III. APPLICATION OF THE VANIK THEORY TO ALASKA TAXES

Each year for the past several years Congressman Vanik has published a study purporting to show the effective federal income tax rate applicable to the nation's major corporations. Briefly stated, Mr. Vanik's technique is to compute the amount of the federal income tax paid by each such corporation as a percentage of that corporation's net income for financial statement purposes. He includes in the total net income figure 100% of the income of subsidiaries (foreign and domestic) in which the corporation owns an interest of more than 50% and the corporation's equity interest in the income of subsidiaries in which it owns an interest of 50% or less. Foreign income taxes are taken as a deduction.

Zeifman and Ainsworth have cited the Vanik study for 1975 in support of their contention that the federal tax base has been unduly eroded by "tax expenditures" and is no longer worthy of use by Alaska for the taxation of oil companies. The Department of Revenue has gone on to convert the Vanik results into Alaska results. The Department takes Vanik's finding that certain oil companies paid an effective

federal tax rate ranging from 1.8% to 35.6% and converts this into effective Alaska tax rates of from .28% to 5% for the same companies. The precise method by which the Department accomplished the conversion has not been disclosed, but for purposes of this discussion it will be assumed that it was done by applying to Vanik's effective federal rates the ratio which the Alaska statutory rate (9.4%) bears to the federal statutory rate (48%).

There are a number of criticisms that can be made of the Vanik approach in the federal context, but even if it is accepted as gospel truth in that context, the extension of it to Alaska is totally undependable.

As previously noted, the federal approach to the taxation of multinational businesses is essentially a separate accounting approach. The foreign operations of multinationals are in large part carried on through foreign subsidiaries, and foreign subsidiaries are not combined with the parent for federal income tax purposes. Alaska, however, does require the inclusion of foreign subsidiaries in a combined report and then applies the apportionment formula to the combined net income. Mr. Vanik also combines them in his approach.

It is erroneous, therefore, to assume that Alaska taxes paid will be in the same proportion to Alaska net income as federal taxes paid bear to Vanik's reconstructed federal net income. A large part of the discrepancy which Vanik finds between federal statutory and effective rates for multinationals must be attributable to the separate accounting method that the federal government uses and the combined method which Vanik uses. Since Alaska also uses the combined method, the discrepancy between Alaska statutory and effective rates should be considerably smaller when properly calculated.

Another aspect of the difference between the federal approach and the Alaska approach to the taxation of multinational corporations has to do with the allowance of credits for foreign taxes. This is pertinent if and to the extent that a U.S.-based multinational corporation conducts foreign operations itself rather than through foreign subsidiary corporations. U.S. corporations are subject to federal income tax on their world-wide income and not just on the income from U.S. sources, as would be the case if the federal government used the formula apportionment approach. Therefore, to avoid the foreign-source income being subjected to duuble taxation, the

federal system allows such a corporation to reduce its federal income tax by the amount of foreign income taxes paid. By contrast, in Alaska and all of the other states inposing income taxes, the double taxation problem is met by taxing the corporation only on its income from sources within the state as determined by formula apportionment. Therefore, states such as Alaska do not, and should not, allow credits for foreign taxes.

Once again, the unreliability of trying to convert Vanik's federal figures and Alaska's figures is apparent. The allowance of foreign tax credits must account for a significant part of the discrepancy which Vanik finds between federal statutory and effective rates, but that is a condition which does not exist in the Alaska tax system.

FOOTNOTES

1. § 43.20.030(d), Alaska Statutes

2. § 19.40.040 AS.

3. § 43.20.031(b)(1) AS.

4. §§ 43.20.031, 43.70.020, 43.70.030 AS.

5. § 21.09.210 AS.

6. Amoco Production Co. v. Arnhold, 213 Kan. 636, 518 P. 2d 453 (1974).

7. Report of Special Subcommittee on State Taxation of Interstate Commerce of the House Committee on the Judiciary (89th Congress) Vol. 4, Part VI, Ch. 39, p. 34. Zeifman and Ainsworth were prominent members of the subcommittee staff, and Zeifman ultimately became the chief counsel. The subcommittee was popularly known as the "Willis Subcommittee" and will hereinafter be so identified.

8. Willis Subcommittee Report, Vol. 1, Part II, Ch. 8, p. 273.

9. § 1(a), UDITPA; § 43.20.170(1) AS.

10. § 1(e), UDITPA; § 43.20.150(5), AS.

11. §§ 4 - 8, UDITPA

12. Shaffer v. Carter, 252 U.S. 37, 52-53 (1919).

13. Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113 (1920).

14. Connecticut General Life Ins. Co. v. Johnson 303 U.S. 77 (1937)

15. Alaska's Oil and Gas Tax Structure: A Study with Recommendations for Improvement, February 1977, pp V-1 (hereinafter referred to as the "Department Report").

16. Department Report, p. V-18

the ground that the extraction factor would generate more tax revenues than the sales factor. Apportionment formulas are not intended to be vehicles to generate tax revenues but are designed to divide income among the states fairly and uniformly so as to avoid multiple taxation.

Finally as to the proposed new tax base and apportionment formula in H.B. 322, the singling out of the oil and gas industry and of companies within the industry having receipts of more than $250,000,000 may well be unconstitutional.

SEPARATE ACCOUNTING -- SENATE CS FOR CS FOR HOUSE BILL 322

I understand that the other major proposal before this Committee is adoption of a tax based upon principles of separate accounting. The declared purpose of this bill is to tax oil and gas production and pipeline transportation income in Alaska by means of a statutory separate accounting, while retaining formula apportionment (as modified) to apportion all other income.

Conceptually, separate accounting constructs an income or loss statement for the activities of a corporation in the state as if it conducted an independent oil and gas production or transportation business solely within Alaska and assumes that all dealings by the business with other

aspects of its business and with the outside world are at arm's-length. I am sure it is an attractive concept to try to isolate the Alaskan income by what purports to be a rational procedure rather than the fixed formula. But let me suggest, as your Department of Revenue has strongly argued, that this approach is doomed to failure. Perhaps with small localized businesses the concept is workable. But to apply this concept to large integrated multinational oil and gas corporations ignores the unitary nature of their operations. Each element of a corporation contributes to the overall net profit of the business. You simply cannot ignore the contribution of out-of-state activity to the creation of income in Alaska and how will separate accounting deal with this?

Separate accounting, in practice, is impossible to administer and determine. I fail to see how a concept which proved to be unworkable in the 1920's, when business was relatively simple, can be expected to work in today's era of complex multistate and multinational business of which the oil companies are a preeminent example. The apportionment formula was resorted to because separate accounting could not be administered.

The current proposal attempts to avoid some of the inherent problems of separate accounting by arbitrarily defining net income. Allocation of overhead expenses is "solved"

by simply denying a deduction for such costs. Pricing differences are "solved" by using as gross income the value of the oil and gas produced as determined for purposes of the production tax. And inadvertently, I assume, the proposal results in a double allocation of production income to Alaska, first by allocating production income in Alaska under the statutory separate accounting formula and then allocating to Alaska a portion of the production income outside Alaska under the two-factor apportionment formula. This is clearly a duplication.

Such duplication can be eliminated only by determining production income by separate accounting both in Alaska and outside Alaska and eliminating both, not just Alaskan production income, from the base subjected to the two-factor apportionment formula.

Accordingly, the current proposal does not by definition even approach theoretical separate accounting, and is at least as arbitrary, if not more so, than formula apportionment. It is, indeed another kind of statutory formula.

The proposal has major infirmities. It purports to be an application of separate accounting but it is not and it incorporates a "double dip" allocation of production income to Alaska. It represents a sharp deviation from uniformity and as such would constitute a major disruption of the common consensus underlying the system of state taxation of interstate business income. Separate accounting defined by legislative fiat and applied by one state to a whole industry in order to increase the state's share of the total income

over that resulting from the three-factor formula necessarily results in multiple taxation because income which is fully taxed by the one state is also apportioned by formula to other states. Such deviant action, particularly when it is directed at one industry, may well be unconstitutional.

Moreover, Alaska must ask itself again whether it is appropriate for it to take unilateral action which will disrupt the progress toward uniformity in the division of income among the states which is essential to avoidance of multiple taxation.

THE MULTISTATE TAX COMPACT

Alaska's continuing membership in the Multistate Tax Compact and the administrative benefits derived from such membership may not be tenable if either of the proposals under consideration are adopted. The courts may find such proposals to be in conflict with the Compact and as a result may hold that Alaska has in effect withdrawn from the Compact or that the Compact remains in effect but enactment of the proposals is ineffective to prevent taxpayers from applying the UDITPA formula under the provisions of the Compact. It will take years of litigation to clarify these issues which will cast doubt on what the applicable law is for taxing the income of the oil and gas industry.

CONCLUSION

The United States Supreme Court presently is considering the constitutionality of Iowa's single-factor sales formula. I cannot predict the Court's decision, nor can I

predict to what extent a state may tamper with the uniform formula without violating constitutional principles. Perhaps the Court is ill suited to act as final arbiter as to whether one method of apportionment is fairer or more reasonable than another. But I suspect that with the nearly nationwide acceptance of UDITPA, the Court will show less tolerance of deviant formulas which result in multiple taxation. In any event years of litigation as to the constitutional validity of either of the proposals if enacted as well as their compatibility with the Multistate Tax Compact must be anticipated.

Great progress has been made in recent years in adopting uniform apportionment methods. Part of the drive for voluntary uniformity has obviously been the desire of both states and taxpayers to avoid Federal intervention. As long as states strive toward uniformity as a goal of fair taxation, Congress will be hesitant to act. If the drive for uniformity falters through unilateral action by states asserting their currently perceived self-interest without restraint and the Supreme Court declines to prescribe a uniform formula, Congress will be constrained to exercise its constitutional responsibility to protect interstate commerce by prescribing a Federal standard of uniformity in the division of multistate business income.

Alaska has been in the forefront of the drive for uniformity. By the collective judgment reflected in the

development and general acceptance of the three-factor formula, Alaska's net income tax fairly and effectively reaches its proportionate share of the income of multinational oil and gas corporations doing business within the state. The proposed changes are designed to produce higher revenue, not a fairer division of multistate income, and they would be destructive of the cooperative effort among the states in developing a uniform approach to the division of multistate business income among them.

Madame Chairman and members of the Committee, I want to reemphasize in conclusion that changing the present formula for determining the portion of the worldwide income of oil and gas companies which is taxable in Alaska is not an appropriate way to increase revenues. If Alaska is to act responsibly it cannot ignore the interests of its sister states and in the long run its own interests in maintaining uniformity in the division of multistate business income among the states. If Alaska believes that the apportionment formula is not fair and reasonable as it applies to oil companies, the proper action to take is under Article 18 of UDITPA or through the Multistate Tax Compact or other cooperative state machinery to persuade other states of a different uniform approach, not unilateral legislation which is destructive of uniformity.

SUMMARY

INCOME TAXATION OF MULTISTATE CORPORATIONS ENGAGED IN OIL AND GAS PRODUCTION AND TRANSPORTATION IN ALASKA

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I. PRINCIPLES OF TAX JURISPRUDENCE

Where the activities of a business extend over two or more states, all of the income from such business cannot reasonably be taxed by each of the states. The whole development of the law regarding state taxation of multistate business income rests on this manifest and undisputed principle. Similarly, international tax jurisprudence and tax treaties are grounded on this basic principle with respect to national taxation of multinational business income.

Under the Constitution and within our federal system, this principle has been implemented by Supreme Court decisions under the commerce and due process clauses and through the voluntary and mutually compatible actions of state legislatures and tax administrators.

The effort has been to avoid multiple taxation of the income of a multistate business through the taxing by each state in which the business has activities of only a portion of the income, determined by some reasonable method of apportionment. The system which has developed has two basic elements: (i) a tax base measured by a company's worldwide income determined by Federal taxable income and (ii) a method of dividing this base through use of an apportionment formula.

The Massachusetts, or three-factor, formula apportions the income of a multistate business to the taxing state on the basis of the average of three fractions: (1) property within the state over total property, (2) payroll within the state over total payroll, and (3) sales within the state over total sales.

It was recognized at the outset that multiple taxation of multistate business income arises not merely from failure to apportion reasonably but from disparity in methods of apportionment as well, even though each method by itself and applied universally might be reasonable. The National Tax Association began advocating uniformity in the method of apportionment as early as 1919. Ultimately, these and other efforts culminated in the Uniform Division of Income for Tax Purposes Act (UDITPA) adopted by the National Commissioners on Uniform State Laws in 1957. UDITPA incorporated the three-factor formula and, most notably, defined the numerator of the sales fraction, with respect to which the greatest divergence from uniformity had developed, as being sales having their destination, that is, delivered to customers, in the state.

The Multistate Tax Compact, inaugurated in 1966 to promote uniformity and thereby avert Federal legislation then under consideration to impose uniformity on the states, incorporates UDITPA.

Out of a total of 44 states and the District of Columbia which impose a corporate net income tax, 40 provide for the three-factor formula, 25 by adoption of UDITPA or the Multistate Tax Compact and 15 by incorporation in their own tax statutes, four of the latter giving greater weight to the sales factor than to the property and payroll factors. Differences in the economies of the states as to whether primarily industrial, or commercial, or agricultural or extractive have not affected the general acceptance of the three-factor formula as essentially fair and reasonable.

II. ALASKA INCOME TAX--PRESENT STRUCTURE AND APPLICATION TO THE OIL AND GAS PRODUCTION AND TRANSPORTATION INDUSTRIES.

Alaska has adopted both UDITPA and the Multistate Tax Compact and determines taxable income by reference to the Federal tax base. No distinction is made between the oil and gas industry and other industries engaged in the production and sale of tangible personal property. Since this is essentially the same treatment which is accorded to the oil and gas industry by all of the states imposing a corporate income tax, Alaska suffers no disadvantage in comparison with other states. Accordingly, there does not appear to be justification for change and departure from uniformity. The burden of proof should rest on those who advocate departure.

III. THE ZEIFMAN-AINSWORTH REPORT

The Zeifman-Ainsworth Report contends that Alaska's tax base has been eroded through Federal tax subsidies and incentives which are unrelated to the definition of net income but which are provided solely to accomplish certain economic and social goals, and that the UDITPA apportionment formula reduces the amount of taxable income attributable to Alaska by corporations which export non-renewable petroleum resources from the state.

Zeifman and Ainsworth's recommendations which have been endorsed by the Department of Revenue and incorporated in H.B. 322 are:

1. Adoption of a tax base measured by the greater of book income or Federal taxable income.
2. Replacement of the destination-oriented sales factor with an "extraction factor" -- the ratio of oil and gas energy units produced in Alaska to total oil and gas energy units produced everywhere.

These changes would apply only to corporations with ordinary gross receipts in excess of $250,000,000 more than 50% of which is derived from production, transportation,

refining, manufacturing, processing, distribution of retail sale of oil or gas or products derived from oil and gas.

The "tax subsidies" cited by Zeifman and Ainsworth are for the most part available to all corporations. It is unfair and perhaps unconstitutional to single out the oil industry.

Furthermore, with respect to the one Federal "tax subsidy" allowed to the oil and gas industries, a current deduction for intangible drilling costs, Alaska does not, as Zeifman and Ainsworth claim, provide an incentive to drill wells outside Alaska. Federal taxable income reflects not only deductions for the cost of wells drilled throughout the world but also the income from such wells. It is not a one-way street. Alaska is no more providing an incentive for drilling outside Alaska than other states are providing an incentive for drilling in Alaska. Denial of this current deduction in Alaska, however, could reduce the incentive to drill wells in Alaska.

Congressman Vanik's computations of "effective taxable income" do not support the view that the adoption of the Federal tax base by Alaska automatically causes Alaska's "effective tax rate" to be less than 9.4%, by something comparable to the difference between the statutory 48% rate and the Vanik "effective U.S. tax rate on

worldwide income". Congressman Vanik's approach of measuring Federal income tax due as a percentage of worldwide income is patently incorrect because the United States, recognizing the principles of international tax jurisprudence, provides a credit against its tax on worldwide income for taxes paid to other countries. Alaska does not provide a credit but imposes its tax rate of 9.4% on a corporation's worldwide income apportioned to Alaska. Obviously after apportionment (or after the foreign tax credit at the Federal level) the amount of Alaskan tax as a percentage of worldwide income will be less than 9.4% (or the Federal tax will be less than 48%).

Book income is an inappropriate tax base. It will greatly increase the administrative and audit costs and burdens of both the oil companies and the Department of Revenue. Furthermore, book income not only reflects taxable income before tax subsidies but also many timing differences unrelated to Congressional tax policies. Use of the higher of Federal taxable income or book income as a tax base would tax income twice to the extent of such timing differences.

The UDITPA apportionment formula provides for fair and equitable division of income of oil and gas corporations between Alaska and the rest of the world and fairly reflects the extent of their activity in Alaska as compared to the rest of the world. The destination sales factor properly

gives recognition to the contribution of the market states to the creation of income. Without the demand and purchasing power of the market states, the value of Alaska's oil and gas would be less and the income tax base of oil and gas companies would be smaller. The extraction factor ignores the contribution of the market state and creates multiple taxation, since nearly every other state uses a destination oriented sales factor.

The extraction factor has been proposed not to make Alaska's apportionment formula "fairer" in terms of reasonable sharing of the income tax base with other states, but to generate more tax revenue. Apportionment formulas are not intended to be vehicles to generate tax revenue but to divide income among the states fairly and uniformly so as to avoid multiple taxation.

IV. SEPARATE ACCOUNTING--S.B. 105

The declared purpose of the "net proceeds" tax is to tax production and pipeline transportation income in Alaska by means of a statutory separate accounting, while retaining formula apportionment (as modified) to apportion all other income.

Conceptually, separate accounting constructs an income or loss statement for the activities of the business in the state as if they constituted an independent business

dealing at arm's-length with the remainder of the business and the outside world. In practice separate accounting is impossible to administer and determine. Separate accounting requires that hypothetical prices be established for goods and services between affiliated companies. Separate accounting must effectively contend with efforts of companies to shift income among divisions, affiliates and states and must devise some reasonable way to attribute overhead expenses to the various business locations and activities of the taxpayer, no doubt by means of an apportionment formula, thereby abandoning to that extent its initial purpose of avoiding the apportionment formula. Furthermore, separate accounting requires maintenance of records needed in the effort to determine geographic income--records which serve no other business function.

S.B. 105 handles the problem of allocating overhead expenses by simply denying a deduction for such costs. Pricing difficulties are "solved" by using as gross income the value of oil and gas produced as determined for purposes of the production tax.

Thus, the proposed net proceeds tax would not by definition apply separate accounting even though it purports to do so.

The proposed net proceeds tax has major infirmities. It purports to be an application of separate accounting but it is not. It represents a sharp deviation

from uniformity and as such would constitute a major disruption of the common consensus underlying the system of state taxation of interstate business income. Separate accounting applied by one state to a whole industry in order to increase its share of tne total income over that resulting from the three-factor formula necessarily results in multiple taxation because income which is fully taxed by one state is also apportioned by formula to other states.

V. THE MULTISTATE TAX COMPACT

Alaska's continuing membership in the Multistate Tax Compact and the administrative benefits derived from such membership may not be tenable if either the Zeifman-Ainsworth proposals or S.B. 105 were adopted. The courts may find such proposals to be in conflict with the Compact and as a result may further hold that Alaska has in effect withdrawn from the Compact or that the Compact remains in effect but enactment of the proposals is ineffective to prevent taxpayers from applying the UDITPA formula under the provisions of the Compact.

VI. UNIFORMITY, COMITY AND ENLIGHTENED SELF-INTEREST

Great progress has been made in recent years in adopting uniform allocation methods. Part of the drive for voluntary uniformity has obviously been the desire of both

states and taxpayers to avoid Federal intervention. As long as states strive toward uniformity as a goal of fair taxation, Congress will be hesitant to act. If the drive for uniformity falters through independent action by states asserting their currently perceived self-interest without restraint, Congress will be constrained to exercise its constitutional responsibility to protect interstate commerce by prescribing a Federal standard of uniformity.

Alaska has been in the forefront of the drive for uniformity. By the collective judgment reflected in the development and general acceptance of the three-factor formula, Alaska's net income tax fairly and effectively reaches its proportionate share of the income of multinational oil and gas corporations doing business within the state. The proposed changes would be destructive of community and comity among the states in dealing reasonably with state taxation of multistate business and are parochially designed to increase tax revenues without regard to the general principles of tax jurisprudence for division of interstate business income adhered to by other states.

A NEW VENTURE IN FEDERALISM— TOWARD A SOLUTION TO STATE TAXATION OF MULTISTATE BUSINESS †

Leonard E. Kust *

I. Introduction

My title—"A New Venture in Federalism" possibly conjures up something far more exciting than my subject. But the obdurate problems involved in state taxation of interstate business require new perspectives and some venturesomeness in statecraft and I will stand by my title, trusting that my subject will at least be challenging if not exactly exciting.

New initiatives are needed to break the sterile impasse with which we have been confronted. All proffered solutions have been rejected.

The present impasse is, of course, part of the historic confrontation between state and national government in a federal system. The problems of state taxation of multistate business arise naturally from a nationwide economy functioning within a federal system. Solutions, on the other hand, necessarily impair in some measure the autonomy of the states.

In spite of this historic context, we must not permit an overweening emphasis on the conflict between "states' rights" and "national supremacy" deflect us from the search for a reasonable accommodation.

Reviewing the history of the controversy, I believe we have passed well beyond a simplistic confrontation between state and national government.

Ever since Chief Justice Marshall in *Brown v. Maryland* [1] declared the obvious, it has remained persuasive that state taxation can impede interstate commerce in violation of the Constitution. Yet as some 300 decisions of the Supreme Court [2] since attest, the judicial process is not a satisfactory

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†This article is based on a talk delivered by Mr. Kust at the TEI Annual Conference in New York City.

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[1] 25 U.S. (12 Wheat.) 419 (1827)

[2] *Northwestern States Portland Cement Co. v. Minnesota*, 380 U.S. 450 at 457, 458 (1959).

instrument for reconciling the sovereign power of states to impose taxes to the needs of a national economy contemplated by the commerce clause of the Constitution.

Recognizing that the taxing power is the most jealously guarded power of sovereignty, it is unfortunate indeed that the first full scale and considered attempt of Congress to exercise its constitutional power to regulate state taxation of interstate commerce should have unnecessarily exacerbated the inherent conflict between state and national government.

Yet H.R. 11798, the result in 1965 of five years of prepatory work by the Subcommittee of the House Judiciary Committee, could not have been better calculated to alarm the states and give credence to a claim of invasion of "states' rights." The drastic departure from prevailing state practice in presenting a two-factor apportionment formula for income taxes and the provision for substantial federal administration provided a momentum for state resistance which has since blocked any reasonable action.

Withdrawal by Congress since to consideration of such modest and really inadequate measures as the Rodino Bill (H.R. 7906) has convinced everyone, I believe, that no undue invasion of "states' rights" is threatened. Reasonable restraints on state taxing power in the interest of freer interstate commerce is now largely accepted on all sides. The quarrel is over what is reasonable and how it should be implemented.

Against this background, let me give you my appraisal of where matters stand and what the prospects are.

II. Possible Solutions in Process

There are presently in process several initiatives in varying degree of implementation and with varying promise of providing reasonable solutions to the problems of state taxation of multistate business.

A. *Uniform Acts.* Since 1890 the National Conference of Commissioners on Uniform State Laws has promoted uniformity in state legislation on subjects where diversity of treatment is an interstate evil.

A National Tax Association Committee issued a report in 1919 urging States to utilize a simple uniform tax on income and in 1921 set forth the model acts which had been drafted pursuant to the 1919 study. Although the NTA persisted in its advocacy of a uniform law, nothing concrete ensued until

1957 when the present Uniform Division of Income for Tax Purposes Act, referred to by the acronym UDITPA, was drafted and approved by the National Commissioners on Uniform State Laws and was in the same year endorsed by the American Bar Association.[3]

After years of standing as the only solution being advocated with respect to the problems of state taxation of interstate business, no sooner had the proposal begun go be implemented than it began to be viewed as inadequate. The Supreme Court decisions in the *Stockham Valve* and *Northwestern Cement* cases[4] in 1959 centered attention on the question of jurisdiction. UDITPA does not deal with jurisdiction. Mr. Justice Frankfurter in his dissent in the forementioned cases urged Congress to act. The business community organized an urgent demand on Congress and Congress, though it had never theretofore recognized any obligation or power in the area, promptly enacted Public Law 86-272 in 1959 delimiting the power of states to impose an income tax on interstate business corporations and calling on the House Judiciary and Senate Finance Committees to make a thorough study and recommend legislation with respect to all of the problems involved, including apportionment of income. When the Supreme Court decided the *Scripto* case[5] in 1960, the impact of sales and use taxes on interstate commerce was by amendment of P.L. 86-272 added to the investigation.[6]

Overtaken by these developments UDITPA has languished. Although efforts continue to have it enacted by state legislatures and some progress continues, the uniform act is now generally viewed as guidance and as a prototype for incorporation in other broader solutions.

But aside from the roll of events, does UDITPA deserve its apparent fate? I believe it has served a laudable and perhaps indispensable purpose in crystallizing thinking about the standards to be incorporated in a uniform apportionment formula, but both its scope and its approach are, I think, clearly inadequate to the needs.

Uniform acts are rarely adopted by all states. Only 25 states and the District of Columbia have adopted UDITPA.[7]

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[3] H.Rep. 1480, 88th Cong., 2d Sess., Vol. 1, pp. 129, et seq. (Willis Subcommittee Report)

[4] *Supra*, 358 U.S. 450 (1959).

[5] *Scripto, Inc. v. Carson*, 362 U.S. 207(1960).

[6] P.L. 87-17; H.Rep. 1480, supra, p. 9.

[7] Alabama, Alaska, Arkansas, California, Colorado, Hawaii, Idaho, Illinois, Indiana, Kansas, Kentucky, Michigan, Missouri, Montana, Nebraska, New Mexico, North Dakota, New Hampshire, Oklahoma, Oregon, South Carolina, Washington, North Carolina, Utah, Virginia.

Usually some deviating amendments are made by state legislatures, as has happened with respect to UDITPA. Some lack of uniformity may be tolerable with respect to other uniform laws, but with respect to UDITPA deviation means a potential duplication of tax burden.

Moreover, as already noted, UDITPA does not deal with jurisdiction. It does not deal with he determination of the income base; it does not deal with the treatment of related taxpayers; and it does not deal with taxes other than the income tax. Finally, the uniform law approach cannot provide machinery for uniform administrative and judicial interpretation which can over time create wide diversity.

I think we can conclude that the uniform law approach will not serve to solve the problems of state taxation of multistate business.

B. *Federal Legislation.* Congressional action and the prospect of additional Congressional action have drained the uniform act approach of vitality. But while federal legislation has distinct advantages over uniform laws, what are the real prospects for effective federal legislation and how would it be implemented?

The prospects are at best uncertain. After its disastrous first proposal for Congressional action incorporated in H.R. 11798, the House Judiciary Subcommittee offered a drastically truncated measure directed primarily to small business. It has been twice passed by the House in spite of adamant opposition by state tax administrators. Now known as the Rodino Bill (H.R. 7906) and pending before the Senate Finance Committee, it is in threat of becoming a casualty a second time as time is running out in this Session of Congress.

Why after so many years and so much effort and such clear need is Congressional action again about to abort?

There is a complex of reasons. There is still a residue of resistance based on the notion that any action represents Congressional interference with states' rights. There is disagreement between business and state tax administrators; there is disagreement among business groups; there is disagreement among tax administrators; and there is reluctance on the part of Congress, particularly the Senate Finance Committee on which all these disagreements have come to bear, to act as arbiter and impose a solution. My reading of the mood of the Finance Committee is quite

frankly that it is waiting for the contending parties to compose their differences.

Overhanging the troubled attempts to solve the problems through federal legislation are some nagging questions if we are to enlarge the narrow scope of the Rodino Bill. How far can the scope be broadened and made effective without provision for administrative and judicial interpretation in a manner which will preserve uniformity? Is federal administration avoidable and if not how can present state opposition be overcome? Is a multistate tax compact an alternative to federal legislation?

C. *The Multistate Tax Compact.* The Multistate Tax Compact was conceived in 1966, and has been promoted as an alternative to federal legislation. It incorporates UDITPA, it provides some sales and use tax standards, it provides for advisory administrative regulations and it provides an arbitration procedure. It is thus clearly superior to the uniform law approach. But it still suffers from some of the defects of a uniform act and encounters some special problems of its own.

In 4 years the Compact has been adopted by only 20 states [8] and has been adopted by none of the major Eastern seaboard industrial states. It has succeeded in getting associate membership from 13 states, including important industrial states, but clearly the prospect of getting broad enough participation to make the compact a self-sufficient solution to the problems of state taxation of multistate business is doubtful.

Moreover, the Compact does not deal with the issues of jurisdiction and its provisions for administrative interpretation are weak. It has no provisions for judicial review. While the contrary is argued, it may well be invalid without Congressional consent. Its enlargement and amendment to meet changing needs would involve cumbersome individual member state legislative approval and if Congressional consent is required, repeated Congressional approval. Facing all of these problems and the present reluctance of additional states to adopt it, the Compact approach also appears unlikely to provide an adequate solution to state taxation of multistate business. It has, nevertheless, served as a rallying point for state tax administrators in their effort to forestall federal legislation, and they have had bills introduced to give Congressional assent to the Compact.

[8] Multistate Tax Newsletter No. 22, July, 1970.

III. AN INNOVATION IN STATECRAFT—FEDERAL LEGISLATION ADMINISTERED UNDER A MULTISTATE COMPACT.

All of the apparently available avenues to solution of the problems of state taxation of interstate business seem to be seriously flawed. How, then, do we proceed?

Obviously some innovative, reconciling initiative is needed. Fortunately this initiative nas been launched, not as a self-conscious exercise in creative statecraft, but intuitively, forced by the logic of the circumstances. It has emerged from the chrysalis of pressure for solution through federal legislation and the counterpressure for solution through a multistate compact. Neither pressure or solution appears sufficient in itself, but an amalgamation of the two approaches may well be the reconciling, innovative answer.

The Bill drafted by the Ad Hoc Committee on Taxation of Interstate Business offers such an answer. I had the privilege of serving as Co-Chairman of this Committee. As you know, the Committee was a volunteer and self-appointed group of state tax administrators and business representatives who subscribed to the view that reconciliation of the positions of business and state tax administrators was necessary and were willing to devote effort to that end.

While palpable hostility between the business and state representatives at the outset threatened the joint enterprise, this gradually gave way to respectful regard for opposing views. Total reconciliation was not achieved but a wide area of accord was defined and, remarkably, from the beginning there was consensus that the solutions to the problems of multistate taxation of interstate business should be implemented through a merger of the compact approach with federal legislation.

I am convinced that, consciously or unconsciously, this was genuinely innovative and regardless of the fact that the Committee's recommendations were not unanimous or whether we individually, on study and reflection, agree with all the details of the Committee's proposals, the larger thrust of the Committee's effort is sound and offers the best and most hopeful solution to the problems of state taxation of multistate business.

A. *The Ad Hoc Committee Proposal.* A brief description of the main provisions of the Ad Hoc Committee's proposal will, I trust, serve to justify this conviction. The fundamental, creative conception is, of course, the merger of the multi-

state tax compact approach and the federal legislation approach.

Under this conception, federal legislation would provide jurisdictional standards, a uniform apportionment formula for income and capital stock taxes, standards for consolidation or combination of affiliated corporations for income tax purposes, standards for sales and use taxes, and procedures for the settlement of disputes, with the Multistate Tax Compact providing the means for administration of the federal legislation.

Such a structure would provide flexibility for adjustment and evolution to improve the system for taxation of interstate business. With the Multistate Tax Compact providing only the administrative machinery under which the States would act cooperatively to administer federal standards, and not itself containing substantive standards, there should be little or no need for future amendments of the Compact. This is desirable since, as already noted, amendment of an interstate compact involves procedures which it would be difficult to make responsive to changing needs and developing thinking with respect to standards for taxation of interstate business. On the other hand, with the Multistate Tax Commission under the Compact acting as the administrative agency it could implement and modify, within the limits of permissible administrative interpretation, the legislative standards under federal law, and when the need for changes exceeded the bounds of permissible administrative interpretation the Commission could seek amendments to the federal legislation, a far more responsive procedure than amendment of an interstate compact. Moreover, under the Committee structure of the Multistate Tax Compact any proposal for amendment of the federal legislation will have been preceded by extensive discussions between state administrators and business representatives and will presumably, therefore, be presented to Congress with a substantial consensus of support.

Time does not permit discussion of the specifics of the standards to be provided by federal legislation or the specifics of the powers of administration delegated to the Multistate Tax Commission. Some are freighted with controversy and the Committee sought to limit itself only to the most pressing problems rather than to deal with all the problems that might arise in the areas which were included in its proposal. The Committee deemed it more important to take an initial step, but a sound one, which would lay the groundwork for perfecting amendments as experience pointed the way.

While the Committee conceived its approach under the compulsion of existential pressures, unaware of historical precedents and unsure of its constitutional propriety, its conception, one finds on research, is not wholly unprecedented and is, with little doubt, wholly constitutional, the latter having been confirmed by competent outside legal counsel during the course of the Committee's deliberations.

B. *Precedents.* In a landmark article in 1925,[9] Mr. Justice Frankfurter, then Professor of Law at Harvard Law School, and James Landis, then his research associate and later Dean of the Law School, analyzed the compact clause of the Constitution and urged a more imaginative use of this clause in dealing with problems requiring interstate adjustments within our federal system. They cited this approach as preservative of the legal autonomy of the states rather than reducing them to departments or mere administrative divisions of the central government. Although acknowledging that the compact cluase had its origin in the boundary disputes pending at the time the Constitution was framed and adopted, they traced its gradual application in other areas and argued that the pressure of modern interstate problems has revealed the rich potentialities of the device. They specifically called attention to its usefulness with respect to interstate conflicts in taxation. The following quotation sounds remarkably current:

> ". . . no one can scan the flood of cases dealing with 'jurisdiction' to tax, rules for apportionment and the like, without realizing that the opportunities for taxation open to the States against common resources might find a more economic and more effective solution through negotiation than through litigation. At all events, in view of the growing burden upon time and feelings, as well as the cost in money due to the conflicts and confusion arising from the administration of independent systems of State taxation, the possibilities of amelioration and economy realizable through an alert use of the Compact Cluase call for more intensive study, as part of a disciplined attack upon the entire tax problem."

This early recognition of the usefulness of the compact clause in interstate taxation has been validated by time, but as we have learned a simple resort to the compact clause is not enough. A more alert and imaginative use is needed. The Ad Hoc Committee's proposal for federal legislation of uniform standards administered under a multistate compact is such a use.

[9] Frankfurter & Landis, THE COMPACT CLAUSE OF THE CONSTITUTION—A STUDY IN INTERSTATE ADJUSTMENTS, 34 Yale Law Journal 685 (1925).

But even this conception is not wholly unprecedented. In an article in 1936,[10] Professor Stevens of Cornell Law School proposed the adoption of uniform corporation laws through a combination of federal legislation and an interstate compact. He suggested federal legislation authorizing an interstate compact to set up an interstate commission on corporation law which would draft and approve uniform corporation law provisions for adoption by member states. But more critically for our purposes, he also suggested that in order to make the compact approach effective the federal legislation should prohibit the conduct of interstate commerce by corporations not formed under an act embodying the uniform law. He had no doubt as to the constitutionality of such a combination of federal regulation of interstate commerce with an interstate compact.[11]

Similarly, there also appears to be ample authority under several Supreme Court decisions[12] to support the administrative and judicial appeal procedures envisioned by the Ad Hoc Committee proposal.

IV. INTERNATIONAL IMPLICATIONS OF THE AD HOC COMMITTEE'S PROPOSAL.

There is more than a federal and interstate dimension to the Ad Hoc Committee's proposal which heightens my interest. The parallel between our interstate problems and the problems of international taxation of multinational business is inescapable. If we can resolve through federal legislation and a multistate compact the problem of interstate taxation, why should not this serve as a prototype for resolution of the problems of international taxation of multinational business through a multilateral treaty? The obstacles may seem insurmountable but the power of the example will be there and and as pressure for solutions mounts with the accelerating growth of multinational business, international machinery may well be implemented to parallel our example. It is clearly in the interest of business not only to solve our domestic problems but to grasp the opportunity through a successful domestic solution to provide a compelling international

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[10] Stevens, UNIFORM CORPORATION LAWS THROUGH INTERSTATE COMPACTS AND FEDERAL LEGISLATION, 34 Michigan Law Rev. 1063 (1936)

[11] See also Holcombe, THE STATES AS AGENTS OF THE NATION, 3 SELECTED ESSAYS ON CONSTITUTIONAL LAW, 1187 (1938).

[12] *Petty v. Tennessee-Missouri Bridge Comm.*, 359 U.S. 275 (1959); *Parden v. Terminal Railway of the Alabama State Docks Department*, 377 U.S. 184 (1964); *Tobin v. U.S.*, 306 F (2) 270 (D.C. Cir. 1962), Cert. den., 371 U.S. 902 (1963).

example. The time may not be so far off when a burgeoning multinational business will require new initiatives to deal with the international implications, including taxes. The impending seriousness of this is attested in the recent testimony on multinational corporations last December and May before the Subcommittee on Foreign Economic Policy of the Joint Economic Committee.

V. PLEA FOR STATESMANSHIP.

I am convinced that nothing less than a new venture in federalism such as the merger of the Multistate Tax Compact and federal legislation will resolve the differences between business and state tax administrators over solutions to the problems of state taxation of interstate business. To me this venture beckons as a challenge to statecraft. It calls for a kind of statesmanship that has not always been abundantly present in the debates on the subject heretofore. But I am optimistic. The not uncommon history of apparently intractible controversies is that they pass from unyielding hostility to grudging recognition of merit in opposing views and gradually to reconciling compromise. I think the multistate business tax controversy is running this course and we may well be entering the last stage of reconciling compromise.

But an acceptable issue out of our difficulties is by no means assured. One must plead for dedication to making our federal system work and for some sustained statesmanship on the part of both tax administrators and business representatives.

I have dealt only with the larger issues but there are specifics which must be incorporated in any solution and my experience on the Ad Hoc Committee makes it only too clear that unyielding adherence to a preferred view with respect to important specifics can destroy the promise of the joint venture.

Aside from its central conception, the genius of the Ad Hoc Committee's proposal, if it merits so laudatory a description, is its spirit of accommodation. There is danger that it may not be considered in the same spirit by contending business groups and state tax administrators now reviewing it.

I do not mean to suggest that the Ad Hoc Committee's proposal must be accepted intact or all will fall. But in seeking adjustments in the proposal let us not rekindle the old hostilities and resume the old intransigent stands.

I question whethe. either of the opposing views in the major specific controversies, such as over use tax jurisdiction and the consolidation of related companies, can wholly prevail. And if we persist in unyielding disagreement, the opportunity for creative statecraft may irrevocably pass, risking to unpredictable future pressures the fashioning of perhaps some drastic solution.

State Taxation of Interstate Business--An Obdurate Issue†

LEONARD E. KUST*

If you are familiar with my past involvement in efforts to resolve the problems and the conflicts in state taxation of interstate business or have yourself been involved as long as I, you will surely agree if I begin by observing that time passes but does not heal . This is not only an observation but a plea for reconciliation to nullify the observation.

A simple roll call of the events of the past 16 years quickly delineates the problems, the conflicts, the fruitless efforts at solutions and the present confusion.

The central problem is inherent in our federal system, the success of which depends on a reasonable accommodation between the soverign powers of the states and the national interest as defined in the Constitution. Specifically with respect to interstate business, the powers of the states to tax such business is subject to the national interest in promoting an open economy as embodied in the commerce clause.

In spite of the clear power of Congress to implement the

† Based on a paper presented at the TEI-Loyola-Tulane-LSUNO State and Local Tax Course, January, 1973.

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commerce clause in this area and the plea addressed by members of the Supreme Court in several cases to Congress to act, the task of accommodating the power of states to tax interstate business to the national interest was left to the fragmentary and uncoordinated process of case by case decisions by the courts.

Finally, in 1957 the National Commissioners on Uniform State Laws adopted the Uniform Division of Income for Tax Purposes Act (UDITPA), and therewith began 16 years of history which almost at once rendered this pioneering effort inadequate if not largely irrelevant. UDITPA had not been adopted by any state when the Supreme Court decisions in the *Stockham Valves* and *Northwestern Cement* cases in 1959 (358 U.S. 450) centered attention on the question of minimum connection as a basis for jurisdiction and UDITPA does not deal with jurisdiction. Prior to those decisions, a foreign corporation engaged solely in interstate activity in a state that had been held not to be subject to a tax measured by net income imposed by such state on the privilege of doing business therein (*Spector Motor Service v. O'Connor*, 340 U.S. 602 (1951)). Under those decisions, however, a tax imposed directly on the net income of such a business was permissible "provided the levy is not discriminatory and is properly apportioned to local activities within the taxing State forming sufficient nexus to support the same" (358 U.S. 450 (1959) at 452).

Alarmed by the exposure to state taxation of income from interstate commerce and the uncertainty of the minimum nexus in the absence of which protection still existed, the business community quickly prevailed upon Congress to take action and within seven months P.L. 86-272 was enacted denying to a state the power to impose a net income tax on an interstate business if the only activity within such state was solicitation. Recognizing that more comprehensive legislation required careful consideration, Congress in P.L. 86-272 called on the House Judiciary and the Senate Finance Committees to make a thorough study and to recommend legislation with respect to all of the problems involved, including apportionment of income. When the Supreme Court decided the *Scripto* case in 1960 (362 U.S. 207), the impact of sales and use tax collection on interstate commerce was added to the investigation.

Against this setting let me simply recall the intervening events in the droning drama that comes to no end and leaves us where we are today. The mere recital without elaboration

conjures up vividly the conflicts and contending views and leaves space to identify the areas of substantial consensus as well as the areas of conflict and to appraise the possibilities of reconciliation and prospective action.

The list of events following P.L. 86-272, unhappily, begins with the legislative proposal, based on the disastrously misconceived conclusions of an elaborate four-year long study by the Willis Subcommittee and embodied in H.R. 11798, which persuaded few but alarmed many, particularly the state tax administrators. This was followed by the drastically truncated measure directed primarily to small business, beginning as the Willis Bill and continuing as the Rodino Bill, which, although thrice enacted by the House has died in three successive sessions of Congress but arises, Phoenix-like, to be introduced again. There is the Multistate Tax Compact promoted by state tax administrators as the alternative to federal legislation. There is the *National Bellas Hess* case (386 U.S. 753 (1967)). There is the unredeemed promise of Senate Finance Committee hearings. There are the first Ad Hoc Committee proposal, the Multistate Tax Commission "Plan", the second Ad Hoc Committee proposal and the Council of State Chambers' COST proposal. There are the competing legislative bills embracing, besides the Rodino Bill (H.R. 1538), the Ribicoff-Mathias Bill (S. 317), the Talcott-Tunney Bill (H.R. 4267), the two Magnuson Bills (S. 1883 and S. 3333) and the Mathias Bill (S. 4080). And, finally, there are the court decisions interpreting P.L. 86-272, the most notable of which are the *Smith, Kline & French* (241 Ore. 50, 403 P. 2d 375 (1965)), *Clairol* (57 N.J. 199, 270 A. 2d 702 (1970) appeal dismissed, 402 U.S. 902 (1971)) and *Heublein* (Dec. 18, 1972) cases, the last of which was just decided last December 18th by the Supreme Court.

There has been plenty of movement; the question is whether it has been forward. The portent of these tangled events is not easy to read. But let us try to devine some meaning from the confused history and venture some views as to where it will or at least should lead.

General Areas of Consensus

The recitation of the recent history of state taxation of interstate business reflects mostly conflict and competing views but there are substantial areas of consensus. It is important not to lose sight of this, for if the differences are to be composed, we shall have to build on the areas of consensus.

There is substantial agreement that there should be a uni-

form formula for the division of interstate business income among the states and that the collection of sales and use taxes by interstate business should be governed by uniform standards.

Although the agreement is less general, it is also broadly agreed that there should be uniform minimum jurisdictional standards for the imposition of an income tax and for the collection of a use tax by interstate business and possibly also for the imposition of capital and gross receipts taxes on such business.

There is accordingly substantial agreement as to the basic elements of needed action. But there is not the same agreement as to means for translating the agreed on general concepts into the needed action nor as to the specifics of such action; indeed, there are some means and some specifics as to which there is only stalemated and unyielding disagreement.

General Areas of Conflict

Having identified the general areas of substantial agreement, let us identify the conflicts as to general concepts that hold little promise of resolution and then consider the specifics with respect to which there is substantial agreement or with respect to which conflict has frustrated the achievement of progress.

First of all, the Rodino Bill, limited to small business and providing a "business location" jurisdictional standard and a two-factor apportionment formula for income has only limited support from business and has been adamantly opposed by the states. It has had the general support of the business community in the past only as a basis of action by the House to permit corrective and enlarging amendments in the Senate. But this has become a worn and tired formula and one wonders whether it will be repeated in this session of Congress.

It seems equally clear that the Multistate Tax Compact cannot carry the day as a self-sufficient solution. Its legal status without Congressional approval remains untested and with business opposition to it as the whole solution, it is unlikely that it will be sufficiently accepted by the large industrial states to work effectively.

It is less clear but probably also true that federal legislation alone, without giving to the states a continuing lead role by way of a modified Multistate Tax Compact, has little chance of being enacted because of state opposition.

This seems to leave only one promising course of action, but

we will deal with this later, turning first to the specific areas of agreement or conflict.

Specific Areas of Agreement or Conflict

Jurisdiction

The problem of the minimum connection required to justify imposition of tax on an interstate business remains as one of the most difficult problems in the accommodation of state and local governments' power to tax to the national interest in an open economy. It is not just a question of equality between in-state and out-of-state business but a question of the deterrence to out-of-state business when the connection with a state or locality is too thin to justify compliance with state and local tax laws by the out-of-state business. This is, of course, primarily a problem of small, expanding business. But this is at the heart of a growing national economy and the encouragement of economic competition. It is also evident that the burden of compliance arises primarily from disparate rules for the determination of income, the apportionment of income, and the obligation to collect use taxes. If the rules were uniform among the states, jurisdictional protection from any state in which there are customers might well prove to be unnecessary, at least with respect to state level taxes.

The proliferation of the imposition of income and use taxes by local governments, however, is another matter. This can be as burdensome to large business as to small, considering that there are some 80,000 local governments. With respect to such taxes, there should be a substantial minimum connection with the taxing jurisdiction.

In spite of the fact that concern about jurisdictional overreach by the states initiated the recent history and remains the prime concern of small business, there has developed far more agreement than may at first be evident.

With respect to income taxes, the Ad Hoc Committee proposal, introduced in the last session of Congress by Senator Magnuson as S. 3333, and the Multistate Tax Commission Plan, both accept P.L. 86-272 as sufficient while the Rodino Bill, the Ribicoff-Mathias Bill and the COST proposal, introduced at the end of the last session of Congress by Senator Mathias as S. 4080, embrace a "business location" concept. But on close examination, how much difference is there between P.L. 86-272 and "business location?" The latter is a more precise and elaborate definition but solicitation by an employee in the state would alone be sufficient in certain circumstances to confer jurisdiction except as solicitation is

rendered insufficient by incorporation of the language of P.L. 86-272 in the definition of "location of an employee." Thus, the minimum connection in both comes to the same thing and by virtue of the same language except for the additional exclusion under the business location standard of installation or repair incidental to an interstate sale, which is important but not a likely matter of critical disagreement.

With respect to the power of state and local governments to impose the obligation on interstate business to collect sales or use taxes, there is substantial agreement in all of the proposals and bills except the Rodino and Ribicoff Bills. The latter bills would impose the business location standard modified only by regular household deliveries. All the other bills and proposals would codify the *Scripto* and *National Bellas Hess* case law extending the jurisdictional reach of states to cover regular solicitation in the state by an employee or representative *(Scripto)*, but not solicitation solely by mail, radio or television *(National Bellas Hess)*. The jurisdiction of local governments, however, would extend beyond the business location test only to regular household deliveries under the Ad Hoc Committee bill, the Multistate Tax Commission Plan and the COST bill, as under the Rodino and Ribicoff Bills.

Thus, again, except for lingering small business interest in the higher state level limitation in the Rodino Bill, there is general agreement as to sales and use tax jurisdiction. It would appear that the far greatest importance of effective limitation of potentially 80,000 local governments requiring collection of their separate sales and use taxes will persuade small business to join in the general consensus.

The Sales Factor

There is no significant controversey with respect to the use or definition of the property and payroll factors of the income apportionment formula. All the conflict centers on the sales factor, first as to whether it should be used and second as to its content. The Rodino and Ribicoff Bills continue to incorporate the two factor formula, omitting sales, which first appeared in H.R. 11798. However, the momentum of support for the two factor formula is waning and was never sufficient to overcome the adamant state opposition. All the other pending proposals employ a three factor formula, including a sales factor on a destination basis.

But disagreement persists with respect to the so-called "throwback" rule, under which sales to customers in a state lacking jurisdiction to tax the seller are assigned to the state of origin. UDITPA, the Multistate Tax Compact and the

Multistate Tax Commission's Plan all incorporate the "throwback" rule. The Ad Hoc Committee Bill (S. 3333) modifies the rule by making it inapplicable to export sales, other than to the U.S. Government, and the COST bill eliminates the "throwback" rule completely.

There is more theoretical fervor than there is practical significance in the disagreement and an accommodation along the lines of the Ad Hoc Committee proposal should be acceptable.

Dividends

There is substantial agreement that the business/nonbusiness income distinction embodied in UDITPA should be avoided and that all income should be apportioned under the formula, with the exception of dividends with respect to which there is strong disagreement.

The Multistate Tax Commission in its regulations and in its Plan would include dividends in apportionable income. The Ad Hoc Committee bill would eliminate from the tax base dividends from 80% owned affiliates and would allocate all other dividends to the commercial domicile of the recipient. The COST bill follows the Ad Hoc proposal but reduces ownership of affiliates to 50%.

The general practice among the states is not to tax intercorporate dividends, but a few states vigorously disagree. It would seem that the taxation of inter-corporate dividends is undoubted double taxation which should certainly not be extended beyond the 15% included in income under the Internal Revenue Code.

The treatment of dividends clearly is one of the most sensitive and important remaining controversies. Failure to resolve it may well stand in the way of the needed accommodation.

Combined or Consolidated Returns.

The treatment of dividends is a sensitive and important issue but the combination or consolidation of related corporations where one is subject to the jurisdiction of the state but the other is not is the more notorious and apparently irreconcilable controversy. Arcane distinctions are drawn between combination and consolidation but for brevity we shall use consolidation as comprehensive.

The storm center of the controversy is the premise, aside from a common ownership, on which consolidation should rest. There are strong advocates of the "unitary business" doctrine among state tax administrators but most administra-

tors appear to be indifferent. On the other hand, business generally strongly adheres to the view that consolidation should be imposed by states only if there has been non-arm's length dealing between the related companies.

Reflecting the controversy, the Ribicoff Bill prohibits consolidation and substitutes reallocation in accordance with the principles of Section 482 of the Internal Revenue Code. The first Ad Hoc Committee bill employed a series of rebuttable presumptions permitting or forbidding consolidation of 80% affiliates, keyed to the volume of intercompany transactions. The Multistate Tax Commission Plan would permit either the state or the taxpayer to elect to consolidate with all 80% affiliates and this was adopted in the second Ad Hoc Committee proposal with the exclusion, however, of affiliates substantially all of the income of which is from foreign sources. The COST bill, on the other hand, permits consolidation only if the state establishes non-arm's length dealing or if the taxpayer establishes that clear reflection of income requires it.

The disparities in the proposals are obviously wide and fundamental but, curiously, the resolution of the conflict may not be as remote as it appears, as I shall explain presently.

Regulations and Appellate Procedures

There are two other specifics over which there is no express general agreement: regulations and appellate procedures. The Multistate Tax Compact provides for the formulation by the Commission of purely advisory regulations while the first Ad Hoc Committee proposal would have conferred on the Multistate Tax Commission the power to promulgate mandatory regulations on nonmembers as well as members of the compact. The second Ad Hoc Committee proposal retreated to advisory regulations which would be adopted only by the action of all states, whether or not members of the compact, and which would not be binding on a state if it took positive administrative action within 180 days rejecting the regulation. None of the other bills or proposals, other than the first Magnuson consent bill, endorse the Multistate Tax Compact or provide for regulations.

With respect to appeals the Multistate Tax Compact provides for arbitration, the first Ad Hoc Committee proposal provided for an appellate procedure within the Multistate Tax Commission from which there was an appeal to the Federal Courts of Appeal, but the second Ad Hoc Committee proposal abandoned all appellate procedure, leaving the resolution of controversies to present state administrative and judicial remedies. The COST proposal does not provide for any ad-

ministrative procedures but would confer jurisdiction on the Court of Claims to review *de novo* final state administrative determinations involving application of the federal legislation.

These are interesting proposals and alternatives for regulations and appeals but they do not represent crucial differences that cannot be dealt with in the context of general agreement with respect to the rest of the legislative package.

The Need for Reconciliation

Having traversed the sixteen years of recent history, where do we stand today? It is my reading of the mood of Congress, particularly of the Finance Committee, that it is waiting for the contending parties to compose their differences. The Congress does not intend to act as arbiter and unless state administrators and business are prepared to give substantial support to one of the existing proposals or a new accommodation it will not act. This is now more likely than ever to be true since Congress will be preoccupied with its constitutional confrontation with the executive. Therefore, unless the past 16 years of effort, contention and substantial accommodation are to come to naught, a final effort to resolve remaining differences must be made.

A Solution to Resolve the Remaining Conflicts

Since neither Federal legislation alone nor the Multistate Tax Compact alone seem capable of commanding sufficient support to provide a solution, the Ad Hoc Committee conception of a combination of the two with appropriate modifications provides the only real promise of reconciliation. It makes sense and deserves support. I do not, however, foreclose; indeed, I encourage, the substitution of a new and broader accord between business and tax administrators, if one can be forged. There is promise of this in the discussions under progress between COST and the Executive Committee of the National Association of Tax Administrators (NATA). One can only hope that the promise will come to an early fruition, since the remaining differences are no longer really so very great, except for some partisans who continue to insist on their own special interest or point of view.

With respect to jurisdiction the existing proposals are not substantively very different with respect to income taxes, and although I would prefer the business location test to simple continuation of P.L. 86-272, I think we should recognize that the business location test would not have resolved beforehand the litigation in the *Clairol* and *Heublein* cases with respect to

the meaning of solicitation under P.L. 86-272. With respect to sales and use tax collection, I believe small business should yield to the more general consensus as to state jurisdiction in order to achieve limitations on the potentially far more burdensome obligation of collecting local government taxes.

The treatment of dividends and consolidation of related companies are the two remaining significant obstacles to general consensus. Again it seems to me that the Ad Hoc Committee proposals are reasonable accommodations. I do not like the elective consolidation by either the state or the taxpayer, since it lacks any rationale except expediency, but it seems to be the only solution that can possibly achieve substantial support from both states and business. The proposal originated with the Multistate Tax Commission Plan and therefore has state support and despite the COST bill's adherence to the arm's-length standard, I have reason to believe that the business community can and would accept the dual elective standard, if affiliates, substantially all of the income of which is from foreign sources, are excluded.

A final effort at accommodation must be made and it must be made during this session of Congress or I fear that all reasonable hope of useful action to bring order and balance into the chaos of state and local taxation of interstate business will be spent, perhaps irrevocably.

An Optimistic Outlook

But I remain optimistic. The not uncommon history of apparently intractable controversies is that they pass from unyielding hostility to grudging recognition of merit in opposing views and gradually to reconciling compromise.

But an acceptable issue out of our difficulties is by no means assured. One must plead for statesmanship on the part of both tax administrators and business representatives. The Ad Hoc Committee conception of a combination of federal legislative standards and the Multistate Tax Compact is a new venture in federalism and, perhaps with some further adjustment, deserves support.. But any other solution with substantial backing by business and state tax administrators, such as the developing COST-NATA accord, deserves encouragement and support. If we persist in unyielding disagreement, the opportunity for creative statecraft may irretrievably pass, risking to unpredictable future pressures the fashioning of perhaps some drastic solution.

Robert Richards

ALASKA ECONOMICS

Alaska's oil and gas tax—one of the highest burdens in the country

Government is the largest sector of Alaska's economy, and the petroleum industry is the major contributor to state government revenue. Let us look at the relationship between these two important sectors:

Government remains the largest employer in Alaska, providing over one-third of all the jobs and about one-quarter of the gross state product. This huge public sector, which at the state and local levels has exhibited strong growth, has been the major factor underlying the stability of the Alaska economy.

The state of Alaska fiscal year 1978 budget provides for total operating expenditures of $1 billion. This represents a 13 percent increase over the level of fiscal year 1977—considerably slower than the 19 percent increase of the previous year.

The state budget has become increasingly dependent on the petroleum industry for its funding. More than one-half of the state's total unrestricted general fund revenue came from petroleum firms in fiscal year 1977. State estimates of fiscal year 1978 petroleum taxes and revenues range from $672 million to $742 million, depending on the wellhead value for North Slope production. These petroleum figures jump to between $856 million and $1.4 billion by 1980. Based on the state's estimated "medium case," the petroleum industry will contribute approximately three-fourths of total state revenue in 1978 and in 1979.

In November, 1976, Alaska voters passed a constitutional amendment creating a Permanent Fund to hold at least one-quarter of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments, and bonuses. The Permanent Fund, by law, must be used only for income-producing investments, and the income is to go into the general fund. Depending on the wellhead value, contributions from Prudhoe Bay and Cook Inlet petroleum production at the 25 percent rate to the Permanent Fund could range between $81 million and $94 million in fiscal year 1978, $90 million to $136 million in fiscal year 1979, and $96 million to $173 million in fiscal year 1980.

An aerial view of a pipe storage yard at Valdez showing some of the 48-inch steel pipe used in construction of the Trans Alaska oil pipeline. The state budget has become increasingly dependent on the petroleum industry for its funding. *Alyeska Pipeline Service Co. photo*

It is expected that the 1978 session of the Alaska legislature will enact legislation establishing the investment policies and objectives and the management structure and procedures of the Permanent Fund.

Alaska's oil and gas tax structure also impose one of the highest burdens in the

country, well in excess of the state's requirements to fund its needs. The petroleum industry pays to the state a multiplicity of taxes, including severance taxes, regulation and conservation taxes, exploration, production and pipeline transportation property taxes, as well as motor fuel taxes and corporate income taxes. These taxes are in addition to royalty, bonus and rental payments. In mid-1977 severance tax rates on petroleum production were legislated higher by about one-half for oil and more than double for gas. As the laws now stand, both severance taxes and royalty payments will net the state about one-quarter of the gross value of production at Prudhoe Bay.

Additionally, Alaska has imposed a $30 million Coastal Protection Fund for oil spills in state waters, an item which is being litigated. There is also a $1-to-$10-per gallon state spill penalties law to protect anadromous streams, estuaries and public lands. On top of state taxes, as the oil is loaded into tankers at Valdez, the owners must pay five cents per-barrel into a federal $100 million Trans-Alaska Pipeline Liability Fund. Considering the small petroleum industry permanent work force in Alaska of about 5,000, this capital intensive industry is a corporate citizen which contributes considerably more public revenue than the burden it imposes on public services.

Accompanying heavy taxation, future pre-leasing requirements by state government may require competing petroleum firms to submit confidential seismic and geological data to the state. Additionally, proposed changes in leasing procedures could result in final tract selections being announced only a half-year in advance of each sale.

Another major issue is the tariff charged by the pipeline owners for the service of moving Prudhoe Bay crude oil to Valdez. The tariff is one of the costs deducted from the price of the oil in calculating the field value upon which state royalty payments and severance taxes are based. The owners have proposed an interim tariff ranging from $6.04 to $6.44 on interstate oil, but the Interstate Commerce Commission (ICC) suggested interim charges from $4.68 to $5.10. However, the Supreme Court stayed the ICC tariff order, and the originally filed tariffs became effective on Oct. 20, 1977. Similarly, the Alaska Pipeline Commission is in the process of determining tariffs for intrastate oil.

Considering the already high operating and production costs associated with Alaska's remote location and severe climate, the Alaska state regulatory and tax burden now looms another impediment to development in the 49th state. □

Robert Richards is Executive Vice President of Alaska Pacific Bank and leading economist in the state of Alaska.

SI N UP SHEET

HEARINGS ON SCS/CS HB 322 - OIL AND GAS CORPORATE FRANCHISE TAX

WEDNESDAY, FEB. 8

DONALD NIELSEN
BRISTOL BAY NATIVE CORP

LEONARD KUST
CONSULTANT, ALASKA OIL & GAS ASSN.

BOB MOORE
CONSULTANT, ARTHUR ANDERSON

FRIDAY, FEB. 10

COMMISSIONER GALLAGHER
DEPT. OF REVENUE

MONTE TAYLOR
EXXON

DICK DONALDSON
SOHIO

JOHN WARREN
CONSULTANT, ALASKA OIL & GAS ASSN

HERMAN LOEB
PENNZOIL

BILL VAN ALEN
H.L. HUNT

EXHIBIT

Reproduced from Congressional Budget Office, Budget Option for Fiscal Year 1977: A Report to the Senate and House Committees on the Budget.

TAX EXPENDITURE ESTIMATES, BY FUNCTION[a]

[Millions of dollars, fiscal years]

Function	Corporations					Individuals				
	1977	1978	1979	1980	1981	1977	1978	1979	1980	1981
National defense (050):										
Exclusion of benefits and allowances to armed forces personnel	.....	.....	.....	.....	.....	650	650	650	650	650
Exclusion of military disability pensions	.....	.....	.....	.....	.....	90	100	110	120	130
International affairs (150):										
Exclusion of income earned abroad by U.S. citizens	.....	.....	.....	.....	.....	160	175	195	205	220
Exclusion of gross-up on dividends of LDC corporations	55	55	55	55	55	.....	.....	.....	.....	.....
Deferral of income of domestic international sales corporations (DISC)	1,420	1,460	1,495	1,580	1,735	.....	.....	.....	.....	.....
Deferral of income of controlled foreign corporations	365	365	365	365	365	.....	.....	.....	.....	.....
Special rate for Western Hemisphere trade corporations	50	50	50	50	50	.....	.....	.....	.....	.....
Natural resources, environment and energy (300):										
Exclusion of interest on state and local government pollution control bonds	170	220	265	300	330	75	100	125	145	160
Expensing of exploration and development costs	840	1,045	1,285	1,540	1,850	195	245	305	365	435
Excess of percentage over cost depletion	1,020	1,015	1,110	1,215	1,325	575	625	640	670	695
Pollution control: 5-year amortization	15	5	.....	.....	.....	.....	.....	.....	.....	.....
Capital gains treatment of royalties on coal and iron ore	20	20	25	25	30	50	60	65	75	85
Capital gains treatment of certain timber income	165	175	190	200	215	65	70	75	80	85
Agriculture (350):										
Expensing of certain capital outlays	115	120	130	135	150	360	370	380	390	400
Capital gains treatment of certain income	40	40	45	50	50	565	655	705	760	820
Cooperatives: deductibility of noncash patronage dividends and certain other items	455	485	520	555	595	.....	.....	.....	.....	.....
Commerce and transportation (400):										
Exemption of credit unions	135	145	155	165	175	.....	.....	.....	.....	.....
Corporate surtax exemption	6,185	6,745	7,300	7,865	8,455	.....	.....	.....	.....	.....
Deferral of tax on shipping companies	130	155	180	205	230	.....	.....	.....	.....	.....
Railroad rolling stock: 5-year amortization	10	5	.....	.....	.....	.....	.....	.....	.....	.....
Financial institutions: excess bad debt reserves	570	635	730	900	1,060	.....	.....	.....	.....	.....
Deductibility of nonbusiness state gasoline taxes	.....	.....	.....	.....	.....	600	665	735	815	910
Depreciation on rental housing in excess of straight line	125	135	145	155	170	455	480	510	545	580
Depreciation on buildings (other than rental housing) in excess of straight line	280	300	325	350	375	215	235	250	275	300

See footnote at end of table.

*Source: Staffs of the Treasury Department & the Joint Committee on Internal Revenue Taxation.

TAX EXPENDITURE ESTIMATES, BY FUNCTION[a]—continued

[Millions of dollars, fiscal years]

Function	Corporations					Individuals				
	1977	1978	1979	1980	1981	1977	1978	1979	1980	1981
Expensing of research and development expenditures	695	725	755	785	815	.....	.....	.....	.....	.....
Capital gains: Corporate (other than farming and timber)	900	1,015	1,090	1,170	1,260	.....	.....	.....	.....	.....
Investment credit	7,585	8,045	8,480	8,890	9,310	1,530	1,635	1,750	1,870	1,995
Asset depreciation range	1,630	1,825	2,000	2,095	2,135	175	195	220	230	235
Dividend exclusion	.....	.....	.....	.....	.....	350	370	385	405	425
Capital gains: Individual (other than farming or timber)	.....	.....	.....	.....	.....	6,225	7,360	7,905	8,490	9,145
Capital gains at death	.....	.....	.....	.....	.....	7,280	8,120	9,015	10,005	11,105
Deferral of capital gains on home sales	.....	.....	.....	.....	.....	890	935	980	1,030	1,080
Deductibility of mortgage interest on owner-occupied homes	.....	.....	.....	.....	.....	4,710	5,225	5,800	6,440	7,150
Deductibility of property tax on owner-occupied homes	.....	.....	.....	.....	.....	3,825	4,245	4,710	5,230	5,805
Deductibility of interest on consumer credit	.....	.....	.....	.....	.....	1,075	1,195	1,325	1,475	1,635
Exclusion of interest on state and local industrial development bonds	195	235	270	315	355	90	110	130	150	170
Excess 1st year depreciation	165	180	200	220	240	85	95	105	115	130
Expensing of construction period interest and taxes	1,065	1,110	1,150	1,190	1,230	570	595	620	645	670
Credit for purchase of new home	.....	.....	.....	.....	.....	100	.....	.....	.....	.....
Community and regional development (450):										
Housing rehabilitation: 5-year amortization	25	20	15	10	10	40	25	15	15	15
Education, training, employment, and social services (500):										
Exclusion of scholarships and fellowships	.....	.....	.....	.....	.....	220	235	245	255	270
Parental personal exemption for student age 19 and over	.....	.....	.....	.....	.....	715	735	760	780	805
Deductibility of charitable contributions (education)	280	325	355	390	430	500	555	610	670	735
Deductibility of child and dependent care expenses	.....	.....	.....	.....	.....	420	460	510	560	615
Child care facilities: 5-year amortization	5	5	.....	.....	.....	.....	.....	.....	.....	.....
Credit for employing AFDC recipients and public assistance recipients under work incentive program	10	10	10	10	10	.....	.....	.....	.....	.....
Deductibility of charitable contributions (social services)	352	402	446	489	536	3,124	3,468	3,847	4,274	4,740
Health (550):										
Exclusion of employer contributions to medical insurance premiums and medical care	.....	.....	.....	.....	.....	4,225	4,730	5,300	5,935	6,650
Deductibility of medical expenses	.....	.....	.....	.....	.....	2,095	2,325	2,580	2,865	3,175
Deductibility of charitable contributions (health)	173	198	219	241	264	831	922	1,023	1,136	1,260

See footnote at end of table.

TAX EXPENDITURE ESTIMATES, BY FUNCTION[a]—continued

[Millions of dollars, fiscal years]

Function	Corporations					Individuals				
	1977	1978	1979	1980	1981	1977	1978	1979	1980	1981
Income security (600):										
Exclusion of social security benefits:										
Disability insurance benefits						370	415	470	525	595
OASI benefits for aged						3,525	3,965	4,460	5,020	5,645
Benefits for dependents and survivors						565	635	715	805	905
Exclusion of railroad retirement system benefits						200	215	230	245	260
Exclusion of unemployment insurance benefits						2,855	2,655	2,470	2,295	2,135
Exclusion of workmen's compensation benefits						640	705	775	855	940
Exclusion of public assistance benefits						130	145	165	185	210
Exclusion of special benefits for disabled coal miners						50	50	50	50	50
Exclusion of sick pay						350	370	385	405	425
Net exclusion of pension contributions and earnings:										
Employer plans						6,475	7,120	7,835	8,620	9,480
Plans for self-employed and others						965	1,065	1,180	1,300	1,440
Exclusion of other employee benefits:										
Premiums on group term life insurance						895	965	1,050	1,135	1,230
Premiums on accident and accidental death insurance						60	65	70	80	85
Income of trusts to finance supplementary unemployment benefits						5	5	5	5	5
Meals and lodging						305	320	335	350	365
Exclusion of capital gains on home sales if over 65						50	55	60	65	70
Excess of percentage standard deduction over minimum standard deduction						1,560	1,635	1,720	1,805	1,895
Additional exemption for the blind						25	25	25	25	25
Additional exemption for over 65						1,220	1,280	1,340	1,410	1,480
Retirement income credit						110	100	90	80	70
Earned income credit: nonrefundable portion						280	270	255	245	235
Earned income credit: refundable portion						1,110	1,065	1,025	985	945
Exclusion of interest on life insurance savings						1,855	2,025	2,210	2,410	2,625
Deductibility of casualty losses						330	355	380	405	430
Maximum tax on earned income						505	580	670	770	885
Veterans' benefits and services (700):										
Exclusion of veterans' disability compensation						595	595	595	595	595
Exclusion of veterans' pensions						30	30	30	30	30
Exclusion of GI bill benefits						280	265	255	240	230

See footnote at end of table.

Ken Kluck
Houston Oil
and Minerals

Regrets testimony
Wed (10-15 min.)
Friday

Per Bill
Hopkins