

SCOMM

83:5

# FISCAL NOTE

STATE OF ALASKA  
1991 LEGISLATIVE SESSION

BILL NO. CSHB12

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

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

COMPONENT SERIAL NO. 1 1 3

## EXPENDITURES/REVENUES: (Thousands of Dollars)

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

## FUNDING: (Thousands of Dollars)

|               |             |             |              |              |              |              |
|---------------|-------------|-------------|--------------|--------------|--------------|--------------|
| GENERAL FUND  | 13.0        | 47.5        | 132.6        | 130.6        | 128.1        | 128.1        |
| FEDERAL FUNDS |             |             |              |              |              |              |
| OTHER         |             |             |              |              |              |              |
| <b>TOTAL</b>  | <b>13.0</b> | <b>47.5</b> | <b>132.6</b> | <b>130.6</b> | <b>128.1</b> | <b>128.1</b> |

## POSITIONS:

|           |     |     |     |     |     |     |
|-----------|-----|-----|-----|-----|-----|-----|
| FULL-TIME | 0.0 | 0.0 | 1.0 | 1.0 | 1.0 | 1.0 |
| PART-TIME |     |     |     |     |     |     |
| TEMPORARY |     |     |     |     |     |     |

Estimate of current year impact: \_\_\_\_\_

ANALYSIS: Attach a separate page for analysis.

ATTACHED

Prepared By: William F. Schuchman  
Division: Income and Excise Audit Division

Phone: (907) 465-2320  
Date: March 12, 1991

Approved by Commissioner: Lee E. Fisher  
Agency: Department of Revenue

Date: 3-12-91

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

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

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

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

# FISCAL NOTE

STATE OF ALASKA  
1991 LEGISLATIVE SESSION

BILL NO. HB12

Revision Date: \_\_\_\_\_  
Title: An act relating to the water's  
edge method of taxation  
Sponsor: Representative Moyer  
Requestor: Representative Moyer

Department Affected: Department of Revenue  
BRU: Revenue Operations  
Component: Income and Excise Audit  
COMPONENT SERIAL NO. | 1 | 1 | 3 |

## EXPENDITURES/REVENUES: (Thousands of Dollars)

| OPERATING          | FY 92               | FY 93            | FY 94            | FY 95            | FY 96            | FY 97            |
|--------------------|---------------------|------------------|------------------|------------------|------------------|------------------|
| PERSONAL SERVICES  | 0.0                 | 56.1             | 183.7            | 247.7            | 247.7            | 247.7            |
| TRAVEL             | 0.0                 | 40.0             | 44.8             | 39.3             | 39.3             | 39.3             |
| CONTRACTUAL        | 13.0                | 15.0             | 17.0             | 17.0             | 17.0             | 17.0             |
| SUPPLIES           | 0.0                 | 2.5              | 7.5              | 10.0             | 10.0             | 10.0             |
| EQUIPMENT          | 0.0                 | 0.0              | 22.0             | 5.0              | 0.0              | 0.0              |
| LANDS & STRUCTURES |                     |                  |                  |                  |                  |                  |
| GRANTS, CLAIMS     |                     |                  |                  |                  |                  |                  |
| MISCELLANEOUS      |                     |                  |                  |                  |                  |                  |
| TOTAL OPERATING    | 13.0                | 113.6            | 275.0            | 319.0            | 314.0            | 314.0            |
| CAPITAL            | 0.0                 | 0.0              | 0.0              | 0.0              | 0.0              | 0.0              |
| REVENUE            | (500.0 -<br>1500.0) | (1000 -<br>3000) | (1000 -<br>3000) | (1000 -<br>3000) | (1000 -<br>3000) | (1000 -<br>3000) |

## FUNDING: (Thousands of Dollars)

|               |      |       |       |       |       |       |
|---------------|------|-------|-------|-------|-------|-------|
| GENERAL FUND  | 13.0 | 113.6 | 275.0 | 319.0 | 314.0 | 314.0 |
| FEDERAL FUNDS |      |       |       |       |       |       |
| OTHER         |      |       |       |       |       |       |
| TOTAL         | 13.0 | 113.6 | 275.0 | 319.0 | 314.0 | 314.0 |

## POSITIONS:

|           |     |     |     |     |     |     |
|-----------|-----|-----|-----|-----|-----|-----|
| FULL-TIME | 0.0 | 1.0 | 3.0 | 4.0 | 4.0 | 4.0 |
| PART-TIME |     |     |     |     |     |     |
| TEMPORARY |     |     |     |     |     |     |

Estimate of current year impact: \_\_\_\_\_

ANALYSIS: Attach a separate page for analysis.

ATTACHED

Prepared By: Carl Meyer, Acting Director Phone: (907) 465-2320  
Division: Income and Excise Audit Division Date: February 5, 1991

Approved by Commissioner: Lee Fisher  
Agency: Department of Revenue Date: 2-7-91

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

Fiscal Note Analysis, HB12  
Income and Excise Audit Division  
Prepared by Carl A. Meyer  
February 5, 1991

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

|                                                                     |               |                |              |                |
|---------------------------------------------------------------------|---------------|----------------|--------------|----------------|
| <u>Personal Services</u>                                            | <u>FY92</u>   | <u>FY93</u>    | <u>FY94</u>  | <u>FY95</u>    |
| 1 Revenue Auditor IV, Seattle                                       | \$0.0         | \$56.1         | \$56.1       | \$56.1         |
| 2 Revenue Auditor IV, Anchorage                                     | \$0.0         | \$0.0          | \$127.6      | \$127.6        |
| 1 Appeals Officer, Juneau                                           | \$0.0         | \$0.0          | \$0.0        | \$64.0         |
| Total Personal Services Costs                                       | \$0.0         | \$56.1         | \$183.7      | \$247.7        |
| <u>Travel</u>                                                       |               |                |              |                |
| Training, 7 @ \$10.0                                                | \$0.0         | \$40.0         | \$20.0       | \$10.0         |
| Management Review, 4 @ \$.5                                         | \$0.0         | \$0.0          | \$2.0        | \$2.0          |
| 12 Audits completed by 3 auditors @ \$1.9                           | \$0.0         | \$0.0          | \$22.8       | \$22.8         |
| 9 Appeals completed in Anchorage @ \$.5                             | \$0.0         | \$0.0          | \$0.0        | \$4.5          |
| Total Travel                                                        | \$0.0         | \$40.0         | \$44.8       | \$39.3         |
| <u>Contractual</u>                                                  |               |                |              |                |
| Printing and Advertising Costs                                      | \$13.0        | \$13.0         | \$13.0       | \$13.0         |
| Telecommunications, Centrex                                         | \$0.0         | \$2.0          | \$4.0        | \$4.0          |
| Total Contractual                                                   | \$13.0        | \$15.0         | \$17.0       | \$17.0         |
| <u>Supplies</u>                                                     |               |                |              |                |
| Office supplies, Computer supplies,<br>Audit Manuals and References | \$0.0         | \$2.5          | \$7.5        | \$10.0         |
| Total Supplies                                                      | \$0.0         | \$2.5          | \$7.5        | \$10.0         |
| <u>Equipment</u>                                                    |               |                |              |                |
| 4 Wang PC Computers, Cable Hookup                                   | \$0.0         | \$0.0          | \$15.0       | \$5.0          |
| 2 Laptop Computers                                                  | \$0.0         | \$0.0          | \$7.0        | \$0.0          |
| Total Equipment                                                     | \$0.0         | \$0.0          | \$22.0       | \$5.0          |
| TOTAL COSTS                                                         | <u>\$13.0</u> | <u>\$113.6</u> | <u>275.0</u> | <u>\$319.0</u> |

The Department is not able to determine the revenue impact of this legislation. However, it should fall within the range of the \$1-\$3 million per year reduction estimated during the 1990 legislative session in CSSB119. The Department is working to develop better numbers and will revise this fiscal note when those numbers become available.

An agency position paper is attached.

HOUSE SPECIAL COMMITTEE ON INTERNATIONAL TRADE AND TOURISM

ALASKA STATE LEGISLATURE

P.O. BOX V, JUNEAU 99811

(907) 465-2973



**MEMORANDUM**

To: Representative Mike Navarre  
Co-Chairman, House Finance Committee

March 13, 1991

From: Representative Tom Moyer *TEM*

Re: CSHB12, Corporate Income Tax Reporting Methods

I would like to request the Finance Committee hold a hearing at your earliest convenience on CSHB12. As you know, I am the bill's sponsor and both the International Trade and Tourism and Labor and Commerce Committees have considered the bill and favorably passed it out.

The bill is designed to attract foreign investment to Alaska by replacing Alaska's unitary tax, widely considered a barrier to foreign investment, with a so-called "water's edge" tax system. Under the bill, only the domestic activities of a foreign or international corporation would be subject to Alaska taxes and oil and gas companies would be exempt.

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

A complete bill file is being transferred to your committee and I am happy to provide any additional information should you need it. I'm also pleased to make myself available to testify about the bill at your convenience.

CC: Representative Eileen MacLean

# **DIVISION OF LEGAL SERVICES**

## **LEGISLATIVE AFFAIRS AGENCY STATE OF ALASKA**

P.O. Box Y, Juneau, Alaska 99811  
(907) 465-3867 or 465-2450  
FAX (907) 465-2029

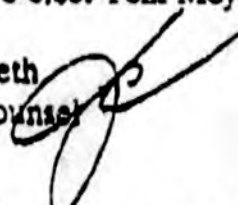
Deliveries to: 240 Main Street  
Court Plaza, Room 300  
Mail Stop 3161

### **MEMORANDUM**

December 17, 1990

**SUBJECT:** Water's edge tax (Work order 7-0237A)

**TO:** Representative-elect Tom Moyer

**FROM:** Jack Chenoweth  
Legislative Counsel 

This draft legislation, based on last session's CSSB 119 reported by the Senate Finance Committee, amends the method of income tax computation for certain corporations in order to set aside a perceived barrier to investment. Simply stated, the measure would direct corporations subject to Alaska's Net Income Tax that are members of affiliated groups owned by foreign corporate parents to file returns based on the so-called "water's edge" method of taxation. That taxing method takes into consideration only the domestic (i.e., United States) activities of the foreign corporation and does not consider income derived from the companies' non-American operations.

In the draft previously provided --

Bill section 2 is the measure's principal operative provision. It adds a new section, proposed AS 43.20.073.

Subsection (a) of proposed AS 43.20.073 sets out the general requirement that a corporation that is a member of an "affiliated group"--a group of two or more corporations in which at least 50 percent of the voting stock of each member of the group is held by one or more common owners or by one or more of the members of the group--must file its state tax returns using the "water's edge combined reporting method." The water's edge combined tax return is to be used by (1) corporations that do substantial business within the United States, irrespective of where incorporated; (2) domestic and foreign sales corporations; and (3) so-called "tax haven" corporations (that have been formed for the purpose of avoiding taxes in the United States). Under this subsection, a corporation is considered to be part of the taxpayer's water's edge tax family, and its income taxable in Alaska, if 20 percent or more of its average property, payroll, and sales factors are within the United States. Under this subsection, a corporation is considered to be part of the taxpayer's water's

Representative-elect Tom Moyer

December 17, 1990

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taxpayers operating as oil and gas transporters by regulated pipeline. Those taxpayers to determine their tax liability using the worldwide combined report.

Proposed AS 43.20.073(g) sets out pertinent definitions of terms used in the section.

As drafted, the measure would take effect immediately [bill section 4], but apply to tax years beginning January 1, 1992 [bill section 3].

JBC:LMB

90-035.LMB



Anchorage • Star of the North  
Chamber of Commerce

January 23, 1990

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

Reference: House Bill 281

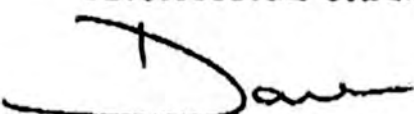
Dear Fran:

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

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

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

Sincerely,  
ANCHORAGE CHAMBER OF COMMERCE

  
Dave Harbour  
Chairman

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

February 6, 1991

H B 12  
POSITION PAPER  
DEPARTMENT OF REVENUE

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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



ALASKA STATE LEGISLATURE  
HOUSE OF REPRESENTATIVES  
RESEARCH AGENCY

P.O. Box Y, State Capitol  
Juneau, Alaska 99811-3100  
Mail Stop 3100  
(907) 465-3991

June 8, 1989

MEMORANDUM

TO:

ATTN:

FROM: Ginny Fay  
Legislative Analyst

RE: Alaska's Unitary Corporate Taxation: Alternatives and Impacts on Revenues  
Research Request 89.165

You requested information on 1) unitary corporate tax laws in Alaska and other states, 2) alternatives to the method of tax collection currently used in Alaska, and 3) the source of Alaska's revenues and impacts on these revenues of changing Alaska's tax law. Specifically, you asked this agency to update House Research Agency Memoranda 85.012, 85.014, and 85.047. To answer your questions, the first part of this memorandum provides an overview of state corporate taxation. This is followed by information on alternative tax methods. The final section identifies sources of Alaska revenues and the potential impact on revenues of changes to Alaska's corporate tax method.

Background

The form of corporate taxation commonly known as unitary tax is based on the concept that the most equitable and efficient method of determining corporate income subject to state taxation is formula apportionment. Under unitary taxation, the total income of a corporation or of an affiliated group of corporations engaged in a unitary (related) business activity is apportioned among states, usually based on the portion of corporate payroll, property, and sales attributable to each state. This apportioned income is the taxable income subject to the respective state's tax rates. Approximately 45 states (including the District of Columbia) currently use some form of the unitary tax to apportion corporate income for state income tax purposes. Alaska currently taxes corporate income by using a form of the unitary tax called worldwide combined reporting.

June 8, 1989

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double taxation because this income is taxed by foreign governments. Foreign multinational corporations have been especially vocal in their criticism of worldwide combined reporting.

### **Alternatives to Worldwide Combined Reporting**

In 1984, eleven states used worldwide combined reporting. As a result of federal government opposition and the threats of economic reprisal by foreign corporations, ten states have changed taxing methods. The degree to which states have backed-off taxing foreign income varies considerably as a result of inconsistency in states' definitions of "waters edge." Alternatives to worldwide combined reporting include:

- worldwide combined reporting for domestic corporations with an alternative tax levied on foreign multinational corporations;
- a waters edge method that includes foreign source dividends in taxable income and includes 80/20 corporations within the definition of waters edge;<sup>4</sup>
- a waters edge method that excludes foreign source dividends from income and excludes 80/20 corporations from the definition of waters edge; and
- separate accounting.

**Worldwide Combined Reporting that Excludes Foreign Multinationals.** This alternative allows United States subsidiaries of foreign corporations to pay an alternative tax rather than a tax based on income apportioned using worldwide combined reporting. Although many types of alternate taxes could be devised, state representatives on the 1984 unitary tax task force recommended that the tax be based on in-state property, payroll, and sales and that the tax rate be based on the tax paid by firms in the same industry conducting unitary business in the state.

Proponents of this option claim that it would reduce the threat of foreign retaliation against U.S. corporations. In addition, this option is claimed to be a fair way to exclude foreign multinational corporations from worldwide combined reporting while protecting the competitive advantage of U.S. multinational corporations and domestic business. This option would also protect state revenues and be relatively easy to implement. Opponents, however, do not view this alternative as an adequate alternative to worldwide combined reporting because corporate income tax rates based on industry

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<sup>4</sup>These corporations are U.S. based corporations that have 80 percent or more of their business activity occurring outside of the United States.

**Separate Accounting.** This alternative to worldwide combined reporting would completely eliminate the use of the unitary tax. States would tax corporate taxpayers only on the income earned in the state and each corporation would be treated as a separate entity for tax purposes (as opposed to a unitary group). This method is also called "arm's length accounting" because all transactions between related corporations are assumed to occur as if no special relationships exist (such as a subsidiary corporation supplying a parent corporation) so that prices are fair market values.

In general, business leaders would like to have all states determine taxable income by using separate accounting because it uses information directly related to traditional accounting income. Opponents, which include many states, claim separate accounting makes states vulnerable to manipulation of income to reduce tax liabilities by corporations that do business in more than one state. However, under the separate accounting method Alaska imposed on the petroleum industry under AS 43.21, revenues from the corporate income tax were considerably higher than under either the standard apportionment formula applied before 1977 or the modified formula used after 1981.<sup>5</sup>

Attachment A provides information on how states using the waters edge unitary approach to corporate taxation treat foreign-source dividends (i.e., the first three alternatives discussed above). In summary, California's approach best represents the first option of providing an alternative tax to foreign multinational corporations. Another ten states would fit under the second option which taxes foreign-source dividends. Nine states partially exempt foreign dividends; 14 fully exempt foreign dividends; and 11 fully exempt dividends if a corporation meets specified conditions, i.e., 34 states' corporate taxation method is similar to the third option.

#### **Alaska Revenue Sources and Relationship to Unitary Taxation**

The revenues that the State of Alaska collects fall into one of three categories:

- **unrestricted revenues** go to the general fund to be appropriated for any purpose,
- **restricted revenues** are received for specific purposes, and
- **special fund revenues** are received by statutorily established funds such as the International Airport Fund.

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<sup>5</sup>For information on the formulas used for corporate taxation in Alaska, see House Research Memoranda 85.012 and 89.303.

Table 2 provides a breakdown of unrestricted revenue by source. As mentioned previously, unrestricted revenues are the only source that allow legislative discretion in appropriation.

TABLE 2  
SOURCES OF UNRESTRICTED REVENUES, FY 88  
(Millions of Dollars)

| REVENUE SOURCE                       | REVENUE   | PERCENT OF<br>TOTAL |
|--------------------------------------|-----------|---------------------|
| Corporate Income Tax                 | \$181.4   | 7.9                 |
| Gross Receipts Tax                   | 58.5      | 2.5                 |
| Severance Tax                        | 818.7     | 35.5                |
| Property Tax                         | 96.2      | 4.2                 |
| Sale/Use Tax                         | 51.8      | 2.2                 |
| Licenses and Permits                 | 28.3      | 1.2                 |
| Intergovernmental Receipts           | 8.9       | 0.4                 |
| State Resource Revenues <sup>a</sup> | 843.9     | 36.6                |
| Facilities Related                   | 32.3      | 1.4                 |
| Service Related                      | 7.5       | 0.3                 |
| Other                                | 16.4      | 0.7                 |
| Special Settlements <sup>b</sup>     | 161.9     | 7.0                 |
| TOTAL                                | \$2,305.8 | 100.0               |

<sup>a</sup>Includes \$694.8 million in royalty income, \$132.6 in investment earnings, and \$6.0 million in rents. Petroleum resource revenues are shown in more detail in Table 3.

<sup>b</sup>Outer Continental Shelf "8(g)" or Dinkum Sands settlement partial payment.

Sources: Alaska Department of Revenue, "Revenue Sources," Fall 1988.

Table 2 indicates that the largest contributions to state unrestricted income are derived from petroleum producers. In fact, the various petroleum revenues account for 85 percent of all state unrestricted revenues--this proportion has not changed since our earlier memorandum on FY 83 revenues.

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**Salmon enhancement taxes** (AS 43.75) are levied on limited entry fishing permit holders within qualified regional aquaculture associations. Rates are two or three percent of the value of the salmon caught, depending on the vote of the aquaculture association. In FY 88, total Salmon Enhancement Tax receipts were \$5.8 million. In effect, this is a pass-through program, since the legislature appropriates these tax revenues to the regional associations from whose members they were collected.

A **seafood marketing tax** (AS 16.51) is levied on seafood processors at a rate of 0.3 percent of the ex-vessel value of seafood products purchased (over \$50,000) in Alaska. Revenue in FY 88 was \$2.7 million. Similar to the Salmon Enhancement Tax, these revenues are passed through to fund the Alaska Seafood Marketing Institute (ASMI).

**Insurance premium taxes** (AS 21.09, AS 21.33, AS 21.34, and AS 23.33) are levied on gross premiums (less certain deductibles) at various rates ranging from 0.075 to 3 percent depending on the type of insurance. In FY 88, revenue from these taxes totaled \$25.6 million.

**Severance Taxes.** Oil production taxes are levied upon oil producers for all oil produced from each lease or property in the state, less any part of production exempt from taxation (AS 43.55). The tax is 15 percent of gross value (except 12.25 percent for the five-year period following commencement of new oil production after June 30, 1981) adjusted by the Economic Limit Factor (ELF) for mature oil fields. The ELF, however, was repealed effective January 1, 1989.<sup>6</sup> Gross value is calculated as the sales price minus transportation costs at the point of production. Gas production taxes (AS 43.55) are levied at the greater of a rate of \$0.64 per thousand cubic feet of taxable gas or ten percent of the gross value of taxable production calculated at the point of production, multiplied by the ELF. During FY 88, \$816.4 million was collected in oil and gas production tax revenues.

The **oil and gas regulation and conservation tax** (AS 43.57) is levied upon oil and gas producers at the rate of four mills per barrel (oil) and four mills per 50,000 cubic feet (gas) of oil and gas removed or sold from each lease or property in the state,

less any tax exemptions. Gross value is calculated as for the production taxes. This tax contributed \$2.3 million to state revenues in FY 88.

**Property Taxes.** The oil and gas property tax (AS 43.56) is levied at 20 mills on the full and true value of taxable property used in oil and gas production and exploration. If a municipality levies a property tax against the same

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<sup>6</sup>The actual effective date on HB 118, Chapter 25 SLA 89, is August 6, 1989, with a retroactive effective date of January 1, 1989. The ELF, however, was in place during FY 88.

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**State Resource Revenues.** State royalty payments (AS 38.05) include royalties from minerals and oil and gas. Depending on the type of resource, royalty payments can be taken in kind. Revenues from royalties are apportioned between the permanent fund and the general fund. General fund royalty revenues totaled \$694.8 million in FY 88.

Other revenue sources within this category are state property sales (\$3.8 million), resource bonus sales (\$5.6 million), state rental revenues (\$6.0 million), and the sale of resources not classified as minerals such as gravel and timber (\$1.1 million).

Facilities-related charges include receipts from airports, the ferry system, food services, and other state facilities. These charges totaled \$32.3 million in FY 88.

Service-related charges include receipts from statutory inspection fees, the court system, and other state service charges. These fees totaled \$7.5 million in FY 88. Another \$16.4 million was collected in miscellaneous revenues.

During FY 88, a special settlement of \$161.9 million was paid to the general fund. The money was 49.5 percent of the \$322.9 million Outer Continental Shelf (OCS) "8(g)" or Dinkum Sands revenue sharing settlement. Fifty percent of the settlement was paid to the Permanent Fund and 0.5 percent to the Public School Fund. The FY 88 figure also reflects \$2.1 million in TransAlaska Pipeline Settlement (TAPS) receipts owed to the general fund.

#### Revenue Implications of Changing Alaska's Corporate Income Tax

While a recent U.S. Supreme Court case, *Shell Oil Company v. Iowa Department of Revenue*, upheld states' use of unitary tax apportionment to calculate taxes owed by multistate and multinational corporations, the determination of a consistent form of the unitary tax still remains to be decided.<sup>7</sup> There are two significant cases whose outcomes are likely to affect Alaska's use of worldwide combined reporting.

In the first case, the U.S. Supreme Court has agreed to decide *Franchise Tax Board of the State of California v. Alcan Aluminum* (No. 88-1400). The hearing for Alcan, a Canadian company, is to determine whether the firm has standing to sue in federal courts over disputed taxes. If the plaintiff prevails, the case will likely go back to lower courts. In this case, Alcan is challenging California's relatively recent changes in corporate taxation. Under pressure from foreign firms, California legislators moved to repeal their worldwide

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<sup>7</sup>"Supreme Court Approves State's Unitary Tax," *Oil & Gas Journal*, November 14, 1988, p. 30, and "Iowa Wins Tax Fight with Shell," *Governing*, January 1989, p. 15.

a number of states, we have moved the states away from uniformity, have shifted the tax burden, and we have looked for an economic boom that has not happened. Therefore, I have to wonder if somewhere down the road, we are going to have to re-invent worldwide unitary.

This conclusion is confirmed by surveys that indicate that state tax treatment is, at best, ranked fourth among corporate factors regarding the location of manufacturing plants in the U.S.<sup>10</sup> A foreign corporation that wishes to invest in a state by constructing a manufacturing plant will try to find a location that offers cheap land and utilities, a skilled labor force, low living costs, and cheap access to suppliers and markets. As long as the particular location can offer these basic benefits, one location is not very different from another. It is this inter-changeability that makes states fearful of foreign threats of economic reprisal.

Foreign corporations that wish to invest in resource extraction have a more limited choice; they must go to the resource location. Because it is so expensive to do business in Alaska, foreign investments are usually relatively large in scale and have high potential profitability to offset the high cost and risks. In this investment climate, the type of taxes levied by a state are probably a secondary consideration.

A related question is the impact of worldwide combined reporting in deterring the development of Alaska as a manufacturing state. It seems unlikely that Alaska will be able to compete in the near future with other states for manufacturing that does not depend on natural resources. Alaska would have trouble competing with other locations based on the criteria mentioned above.

**Federal Action to Ban the Use of Worldwide Combined Reporting.** It is quite clear that the federal government opposes the use of worldwide combined reporting. At this point, however, there is little action to ban worldwide combined reporting because all states except Alaska have moved to waters edge taxation.

**U.S. Supreme Court Action.** As mentioned previously, the next chapter on the application of unitary taxation is likely to be written by the U.S. Supreme Court. Based on the outcome of current lawsuits, Alaska may have little choice but to change its corporate tax law.

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<sup>10</sup>Larry C. Ledebur and William W. Hamilton, "The Failure of Tax Concessions as Economic Development Incentives," in *Reforming State Tax Systems*, ed., Steven D. Gold, National Conference of State Legislatures, December 1986. Attachment B is a copy of this article.

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providing equal competitive footing to U.S. multinational corporations--a \$3 to \$4 million cost is relatively low. It should be noted, however, that many states expect increases in personal income tax revenues--resulting from employment growth--and increase in sales tax revenues--from increased economic activity--to offset corporate tax losses. Alaska currently lacks both of these vehicles for offsetting losses.

With no state personal income tax or sales tax, Alaska currently has a very narrow tax base--taxes on the petroleum industry account for 85 percent of unrestricted revenues. The 13 cents per pack cigarette tax increase passed in House Bill 80 during the 1989 legislative session is expected to increase state revenues by approximately \$4 million annually--enough to offset the expected decrease in nonpetroleum corporate income taxes. Similarly, repeal of the ELF is expected to result in an annual increase in state revenues of over \$150 million. Reinstating the personal income tax at about 1.9 percent would raise about \$217 million annually in revenue and a one percent state sales tax would raise \$49 million annually. Therefore, because of the options available to offset any tax losses, modification of the state corporate income tax is more a public policy question than a revenue question.

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I hope this answers your questions. If you would like additional information, please do not hesitate to call.

Attachments

**ATTACHMENT A**  
**State Treatment of Foreign-Source Dividends**

STATE TREATMENT OF FOREIGN-SOURCE DIVIDENDS  
Jean A. Walker, Committee on State Taxation

|               | Exempt | Exemption<br>Conditional                                                                                                                                                                                                                                                                                        | Partial                                                                                                                                             | Treatment<br>of Balance |           | Statute(s)                                                                                        |
|---------------|--------|-----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------|-----------|---------------------------------------------------------------------------------------------------|
|               |        |                                                                                                                                                                                                                                                                                                                 |                                                                                                                                                     | Allocate                | Apportion |                                                                                                   |
| ALABAMA       |        |                                                                                                                                                                                                                                                                                                                 |                                                                                                                                                     | X                       |           | §440-18-36, 40-18-36(14), Reg. 810-3-31.02                                                        |
| ARIZONA       | X      |                                                                                                                                                                                                                                                                                                                 |                                                                                                                                                     |                         |           | §43-1122(d), L. 1986, c. 109, eff. for<br>taxable years beginning from/after<br>12-31-83          |
| ARKANSAS      |        | If 95% ownership of payor.                                                                                                                                                                                                                                                                                      |                                                                                                                                                     |                         | X         | §84-2008(2)(j)                                                                                    |
| CALIFORNIA 1) |        | If more than 50% ownership of payor, 75% exclusion<br>of base period dividends (greatest amount of dividends<br>received in any one of 1984, 1985 or 1986 income<br>years); exclusion of foreign dividends in excess<br>of base period amount dependent upon increase or<br>decrease in foreign payroll factor. |                                                                                                                                                     |                         | X         | §524271, 24402                                                                                    |
| 2)            |        |                                                                                                                                                                                                                                                                                                                 |                                                                                                                                                     |                         | X         | §24411, L. 1986, c. 680, eff. for tax<br>years beginning on/after 1-1-88                          |
| COLORADO      |        |                                                                                                                                                                                                                                                                                                                 | Amount of exclusion<br>of all foreign-source<br>income dependent upon<br>election of federal<br>foreign tax deduction<br>or credit.                 | X                       |           | §29-22-304, §29-22-305(10); L. 1985,<br>H. 3010, eff. for tax years beginning<br>on/after 1-1-86  |
| CONNECTICUT   | X      |                                                                                                                                                                                                                                                                                                                 |                                                                                                                                                     |                         |           | §12-217(d)(D)                                                                                     |
| DELAWARE      | X      |                                                                                                                                                                                                                                                                                                                 |                                                                                                                                                     |                         |           | §1903(a)(2)                                                                                       |
| FLORIDA       | X      |                                                                                                                                                                                                                                                                                                                 |                                                                                                                                                     |                         |           | §220.13(1)(b)2.a, ch. 64-549, Laws of<br>Florida, eff. for tax years beginning<br>on/after 9-1-84 |
| GEORGIA       | X      |                                                                                                                                                                                                                                                                                                                 |                                                                                                                                                     |                         |           | §40-7-21(b)(9)                                                                                    |
| HAWAII        |        |                                                                                                                                                                                                                                                                                                                 |                                                                                                                                                     | X                       |           | §236.7(c)                                                                                         |
| IDaho 1)      |        |                                                                                                                                                                                                                                                                                                                 | 85% exclusion.                                                                                                                                      | X                       |           | §43-3022                                                                                          |
| 2)            |        |                                                                                                                                                                                                                                                                                                                 |                                                                                                                                                     | X                       |           | §43-3027, L. 1986, c. 342 (HB 669),<br>eff. for tax years beginning 1-1-88                        |
| ILLINOIS      |        | If 80% ownership of payor.                                                                                                                                                                                                                                                                                      | Otherwise, 85% exclusion.                                                                                                                           | X                       |           | §2-208(b)(2)(D), L. 1982, P.A. 82-1029,<br>eff. for taxable years ending on/after<br>12-31-82     |
| INDIANA 1)    |        | If 80% ownership of payor.                                                                                                                                                                                                                                                                                      | Otherwise, 85% exclusion if<br>ownership of payor is less<br>than 80% but at least 50%, or<br>50% exclusion if less than<br>50% ownership of payor. | X                       |           | §43-3027, L. 1987, P.L. 383, eff. for<br>taxable years beginning after 12-31-87                   |
| 2)            |        |                                                                                                                                                                                                                                                                                                                 |                                                                                                                                                     | X                       |           |                                                                                                   |
| IOWA          |        |                                                                                                                                                                                                                                                                                                                 |                                                                                                                                                     | X                       |           | §422-35                                                                                           |
| KANSAS 1)     |        |                                                                                                                                                                                                                                                                                                                 | 80% exclusion.                                                                                                                                      | X                       |           | §79-32, 138                                                                                       |
| 2)            |        |                                                                                                                                                                                                                                                                                                                 |                                                                                                                                                     | X                       |           | §79-32, 138(c)(vi), L. 1987, c. 306,<br>eff. for taxable years beginning<br>after 12-31-87        |
| KENTUCKY      | X      |                                                                                                                                                                                                                                                                                                                 |                                                                                                                                                     |                         |           | §141.010(12)(b)                                                                                   |
| LOUISIANA     |        |                                                                                                                                                                                                                                                                                                                 |                                                                                                                                                     | X                       |           | §542.A, 63, 242(1)(d), 243.A(4)                                                                   |

|                                           | Exemption |                            |                | Treatment of Balance |           | Statute(s)                                                                                                                                                                                                                                   |
|-------------------------------------------|-----------|----------------------------|----------------|----------------------|-----------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
|                                           | Exempt    | Conditional                | Partial        | Allocate             | Apportion |                                                                                                                                                                                                                                              |
| RHODE ISLAND<br>SOUTH CAROLINA1)          |           | If 80% ownership of payor. |                | X                    | X         | §§44-11-11, 44-11-12<br>§12-7-700(15) repealed L. 1985, S351,<br>eff. for tax years beginning after<br>12-31-84; §12-7-1120(2)<br>§§12-7-415, 12-7-430 added L. 1985,<br>S351, eff. for tax years beginning<br>after 12-31-84; §12-7-1120(2) |
| 2)                                        |           |                            |                | X                    |           | §§12-7-415, 12-7-430 added L. 1985,<br>S351, eff. for tax years beginning<br>after 12-31-84; §12-7-1120(2)                                                                                                                                   |
| TENNESSEE<br>UTAH                         |           | If 80% ownership of payor. | 50% exclusion. |                      | X         | §§7-2704(b)(2)(A)<br>§§9-12-8(2)(d), L. 1984, c. 80<br>(§§ 30), eff. for tax years<br>beginning on or after 7-1-85                                                                                                                           |
| VERMONT<br>VIRGINIA<br>WEST VIRGINIA 1) X |           | If 50% ownership of payor. |                | X                    |           | §§11-107<br>§§10-151, 102(a), 102(b), 107<br>§11-24-6(c)(3), L. 1985, S351,<br>1985, eff. for tax years beginning<br>before 7-1-87                                                                                                           |
| 2)<br>3) X                                |           |                            |                |                      |           | §§11-24-6, 11-24-7(a)(3)<br>§11-24-6(c)(10), L. 1985, S351, 4475, eff.<br>for taxable years ending after 7-1-88                                                                                                                              |
| WISCONSIN<br>DISTRICT OF COLUMBIA         |           | If 80% ownership of payor. |                | X                    | X         | §71-04(4)<br>§47-1810.1                                                                                                                                                                                                                      |
| <u>Worldwide Combination States*</u>      |           |                            |                |                      |           |                                                                                                                                                                                                                                              |
| ALASKA                                    |           |                            |                |                      |           | §41-20-050                                                                                                                                                                                                                                   |

\*Dividends between combined corporations are eliminated from income, thus the indicated treatment of dividends is only to dividends received by members of the combined group from corporations not included in the combination.

RECEIVED  
ALASKA DEPARTMENT OF REVENUE

MEMORANDUM

JAN 28 1991

STATE OF ALASKA

DEPARTMENT OF REVENUE

COMMISSIONER'S OFFICE

TO: Lee Fisher  
Commissioner  
Department of Revenue

DATE: January 28, 1991

FILE NO:

TELEPHONE NO: 465-2343

SUBJECT: Constitutionality  
of Worldwide Combined  
Reporting-The Barclays  
Case-Some Thoughts.

FROM: Carl Meyer *Carl*  
Acting Director  
Income and Excise Audit Division

This memorandum is in response to your request of January 23 for an overview addressing, among other things, the constitutionality of the worldwide combined reporting method as recently viewed by two lower courts in California and the impact on the state in the event the method would ultimately be declared unconstitutional by the United States Supreme Court. Before addressing these matters, however, a brief description of the so-called "unitary tax" concept is appropriate.

The term "unitary tax" is actually a misnomer. A tax is not imposed upon the unitary business nor upon all the corporations included within the unitary business. The tax can only be imposed on those corporations having a taxable presence in the state and the tax must be designed to reach only those profits earned within the state. Earth Resources v. Alaska, Dept. of Revenue, 665 P.2d 960 (Alaska 1983).

The unitary concept actually focuses on the nature of the business activities of one or more corporations. A factual inquiry is necessary to determine the parameters of a unitary business. Once the facts have been established, the sufficiency of those facts to establish a unitary business is a question of law. A business is considered unitary if it is characterized as having the attributes of functional integration, centralization of management, and economies of scale. Essentially, this means there must exist a flow of value within the business. Container Corp. of America v. Franchise Tax Board, 463 U.S. 159 (1983).

Once the unitary business has been identified, various accounting methods may then be applied to determine the income earned or attributed to those corporations with a presence in the state. The accounting methods applicable to unitary businesses include worldwide combination and water's edge combination. There can be unique variations to each of the methods. It has been held that the linchpin of apportionability in the field of state income taxation is the unitary business principle.

Mobil Oil Corp. v. Commissioner of Taxes, 445 U.S. 425 (1980). The courts and legal scholars have generally favored apportionment. However, while separate accounting is not constitutionally required, it is a permissible state method. Atlantic Richfield Company v. State Department of Revenue, 705 P.2d 418 (Alaska 1985).

Separate accounting disregards the unitary business in its entirety. The difference between an arms length/separate accounting method and the unitary method is that the latter focuses upon the extent of business activity in a state while the former ignores business activity and focuses upon the precise geographic source for the generation of the income. Because of the transactional nature of the focus under separate accounting, it is subject to much manipulation by taxpayers. Administratively, separate accounting is much more difficult and time consuming to audit and administer.

Alaska still requires worldwide combination. Worldwide combination is also required in California although a taxpayer can elect water's edge. A taxpayer in California must pay an election fee to escape worldwide combination. Since 1983, Arizona, Colorado, Oregon, North Dakota, Utah, Montana, Florida, Indiana, New Hampshire, and Idaho have also moved from worldwide to water's edge. Like California, however, North Dakota, Montana, Utah, and Idaho also place restraints or conditions on the water's edge election.

The United States Constitution imposes various requirements or preconditions on the authority of a state to impose a tax on a multistate or multinational business enterprise. See Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977). The first of these requirements is a nexus standard; that is, there must exist a minimal connection between the activities outside the state with those inside the state. Nexus is generally supplied when a taxpayer avails itself of the substantial privilege of carrying on business within a state. Wisconsin v. J.C. Penney, 311 U.S. 435, 444 (1940).

The second requirement is that there be a rational relationship between the income attributed to the state and the intrastate values of the enterprise. Basically, all that is required is that the measure of the tax be reasonably related to the extent of a taxpayers contact with the state. See Commonwealth Edison v. Montana, 453 U.S. 609 (1981).

The third requirement is that the tax be fairly apportioned. The fact that the apportionment formula looks to affairs outside the state in valuing the instate activity does not destroy the validity of the tax. The tax is fairly apportioned if the formula is designed to reach only those profits measured by approximating the income that is reasonably related to the instate activities. Wallace v. Hines, 253 U.S. 66 (1920); Sjong v. State Department of Revenue, 622 P.2d 967 (Alaska 1981).

The last requirement is designed to prohibit states from

discriminating against interstate commerce through the establishment of economic barriers against competition with the products of another state or the labor of its citizens. See Hughes v. Alexandria Scrap Corp., 426 U.S. 794 (1976). The Alaska Supreme Court has determined that the standard three factor apportionment formula does not violate these constitutional provisions. See Earth Resources Company of Alaska v. State, Department of Revenue, *supra*.

Additionally, in the context of foreign commerce, two additional constitutional tests have evolved. First, the tax must not create a substantial risk of international multiple taxation. Second, the tax must not impair federal uniformity in an area where federal uniformity is essential by preventing the United States from "speaking with one voice" in regulating foreign trade. Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979). Courts in California have held that it is these constitutional tests that preclude the use of worldwide combined reporting. See Barclays Bank International Limited v. Franchise Tax Board, Court of Appeal, Third Appellate District (Sacramento), November 30, 1990; Colgate-Palmolive Co. v. Franchise Tax Board, Superior Court (Sacramento), December 12, 1988).

The Barclays case involves a foreign parent corporation with a foreign subsidiary doing business in California directly and through a California subsidiary corporation. California required the foreign parent and all the foreign subsidiaries to be included in a worldwide combined report. The California Court, in rejecting the application of worldwide reporting as applied to foreign parents, held:

On this record we feel confident in saying that the executive branch has spoken clearly. Through that branch, the policy of the United States since the (worldwide combined reporting) problem in the present context arose in the 1970's has been established; (Worldwide combined reporting) is not to be applied to foreign based corporate groups--those groups are to be taxed by the states only on income derived from the United States.

In Colgate-Palmolive, the taxpayer is a United States corporation engaged in business in California. In addition, the taxpayer owns a controlling interest in 75 foreign subsidiaries. California required that the foreign subsidiaries, none of which were engaged in business in California, were to be included in the worldwide combined report of the taxpayer for California tax purposes. The trial court held that worldwide combined reporting as applied to domestic multinationals was unconstitutional:

I find that the executive branch of the federal government has clearly expressed a federal policy supporting the principle of water's edge taxation of multinational corporations and disapproving the world-wide unitary method. Thus, inescapably, defendant's unitary method of taxation of multinational corporations

impermissibly interferes with the federal government's power to conduct foreign commerce and is thus unconstitutional.

Therefore, for California purposes Barclays represents a victory for taxpayers with foreign parents while Colgate-Palmolive represents a victory for taxpayers with domestic parents. If the underlying rationale of the cases is correct and sustained by the United States Supreme Court on the constitutional grounds, the combination of the two cases would certainly result in the instant death of the worldwide combined reporting method. However, there is no compelling reason to believe the Court would reverse its prior decisions so readily. The combination of the two California cases results in holding form over substance and places domestic corporations at a severe competitive disadvantage. Robert Horton, the Chairman of British Petroleum, stated that:

. . . we are officially a foreign company. But actually, we are no more foreign than IBM, when you think about it. . . We have more American employees than we have any other nationality. Most of us have spent a lot of our career working overseas. We produce more crude oil than any other American company. And the fact that we are registered in London is a historical accident.

CNN Moneyline, May 14, 1990.

Thus, there are compelling reasons and arguments to counter the California cases. The war is certainly not over. Furthermore, the California decisions may likely reflect unstated but understood state policy concerns that would not exist in states such as Alaska.

The opinions expressed by taxpayers and others lead me to believe the California Supreme Court will not grant review of the Barclays decision. Perhaps that is based on the backlog in docketed cases before that Court or because of the view the United States Supreme Court will decide the case eventually in any event. Therefore, the case might well move next on certiorari to the United States Supreme Court. In that event, and assuming the Court grants the cert, a decision could be handed down in 1992.

It is important to note, as mentioned above, that the United States Supreme Court in Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983), held that there was no constitutional bar to application of world-wide combination to a multinational group of corporations engaged in a unitary business in the state, at least where the parent of the group was a domestic corporation. The Court found no foreign commerce problem on the basis that the "tax here falls, not on the foreign owners of an instrumentality of foreign commerce, but on a corporation domiciled and headquartered in the United States." The implication of Container, at least as argued by some, is that worldwide combination involving foreign parents is precluded under the Commerce Clause. Barclays reflects that implication. However, it would be premature to assume the United States Supreme Court will embrace the

Barclays decision.

Colgate-Palmolive goes further that Barclays and is opposite to the Container decision. Yet, it distinguishes Container based on the fact that the position of the federal government had not been made clear in that case. The federal government did not file an amicus curiae brief in the Container case. Colgate-Palmolive found that "the position of the executive branch of the federal government is now crystal clear" and "the President of the United States instructed the Secretary of the Treasury to pursue through legislation and the Attorney General to pursue through litigation, the federal policy that multinational corporations be taxed by states only on income derived from the United States and not on income derived from foreign subsidiaries, i.e. the unitary method." The Court found no distinction between foreign and domestic parents by the federal executive.

Alaska has aggressively applied the worldwide combined reporting method for the last 15 years. It goes without saying that California decisions have no precedential weight in Alaska. However, for the sake of argument and assuming the method is determined to be unconstitutional, the impact would essentially be in two areas. First, potential contingent liabilities for refunds. Second, a mandated change to the statutory tax reporting method.

The determination of whether a constitutional decision of the United States Supreme Court is retroactive is a matter of federal law. See Great Northern R. Co. v. Sunburst Oil & Refining Co., 287 U.S. 358 (1932); Chapman v. California, 386 U.S. 18 (1967). Of course, state courts must make the initial inquiry of determining appropriate relief. See American Trucking Associations, Inc. v. Scheiner, 483 U.S. 266 (1987).

In Chevron Oil Co. v. Huson, 404 U.S. 97 (1971), the United States Supreme Court established a three prong test in determining whether a decision of the Court is retroactive. The first prong concerns whether the decision establishes a new principal of law, either by overruling clear past precedent on which litigants have relied, or by deciding an issue of first impression whose resolution was not clearly foreshadowed. The second prong focuses upon whether the Commerce Clause dictates retroactive application of the decision to deter future violations by states. The third prong analyzes whether retroactive application would produce substantial inequitable results.

It is certainly arguable that a decision finding worldwide combination to be unconstitutional would meet the Chevron test for nonretroactivity. The last word from the United States Supreme Court, at least with respect to domestic parents, is that worldwide combination is constitutional. See Container, *supra*. Further, since the Commerce Clause does not prohibit legitimate state taxation of interstate or foreign commerce, and worldwide combination is consistent with legitimate

state taxation as evidenced by the Court's prior decisions, the Commerce Clause would not appear to dictate retroactive application abstractly to deter potential future free trade violations. Lastly, it would seem to be unjust and inequitable to penalize the state for relying on past precedents.

Nevertheless, where a state can foresee the invalidation of its law, there is little merit to reliance on past precedents. See McKesson Corporation v. Florida, \_\_\_ U.S. \_\_\_ (1990). The reservation of the foreign parent situation in Container, coupled with the federal executive's communication to the states of the federal policy concerns with worldwide combination, could arguably be viewed as giving the states an indication that the system would be invalidated. There are other recent cases involving unrelated issues that have addressed the retroactivity problem. See American Trucking Associations, Inc. v. Smith, \_\_\_ U.S. \_\_\_ (1990); Ashland Oil, Inc. v. West Virginia, \_\_\_ U.S. \_\_\_ (1990); National Mines Corporation v. West Virginia, \_\_\_ U.S. \_\_\_ (1990); Ragsdale v. Oregon Department of Revenue, \_\_\_ P.2d \_\_\_ (Oregon 1990).

Regardless of the federally mandated result on the retroactivity issue, state law likely would allow refunds to many taxpayers in any event. AS 43.05.275 allows refund claims to be filed within three years from the date the tax return is filed or two years from the date the tax is paid, whichever is later. Since virtually all taxpayers that are in appeal statuses have not yet paid the additional assessments, the taxpayers at a minimum could seek an offset against the additional assessment. Most taxpayers, however, have already raised the constitutional issue in the protest and made it a direct issue to be resolved in the administrative appeal process. Thus, there would be no requirement for these taxpayers to file a refund claim.

The statute of limitations for closed audit cases should preclude refunds to those taxpayers. Similarly, refunds would not be appropriate to taxpayers that have entered into settlement agreements. This is a two way street since worldwide combination may have been favorable to individual taxpayers.

The second impact is that a decision invalidating worldwide combination would require the application of some other method. While it is clear that there is currently no statutory "backstop" provision to fill the void, and considering that the Alaska statutes specifically require "worldwide" factors, it might be reasonable to assume that a contraction of the worldwide method to the United States water's edge would be acceptable to the courts. That cannot be a certainty, however, and the worst case scenario is that there would be no tax method in place to apply to the oil and gas companies.

Perhaps another scenario is that the Department would be free to use any appropriate method. For instance, separate accounting was stated by

the legislature to be the preferred method in 1981 for oil and gas companies but was abandoned due to the fear of the constitutional challenge to that method and the devastating impact on the budget refunds would have. However, separate accounting requires a much different approach than the worldwide method found in AS 43.20. During the separate accounting years, those unique provisions were contained in AS 43.21. Because of the great differences between combination and separate accounting, it is more reasonable to believe that some form of combination would be preferred by the courts over separate accounting.

There are no definitive numbers available to quantify the revenue impact between worldwide and water's edge combinations. However, it was estimated last session that revenues would be reduced by approximately \$3 million dollars each year by moving all non-oil and gas corporations to the water's edge. We believe the revenue impact each year for oil and gas corporations would run well into the hundreds of millions of dollars. Conversely, we believe separate accounting would result in increased revenues in the near term and decreased revenues in later years.

The 1981 legislature enacted modified apportionment on a worldwide basis based on the fact it, combined with an increase in the severance tax rate, would generate total revenue equal to those then generated under separate accounting. That did not materialize for various reasons and revenues were substantially less than anticipated. The legislature also envisioned the modified apportionment system would be constitutional. If in the worst case scenario neither of these legislative assumptions are correct, the oil and gas taxpayers have no legitimate complaint to an effort by the state to rectify the problem. Historical data establishes that they have reaped significant benefits.

Therefore, and for all the reasons expressed in the foregoing paragraphs, strategies such as backstop legislation could be considered at this time. However, caution must be exercised before any changes to the current statutory scheme are recommended. The California cases are certainly there, but their underlying validity has yet to be tested by either the Alaska Supreme Court or the United States Supreme Court. It would be a serious mistake to automatically accept the basis of the California decisions as constituting a correct interpretation of the federal constitutional provisions.

Correspondingly, and with respect to the question whether fiscal incentives or taxes play a major part in attracting increased state investment, your intention to schedule a meeting on the unitary tax issues with the Department of Trade and Economic Development and their Division of International Trade is a very good approach. Perhaps the Department of Law might also be included for their view of the legal climate.

I am not aware of any empirical evidence that establishes tax methods have any significant impact on business location decisions. In

Commissioner Lee Fisher  
January 25, 1991  
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fact, the studies generally conclude that taxes and tax policy, with one possible exception, are not a major influence on state economic growth. The one exception might be that a fiscal climate of stability, predictability, and uniformity is more likely to attract business-- regardless of the taxes and tax methods in place in a state. For that reason, the burden of proof for using tax policy to stimulate growth generally rests with those who advocate a change. Otherwise a change, even should it reduce state revenue in favor of the taxpaying population, could have precisely the opposite result than was contemplated.

I am available at your convenience should you desire to discuss further any of the matters addressed in this memorandum.

cc: William E. Floerchinger

A PERSPECTIVE  
OF  
UNITARY TAX REFORM

BY: THE IBM CORPORATION

The unitary principle of taxing multinational corporations has been the most controversial state tax issue of the eighties. This Study examines many of the policy issues which have been part of the unitary tax debate.

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

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

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

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1. Bureau of National Affairs Daily Tax Report, September 19, 1983, p. G-7 listed 12 states then using worldwide unitary, according to the Multi-state Tax Commission: Alaska, California, Colorado, Florida, Idaho, Indiana, Massachusetts, Montana, New Hampshire, North Dakota, Oregon and Utah.
2. *Container Corp. of America v. Franchise Tax Board*, 103 S. Ct. 2933 (1983). In this decision, the U.S. Supreme Court upheld California's right to impose worldwide unitary on U.S. multinational corporations as discussed later in this paper; however, the continued validity of this decision is open to some serious speculation.

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

TABLE 1.

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

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

state income taxes include real estate, personal property, payroll, sales, etc. So when business decides not to invest further in a state, the lost revenue to that state is many times the potential income tax.

Just in the last few weeks, California's legislature began considering and almost passed a so-called alternative to worldwide combination. That legislative proposal is deceiving in that it appears to move away from Worldwide Unitary. The deception lies in the fact that the legislation also calls for the taxation of earnings distributed as dividends by foreign subsidiaries after they have already borne full taxation abroad. As I mentioned before, this alternative would increase IBM's tax by 50%. But the legislation's purpose is to provide discriminatory benefits to foreign-owned companies. Foreign multinationals will elect the California alternative to escape worldwide taxation because the dividend approach in the legislation does not negatively affect foreign-owned companies and will reduce their cost of doing business in California. Our foreign competitors will now be able to use California to ship to other states at a competitive advantage over U.S.-owned companies.

Certainly, the approach of the California proposed legislation fails any reasonable man's standard of implementing a fair solution to the problem of taxing foreign income with which the Working Group grappled. For U.S. multinationals like IBM, the California so-called alternative is worthless and would only increase our tax burden. The proposed California legislation would lead to unfair advantage to our foreign-based competitors because combining foreign earnings distributed as dividends in the states' tax base is even more onerous than worldwide combination for U.S. multinationals but results in a decrease in the California tax of foreign multinationals."

Another IBM executive, Ray S. Abuzayyad<sup>7</sup>, commented on the same California proposed legislation that:

"(it) subsidizes failure and penalizes success. Less efficient U.S.-based companies that are losing money abroad can write off those losses in California. In effect, California taxpayers would be forced to subsidize those overseas losses.

Ironically, the proposed bill would penalize success by raising the taxes of those companies that make a positive balance-of-payments contribution to the United States via

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7. Ray S. AbuZayyad, President, IBM General Products Division, "Unitary Tax Bill Punishes Success, Subsidizes Failure", San Jose Mercury, August 13, 1985.

Illinois railroad companies. The decision applied the "unit rule" to property physically connected over state lines, allowing the total value of the unit to be allocated to each state by formula. Other decisions expanded the unitary concept and extended it to corporate taxation.<sup>/10.</sup>

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10. Ohio State Auditor, 166 U.S. 185 (1897) applied the Railroad decision to property that was not physically linked.

Underwood Typewriter Co. v. Chamberlain, 245 U.S. 113 (1920) was the first corporate unitary income decision.

Bass, Etc., Ltd. v. State Tax Commission, 266 U.S. 271 (1924) upheld application of the unitary concept to a British corporation doing business in New York.

Hans Rees' Sons, Inc. v. North Carolina, 283 U.S. 123 (1931) restrained the power of the state to apply arbitrary or unreasonable unitary allocations.

Butler Bros. v. McColgan, 315 U.S. 501 (1942) approved California's application of unitary to a corporation operating through divisions in several states.

Edison California Stores, Inc. v. Mc Colgan 183 P.2d 16 (Sup. Ct. Cal. 1947), extended application of the Butler decision to affiliated controlled corporations.

taxpayers threatened with audit by the MTC.<sup>/13.</sup>

Immediately following the U.S. Steel decision, the MTC undertook extensive multi-state audits of large groups of taxpayers. Many of these audits remain unsettled to this day. Although the MTC contends today that it does not officially endorse worldwide unitary,<sup>/14.</sup> these earlier assessments in fact were proposed on a worldwide unitary basis. In contrast to the MTC's current position, the Commission adopted the following resolution in May, 1977, which strongly suggested an official MTC position in favor of worldwide unitary: <sup>/15.</sup>

"Be it RESOLVED that:

(1) It is the official policy of the Multistate Tax Commission that the unitary business concept is appropriate for attributing income with respect to all businesses affected by the Uniform Division of Income for Tax Purposes Act; and that

(2) It is appropriate on a worldwide as well as a domestic basis regardless of whether the parent or some or all of the

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13. U.S. Steel, Standard Brands Inc., General Mills, Inc. and the Procter & Gamble Distributing Co. filed the action. Bethlehem Steel Corp., Bristol Myers Co., Eltra Corp., Goodyear Tire & Rubber Co., Green Giant Co., International Business Machines Corp., International Harvester Co., International Paper Co., International Telephone & Telegraph Corp., McGraw Hill, Inc., NL Industries, Inc., Union Carbide Corp., and Xerox Corp. intervened as plaintiffs. IBM and Xerox withdrew as intervenor plaintiffs before decision.
14. Gene Corrigan, first Executive Director of the MTC, and later General and Executive Counsel until leaving the MTC in January, 1989, stated in "A Final Review", published in MTC Review, March 1989, that "(F)rom the beginning, I advocated combined reporting along lines previously established by California and Oregon. EVEN THOUGH THE MTC NEVER TOOK AN OFFICIAL POSITION ON THE SUBJECT, most of its member States supported that approach." (emphasis added).
15. Jerome R. Hellerstein, State Taxation, Warren, Gorham & Lamont, (1983), Chapter 8.10[7], footnote 252.

The states obviously were concerned by what they considered federal intrusion into state's prerogatives<sup>/18</sup>.

The estimated revenue affect for the three states was \$40 million. The quid pro quo from U.K. was \$375 million under the U.K. ACT.<sup>/19</sup> A spokesman for the British Embassy told Tax Notes<sup>/20</sup> that he could not pinpoint the course of action that Britain would take toward the Senate reservation. That course ultimately proved to be the U.K. retaliation threats which propelled unitary reform and which are now central to the issues on appeal in the Colgate case.

During the Senate debate on the U.K. Treaty, Governor Jerry Brown of California "threw the state lobbyists into high dungeon" by writing the Senate Foreign Relations Committee to support the worldwide unitary prohibition. The California Franchise Tax Board continued to oppose Article 9(4) of the treaty, but both California senators supported it including the worldwide unitary prohibition. Oregon and Alaska senators opposed Article 9(4).<sup>/21</sup>

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18. Ironically, however, a recent decision from a California superior court ruled that application of worldwide unitary principles to domestic multinational corporations violates the U.S. Constitution because worldwide unitary involves impermissible intrusion by states into U.S. foreign policy. Colgate-Palmolive Co. v. Franchise Tax Bd., California Superior Court No. 319715 (1988). This decision is currently being appealed to the California Courts of Appeals.
  19. ACT (Advance Corporation Tax) was designed to eliminate double taxation of American investors in the U.K.
  20. "Senate Reserves Article 9(4), "Tax Notes", July 3, 1978
  21. U.K. Treaty: Whose Horses Got Traded?, Tax Notes, November 7, 1977, p.9.

question of how far the limits of distortion could be pushed before the tax was overturned.<sup>/23.</sup>

In the famous footnote 32 of the decision, the court implies that a different result might be reached in the case of a foreign parent<sup>/24.</sup> and Justice Powell in his dissent speculates that such a tax would be unconstitutional, ultimately invalidating the unitary method for both foreign and domestic multinationals.<sup>/25.</sup>

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23. The court found that distortion in Container is 14 percent, "a far cry from the more than 250 percent difference which led us to strike down the State tax in Hans Rees' Sons, Inc., and a figure certainly within the substantial margin of error inherent in any method of attributing income among the components of a unitary business."
24. In distinguishing Container from Japan Lines on the issue of impairment of the Federal government's ability to "speak with one voice" on international trade matters, the court stated in footnote 32 that "we recognize that the fact that the legal incidence of a tax falls on a corporation whose formal corporate domicile is domestic might be less significant in the case of a domestic corporation that was owned by foreign interest. We need not decide here whether such a case would require us to alter our analysis."
25. "The Court's argument is even more difficult to accept when one considers the dilemma it creates for cases involving foreign corporations. If California attempts to tax the American subsidiary of an overseas company on the basis of the parent's worldwide income, with the result that double taxation occurs, I see no acceptable solution to the problem created. Most of the Court's analysis is inapplicable to such a case. There can be little doubt that the parent's government would be offended by the State's action and that international disputes, or even retaliation against American corporations, might be expected. It thus seems inevitable that the tax would have to be found unconstitutional--at least to the extent it is applied to foreign companies. But in my view, invalidating the tax only to this limited extent also would be unacceptable. It would leave California free to discriminate against a Delaware corporation in favor of an overseas corporation. I would not permit such discrimination without explicit congressional authorization."

This decision came after a long series of unsuccessful challenges by foreign parent companies,<sup>/31.</sup> prompted by the open question in Container of the constitutionality of applying unitary taxation to foreign-based multinationals.

In upholding Alcan's and Imperial's standing to challenge California's unitary tax, the Seventh Circuit stated that:

"(t)hese companies will show a higher taxable income in California under the unitary tax scheme than they would if they engaged in precisely the same foreign commerce through arm's length contracts with unaffiliated companies. From the perspective of the foreign parent, therefore, the unitary tax diminishes the attractiveness of owning American subsidiaries in comparison with entering into contracts with independent companies as a means of engaging in foreign commerce.

Viewed in these terms, Alcan's and Imperial's injuries are direct and independent of the injury to their subsidiaries and standing should follow. To the extent that California's franchise tax burdens foreign companies' decisions to conduct business through subsidiaries operating in California, it threatens to offend this country's trading partners, many of whom must deal with conflicting internal views on the proper role of American investment in their economies, and to elicit retaliatory measures.

It is important that these injuries, which the FTB would have us label indirect under an expansive view of the shareholder standing bar, have fueled a simmering trade controversy which has raised concerns about foreign retaliation and the country's ability to speak with one voice on matters of foreign commerce -- concerns that are central to the purposes of the foreign commerce clause."

On April 17, 1989, the U.S. Supreme Court agreed to review the

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31. In *Shell Petroleum v. Graves*, 709 F2d 593 (CA 9 1983), the court held no injury independent of the domestic subsidiaries; in *Alcan Aluminum Ltd. v. Department of Revenue*, 724 F2d 1294 (CA 7 1984), the court dismissed Oregon's unitary application as "unripe"; in *EMI Ltd.*, 738 F2d (9th Cir.) cert. denied, 469 U.S. 1041 (1984) and in *Alcan Aluminum Ltd. v. Franchise Tax Board*, 742 F2d 1430 (2d Cir. 1983), cert. denied, 464 U.S. 1041 (1984), the court held injuries to be indirect, suffered in status as majority shareholders.

At its first meeting on November 2, 1983, the Working Group appointed a Task Force to study the issues and develop options. Between November and April, 1984, the Task Force met in Washington 20 different times for a total of about 150 working hours (not counting countless hours of private deliberation by state and business groups). The Working Group was unable to agree on the six options presented to it by the Task Force. Although there were some common areas of agreement, both sides held fast to their positions on taxation of foreign dividends and 80/20 companies. Nevertheless, the process did clarify the issues and narrow the differences, and probably facilitated the legislative process considerably in states undertaking unitary reform subsequent to the Working Group effort.

At the final meeting of the Working Group on May 1, 1984, agreement was reached that State tax policy in this area should be based on three principles:

- (1) Water's edge unitary combination for both U.S. and foreign based companies.
- (2) Increased Federal administrative assistance and cooperation with the States to ensure full taxpayer disclosure and accountability.
- (3) Competitive balance for U.S. and foreign multinationals and purely domestic businesses.

Both sides agreed that the three principles are "an indivisible package".

On July 31, 1984, Secretary Regan submitted the "Chairman's Report on the Worldwide Unitary Taxation Working Group: Activities, Issues and Recommendations". The letter transmitting

States' and MTC's attitude throughout the Working Group sessions that multinational corporations engaged in widespread tax cheating. Finally, he outlines six reasons which, he asserts, justify different treatment for foreign multinationals than for domestic multinationals.

In his response, Mr. Mattson, who was a member of the Task Force of the Working Group and actually participated in it's deliberations, disputes Mr. Dexter's contention that the scope was limited to considering the affect of worldwide unitary taxation on foreign multinationals. He rebuts each of the "six reasons", and generally portrays the efforts of the Working Group in a more favorable light.<sup>/36.</sup>

Mr. Mattson concludes with the following prediction:

"The principle of equal treatment for domestic and foreign MNC's (multinational corporations) makes sense from both an economic and a constitutional standpoint. Nondiscrimination is required by the Working Group Principle Three. Indeed, THE PRINCIPLE OF NONDISCRIMINATION IS THE ACHILLES' HEEL OF THE ADVOCATES OF THE WORLDWIDE COMBINED UNITARY TAX. The litigation regarding the constitutionality of the worldwide combined scheme as applied to foreign MNC's is proceeding in both the state and federal courts and will soon reach a trial on the merits. If, as seems inevitable, the tax is ultimately found unconstitutional, the tax as applied to domestic MNC's will have to be relitigated on the issue of discrimination. Under those circumstances, the victory of California in Container Corporation may ultimately turn out to have been both narrow and interim."

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36. "The considerable debate in a highly structured forum served to clarify many misunderstandings and bring the adversaries together on a long list of points of contention. Indeed, Mr. Dexter's continued hyperbole on the fringes of the argument serve only to undo the considerable goodwill generated by the task force effort."

During 1986, after the introduction of S. 1974, California, Idaho, New Hampshire and Utah enacted unitary legislation, bringing the number of states that had repealed or modified their unitary laws to nine. Subsequently, in 1987, Montana and North Dakota passed water's edge legislation, leaving Alaska the only remaining worldwide unitary state.

Because of the progress that had been made during 1986, the Administration as well as the sponsor withdrew support for S. 1974. Both, however, made statements citing major remaining questions involving inadequate relief provided for foreign dividends<sup>/39.</sup> and taxation of 80/20's in certain states. These problems remain, despite modifications to California's unitary reform in 1987 and 1988. Consequently, Federal legislation was re-introduced in 1987<sup>/40.</sup> and 1989.<sup>/41.</sup>

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38. Statements of J. Roger Mentz, Assistant Secretary, Treasury, and Sen. Pete Wilson, Hearings, September 29, 1986.
39. California's 75 percent exclusion and linkage to foreign payroll factors; New Hampshire's "bifurcated formula"; and Utah's 50 percent exclusion with factor relief on taxable 50 percent. Additionally, Alaska's continued mandatory imposition of worldwide unitary.
40. H.R. 2940, Rep. Frenzel (R-Minn.) / S. 1843, Sens. Roth (R-Del.) and Fowler (D-Ga.), carried over to 1988.
41. H.R. 1390, Rep. Frenzel and 13 other representatives, 9 of whom are members of Ways and Means / S. 1139, Sens. Roth, Fowler, Glenn, Simon, Symms, Lugar and Nunn.

business will shun such states. They will not invest that extra dollar over and above what is necessary to maintain its presence in the state, but will look elsewhere when making discretionary investments.

This does not necessarily mean that business will seek out the low tax state. In fact, low taxes may result in a lack of the very resources which may be far more important. Corporations are willing to pay a high tax bill to support conditions which it feels are necessary for the conduct of its business. But few CEO's would invest that extra dollar in a unitary state.

After Container, this realization suddenly became obvious to state legislatures and others in state government responsible for economic development. The depth of business' attitude to unitary encouraged a growing recognition that states could not continue to impose such a universally disliked tax. This contributed to the unitary retreat perhaps more than any other factor.

## (2) STATE COMPETITION AND ECONOMIC DEVELOPMENT

The mirror image of a negative business climate created by the imposition of bad taxes is development of a positive economic development policy and active competition with other states for business investments.

Over the years, many studies have been made on the impact of taxes on economic development. Earlier ones generally discounted

Then, in 1987, Johnson said, the Iowa governor came to Nebraska asking companies to move to his state. ConAgra, the state's largest employer, had done a state-by-state study of the tax climate and was planning to move to Tennessee. In response, Nebraska passed legislation giving tax breaks to business. As a result, according to Sen. Johnson, ConAgra stayed, and Nebraska gained 15,000 new jobs in the first year after the legislation was enacted.

Business in general reacts more favorably to the overall tax policy of a state than it does to "special deals" given on a company-by-company basis. As Bill Brown, President of COST has stated "in the long run indiscriminate use of special incentives or deals are likely to be counterproductive. For one thing the company that is attracted by such an approach is likely to move on to 'greener pastures' or attempt to 'extort' further concessions."/<sup>46</sup> Mr. Brown goes on to state that

"(i)n order for a tax incentive to contribute to a Good Business Climate, and not detract, it should be generally available to all taxpayers with like circumstances. It definitely should not discriminate against existing businesses - yet most special incentives or deals do exactly that! It needs to be recognized that generally the best prospect for increasing jobs is expansion of existing businesses rather than chasing around the country attempting to lure some prospect that everybody else is working on too."

The folly of using special tax deals to encourage development

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46. National Tax Association - Tax Institute of America  
Annual Conference, Des Moines, Iowa, September 26, 1988.

See also, "Holdup in the Windy City -- Chicago is the latest loser in the tax-incentive wars", U.S. News & World Report, July 17, 1989.

### Alaska Unitary Statement

My name is Susan Burke and I am here today representing the IBM Company and their interest in corporate tax reform.

IBM has a long business history in Alaska. They currently employ 170 people in our State. Their annual payroll exceeds \$10 million. The company is an active corporate citizen contributing more than \$125,000 to charities and community projects in the last year.

IBM is most interested in the Governor's proposal to reform our State's worldwide unitary method of taxation. However, they are disappointed and concerned that the proposed legislation is limited to only foreign corporations. The proposed legislation benefits only corporations who are non U.S. companies and thus would discriminate against U.S. domestic corporations and put them at even more of a tax disadvantage than today. IBM agrees with the fundamental need to repeal Alaska's world wide unitary taxation; however, the legislation must be expanded to include domestic corporations or it will only exacerbate tax inequities for U.S. companies.

While one issue is competitive fairness between foreign and domestic companies, an equally important issue is good tax policy. Repeal of worldwide unitary taxation has been a priority of IBM and the business community for years.

Alaska is the only state currently requiring worldwide unitary taxation. In the past four years, 11 states have revised their tax laws to no longer require this form of state taxation. In addition, no country in the world uses this method of taxation. In fact, many countries have petitioned the U.S. government protesting the fact that states use worldwide combination.

Why does IBM oppose worldwide unitary taxation? IBM operates in more than 130 countries around the world. When an IBM overseas affiliate earns income, it pays taxes to the country in which the income was earned. In most cases, the foreign tax is at a higher rate than in the United States. A fundamental tenet of international tax law and practice is that foreign source income is not taxed by the home country until it is repatriated and then only to the extent that it is not offset by foreign tax credits. Clearly, the intent of this policy is to avoid double taxation of foreign source income.

A state, like Alaska, that uses worldwide unitary taxation, taxes foreign source income when it is earned even if it is never brought back to the U.S. Furthermore, using foreign income in calculating state tax liability may result in over apportionment of income to a state, taxation of income already taxed by a foreign government (and not taxed by the U.S. government), and potentially disruptive effects on international trade. Thus, use of the worldwide unitary method of taxation can distort a

company's taxation relationship to a state and mean double taxation of income earned in another governmental jurisdiction.

Corporate taxes are a basic and significant cost of doing business and no company can withstand a tax disadvantage without suffering an important economic impact. Therefore, IBM strongly recommends repeal of Alaska's worldwide unitary tax system for all corporations.

Reform of the worldwide unitary system will make Alaska a more attractive place to invest if it is applied equally to domestic U.S. corporations and foreign corporations. If worldwide unitary reform applies only to foreign corporations, they would no longer be taxed on their foreign income, while U.S. corporations will continue to be taxed of foreign income. This is not only a disincentive to investment in Alaska by U.S. corporations, but penalizes them compared to their foreign competitors.

IBM would be pleased to work with the Legislature in an effort to draft legislation that provides meaningful and comprehensive reform of the worldwide unitary tax system.