is at least a 60-90 day period after they have been drafted and filed during which the legislature has the authority to disapprove any of their provisions. § 10.50.335. Activities before share issuance but after finalization of the articles and bylaws, including preparation of offering materials and procedures for share distribution, will also take considerable time,

[Footnote continued on following page]

the pool of eligible individuals and increase the number of Alaska citizens who will be resident within the state on the date of issuance or before distribution but ineligible to receive AGSOC shares. The latter will increase the potential for challenges to the constitutionality of AGSOC, and may undercut the political acceptability of AGSOC as well.

A possible solution to these problems would be to revise S. 170 to provide that the eligibility period will commence on a fixed date prior to the date of share issuance[35/] -- *e.g.*, three to six months before issue. This approach has the advantage that if there is an issuance of shares subsequent to the initial distribution, later arriving residents could be included as long as they had

[Footnote continued]

for example, section 10.50.345 provides for notice to allow for application for shares of at least 90 days before the date of issuance. Litigation by opponents of some aspect of the program could cause indefinite delay. It appears extremely likely that the total period involved may exceed six months and could create constitutional problems under both the federal and State of Alaska constitutions. As we have mentioned previously, Alaska courts have taken a particularly strong stance against durational residency requirements. Constitutional Memorandum at 1, n.1, 34, n.38.

35/ The pivotal "date of issuance of shares" of S. 170 §§ 10.50.345 and 355 may not be effectual, since the bill appears to contemplate sporadic issue. Perhaps, the standard "the date of initial notification to the public of its intention to issue shares" would better carry out the purpose.

been and remained residents for the applicable period to the later issuance. This approach would, of course, exclude charter residents who leave the state prior to any secondary issuance.

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December 15, 1978

MEMORANDUM

Summary of Conclusions and Recommendations
Regarding Constitutionality of Residency
Restrictions and Other Features of
General Stock Ownership Corporations

In light of the history of constitutional challenges to a number of Alaskan laws that have treated residents more favorably than non-residents, an eventual constitutional challenge to the state's creation of a General Stock Ownership Corporation ("GSOC") would not be unexpected. Many of the requirements restricting ownership and transferability of GSOC shares to Alaskan residents are mandated by Congress in the Internal Revenue Code and appear to have a rational basis that would withstand constitutional scrutiny. We believe also that certain additional limitations that may be added by the state legislature can be formulated in a way that will minimize the possibility of success of any constitutional challenge. However, a favorable result cannot be guaranteed because of the ever-shifting and sometimes inconsistent application of constitutional principles in this area.

To lessen the risk of a successful constitutional challenge, we recommend that the following points be considered by the state legislature in drafting the enabling legislation:

(1) The most difficult constitutional problem is caused by the "closed-class" feature of the GSOC, i.e., limiting ownership to residents on a certain date and precluding persons who later qualify as residents from becoming shareholders. Whether to provide a mechanism for opening the class is a policy decision for the legislature. One possibility would be to rely on the apparent requirement in the Internal Revenue Code for a closed-class and open the class only if required by court decision. Another possibility would be to provide a mechanism for extending GSOC membership to new residents; this approach, however, should be cleared with the Internal Revenue Service as being consistent with the federal legislation.

(2) The Internal Revenue Code requires that a person eligible to receive GSOC shares must be a resident on an eligibility date specified by the legislature and on the date of issuance of the shares. The time lapse between the eligibility date and date of issuance should

be minimized and the state law definition of resident liberally set in order to counter the argument that any substantial delay infringes the right to travel.

(3) The federal legislation does not require a resident to dispose of his GSOC shares if he ceases to be a resident. However, the state may wish to consider a provision requiring redemption by the GSOC or sale to a third party whenever a shareholder ceases to be a resident. This could be attacked as an infringement on the right to travel, but the success of any such challenge would be lessened if a shareholder is permitted to sell to a third party or redeem at fair market value.

(4) Great care should be exercised in drafting Alaska's legislative findings in support of the GSOC enabling legislation. Such findings provide an opportunity, in anticipation of litigation, to describe the government's interest and how the legislation is rationally related to the accomplishment of legitimate government ends. In particular, the record should show why each restriction is the most effective or only way to accomplish specific goals.

The major rationale of the federal legislation, which should be reaffirmed by the state, is that citizens should have a greater ownership stake in the private

enterprise system which would lead to a better understanding and operation of that system. Sen. Rep. No. 1263, 95th Cong., 2d Sess., at 107. A secondary rationale of Congress was that an experimental GSOC program would enable Congress to study a method of replacing transfer payments with dividend income. The state should not emphasize the reduction of transfer payment rationale because of a number of cases that impose stricter tests for residency restrictions on "necessities of life" -- such as welfare -- than on other benefits.

Our conclusions are necessarily abstract and preliminary since the enabling legislation has not been drafted; we recommend that the constitutional issues be revisited after they are focussed in terms of a specific legislative proposal.

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December 15, 1978

MEMORANDUM FOR THE
COMMISSIONER OF REVENUE
STATE OF ALASKA

Federal Constitutional Issues
Presented by Alaska's GSOC

You have asked us to review the federal constitutional issues raised by Alaska's creation of a general stock ownership corporation ("GSOC") as permitted by section 1391 of the Internal Revenue Code, enacted as section 601 of the Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2892.[1/]

This memorandum concludes that, while there are several bases from which an attack on various aspects of the proposed GSOC could be launched, on the whole we believe

1/ This memorandum does not cover issues of state constitutional law which are more appropriately addressed to Alaska counsel. In some instances the Alaska Supreme Court has interpreted provisions in the Alaska Constitution more restrictively than the Supreme Court has interpreted parallel provisions in the U.S. Constitution. See generally, Comment, Durational Residency Requirements: The Alaskan Experience, 6 U.C.L.A. - Alas. L. Rev. 50 (1976). In this regard, the outcome of the challenge to the Beirne initiative in the Alaska Supreme Court will be most instructive. See Bailey v. Thomas, No. 3AN-78-1592 (Alas. Super. Ct., Aug. 11, 1978), appeal pending.

that the GSOC can be organized and operated in a fashion that will minimize the likelihood that any constitutional challenge would be successful. We caution, however, that the ever-shifting application of constitutional principles by the courts precludes any absolute measure of certainty in this area. Moreover, until the state's enabling legislation is actually drafted, any discussion of constitutional problems is necessarily abstract and preliminary.

This memorandum will first describe the federally imposed definition of a GSOC and identify several constitutional issues raised by that definition as well as certain additional restrictions Alaska may wish to impose. It will then analyze the major constitutional doctrines relevant to our concerns. Finally it will focus on application of these constitutional principles to the questions raised by specific federal or state restrictions. Our conclusions and recommendations are set forth in the accompanying summary memorandum.

I. Introduction - the Nature of a GSOC and the Constitutional Issues It Presents

Section 1391 of the Internal Revenue Code provides special federal tax treatment for a GSOC whose shares are

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owned by residents of the state which creates it. It is contemplated that a GSOC will acquire an interest in one or more business enterprises with borrowed funds, perhaps aided by state grants or guarantees. The cash flow from the acquired business interests will be used to repay loans and pay dividends to the residents of the state who are its shareholders. If the GSOC files the prescribed election, the corporation will be exempt from federal income tax and the shareholders will be taxed on their pro rata share of earnings whether or not distributed.

The GSOC legislation was structured with a minimum of federal restrictions in order to provide states with maximum flexibility to organize a GSOC on their own terms. However, the Internal Revenue Code requires that a GSOC must be chartered and organized after 1978 and before 1984 by an act of a state legislature or as a result of a statewide referendum. In addition, the GSOC's charter must provide that:

(1) Stock may be issued only to "eligible individuals." An eligible individual is "an individual who is, as of a date specified in the state's enabling legislation for the GSOC, a resident of the chartering

state and who remains a resident of such state between that date and the date of issuance." I.R.C. § 1391(c).

(2) Only one class of stock may be issued and at least one share must be issued to each eligible individual unless that individual elects within one year not to receive his share.

(3) No share may be transferable for five years after issuance, other than by will or by the laws of descent, except where the shareholder ceases to be a resident of the state.

(4) Shares may only be transferred to a resident of the state.

(5) Shares may not be transferred to any individual who would own more than ten shares of the GSOC after the transfer.

(6) The corporation must qualify as a GSOC under the Internal Revenue Code.

In addition, a GSOC may not hold a 20 percent or more interest in any subsidiary, may not acquire its business properties from an unwilling seller through the use of the state's power of eminent domain, and is

considered to be a private corporation and not a governmental unit for federal tax purposes.

Potential constitutional issues center on the statutory restrictions of GSOC ownership and transferability enumerated above. Those requirements are mandated by the Internal Revenue Code; other restrictions may be added, or these restrictions made more severe in application, by the state's enabling legislation or the articles of incorporation of the GSOC. Thus, constitutional questions may pertain either to the federal tax statute itself or to the GSOC program as implemented by the state.

There are three principal questions raised by the federal legislation which must be assessed under various constitutional provisions:

(1) May the initial issuance of GSOC shares be restricted to residents?

(2) May the issuance of GSOC shares be limited to a "closed class" of eligible individuals who are residents of the chartering state on a specified date without allowing persons who later qualify as residents to participate in the ownership of the GSOC?

(3) May various restrictions be imposed on the transferability of GSOC shares including (a) a temporary prohibition on the transfer of shares for five years after issuance, and (b) an absolute prohibition on transfers to non-residents, resident corporations (and other legal entities) and residents who would own more than ten shares after the transfer?

Two additional questions concern restrictions not mandated by the federal legislation which Alaska may wish to consider imposing:

(4) May Alaska require that GSOC shares be surrendered, redeemed or transferred when the owner ceases to be a resident?

(5) May Alaska restrict issuance of GSOC shares to a limited class of residents, such as residents over a certain age or residents of limited means?

II. Overview of Constitutional Issues

There are four constitutional provisions that may be pertinent to the questions presented above: (1) the equal protection clauses (U.S. Const. amends. V, cl. 3, and XIV, § 1); (2) the due process clauses (U.S. Const. amends. V, cl. 3, and XIV, § 1); (3) the privileges and

immunities clause (U.S. Const. art. IV, § 2); and (4) the commerce clause (U.S. Const. art. I, § 8, cl. 3). Each is discussed below.

A. Equal Protection of the Laws

The constitutional command that no person be denied equal protection of the laws sets a constitutional limit on classifications that can be made by the government in dispensing benefits or imposing burdens. Both the Fifth Amendment[2/] and the Fourteenth Amendment[3/] to the U.S. Constitution form the basis of the guaranty. Since the Internal Revenue Code requires that a GSOC be chartered by the state and sets forth certain provisions that must be included in the charter, any challenge would probably be directed both at the federal legislation and at the

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2/ The Fifth Amendment provides that no person shall "be deprived of life, liberty, or property, without due process of law." The Supreme Court interprets the due process clause of the Fifth Amendment to require it to test classifications arising from federal statutes under the same standard of review used against state legislation under the equal protection clause of the Fourteenth Amendment. Bolling v. Sharpe, 347 U.S. 497, 499 (1954).

3/ The Fourteenth Amendment, in relevant part, prohibits any state from "deny[ing] to any person within its jurisdiction the equal protection of the laws."

state's enabling legislation.[4/]

4/ Both sources of equal protection require that a person be deprived of equal treatment by "state action." It should be considered at the outset whether constitutional issues can be avoided by the argument that the various GSOC restrictions do not involve "state action." Probably not.

To the extent that GSOC restrictions are imposed by the Internal Revenue Code (a federal statute) as a condition for special tax treatment, there probably is "state action" by the federal government even though the Code specifies that the GSOC is a private corporation for tax purposes. A recognized ground for "state action" is governmental encouragement or compulsion of a private party to undertake the challenged practice. See Moose Lodge No. 107 v. Irvis, 407 U.S. 163 (1972). Compare Jackson v. Metropolitan Edison Co., 419 U.S. 345, 357 (1974); Flagg Bros. v. Brooks, 436 U.S. 149, 164-66 (1978). For the possibility that "state action" would also arise from the "special subsidy" of the federal tax exemption, see McGlotten v. Connally, 338 F. Supp. 448 (D.D.C. 1972). But see Bittker & Kaufman, Taxes and Civil Rights: "Constitutionalizing" the Internal Revenue Code, 82 Yale L.J. 51 (1972).

Moreover, a number of factors would support a finding of "state action" by the state of Alaska. First, §§ 1391(a)(3) and (4) of the IRC appear to require that the state's enabling legislation include the specific restrictions necessary for the GSOC's qualification for the tax exemption. Even if these provisions were interpreted to require only that the corporation include these restrictions in its articles of incorporation, § 1391(c) would still appear to require that the state specify in its enabling legislation the residency date that would determine eligibility for the receipt of GSOC shares. "State action" would exist if these restrictions were specified by the enabling legislation in compulsory terms.

In addition, a state loan or guarantee of loans to the GSOC would be a subsidy that could be viewed as state encouragement or participation sufficient to constitute "state action." See Norwood v. Harrison, 413 U.S. 455 (1973) (loan of books to private schools sufficient for state action); Gilmore v. City of Montgomery, 417 U.S. 556 (1974) (use of city facilities sufficient for state action). Finally, if GSOC dividends are intended to reduce the need for welfare payments, there would appear to be "state action" on the ground that the GSOC is performing a governmental function "traditionally

In deciding whether a particular restriction denies equal protection to some class of persons who are excluded or disadvantaged by the restriction, the federal courts look to the interest the federal or state government advances in support of the classification,[5/] the individual interests the challenger claims are adversely affected, and the nature of the statutory classification. The Supreme Court has developed more than one test under which to conduct its inquiry, depending on what interests are affected or what basis of classification is used. If a classification is based on suspect criteria (such as race) or if it impinges on a fundamental right (such as the right to travel or to vote), it can be upheld only if necessary

[Footnote continued]
exclusively reserved to the State." Jackson, supra, 419 U.S. at 352.

Despite the above authorities there still remains the argument that there is no "state action" because the GSOC is essentially a private corporation. To the extent that the state wishes to incorporate additional restrictions on the operation of the GSOC that are not required by the Internal Revenue Code, consideration should be given to placing those restrictions in the articles of incorporation of the GSOC rather than in the enabling legislation to preserve the argument of no "state action."

5/ Since equal protection analysis is identical whether a restriction is imposed by the federal or state government, for convenience, in the remainder of this memorandum we refer to the interest of both the federal and state governments as "the government interest." In instances where the interests may not be identical, the interest of the state government will be separately described.

to promote a compelling state interest. This test is called "strict scrutiny." Otherwise, the "rational basis test" is used, and the classification will stand if it is rationally related to a legitimate government interest. The choice of which standard of review to apply is largely outcome determinative of the success of the challenge to the statute.[6/]

If a statute under challenge is economic or social welfare legislation, the Court will uphold it if the government is promoting a legitimate state interest and if the classification is "rationally related" to the accomplishment of legitimate government ends,[7/] at least

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6/ But see Antonio Independent School Dist. v. Rodriguez, 411 U.S. 1, 98-110 (1973) (Marshall, J., dissenting) and Massachusetts Bd. of Retirement v. Murgia, 427 U.S. 307, 318-21 (1976) (Marshall, J., dissenting), noting that it is somewhat simplistic to say that all of the Court's decisions fit neatly within the two tests, and that in practice the Court's method of analysis tends to be a balancing of the importance of the interest of the government and the interest of the individual.

7/ See, for examples of economic regulations, City of New Orleans v. Dukes, 427 U.S. 297, 303-04 (1976) (a city may prohibit pushcart sales except by those vendors who have been in business for eight years, to protect the character of the city); Hughes v. Alexandria Scrap Corp., 426 U.S. 794, 810-13 (1976) (state may make it easier for in-state businesses to receive a government bounty than out-of-state businesses, to rid the state of abandoned automobiles). The Dukes case expressly overruled the one Supreme Court decision which had applied the "strict scrutiny" test to an economic regulation (Morey v. Doud, 354 U.S. 457 (1957)).

See, for examples of social welfare legislation, Califano v. Aznavorian, 47 U.S.L.W. 4037, 4039 (U.S. Dec. 11, 1978) (upholding restricting SSI benefits to months when recipient

so long as an "inherently suspect" classification has not been used[8] and a "fundamental right" of the challenger is not being seriously penalized.[9] In addition, it should be noted that the Supreme Court has been especially deferential in its review of whether a classification appearing in tax legislation is justified by a legitimate governmental interest.[10] The federal GSOC legislation,

[Footnote continued]
within United States); Maher v. Roe, 432 U.S. 464 (1977) (upholding state funding for childbirth but not abortion); Weinberger v. Salfi, 422 U.S. 749 (1975) (upholding duration of relationship test for widow and child to be eligible for social security benefits); Dandridge v. Williams, 397 U.S. 471 (1970) (upholding ceiling on AFDC grant based on family size). In the Aznavorian case, the Court noted that "[s]ocial welfare legislation, by its very nature, involves drawing lines among categories of people, lines that necessarily are sometimes arbitrary. This Court has consistently upheld the constitutionality of such classifications in federal welfare legislation, where a rational basis existed for Congress' choice."

8/ Inherently suspect classifications are, for example, those based on race or national origin. See, e.g., Brown v. Bd. of Educ., 347 U.S. 483 (1954); Korematsu v. United States, 323 U.S. 214 (1944).

9/ Fundamental rights are, for example, the right to marry (Zablocki v. Redhail, 434 U.S. 374 (1978)), the right to travel (Shapiro v. Thompson, 394 U.S. 618 (1969)), and the right to vote (Carrington v. Rash, 380 U.S. 89 (1965)).

10/ See, e.g., Lehnhausen v. Lake Shore Auto Parts Co., 410 U.S. 356, 359 (1973) (in denying equal protection challenge to Illinois statute subjecting corporations but not individuals to personal property tax, Court stated that "[w]here taxation is concerned and no specific federal right, apart from equal protection, is imperiled, the States have large leeway in making classifications and drawing lines which in their judgment produce reasonable systems of taxation"); Madden v. Kentucky, 309 U.S. 83, 88 (1940) ("in taxation, even more than in other fields,

which is part of the Internal Revenue Code, may receive an extra measure of protection from challenge for this reason.

If a fundamental right of the individual is significantly interfered with, however, economic and social welfare legislation may be subject to strict scrutiny. The right to economic benefits itself is not considered "fundamental," at least as long as the benefits cannot be considered "necessities of life."[11/] The Court has

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[Footnote continued]
legislatures possess the greatest freedom in classification"); Mapes v. United States, 576 F.2d 896, 903-04 (Ct. Cl.), cert. denied, 47 U.S.L.W. 3405 (U.S. Dec. 11, 1978) (deference to congressional determination of tax policy noted in upholding the constitutionality of the IRC "marriage penalty"). Compare Austin v. New Hampshire, 420 U.S. 656 (1975) (deference to legislature on tax matters overridden in invalidating New Hampshire income tax on non-residents as violation of privileges and immunities clause).

11/ One court has distinguished the receipt of welfare benefits from the receipt of a subsidized education on this basis. Starns v. Malkerson, 326 F. Supp. 234, 238 (D. Minn. 1970), aff'd, 401 U.S. 985 (1971). However, the rational basis test has been applied even in grant of benefit situations in which one could argue that fundamental rights were being impacted by the classification. For example, in Dandridge v. Williams, 397 U.S. 471 (1970), the rational basis test was applied to test a dollar limit on welfare payments to a single family under which large families received less per child, even though the Court recognized that the "administration of public welfare assistance, by contrast [to regulation of business or industry], involves the most basic economic needs of impoverished human beings." Id. at 485.

However, even if the Court were to believe that GSOC benefits constituted necessities of life, we believe that a recent decision of the Supreme Court has substantially weakened

put the rule succinctly: "a noncontractual claim to receive funds from the public treasury enjoys no constitutionally protected status." Weinberger v. Salfi, 422 U.S. 749, 772, 774 (1975).

However, the right to interstate travel -- which is relevant to an evaluation of the GSOC legislation -- has been recognized as a "virtually unqualified" fundamental right. Califano v. Torres, 435 U.S. 1, 4 n.6 (1978); see also Shapiro v. Thompson, 394 U.S. 618, 634 (1969); United States v. Guest, 383 U.S. 745, 757-58 (1966).

Even though the right to travel is fundamental, residency has never been considered an "inherently suspect" distinction such as race, religion or alienage, so as to promote strict scrutiny for that reason alone.[12/] And

[Footnote continued]
the possibility that the legislation would for this reason be subject to strict scrutiny. In Maher v. Roe, 432 U.S. 464 (1967), the Court upheld a state's decision to fund publicly those indigent pregnant women who elected to give birth, and deny funding to those who sought an abortion. The Court reasoned that by making such a distinction the state was not restricting the constitutionally guaranteed right to an abortion, but only choosing to encourage the alternative of childbirth by funding it; since women could still receive abortions by private financing, the right to receive an abortion had not been restricted. The Court dealt with an argument that poor women would be effectively foreclosed from the abortion alternative by responding that distinctions based on wealth have never been sufficient to create a suspect class which would necessitate strict scrutiny by the Court.

12/ City of New Orleans v. Dukes, 427 U.S. 297, 303 (1976).

courts have held that the right to travel is not violated when a state chooses to dispense benefits only to its residents, and thus have upheld the restriction of a wide range of public benefits to state residents under the rational basis test. See, e.g., McCarthy v. Philadelphia Civil Service Commission, 424 U.S. 645, 646 (1976) (city may restrict public municipal employment to residents); Hughes v. Alexandria Scrap Corp., 426 U.S. 794, 813 (1976) (state may prefer its residents in paying bounty); Starns v. Malkerson, 326 F. Supp. 234, 236 (D. Minn. 1970), aff'd, 401 U.S. 985 (1971) (upholding reduced tuition at a public university for state residents); Consumers Union of United States, Inc. v. Albright, 427 F. Supp. 840, 844 (S.D.N.Y. 1977), vacated and remanded sub nom. Consumers Union of United States, Inc. v. Heimann, 98 S. Ct. 3117 (1978) (state may restrict savings bank life insurance to state residents).

The primary situations in which statutory classifications have been subject to strict scrutiny as penalizing the fundamental right to interstate travel are the so-called durational residency cases, where states have refused state benefits to residents until they have lived within the state for a set period of time. In Shapiro v. Thompson, 394 U.S. 618 (1969), for example, state

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statutes denying welfare benefits (deemed to be "necessities of life") to persons who had not lived in the jurisdiction for one year were held to deny equal protection of the laws after strict scrutiny as to whether the restriction was "necessary to promote a compelling governmental interest." Id. at 634 (emphasis in original). The Court rejected various rationales offered by the states. The objective of reducing welfare costs by the one-year waiting period was held to be per se unconstitutional because its very purpose was to deter the migration of indigents. The Court also rejected the concept that new and old residents could be distinguished on the basis of past tax contributions to the community since the equal protection clause prohibits the apportionment of state services based on tax contributions. Other justifications -- facilitating the planning of the welfare budget, providing an objective test of residency, minimizing welfare fraud and encouraging early entry of new residents into the labor force -- were dismissed as unfounded, solvable by less drastic means or simply not compelling.

While the Shapiro decision sets the high standard of strict scrutiny for any durational residency restriction

to meet,[13/] later cases reflect application of a balancing test upholding reasonable restrictions that serve a very significant governmental interest which justifies a limitation on the travel right.[14/] In this regard, the courts have examined the degree of "penalty" imposed on the travel right in terms of the type of benefit that is restricted. For example, in Memorial Hospital v. Maricopa County, 415 U.S. 250 (1974), the Court struck down a one-year residency requirement for receipt of free non-emergency medical care, and noted that the right to travel had been penalized by denial of vital benefits:

13/ The Court left open the possibility that not all durational residency restrictions would fail to pass the test:

> We imply no view of the validity of waiting-period or residence requirements determining eligibility to vote, eligibility for tuition-free education, to obtain a license to practice a profession, to hunt or fish, and so forth. Such requirements may promote compelling state interests on the one hand, or, on the other, may not be penalties upon the exercise of the constitutional right of interstate travel. Id. at 638 n.21. (Emphasis supplied.)

14/ Compare Dunn v. Blumstein, 405 U.S. 330 (1972) (durational residency requirements of one year and three months for voting invalidated under strict scrutiny rationale) with Rosario v. Rockefeller, 410 U.S. 752 (1973) (requirement to enroll in party 30 days before a general election as a prerequisite to voting in the following primary - almost a year's delay - upheld as allowing state to discourage party raiding).

> In Shapiro, the Court found denial of the basic "necessities of life" to be a penalty. Nonetheless, the Court has declined to strike down state statutes requiring one year of residence as a condition to lower tuition at state institutions of higher education.
>
> Whatever the ultimate parameters of the Shapiro penalty analysis, it is at least clear that medical care is as much "a basic necessity of life" to an indigent as welfare assistance. And, governmental privileges or benefits necessary to basic sustenance have often been viewed as being of greater constitutional significance than less essential forms of governmental entitlements. 415 U.S. at 259. [Footnotes omitted.] 15/

As the Court in Memorial Hospital pointed out, prior cases had approved a one-year durational residency requirement for lower state university tuition. 16/ And more recently, in Sosna v. Iowa, 419 U.S. 393 (1975), the Court upheld a requirement of one year's residence before one was

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15/ The Court rejected what the state asserted as its compelling interests -- fiscal savings, inhibiting migration to obtain medical benefits, protection of past taxpayers, administrative convenience, budget predictability, and prevention of fraud. Id. at 262-69.

16/ Starns v. Malkerson, 401 U.S. 985 (1971), aff'g 326 F. Supp. 234 (D. Minn. 1970), cited with approval in Vlandis v. Kline, 412 U.S. 441, 452-53 n.9 (1973). The lower court in Starns distinguished tuition from the welfare payments in Shapiro v. Thompson in two ways -- first, that the restriction there had been intended to exclude poor persons from the state; and second, that denial of welfare had the effect of denying the necessities of life to needy residents. 326 F. Supp. at 237-38.

eligible to seek a divorce in state court. The Court reasoned that the restriction before it was "of a different stripe" since the plaintiff was not permanently foreclosed from receiving the benefit but merely suffered a temporary delay in access. Id. at 406.[17/]

Assuming that the rational basis test is to be applied to test restrictions on participation in a program implemented by both a federal and a state statute, the first step in equal protection analysis is to determine that the objectives of both governments in creating the program are the promotion of legitimate economic and social welfare goals.[18/] In addition to the primary goal of the

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17/ In addition, the interests urged by the state were more than merely budgetary considerations or administrative convenience. The state argued that the restriction allowed it to avoid becoming a divorce mill and protected its decrees from collateral attack. Id. at 406-09.

Compare "incidental" restrictions on other fundamental rights which have not resulted in strict scrutiny. E.g., Zablocki v. Redhail, 434 U.S. 374, 386 (1978) ("reasonable regulations" which may result in a mere incidental penalty on the fundamental right to marry do not require strict scrutiny).

18/ For example, the legislative history of the federal GSOC proposal indicates that it was designed to allow the states to experiment with new ways of expanding public participation in capitalism. S. Rep. No. 1263, 95th Cong., 2d Sess. 107 (1978); remarks of Senator Gravel, 124 Cong. Rec. S. 19,168-69 (daily ed. Oct. 14, 1978). We assume that such a rationale would be seen as the promotion of public welfare and therefore proper. Moreover, allowing states room for flexible experimentation has been approved as a valid congressional purpose under the rubric "cooperative federalism." Carroll v. Finch, 326 F. Supp. 891, 895 (D. Alas. 1971).

promotion of social welfare,[19] however, the courts will also consider preservation of the fisc,[20] alleviation of tax burdens[21] and administrative convenience[22] to be proper ancillary objectives under the rational basis test.

19/ In the present instance, it is our understanding that Alaska wishes to avail itself of the federally-granted opportunity to form a GSOC to broaden the base of ownership of in-state projects which have broad public impact and to encourage informed citizen participation in corporate decisions affecting vital state projects by spreading the opportunity to participate in capitalism more widely among its citizens. In addition, by giving state residents an interest in the profit-making resources of their state, Alaska hopes ultimately to pass on the economic benefits arising from development of state resource projects to residents within the state, and to spread the wealth more widely. We believe that all of these state interests will be considered consistent with the purposes of the federal legislation and valid objectives under the state's general power and duty to provide for the welfare of its citizens. (See, however, the discussion (infra at 25-27) of possible problems arising from allegations that some of these goals may impair the flow of interstate commerce.)

20/ See in a different context, City of Philadelphia v. New Jersey, 98 S. Ct. 2531, 2537 (1978) ("we assume New Jersey has every right to protect its residents' pocketbooks . . . ."); Geduldig v. Aiello, 417 U.S. 484, 495-96 (1974).

21/ Baldwin v. Fish & Game Comm'n, 436 U.S. 371, 388-90 (1978) (state's efforts to require non-residents to pay higher license fees to hunt elk upheld as rationally related to state's need to use tax dollars to support elk population).

22/ Weinberger v. Salfi, 422 U.S. 749, 777 (1975).

In the second step of analysis under the rational basis test, each restriction subject to attack must be shown to be rationally related to one or all of these proper government objectives. However, a statutory classification dealing only with economic matters which does not impinge on a fundamental interest need not be drawn with precision to fit the state's purposes. Hughes v. Alexandria Scrap Corp., 426 U.S. 794, 813 (1976); Williamson v. Lee Optical of Oklahoma, Inc., 348 U.S. 483, 489 (1955).

B. Privileges and Immunities Clause

The privileges and immunities clause of the Constitution provides: "The Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States." Art. IV, § 2, cl. 1.[23/] The terms "citizens" and "residents" are interchangeable for purposes

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23/ A similar clause protecting the rights of national citizenship is found in the Fourteenth Amendment, which states that "[n]o State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States." U.S. Const. amend. XIV, § 1. The privileges and immunities clause of article IV is broader in that it is not restricted in its language to actions by the states, and thus arguably applies to the federal government as well. The applicability of the clause to federal statutes need not be debated at this time, however, since the state in chartering the GSOC will adopt the basic restrictions against non-residents required in the federal legislation as a condition to special tax treatment.

of the clause.[24/] The origins of the clause indicate that its purpose was to "fuse into one Nation a collection of independent, sovereign States. It was designed to insure to a citizen of State A who ventures into State B the same privileges which the citizens of State B enjoy." Toomer v. Witsell, 334 U.S. 385, 395 (1948).

While the clause does not enumerate the privileges which may not be infringed, early decisions have made it clear that the clause gives an out-of-stater the right to "pass into any other State of the Union for the purpose of engaging in lawful commerce, trade, or business without molestation; to acquire personal property . . . and to be exempt from any higher taxes or excises than are imposed by the State upon its own citizens." Ward v. Maryland, 79 U.S. (12 Wall.) 418, 430 (1870). In any event, the protections of the clause are not absolute. When a state can show substantial, valid justifications for discrimination against out-of-staters, the discrimination will sometimes stand if it is closely related to the state's needs, especially if important interests of the individual are not infringed. The method of analysis becomes much

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24/ Hicklin v. Orbeck, 98 S. Ct. 2482, 2487 n.8 (1978); Austin v. New Hampshire, 420 U.S. 656, 662 n.8 (1975).

like the balancing of interests conducted under the equal protection clause and, like that clause, there appear to be at least two articulated tests.

Two recent Supreme Court decisions illuminate the different approaches toward the application of the clause to a state preference for residents over non-residents in dispensing state benefits. In Baldwin v. Fish and Game Commission, 436 U.S. 371 (1978), the Court upheld a provision of Montana law providing for stiffer license fees for the hunting of elk for non-residents than those required for residents of the state. The Court's analysis followed a line of cases limiting application of the privileges and immunities clause to the protection of those rights which historically had been "fundamental" and which bear "upon the vitality of the Nation as a single entity." The Court reasoned that as a "sport," "not basic to the maintenance or well-being of the Union" and not affecting a means of livelihood or access to travel to any part of the state, the hunting of elk was not sufficiently "fundamental" so as to invoke the clause. Id. at 383, 388.

The second case is Hicklin v. Orbeck, 98 S. Ct. 2482 (1978). There, a unanimous Court invalidated an Alaska statute ("Alaska Hire") requiring all oil or gas leases, right-of-way permits or similar contracts to which the state was a party to include a clause favoring the employment of qualified Alaska residents, as opposed to non-residents. The statute was struck down under a method of analysis derived from two prior cases[25/] where the inquiry was not centered on whether the plaintiff's right was "fundamental," but rather whether non-citizens constituted a particular source of the evil at which the statute was aimed and whether the statute was carefully drawn to meet that evil.[26/] The Court found that Alaska had not proven that unemployment in Alaska (the "evil") was substantially caused by non-residents seeking in-state jobs, and noted that in any event the regulation was not sufficiently well-tailored to the "particular evil" asserted.[27/]

25/ Toomer v. Witsell, 334 U.S. 385 (1948), and Mullaney v. Anderson, 342 U.S. 415 (1952).

26/ Of course the "evil" the statute is aimed at must be a legitimate goal for the state to pursue. See the discussion of possible commerce clause problems, infra.

27/ The Alaska Supreme Court in Hicklin had held that the one year residency provision of Alaska Hire violated the equal protection clause of the federal and state constitutions but upheld the remainder of the statute. The Alaska court found

C. Commerce Clause

The commerce clause of the Constitution[28/] preserves to the federal Congress the power to regulate commerce among the several states. State statutes which interfere with the flow of commerce from state to state are subject to invalidation under this clause. There are again two tests which the Supreme Court has developed to evaluate such state statutes. If the statute is simply economic protectionism on the part of the state, the statute is *per se* invalid; but if the statute evenhandedly acts to effectuate a legitimate local public interest and only incidentally affects interstate commerce, a balancing test is applied and the statute will be upheld unless the burdens on interstate commerce outweigh the local interest, in light of less burdensome alternatives available to promote that local interest. *City of Philadelphia v. New Jersey*,

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[Footnote continued]
no violation of the privileges and immunitites clause when a state law preferred its residents in protecting its ownership interest in its resources. 565 P.2d 159, 167-69 (Alaska 1977). The United States Supreme Court rejected the ownership rationale as an exemption from operation of the privileges and immunities clause, and held that state "ownership" of natural resources was only one factor acting to strengthen a state's interest in preferring its residents. 98 S. Ct. at 2492.

28/ Art. I, § 8, cl. 3.

98 S. Ct. 2531, 2537 (1978); Pike v. Bruce Church, Inc., 397 U.S. 137, 142 (1970).

Commerce clause principles may impact other constitutional doctrines, however. In Hicklin v. Orbeck, 98 S. Ct. 2482 (1978), the Court addressed the interrelation between the privileges and immunities clause and the commerce clause. Although the commerce clause had not been raised by plaintiffs in Hicklin, the Court found that the expected impact on commerce from a law favoring residents for jobs on the Alaska pipeline acted to minimize the state's legitimate interest in favoring its residents for employment:

> [T]he Commerce Clause circumscribes a State's ability to prefer its own citizens in the utilization of natural resources found within its borders, but destined for interstate commerce. . . . Although the fact that a state owned resource is destined for interstate commerce does not, of itself, disable the State from preferring its own citizens in the utilization of that resource, it does inform analysis under the Privileges and Immunities Clause as to the permissibility of the discrimination the State visits upon nonresidents based on its ownership of the resource. Here, the oil and gas upon which Alaska hinges its discrimination against nonresidents are of profound national importance. On the other hand, the breadth of the discrimination mandated by Alaska Hire goes far beyond the degree of resident bias Alaska's ownership of

> the oil and gas can justifiably support.
> Id. at 2492 (footnote omitted).29/

Hence, reasoning traditionally applied to invalidate state statutes as impermissibly burdening interstate commerce may lead a court to hold that a government's interest is illegitimate or insufficiently strong to justify a classification or restriction under the tests applied under the privileges and immunities clause or the equal protection clause.30/

29/ See also Baldwin v. Fish & Game Comm'n, 436 U.S. 371, 392 (1978) (concurring opinion of Burger, J.).

30/ There is good authority to argue that commerce clause reasoning is not applicable to the GSOC proposal. First, Alaska can argue as a factual matter that its GSOC is not designed to impact nor will it negatively influence the flow of interstate commerce. Our understanding is that the GSOC will not monopolize the opportunity to invest in any particular projects. In addition, the Supreme Court has recently openly declined to express a view as to whether a state's decision to restrict to residents state benefits or the spending of state funds would survive an attack under the commerce clause. City of Philadelphia v. New Jersey, 96 S. Ct. 2531, 2537, n.6 (1978). We believe that on the authority of Hughes v. Alexandria Scrap Corp., 426 U.S. 794 (1976), the Court would uphold such state action. In Hughes, the Court ruled that the commerce clause is not involved when a state enters into the market for abandoned automobiles by offering a bounty favoring state residents; the Court distinguished the usual commerce clause case as involving state prohibitions or burdensome regulations interfering with the natural functioning of the interstate market. Although the Maryland statute in question had burdened out-of-state participation in a pre-existing bounty program, the Court rejected any constitutional implication of this kind of "burden":

> We would hesitate to hold that the Commerce Clause forbids state action reducing or eliminating a flow of commerce dependent

D. Due Process

Both federal and state action[31] must comport with the constitutional guaranty of due process of law as set forth in the Fifth and Fourteenth Amendments to the Constitution. The tests employed to evaluate whether statutory limitations on a benefit comply with due process are substantially equivalent to those used to test

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[Footnote continued]

> for its existence upon state subsidy instead of private market forces . . . Nothing in the purposes animating the Commerce Clause prohibits a State . . . from participating in the market and exercising the right to favor its own citizens over others. 426 U.S. at 809 n.18 & 810.

See also the strong concurring opinion of Justice Stevens:

> . . . the Commerce Clause surely does not impose on the States any obligation to subsidize out-of-state business. Nor, in my judgment, does that Clause inhibit a State's power to experiment with different methods of encouraging local industry. Whether the encouragement takes the form of a cash subsidy, a tax credit, or a special privilege intended to attract investment capital, it should not be characterized as a "burden" on commerce. 426 U.S. 815-16.

31/ The possibility exists that Alaska may be able to insulate some restrictions from a nexus of governmental "action," and thus avoid due process problems as well as those arising under the equal protection clause. See supra at n.4.

classifications under the equal protection clause, and therefore a repetition of that analysis is unnecessary here. At the least, legislation must advance legitimate government goals and cannot be totally arbitrary and totally lacking in rational relationship to the legislative objectives. Weinberger v. Salfi, 422 U.S. 749, 767-77 (1975). As with equal protection analysis, unless there is no conceivable legitimate basis for a statutory provision, it will be upheld. For example, in Richardson v. Belcher, 404 U.S. 78 (1971), the Court looked to what "Congress could rationally [have concluded]" in upholding under the rational basis test an allegedly arbitrary Social Security Act provision which resulted in a reduction in benefits. 404 U.S. at 84.

In addition, in certain situations it has been held to be a violation of the due process clause for a legislature to dispense benefits by classifications based on irrebuttable presumptions. See, for example, Vlandis v. Kline, 412 U.S. 441 (1973), where the presumption

involved the concept of residency.[32/] It appears, however, that the Vlandis rule, which applied what amounts to "strict scrutiny" to invalidate a residency presumption, has been cut back substantially in later cases.[33/]

32/ In Vlandis, the Supreme Court invalidated as a denial of due process an irrebuttable statutory presumption that a student at the University of Connecticut would always be a resident of the place where he resided at the time of application to the university, and that he could not prove that he later became a resident of Connecticut for purposes of obtaining the lower tuition charged in-state students. The Court was not moved by Connecticut's justification for the presumption (primarily that it needed an administrative mechanism to restrict the tuition subsidy to in-state students, and that it was rational to favor long-time residents whose tax contributions to the state had been higher).

Moreover, the Court in Vlandis indicated that the tax rationale would run afoul of the equal protection clause and cited Shapiro for the proposition that the tax-based rationale would:

> logically permit the State to bar new residents from schools, parks, and libraries or deprive them of police and fire protection. . . . The Equal Protection Clause prohibits such an apportionment of state services. 412 U.S. at 450 n.6 (quoting Shapiro v. Thompson, 394 U.S. at 632-33).

In quoting Shapiro, the Court indicated that its evaluation under the due process clause was similar to strict scrutiny under the equal protection clause; the taxpayer rationale has been accepted under the rational basis test of the equal protection clause.

Irrebuttable presumptions in the form of residency requirements for voting purposes have also been invalidated after strict scrutiny under the equal protection clause, on the theory that voting is a fundamental right. See Dunn v. Blumstein, 405 U.S. 330, 349-52 (1972); Carrington v. Rash, 380 U.S. 89, 96-97 (1965).

33/ In Sosna v. Iowa, 419 U.S. 393 (1975), the Court upheld a state's requirement that a divorce petitioner be a resident of the state for one year before she could file for divorce. The Court rejected an argument, based

III. Application of Constitutional Principles to Specific Restrictions

A. MAY THE INITIAL ISSUANCE OF GSOC SHARES BE RESTRICTED TO RESIDENTS?

The federal legislation provides that only "eligible individuals" will be issued[34/] GSOC shares. To be eligible, an individual must be "as of a date specified in the State's enabling legislation for the GSOC, a resident of the chartering State and who remains a resident of such State between that date and the date of issuance." 26 I.R.C.

[Footnote continued]
on Vlandis, that such a showing was an irrebuttable presumption and that the petitioner had a due process right to make an individualized showing of good-faith residency without waiting for one year. The Court stressed the importance of the state's interests in not becoming a divorce mill and in avoiding collateral attack on its decrees, and distinguished Vlandis in that there the court had indicated that a reasonable durational residency requirement was permissible as one element in establishing bona fide residency. And in Weinberger v. Salfi, 422 U.S. 749, 771-73 (1975), the court refused to apply the Vlandis rule to invalidate an irrebuttable presumption that denied social security insurance benefits to wives and stepchildren of deceased wage-earners who had not been in that relationship for at least nine months prior to the wage-earner's death. The court reasoned that due process had not been denied as long as it was rational that the presumption prevented the abuse of straw marriages to receive death benefits.

34/ Although the federal legislation appears to allow a state the option of selling GSOC shares to its residents, our understanding is that Alaska plans to issue shares to all Alaska residents at no charge. See remarks of Senator Gravel, 124 Cong. Rec. S. 19,168 (daily ed. Oct. 14, 1978).

§ 1391(c). Hence, to qualify for federal tax benefits, each recipient must be a resident (as defined by state law)[35/] on date of issuance, and Alaska apparently has some latitude to set an earlier date at which time the recipient must also be a resident.

1. Equal Protection of the Laws

The rational basis test will be applied to test the limitation that only a resident can initially receive a GSOC share. As noted above, laws restricting distribution of benefits to state residents have been uniformly subject to this test since the right to travel is not penalized, and the chance to receive a GSOC share should not be viewed as one of the "necessities of life" requiring stricter scrutiny.[36/]

35/ The legislative history of the federal statute provides that "[a] State may define a resident for purposes of its GSOC so long as such definition is consistent with constitutional principles." S. Rep. No. 1263, 95th Cong., 2d Sess. 108 (1978).

36/ It seems improbable that opportunity to participate in the Alaska GSOC will be considered to be a more fundamental right than the welfare payments discussed in Dandridge v. Williams, supra. We note, however, that one of the asserted purposes behind the federal GSOC legislation is to reduce the need for various government transfer payments. The Senate Finance Committee stated that "[t]he committee believes that an experimental program permitting States to form such private corporations for the benefit of their citizens may enable Congress to study a method of replacing transfer payments with dividend income." S. Rep. No. 1263, 95th Cong., 2d Sess. 107 (1978).

The first step in applying the rational basis test will be to search the federal and state legislative records to determine whether the residency restriction is consistent with the goals of the GSOC program. It seems beyond question that restricting the original issuance of GSOC shares to each state's residents is rationally related to the substantive purposes of the GSOC. If each state were required to set up a corporation whose shares would be freely distributed to residents of all states, a state would have little incentive to undertake such an experiment. Of course, each state also would want to restrict the benefits flowing from expenditure of state funds in establishing and initially administering its GSOC to residents whose past taxes will initially support the GSOC operation and to reduce the administrative difficulties which would ensue if the GSOC ownership were nationwide. As with limitations on the receipt of subsidized college tuition, restrictions on eligibility for government jobs, and receipt of a state bounty -- all of which have been

[Footnote continued]

At least at the time of its initial issue the value of a GSOC share will be minimal. However, we believe it will help to insulate the Alaska GSOC from successful constitutional challenge if the welfare rationale is not stressed in the state legislative record and if normal levels of transfer payments are maintained to eligible residents who are not residents at the time of the issuance of GSOC shares.

upheld against challenges that favoring residents for those benefits denied non-residents equal protection of the laws[37/] -- we conclude that the provision in the GSOC legislation restricting issuance of shares to residents should survive an equal protection challenge.

However, the question remains as to how Alaska should set the dates on which a person must be a resident in order to become an individual eligible to receive a GSOC share. If Alaska in its enabling legislation sets an eligibility date (when a recipient must be a resident) that substantially precedes the issuance date (when a recipient must also be a resident), it could be argued that the time lapse between the two dates acts as a durational residency requirement which penalizes those who have recently traveled interstate. Since such travel is a fundamental right, the statute might be subjected

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37/ Starns v. Malkerson, supra; McCarthy v. Philadelphia Civil Serv. Comm'n, supra; Hughes v. Alexandria Scrap Corp., supra.

See also Consumers Union of United States, Inc. v. Albright, 427 F. Supp. 840, 844 (S.D.N.Y. 1977), wherein an equal protection challenge to a restriction on the sale of savings bank life insurance to state residents failed. But see Hicklin v. Orbeck, 98 S. Ct. 2482 (1978), calling into question the results in the McCarthy and Albright situations in the face of an attack under the privileges and immunities clause; Albright was vacated and remanded by the Supreme Court for reconsideration in light of Hicklin. 98 S. Ct. 3117 (1978).

to the strict scrutiny test. See Dunn v. Blumstein, 405 U.S. 330, 335 (1972); Shapiro v. Thompson, 394 U.S. 618 (1969). For this reason, we recommend that Alaska seek to minimize the time gap between the two dates.[38/]

2. Privileges and Immunities Clause

It appears that Alaska's plans for a one-time gift of a GSOC share to each of its residents should pass muster under either the "fundamental" right test of Baldwin v. Fish & Game Commission, supra, or under the "source of the evil" analysis of Hicklin v. Orbeck, supra. Under the Baldwin analysis, it seems unlikely that the gift of a share of stock will be considered a fundamental national right.[39/] However, if the Hicklin analysis is applied,

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38/ We note in addition that under rulings of the Alaska Supreme Court apparently Alaska cannot under state law require a person to have lived in Alaska for more than thirty days in order to be considered a "resident," lacking a compelling state interest and no reasonable, less drastic alternative to promote that interest. Hicklin v. Orbeck, 565 P.2d 159, 171 (Alaska 1977), rev'd on other grounds, 98 S. Ct. 2482 (1978).

Moreover, if the federal courts apply strict scrutiny, it will be relevant to the analysis -- and detrimental to Alaska's defense of the challenge -- if Alaska defines residency more broadly for other state purposes without dire results to the state. See, e.g., Evans v. Cornman, 398 U.S. 419, 421 (1970), Carrington v. Rash, 380 U.S. 89, 95-96 (1965).

39/ Indeed, the GSOC is a novel idea and hardly a right which has -- in the words of one early case on which the Baldwin court relies -- "at all times, been enjoyed by the citizens of the several states which compose this Union, from the time

it will become crucial how the government describes its purposes in enacting the limitations in the legislation.40/

The answer to the Hicklin line of analysis is that neither the GSOC legislation nor any of its provisions is really aimed at any "evil." Issuance of GSOC shares is a one-time benefit, and it is a benefit initially supported by the state government as an experiment to broaden popular participation in the ownership of state investment opportunities. Dispensing such a benefit is different from imposing a penalty or restriction on non-

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[Footnote continued]
of their becoming free, independent, and sovereign." Corfield v. Coryell, 6 F. Cas. 546, 551 (C.C.E.D. Pa. 1823).

40/ For example, one could argue that the legislative history of the federal legislation contemplates that the "evil" the GSOC is aimed at is the monopolization of the opportunities of capitalism by the wealthy. If so, limiting GSOC ownership to residents of the chartering state is not aimed at such an "evil." But the states could respond that by choosing to charter a GSOC the initial shares of which will be issued only to its residents, each state aims to avoid the "evil" of dilution of the financial opportunity the state hopes to present to its residents by the gratuitous participation of out-of-staters. As long as this purpose is legitimate, out-of-staters are by definition the source of the "evil" and the restriction is aimed precisely at it.

The Supreme Court has noted that preserving a state's financial resources from dilution is a "presumably legitimate goal" as long as it is not done by means that violate the commerce clause (or, presumably, any other constitutional guarantee). City of Philadelphia v. New Jersey, 98 S. Ct. 2531, 2537 (1978). For reasons set forth supra at 25-27, we do not believe that commerce clause reasoning should lead to the invalidation of the GSOC restriction.

residents, as was the case in Hicklin. For this reason, we think the GSOC concept can be distinguished from the Hicklin case and can survive an attack based on denial of the privileges of citizenship.[41/]

3. Commerce Clause

The restriction on initial issuance to residents of the chartering state is made by a federal statute; the only role of the state legislature is to set the date (or dates) as of which the recipient must be a resident. Hence, if the restriction restrains the flow of commerce out of the state of Alaska,[42/] it does so at the express direction of Congress, which has plenary power to regulate interstate commerce.[43/]

41/ One lower court case decided before Hicklin makes use of the distinction described above. Consumers Union of United States v. Albright, 427 F. Supp. 840, 846 n.10 (S.D.N.Y. 1977) (when non-residents are denied the right to purchase savings bank life insurance, they are not penalized; they are merely deprived of a benefit). The fact that the Albright case has been vacated and remanded for reexamination in light of Hicklin v. Orbeck (98 S. Ct. 3117 (1978)) diminishes somewhat the likelihood of sustaining the benefit/penalty distinction.

42/ State statutes which restrain commerce within the state are as vulnerable under the clause as those that prohibit entry of items of commerce. City of Philadelphia v. New Jersey, 98 S. Ct. 2531, 2538 (1978).

43/ To avoid commerce clause problems, however, it is advisable that Alaska fashion the least restrictive definition of "residency" possible, to avoid a charge that, in implementing the federal legislation by state law, Alaska has impermissibly

4. Due Process

To invalidate the restriction of issuance of GSOC shares to residents of Alaska under the due process clause, one would have to show that the government was acting either on behalf of improper goals or that the decision to exclude non-residents was totally arbitrary. Moreover, the government is given broad latitude in prescribing criteria for eligibility for public funds. Weinberger v. Salfi, supra. Giving non-residents an original GSOC share would dilute the primary purpose behind the statute -- allowing a state to choose to provide a stake in capitalism for its residents. Seen from this perspective, the limitation is hardly arbitrary.

[Footnote continued]
burdened interstate commerce. For example, in addition to our suggestion that the time between two dates which the legislature sets to define "eligible individuals" be as short as practicable, we suggest that Alaska define "residency" for GSOC purposes as liberally as possible, with an explicit recognition that such a definition has been drafted to avoid incidental effects on interstate commerce (and the right to travel).

B. MAY ALASKA CREATE A "CLOSED CLASS" OF PERSONS TO RECEIVE GSOC SHARES, AND REFUSE TO ISSUE A GSOC SHARE TO A PERSON WHO BECOMES A BONA FIDE RESIDENT AFTER THE DATE OF INITIAL ISSUANCE?

The federal legislation provides that the GSOC's charter shall provide for the issuance of shares to "each eligible individual." An "eligible individual" is defined as "an individual who is, as of a date specified in the State's enabling legislation for the GSOC, a resident of the chartering State and who remains a resident of such State between that date and the date of issuance." On its face the federal statute would appear to require that a GSOC issue shares only to a closed class of persons who are residents on one certain set date (or dates) and issue no shares to persons who later become bona fide residents of Alaska. However, it also may be possible to read the federal legislation to allow the state in its enabling legislation to set a number of dates on which new state residents would become "eligible" to be issued a GSOC share.[44/] To avoid the problems discussed below, Alaska might wish to consider opening GSOC ownership to new residents,

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44/ We had recommended (by letter of October 12, 1978) that the definition of "eligible individual" in the federal legislation be left to state law definition so that a measure of flexibility to avoid constitutional confrontation would be available, but that suggestion was not adopted by Congress.

although we realize that such a solution creates administrative problems; if chosen, this solution should be cleared with the Internal Revenue Service as being consistent with the federal statute.

On the assumption that Alaska does not desire to follow such a course, what will be the impact on a person who moves to Alaska after the original issuance date? He has missed the one-time issuance of GSOC shares. But, at some point in time, he will become a bona fide "resident" as that concept is defined under Alaska law. If the state legislation provides no authority for the GSOC to issue him a share, the only mechanisms by which he could acquire GSOC ownership are (1) if he receives a share "by will or the laws of descent and distribution" from an Alaskan who has received a share, 26 U.S.C. § 1391(a)(4)(D)(i);[45/] or (2) if the state legislation provides for trading in GSOC shares after the five-year trading proscription set forth in the federal legislation, and an Alaskan sells

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45/ Although the federal legislation leaves some room for doubt, it appears that to receive a share by will or descent, a person must be a "resident individual" of Alaska at the time of receipt as defined by general concepts of residency under Alaska law. The state legislation should clarify what becomes of a GSOC share willed to an out-of-stater or to one which would pass under the Alaska law of intestate succession to a non-resident of Alaska.

him a share. Does this deprivation give rise to a constitutional claim by the new resident under the precedents discussed above?

1. Equal Protection of the Laws

A restriction on the grant of an economic or social benefit should ordinarily be evaluated under the rational basis test. However, if the closed class penalizes the fundamental right to travel, a stricter standard of review is appropriate. Alaska must distinguish the GSOC situation from the denial of welfare benefits in Shapiro v. Thompson to escape the strict scrutiny test. Alaska can do so by arguing that, in Shapiro, the plaintiff was denied welfare benefits which others who had not recently traveled interstate were then being granted. In contrast, the new resident of Alaska would be advancing the unprecedented notion that the state has an obligation to treat him equally with persons resident at an earlier date in time when the GSOC shares were given away. Moreover, even if denying a new resident a GSOC share may theoretically penalize him for having recently been resident elsewhere and subsequently moving to Alaska, the penalty he has suffered does not rise to the level of deprivation of a necessity of life.

It may help to sustain the closed class concept even if strict scrutiny is applied if Alaska takes advantage of what appears to be room in the federal legislation to allow residents leaving the state to transfer their shares to new residents. Under section 1391(a)(4)(D)(i), no shareholder may transfer a share for five years after issuance "except where the shareholder ceases to be a resident of the State." It appears that the federal statute leaves room for Alaska to allow (or perhaps even require) departing residents to sell their GSOC shares to newcomers who satisfy Alaska's state law definition of "residency."[46/] In this way, any "penalty" placed on persons who do not meet the tests of "eligible individual" at the time of the original GSOC issue is made less onerous. Under this suggestion, new residents would be burdened only by some measure of delay in obtaining their shares (assuming more persons come to Alaska than leave), and by being required to pay fair value for their shares.[47/] These burdens

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46/ Problems of the proper valuation to place on a GSOC share in this event and problems under the securities laws which may be accelerated due to the earlier creation of a trading market should be carefully considered in the state legislation.

47/ See infra at 51-57. Under the analysis of Maher v. Roe, supra, this provision would enhance the argument that an equal protection attack should be unsuccessful.

probably amount to at best a slight interference with the right to travel which the courts would uphold in light of the legitimate state interests advanced.

Assuming that the Shapiro rationale does not apply and that the closed class concept is properly evaluated under the rational basis test, it is important that the state legislative record list with as great a particularity as possible the reasons why the "closed class" restriction is highly useful to meet the legislative goals. Presumably the administrative burdens would be greatly reduced by the closed class. In addition, Alaska could recognize the possibility that it might charter additional GSOC's if the experiment is successful. Moreover, the closed class would avoid the problem of dilution of GSOC benefits by newcomers moving to Alaska merely to profit from Alaska's experiment. Finally, Alaska should point out that it reads section 1391(c) of the Internal Revenue Code to require the closed class.

2. Privileges and Immunities Clause

It is under the equal protection clause that disparate treatment given various classes of Alaska residents would be tested. The privileges and immunities clause is designed to rectify unreasonable state

discriminations between its residents and non-residents. Hicklin v. Orbeck, 98 S. Ct. 2482, 2485 (1978); Toomer v. Witsell, 334 U.S. 385, 395-96 (1948). Any harm which the new Alaska resident asserts should be tested under the equal protection guaranty.

3. Due Process

Alaska can argue that the closed class does not constitute a presumption of non-residency which excludes the new resident from state benefits. In Vlandis v. Kline, supra, the new resident was precluded by the presumption under attack from showing he was a Connecticut resident and thus receiving ongoing state benefits for all of his student years.[48/] In the GSOC situation, unless the Alaska legislature sets a series of eligibility dates or permits GSOC sales by departing residents to new residents, the new resident presumably is barred for five years after issuance from purchasing a GSOC share. But the benefit from which he is excluded -- a GSOC share -- is not one other residents of Alaska are currently receiving.

48/ 412 U.S. at 452-53 n.9. The Court noted that in Starns v. Malkerson, 326 F. Supp. 234 (D. Minn. 1970), aff'd mem., 401 U.S. 985 (1971), it had approved a tuition situation in which the student after one year in the state was allowed to prove bona fide residency.

Presumably, the ongoing benefit denied the new resident is the dividend income which is generated by the GSOC shares previously given to older residents. And this income is a benefit generated and distributed by the GSOC itself and arguably is not a product of "action" by the state of Alaska.

Moreover, even if the closed-class restriction is viewed as being mandated by the federal legislation and as creating a presumption of non-residency for GSOC purposes, Sosna and Weinberger teach that such presumptions can be upheld if they are rationally designed to prevent abuses and to secure important state goals. Presumably, there are no easy administrative means by which Alaska could admit new residents into the GSOC program; Vlandis largely rested on the fact that individual determinations could easily have been made. Alaska should rely on the language of Weinberger:

> The question is whether Congress, its concern having been reasonably aroused by the possibility of an abuse which it legitimately desired to avoid, could rationally have concluded both that a particular limitation or qualification would protect against its occurrence, and that the expense and other difficulties of individual determinations justified the inherent imprecision of a prophylactic rule. 422 U.S. at 777.

In sum, to the extent that there are valid administrative reasons to support the necessity to proceed on a closed class basis, there are strong defenses to any constitutional challenge. Nevertheless the closed class concept remains a troubling feature of the legislation from a constitutional standpoint.

C. MAY VARIOUS RESTRICTIONS BE IMPOSED ON THE TRANSFERABILITY OF GSOC SHARES INCLUDING (a) A TEMPORARY PROHIBITION ON THE TRANSFER OF SHARES FOR FIVE YEARS AFTER ISSUANCE, AND (b) AN ABSOLUTE PROHIBITION ON TRANSFERS TO NON-RESIDENTS, RESIDENTS WHO WOULD OWN MORE THAN TEN SHARES AFTER THE TRANSFER AND RESIDENT CORPORATIONS (AND OTHER LEGAL ENTITIES)?

The federal legislation provides various limitations on the powers of residents receiving GSOC shares to transfer their shares to others. Among those restrictions are: (1) a holder may not transfer his share for five years (except by will or descent) except where he ceases to be a resident of Alaska (§ 1391(a)(4)(D)(i)); (2) a holder may not transfer shares at any time to anyone not a resident of Alaska (§ 1391(a)(4)(D)(ii)); (3) a holder may not sell to any resident who, after the transfer, would own more than 10 GSOC shares (§ 1391(a)(4)(D)(iii)); and (4) a holder may not sell to a legal entity as opposed to an individual (§ 1391(a)(4)(D)(ii)).

Each of these restraints is required by the Internal Revenue Code as a condition of special tax treatment.[49/] While it could be argued that the restraints are a deprivation of substantive due process, on the ground that they unreasonably infringe on the holder's right to alienate his property, it is extremely unlikely that such an argument would be successful.[50/] State residents would certainly have no "fundamental right" to alienate their GSOC shares free of all restrictions. Rational bases for each restriction -- which are not set forth in the federal legislative history -- can and should be adduced in the state legislative record. For example, the five-year prohibition on transfer will greatly simplify the early administration of the GSOC. If shares could be transferred to non-residents, the administrative burden would expand, and one purpose of the GSOC -- to increase the participation of state residents in the development of the state -- would be hindered by sales out of state which would dilute the

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49/ Similar restrictions on alienation are imposed in other sections of the Internal Revenue Code as a condition to receiving tax benefits. For example, Section 422(a)(1) provides special treatment for qualified stock options provided that shares received upon exercise of the option are not disposed of for three years.

50/ We have not addressed the issue of whether these restraints on alienation present any problem under state law.

holdings of residents. To the extent that GSOC shares are expected to steadily increase in value, each state which chooses to implement a GSOC could reasonably desire to confer this benefit on its own residents. If ownership were not restricted to 10 shares per person, concentrated holdings of GSOC shares would hinder achievement of the purpose of widespread participation in capitalism. And if shares could be transferred to legal entities, such transfers could be used by residents holding ten GSOC shares, or by non-residents, to avoid the other alienation restrictions; in addition, holdings by legal entities would not be in furtherance of the avowed Congressional purpose of increasing individual participation in the free enterprise system.

D. MAY ALASKA REQUIRE HOLDERS OF GSOC SHARES TO SURRENDER (OR SELL) THOSE SHARES WHEN THEY LEAVE THE STATE?

While the federal law does not explicitly require that a GSOC holder surrender or sell his shares when leaving Alaska, it provides that no share of a GSOC may be transferable for five years after issuance "except where the shareholder ceases to be a resident of the State." (§ 1391(a)(4)(D)(i)). The federal law is thus silent as

to whether a shareholder must remain a resident in order to continue as a shareholder.

Presumably, Alaska will wish to clarify what is to become of a GSOC share when its owner leaves Alaska and ceases to be a resident. Of course, Alaska could merely allow the holder to retain his share and continue to receive dividends. Three alternatives come to mind: (1) that the GSOC share could cease to earn dividends when the holder leaves Alaska; (2) the holder could be obliged to surrender his share to the GSOC when leaving the state; and (3) the holder could be obliged to sell his share (at some value) to the GSOC or to another resident when leaving the state.

Each of these alternatives is fraught with problems of administration and enforcement, and each has important practical effects on the GSOC's operations. What legal complaints could a holder who moves out of the state make if Alaska chose one of these "recapture" provisions?

1. Equal Protection of the Laws

A former resident of Alaska may assert that in being obliged to surrender (or sell) his GSOC share or to be deprived of its earning ability merely because he has left the state, he has been penalized for exercising

his fundamental right to travel interstate and thus denied equal protection of the laws. Although one might think that strict scrutiny could be applied if involuntary deprivation of a GSOC share or its income could be seen as comparable to a denial of the necessities of life,[51/] a similar claim has been rejected by the Supreme Court. In Califano v. Torres, 435 U.S. 1 (1978) the Court analyzed and rejected under the rational basis test a claim that to cut off welfare benefits when a recipient moved to Puerto Rico penalized his right to travel.[52/] The Court stated that to require a person who travels to Puerto Rico to be given benefits superior to those enjoyed by other residents of Puerto Rico simply because he enjoyed them in the state from which he came "would require a State to continue to pay those benefits indefinitely to any persons who had once resided there." Id. at 4. Of course, whatever "penalty" on the travel right could be found in the GSOC situation after application of the Court's reasoning in Torres will be lessened if any Alaska recapture

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51/ Presumably in the future substantial value could be involved.

52/ Since Puerto Rico is not a state, a less fundamental right to international travel was probably involved. Cf. Califano v. Aznavorian, 47 U.S.L.W. 4037, 4039 (U.S. Dec. 11, 1978).

provision requires full payment of the value of the GSOC share.53/

Assuming the rational basis test is applied, administrative and policy reasons for restricting ownership to each state's residents set forth above probably would suffice to justify a GSOC provision that merely requires a departing resident to exchange his GSOC interest for fair market value. However, a more formidable problem would be presented by a provision that forfeited the share or the dividends of any resident departing the state. Justifications for such a provision could be made, however. For example, it could be asserted that it is reasonable for the GSOC to avoid both the depletion of cash reserves on account of direct cash payments and the administrative burden of establishing and regulating a market for the trading of this very limited number of shares, in light of the lack of a trading market for the shares in the early years and the difficulty of establishing a fair value. Perhaps, Alaska could also assert the need to qualify for the intrastate exemption from the Securities Act of 1933 and/or whatever conditions the Securities and Exchange

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53/ Presumably, it would also be less if the state into which the plaintiff moves has also established a GSOC with a policy of entry for new residents.

Commission imposes on whatever exemptions it grants the Alaska GSOC.[54/] In addition, it could be argued that the purpose of the GSOC is to establish long-term investment holdings by state residents, not to give cash windfalls to former residents. Nonetheless, these justifications are much weaker than the justifications for mere restraints on alienation, and the injury to affected individuals much greater. There is a substantial likelihood that a rational basis challenge to such a provision would be successful, and since it is possible that the strict scrutiny test would be applied due to the penalty on the travel interest involved, we believe inclusion of any confiscatory provision would be at the risk of invalidation.

1. Privileges and Immunities

A GSOC owner who ceases to be a resident may argue that Alaska is treating him differently from its residents in requiring him to surrender or sell his shares in violation of his privileges and immunities of state citizenship.

54/ See our Memorandum, Application of Federal Securities Laws to General Stock Ownership Corporations, dated November 2, 1978.

While involuntary relinquishment of a GSOC share which may by the time in question have substantial value and value-producing capacity is more substantial than the elk hunting restriction in Baldwin, a provision for Alaska's recapture of GSOC shares may nevertheless satisfy the Baldwin test if Alaska can assert rational policy reasons for the provision. Under the Hicklin analysis, presumably the evil which the recapture measure seeks to avoid is the dilution of the investment by Alaskans in Alaskan projects, as well as what may be an overwhelming administrative burden. In addition, if the former resident is either given fair value for his share or allowed to sell it, a strong argument can be made that since rational reasons support the decision to limit GSOC shares to state residents, and because he is being given "substantial equality of treatment" in comparison with residents, Austin v. New Hampshire, 420 U.S. 656, 665 (1975), a provision requiring the transfer of shares from all departing residents should be upheld in the face of a privileges and immunities challenge.

2. Commerce Clause

If a recapture provision is inserted in an Alaska statute, the commerce clause itself provides a basis for

attack.[55/] Presumably, the recapture provision, as one small part of a large and complex legislative program, would not be characterized as simple economic protectionism and *per se* invalid. Alaska would argue that any effect on commerce would be merely incidental and therefore permissible under the balancing test applied under the clause. In addition, Alaska can assert that a commerce clause challenge should be barred by operation of the *Hughes* decision, which held that the commerce clause was not violated when a state entered the market to increase commerce and in so doing favored its residents.

3. Due Process

Could a provision requiring the surrender by former residents of GSOC shares or their dividends be challenged successfully on the ground that it is an unconstitutional taking of property without payment of fair compensation? It is possible that the "taking" problem could be avoided by the statement on each GSOC share that it remains outstanding only as long as its holder remains an Alaskan resident, with the share either reverting to the state

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55/ For this reason, placing any such restriction in the GSOC's articles of incorporation would be preferable.

or losing its dividends if the holder moves out of state.[56/] There would be no taking of property without compensation to the extent that the alleged property interest infringed never existed.

A second possible due process problem is presented by a resident temporarily moving out of state who wishes to retain his state citizenship; he may claim he is entitled to procedural due process before he can be forced to sell or surrender his GSOC share. Assuming "state action" were found, the procedures that should be afforded in this situation could be modeled after procedures which must be afforded by universities in deciding whether a person is a resident for the purposes of in-state tuition.[57/]

On balance, we believe that if Alaska can assert strong reasons for its need for one or the other recapture provision, the provision should be enforceable; chances of survival are increased if the provision is placed in

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56/ This provision could be eternal, or could be limited to the first five years. Presumably after five years, a private market will have been established in which the former resident could receive fair value if forced to sell.

57/ See, e.g. Vlandis v. Kline, 412 U.S. at 451-53 (1973).

the GSOC's articles of incorporation and the former resident is fairly compensated.58/

E. MAY ALASKA RESTRICT ISSUANCE OF GSOC SHARES TO A LIMITED CLASS OF RESIDENTS, SUCH AS RESIDENTS OVER A CERTAIN AGE OR RESIDENTS OF LIMTED MEANS?

As a matter of statutory interpretation, we do not believe that the federal GSOC legislation leaves room for Alaska to restrict issuance of GSOC shares to a class more narrow than "eligible individuals" as defined in the tax legislation. Section 1391(a)(4)(C) specifies that the GSOC charter shall provide "for the issuance of at least one share to each eligible individual . . . ." (emphasis added). Section 1391(c) defines an "eligible individual" as a resident of the state on a date to be specified by the state, who remains a resident until share issuance. Read together, we believe these provisions simply leave no latitude for the state to issue GSOC shares to less than all eligible individuals as defined in the federal statute. Since the consequence of departing from the requirements imposed by the Internal Revenue Code is the

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58/ See footnote 4, supra.

We believe further analysis of the recapture problem is warranted once Alaska has decided it wishes to follow one or another of the alternatives.

loss of special tax benefits availabe to a GSOC, no attempt should be made to narrow the definition of "eligible individuals" without first receiving a ruling from the Internal Revenue Service that such action is consistent with the federal legislation.

If Alaska were permitted by the Service to restrict the class of eligible individuals, the choice to restrict GSOC ownership to adults or to those of limited means probably could not be successfully attacked on constitutional grounds.[59/]

59/ Age classification has not been recognized as constitutionally "suspect" and subject to strict scrutiny, Massachusetts Board of Retirement v. Murgia, 427 U.S. 307, 312-314 (1976), and the rational basis test would thus be applied in the review of a provision of Alaska law that GSOC shares be distributed only to residents over a certain age. If Alaska should desire to impose an age classification, it appears that sufficient rational bases exist to justify it. For example, Alaska could accept the traditional view that children of minority age do not have sufficient sense of responsibility to manage their own financial affairs; Alaska thus may desire to provide GSOC benefits only to those who will prudently use them. And Alaska may desire to give approximately the same GSOC benefit to each family, rather than to give a windfall to those families that include many children.

Furthermore, a wealth classification (for example, a restriction to families of limited means) would certainly not be consitititutionally "suspect" and subject to strict scrutiny. Wealth has never been a suspect class, and there would be no problem formulating a rational basis for aid to the poor. However, it should be noted that were Alaska to decide to restrict issuance of shares to residents of limited means, and obtained a revenue ruling which permitted this, GSOC dividends would have the character of welfare payments with the consequence of strengthening the argument that, because necessities of life may be involved, various GSOC restrictions penalize the exercise of the right to travel. See Shapiro, supra.

Conclusion

Although legal challenges to the GSOC concept and its particulars may occur, there are substantial arguments to be made in defense of the constitutionality of the salient features of the GSOC proposal as outlined in this memorandum.

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September 17, 1979

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BUDGET/AUDIT
COMMITTEE

Representative James Duncan
Chairman, Legislative Budget
and Audit Committee
Alaska Legislature
Pouch V
Juneau, Alaska 99811

Dear Representative Duncan:

I enclose a memorandum for your Committee on the federal tax and securities law issues raised by Senate Bill No. 170. The memorandum suggests several possible changes in S. 170 in order to facilitate the necessary federal action. Consistent with our contract with you of June 1, 1979, we have focused mainly on the securities and tax issues and have not attempted a review from the standpoint of constitutional questions or corporate law. However we have, in Section III of the memorandum, questioned the desirability on constitutional grounds, of the waiting period for eligibility under S. 170 and suggested an alternative.

Finally the memorandum outlines the approaches we recommend to the IRS and SEC. We would be grateful for your reaction to the memorandum and authorization to begin preliminary discussions with appropriate IRS and SEC officials. In the interest of time, we have begun drafting submissions to the two agencies along the lines proposed in our memorandum.

Sincerely,

Samuel A. Stern

Samuel A. Stern

cc: Mr. Dale E. Staley
Mr. Jerry Gauche

WILMER, CUTLER & PICKERING
1666 K STREET, N.W.
WASHINGTON, D. C. 20006

September 14, 1979

MEMORANDUM FOR THE LEGISLATIVE
BUDGET AND AUDIT COMMITTEE, STATE OF ALASKA

Subject: Proposed CSSS Senate Bill No. 170:
Federal Tax and Securities Laws Issues
and Suggested Approaches

You have asked us to review pending legislation[1/] permitting the establishment of an Alaskan General Stock Ownership Corporation ("AGSOC") in conformance with the recently enacted Subchapter U of the Internal Revenue Code.[2/] We have considered issues which may arise under the federal tax and securities laws in connection with this legislation, having previously, in our memorandum of November 2, 1978, for the Alaska Commissioner of Revenue, treated the securities law issues. This memorandum summarizes those issues, identifies optional approaches to resolution of certain problems, and identifies sections of S. 170 which you may wish to consider revising in order to facilitate regulatory approvals. We also propose an

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1/ CSSS Senate Bill No. 170, introduced as amended April 27, 1979. (Hereafter "S. 170").

2/ 26 U.S.C. §§ 1391-97, eff. November 6, 1978.

approach for our presentations to the Internal Revenue Service ("IRS"), and the Securities and Exchange Commission ("SEC") to facilitate the creation and operation of AGSOC in conformity with the federal regulatory provisions administered by those agencies.

I. SECURITIES REGULATION OF AGSOC

Our firm's Securities Law Memorandum of November 2, 1978, indicated that AGSOC will potentially be subject to provisions of three of the federal securities laws: the registration provisions of the Securities and Exchange Act of 1933 (the "1933 Act"); the registration, reporting, and proxy rules of the Securities Exchange Act of 1934 (the "1934 Act"), and the registration, conduct regulation and disclosure requirements of the Investment Company Act of 1940 (the "1940 Act").

S. 170 poses no securities regulation problems beyond those raised in our earlier memorandum.[3/] Because the statute is an adaptation of general corporation law,

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3/ However, we do recommend herein minor modifications to S. 170 to facilitate conformance with the intrastate exemption to the 1933 Act.

it does not deal with most of the subject areas which are likely to concern the SEC: particularly disclosure of risks to potential shareholders, periodic reports on financial condition, the administration of the "ballot" mechanisms, and fiduciary duties of officers and directors. Moreover, our initial approach to the SEC will be made at a time when the final form of the AGSOC has not yet been determined. For example, the question of the appropriate basis for exemption from the registration requirements of the 1933 Act must await a final decision as to whether payment of consideration will be required of Alaska citizens who wish to acquire AGSOC shares.[4/]

4/ We presume that an initial free issuance is preferred if we are able to obtain a ruling from the IRS that a tax will not be imposed upon citizens who receive shares. However, AGSOCA provides in Section 10.50.080 that

> "Shares may be issued without consideration or for consideration fixed by the shareholders before issuance. Consideration for shares shall be fixed by a vote of a majority of the shares voting on the issue."

This provision appears to suggest that AGSOC may charge consideration for shares only after the initial distribution as no shareholders will exist until then to fix the consideration. This point should be clarified if an initial charge for shares is contemplated. If you wish to leave the option open, Section 10.50.075 could be amended to read: "Shares may be issued without consideration or for consideration fixed by the Board of Directors before issuance."

We propose to present to the SEC a briefing memorandum describing the proposed AGSOC as set out in the S. 170 draft offered April 27, 1979, formally requesting a 1933 Act exemption, and requesting the commencement of negotiations to develop a modified form of 1934 Act regulation and a waiver of the 1940 Act's requirements during the first five years of AGSOC existence. We plan a preliminary presentation and discussions with the SEC prior to making detailed requests for rulings on the latter points so that we may involve them in establishing a creative approach to GSOC regulation. We hope to have received preliminary feedback from the SEC before S. 170 is passed in final form.

Provisions of the Securities Act of 1933

We believe, as we indicated in our Securities Memorandum, that AGSOC should not be subject to the registration requirements of the 1933 Act, either on the basis that an initial distribution of shares is not a "disposition . . . for value" within the meaning of Section 2(3) of the 1933 Act, or on the basis of the "intrastate exemption" provided by Section 3(a)(11) of

the same Act. We propose to argue both points to the SEC.[5/]

Even if the AGSOC shares are sold for consideration or if the SEC deems the disposition otherwise to be for value, we anticipate that we will be able to prevail on the theory that its shares are exempt from registration under the 1933 Act by virtue of the intrastate exemption in section 3(a)(11).[6/] The characteristics of offerings the SEC will deem as falling within

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5/ Of course, even if the initial distribution of shares is free of charge and thus falls within a "not for value" exemption to the Securities Act of 1933, any additional issuances which are for value would fall within the registration requirement unless they are otherwise exempt. This would include exchanges of shares for property or services as provided for in S. 170 § 10.50.085.

6/ This section exempts from registration:

> "Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory."

Section 3(a)(11) are described in non-exclusive Rule 147 (17 C.F.R. § 230.147).[7/] The rule requires that both the purchasers of the securities and the issuer have certain characteristics to ensure that both are truly residents of the state and that sales and resales are restricted to state residents. We believe that several minor changes in S. 170 are advisable in that they will bring the AGSOC within Rule 147 and thus simplify our task if the intrastate exemption need be relied on (either for the initial or any later issues).

AGSOC will be an Alaska corporation as required by Rule 147. Its principal place of business will probably be located in Alaska (Rule 147(c)(1)(i) and (2)(iv)), although the latter is not required by S. 170.[8/] We suggest that the legislature consider

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7/ Issuers may avail themselves of the intrastate exemption even if they do not satisfy all the provisions of this rule. 17 C.F.R. § 230.147 (Preliminary Notes, p. 1). If an issue satisfies all of Rule 147's provisions, however, the intrastate exemption will apply.

8/ S. 170 § 10.50.050 requires only that the corporation maintain a "registered office" within the state.

requiring AGSOC to have its principal place of business in Alaska as this would clarify this aspect of compliance with Rule 147.

Rule 147 restrictions on sales and resales to state residents are clearly satisfied by AGSOC.[9/] The basic purpose of Rule 147's limitations on resale is to ensure that securities do not enter the interstate marketplace. It does not appear that the fact that a few shares pass by descent after five years to out-of-state holders or that former residents may retain their AGSOC shares if they leave the state after five years is so inconsistent with those principles as to upset application of the exemption.

Rule 147 also requires that the issuer's business be conducted predominantly within the state in which the securities are distributed.[10/] The gross revenues and

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9/ Subchapter U and S. 170 provide that shares may only be transferred voluntarily or involuntarily to persons who are residents of the state. 26 U.S.C. § 1391(4)(D)(ii); S. 170 §§ 10.50.320(a)(6) & 8(B). The general prohibition against transfers except by descent for five years also helps to meet the Rule 147 requirement that resales in a nine-month period after the initial distribution be restricted to state residents. S. 170 also provides that if the shareholder leaves the state or shares pass by operation of law to a non-resident, the corporation shall repurchase them at book value. S.170, Section 4(c).

10/ The issuer must derive at least 80 percent of its gross revenues from within the State and have at least [Footnote continued on following page]

asset provisions of the rule will only be applicable to the initial GSOC distribution if AGSOC becomes operational before its shares are distributed. 11/ The use of proceeds provision will only apply if AGSOC charges for the shares, and it may be satisfied easily by segregating issue proceeds to ensure that they are spent within Alaska. If AGSOC is to acquire an asset prior to share distribution we must know what the asset is to formulate arguments that the asset and its income are "within" the State within the meaning of Rule 147 and section 3(a)(11). AGSOC will presumably be acquiring a minority participation in a joint venture as an asset. If majority control of that venture is in the hands of non-Alaskans, it is arguably not an Alaska asset. Also, income may or may not be deemed derived from within the state -- e.g., sales of oil to out-of-state corporations may be deemed non-Alaska income. Even if the initial

[Footnote continued]

80 percent of its assets within the State. Rule 147 (c)(2)(i) and (ii). It must also intend to use 30 percent of the net proceeds from sales of the issues in question within the State.

11/ Rule 147 provides that if gross revenues for the most recent twelve-month period are less than $5,000, the proceeds provision is not applicable.

distribution is of shares in a shell company, it will be necessary to examine whether AGSOC revenues can be deemed to arise from the "operation of a business or of real property within the state," with regard to subsequent issues of shares. The legislature may wish to consider so restricting the corporation in its enabling legislation.

S. 170 does not now specifically provide for procedures required by Rule 147 to ensure that the reality comports with the intent of the issuer.[12/] We recommend that the legislature amend S. 170 to provide for adequate legends on share certificates;[13/] and that

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12/ A legend on the share certificates must identify the limitations on resale and warn of the lack of registration, stop transfer instructions must be given to the transfer agent, and purchasers must be required to make written representations as to their residence. Rule 147 (b)(1). The issuer must also restrict sales of shares which are part of the same issue and make appropriate disclosures. *Id.* § (f)(2) and (3). S. 170 does require that eligible individuals apply for shares and that their interest will become void if it is determined that they misrepresented their eligibility. § 10.50.345-360. The SEC may wish to make rules in this regard or examine AGSOC procedures for establishing residency prior to authorizing sale or distribution without registration.

13/ S. 170 § 10.50.105 provides for extremely limited information to be contained on the certificate. We recommend that the legislature amend this section to require disclosure on the certificate of all the restraints on transfer, including the fact that shares are not transferable to non-residents.

the AGSOC provide for the application and stop transfer requirements in the articles of incorporation or the by-laws.

The Securities Exchange Act of 1934 and The Investment Company Act of 1940

As was indicated in our firm's Securities Memorandum, AGSOC does not fall within any statutory exemptions to either the 1934 or the 1940 Acts, and without special provision by the SEC, it will be required to register its securities, to file periodic reports, to comply with proxy rules, to comply with disclosure and trading rules under the 1934 Act and to file under and comply with the fiduciary standards of the 1940 Act.

The primary goals of the 1934 Act are to ensure that shareholders have adequate information concerning the financing and operations of registered companies to permit informed investment decisions, to ensure that shareholders have similar information when they are called upon to vote on corporate matters, and finally to ensure that sales and exchanges of shares occur in a free and open fair market exchange. The 1940 Act has similar goals although it additionally imposes certain fiduciary standards upon the management of investment companies because of the risks that it might usurp control of shareholder assets.

S. 170 permits the AGSOC to be run as a fairly conventional private corporation. It is primarily subject to control by the legislature in its initial stages[14/] and it is thereafter subject to governance by shareholders[15/] and the board of directors.[16/] It is unique in other respects: (1) its shareholders, constituting a cross-section of the state's citizens, will be in large measure unsophisticated in the exercise of shareholder rights and investment decisions;[17/] (2) shareholders will have little or no initial equity investment in AGSOC; (3) they will be subject to severe limitations on sales or transfers of their shares, particularly during the first five years

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14/ The legislature must amend the enabling legislation pursuant to § 10.50.640 to control it thereafter.

15/ A vote of shareholders is required to amend the articles of incorporation, § 10.50.375, and to approve certain asset sales.

16/ The directors may create and amend the bylaws, § 10.50.125, and have other standard management powers of corporate directors.

17/ Many shareholders will be minors or other legal incompetents.

after distribution;[18/] (4) ownership of shares will remain unconcentrated by statutory mandate; (5) bars to proxy

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18/ In conformance with Subchapter U, S. 170 provides many restrictions which will make it extremely difficult for a trading market in AGSOC shares to develop. For example, shares may not be transferred, voluntarily or involuntarily, within the first five years after issuance, and they may thereafter only be transferred to "resident individuals of the chartering State." It will not be possible for security brokers or dealers to make a market in AGSOC shares if this section is interpreted to mean such entities cannot hold AGSOC shares. Also, since no individual can own more than ten shares, it may not be feasible to create a trading market funded through transfer fees in a manner comparable to those which exist for other private corporate securities. The legislature should, as we previously recommended, give serious consideration to empowering AGSOC to be its own transfer agent or to the creation of a transfer mechanism for bringing together willing buyers and sellers.

Another potential problem is presented by the involuntary transferor. The AGSOC legislation provides at several points that redemption of shares shall be at book value. It is possible that there will be no or negative book value for the shares at stages during the operation of the corporation, when the carrying value of assets approximates the unamortized acquisition debt. This means that shareholders who leave the state or whose shares pass by operation of law to non-residents during the first five years after issuance may end up being forced to "sell" for far less than what would otherwise be market value. The legislature may wish to consider enabling AGSOC to pay a "fair market value" rather than book value to avoid unfairness.

usage[19/] and cumulative voting[20/] will limit shareholder power (while simultaneously barring usurpation of it by certain groups) and (6) AGSOC equity will be primarily supplied by loans from large financial institutions in reliance upon state guarantees. The existence of a diffuse, unsophisticated, and passive shareholder population together with a sophisticated and concerned set of creditors provides potential for abuses. S. 170 does not contain provisions which are adequate substitutes for most of the investor protections of the 1934 and 1940 Acts.[21/]

19/ §§ 10.50.155 & 175.

20/ § 10.50.160.

21/ For example, because of the large shareholder population involved and the large sums of money which will be sought from financial institutions, this entity may have major impact upon financial markets. The SEC will probably be quite concerned about the contents of disclosures made to potential shareholders because of the lack of sophistication of this group of people compared with other investors in corporate securities. Particular care should be given to disclosure of the rights of minors and incompetents, who will probably compose a significant portion of shareholders. We propose to represent to the SEC that the notices to Alaska residents, the prospectus or other offering circulars, and other explanations of AGSOC made available to the public will contain full disclosure of the risks to shareholders.

In addition, S. 170 has no provision imposing fiduciary duties on officers or directors, other than requirements that loans not be made to officers or directors and

[Footnote continued on following page]

Our briefing memorandum prepared for the SEC will suggest that a modified form of 1934 Act regulation will be adequate to meet these problems during the five years after the initial distribution and that 1940 Act regulation would be unnecessarily burdensome. However, we anticipate that some modifications to S. 170 may be requested by the SEC during the course of these discussions because of the possibilities for abuse.

II. FEDERAL TAXATION OF AGSOC AND AGSOC SHAREHOLDERS

Subchapter U permits the creation of GSOCs by states and generally provides that a GSOC set up in conformance with its requirements will be exempt from federal taxation. 26 U.S.C. § 1392.[22/] Taxation of the income of such corporations occurs at the shareholder level. § 1393. Shareholders also receive investment

[Footnote continued]

that distributions not be made unless there are adequate resources in the corporation. § 10.50.230. It provides for no periodic reports but only that shareholders may receive the most recent financial statements of the corporation upon written request. § 10.50.285.

22/ *See generally* Joint Committee on Taxation, *General Explanation of the Revenue Act of 1978* (H.R. 13511, 95th Cong.; P.L. 95-600)(Joint Committee Print, March 12, 1979, pp. 321-24).

tax credits which would otherwise accrue to the corporation. § 1393(b). The corporation, rather than its shareholders, utilizes net operating losses which it may incur, and these may be carried forward for a ten-year period. § 172(b)(1)(H). The GSOC is required by Subchapter U to distribute 90 percent of its annual taxable income to shareholders,[23/] (§ 1396), but to withhold 25 percent of such distributions for the IRS on behalf of shareholders. § 3402(r). AGSOC must file an informational tax return that identifies all shareholders and the distributions they have received. § 6039B.

Subchapter U permits a state to establish a GSOC between December 31, 1978 and January 1, 1984 by a charter enacted by the state legislature or a state-wide referendum. §§ 1391(a)(2) and (3). For the GSOC to qualify for the benefits of the Subchapter,

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23/ These distributions must be made by January 31 of the year following the taxable year in question. A GSOC must maintain a segregated shareholder income account for purposes of accounting for such distributions. § 1394. At certain points, S. 170 refers to "dividends" rather than distributions. *See*, *e.g.*, §§ 10.50.115(b), 10.50.140(a) and (b), 10.50.350, and 10.50.360; *cf.* § 10.50.215. These provisions should be conformed to the Subchapter U language.

its charter must provide for the issuance of only one class of stock, for the issuance of the stock only to "eligible individuals,"24/ for the issuance of at least one share of stock to each "eligible individual" unless such individual elects not to receive a share, and for certain restrictions on the transfer of shares. Id. § 1391(a)(4).25/ GSOCs may not own more than 20 percent of another company, (§ 1391(a), 1504), and may not obtain investment properties through the exercise of the state's power of eminent domain. § 1391(a)(5).

S. 170 contains the obligatory provisions required by Subchapter U26/ and generally appears to conform to the statutory standards. However, there are a few respects in which modifications to S. 170 may facilitate conformance of AGSOC with Subchapter U.

24/ Eligible individuals are defined as individuals who are residents of the chartering state during a period between "a date specified in the State's enabling legislation . . . and the date of issuance" of shares. § 1391(c).

25/ Shares may not be transferred for five years except by reason of death or if the shareholder ceases to reside in the state. Thereafter they may only be transferred to individual state residents who may not acquire more than 10 shares. Id. § 1391(a)(4)(D).

26/ See § 10.50.320(a), which requires AGSOC to set forth in its articles of incorporation Subchapter U's limitations on classes of shares, issuance, and restraints on alienation. S. 170 also requires that AGSOC must qualify under Subchapter U. § 10.50.320(9).

Taxation of Shareholders
at the Time of Distribution

Section 102 of the Internal Revenue Code provides that "gross income does not include the value of property acquired by gift . . . ." A gift has been defined as a voluntary transfer of property by one to another without any consideration or compensation therefor. Gray v. Barton, 55 N.Y. 68. The recipients of the shares are not required to do anything in order to be entitled to participate in AGSOC. They need only be residents of Alaska which they already are and will be. It cannot reasonably be argued that the possibility of becoming a shareholder will induce anyone to move to, or remain in Alaska. The recipients only have to be in Alaska to share in the disinterested generosity on the part of the donor. See Commissioner of Internal Revenue v. Duberstein, 363 U.S. 278 (1960).

It must be recognized that the IRS may resist treating the share distribution as a gift. For example, there is precedent for treating amounts as income where the recipient has done little or nothing to acquire the property. See Rev. Rul. 53-61, 1953-1 C.B. 17, holding treasure trove to be income to the finder. See also Cesarini v. United States, 428 F.2d 812 (6th Cir. 1970),

where a taxpayer was required to include in income c rrency discovered in a used piano bought at auction. The IRS has also held that payments under the Soil Bank Act, 7 U.S.C. § 1801, for refraining from planting crops constitute income. Rev. Rul. 60-32, 1960 C.B. 23. These precedents, which involve some minimal taxpayer activity, or induced inactivity, may be distinguishable in the mind of IRS. They do indicate, however, that there may be some reluctance on the part of IRS to exclude amounts from income, for example, where there is a transfer of property outside the normal family situation.

An alternative argument should also be considered. The receipt of shares by Alaska residents is comparable to a non-taxable transfer payment by a government. Support for the transfer payment analogy is found in the legislative history of Subchapter U.[27/]

In general, the IRS has taken the position that transfer payments such as social welfare payments are not non-taxable, although no statutory authority for it to do so exists. United States v. Kaiser, 363 U.S. 299, 305-14 & App. (1960)(concurring opinion of Mr.

27/ Senator Gravel emphasized the hope that GSOC income could ultimately become a substitute for welfare.

Justice Frankfurter); see, e.g., I.T. 3230, 1938-2 C.B. 136 (unemployment benefits); I.T. 3447, 1941-1 C.B. 191 (social security payments); Rev. Rul. 57-102, 1957-1 C.B. 26 (aid to the blind); Rev. Rul. 72-340, 1972-2 C.B. 31 (job training); Rev. Rul. 36-395, 1976-2 C.B. 16 (home rehabilitation grants).

Rev. Rul. 76-131, 1976-1 C.B. 16, holding that benefit payments under the Alaska Longevity Bonus Act are taxable appears readily distinguishable. Those payments are available to all Alaskans "to provide an incentive to continue uninterrupted residence in the State and under no circumstances is to be considered a form . . . of public relief." The payments by Alaska under this Act must have been sufficient in amount to provide a realistic inducement for persons to remain in the State and are comparable to the Soil Bank Act payments in Rev. Rul. 60-92, supra.

It will, of course, be helpful to a favorable determination by IRS that the value of these shares of AGSOC will be readily perceived to be negligible, or possibly zero. The cost basis for gain on a future sale of the shares by the donee shareholder will be the same as the cost to the donor, i.e., negligible or possibly zero. 26 U.S.C. § 1015. Accordingly, the IRS may

recognize the administrative convenience of not taxing the initial distribution but instead deferring the tax until eventual sale when the entire proceeds will be subject to tax.

Finally, in the event that IRS is unwilling to rule favorably on the tax treatment of the initial stock distribution, consideration may be given to obtaining the opinion of two reputable appraisers, if it can reasonably be anticipated that a conclusion of zero value will be reached. In view of the apparent negligible revenue loss involved, if any, it would be highly unlikely that such appraisal would not be accepted as conclusive of the issue.

Tax Consequences After the
Initial Distribution of Shares

Under federal law, AGSOC will become eligible for Subchapter U treatment once it qualifies and so elects. 26 U.S.C. 1392(a). It may revoke its election for a year or more with the consent of the Secretary of the Treasury. *Id.* § 1392(f). S. 170 provides that AGSOC shall be formed in conformance with Subchapter U, (§ 10.50.010), and that its Articles of Incorporation shall set out that it "must qualify" as a GSOC under Subchapter U. § 10.50.320(9). The Articles may be

amended in conformance with Section 10.50.365 *et seq.* but only if as amended the Articles "contain provisions which would be lawfully contained in original articles of incorporation at the time the amendment is made."

While the matter is not free from doubt, we believe the state legislation is thus more restrictive than Subchapter U,[28/] and requires AGSOC to maintain its election as a Subchapter U entity. We believe it would be preferable to permit a maximum flexibility by allowing the Articles to be amended to drop Subchapter U status under the usual procedure whereby the Board of Directors (or 1000 shareholders) proposes an amendment subject to shareholder approval. § 10.50.375. To accomplish this end, we believe § 10.50.320(9) should be modified[29/] and that the possibility of such a change should be added to the list in § 10.50.370.

28/ AGSOC may also lose its Subchapter U status under federal law by "ceasing to be" a GSOC, 26 U.S.C. § 1392(f), but it would appear that this can only occur by such affirmative actions as passing amendments which do not conform to § 1391(a)(4), acquiring assets through exercise of the power of eminent domain, or becoming a member of an affiliated group (*i.e.*, obtaining a greater than 20% investment in another group).

29/ The phrase "unless any election to so qualify is terminated under section 1392(f) of such Subchapter" would be added to the section.

Tax consequences to individuals holding AGSOC shares are set forth in Subchapter U, and nothing in S. 170 raises questions in this regard. The Internal Revenue Code provides that the IRS may by rule provide for a certification procedure by which AGSOC could be exempt, as to non-taxpayers, from the requirement of section 3402(r) that the GSOC reserve 25 percent of distributions as withheld taxes on behalf of shareholders as if it were their employer. 26 U.S.C. 3402(r). We propose to explore the feasibility of establishing such a procedure with the IRS. While such a procedure is desirable from a social welfare perspective (permitting these individuals to receive full distribution value as soon as possible and removing the burden of filing a federal tax return), a technique will have to be established to minimize administrative burdens upon AGSOC which would have to determine and keep a record of which of its anticipated 400,000 shareholders were taxpayers in any given year.

Summary of Points To Be Discussed with the IRS

We propose to present a brief memorandum describing AGSOC and S. 170 to officials of the IRS.

The focal point of our discussions will be the tax consequences of the initial distribution of shares. We propose to request a revenue ruling on this point on behalf of the citizen shareholders of the State of Alaska. Consideration should also be given to discussing the following matters with IRS:

(1) Confirmation of our understanding of how Subchapter U will work, including

  (a) AGSOC obligations to the IRS;

  (b) AGSOC shareholder obligations to the IRS;

  (c) The general type of reports IRS will desire from GSOCs and the types of regulations contemplated to be issued for GSOCs.

(2) Confirmation that AGSOC as proposed in S. 170 will be viewed in conformance with Subchapter U, including

  (a) That S. 170 is a sufficiently detailed "charter" within the meaning of 26 U.S.C. § 1391(a);30/

  (b) That the definition of "eligible individuals" conforms to Subchapter U requirements;

30/ It could be argued that such a charter must contain details of AGSOC governance as currently planned for the Articles of Incorporation.

(c) That charging consideration for shares will not defeat Subchapter U status;

(d) That S. 170 provisions requiring eligible individuals to apply for shares are compatible with Subchapter U status;31/

(e) That secondary issuances of shares will not be considered different classes of stocks in conflict with 26 U.S.C. § 1391(a)(4)(A).

III. CONSTITUTIONAL ISSUES

For purposes of determining who is an "eligible individual, the drafters of S. 170 would begin the mandatory period of state residency on the effective date of the enabling legislation. § 10.50.320(6). Persons who are entitled to receive shares thus must remain residents of Alaska for the entire period from the effective date of S. 170 until the date of issuance of shares.32/ As now defined, the class of eligible individuals is permanently fixed and any later issuances of shares by AGSOC apparently

31/ The federal legislation states that the GSOC shall provide for the "issuance of at least one share to each eligible individual," 26 U.S.C. § 1391(a)(4)(C). S. 170 makes clear that receipt of a share is dependent upon application by residents in response to state-wide notification procedures. § 10.50.345-360. We will attempt to clarify that the IRS does not deem GSOCs as under a duty to seek out and issue shares to all eligible individuals. Such a view could be fatal to AGSOC's tax-free status.

32/ These individuals are referred to herein as "charter residents."

may only be made to charter residents. We again call to your attention our reasons for questioning this approach, although it appears acceptable under Subchapter U.

First, this restriction of eligible individuals to members of a closed class of persons resident within the state at a fixed point in time may pose significant constitutional problems. See Wilmer, Cutler & Pickering, Memorandum for the Commissioner of Revenue, State of Alaska: Federal Constitutional Issues Presented by Alaska's GSOC (December 15, 1978).[33/] S. 170 exaggerates some of the problems we have previously raised because it also provides that within five years of issuance, shares must be sold back to the corporation if charter residents leave the state or die leaving their shares to nonresidents. This means that the pool of AGSOC shareholders will include only those charter residents who stay within the state for five years (and the small group who move into the state within this period and inherit shares from a charter resident). After five years, right to AGSOC shares seemingly vests in charter residents and their heirs may retain

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33/ (Hereinafter "Constitutional Memorandum"). As we indicated there, such limited eligibility for a government benefit must at least be based upon significant state interests as recited in legislative findings.

AGSOC shares even if they do not reside in Alaska. Establishing a fixed class which excludes Alaska citizens who are born in or move to Alaska after S. 170's effective date from AGSOC share issuances may then appear particularly inequitable in view of the fact that these non-Alaskan heirs will hold shares and receive AGSOC income. Even if later arriving residents may acquire shares from charter residents after the five-year period, there can be no assurance that a market in such shares will exist.

The possible constitutional problems are exacerbated by the fact the residency period to qualify as a charter resident could be lengthy, as AGSOC must be organized and become sufficiently operational to issue shares.[34/] The longer the eligibility period the more difficult it will be to verify compliance with residency requirements. A long residency period will also reduce

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34/ Incorporators must be selected, and an initial slate of directors chosen. The latter are subject to disapproval within 15 days of their nominations which could cause delay. S. 170 § 4(b). The directors must prepare articles of incorporation and bylaws, and there is at least a 60-90 day period after they have been drafted and filed during which the legislature has the authority to disapprove any of their provisions. § 10.50.335. Activities before share issuance but after finalization of the articles and bylaws, including preparation of offering materials and procedures for share distribution, will also take considerable time,

[Footnote continued on following page]

the pool of eligible individuals and increase the number of Alaska citizens who will be resident within the state on the date of issuance or before distribution but ineligible to receive AGSOC shares. The latter will increase the potential for challenges to the constitutionality of AGSOC, and may undercut the political acceptability of AGSOC as well.

A possible solution to these problems would be to revise S. 170 to provide that the eligibility period will commence on a fixed date prior to the date of share issuance[35/] -- *e.g.*, three to six months before issue. This approach has the advantage that if there is an issuance of shares subsequent to the initial distribution, later arriving residents could be included as long as they had

[Footnote continued]

for example, section 10.50.345 provides for notice to allow for application for shares of at least 90 days before the date of issuance. Litigation by opponents of some aspect of the program could cause indefinite delay. It appears extremely likely that the total period involved may exceed six months and could create constitutional problems under both the federal and State of Alaska constitutions. As we have mentioned previously, Alaska courts have taken a particularly strong stance against durational residency requirements. Constitutional Memorandum at 1, n.1, 34, n.38.

35/ The pivotal "date of issuance of shares" of S. 170 §§ 10.50.345 and 355 may not be effectual, since the bill appears to contemplate sporadic issue. Perhaps, the standard "the date of initial notification to the public of its intention to issue shares" would better carry out the purpose.

been and remained residents for the applicable period to the later issuance. This approach would, of course, exclude charter residents who leave the state prior to any secondary issuance.

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September 17, 1979

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BUDGET/AUDIT
COMMITTEE

Representative James Duncan
Chairman, Legislative Budget
and Audit Committee
Alaska Legislature
Pouch V
Juneau, Alaska 99811

Dear Representative Duncan:

I enclose a memorandum for your Committee on the federal tax and securities law issues raised by Senate Bill No. 170. The memorandum suggests several possible changes in S. 170 in order to facilitate the necessary federal action. Consistent with our contract with you of June 1, 1979, we have focused mainly on the securities and tax issues and have not attempted a review from the standpoint of constitutional questions or corporate law. However we have, in Section III of the memorandum, questioned the desirability on constitutional grounds, of the waiting period for eligibility under S. 170 and suggested an alternative.

Finally the memorandum outlines the approaches we recommend to the IRS and SEC. We would be grateful for your reaction to the memorandum and authorization to begin preliminary discussions with appropriate IRS and SEC officials. In the interest of time, we have begun drafting submissions to the two agencies along the lines proposed in our memorandum.

Sincerely,

Samuel A. Stern

Samuel A. Stern

cc: Mr. Dale E. Staley

WILMER, CUTLER & PICKERING
1666 K STREET, N. W.
WASHINGTON, D. C. 20006

September 14, 1979

MEMORANDUM FOR THE LEGISLATIVE
BUDGET AND AUDIT COMMITTEE, STATE OF ALASKA

Subject: Proposed CSSS Senate Bill No. 170: Federal Tax and Securities Laws Issues and Suggested Approaches

You have asked us to review pending legislation[1/] permitting the establishment of an Alaskan General Stock Ownership Corporation ("AGSOC") in conformance with the recently enacted Subchapter U of the Internal Revenue Code.[2/] We have considered issues which may arise under the federal tax and securities laws in connection with this legislation, having previously, in our memorandum of November 2, 1978, for the Alaska Commissioner of Revenue, treated the securities law issues. This memorandum summarizes those issues, identifies optional approaches to resolution of certain problems, and identifies sections of S. 170 which you may wish to consider revising in order to facilitate regulatory approvals. We also propose an

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1/ CSSS Senate Bill No. 170, introduced as amended April 27, 1979. (Hereafter "S. 170").

2/ 26 U.S.C. §§ 1391-97, eff. November 6, 1978.

approach for our presentations to the Internal Revenue Service ("IRS"), and the Securities and Exchange Commission ("SEC") to facilitate the creation and operation of AGSOC in conformity with the federal regulatory provisions administered by those agencies.

I. SECURITIES REGULATION OF AGSOC

Our firm's Securities Law Memorandum of November 2, 1978, indicated that AGSOC will potentially be subject to provisions of three of the federal securities laws: the registration provisions of the Securities and Exchange Act of 1933 (the "1933 Act"); the registration, reporting, and proxy rules of the Securities Exchange Act of 1934 (the "1934 Act"), and the registration, conduct regulation and disclosure requirements of the Investment Company Act of 1940 (the "1940 Act").

S. 170 poses no securities regulation problems beyond those raised in our earlier memorandum.[3/] Because the statute is an adaptation of general corporation law,

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3/ However, we do recommend herein minor modifications to S. 170 to facilitate conformance with the intrastate exemption to the 1933 Act.

it does not deal with most of the subject areas which are likely to concern the SEC: particularly disclosure of risks to potential shareholders, periodic reports on financial condition, the administration of the "ballot" mechanisms, and fiduciary duties of officers and directors. Moreover, our initial approach to the SEC will be made at a time when the final form of the AGSOC has not yet been determined. For example, the question of the appropriate basis for exemption from the registration requirements of the 1933 Act must await a final decision as to whether payment of consideration will be required of Alaska citizens who wish to acquire AGSOC shares.[4/]

4/ We presume that an initial free issuance is preferred if we are able to obtain a ruling from the IRS that a tax will not be imposed upon citizens who receive shares. However, AGSOCA provides in Section 10.50.080 that

> "Shares may be issued without consideration or for consideration fixed by the shareholders before issuance. Consideration for shares shall be fixed by a vote of a majority of the shares voting on the issue."

This provision appears to suggest that AGSOC may charge consideration for shares only after the initial distribution as no shareholders will exist until then to fix the consideration. This point should be clarified if an initial charge for shares is contemplated. If you wish to leave the option open, Section 10.50.075 could be amended to read: "Shares may be issued without consideration or for consideration fixed by the Board of Directors before issuance."

We propose to present to the SEC a briefing memorandum describing the proposed AGSOC as set out in the S. 170 draft offered April 27, 1979, formally requesting a 1933 Act exemption, and requesting the commencement of negotiations to develop a modified form of 1934 Act regulation and a waiver of the 1940 Act's requirements during the first five years of AGSOC existence. We plan a preliminary presentation and discussions with the SEC prior to making detailed requests for rulings on the latter points so that we may involve them in establishing a creative approach to GSOC regulation. We hope to have received preliminary feedback from the SEC before S. 170 is passed in final form.

Provisions of the Securities Act of 1933

We believe, as we indicated in our Securities Memorandum, that AGSOC should not be subject to the registration requirements of the 1933 Act, either on the basis that an initial distribution of shares is not a "disposition . . . for value" within the meaning of Section 2(3) of the 1933 Act, or on the basis of the "intrastate exemption" provided by Section 3(a)(11) of

the same Act. We propose to argue both points to the SEC.[5/]

Even if the AGSOC shares are sold for consideration or if the SEC deems the disposition otherwise to be for value, we anticipate that we will be able to prevail on the theory that its shares are exempt from registration under the 1933 Act by virtue of the intrastate exemption in section 3(a)(11).[6/] The characteristics of offerings the SEC will deem as falling within

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5/ Of course, even if the initial distribution of shares is free of charge and thus falls within a "not for value" exemption to the Securities Act of 1933, any additional issuances which are for value would fall within the registration requirement unless they are otherwise exempt. This would include exchanges of shares for property or services as provided for in S. 170 § 10.50.085.

6/ This section exempts from registration:

> "Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory."

Section 3(a)(11) are described in non-exclusive Rule 147 (17 C.F.R. § 230.147).[7/] The rule requires that both the purchasers of the securities and the issuer have certain characteristics to ensure that both are truly residents of the state and that sales and resales are restricted to state residents. We believe that several minor changes in S. 170 are advisable in that they will bring the AGSOC within Rule 147 and thus simplify our task if the intrastate exemption need be relied on (either for the initial or any later issues).

AGSOC will be an Alaska corporation as required by Rule 147. Its principal place of business will probably be located in Alaska (Rule 147(c)(1)(i) and (2)(iv)), although the latter is not required by S. 170.[8/] We suggest that the legislature consider

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7/ Issuers may avail themselves of the intrastate exemption even if they do not satisfy all the provisions of this rule. 17 C.F.R. § 230.147 (Preliminary Notes, p. 1). If an issue satisfies all of Rule 147's provisions, however, the intrastate exemption will apply.

8/ S. 170 § 10.50.050 requires only that the corporation maintain a "registered office" within the state.

requiring AGSOC to have its principal place of business in Alaska as this would clarify this aspect of compliance with Rule 147.

Rule 147 restrictions on sales and resales to state residents are clearly satisfied by AGSOC.[9/] The basic purpose of Rule 147's limitations on resale is to ensure that securities do not enter the interstate marketplace. It does not appear that the fact that a few shares pass by descent after five years to out-of-state holders or that former residents may retain their AGSOC shares if they leave the state after five years is so inconsistent with those principles as to upset application of the exemption.

Rule 147 also requires that the issuer's business be conducted predominantly within the state in which the securities are distributed.[10/] The gross revenues and

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9/ Subchapter U and S. 170 provide that shares may only be transferred voluntarily or involuntarily to persons who are residents of the state. 26 U.S.C. § 1391(4)(D)(ii); S. 170 §§ 10.50.320(a)(6) & 8(B). The general prohibition against transfers except by descent for five years also helps to meet the Rule 147 requirement that resales in a nine-month period after the initial distribution be restricted to state residents. S. 170 also provides that if the shareholder leaves the state or shares pass by operation of law to a non-resident, the corporation shall repurchase them at book value. S.170, Section 4(c).

10/ The issuer must derive at least 80 percent of its gross revenues from within the State and have at least [Footnote continued on following page]

asset provisions of the rule will only be applicable to the initial GSOC distribution if AGSOC becomes operational before its shares are distributed.[11/] The use of proceeds provision will only apply if AGSOC charges for the shares, and it may be satisfied easily by segregating issue proceeds to ensure that they are spent within Alaska. If AGSOC is to acquire an asset prior to share distribution we must know what the asset is to formulate arguments that the asset and its income are "within" the State within the meaning of Rule 147 and section 3(a)(11). AGSOC will presumably be acquiring a minority participation in a joint venture as an asset. If majority control of that venture is in the hands of non-Alaskans, it is arguably not an Alaska asset. Also, income may or may not be deemed derived from within the state -- e.g., sales of oil to out-of-state corporations may be deemed non-Alaska income. Even if the initial

[Footnote continued]

80 percent of its assets within the State. Rule 147 (c)(2)(i) and (ii). It must also intend to use 30 percent of the net proceeds from sales of the issues in question within the State.

11/ Rule 147 provides that if gross revenues for the most recent twelve-month period are less than $5,000, the proceeds provision is not applicable.

distribution is of shares in a shell company, it will be necessary to examine whether AGSOC revenues can be deemed to arise from the "operation of a business or of real property within the state," with regard to subsequent issues of shares. The legislature may wish to consider so restricting the corporation in its enabling legislation.

S. 170 does not now specifically provide for procedures required by Rule 147 to ensure that the reality comports with the intent of the issuer.[12/] We recommend that the legislature amend S. 170 to provide for adequate legends on share certificates;[13/] and that

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12/ A legend on the share certificates must identify the limitations on resale and warn of the lack of registration, stop transfer instructions must be given to the transfer agent, and purchasers must be required to make written representations as to their residence. Rule 147 (b)(1). The issuer must also restrict sales of shares which are part of the same issue and make appropriate disclosures. Id. § (f)(2) and (3). S. 170 does require that eligible individuals apply for shares and that their interest will become void if it is determined that they misrepresented their eligibility. § 10.50.345-360. The SEC may wish to make rules in this regard or examine AGSOC procedures for establishing residency prior to authorizing sale or distribution without registration.

13/ S. 170 § 10.50.105 provides for extremely limited information to be contained on the certificate. We recommend that the legislature amend this section to require disclosure on the certificate of all the restraints on transfer, including the fact that shares are not transferable to non-residents.

the AGSOC provide for the application and stop transfer requirements in the articles of incorporation or the by-laws.

The Securities Exchange Act of 1934
and The Investment Company Act of 1940

As was indicated in our firm's Securities Memorandum, AGSOC does not fall within any statutory exemptions to either the 1934 or the 1940 Acts, and without special provision by the SEC, it will be required to register its securities, to file periodic reports, to comply with proxy rules, to comply with disclosure and trading rules under the 1934 Act and to file under and comply with the fiduciary standards of the 1940 Act.

The primary goals of the 1934 Act are to ensure that shareholders have adequate information concerning the financing and operations of registered companies to permit informed investment decisions, to ensure that shareholders have similar information when they are called upon to vote on corporate matters, and finally to ensure that sales and exchanges of shares occur in a free and open fair market exchange. The 1940 Act has similar goals although it additionally imposes certain fiduciary standards upon the management of investment companies because of the risks that it might usurp control of shareholder assets.

S. 170 permits the AGSOC to be run as a fairly conventional private corporation. It is primarily subject to control by the legislature in its initial stages[14/] and it is thereafter subject to governance by shareholders[15/] and the board of directors.[16/] It is unique in other respects: (1) its shareholders, constituting a cross-section of the state's citizens, will be in large measure unsophisticated in the exercise of shareholder rights and investment decisions;[17/] (2) shareholders will have little or no initial equity investment in AGSOC; (3) they will be subject to severe limitations on sales or transfers of their shares, particularly during the first five years

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14/ The legislature must amend the enabling legislation pursuant to § 10.50.640 to control it thereafter.

15/ A vote of shareholders is required to amend the articles of incorporation, § 10.50.375, and to approve certain asset sales.

16/ The directors may create and amend the bylaws, § 10.50.125, and have other standard management powers of corporate directors.

17/ Many shareholders will be minors or other legal incompetents.

after distribution;[18/] (4) ownership of shares will remain unconcentrated by statutory mandate; (5) bars to proxy

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18/ In conformance with Subchapter U, S. 170 provides many restrictions which will make it extremely difficult for a trading market in AGSOC shares to develop. For example, shares may not be transferred, voluntarily or involuntarily, within the first five years after issuance, and they may thereafter only be transferred to "resident individuals of the chartering State." It will not be possible for security brokers or dealers to make a market in AGSOC shares if this section is interpreted to mean such entities cannot hold AGSOC shares. Also, since no individual can own more than ten shares, it may not be feasible to create a trading market funded through transfer fees in a manner comparable to those which exist for other private corporate securities. The legislature should, as we previously recommended, give serious consideration to empowering AGSOC to be its own transfer agent or to the creation of a transfer mechanism for bringing together willing buyers and sellers.

Another potential problem is presented by the involuntary transferor. The AGSOC legislation provides at several points that redemption of shares shall be at book value. It is possible that there will be no or negative book value for the shares at stages during the operation of the corporation, when the carrying value of assets approximates the unamortized acquisition debt. This means that shareholders who leave the state or whose shares pass by operation of law to non-residents during the first five years after issuance may end up being forced to "sell" for far less than what would otherwise be market value. The legislature may wish to consider enabling AGSOC to pay a "fair market value" rather than book value to avoid unfairness.

usage[19/] and cumulative voting[20/] will limit shareholder power (while simultaneously barring usurpation of it by certain groups) and (6) AGSOC equity will be primarily supplied by loans from large financial institutions in reliance upon state guarantees. The existence of a diffuse, unsophisticated, and passive shareholder population together with a sophisticated and concerned set of creditors provides potential for abuses. S. 170 does not contain provisions which are adequate substitutes for most of the investor protections of the 1934 and 1940 Acts.[21/]

19/ §§ 10.50.155 & 175.

20/ § 10.50.160.

21/ For example, because of the large shareholder population involved and the large sums of money which will be sought from financial institutions, this entity may have major impact upon financial markets. The SEC will probably be quite concerned about the contents of disclosures made to potential shareholders because of the lack of sophistication of this group of people compared with other investors in corporate securities. Particular care should be given to disclosure of the rights of minors and incompetents, who will probably compose a significant portion of shareholders. We propose to represent to the SEC that the notices to Alaska residents, the prospectus or other offering circulars, and other explanations of AGSOC made available to the public will contain full disclosure of the risks to shareholders.

In addition, S. 170 has no provision imposing fiduciary duties on officers or directors, other than requirements that loans not be made to officers or directors and
[Footnote continued on following page]

Our briefing memorandum prepared for the SEC will suggest that a modified form of 1934 Act regulation will be adequate to meet these problems during the five years after the initial distribution and that 1940 Act regulation would be unnecessarily burdensome. However, we anticipate that some modifications to S. 170 may be requested by the SEC during the course of these discussions because of the possibilities for abuse.

II. FEDERAL TAXATION OF AGSOC AND AGSOC SHAREHOLDERS

Subchapter U permits the creation of GSOCs by states and generally provides that a GSOC set up in conformance with its requirements will be exempt from federal taxation. 26 U.S.C. § 1392.[22/] Taxation of the income of such corporations occurs at the shareholder level. § 1393. Shareholders also receive investment

[Footnote continued]

that distributions not be made unless there are adequate resources in the corporation. § 10.50.230. It provides for no periodic reports but only that shareholders may receive the most recent financial statements of the corporation upon written request. § 10.50.285.

22/ See generally Joint Committee on Taxation, General Explanation of the Revenue Act of 1978 (H.R. 13511, 95th Cong.; P.L. 95-600)(Joint Committee Print, March 12, 1979, pp. 321-24).

tax credits which would otherwise accrue to the corporation. § 1393(b). The corporation, rather than its shareholders, utilizes net operating losses which it may incur, and these may be carried forward for a ten-year period. § 172(b)(1)(H). The GSOC is required by Subchapter U to distribute 90 percent of its annual taxable income to shareholders,[23/] (§ 1396), but to withhold 25 percent of such distributions for the IRS on behalf of shareholders. § 3402(r). AGSOC must file an informational tax return that identifies all shareholders and the distributions they have received. § 6039B.

Subchapter U permits a state to establish a GSOC between December 31, 1978 and January 1, 1984 by a charter enacted by the state legislature or a state-wide referendum. §§ 1391(a)(2) and (3). For the GSOC to qualify for the benefits of the Subchapter,

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23/ These distributions must be made by January 31 of the year following the taxable year in question. A GSOC must maintain a segregated shareholder income account for purposes of accounting for such distributions. § 1394. At certain points, S. 170 refers to "dividends" rather than distributions. See, e.g., §§ 10.50.115(b), 10.50.140(a) and (b), 10.50.350, and 10.50.360; cf. § 10.50.215. These provisions should be conformed to the Subchapter U language.

its charter must provide for the issuance of only one class of stock, for the issuance of the stock only to "eligible individuals,"[24/] for the issuance of at least one share of stock to each "eligible individual" unless such individual elects not to receive a share, and for certain restrictions on the transfer of shares. Id. § 1391(a)(4).[25/] GSOCs may not own more than 20 percent of another company, (§ 1391(a), 1504), and may not obtain investment properties through the exercise of the state's power of eminent domain. § 1391(a)(5).

S. 170 contains the obligatory provisions required by Subchapter U[26/] and generally appears to conform to the statutory standards. However, there are a few respects in which modifications to S. 170 may facilitate conformance of AGSOC with Subchapter U.

24/ Eligible individuals are defined as individuals who are residents of the chartering state during a period between "a date specified in the State's enabling legislation . . . and the date of issuance" of shares. § 1391(c).

25/ Shares may not be transferred for five years except by reason of death or if the shareholder ceases to reside in the state. Thereafter they may only be transferred to individual state residents who may not acquire more than 10 shares. Id. § 1391(a)(4)(D).

26/ See § 10.50.320(a), which requires AGSOC to set forth in its articles of incorporation Subchapter U's limitations on classes of shares, issuance, and restraints on alienation. S. 170 also requires that AGSOC must qualify under Subchapter U. § 10.50.320(9).

Taxation of Shareholders
at the Time of Distribution

Section 102 of the Internal Revenue Code provides that "gross income does not include the value of property acquired by gift . . . ." A gift has been defined as a voluntary transfer of property by one to another without any consideration or compensation therefor. Gray v. Barton, 55 N.Y. 68. The recipients of the shares are not required to do anything in order to be entitled to participate in AGSOC. They need only be residents of Alaska which they already are and will be. It cannot reasonably be argued that the possibility of becoming a shareholder will induce anyone to move to, or remain in Alaska. The recipients only have to be in Alaska to share in the disinterested generosity on the part of the donor. See Commissioner of Internal Revenue v. Duberstein, 363 U.S. 278 (1960).

It must be recognized that the IRS may resist treating the share distribution as a gift. For example, there is precedent for treating amounts as income where the recipient has done little or nothing to acquire the property. See Rev. Rul. 53-61, 1953-1 C.B. 17, holding treasure trove to be income to the finder. See also Cesarini v. United States, 428 F.2d 812 (6th Cir. 1970),

where a taxpayer was required to include in income currency discovered in a used piano bought at auction. The IRS has also held that payments under the Soil Bank Act, 7 U.S.C. § 1801, for refraining from planting crops constitute income. Rev. Rul. 60-32, 1960 C.B. 23. These precedents, which involve some minimal taxpayer activity, or induced inactivity, may be distinguishable in the mind of IRS. They do indicate, however, that there may be some reluctance on the part of IRS to exclude amounts from income, for example, where there is a transfer of property outside the normal family situation.

An alternative argument should also be considered. The receipt of shares by Alaska residents is comparable to a non-taxable transfer payment by a government. Support for the transfer payment analogy is found in the legislative history of Subchapter U.[27/]

In general, the IRS has taken the position that transfer payments such as social welfare payments are not non-taxable, although no statutory authority for it to do so exists. United States v. Kaiser, 363 U.S. 299, 305-14 & App. (1960)(concurring opinion of Mr.

27/ Senator Gravel emphasized the hope that GSOC income could ultimately become a substitute for welfare.

Justice Frankfurter); see, e.g., I.T. 3230, 1938-2 C.B. 136 (unemployment benefits); I.T. 3447, 1941-1 C.B. 191 (social security payments); Rev. Rul. 57-102, 1957-1 C.B. 26 (aid to the blind); Rev. Rul. 72-340, 1972-2 C.B. 31 (job training); Rev. Rul. 36-395, 1976-2 C.B. 16 (home rehabilitation grants).

Rev. Rul. 76-131, 1976-1 C.B. 16, holding that benefit payments under the Alaska Longevity Bonus Act are taxable appears readily distinguishable. Those payments are available to all Alaskans "to provide an incentive to continue uninterrupted residence in the State and under no circumstances is to be considered a form . . . of public relief." The payments by Alaska under this Act must have been sufficient in amount to provide a realistic inducement for persons to remain in the State and are comparable to the Soil Bank Act payments in Rev. Rul. 60-92, supra.

It will, of course, be helpful to a favorable determination by IRS that the value of these shares of AGSOC will be readily perceived to be negligible, or possibly zero. The cost basis for gain on a future sale of the shares by the donee shareholder will be the same as the cost to the donor, i.e., negligible or possibly zero. 26 U.S.C. § 1015. Accordingly, the IRS may

recognize the administrative convenience of not taxing the initial distribution but instead deferring the tax until eventual sale when the entire proceeds will be subject to tax.

Finally, in the event that IRS is unwilling to rule favorably on the tax treatment of the initial stock distribution, consideration may be given to obtaining the opinion of two reputable appraisers, if it can reasonably be anticipated that a conclusion of zero value will be reached. In view of the apparent negligible revenue loss involved, if any, it would be highly unlikely that such appraisal would not be accepted as conclusive of the issue.

Tax Consequences After the Initial Distribution of Shares

Under federal law, AGSOC will become eligible for Subchapter U treatment once it qualifies and sc elects. 26 U.S.C. 1392(a). It may revoke its election for a year or more with the consent of the Secretary of the Treasury. *Id.* § 1392(f). S. 170 provides that AGSOC shall be formed in conformance with Subchapter U, (§ 10.50.010), and that its Articles of Incorporation shall set out that it "must qualify" as a GSOC under Subchapter U. § 10.50.320(9). The Articles may be

amended in conformance with Section 10.50.365 et seq. but only if as amended the Articles "contain provisions which would be lawfully contained in original articles of incorporation at the time the amendment is made."

While the matter is not free from doubt, we believe the state legislation is thus more restrictive than Subchapter U,[28/] and requires AGSOC to maintain its election as a Subchapter U entity. We believe it would be preferable to permit a maximum flexibility by allowing the Articles to be amended to drop Subchapter U status under the usual procedure whereby the Board of Directors (or 1000 shareholders) proposes an amendment subject to shareholder approval. § 10.50.375. To accomplish this end, we believe § 10.50.320(9) should be modified[29/] and that the possibility of such a change should be added to the list in § 10.50.370.

28/ AGSOC may also lose its Subchapter U status under federal law by "ceasing to be" a GSOC, 26 U.S.C. § 1392(f), but it would appear that this can only occur by such affirmative actions as passing amendments which do not conform to § 1391(a)(4), acquiring assets through exercise of the power of eminent domain, or becoming a member of an affiliated group (i.e., obtaining a greater than 20% investment in another group).

29/ The phrase "unless any election to so qualify is terminated under section 1392(f) of such Subchapter" would be added to the section.

Tax consequences to individuals holding AGSOC shares are set forth in Subchapter U, and nothing in S. 170 raises questions in this regard. The Internal Revenue Code provides that the IRS may by rule provide for a certification procedure by which AGSOC could be exempt, as to non-taxpayers, from the requirement of section 3402(r) that the GSOC reserve 25 percent of distributions as withheld taxes on behalf of shareholders as if it were their employer. 26 U.S.C. 3402(r). We propose to explore the feasibility of establishing such a procedure with the IRS. While such a procedure is desirable from a social welfare perspective (permitting these individuals to receive full distribution value as soon as possible and removing the burden of filing a federal tax return), a technique will have to be established to minimize administrative burdens upon AGSOC which would have to determine and keep a record of which of its anticipated 400,000 shareholders were taxpayers in any given year.

Summary of Points To Be Discussed with the IRS

We propose to present a brief memorandum describing AGSOC and S. 170 to officials of the IRS.

The focal point of our discussions will be the tax consequences of the initial distribution of shares. We propose to request a revenue ruling on this point on behalf of the citizen shareholders of the State of Alaska. Consideration should also be given to discussing the following matters with IRS:

(1) Confirmation of our understanding of how Subchapter U will work, including

   (a) AGSOC obligations to the IRS;

   (b) AGSOC shareholder obligations to the IRS;

   (c) The general type of reports IRS will desire from GSOCs and the types of regulations contemplated to be issued for GSOCs.

(2) Confirmation that AGSOC as proposed in S. 170 will be viewed in conformance with Subchapter U, including

   (a) That S. 170 is a sufficiently detailed "charter" within the meaning of 26 U.S.C. § 1391(a);30/

   (b) That the definition of "eligible individuals" conforms to Subchapter U requirements;

30/ It could be argued that such a charter must contain details of AGSOC governance as currently planned for the Articles of Incorporation.

(c) That charging consideration for shares will not defeat Subchapter U status;

(d) That S. 170 provisions requiring eligible individuals to apply for shares are compatible with Subchapter U status;31/

(e) That secondary issuances of shares will not be considered different classes of stocks in conflict with 26 U.S.C. § 1391(a)(4)(A).

III. CONSTITUTIONAL ISSUES

For purposes of determining who is an "eligible individual, the drafters of S. 170 would begin the mandatory period of state residency on the effective date of the enabling legislation. § 10.50.320(6). Persons who are entitled to receive shares thus must remain residents of Alaska for the entire period from the effective date of S. 170 until the date of issuance of shares.32/ As now defined, the class of eligible individuals is permanently fixed and any later issuances of shares by AGSOC apparently

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31/ The federal legislation states that the GSOC shall provide for the "issuance of at least one share to each eligible individual," 26 U.S.C. § 1391(a)(4)(C). S. 170 makes clear that receipt of a share is dependent upon application by residents in response to state-wide notification procedures. § 10.50.345-360. We will attempt to clarify that the IRS does not deem GSOCs as under a duty to seek out and issue shares to all eligible individuals. Such a view could be fatal to AGSOC's tax-free status.

32/ These individuals are referred to herein as "charter residents."

may only be made to charter residents. We again call to your attention our reasons for questioning this approach, although it appears acceptable under Subchapter U.

First, this restriction of eligible individuals to members of a closed class of persons resident within the state at a fixed point in time may pose significant constitutional problems. See Wilmer, Cutler & Pickering, Memorandum for the Commissioner of Revenue, State of Alaska: Federal Constitutional Issues Presented by Alaska's GSOC (December 15, 1978).[33/] S. 170 exaggerates some of the problems we have previously raised because it also provides that within five years of issuance, shares must be sold back to the corporation if charter residents leave the state or die leaving their shares to nonresidents. This means that the pool of AGSOC shareholders will include only those charter residents who stay within the state for five years (and the small group who move into the state within this period and inherit shares from a charter resident). After five years, right to AGSOC shares seemingly vests in charter residents and their heirs may retain

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33/ (Hereinafter "Constitutional Memorandum"). As we indicated there, such limited eligibility for a government benefit must at least be based upon significant state interests as recited in legislative findings.

AGSOC shares even if they do not reside in Alaska. Establishing a fixed class which excludes Alaska citizens who are born in or move to Alaska after S. 170's effective date from AGSOC share issuances may then appear particularly inequitable in view of the fact that these non-Alaskan heirs will hold shares and receive AGSOC income. Even if later arriving residents may acquire shares from charter residents after the five-year period, there can be no assurance that a market in such shares will exist.

The possible constitutional problems are exacerbated by the fact the residency period to qualify as a charter resident could be lengthy, as AGSOC must be organized and become sufficiently operational to issue shares.[34/] The longer the eligibility period the more difficult it will be to verify compliance with residency requirements. A long residency period will also reduce

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34/ Incorporators must be selected, and an initial slate of directors chosen. The latter are subject to disapproval within 15 days of their nominations which could cause delay. S. 170 § 4(b). The directors must prepare articles of incorporation and bylaws, and there is at least a 60-90 day period after they have been drafted and filed during which the legislature has the authority to disapprove any of their provisions. § 10.50.335. Activities before share issuance but after finalization of the articles and bylaws, including preparation of offering materials and procedures for share distribution, will also take considerable time,

[Footnote continued on following page]

the pool of eligible individuals and increase the number of Alaska citizens who will be resident within the state on the date of issuance or before distribution but ineligible to receive AGSOC shares. The latter will increase the potential for challenges to the constitutionality of AGSOC, and may undercut the political acceptability of AGSOC as well.

A possible solution to these problems would be to revise S. 170 to provide that the eligibility period will commence on a fixed date prior to the date of share issuance[35/] -- *e.g.*, three to six months before issue. This approach has the advantage that if there is an issuance of shares subsequent to the initial distribution, later arriving residents could be included as long as they had

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[Footnote continued]

for example, section 10.50.345 provides for notice to allow for application for shares of at least 90 days before the date of issuance. Litigation by opponents of some aspect of the program could cause indefinite delay. It appears extremely likely that the total period involved may exceed six months and could create constitutional problems under both the federal and State of Alaska constitutions. As we have mentioned previously, Alaska courts have taken a particularly strong stance against durational residency requirements. Constitutional Memorandum at 1, n.1, 34, n.38.

35/ The pivotal "date of issuance of shares" of S. 170 §§ 10.50.345 and 355 may not be effectual, since the bill appears to contemplate sporadic issue. Perhaps, the standard "the date of initial notification to the public of its intention to issue shares" would better carry out the purpose.

been and remained residents for the applicable period to the later issuance. This approach would, of course, exclude charter residents who leave the state prior to any secondary issuance.

Wilmer, Cutler & Pickering

WILMER, CUTLER & PICKERING