ALASKA LEGISLATURE COMMITTEE FILES 1991-1992 8672
7216 HOUSE RULES

1 stock of the corporation.

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

5 (e) The department may require a corporation that files under (a) of this section to file
6 a report under AS 43.20.065 - 43.20.071 prepared without regard to this section if the corporation
7 or an affiliated corporation

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

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

13 (f) This section does not apply to taxpayers subject to AS 43.20.072 engaged in

14 (1) the production of oil or gas from a lease or property in the state; or

15 (2) the transportation of oil or gas by regulated pipeline in the state.

16 (g) In this section,

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

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

23 (3) "foreign corporation" means a corporation created or organized outside of the
24 United States, the District of Columbia, the Commonwealth of Puerto Rico, or a possession of
25 the United States;

26 (4) "water's edge combined reporting method" means a reporting method in which
27 the only corporations besides the taxpayer that may be included in the return are the corporations
28 listed in (a) of this section.

29 * Sec. 4. This Act applies to tax years beginning after December 31, 1991.

30 * Sec. 5. This Act takes effect immediately under AS 01.10.070(c).

# CS FOR HOUSE BILL NO. 12 (FINANCE)

## IN THE LEGISLATURE OF THE STATE OF ALASKA

## SEVENTEENTH LEGISLATURE - FIRST SESSION

BY THE HOUSE FINANCE COMMITTEE

Offered: 5/1/91
Referred: Rules

Sponsor(s): REPRESENTATIVES MOYER, Brown, Koponen, Ellis

## A BILL

## FOR AN ACT ENTITLED

1 "An Act relating to the water's edge method of calculating income taxes for certain
2 corporations, and to the determination of net income subject to state income tax from the
3 operation of a ship or water transportation carrier for a foreign corporation; and
4 providing for an effective date."

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

6 * Section 1. PURPOSE. (a) By setting aside the exclusion from gross income of the income earned
7 by foreign corporations from vessel operations, it is the purpose of AS 43.20.030(h), added by sec. 3 of
8 this Act, to establish a uniform policy relating to the taxation of water transportation carriers, domestic
9 or foreign, subject to the apportionment of business income under AS 43.20.071.
10 (b) It is the purpose of the addition of AS 43.20.073, added by sec. 4 of this Act, to promote
11 investment and trade opportunities in the state.
12 * Sec. 2. LEGISLATIVE INTENT. The amendments to the Alaska Net Income Tax made by this
13 Act are not intended to reflect a determination or conclusion by the legislature as to the assertion that

1 the imposition of the worldwide combined reporting method directed for use by certain taxpayers by
2 AS 43.20 violates the foreign commerce clause of the United States Constitution.
3 * Sec. 3. AS 43.20.030 is amended by adding a new subsection to read:
4 (h) For purposes of determining the net income of a foreign corporation from the
5 operation of a ship or water transportation carrier, the provisions of 26 U.S.C. 883(a)(1) do not
6 apply. The taxpayer shall calculate gross income taking into consideration income derived from
7 the operation of a ship or water transportation carrier, and the provisions of AS 43.20.071 apply
8 to the determination of income subject to taxation by the operation of this subsection.
9 * Sec. 4. AS 43.20 is amended by adding a new section to read:
10 Sec. 43.20.073. AFFILIATED GROUPS. (a) A corporation that is a member of an
11 affiliated group shall file a return using the water's edge combined reporting method. A return
12 under this section must include the following corporations if the corporations are part of a unitary
13 business with the filing corporation:
14 (1) an affiliated corporation that is eligible to be included in a federal consolidated
15 return under 26 U.S.C. 1501 - 1505 (Internal Revenue Code) if the corporation's property,
16 payroll, and sales factors in the United States average
17 (A) 20 percent or more; or
18 (B) under 20 percent, if the corporation does not meet the requirements
19 of 26 U.S.C. 861(c);
20 (2) a domestic international sales corporation; in this paragraph, "domestic
21 international sales corporation" has the meaning given in 26 U.S.C. 992(a);
22 (3) a foreign sales corporation; in this paragraph, "foreign sales corporation" has
23 the meaning given to the term "FSC" in 26 U.S.C. 922(a);
24 (4) a corporation, regardless of the place where the corporation was incorporated,
25 if the corporation's property, payroll, and sales factors in the United States average 20 percent
26 or more;
27 (5) a corporation that is incorporated in or does business in a country that does
28 not impose an income tax, or that imposes an income tax at a rate lower than 90 percent of the
29 United States income tax rate on the income tax base of the corporation in the United States, if
30 (A) 50 percent or more of the sales, purchases, or payments of income or
31 expenses, exclusive of payments for intangible property, of the corporation are made


New Text Underlined [DELETED TEXT BRACKETED]

1 directly or indirectly to one or more members of a group of corporations filing under the
2 water's edge combined reporting method;
3 (B) the corporation does not conduct significant economic activity.
4 (b) When computing taxable income for a corporation under (a) of this section, the
5 following amounts shall be excluded:
6 (1) 80 percent of dividend income received from foreign corporations;
7 (2) an amount treated as a dividend under 26 U.S.C. 78;
8 (3) 80 percent of the royalties accrued or received from a foreign corporation.
9 (c) In (b)(1) and (3) of this section, a payment is considered to be received from a
10 corporation that is part of the unitary business if the payment is received
11 (1) by a member of an affiliated group included in a water's edge combined
12 report filed under this section; and
13 (2) from a corporation in which the recipient owns 50 percent or more of the
14 stock of the corporation.
15 (d) Dividends and royalties taxable to a corporation using the water's edge combined
16 reporting method are in lieu of an expense attribution for income excluded under (b) of this
17 section.
18 (e) The department may require a corporation that files under (a) of this section to file
19 a report under AS 43.20.065 - 43.20.071 prepared without regard to this section if the corporation
20 or an affiliated corporation
21 (1) fails to comply with regulations adopted under this chapter, including domestic
22 disclosure spread sheet filing requirements; or
23 (2) does not provide information that is requested by the department that is
24 necessary for the department to audit the taxpayer's corporate return in a reasonable period of
25 time.
26 (f) This section does not apply to taxpayers subject to AS 43.20.072 engaged in
27 (1) the production of oil or gas from a lease or property in the state; or
28 (2) the transportation of oil or gas by regulated pipeline in the state.
29 (g) In this section,
30 (1) "affiliated corporation" means a member of an affiliated group to which the
31 taxpayer filing a return under (a) of this section belongs;

1 (2) "affiliated group" means a group of two or more corporations in which 50
2 percent or more of the voting stock of each member of the group is directly or indirectly owned
3 by one or more corporate or noncorporate common owners, or by one or more of the members
4 of the group;
5 (3) "foreign corporation" means a corporation created or organized outside of the
6 United States, the District of Columbia, the Commonwealth of Puerto Rico, or a possession of
7 the United States;
8 (4) "water's edge combined reporting method" means a reporting method in which
9 the only corporations besides the taxpayer that may be included in the return are the corporations
10 listed in (a) of this section.
11 * Sec. 5. This Act applies to tax years beginning after December 31, 1991.
12 * Sec. 6. This Act takes effect immediately under AS 01.10.070(c).

# CS FOR HOUSE BILL NO. 12 (ITT)

## IN THE LEGISLATURE OF THE STATE OF ALASKA

## SEVENTEENTH LEGISLATURE - FIRST SESSION

BY THE HOUSE SPECIAL COMMITTEE ON INTERNATIONAL TRADE AND TOURISM

Offered: 2/19/91
Referred: Labor and Commerce, Finance

Sponsor(s): REPRESENTATIVES MOYER, Brown, Koponen, Ellis

## A BILL

## FOR AN ACT ENTITLED

1 "An Act relating to the water's edge method of calculating income taxes for certain
2 corporations other than corporations engaged in the production of oil or gas from a lease
3 or property in the state or in the transportation of oil or gas by regulated pipeline in
4 the state; and providing for an effective date."

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

6 * Section 1. It is the purpose of this Act to promote investment and trade opportunities in the state.
7 * Sec. 2. AS 43.20 is amended by adding a new section to read:
8 Sec. 43.20.073. AFFILIATED GROUPS. (a) A corporation that is a member of an
9 affiliated group shall file a return using the water's edge combined reporting method. A return
10 under this section must include the following corporations if the corporations are part of a unitary
11 business with the filing corporation:
12 (1) an affiliated corporation that is eligible to be included in a federal consolidated
13 return under 26 U.S.C. 1501 - 1505 (Internal Revenue Code) if the corporation's property,

VI

1 payroll, and sales factors in the United States average
2 (A) 20 percent or more; or
3 (B) under 20 percent, if the corporation does not meet the requirements
4 of 26 U.S.C. 861(c);
5 (2) a domestic international sales corporation; in this paragraph, "domestic
6 international sales corporation" has the meaning given in 26 U.S.C. 992(a);
7 (3) a foreign sales corporation; in this paragraph, "foreign sales corporation" has
8 the meaning given to the term "FSC" in 26 U.S.C. 922(a);
9 (4) a corporation, regardless of the place where the corporation was incorporated,
10 if the corporation's property, payroll, and sales factors in the United States average 20 percent
11 or more;
12 (5) a corporation that is incorporated in or does business in a country that does
13 not impose an income tax, or that imposes an income tax at a rate lower than 90 percent of the
14 United States income tax rate on the income tax base of the corporation in the United States, if
15 (A) 50 percent or more of the sales, purchases, or payments of income or
16 expenses, exclusive of payments for intangible property, of the corporation are made
17 directly or indirectly to one or more members of a group of corporations filing under the
18 water's edge combined reporting method;
19 (B) the corporation does not conduct significant economic activity.
20 (b) When computing taxable income for a corporation under (a) of this section, the
21 following amounts shall be excluded:
22 (1) 80 percent of dividend income received from foreign corporations;
23 (2) an amount treated as a dividend under 26 U.S.C. 78;
24 (3) 80 percent of the royalties accrued or received from a foreign corporation.
25 (c) In (b)(1) and (3) of this section, a payment is considered to be received from a
26 corporation that is part of the unitary business if the payment is received
27 (1) by a member of an affiliated group included in a water's edge combined
28 report filed under this section; and
29 (2) from a corporation in which the recipient owns 50 percent or more of the
30 stock of the corporation.
31 (d) Dividends and royalties taxable to a corporation using the water's edge combined

reporting method are in lieu of an expense attribution for income excluded under (b) of this section.

(e) The department may require a corporation that files under (a) of this section to file a report under AS 43.20.065 - 43.20.071 prepared without regard to this section if the corporation or an affiliated corporation

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

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

(f) This section does not apply to taxpayers subject to AS 43.20.072 engaged in

(1) the production of oil or gas from a lease or property in the state; or

(2) the transportation of oil or gas by regulated pipeline in the state.

(g) In this section.

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

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

(3) "foreign corporation" means a corporation created or organized outside of the United States, the District of Columbia, the Commonwealth of Puerto Rico, or a possession of the United States;

(4) "water's edge combined reporting method" means a reporting method in which the only corporations besides the taxpayer that may be included in the return are the corporations listed in (a) of this section.

* Sec. 3. This Act applies to tax years beginning after December 31, 1991.

* Sec. 4. This Act takes effect immediately under AS 01.10.070(c).

BOGLE & GATES

MEMORANDUM

V

April 1, 1991 21688/01012

TO: House Finance Committee Members

FROM: Brian W. Durrell BWD

RE: Water's Edge Tax Legislation

What is Barclays[1]? It is a recent California Court of Appeals decision holding that, as applied to foreign-based unitary groups, the California "worldwide" combined reporting method ("WWCR") violates the foreign commerce clause of the U.S. Constitution. A unitary group is a group of corporations with common ownership that have attributes of functional integration, centralized management and economies of scale. A foreign-based unitary group is one in which the parent corporation is based in a country other than the U.S. By contrast, a unitary group with a parent corporation based in the U.S. is known as a domestic-based unitary group. A WWCR method is one which taxes a portion of a unitary group's income no matter where it was earned in the world. The California Court of Appeals is an intermediate appellate court. Its decision was appealed by the California Franchise Tax Board to the California Supreme Court which has accepted the appeal. A ruling is not expected from the California Supreme Court for at least a year. Its decision - no matter what it is - is expected to be appealed to the U.S. Supreme Court.

What effect does Barclays have on Alaska? Barclays will have substantial persuasive weight to any Alaska court which may be presented with the issue of the constitutionality of Alaska's WWCR as applied to foreign-based unitary groups. Only a decision of the U.S. Supreme Court, however, would be controlling upon an Alaska court addressing this issue. Barclays appears to impact equally Alaska's income tax imposed both upon foreign-based non-oil & gas and foreign-based oil & gas unitary groups. Both are currently taxed under WWCR. It is important to note that domestic-based unitary groups are unaffected by Barclays. In fact, an earlier U.S. Supreme Court case, Container Corp.[2], held that California's WWCR was constitutional as applied to domestic-based unitary groups. We have no data as to the number of non-oil & gas foreign-based unitary groups doing business in Alaska. Upon inquiry, we have learned that perhaps as few as three oil & gas foreign-based unitary groups do business in Alaska, with the most significant being BP.

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Would Barclays' effect be retroactive? If Alaska's corporate income tax method is unconstitutional, any affected taxpayer could demand a refund for any open year, so long as the tax was paid under protest. A year is generally open if the return was filed within the prior three years or the tax was paid within the prior two years.

How does HB 12 address that effect? HB 12 is a bill that would change the method of reporting from a WWCR to a "water's edge" combined method. A water's edge method taxes only income earned within the "water's edge" of the U.S. The bill applies equally to foreign-based and domestic-based unitary groups. The bill does not apply to corporations engaged in the production or transportation of oil & gas. The water's edge method of reporting does not affect business activities that are wholly foreign. Therefore, the water's edge method of reporting does not violate the foreign commerce clause of the U.S. Constitution.

What is the difference between worldwide and water's edge combined reporting? Combined reporting must include some method of allocating a portion of the unitary group's income to Alaska for income tax purposes. The portion is usually determined by comparing the amounts of three factors - sales, property and payroll - within the State to the amounts found throughout the entire world (i.e., worldwide) or within the bounds of the U.S. (i.e., water's edge). Each of the three factors is reduced to a fraction, the numerator of which is, for instance, the sales in Alaska. Under the worldwide method the denominator would be the sales of the unitary group throughout the world. Under the water's edge method, the denominator would be just the sales of those members of the unitary group which conduct substantial activity within the water's edge of the U.S. Under the worldwide method, the average of the three factors' fractions would then be multiplied by the worldwide income of the unitary group. Under the water's edge method, the average of the three factors' fractions would then be multiplied by just the income of those members of the unitary group which conduct substantial activity within the water's edge of the U.S. The tax generated from the water's edge method is not necessarily less than the tax generated from the worldwide method. The tax difference will vary on a case by case basis, but in many cases the tax from a water's edge method will be greater than the tax from a worldwide method. Which method produces the greater amount of tax depends upon whether a unitary group's foreign or domestic activities are more profitable.

Must HB 12 address the income tax upon oil and gas companies? The differing methods of taxation for oil & gas corporations and, under HB 12, for non-oil & gas corporations do not appear to create a constitutional problem. In the ARCO[3] case, the Alaska Supreme Court upheld the use of the separate accounting

method of reporting for oil & gas corporations despite the claim that it violated the equal protection clause because other corporations were taxed under a different and (arguably) more favorable method. The different methods of reporting occasioned by HB 12 would almost certainly withstand an equal protection challenge. The oil & gas industry does not appear to be concerned with HB 12. The industry's fear of separate accounting appears to have kept it from advocating any change to the method in which the State taxes oil & gas corporations. Therefore, HB 12 need not address the method of taxation for oil & gas unitary groups. However, the likely impact of Barclays upon the current method of taxing foreign-based oil & gas unitary groups may mean that the issue of constitutionality should be addressed.

cc: David P. Harlow

1. Barclays Bank International Limited v. Franchise Tax Board, 275 Cal. Rptr. 626 (Cal. Ct. App. 1990)

2. Container Corp. v. Franchise Tax Board, 463 U.S. 159, 103 S.Ct.2933, 77 L.Ed.2d 545 (1983)

3. Atlantic Richfield Company v. State of Alaska, 705 P.2d 418 (Alaska 1985)

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VI

**Department of Commerce & Economic Development / POSITION PAPER**

**House Bill 12:** **An Act Relating to the Water's Edge Method of Calculating Income Tax**

The Department of Commerce and Economic Development supports passage of House Bill 12 and its objective to promote investment and trade opportunities in the state. Accomplishment of this goal is dependent on numerous factors. These amendments to the current unitary tax are an important step to help foster a favorable international business climate for Alaska.

Major resource development projects must compete for international investment dollars. Limited access and infrastructure, climate, small work force, distance to markets, land status, and regulatory issues are among the numerous factors which have bred an extremely cautious attitude towards investment in this state. The worldwide unitary taxation method unique to Alaska is perceived by foreign and domestic corporations with international holdings as a further disincentive to investment in Alaska.

This administration has clearly stated its intent to promote economic diversification as a primary objective to compensate for pending revenue declines. Amending the unitary tax structure to the more common water's edge method will help demonstrate to the international business community that the Alaskan Legislature is willing to work cooperatively with the administration in this effort to reduce disincentives for Alaskan investments.

Passage of this bill may be timely from an international perspective. Major mineral development, for example, relies totally on international investors. Many mineral rich countries, such as Canada, South Africa, and Australia, are just beginning their national debates on aboriginal rights and resource regulation. Alaska's twenty-year struggle with these issues is behind us. The ground rules for development have been laid. The additional certainty that Alaskan taxes will not be based on worldwide income will be an additional incentive for potential investors.

We recognize that other states have not been able to precisely measure the economic growth that resulted from this amendment to tax law. This inherent imprecision in economic projections is cited by critics of the bill as a good reason to maintain the status quo.

Psychology also plays an important role in business decisions. The Department of Revenue's initial rough estimates indicate a $1-3 million annual revenue loss from passage of HB 12. We believe this is a small price to pay for the business incentive it provides and anticipate that these losses, which assume no increase in economic activity in the state, will be compensated by an expansion in the state's industrial base.

Spec. Asst II

Glenn A. Olds, Commissioner

Date: 2-28-91

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VII

# FISCAL NOTE

STATE OF ALASKA
1991 LEGISLATIVE SESSION

No. 2
Bill Version: CSHB 12 (FIN)
(H) Publish Date: 3/20/91

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 | 1 | 3 |

EXPENDITURES/REVENUES: (Thousands of Dollars)

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

FUNDING: (Thousands of Dollars)

| | FY 92 | FY 93 | FY 94 | FY 95 | FY 96 | FY 97 |
|---|---|---|---|---|---|---|
| GENERAL FUND | 13.0 | 47.5 | 132.6 | 130.6 | 128.1 | 128.1 |
| FEDERAL FUNDS | | | | | | |
| OTHER | | | | | | |
| TOTAL | 13.0 | 47.5 | 132.6 | 130.6 | 128.1 | 128.1 |

POSITIONS:

| | FY 92 | FY 93 | FY 94 | FY 95 | FY 96 | FY 97 |
|---|---|---|---|---|---|---|
| FULL-TIME | 0.0 | 0.0 | 1.0 | 1.0 | 1.0 | 1.0 |
| PART-TIME | | | | | | |
| TEMPORARY | | | | | | |

Estimate of current year impact:

ANALYSIS: Attach a separate page for analysis.

ATTACHED

Prepared By: Cliff Goerchinger
Phone: (907) 465-2320
Division: Income and Excise Audit Division
Date: March 12, 1991

Approved by Commissioner: Lee E. Fisher
Agency: Department of Revenue
Date: 3-12-91

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

Rev 10/90



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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.

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

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FISCAL NOTE

No. 3

Bill Version: CSHB 12 (FIN)

(H) Publish Date: 3/20/91

STATE OF ALASKA
1991 LEGISLATIVE SESSION

Revision Date: ______

Department Affected: Commerce & Economic Dev.

Title: An Act Relating to the Water's Edge Method of Calculating Income Tax

BRU: Banking, Securities & Corporations

Component: ______

Sponsor: Rep. Moyer

Requestor: ______

COMPONENT SERIAL NO. ______

Expenditures/Revenues: (Thousands of Dollars)

| OPERATING | FY 92 | FY 93 | FY 94 | FY 95 | FY 96 | FY 97 |
|---|---|---|---|---|---|---|
| PERSONAL SERVICES | | | | | | |
| TRAVEL | | | | | | |
| CONTRACTUAL | | | | | | |
| SUPPLIES | | | | | | |
| EQUIPMENT | | | | | | |
| LAND & STRUCTURES | | | | | | |
| GRANTS. CLAIMS | | | | | | |
| MISCELLANEOUS | | | | | | |
| TOTAL OPERATING | 0 | 0 | 0 | 0 | 0 | 0 |
| CAPITAL | 0 | 0 | 0 | 0 | 0 | 0 |
| REVENUE | 0 | 0 | 0 | 0 | 0 | 0 |

FUNDING: (Thousands of Dollars)

| | FY 92 | FY 93 | FY 94 | FY 95 | FY 96 | FY 97 |
|---|---|---|---|---|---|---|
| GENERAL FUND | | | | | | |
| FEDERAL FUNDS | | | | | | |
| OTHER | | | | | | |
| TOTAL | 0 | 0 | 0 | 0 | 0 | 0 |

POSITIONS:

| | FY 92 | FY 93 | FY 94 | FY 95 | FY 96 | FY 97 |
|---|---|---|---|---|---|---|
| FULL-TIME | 0 | 0 | 0 | 0 | 0 | 0 |
| PART-TIME | | | | | | |
| TEMPORARY | | | | | | |

Estimate of current year impact: ______

ANALYSIS: (Attach a separate page if necessary.) This bill proposes to amend the method of computing corporate Net Income Tax payable to Alaska. Definitions for the corporation's "affiliated groups" and criteria for determining the U.S. taxable income are given. Corporations producing or transporting oil and gas are not subject to the water's edge method. The purpose of the bill is to promote investment and trade opportunities in the state.

Prepared By: Willis F. Kirkpatrick, Director

Phone: 465-2521

Division: Banking, Securities & Corporations

Date: 2/27/91

Approved by Commissioner: Glenn A. Olds

Agency: Department of Commerce & Economic Development

Date: [illegible]

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

Rev 10/90
OM/dg19012D/022891a

Page 1 of 1

COMMITTEE COPY

2-17-91

Fairbanks Daily News-Miner, Fai

VIII

# 'Water's edge' tax stands to benefit state coffers

State Rep. Tom Moyer, D-Fairbanks, is moving quickly this legislative session to rewrite state corporate income tax laws in ways he believes will attract more foreign companies to invest here.

Moyer introduced HB 12, with Rep. Niilo Koponen, D-Fairbanks, and two others as cosponsors, to change the corporate income tax reporting formula from the "worldwide combined" method used here for almost two decades to a "water's edge" formula.

You don't have to be a tax attorney to appreciate the difference, although it would help. The whole issue revolves around

Fred Pratt

how a political jurisdiction like the State of Alaska should determine how much of a multinational corporation's income comes from operations in just our state.

The worldwide combined method offers a simple approach. It totals all of a corporations income, then calculates a share for Alaska by taking into account the corporation's property, payroll and sales in Alaska.

Prudhoe Bay oil companies like this because their payroll and sales in Alaska are very small, relative to other areas, so their corporate income tax payments here were quite low in comparison to the huge profits they made from oil produced here. This led the Legislature in 1977 to adopt a "separate accounting" formula just for oil companies, aimed at taxing a more accurately calculated estimate of their real Alaska income.

This wasn't popular among the oil companies and they challenged the constitutionality of separate accounting. In 1981, while the challenge was still in court, a group of Anchorage Republicans took over the leadership of the State House and repealed the separate accounting law.

The U.S. Supreme Court eventually ruled separate accounting was constitutional, but by then Alaska had already gone back to worldwide combined, at the cost of many millions of dollars a year.

But during this same time most other states were following Alaska's lead of 1977 and changing all corporate income tax to "water's edge," which is basically an easier form of separate accounting. It's more complicated than worldwide combined, because it has to calculate a multinational corporation's earnings just from Alaska, stopping at our "water's edge," but it's more fair and it keeps Alaskan revenue agents out of a foreign corporation's other books.

By the late 1980s Alaska was the last state to still use worldwide combined corporate income tax reporting. A change we pioneered is used by everyone but us.

In 1988 a bunch of Republicans in the Alaska Legisalture hired Arthur B. Laffer, the economist whose teachings guided Ronald Reagan in developing "Reaganomics," to tell us how we could change our tax codes to help business. Laffer's champions in Juneau were rather shocked when he told them one of the best and fastest changes they should make was to scrap worldwide combined accounting.

"The worldwide combined method discourages investments in Alaska by foreign corporations," Laffer flatly stated. "For example, the Idemitsu Company has postponed development of the Wishbone Hill coal deposit because it believes the cost of the porject will be too high if their taxes are computed using worldwide combination. Foreign corporations are reluctant to have their books on operations outside the United States examiend by auditors from Alaska."

Laffer noted that in Fiscal Year 1977 non-oil corporate income taxes in Alaska totaled only $20.5 million, or 1.1 percent of the state's total general fund revenues. ". . . the way many

(See PRATT, Page B-6)

## PRATT: Changing formula

(Continued from Page B-1)

businesses are avoiding Alaska's relatively high unitary tax is by not locating in Alaska," Laffer said. "The only businesses locating in Alaska will be those that cannot do business elsewhere.

"Aside from natural resource processing firms, the state's continued use of a worldwide-combined unitary tax will discourage non-resource processing multinational corporations from locating in Alaska," Laffer predicted.

The problem with fixing this is that too many people like to play with the solution. Former Gov. Steve Cowper tried to push a "water's edge" bill through last year that would have only applied to foreign corporations, leaving U.S. multinational corporations under the higher tax formula.

HB 12 still has some problems. One has to consider the fairness to small Alaska corporations who won't get some tax breaks allowed large outside competitors, and there may be some problem with excluding the oil companies from the deal.

But when Moyer brought HB 12 out for its first hearing last week, it drew support from the Anchorage Chamber of Commerce, the Alaska State Chamber of Commerce, the Alaska Miners Association, and the Anchorage Economic Development Corp.

The Department of Revenue reported that the change would cost at most $3 million a year in lost revenue and require hiring four new auditors, certainly a cheap price to pay for a even a hint of foreign interest in Alaska.

■ Free-lance journalist Fred Pratt has been covering Alaska business and politics for the past 15 years.

Files

# HOUSE COMMITTEE REPORT

(11)

Date Referred: March 20, 1991

FURTHER REFERRALS:

Date of Committee Action: 4.29.91

The FINANCE Committee considered: HB 12

HOUSE BILL NO. 12 — CORPORATE INCOME TAX REPORTING METHODS

"An Act relating to the water's edge method of calculating income taxes for certain corporations other than corporations engaged in the production of oil or gas from a lease or property in the state or in the transportation of oil or gas by regulated pipeline in the state; and providing for an effective date."

RECOMMENDATIONS:
be replaced with CS HB 12 (Fin) [ ] the same title [X] a new title

[ ] have attached amendments(s)
[ ] do pass
[ ] do not pass
[X] no recommendations
[ ] individual recommendations
[ ] additional referral to the ______ Committee

ADOPTS: ______ letter of Intent

ATTACHES NEW FISCAL NOTE(s): (Dept)

[ ] fiscal impact ______

[ ] zero fiscal note ______

APPROVES PREVIOUS: (Dept/Date)

[X] fiscal note(s) REVENUE 3-20-91

[X] zero fiscal note(s) DCED 3-20-91

| SIGNING DO PASS | DP | OTHER RECOMMENDATIONS | DNP | NR | AM |
|---|---|---|---|---|---|
| Fran Brown | ✓ | Eileen P. MacLean | | ✓ | |
| [illegible signature] | ✓ | [illegible signature] | | | |
| Ramona L. Barnes | | [illegible signature] | | X | |
| Ronald L. [illegible] | X | [illegible signature] | | ✓ | |
| | | [illegible signature] | X | | [illegible] |
| | | do not pass unless amended | | | |
| | | [illegible signature] | | X | |
| | | Mike Navarre | | X | |
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| | | | | | |

Mike Navarre Eileen P. MacLean
CHAIRMAN'S SIGNATURE

# Alaska State Legislature

## HOUSE OF REPRESENTATIVES

Official Business

P.O. Box V
State Capitol
Juneau, Alaska 99811

April 23, 1991

To: House Finance Committee

From: Representative Kay Brown
Chair, Subcommittee on HB12

The Subcommittee on HB12 requested the attached draft committee substitute. Note that the bill title was broadened in order to accommodate a change relating to taxation of international cruise companies. The following is a discussion of major issues discussed by the subcommittee and changes made in the proposed committee substitute.

I. Impact of HB12 on Revenues

The Department of Revenue informed the subcommittee that it would be unable, in the time allowed, to provide an analysis of how revenues would be affected if the Water's Edge method of taxation were applied to the oil and gas industry. Department representatives said such an analysis would take several months. As a result, the subcommittee made no changes to provisions that would apply the bill only to non-oil and gas corporations. The subcommittee, however, recommends that the full committee request such an analysis from the Department of Revenue and that it be reviewed during the interim.

II. Legal Issues

The Department of Law informed the committee in writing that it could foresee no legal problems with treating the oil and gas industry differently than other corporations, so long as there is a legitimate public interest to do so. The Department of Law memorandum is attached. As you may recall, there was testimony before the full committee on this bill regarding the affect on Alaska of the recent "Barclays' decision." The California Court of Appeals ruled that the worldwide method of apportionment, when applied to foreign-based unitary groups, is unconstitutional. The Department of Law sees no

reason for the legislature to try and change the law while the case is still in the courts. The subcommittee added a section to the bill, Section 2, that states the legislature, by passage of HB12, is making no admission regarding the constitutionality of the worldwide apportionment tax method.

III. Cruise Industry

The subcommittee discussed current corporate income taxes and how they relate to the cruise industry. The Department of Revenue, in answer to questions from the subcommittee, reported that the international cruise industry now pays no corporate income tax. The Department of Law has for the past 10 months been reviewing the Alaska tax code and its applicability to cruise companies. That review is not yet complete. International cruise industry representatives argue that they are excluded from state corporate income tax by section of the US tax code regarding exclusions from taxation due to treaties. The subcommittee recommends that the legislature clarify the situation with a new Section Three to HB12. It states that the tax exemption granted in the U.S. Code does not apply in Alaska. The subcommittee asked the Department of Revenue to estimate tax revenues that will result from this provision. The department was also asked to report to the legislature on how the cruise industry is taxed in other states.

If you have any questions or comments, please contact me.

C.C. Representative Tom Moyer
Commissioner of Revenue Lee Fisher

7-LS0237\G
Chenoweth
4/19/91

CS FOR HOUSE BILL NO. 12 ( )

IN THE LEGISLATURE OF THE STATE OF ALASKA

SEVENTEENTH LEGISLATURE - FIRST SESSION

BY

Offered:
Referred:

Sponsor(s): REPRESENTATIVES MOYER, Brown, Koponen, Ellis

A BILL

FOR AN ACT ENTITLED

1 "An Act relating to income taxes imposed on certain corporations; and providing for an
2 effective date."

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

4 * Section 1. PURPOSE. (a) By setting aside the exclusion from gross income of the income earned
5 by foreign corporations from vessel operations, it is the purpose of AS 43.20.030(h), added by sec. 3 of
6 this Act, to establish a uniform policy relating to the taxation of water transportation carriers, domestic
7 or foreign, subject to the apportionment of business income under AS 43.20.071.
8 (b) It is the purpose of the addition of AS 43.20.073, added by sec. 4 of this Act, to promote
9 investment and trade opportunities in the state.
10 * Sec. 2. LEGISLATIVE INTENT. The amendments to the Alaska Net Income Tax made by this
11 Act are not intended to reflect a determination or conclusion by the legislature as to the assertion that
12 the imposition of the worldwide combined reporting method directed for use by certain taxpayers by
13 AS 43.20 violates the foreign commerce clause of the United States Constitution.
14 * Sec. 3. AS 43.20.030 is amended by adding a new subsection to read:

1 (h) For purposes of determining the net income of a foreign corporation from the
2 operation of a ship or water transportation carrier, the provisions of 26 U.S.C. 883(a)(1) do not
3 apply. The taxpayer shall calculate gross income taking into consideration income derived from
4 the operation of a ship or water transportation carrier, and the provisions of AS 43.20.071 apply
5 to the determination of income subject to taxation by the operation of this subsection.
6 * Sec. 4. AS 43.20 is amended by adding a new section to read:
7 Sec. 43.20.073. AFFILIATED GROUPS. (a) A corporation that is a member of an
8 affiliated group shall file a return using the water's edge combined reporting method. A return
9 under this section must include the following corporations if the corporations are part of a unitary
10 business with the filing corporation:
11 (1) an affiliated corporation that is eligible to be included in a federal consolidated
12 return under 26 U.S.C. 1501 - 1505 (Internal Revenue Code) if the corporation's property,
13 payroll, and sales factors in the United States average
14 (A) 20 percent or more; or
15 (B) under 20 percent, if the corporation does not meet the requirements
16 of 26 U.S.C. 861(c);
17 (2) a domestic international sales corporation; in this paragraph, "domestic
18 international sales corporation" has the meaning given in 26 U.S.C. 992(a);
19 (3) a foreign sales corporation; in this paragraph, "foreign sales corporation" has
20 the meaning given to the term "FSC" in 26 U.S.C. 922(a);
21 (4) a corporation, regardless of the place where the corporation was incorporated,
22 if the corporation's property, payroll, and sales factors in the United States average 20 percent
23 or more;
24 (5) a corporation that is incorporated in or does business in a country that does
25 not impose an income tax, or that imposes an income tax at a rate lower than 90 percent of the
26 United States income tax rate on the income tax base of the corporation in the United States, if
27 (A) 50 percent or more of the sales, purchases, or payments of income or
28 expenses, exclusive of payments for intangible property, of the corporation are made
29 directly or indirectly to one or more members of a group of corporations filing under the
30 water's edge combined reporting method;
31 (B) the corporation does not conduct significant economic activity.

1 (b) When computing taxable income for a corporation under (a) of this section, the
2 following amounts shall be excluded:
3 (1) 80 percent of dividend income received from foreign corporations;
4 (2) an amount treated as a dividend under 26 U.S.C. 78;
5 (3) 80 percent of the royalties accrued or received from a foreign corporation.
6 (c) In (b)(1) and (3) of this section, a payment is considered to be received from a
7 corporation that is part of the unitary business if the payment is received
8 (1) by a member of an affiliated group included in a water's edge combined
9 report filed under this section; and
10 (2) from a corporation in which the recipient owns 50 percent or more of the
11 stock of the corporation.
12 (d) Dividends and royalties taxable to a corporation using the water's edge combined
13 reporting method are in lieu of an expense attribution for income excluded under (b) of this
14 section.
15 (e) The department may require a corporation that files under (a) of this section to file
16 a report under AS 43.20.065 - 43.20.071 prepared without regard to this section if the corporation
17 or an affiliated corporation
18 (1) fails to comply with regulations adopted under this chapter, including domestic
19 disclosure spread sheet filing requirements; or
20 (2) does not provide information that is requested by the department that is
21 necessary for the department to audit the taxpayer's corporate return in a reasonable period of
22 time.
23 (f) This section does not apply to taxpayers subject to AS 43.20.072 engaged in
24 (1) the production of oil or gas from a lease or property in the state; or
25 (2) the transportation of oil or gas by regulated pipeline in the state.
26 (g) In this section,
27 (1) "affiliated corporation" means a member of an affiliated group to which the
28 taxpayer filing a return under (a) of this section belongs;
29 (2) "affiliated group" means a group of two or more corporations in which 50
30 percent or more of the voting stock of each member of the group is directly or indirectly owned
31 by one or more corporate or noncorporate common owners, or by one or more of the members

1 of the group;

2 (3) "foreign corporation" means a corporation created or organized outside of the
3 United States, the District of Columbia, the Commonwealth of Puerto Rico, or a possession of
4 the United States;

5 (4) "water's edge combined reporting method" means a reporting method in which
6 the only corporations besides the taxpayer that may be included in the return are the corporations
7 listed in (a) of this section.

8 * Sec. 5. This Act applies to tax years beginning after December 31, 1991.

9 * Sec. 6. This Act takes effect immediately under AS 01.10.070(c).

# STATE OF ALASKA

**DEPARTMENT OF LAW**

*OFFICE OF THE ATTORNEY GENERAL*

*WALTER J. HICKEL, GOVERNOR*

*REPLY TO:*

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☒ *P.O. BOX K — STATE CAPITOL*
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PHONE: (907) 465-3600
FAX: (907) 463-5295

April 18, 1991

Honorable Kay Brown
Chair, House Finance Subcommittee on HB 12
Alaska House of Representatives
P. O. Box V
Juneau, Alaska 99811

Re: HB 12 - Water's Edge
Apportionment

Dear Representative Brown,

You have asked us to address certain questions regarding House Bill 12, which would enact a water's edge apportionment method for certain Alaska corporate taxes. Specifically, you have asked about the application of the equal protection doctrine for taxation purposes, and the impact of a California Court of Appeals decision, Barclays Bank International v. Franchise Tax Board, 275 Cal.Rptr. 626 (Cal.App. 1990), review granted, 278 Cal.Rptr. 836, 806 P.2d 308 (Cal. 1991), on Alaska tax methods. Our short answer is that we do not see a serious constitutional problem in HB 12; a more detailed discussion follows.

In Atlantic Richfield Co. v. State, 705 P.2d 418 (Alaska 1985), the Alaska Supreme Court considered the oil companies' equal protection challenge to the separate accounting method of taxation. The court upheld the taxation method under both Federal and state analysis. The court found that the interest involved, "freedom from disparate taxation," lies at the low end of the continuum of interests protected by the equal protection clause, that taxing the oil companies differently from other businesses to rectify a perceived inequity was a valid state purpose, and that the use of separate accounting was sufficiently related to the legislative purpose. Id. at 437. This was sufficient to uphold the tax under state equal protection analysis. Under a Federal analysis, separate accounting was found to have a rational relationship to the state's legitimate interest of correcting a perceived inequity. Id.



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From the above it can be deduced that, while the equal protection clause of the Federal and state constitutions do apply to taxation methods, a method will not be found unconstitutional so long as it is reasonably related to and furthers a legitimate state interest. Classification is not unconstitutional if any state of facts reasonably can be conceived that would sustain it. Allied Stores of Ohio, Inc. v. Bowers, 358 U.S. 522, 528 (1959). Thus, the disparate treatment of oil and gas taxpayers under the bill likely would withstand challenge.

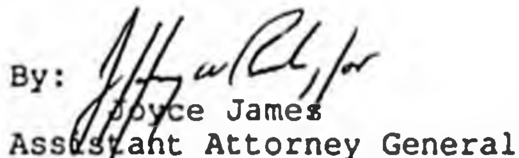
In addition, so long as the worldwide method used for oil and gas corporations is not clearly unconstitutional under current case law, it does not need to be changed. To the extent that the Barclays case invalidates worldwide apportionment, it is not binding in this state until it is affirmed by the United States Supreme Court or adopted by our own supreme court. Of course, were this to eventually happen, any taxes paid under protest (AS 43.10.210) would need to be refunded to the taxpayer if the taxpayer ultimately prevails in having the tax declared unconstitutional. Principal Mut. Life Ins. v. Div. of Ins., 780 P.2d 1023, 1030 (Alaska 1989).

Finally, we are unaware of any set of circumstances related to worldwide or water's edge apportionment that would give rise to potential liability to Mental Health Trust advocates.

We hope this addresses your concerns. If we may be of further assistance, please advise.

Sincerely,

CHARLES E. COLE
ATTORNEY GENERAL

By: 
Joyce James
Assistant Attorney General

JJ:prm

WALTER J. HICKEL, GOVERNOR

# DEPARTMENT OF REVENUE

STATE OFFICE BUILDING
P.O. BOX SA
JUNEAU, ALASKA 99811-0400

April 26, 1991

The Honorable Kay Brown
Chair, House Finance Sub-Committee on HB12
Alaska State Legislature
Capital Room 513
P.O. Box V
Juneau, Alaska 99811

APR 29 1991

Re: HB 12 - Cruise Ship Question

Dear Representative Brown:

We have made an attempt to estimate the revenue impact of amending Alaska law to very specifically exclude IRC Sections 883 and 894. Taxpayers such as those engaged in the cruise ship industry have taken the position that those sections are incorporated into Alaska law. The Income & Excise Division has taken a contrary view and the Department has not yet officially considered the question. Unfortunately, our efforts to quantify the tax involved have not been successful as the necessary information is simply not available.

The problem is that the Internal Revenue Code in Section 883 provides that the gross income derived by a foreign corporation from the operation of a ship or ships is not included in gross income. Similarily, Section 894 provides that income subject to a United States treaty obligation is not to be included in gross income. Therefore, unlike other items that are shown as subtractions from income, the income in question is not reported as income on either the United States or Alaska income tax returns. This is similar to the treatment for interest on state and local bonds which generally is not included in gross income.

Shipping income would be reflected in book income. The federal tax return does contain a schedule for reconciling book and taxable income for those corporations included in the return. However, the precise nature and breakdown of the income shown on the reconciliation cannot always be ascertained from the return detail. In our review, we were unable to identify any income from shipping operations. That is not surprising since the foreign corporations with the shipping operations would not generally be filing with any related United States corporations.

Foreign corporations are generally subject to United States tax on gross income derived from sources within the United States or otherwise effectively connected with the conduct of a trade or business in the United States. Therefore, since the shipping and treaty income is not a part of federal gross income, there is no requirement that it be reported.

04-04LH

A state unitary tax return would include all income from foreign and domestic corporations within the unitary business. A taxpayer may then show various subtractions from that income on the return. For instance, a taxpayer would show as a deduction the interest on obligations of the United States that are taxable at the federal level but which are not subject to state taxation. However, where a taxpayer uses the Internal Revenue Code to exclude an item of income from the tax base, as is the situation here, it will not be reflected anywhere on the Alaska return.

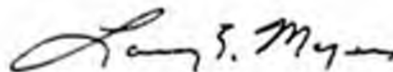
We would have a similar problem in trying to determine an apportionment factor to the tax base. The apportionment factor would be based on property, payroll, and sales. Since we are dealing with transportation property and personnel that do not remain in one location, this would require that the mobile property and personnel be allocated among the taxing jurisdictions. The regulations of the Department provide generally for a "port day" methodology in this situation. For example, the value of the cruise ship would be reflected in the numerator of the property factor in the ratio that the Alaska port days bear to port days everywhere. That information is not available except upon audit.

The above provisions of the IRC have application beyond just the cruise ship industry. However, the exclusion for shipping income was narrowed in 1987 to remove controlled foreign corporations. A controlled foreign corporation is any foreign corporation that is more than 50% owned by United States shareholders. Nevertheless, this illustrates that a tie-in to the federal provisions in this area leaves a great deal of uncertainty and makes Alaska subject to wholly unrelated federal policy considerations that are reflected in the tax code in laws such as Sections 883 and 894.

I have attached information as you requested concerning how other states treat this issue. It can be assumed that the majority of other states that incorporate federal taxable income have the same problem.

I hope that these explanations satisfy your request. I am sorry that we could not generate the numbers that the sub-committee is interested in. We appreciate the consideration that you and the sub-committee have given to this important legislation.

Sincerely,



Larry E. Meyers
Director
Income and Excise Audit Division

LEM:CM
91-77

Enclosure

cc: Lee E. Fisher, Commissioner
Representative Fran Ulmer

# 1991 Multistate Corporate Tax Guide

**Volume I**
**Corporate Income Tax**

WILLIAM A. RAABE, PhD, CPA
KAREN J. BOUCHER, MST, CPA
JUDITH A. SHANLEY, MST, CPA

## Conformity to Federal Rules for Determining Taxable Income and Income Tax Rates

The Internal Revenue Code (IRC) is typically the starting point for computing state corporate taxable income. State statutes may specifically adopt the IRC as the starting point or they may adopt provisions of the IRC without designating it as the actual starting point. In either case, the state corporate taxable income is directly impacted by the federal statutes in most states after which specific state modifications are made.

The adoption of the IRC may be current or as of a specific reference date. A state that adopts the current IRC automatically incorporates any changes in the federal statutes into its own state statutes. The adoption of the IRC as of a specific reference date requires periodic updates to the state statutes for conformity to the IRC. For those states where a specific reference date applies, annual legislation is almost automatic to accomplish state statutory updates. In the latter case, care must be taken to consider the differences that may arise as the result of the delayed adoption of federal statutory provisions.

A complete tie-in to the IRC by the states would simplify tax administration and compliance. However, two primary considerations prevent this situation from occurring. First, the state's judiciary might consider a complete tie-in to be an unconstitutional delegation of legislative power to Congress. Second, state legislatures typically like to review amendments to the IRC before they are adopted for state tax purposes.

A complete tie-in also carries with it political issues. State legislators fear possible federal economic coercion of the states. Traditionally, there has been an underlying suspicion of federal interference in state activities that could lead to a state's loss of control over its own tax policy. Specific problems revolve around an absence of common goals in the state and federal tax laws. A state's tax policy tends to be responsive to regional needs, which are necessarily subordinated at the federal level. Federal tax policy is motivated by broader concerns.

The effects of federal tax changes on state revenues are often difficult to predict. This was particularly true of the extensive revisions included in the Tax Reform Act of 1986 and continues to be true to a lesser extent with more recent federal tax legislation. Some states respond quickly with legislation affecting state tax laws and other states defer any response until the impact of the tax changes are more fully known. The states face a difficult problem in evaluating the effect of federal tax legislation on state revenues. States will continue to evaluate how closely to conform to the IRC. A state's budgetary objectives as well as objectives related to economic development and social concerns will always be emphasized over conformity.

The following chart indicates whether the state follows the IRC for determining gross income and deductions and the respective date of adoption of federal tax statutes. Some states use final federal taxable income as the starting point, while others use federal taxable income before special deductions (e.g., dividends-received or net operating loss deductions). The chart also includes selected tax rate information and related state statutory citations.

## Trends

As indicated by the charts, most states adopt the IRC as the starting point for computing state corporate taxable income. Fewer and fewer states depart from the use of federal income as the starting point. For example, Wisconsin recently revised its statutes to consider federal taxable income as the starting point for state taxable income, and California recently enacted tax legislation that incorporates much of the IRC, bringing the California State income tax calculation in closer conformity to the IRC.

Many states indicated current references to the IRC as amended to date. Other states adopt the federal tax rules as of a specific date which may reflect judicial or political considerations or possibly a desire to review the impact of the federal provisions before adopting them as part of the state tax calculation.

The tax rates and methods of applying them vary from state to state. Many states have a single rate flat-tax. There are also numerous states that have a graduated tax ranging from 2 brackets to a total of 10 brackets in the state of Alaska. Several states have indicated changes to their tax rates or adopted surtaxes in response to revenue and budgetary concerns.

## Conformity to Federal Rules for Determining Taxable Income and Income Tax Rates

| | *Does State Computation of Taxable Net Income Start with a Figure from Federal Form 1120?* | *Date of Adoption of Federal Income Tax Rules* | *Tax Rates* | *State Statute(s) That Apply in These Areas* |
|---|---|---|---|---|
| Alabama | Yes. Starts with taxable income before special deductions | Various | 5% of Alabama taxable income | Ala. Code §§40-18-31, 40-18-33, 40-18-34 |
| Alaska | N/R | N/R | N/R | Alaska Stat. §§43.20.011, 43.20.021 |
| Arizona | N/R | N/R | N/R | Ariz. Rev. Stat. Ann. §§43-102, 43-1101, 43-111 |
| Arkansas | No | N/A | $ 0-3,000: 1%<br>3,001-6,000: 2%<br>6,001-11,000: 3%<br>11,001-25,000: 5%<br>25,000 or more: 6% | Ark. Stat. Ann. §26-51-205 |
| California | Yes. Starts with taxable income before special deductions | Various | 9.3%; except for banks and financial institutions, which are taxed at 10.668% | Cal. Rev. & Tax Code §§23151, 23501, 24271 |
| Colorado | Yes. Starts with taxable income after special deductions | Current | $0-50,000: 5%. A surcharge tax of 5.2% for taxable income in excess of $50,000 is in effect until 7/1/91 | Colo. Rev. Stat. §39-22-30 |
| Connecticut | Yes. Starts with taxable income before special deductions | Current | 11.5%; net income base; a 20% surtax for years beginning on or after 1/1/89; 0.0031 per capital base for years beginning after 1/1/89; $250 minimum tax | Conn. Gen. Stat. §§12-214, 12-217 |
| Delaware | Yes. Starts with taxable income after special deductions | 1901(5) and 1903(a) of 30 DEL C. | 8.7% | Del. Code. Ann. tit. 30 §1902 |
| District of Columbia | No | 1986 Code was approved 10/22/86 | 10% plus 5% surtax | D.C. Code. Ann. §§47-1803.2, 47-1807.2 |
| Florida | Yes. Starts with taxable income after special deductions | 1/1/90 | 5.5% (regular tax) for all taxpayers | Fla. Stat. §§220.11, 220.12 |

| | | | | |
|---|---|---|---|---|
| Georgia | Yes. Starts with taxable income after special deductions | 1/1/90 | 6% | Ga. Code Ann. §48-7-21 |
| Hawaii | No. | January 1, 1990 for the amendments made as of December 31, 1989 to the Internal Revenue Code Sections operative for the state | 4.4% on first $25,000<br>5.4% on next $75,000<br>6.4% above $100,000 | Haw. Rev. Stat. §235-2.3, 235-71 |
| Idaho | Yes. Starts with taxable income after special deductions | 1/1/90 | 8%. With $20 minimum for each corporation that is required to file | Idaho Code §§63-3022, 63-3025 |
| Illinois | Yes. Starts with taxable income after special deductions | Current | 7.3% for taxable years ending 7/1/89 through 6/30/91. 6.5% thereafter. 1.5% for S corporations | Ill. Rev. Stat. Ch. 120, Para. 2-201(b), 2-203 |
| Indiana | Yes. Starts with taxable income after special deductions | 1/1/90 | 3.4% of adjusted gross income, plus supplemental net income tax at 4.5% | Ind. Code §§6-3-3-2, 6-3-1-3.5 |
| Iowa | Yes. Starts with taxable income after special deductions and before NOL | 1/1/90 | $ 0-25,000: 6%<br>25,001-100,000: 8%<br>100,001-250,000: 10%<br>250,000 or more: 12% | Iowa Code §422.33 |
| Kansas | Yes. Starts with taxable income after special deductions | Current | $ 0-25,000: 4.5%<br>25,000 or more: 6.75% | Kan. Stat. Ann. §§79-32, 110, 79-32, 138 |
| Kentucky | No. See KRS 141.010 and 141.0101 for definition of gross and net income and deductions | 12/31/89 | $ 0-25,000: 4%<br>25,001-50,000: 5%<br>50,001-100,000: 6%<br>100,001-250,000: 7%<br>250,000 or more: 8.25% | Ky. Rev. Stat. Ann. §§141.010, 141.040 |
| Louisiana | Yes. Starts with taxable income before special deductions; modifications do exist. | 1/1/87 | $ 0-25,000: 4%<br>25,001-50,000: 5%<br>50,001-100,000: 6%<br>100,001-200,000: 7%<br>200,000 or more: 8% | La. Rev. Stat. Ann. §§47-287.12, 47-287.61 |
| Maine | Yes. Starts with taxable income after special deductions | 12/31/89 | $ 0-25,000: 3.5%<br>25,001-75,000: 7.93%<br>75,001-250,000: 8.33%<br>250,000 or more: 8.93% | Me. Rev. Stat. Ann. tit. 36 §5200 |

# Conformity to Federal Rules for Determining Taxable Income and Income Tax Rates *(continued)*

| | *Does State Computation of Taxable Net Income Start with a Figure from Federal Form 1120?* | *Date of Adoption of Federal Income Tax Rules* | *Tax Rates* | *State Statute(s) That Apply in These Areas* |
|---|---|---|---|---|
| Maryland | Yes. Starts with taxable income after special deductions | Current | 7% | Md. Tax-General Code Ann. §§10-105, 10-304 |
| Massachusetts | N/R | N/R | N/R | Mass. Gen. L. Ch. 63 §§30, 32, 39 |
| Michigan | Yes. Starts with taxable income after special deductions | 1/1/87 | 2.35% | Mich. Comp. Laws §§7.558(3), 7.558(31) |
| Minnesota | Yes. Starts with taxable income before special deductions | 12/31/86 | 9.8% | Minn. Stat. §§290.01, 290.06 |
| Mississippi | No. Taxpayer can begin with line 28 and make state adjustments, but is not required to do so | N/A | $ 0-5,000: 3%<br>5,001-10,000: 4%<br>10,000 or more: 5% | Miss. Code Ann. §27-7-5 |
| Missouri | Yes. Starts with taxable income after special deductions | N/R | 5%. However, for all tax years beginning on/after 1/1/90 but not after 12/31/91, tax is as follows:<br>$ 0-100,000: 5%<br>100,001-335,000: 6%<br>over 335,000: 6.5% | Mo. Rev. Stat. §§143.071, 143.441 |
| Montana | Yes. Starts with taxable income before special deduction | State code annotated §§15-31-113 and 15-31-114 | 6.75%; a 5% surtax is imposed for tax years beginning after 12/31/89; 7% for water's-edge elections | Mont. Code Ann. §§15-31-113, 15-31-121 |
| Nebraska | Yes. Starts with taxable income after deductions | Current | $ 0-50,000: 5.17%<br>50,001 or more: 7.24% | Neb. Rev. Stat. §§77-2734.02, 77-2734.04 |
| Nevada | Nevada Does Not Impose a Corporate Income Tax. | | | |
| New Hampshire | Yes. Starts with taxable income before special deductions | Current | 8% | N.H. Rev. Stat. Ann. §§77-A:1, 77-A:2 |

| | | | | |
|---|---|---|---|---|
| New Jersey | Yes. Starts with taxable income before special deductions and the NOL | Adopted by reference N.J.S.A. 54:10A-4(k) | 9%. A surcharge of .417% is in effect and is annually reviewed | N.J. Rev. Stat. §§54:10A-4, 54:10E-4, 54:10E-5, 54:10A-5 |
| New Mexico | N/R | N/R | N/R | N.M. Stat. Ann. §§7-2A-2, 7-2A-5 |
| New York | Yes. Starts with taxable income before special deductions | Current | 9% on income; 8% graduated rate for small businesses. Also, surtax of 15% in fiscal 1991 and 1992; 10% in 1993 | N.Y. Tax Law §§208, 210 |
| North Carolina | Yes. Starts with taxable income before special deductions | 1/1/90 under proposed/introduced legislation | 7% | N.C. Gen. Stat. §§105-130.2, 105-130.3 |
| North Dakota | Yes. Starts with taxable income after special deductions | Perpetual except for safe harbor leases, foreign sales corporations (formerly domestic international sales corporations), and certain adjustments for depreciation | $ 0-3,000: 3%<br>3,001-8,000: 4.5%<br>8,001-20,000: 6%<br>20,001-30,000: 7.5%<br>30,001-50,000: 9%<br>50,000 or more: 10.5% | N.D. Cent. Code §§57-38-01.3, 57-38-30 |
| Ohio | Yes. Starts with taxable income before special deductions | Statute refers to IRC as amended, not a specific adoption date | Greater of:<br>(a) $ 0-50,000: 5.1%<br>Over 50,000: 8.9%<br>or<br>(b) 5.82 mils multiplied by net worth; a surtax of 0.11% on the first $50,000 and 0.22% over $50,000 of net income or 0.00014 of net worth is imposed through 1992 | Ohio Rev. Code Ann. §§5733.04, 5733.04.1, 5733.06 |
| Oklahoma | N/R | Current | 6% | Okla. Stat. tit. 68 §§2353, 2355 |
| Oregon | Yes. Starts with taxable income after special deductions | Federal effective date, or tax years beginning on or after 1/1/89 | 6.6% of apportioned income | Or. Rev. Stat. §§317.010, 317.259, 318.020 |
| Pennsylvania | Yes. Starts with taxable income before special deductions | 1971 | 8.5% | 72 Pa. Cons. Stat. §§7401, 7402 |
| Rhode Island | Yes. Starts with taxable income before special deductions | Current | 9% effective 1/1/89 | R.I. Gen. Laws §§44-11-2, 44-11-11 |

## Conformity to Federal Rules for Determining Taxable Income and Income Tax Rates *(continued)*

| | *Does State Computation of Taxable Net Income Start with a Figure from Federal Form 1120?* | *Date of Adoption of Federal Income Tax Rules* | *Tax Rates* | *State Statute(s) That Apply in These Areas* |
|---|---|---|---|---|
| South Carolina | Yes. Starts with taxable income after special deductions | 12/31/88 | 5% | S.C. Code Ann. §§12-7-230, 12-7-415 |
| South Dakota | South Dakota Does Not Impose a Corporate Income Tax. | | | |
| Tennessee | Yes. Starts with taxable income before special deductions | Federal rules not specifically adopted. T.C.A. 67-4-805 uses federal taxable income before NOL and special deductions as starting point for excise tax base | 6% on all income | Tenn. Code Ann. §§67-4-805, 67-4-806 |
| Texas | Texas Does Not Impose a Corporate Income Tax. | | | |
| Utah | Yes. Starts with taxable income before special deductions | Federal rules not adopted | 5%; $100 minimum | Utah Code Ann. §§59-7-102, 59-7-107, 59-7-201 |
| Vermont | Yes. Starts with taxable income after special deductions | Current | 5% to 8.25% | Vt. Stat. Ann. tit. 32 §§5811, 5832 |
| Virginia | Yes. Starts with taxable income after special deductions. The NOL Deduction cannot create or increase a net operating loss, i.e. F.T.I. cannot be reduced below zero by a NOLD | Current | 6% | Va. Code Ann. §§58.1-400, 58.1-402 |
| Washington | Washington Does Not Impose a Corporate Income Tax. | | | |
| West Virginia | Yes. Starts with taxable income after special deductions | Current | 9.30% | W. Va. Code §§11-24-4, 11-24-6 |
| Wisconsin | Yes. Starts with taxable income before NOL and special deductions | 12/31/89, with certain exceptions | 7.9% | Wis. Stat. §§71.26, 71.27 |
| Wyoming | Wyoming Does Not Impose a Corporate Income Tax. | | | |

Legend:
N/A. Not applicable
N/R. Not reported

# Alaska State Legislature

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## House of Representatives

Committee on Finance
P.O. Box V, Juneau, Alaska 99811

4/15/91

TO: ALL HOUSE FINANCE COMMITTEE MEMBERS

FROM: REPRESENTATIVE NAVARRE Mike

RE: HB 12- AN ACT RELATING TO THE WATER'S EDGE METHOD OF CALCULATING INCOME TAXES... ( UNITARY TAX BILL)

Attached is an article from the April 15, 1991 issue of NEWSWEEK Magazine. This article, The Corporate Shell Game, details the approach that many foreign corporations are utilizing in their global efforts to avoid and/or evade taxes. The approach is termed "transfer pricing". Put simply, subsidiaries - with internal transactions - use "transfer pricing" to shift their profits to low tax jurisdictions. This is graphically demonstrated by the article's inset: Who's Got the Profits?

Not only is the Federal tax structure subject to major revenue leakage, the article further points out its added administrative difficulties and costs.

These are many of the same problems presented by HB 12, and they must be addressed by the Committee before we pass the measure out.

RECYCLED

# The Corporate Shell Game

## How multinational firms use 'transfer pricing' to evade at least $20 billion in U.S. taxes

For taxpayers battling their 1040 forms and legislators peering into the black hole of the federal budget deficit, there's good news: the Internal Revenue Service, armed with fresh troops and new legal tools, is setting out to mine a mother lode of $25 billion in unpaid taxes. But there's also a catch: nobody expects much more than a trickle of new revenue to come from it.

The mother lode is unpaid business taxes, largely from foreign corporations doing business in the United States. In effect, like street-corner artists hiding peas under walnut shells, such companies play games with their profits. By manipulating the prices charged among their own subsidiaries, the multinationals can concentrate profits in countries with low corporate rates and thus get away with a smaller total tax bite (chart). The bottom line is that most foreign corporations operating in the United States pay little or no tax to Washington.

**Tax loss:** All told, the Treasury's loss is enormous. At hearings last summer before the House Oversight Subcommittee, chairman J. J. Pickle of Texas said he had heard estimates ranging up to $30 billion. IRS Commissioner Fred T. Goldberg Jr. said that was "on the high side," but conceded that the agency should be doing better. Michigan tax experts James Wheeler and Richard Weber calculate that foreign-based multinationals dodge $20 billion in U.S. taxes every year. And that's not considering U.S.-based companies, many of which also find ways to tuck away profits in tax havens. They usually do it on a smaller scale, since it's harder for them to dodge the IRS.

The corporate shell game has been going on for at least 30 years, ever since multinational operations became a significant factor in the corporate world, and there have been periodic attempts to crack down. The latest was prompted last summer, when the IRS published a table showing that foreign-based companies sold $543 billion worth of goods and services in the United States in 1986, but claimed to have net losses of $1.3 billion on that trade. That year was an aberration; before and since, overseas companies in the United States have actually reported net profits, albeit tiny ones. But the 1986 "loss" was riveting. "That tore it," says Ronald Pearlman, former chief of staff of the congressional Joint Tax Committee, now practicing law at Covington & Burling. Congress voted a stiff new 20 percent fine and gave the IRS broader power to subpoena records from parent companies overseas. The tax agency also got to expand its overworked international staff and dangle a small salary premium to recruit talent.

Abuses in pricing across borders—"transfer pricing," in corporate jargon—are illegal, if they can be proved. Corporations dealing with their own subsidiaries are required to set prices at "arm's length," just as they would for unrelated customers. And there's no question that abuses can be enormous. In its biggest known victory, the IRS made its case that Japan's Toyota had been systematically overcharging its U.S. subsidiary for years on most of the cars, trucks and parts sold in the United States. What would have been profits from the United States had wafted back to Japan. Toyota denied improprieties but agreed to a reported $1 billion settlement, paid in part with tax rebates from the government of Japan.

But such triumphs are rare, and the hurdles are mountainous. For one thing, small armies of accountants are needed to sift through corporate records in several countries, even if access is granted—by no means a sure thing. In one case, an agent who requested a specific document was sent 40 boxes of papers, without an index. Trained economists must rule in each case whether costs were realistically allocated. And since real-world cases are usually far more subtle than simple illustrative anecdotes, there is room for years of legal maneuvering over disputed facts, accounting practices and business judgments.

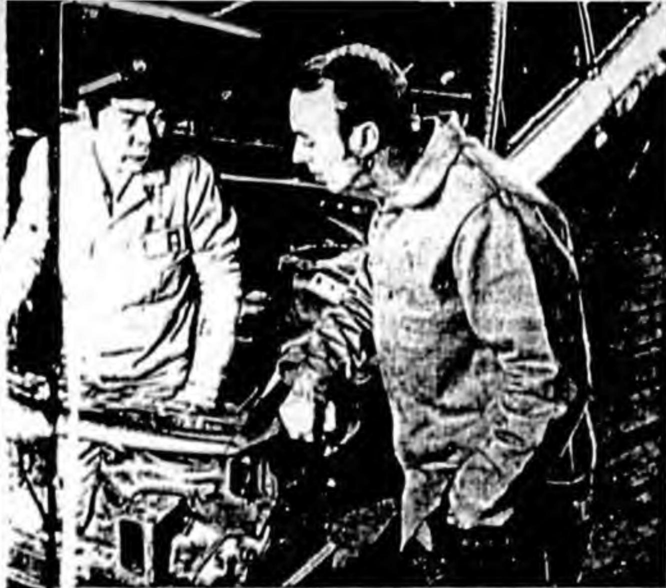
### Who's Got the Profits?

By using tax havens and "trick" pricing, a corporation could slash its U.S. tax bill by transferring profits to low-tax countries. This typical transaction follows one trail.

**Germany**

An item is manufactured at a cost of $80. It is then sold to an Irish subsidiary for $80.

**Tax Rate: 48%** **Tax Paid: $0**



PHOTOS BY LOUIS PSIHOYOS—MATRIX

BOB CRANDALL—PICTURE GROUP

**Dodge ball:** *Toyota workers (above), Westinghouse researcher (left), Goldberg*

Some abuses are blatant. One foreign manufacturer, for instance, sold TV sets to its U.S. subsidiary for $250 each, but charged an unrelated company just $150. Most cases are nowhere near as clear. What if the set sold outside has a slight change in the casing? Which subsidiary gets charged for shipping and insurance? In one current case, the IRS says Japan's Yamaha forced Yamaha Motor Corp., U.S.A., to overstock motorcycles and all-terrain vehicles in the early '80s, and then made the subsidiary pay for discounts and promotions to unload the excess inventory. The result, says the tax agency, was that Yamaha Motor U.S.A. paid only $5,272 in corporate tax to Washington over four years. Proper accounting would have shown a profit of $500 million and taxes of $127 million, the agency says. But Yamaha argues that the IRS case ignores the colossal reality of the 1982 recession, which caught the company just as unprepared as its U.S. competitors. The U.S. Tax Court is mulling the case.

American-based multinationals have also been accused of squirreling profits away. Tax agents find it easier to monitor their books, since they're all in this country and follow SEC standards; as Wheeler explains it, "It's the difference between examining the head and several arms of an octopus, rather than just one tentacle." Even so, he thinks the U.S. multinationals could easily account for an additional $5 billion in lost taxes on profits dubiously allocated to tax havens. Wheeler and Richard Weber say they've found one case that is suggestive: Westinghouse Electric managed to book 27 percent of its 1986 domestic profit in Puerto Rico, where its final sales are tiny. To spur the Puerto Rican economy, Washington has set the corporate-tax rate there at zero. (Westinghouse says the accounting is proper, since its "highest-profit products are made in Puerto Rico.")

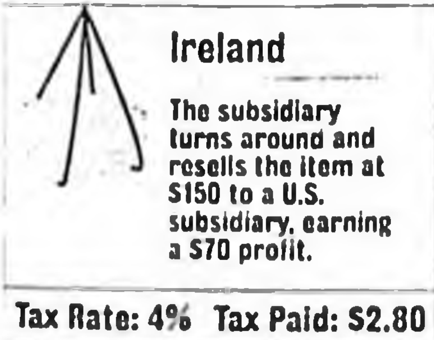
The IRS professes to be delighted with its new powers and loaded for bear. "We've been outmanned and outgunned in the past," says Steven Lainoff, chief IRS lawyer for international enforcement. "Now we've got the tools and people to really attack this problem." But that is at least questionable. The new fine, for instance, stipulates a 20 percent penalty for any company whose transfer pricing results in underpayment of $10 million or more in taxes. Experts call that a crude weapon that may well fail to stand up in court; even the IRS initially objected to it. And in testing their new subpoena powers in foreign countries, IRS agents will be under the scrutiny of tax people there, who stand to lose any taxes that Uncle Sam succeeds in claiming. The prospects for litigation are wearying.

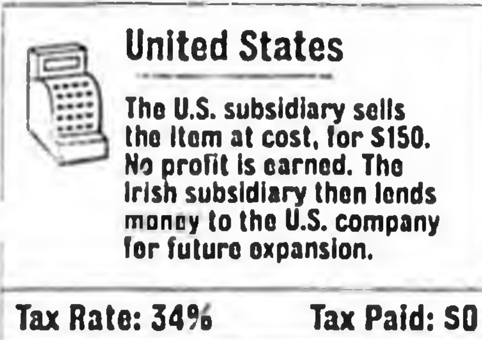
When it comes to litigation, the IRS may also find little comfort in its expanded international staff (to 700 from 550) or its big-city salary premiums of 8 percent over government standards. The agency is now eight years behind in merely auditing multinationals; corporate officials who make a decision may well be dead or transferred when the tax people finally show up to question it. And in competing for legal and accounting talent, the IRS is still severely outmatched. Senior partners in private tax practice routinely get $500,000 to $1 million a year. Goldberg recalls ruefully that when he took office as IRS commissioner in 1989, his new salary of $80,000 was just what his former firm was paying newly fledged lawyers fresh out of school.

**Bad record:** All told, it's not surprising that when the IRS does bring a case, it frequently loses. Thomas Field of Tax Analysts says the agency typically settles for just 10 cents on the dollar of its initial claims against foreigners, and the IRS doesn't dispute that. At one major multinational firm, the head of taxes says he tries to do the right thing. "But there's no way the IRS is going to find chinks in our armor," he says. "We're just too smart and way too well prepared."

If the new reforms don't bear fruit, Pickle and Senate Finance Committee chairman Lloyd Bentsen say they are ready to propose something else. Ideally, that might be a whole new approach to international taxes, one that ignores the details of transactions and focuses on allocating shares of the total profit. Most U.S. states have similar laws, essentially basing corporate taxes on what percentage of a company's employees, sales and assets are located in the state. In the long run, reforming international taxes along those lines may be inevitable. But any such attempt would be formidably complicated; few major foreign countries would welcome an overhaul of the entire structure, which in effect would require unanimous consent. For the foreseeable future, the corporate shell game goes on.

[illegible]



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.

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**ADMITTED IN VIRGINIA, WASHINGTON, D.C. AND ALASKA

ALL OTHERS ADMITTED IN ALASKA

# MEMORANDUM

**TO:** House Finance Committee: Representatives MacLean, Navarre, Boyer, Brown, Jacko, Koponen, Larson, Ulmer, Barnes, R. Phillips, and Sharp

**FROM:** Robert Blasco and Mary Nordale RPB

**DATE:** April 26, 1991

**RE:** House Bill 12

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Enclosed for your review is information regarding the economic benefit derived by the state as a result of the multi-faceted operations of Holland America Lines Westours, Inc. By its own operations and aligned businesses and industries, Holland America stimulates economic health and growth throughout most of the state. In addition to the stimulus Holland America provides to the economy, Holland America already pays $3.4 million in taxes to the state, not including taxes paid in local communities.

The present draft of HB 12 would eliminate a long standing tax exemption afforded foreign vessels. The exemption would be contrary to federal law and presents significant legal questions. Equally important, should the state begin to tax foreign vessels, Holland America will be forced to review its services to Alaska, and potentially relocate those services in other ports. It can be expected that Holland America would limit its operations in Alaska so as not to incur this additional burden.

We would be happy to speak with you at your convenience. Please do not hesitate to contact one of us if you have questions or would like additional information.

Enclosure
RPB:MAN:na

Holland America Line
Westours Inc.

## 1990 ALASKA ECONOMIC IMPACT BY HOLLAND AMERICA WESTOURS AND ITS PASSENGERS

Alaska is the third most popular cruise destination after the Caribbean and the Mediterranean. The Alaska market is currently estimated to represent 7 percent of the entire North American cruise industry. Over the next decade, the Alaska cruise market is forecast to grow at 6 to 8 percent annually.

The number of cruise passengers carried to Alaska by Holland America Line, one of the largest operators in the Alaska market, has grown from 16,000 in 1983 to 101,000 for 1990, including Alaska cruise passengers and Alaska and Canadian Rockies cruisetour passengers.

Holland America Westours and its subsidiaries, Gray Line of Alaska and Westmark Hotels and Inns, employed a total of 2,343 people in 1990. All of the year-round employees are Alaska residents, as are 89 percent of the seasonal workers. The company also does business with 1,050 vendors around the state. In addition, Holland America Westours spends nearly $14 million annually in advertising to promote Alaska tourism and distributes nearly 2.5 million Alaska brochures to consumers and travel agencies across the United States and Canada.

Cruise- and cruisetour-related contributions to the Alaska economy by Holland America Line and Windstar Sail Cruises directly and their passengers indirectly in 1990 amounts to an estimated $89,453,514 statewide. The breakdown follows:

| | |
|---|---:|
| Estimated passenger spending (Includes cruisetour, Gray Line of Alaska and Westmark Hotels) | $35,978,727 |
| HAL-W direct spending (Includes taxes, rent, fuel, food/ beverage, utilities, equipment, local advertising, contributions, capital projects/ maintenance, other tour operators, air transportation) | 37,363,459 |
| Estimated crew spending | 1,416,000 |
| HAL-W statewide payroll | 14,695,328 |
| Total direct and indirect impact | $89,453,514 |
| Total estimated statewide economic impact (using commonly [illegible] economic multipliers) | $242,275,476 |

[illegible]
Seattle, WA 98119
206-281-3535
Telex: [illegible] HALW SEA
FAX: [illegible] or 206-281-7110

Holland America Line
Westours Inc.

March 27, 1991

Rep. Mike Navarre
Co-Chairman
House Finance Committee
P.O. Box V (MS 3100)
Juneau, Alaska 99811

Dear Representative Navarre:

House Bill No. 12, the so-called "Water's Edge Act", makes the State of Alaska a far more hospitable place for business and undoubtedly, will encourage both the expansion of Alaska enterprises and the establishment of Alaska offices by businesses headquartered elsewhere. Personally, and on behalf of Holland America Line, I support the bill.

In reviewing the bill, I did note two potential problems that result from other statutes within the Alaska income tax act. First, the bill may require that a business that derives income excluded under federal tax laws join in the filing of an Alaska unitary return. Even though this company would add nothing to the unitary taxable income subject to apportionment, other statutes would require that its property and payroll be included in the unitary apportionment factors.

To avoid this unanticipated loss of revenue to the state, I propose that all foreign corporations which derive income which is entirely excluded from federal taxable income, be excluded from the Alaska unitary income tax return.

The second change that I propose will codify an existing regulation which permits foreign corporations to claim certain deductions to derive taxable income. If a foreign corporation does not derive income which is "effectively connected with a United States trade or business", federal statutes deny the corporation any deductions and impose a tax on the company's gross income.

Under existing Alaska statutes and House Bill No. 12, such a corporation could, under certain circumstances, be required to join in the filing of a unitary income tax return. Since Alaska has adopted the Internal Revenue Code for the purpose of determining taxable income, this corporation's gross income would, absent other authority, be included in the unitary base.

The Department of Revenue currently has a regulation that permits a corporation in this situation to claim deductions. However, it is my opinion that this regulation is not authorized by existing statutes. The amendment I propose closely follows this regulation,

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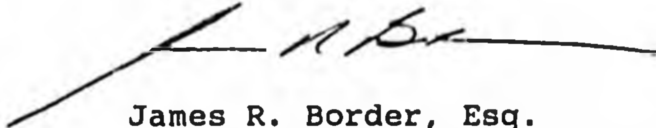
with some changes to ease its administration and to make it work more equitably.

The specific amendments to the bill, together with a detailed technical explanation are attached. If there is any additional information that I can provide or if I can be of assistance in any way, please do not hesitate to contact me.

Sincerely,



James R. Border, Esq.
Corporate Director - Taxation

## PROPOSED AMENDMENTS TO HOUSE BILL NO. 12

### I. INELIGIBLE FOREIGN CORPORATIONS - EXCLUSION FROM UNITARY RETURN

Subparagraph (g) of AS 43.20.073, page 3 of the bill, beginning on line 21, is amended to read:

(3) "foreign corporation" means a corporation created or organized outside of the United States, the District of Columbia, the Commonwealth of Puerto Rico, or a possession of the United States, provided however, a "foreign corporation" does not include any corporation subject to the internal revenue laws of the United States if all of such corporation's income is excluded pursuant to the provisions of the Internal Revenue Code adopted as part of this chapter in AS 43.20.021(a) or excluded pursuant to any treaty to which the United States is a party;

### II. ALLOWANCE OF DEDUCTIONS TO FOREIGN CORPORATION REQUIRED TO JOIN IN A UNITARY RETURN

On Page 3 of the Bill, Line 27, a new "Section 3" is added to read:

*Sec. 3 AS 43.20.036 is amended by redesignating subsection (j) as subsection (d) and adding a new subsection to read:

(e) For purposes of calculating the tax payable under this chapter, a foreign corporation required to join in the filing of a unitary return is entitled to the same deductions as a domestic corporation.

(1) A corporation permitted deductions under this paragraph may elect to report as its taxable income either:

(A) income reported in its financial statements prepared in accordance with generally accepted accounting principles;

(B) earnings and profits as determined under tit. 26 USC; or

(C) taxable income that would have been reported if the foreign corporation had used the same rules as a domestic corporation for the calculation of allowable deductions.

(2) An election under this paragraph:

(A) must be made for all members of the unitary group that are not required to file a federal income tax return which encompasses all of their income, unless approval is obtained from the department to exclude particular members from the election; and

(B) the election is binding for all subsequent years unless prior approval is obtained from the department to rescind the election.

On Page 3 of the Bill, Lines 27 and 28, former Sections 3 and 4 are redesignated as Sections 4 and 5, respectively.

# EXPLANATION OF THE PROPOSED AMENDMENTS TO HOUSE BILL NO. 12

## I. INELIGIBLE FOREIGN CORPORATIONS - EXCLUSION FROM UNITARY RETURN

Through Alaska Statutes § 43.20.021(a), the State has adopted specific sections of the Internal Revenue Code (tit. 26, USC). Included in the sections adopted are several which exclude certain classes of gross income derived by foreign corporations from income taxation. This amendment recognizes that, by adopting the Internal Revenue Code by reference, Alaska also excludes these specific items from gross income for Alaska income tax purposes.

Without this amendment, certain foreign corporation which derive income which is technically from United States sources but excluded pursuant to the Internal Revenue Code, would have to join in the filing of a unitary return, adding nothing to the group's taxable income subject to apportionment.

Since these income elements are excluded from gross income they would not enter into the calculation of taxable income or the sales apportionment factor. However, if included in a unitary return, the property and payroll information of these entities could be used in the determination of the combined apportionment factors. If the entities conduct significant business abroad as required by these exclusion sections, this will serve to disproportionately allocate income outside the State. For example, see the rules applicable to financial organizations contained in 15 AAC 20.610, excluding from the apportionment factors all tax exempt receipts but including all property and payroll.

This amendment addresses only those situations where a foreign corporation is required to file a tax return and the income is excluded by statute or treaty. To the extent that a foreign corporation is required to join in the filing of a unitary return under this bill, but has not been required to file a federal income tax return, its income is determined as under prior law and regulations, with the amendments offered below.

## II. ALLOWANCE OF DEDUCTIONS TO FOREIGN CORPORATION REQUIRED TO JOIN IN A UNITARY RETURN

The redesignation of paragraph (j) is a clerical amendment.

New paragraph (e) permits foreign corporations which are part of a unitary group to deduct expenses which relate to the income required to be reported. Under the Internal Revenue Code, many of these corporations are not permitted any deductions and therefore, the Alaska income tax could operate to tax these entities on a gross income basis.

For example, assume that the only income corporation derives are royalties from the use of a patent in the United States. For federal income tax purposes, the corporation is subject to a 30% tax on the gross income it receives. Pursuant to 26 USC 882(c)(1)(A), this corporation would not be permitted any deductions against this income, even those deductions which directly relate to its production.

If the tax due by this corporation has been withheld by the payor, it is not required to file a United States income tax return. If the corporation's tax liability is not satisfied by withholding, it must file an income tax return and remit the tax due.

If this corporation is required to join in the filing of an Alaska unitary return, all of its gross income, including the royalties, are considered. However, the incorporation of the Internal Revenue Code in AS 43.20.021(a) includes the disallowance of deductions to which this corporation is entitled under 26 USC 882(c)(1)(A). Thus, this corporation would be subject to Alaska income tax on its gross income rather than its taxable income.

This problem is currently addressed by regulation 15 AAC 20.300(c) which states, in relevant part:

> The total unitary income subject to apportionment is the business income, as defined in AS 43.19.010 of the unitary business, which is the sum of (1) for income of a unitary business that must be reported as income under the Internal Revenue Code, the taxable income under chapter 1 of Subtitle A of the Internal Revenue Code of 1954, as amended ...; and (2) for income of the unitary business which is not required to be reported as income under the Internal Revenue Code, the income reported for financial statement purposes, plus taxes, based on or measured by net income that were deducted, less dividends received from that corporation included in the unitary business, except that (a) a corporation may elect to report this income as the income is reported on the "Information Return With Respect to a Foreign Corporation" filed with the Internal Revenue Service: (b) if the taxpayer makes the election under (a) of this paragraph (i) the election must be made upon the filing of a return under AS 43.20; (ii) the election must be made for all members of the unitary group that are not required to report income under the Internal Revenue Code unless approval is obtained from the department to exclude particular members from the election; and (iii) the election is binding for all subsequent years unless prior approval is obtained from the department to rescind the election; (iv) the taxpayer may use any method of depreciation allowed under Sec. 167 of the Internal Revenue

Code (26 U.S.C. Sec. 167) as that section read on June 30, 1981; and (v) the taxpayer may take the cost depletion deduction allowed under Sec. 611 of the Internal Revenue Code (26 U.S.C. Sec. 611).

As drafted, this regulation presents several difficulties. First and foremost of these is the lack of statutory authority for the alternative methods of accounting permitted foreign corporations. The regulation addresses the difficulties inherent when entities which do not file federal income tax returns are included in a unitary return. However, statutory authority for this is required.

The second problem is that the methods of accounting under subparagraph (2), both mandatory and elective, are limited to entities which receive income which <u>is not required to be reported under the Internal Revenue Code</u>. As pointed out above, whether or not certain types of income are "required to be reported" by a foreign corporation depends on whether or not adequate income taxes were withheld. The adequacy of withholding is solely within the control of the payor and can not be controlled by the corporation to be included in the unitary return.

If sufficient taxes are withheld to satisfy a foreign corporation's tax liability, its taxable income would be determined pursuant to subparagraph (2) of the regulation. On the other hand, if the same corporation's federal income tax liability is not satisfied by withholding, its income is "required to be reported" and its taxable income would be determined under subparagraph (1). This being the case, there is no justifiable reason for any difference in the methods of accounting available to entities which are similarly situated except for the actions of the withholding agent.

The third problem is a byproduct of the adoption of the Internal Revenue Code through AS 43.20.021(a), the unitary method of taxation in general, subparagraph (1) of this regulation, and the dual tax systems applicable to foreign corporations under federal law. If a corporation is required to report income to the Internal Revenue Service, its taxable income for Alaska purposes is determined under subparagraph 1 of the regulation. Under the facts of the above example, "taxable income" reported under chapter 1 of Subtitle A of the Internal Revenue Code will be the company's gross income, no deductions permitted.

Since the State imposes a "net income" tax, the deductions which give rise to income to be included in an Alaska unitary income tax return should be permitted. Alaska has no comparable "gross income" tax on earnings derived from Alaska sources and therefore, modifications to the federal scheme are required to achieve an equitable result.

The department's regulation attempts to address the problems faced by foreign corporations that are required to join in an Alaska unitary return. The amendment generally follows the department's existing regulation with the following changes to alleviate the problems outlined above.

1. The corporations to which the elective methods of accounting are available is expanded to include all foreign corporations. This will avoid any disparate treatment of similarly situated corporations.

2. A third method of accounting is made available to these corporations, the use of taxable income under United States tax principles. This change is made to accommodate those foreign corporations which are required to report income to the Internal Revenue Service on the basis of "taxable income". Essentially, this codifies subparagraph (1) of the regulation and makes this method of accounting available to all corporations.

3. The election to use financial statement income is changed to incorporate United States generally accepted accounting principles (GAAP). Due to the lack of uniformity in accounting methods internationally, GAAP is designated as the financial accounting method to be used.

4. The previously existing election to use income reported on "Form 5471" is changed to "earnings and profits". Earnings and profits determined under United States tax laws are reported on this form and it appears that this is the "income" to which the regulation alluded. However, GAAP income is also disclosed on this form.

   The amendment clarifies the prior regulation and provides that earnings and profits can be used by foreign corporations which are not controlled foreign corporations required to file Form 5471.

5. The amendment omits the references to the Internal Revenue Code of 1954 since 26 USC is now known as the Internal Revenue Code of 1986.

6. The amendment deletes the restriction on methods of depreciation contained in the regulation. The depreciation methods permitted foreign corporations are limited under current law. Assets used predominately outside the United States are not allowed either the shorter lives or accelerated methods permitted assets used in the United States. This being the case, the requirement that taxpayers continue to use methods determined under 1981 federal tax laws increases the

complexity of the administration of Alaska law and unnecessarily burden taxpayers.

WALTER J. HICKEL, GOVERNOR

# DEPARTMENT OF REVENUE

OFFICE OF THE COMMISSIONER

P.O. BOX S
JUNEAU, ALASKA 99811-0400
PHONE: (907) 465-2300
TELEFAX: (907) 465-2389

April 2, 1991

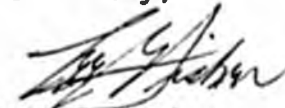
The Honorable Mike Navarre
Alaska State Legislature
P.O. Box V
Juneau, AK 99811

RE: HB 12 - Water's Edge Tax Legislation

Dear Representative Navarre:

As promised in my earlier letter I am forwarding, a copy of Attorney Brian Durrell's letter of April 1, 1991 and his proposed comments to the House Finance Committee.

Sincerely,



Lee E. Fisher
Commissioner

LEF:mll
Enclosure

91-52

04-02LH

# BOGLE & GATES

LAW OFFICES

BRIAN W. DURRELL

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Portland
Tacoma
Vancouver, B.C.
Washington, D.C.
Yakima

21644-01012

April 1, 1991

VIA FACSIMILE 465-2389

Mr. Lee Fisher
Commissioner
Department of Revenue
P.O. Box S
Juneau, Alaska 99811-0400

Re: Water's Edge Tax Legislation

Dear Lee:

Attached is a copy of the memo that you suggested I prepare. I hope that you find the memo useful and appropriate to share with members of the House. I have arranged my schedule so that I will be available to testify on HB 12 before the House Finance Committee in Juneau this Wednesday. Please advise me whether in your opinion my testimony would be helpful.

As David Harlow may have advised you, we have a few amendments that we believe should be made to the current version of HB 12. I would like an opportunity to discuss these amendments with you prior to the hearing. If you agree with the amendments, you are likely best suited to facilitate their introduction. Please advise me if you will have time Wednesday morning to meet and discuss these matters.

I look forward to working with you on this matter.

Very truly yours,

BOGLE & GATES

Brian W. Durrell

Attachment(s)
cc: David Harlow (w/attch.)
C:\[illegible]\LFISHER.LTR

BOGLE & GATES MEMORANDUM

April 1, 1991 21688/01012

TO: House Finance Committee Members

FROM: Brian W. Durrell BWD

RE: Water's Edge Tax Legislation

What is Barclays[1]? It is a recent California Court of Appeals decision holding that, as applied to foreign-based unitary groups, the California "worldwide" combined reporting method ("WWCR") violates the foreign commerce clause of the U.S. Constitution. A unitary group is a group of corporations with common ownership that have attributes of functional integration, centralized management and economies of scale. A foreign-based unitary group is one in which the parent corporation is based in a country other than the U.S. By contrast, a unitary group with a parent corporation based in the U.S. is known as a domestic-based unitary group. A WWCR method is one which taxes a portion of a unitary group's income no matter where it was earned in the world. The California Court of Appeals is an intermediate appellate court. Its decision was appealed by the California Franchise Tax Board to the California Supreme Court which has accepted the appeal. A ruling is not expected from the California Supreme Court for at least a year. Its decision - no matter what it is - is expected to be appealed to the U.S. Supreme Court.

What effect does Barclays have on Alaska? Barclays will have substantial persuasive weight to any Alaska court which may be presented with the issue of the constitutionality of Alaska's WWCR as applied to foreign-based unitary groups. Only a decision of the U.S. Supreme Court, however, would be controlling upon an Alaska court addressing this issue. Barclays appears to impact equally Alaska's income tax imposed both upon foreign-based non-oil & gas and foreign-based oil & gas unitary groups. Both are currently taxed under WWCR. It is important to note that domestic-based unitary groups are unaffected by Barclays. In fact, an earlier U.S. Supreme Court case, Container Corp.[2], held that California's WWCR was constitutional as applied to domestic-based unitary groups. We have no data as to the number of non-oil & gas foreign-based unitary groups doing business in Alaska. Upon inquiry, we have learned that perhaps as few as three oil & gas foreign-based unitary groups do business in Alaska, with the most significant being BP.

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Would Barclays' effect be retroactive? If Alaska's corporate income tax method is unconstitutional, any affected taxpayer could demand a refund for any open year. A year is generally open if the return was filed within the prior three years or the tax was paid within the prior two years. Additionally, any year in which an assessment has been made and appealed by the taxpayer will generally be open. The taxpayer's right to claim a refund for a closed year would turn upon whether the state of Alaska could have foreseen, at the time the tax was imposed, the unconstitutionality of the worldwide combined reporting method. Since the date of the Barclays decision, November 30, 1990, (and perhaps even earlier) its likely that the State should have been able to foresee the constitutional problem.

How does HB 12 address that effect? HB 12 is a bill that would change the method of reporting from a WWCR to a "water's edge" combined method. A water's edge method taxes only income earned within the "water's edge" of the U.S. The bill applies equally to foreign-based and domestic-based unitary groups. The bill does not apply to corporations engaged in the production or transportation of oil & gas. The water's edge method of reporting does not affect business activities that are wholly foreign. Therefore, the water's edge method of reporting does not violate the foreign commerce clause of the U.S. constitution.

What is the difference between worldwide and water's edge combined reporting? Combined reporting must include some method of allocating a portion of the unitary group's income to Alaska for income tax purposes. The portion is usually determined by comparing the amounts of three factors - sales, property and payroll - within the State to the amounts found throughout the entire world (i.e., worldwide) or within the bounds of the U.S. (i.e., water's edge). Each of the three factors is reduced to a fraction, the numerator of which is, for instance, the sales in Alaska. Under the worldwide method the denominator would be the sales of the unitary group throughout the world. Under the water's edge method, the denominator would be just the sales of those members of the unitary group which conduct substantial activity within the water's edge of the U.S. Under the worldwide method, the average of the three factors' fractions would then be multiplied by the worldwide income of the unitary group. Under the water's edge method, the average of the three factors' fractions would then be multiplied by just the income of those members of the unitary group which conduct substantial activity within the water's edge of the U.S. The tax generated from the water's edge method is not necessarily less than the tax generated from the worldwide method. The tax difference will vary on a case by case basis, but in many cases the tax from a water's edge method will be greater than the tax from a worldwide method. Which method produces the

greater amount of tax depends upon whether a unitary group's foreign or domestic activities are more profitable.

Must HB 12 address the income tax upon oil and gas companies? The differing methods of taxation for oil & gas corporations and, under HB 12, for non-oil & gas corporations do not appear to create a constitutional problem. In the ARCO[3] case, the Alaska Supreme Court upheld the use of the separate accounting method of reporting for oil & gas corporations despite the claim that it violated the equal protection clause because other corporations were taxed under a different and (arguably) more favorable method. The different methods of reporting occasioned by HB 12 would almost certainly withstand an equal protection challenge. The oil & gas industry does not appear to be concerned with HB 12. The industry's fear of separate accounting appears to have kept it from advocating any change to the method in which the State taxes oil & gas corporations. Therefore, HB 12 need not address the method of taxation for oil & gas unitary groups. However, the likely impact of Barclays upon the current method of taxing foreign-based oil & gas unitary groups may mean that the issue should be addressed, perhaps through the enactment of some form of a "backstop" tax.

cc: David P. Harlow

1. Barclays Bank International Limited v. Franchise Tax Board, 275 Cap.Rptr. 626 (CalApp 1990)

2. Container Corp. v. Franchise Tax Board, 463 U.S. 159, 103 S.Ct.2933, 77 L.Ed.2d 545 (1983)

3. Atlantic Richfield Company v. State of Alaska, 705 P.2d 418 (Alaska 1985)

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WALTER J. HICKEL, GOVERNOR

**DEPARTMENT OF REVENUE**

OFFICE OF THE COMMISSIONER

P.O. BOX S
JUNEAU, ALASKA 99811-0400
PHONE: (907) 465-2300
TELEFAX: (907) 465-2389

March 26, 1991

The Honorable Mike Navarre
Co-Chair House Finance Committee
Alaska State Legislature
P.O. Box V
Juneau, AK 99811

RE: HB 12 - Unitary tax legislation

Dear Representative Navarre:

In response to your letter of March 22, 1991, I must start with an apology for the confusion you have experienced. Simply stated, it was caused by my inability to pay sufficient attention to this Bill and the related fiscal note when it originally was brought to my attention by Carl Meyers, the Acting Director of Income and Excise Audit Division.

At that time Carl briefed me in a completely one-sided presentation which had its roots in the attitude of the prior administration. I told him that I expected the new administration would support the "water's edge" concept.

Several events and items with higher priority then took my attention and while I do not fault Carl for testifying as he did, he knew that he was taking a position that was going to be reversed. I regret that this has caused a problem for you.

The wording in the February 6, 1991 position paper is a throw-back to Hugh Malone's position in prior years. The fiscal note reflecting four new positions was challenged by me and Assistant Commissioner Floerchinger, resulting in the revised fiscal note dated March 20, 1991. There are no legislative amendments of which I am aware. The only important events that have transpired to cause this reversal are Governor Hickel's election and my appointment. We are pro-development and view the "water's edge" concept as being in keeping with our philosophies.

# Alaska State Legislature

Mike Navarre
Co-Chair
(907) 465-3706

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Eileen MacLean
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## House of Representatives

Committee on Finance
P.O. Box V, Juneau, Alaska 99811

March 22, 1991

The Honorable Lee Fisher
Commissioner
Department of Revenue
11th Floor
State Office Bldg.

Dear Commissioner Fisher:

As you are aware HB 12- " An Act relating to the water's edge method of calculating income taxes..."- currently resides in the House Finance Committee. This is an important piece of legislation; it deserves a very careful review.

I have reviewed some of the file materials relating to this measure. Frankly, I am more than a bit confused by the documentation that has been submitted by your Department on this subject. To help clear up my concerns, and before this measure comes before the full committee, I would like a written response to the questions listed below:

1. Why has the Department submitted two, and very different, fiscal notes to a bill that has undergone very little change since its introduction? Your original fiscal note, dated 2/7/91, addresses the need for four new positions by FY 95. The most recent fiscal note, dated 3/20/91, declares a need for only one new position within the same time period. What specific legislative amendments have caused you to so drastically modify you initial fiscal note?

RECYCLED

# CORRECTION

THIS DOCUMENT
HAS BEEN REPHOTOGRAPHED
TO ASSURE LEGIBILITY

)2–576(2/77)

WALTER J. HICKEL, GOVERNOR

**DEPARTMENT OF REVENUE**

OFFICE OF THE COMMISSIONER

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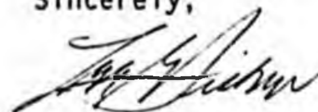
The wording in the February 6, 1991 position paper is a throw-back to Hugh Malone's position in prior years. The fiscal note reflecting four new positions was challenged by me and Assistant Commissioner Floerchinger, resulting in the revised fiscal note dated March 20, 1991. There are no legislative amendments of which I am aware. The only important events that have transpired to cause this reversal are Governor Hickel's election and my appointment. We are pro-development and view the "water's edge" concept as being in keeping with our philosophies.

The issue you raise in regards to oil and gas companies and the Barclay case is better addressed to an attorney such as the author of the Bogle & Gates memo. Your question has caused me to contact that firm's managing partner, Brian Durrell. He is preparing a short response intended to remove concerns about the oil and gas industry. I will convey it to you immediately upon receipt at DOR.

My only new information on this issue is a recent conversation with one of my former partners, resident in Portland, Oregon. He placed me in touch with my counterpart in the Oregon administration. This gentleman is mailing me a copy of their statute and a brief overview of the simplified methodology used by Oregon.

I am troubled by the fact that Alaska is the only remaining state to use the concept of world wide accounting. What do we know that is unknown to all other jurisdictions?

Sincerely,



Lee E. Fisher
Commissioner

LEF:mll
91-43

cc: D. Max Hodel
Chief of Staff

# Alaska State Legislature

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RECYCLED

2. Your Deparment's February 6, 1991 POSITION PAPER is very critical of this legislation. In fact, it states that "... at present we are skeptical and certainly not convinced there is anything to be gained by changing from worldwide to the water's edge." In contrast, before the House Labor and Commerce Committee you testified in support of HB 12. What has transpired to cause the Department to do a complete reversal?

3. In the same PAPER your Department concluded that "... 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...". Is your reversal in position based on some recently concluded study on this issue? If so, please forward a copy to my office.

4. During your confirmation hearing you referenced Bogle & Gates' February 20, 1991, memo as a very good analysis of the Water's Edge issue. Among its many points, this memo advises the legislature to revise the bill to comply with the California Barclays case. In this case the California Court of Appeals found that the worldwide unitary method of taxation, at least as it applies to multinational corporations with foreign parents, unconstitutional. The issue being, states need to move away from worldwide if they are to avoid constitutional problems. If this is the case, would we not also be required to adopt a similar approach for all taxpayers--oil and gas taxpayers included? How could we comply with this advice if we restrict water's edge to non-oil and gas taxpayers, while requiring all multinational oil and gas taxpayers--including those with foreign parents--to file under worldwide apportionment? What are your thoughts and position?

Thank you,

Representative Mike Navarre
MN/rw

ADDRESS OF
SENATOR FRANK H. MURKOWSKI
TO
THE LEGISLATURE OF THE STATE OF ALASKA
March 26, 1991

## NEW WORLD ORDER

I began today by pointing out three major events addressing us in 1991. The first was the war in the Gulf, and the second is the New World Order. President Bush embraced this idea to pull allies together during the Persian Gulf crisis. The new world order also entails multilateral cooperation on economic issues.

Alaska is positioned perfectly to play a key role in the new economic world order. As cooperation and interdependence grow, so will opportunities for Alaskans.

Basic is the need to attract outside capital -- that is the only way to guarantee long-term economic growth. The legislature should discard Alaska's outdated unitary tax system. By attracting capital we will fulfill our potential as a natural jumping-off point for corporations doing business in our part of the world.

# KEIDANREN

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

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Facsimile: 03-3246-2573

March 1, 1991

The Hon. Walter Hickel
Governor of Alaska
P.O. Box A
Juneau, Alaska 99811-0101
U. S. A.

Dear Governor Hickel:

We are very pleased to know that Alaska legislature is now deliberating an amendment of the worldwide unitary taxation in Alaska.

We have opposed the worldwide unitary taxation because it hampers foreign companies' willingness to make investment. I have attached herewith the materials expressing our position including the paper dated September 7, 1988, which was prepared by Keidanren Investment Mission to your state and used for the discussion during their stay there.

We are looking forward to the progress of deliberation in Alaska legislature toward the abolishment of the worldwide unitary taxation, and would appreciate your initiative in encouraging this movement.

Sincerely yours,

Kazuo Nukazawa
Managing Director

Attachment

September 7, 1988

On the Worldwide Unitary Taxation

Keidanren Investment Mission

Alaska is the only remaining state in the U.S. which still maintains the worldwide unitary taxation. Keidanren Investment Mission urges Alaska to abolish its worldwide unitary taxation.

Under the worldwide unitary taxation, all the income of a corporate group is combined and subject to taxation on the basis of the property, payroll and sales of not only the subsidiary concerned, but also the subsidiary's parent company and all other subsidiaries of the parent, regardless of their location.

We oppose the worldwide unitary taxation for the following reasons.

1) It results in taxing the foreign-source income of foreign entities beyond the jurisdiction of the individual state, causing what amounts to double taxation and giving rise to arbitrary application of the tax.

2) It deviates from international customs and practices on taxation based on separate accounting.

3) It requires an inordinate amount of time and cost to translate documents, convert figures, and revise their financial statements to meet complicated requirements for disclosure of information.

We consider that these factors hamper foreign companies' willingness to invest in the state that applies the worldwide unitary method of taxation.

Thus, the existence of the worldwide unitary taxation in the State of Alaska provides the negative image to the general investment climate.

Keidanren Investment Mission is not supposed to be involved in direct business talks, but to report on the state's overall investment climate to its members, consisting of 915 major corporations and 120 leading associations in Japan. The worldwide unitary taxation issue will be an essential part of the mission's report.

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No. 17 March 1984 KKC Brief KEIZAI KOHO CENTER Japan Institute for Social and Economic Affairs

# How U.S. States Can Lose Business Investment

## Keidanren Statement on Worldwide Unitary Taxation

*In February 1984 Keidanren (Japan Federation of Economic Organizations) sent a delegation to the United States to urge abolition of the worldwide unitary method of taxing corporate income that has been adopted by more than 10 states. Under worldwide unitary taxation, all the income of a corporate group is combined and subject to taxation in a state. Stated more specifically, taxation of the income of a subsidiary located in a particular state in the United States is calculated on the basis of the property, payroll, and sales of not only the subsidiary concerned but also the subsidiary's parent company and all other subsidiaries of the parent, regardless of their location. This constitutes the extraterritorial application of law by the local state, and it also results in double taxation. Furthermore, companies are forced to spend an inordinate amount of time and money to translate documents, convert currency figures, and revise their financial statements to meet complicated requirements for disclosure of information.*

*Below is a summary of the position paper distributed in the United States by the Keidanren delegation. Unless states eliminate worldwide unitary taxation, it warns, Japanese companies will channel their investments elsewhere. And if this tax method spreads to other parts of the globe, it will be the United States and its multinational corporations that will be hurt the most.*

We regret that more than 10 states in the United States have adopted the unitary method of taxation to tax the worldwide income of multinational enterprises, because this impedes Japanese investment in the United States just at the time that positive steps by the Japanese business community have been increasing. Worldwide unitary taxation results in taxing the foreign-source income of foreign entities beyond the jurisdiction of the individual state, causing what amounts to double taxation and giving rise to arbitrary application of the tax. It also deviates from international agreements on taxation based on separate accounting.

These factors hamper foreign companies' willingness to invest in those states that apply the worldwide unitary method of taxation. We are concerned that some of our member companies are reconsidering their investments or refraining from investing in states with unitary taxation.

We would like to reiterate President Reagan's statement on international investment, which we fully support: "Both home and host country economies benefit from an open international investment system. . . . The United States welcomes foreign investment and accords foreign investors the same fair, equitable and nondiscriminatory treatment it believes all governments should accord foreign investment."

Keidanren has surveyed its member companies on their experience with the worldwide unitary tax now being implemented in more than 10 U.S. states and has examined the issue in the light of the views stated above. We have concluded that we oppose the worldwide unitary tax for the following reasons.

### Worldwide unitary taxation oversteps the tax jurisdiction of the state and results in double taxation

*Beyond tax jurisdiction*

In practice, the worldwide unitary tax method imposes tax on the foreign-source income of entities residing outside the state and even outside the United States by combining the income of all corporations in the group to which the resident corporation belongs and apportioning it to each geographical area. This constitutes the extraterritorial application of law by the local state, and does not reflect the actual state of transactions. For example, the U.S. subsidiary of a Japanese company usually has nothing to do with the income that the parent company earns from transactions with its subsidiaries located in Southeast Asia or Europe. But under the worldwide unitary taxation system, part of the income earned from such transactions will be apportioned to the state in which the U.S. subsidiary has its domicile, even though the U.S. subsidiary was not involved in earning this income.

We have difficulty understanding why a state has the authority to tax income totally unrelated to that

state, especially when the state in turn provides none of the benefits normally furnished to a taxpaying entity, such as infrastructure and workers' education and training programs. The power to impose taxes derives from the general benefits and protection that a government provides to taxpayers and their property. Where no such benefits exist, the power to tax is not clear. Therefore, a tax authority is empowered to tax only within its proper jurisdiction or territorial boundaries. Tax jurisdictions must be respected, for a government's taxing of income beyond its jurisdiction contradicts international practices and allows unreasonable taxation.

*Inevitable double taxation*

Under the system of separate accounting, corporate group members not doing business in the United States are taxed on the income they earn outside the United States by the local authorities where they are domiciled or doing business. Double taxation is inevitable when the profits of foreign corporations are included in the income earned in a unitary state. Furthermore, bilateral tax treaties cannot relieve such corporations from double taxation, because the federal government has no authority over local taxes.

Corporation A reports, "Even though our U.S. subsidiary operated at a deficit in 1976 and 1977, it was still taxed under the worldwide unitary method. After turning a profit in 1978, its income under the worldwide unitary method was estimated to be 8.4 times higher than its income under the system of separate accounting, and a tax totaling 93 times the amount under the separate accounting system was imposed."

Corporation B states, "Even though we recorded a loss in the 1980 fiscal year, we were assessed tax totaling 294 times the minimum amount."

The sum of the tax burden of Corporation C from 1979 through 1982 by the worldwide unitary method gives the corporation an effective tax rate of 101%, which means that all its profits have been siphoned off by the state.

Corporation D reports, "We were charged penalties amounting to 14 times our tax according to the separate accounting system in fiscal 1981, 42 times in fiscal 1982, and 21 times in fiscal 1983."

Corporation E says, "After several years of paying taxes according to the system of separate accounting, we were suddenly told that our taxes had to be calculated by the worldwide unitary method. Now we must pay additional taxes and interest ranging from 4 to 35 times the tax we paid in previous years."

Corporation F reports, "In 1981 we received notice that we were being assessed for additional taxes as far back as 1969. The interest was so high that we ended up having to pay four to five times the tax amount we had previously paid under the separate accounting system."

The taxable income that serves as the base for calculating the additional tax has already been taxed in Japan, where the parent company is domiciled. For a state to tax the same income again is a clear case of double taxation.

Particularly during the initial period of an investment, the unitary tax method tends to result in double taxation, especially when the local operation is in the red. Corporation G therefore makes it a policy to estimate a higher tax rate than normal when it starts up new projects in states where worldwide unitary taxation has been adopted.

In the case of the Caterpillar Tractor Company, worldwide combined reporting reduced its state taxable income. Such undertaxation, however, does not justify the overtaxation of others. Two wrongs do not make a right.

**Worldwide unitary taxation is impractical**

*Vague concept*

Fair and just taxation is the fundamental principle of modern taxation and is indispensable in obtaining the confidence of taxpayers in the tax system. In this regard, it is important that the procedures for calculating taxable income be set forth clearly. The procedures should also induce in both taxpayers and the authorities a willingness to abide by the system. A tax system that does not have clear procedures and relies on the arbitrary judgment of tax authorities is deficient and inappropriate.

Under the unitary tax method, arbitrary treatment by tax authorities is inevitable because there is no clear definition of a "unitary business." Some states apply a "three unities" test, in which they assess the unities of ownership, use, and operation. Ownership aside, the definitions of "use" and "operation" are very vague.

For instance, Corporation H was judged to be part of a unitary business by mere reason of its holding more than 50% of the stock of a U.S. subsidiary, even though the unities of use and operation were absent. There was no exchange of raw materials or goods between the Japanese parent and the U.S. subsidiary, no centralization of managerial and supervisory functions on the part of the parent, and no financing or loan guarantees provided to the subsidiary by the parent.

In unitary taxation, the total income of a corporate group is generally distributed among the group's member companies giving equal weight to the three factors of property, payroll, and sales. No recognition is given to the fact that these three factors do not carry equal weight in the incomes of many multinational enterprises.

Also, when income is apportioned by these three factors, the higher the level of these factors are, the more income is apportioned to that company. Such levels are higher in the United States than in the developing countries, so states with a worldwide unitary tax are apportioned more income than are the developing countries. But the economic and political risks are much higher in the developing countries than in the United States. Investment will not be made where the risks are great unless the anticipated return is higher than that of an investment in the United States. Apportioning income by the three-factor formula gives no consideration to this fact.

Bank I reports, "Our California subsidiary employs 4,000 people and is contributing to the economic welfare of that state. However, its payroll factor is more than twice as large, and in some years even four times as large, as its sales and property factors. Because of this, its income apportionment is abnormally high."

The more broadly the unitary tax is applied in the economically diverse areas of the world, especially with regard to the value of property, payroll, and sales, the greater will be the negative impact of this irrational and ambiguous method of taxation.

We must also point out that the broader the application of the unitary tax method, the greater the potential for instability of state revenues due to ambiguity. Although the worldwide unitary tax method may enable states to collect income tax from corporations domiciled in the state that have earned no income in a particular year, if the combined income of a unitary business shows a loss, it will result in a tax reduction or refund even if the corporation domiciled in the state turned a profit. This instability of revenue will be greatly compounded as the unitary concept spreads to vastly diverse areas of the world. Our members report that because of this unpredictability, tax authorities tend to implement unitary taxation in an arbitrary manner.

Corporations J and K report that worldwide unitary taxation is applied in some years but not in others. And many other Keidanren member corporations say that they were being taxed only on the combined incomes of the U.S. subsidiary and Japanese parent, but suddenly and without any notification as to which companies were to be considered part of their unitary business, the state tax authorities informed them that they would have to combine the incomes of all affiliated companies.

*Intolerable paperwork and costs*

It is desirable that tax payment procedures be made as simple as possible. Tax methods that require an inordinate amount of expense and effort in relation to the amount of tax to be paid or that are likely to lead to frequent disputes should not be adopted.

The worldwide unitary method of taxation is both troublesome and costly because of its complicated concept of taxation and computation of taxable income. State tax authorities and companies alike have difficulty calculating tax amounts by the correct procedures. As a result, arbitrary judgments by the tax authorities prevail, and taxpayers are forced to carry out costly, time-consuming procedures in order to comply.

"We have to revise financial statements that were prepared in Japan to comply with the U.S. standards of accounting and tax code," complains Corporation J. "In addition, we also have to explain in detail in English the differences between the Japanese and U.S. accounting methods. This is an enormous task." Corporation A adds, "Individual adjustments in the values of property and sales also create a lot of work."

Corporation L says, "It takes time to collect information from foreign subsidiaries outside the United States in order to comply with the worldwide unitary method of taxation. Adjusting special allowances and depreciation allowances so that they comply with U.S. accounting standards is extremely time-consuming."

Bank I reports, "The California state tax authorities told us that we had to calculate the amounts in the bad-debt reserves of the parent bank and affiliated banks by the California method. The paperwork, which involved going back a number of years and computing these amounts, was tremendous."

When state tax authorities unilaterally decide that foreign-source income should be included in taxable income, it is the companies that are responsible for providing any evidence to the contrary. However, it is impossible for companies to provide such evidence because of all the effort and money that must be put into deciding which companies are part of the unitary business, computing taxable income, and apportioning worldwide income. This is especially true for such multinationals as trading companies, which have numerous subsidiaries all over the world.

Corporations E and L report, "Even though we object to unitary taxation, arguing with the tax authorities would only cost us more. Instead, we get our tax reduced by negotiating with them." A number of companies also report that when the rate of penalty was raised, they paid the additional tax assessed, but registered a protest so that they will be able to claim a refund if their claim is upheld.

**Worldwide taxation is detrimental to the sound development of capital exchange**

*Negative impact on investment*

It is desirable that taxation have as neutral an effect as possible on corporate decisions where the

worldwide unitary tax is being enforced. However, the managements of corporations domiciled in unitary states are caught in a dilemma of being unable to estimate their taxes or formulate a business strategy because the connection between their business performance and the amount of tax they must pay has been severed. Moreover, if the tax authorities arbitrarily change the tax calculation method, the willingness of corporations to invest will be severely hampered. Japanese companies are in fact becoming reluctant to invest in states that have adopted the worldwide unitary tax method.

According to Corporation C, "No state is 'safe' to invest in, because the worldwide unitary tax can be adopted so readily."

Corporation F reports, "We decided not to invest in California because it has a worldwide unitary tax, and set up operations in Alabama instead."

Corporation M says, "We had been considering investing in Oregon, but dropped it in favor of North Carolina."

Corporation N is considering pulling out of California.

Corporations F and J report, "We would like to expand our facilities in California, where we already have a factory, but we probably will not."

Corporation A says, "We place top priority on investing in those states that do not apply the worldwide unitary method of taxation."

Corporation D says, "In the future we will have to rethink our investment strategy because more than ten states have been applying the worldwide unitary tax."

Corporation O says, "We have been audited in the past, but we were never notified that we would be taxed on a worldwide unitary base. However, we are concerned about the possibility of being taxed unreasonably by the worldwide unitary method, so from now on we will consider new investments only in nonunitary states."

Corporation P asserts, "We are not making new investments in states that have been applying the unitary method of taxation."

Many Keidanren member companies regard the worldwide unitary method of taxation as a negative factor in deciding where to make their future investments.

*Confusion in the international tax system*

Because nations have grown more economically interdependent and international transactions have rapidly increased, it is necessary that efforts be made to harmonize nations' tax methods. The United States and other OECD member countries have worked hard toward this goal, the result being the establishment of an internationally accepted system. Tax treaties based on this system have been concluded among OECD nations to avoid taxing the same income twice in the recognition that double taxation has the effect of distorting the flow of goods, services, and investments. Such efforts have contributed greatly to the expansion and development of the world economy.

Under these circumstances, it is most regrettable that a concept of taxation that differs so greatly from internationally accepted principles and discourages the further expansion of trade and investment is being applied in the United States, a nation that should be the main pillar of the free economic system. Worldwide unitary taxation not only brings to naught the efforts that nations have persistently devoted to the important issue of eliminating double taxation. If developing nations follow suit in implementing worldwide unitary taxation, the framework of international taxation that has been built up so far will collapse, and the development of international trade and investment will come to a complete halt with the ensuing scramble to collect as much tax as possible. If this should happen, the United States, which has more multinationals than any other country, would suffer the most damage.

KEIDANREN (Japan Federation of Economic Organizations) is a private nonprofit economic organization representing all branches of economic activity in Japan. While maintaining close contact with economic sectors at home and abroad, Keidanren endeavors not only to find practical solutions to economic problems but also to contribute to the sound development of the economies of Japan and other countries around the world. As of January [illegible], 1984, Keidanren's membership numbered 117 associations and [illegible] corporations. The association members include trade associations and regional economic organizations. The corporate members are leading Japanese enterprises and foreign companies operating in Japan.

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KEIZAI KOHO CENTER (Japan Institute for Social and Economic Affairs) is a private nonprofit organization that works in cooperation with Keidanren to provide information on the Japanese economy.
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21644-01012

February 20, 1991

The Honorable David Finkelstein
House of Representatives
P. O. Box V
Juneau, Alaska 99811

Re: **Proposed Water's Edge Tax Legislation (HB12)**

Dear Mr. Finkelstein:

At the request of Mr. David Harlow, General Reporter of the Commission on Taxation of the International Chamber of Commerce, we send to you the attached final policy statement of the Commission on Taxation with respect to proposed water's edge tax legislation in Alaska.

As you will see from the attached policy statement, the International Chamber of Commerce strongly urges the Alaska State Legislature to enact legislation changing the State's method of corporate income taxation from a "worldwide unitary" method to a "water's edge" method of taxation. Representative Tom Moyer has already introduced a bill to enact the change. The bill, HB12, is essentially the same as the Senate Finance Committee substitute bill for SB119 from the last legislative session.

Since the close of the last session, an important court decision was issued by the California Court of Appeal, Barclays Bank of California vs. Franchise Tax Board, Court of Appeal, Third District (Nov. 30, 1990). In Barclays, the court found that the worldwide unitary method of taxation, at least insofar as it applies to multinational corporations with foreign parents, is unconstitutional under the foreign commerce clause of the United States Constitution. It is believed that the Barclays opinion, because of its reasoning, will have strong influence in any U.S. federal or state court that addresses the issue. With minor revisions designed primarily toward complying with the holding in Barclays, the International Chamber of Commerce endorses the enactment of legislation similar to HB12 in Alaska.

Mr. David Harlow, in his capacity as an officer of the International Chamber of Commerce, will be making a special trip to Juneau from his office in London to deal with this important matter. Mr. Harlow will be available during March 11 through 15 to meet with members of the legislature and the administration to discuss the importance of enacting a water's edge method of taxation.

Should you have any questions concerning this matter prior to Mr. Harlow's visit, feel free to contact the undersigned.

Very truly yours,

BOGLE & GATES

Brian W. Durrell

Enclosure(s)

cc: David Harlow

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Policy and Programme Department
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COMMISSION ON TAXATION

**PROPOSED WATER'S EDGE LEGISLATION IN ALASKA**

*Statement on Unitary Taxation*

1. The International Chamber of Commerce (ICC) is an international organisation representing the business community worldwide. With 7,000 members comprised of companies and business associations in more than 100 countries, the ICC works to promote the principles of a free market economy, and a fair and open system of international trade and investment.

2. The ICC has over many years consistently opposed the use of worldwide unitary method of taxation ("worldwide unitary"). Worldwide unitary conflicts with the established principles of taxation as practised federally and internationally and acts as an impediment to the free flow of international trade and investment. The ICC has long advocated its removal and, in its place, the secure provision for international business of the unconditional right to be taxed by the States in accordance with internationally accepted principles, as is the case for federal purposes.

3. The US Treasury Secretary (at the time James A. Baker III) wrote to the Chairman of the US Senate Finance Committee (at the time The Honourable Bob Packwood) on 5th March 1986 in connection with proposed Federal legislation in this area. The body of the letter is attached as an Appendix to this statement. There have been some changes in the law and the position of individual States since the letter was written.

   The ICC has previously endorsed the strong condemnation of the use of worldwide unitary in Part II of the letter.

4. In the view of the ICC, a satisfactory, universal and lasting solution is only likely to be found through federal legislation. Even so the ICC seeks to encourage States to introduce 'water's edge legislation' (taxing multinationals only on income derived from the territory of the United States). Such legislation should not reach out beyond the United States to tax companies, by the use of worldwide unitary, on income earned outside the United States by them or by non-US companies in the same affiliated group.

5. Whilst the fact that California has clearly recognised the strength of the case against

In particular:

(1) It does not grant an unconditional right to be taxed on the water's edge basis. Instead it makes the right to elect water's edge subject to a number of undertakings and conditions.

Most seriously, the water's edge basis is only available to a company which contracts with the State for a five year period, on an evergreen basis, to pay an annual fee calculated as a percentage of its California payroll, property and sales.

(2) The State retains the power, in a range of circumstances in which normally a financial penalty would be the appropriate sanction (and in which indeed the State does in addition impose the customary financial penalties), to disregard a company's water's edge election with retroactive effect and to subject it mandatorily to worldwide unitary.

The protection afforded by the Californian legislation is thus hedged about the conditions and uncertainty. The door is left open to the mandatory reimposition of worldwide unitary. Further, payment (the annual fee) is demanded as the price for being taxed on a basis consistent with that practised federally and internationally, rather than on a basis (worldwide unitary) which has been so widely and powerfully condemned by the federal government, by the major trading partners of the US and by international business, both US and foreign, for the reasons already mentioned.

The ICC would discourage Alaska from legislating on the Californian model.

6. The ICC urges that the boundary in water's edge legislation be drawn so as to exclude foreign corporations whose nexus with the United States is slender, or even non-existent. Instead the water's edge boundary should be drawn on a basis compatible with the permanent establishment approach, thus clearly confining the State's taxing powers to income derived from the territory of the United States. This would put the foreign investor at the State level on the same basis as that already existing at the Federal level.

7. ICC notes the unanimous decision of the Californian Court of Appeal of November 1990 holding that California's unitary tax method of worldwide combined reporting as applied to foreign-based unitary groups, is unconstitutional under the foreign commerce clause of the United States Constitution and finds it difficult to distinguish the position in Alaska from that in California.

8. In concluding, the ICC warmly welcomes the positive initiative which has been taken in Alaska by the introduction of SB119 followed, in substitution, by the Senate Finance Committee Substitute Bill. It hopes that the Alaskan legislature will be able to resolve the worldwide unitary problem for the foreign investor in Alaska during the forthcoming session.

********

## APPENDIX

### I. Description of Current State Corpororate Income Tax Practice

When a corporation (or related group of corporations) operates across state or national boundaries, competing tax claims of the jurisdictions in which the corporate group operates are resolved by identifying the income attributable to each jurisdiction. Two different taxation methods are in use for making this determination: separate accounting and worldwide unitary combination.

Separate accounting is the method of taxation in use generally throughout the world and is employed by the federal government. Under separate accounting, taxable income is determined separately for each individual corporation. Any improper income or profit shifting between related corporations for tax avoidance purposes is corrected by requiring "arm's length" pricing in related party transactions. That is, flows of goods and services between related or commonly-owned corporations are required to be valued at prices corresponding to those that would govern transactions between unrelated entities operating at arm's length. Under the separate accounting method, double taxation between jurisdictions is relieved either through exemption from tax by the residence jurisdiction (usually the place of incorporation or management control) of income derived in the source jurisdiction (the place the income is earned), or by the residence jurisdiction granting a credit for taxes paid to the source jurisdiction. The United States federal tax law used the latter approach.

The alternative method, worldwide unitary combination, is currently used by seven states (Alaska, California, Idaho, Montana, New Hampshire, North Dakota, and Utah) to determine a multinational enterprise's state corporate tax liability. Under this approach, the business income of all individual companies in the commonly controlled enterprise which operate in the same general line of business (the "unitary business") as the corporation or corporations subject to the state's taxing jurisdiction is aggregated, regardless of (i) whether the other individual companies are foreign or domestic; (ii) whether the other individual companies have a tax nexus with or presence in the state in question; and (iii) whether the income of the other individual companies would be treated as derived from foreign or domestic sources under federal tax rules or generally accepted international taxation principles. A share of the aggregated income of the worldwide unitary group is then assigned or apportioned to the taxing state on the basis of a formula which is intended to measure how much of the activity of the unitary business (and hence its income) is attributable to the taxing jurisdiction.

The apportionment formula generally used is based on relative amounts of payroll, property, and sales. If, for example, 25 percent of the payroll, property, and sales of the unitary group is located in the taxing jurisdiction, then 25 percent of the group's aggragate income from the unitary business

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would be apportioned to that state. Because the apportionment formula is considered to assign the appropriate amount of income to a particular state, no further measures are taken to relieve any multiple taxation of the same income which may arise from the use of different income sourcing rules by other taxing jurisdictions.

Under the worldwide unitary method, dividends paid by one corporation to another within the unitary business group are eliminated as intercorporate transfers. Under separate accounting, in contrast, intercorporate dividends are recognised explicitly as a flow of income from the dividend-paying corporation to the dividend-receiving corporation. A "water's edge" limitation on the unitary method, i.e., excluding foreign corporations, would respect the separate entity status of related domestic and foreign corporations. It therefore gives rise to the question of how dividends received by a U.S. corporation that is a member of a "water's edge" unitary group from a foreign corporation that is not a member of the "water's edge" group should be treated for state tax purposes. The question of state taxation of foreign-source dividends is thus inextricably linked to the issue of worldwide unitary taxation and, as described below, is therefore addressed in the proposed legislation.

Under present law, state taxation of intercorporate dividends, foreign and domestic, exhibits a range of practice. Though dividends from a domestic corporation income tax, most of these states also grant a dividends-received deduction, frequently the 85 percent or 100 percent deduction allowed under federal law. As at the federal level, the effect of this treatment is largely to exempt dividends paid by a domestic corporation from state corporate income taxation. Dividends received from a foreign corporation are subject to varying treatment, ranging from full allocation (and thus taxation) to the recipient's commercial domicile, to apportionment, to either full or partial exemption. Unlike the federal government, no state alleviates international double taxation of foreign dividends by allowing a foreign tax credit.

## II. Reasons for Administration Opposition to Worldwide Unitary Taxation

It has been the longstanding policy of the United States to favor the separate accounting method for allocating income among nations for purposes of taxation. This policy is embodied in the Internal Revenue Code and is a central feature in our bilateral tax treaties. Separate accounting is also the international standard. The model tax treaties published by the Organisation for Economic Cooperation and Development ("OECD") and the United Nations ("UN") specify that transnational income is to be taxed on a separate accounting basis. Thus, continued state worldwide unitary taxation is directly in conflict with federal and internationally accepted practice and impedes the ability of the federal government to pursue this policy in its international dealings.

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During the debate over worldwide unitary taxation, foreign governments have repeatedly petitioned the federal government to act to curb state use of the worldwide unitary method. Diplomatic notes articulating the problems caused by state worldwide unitary taxation have been received from virtually every developed country in the world, including Canada, the United Kingdom, Germany, France, Belgium, the Netherlands, Italy, Switzerland, Japan, and Australia. The United Kingdom, in July, 1985, adopted anti-unitary retaliatory legislation that would permit the U.K. government to effectively increase the U.K. tax on dividend distributions from U.K. subsidiaries to their U.S. parent corporations operating in worldwide unitary states. If implemented, this legislation would clearly violate the U.S.-U.K. bilateral income tax treaty. This legislation, by virtue of a provision which makes possible the retroactive imposition of heavy penalties, was having an adverse effect on the willingness of U.S. companies to repatriate earnings of their U.K. subsidiaries to the United States. (The U.K. has now agreed to defer implementation of this legislation for the time being.) The adoption of this legislation by the U.K. illustrates that state worldwide unitary taxation is clearly adversely affecting the United States' foreign economic relations.

Foreign governments and businesses that are subject to worldwide unitary taxation argue that this method of computing state tax gives rise to double taxation of foreign income. They also contend that worldwide unitary taxation is administratively burdensome, particularly for foreign owned companies. These results are inevitable as long as a few states rely on a method of measuring income that is different from the approach used by the rest of the world.

Theoretically, if all jurisdictions, domestic and foreign, were to adopt a uniform unitary method of taxation, and apply it consistently, there would be no double taxation as the formula would not apportion the same income to more than one jurisdiction. The problem, however, arises from the fact that combined reporting on a worldwide unitary basis is a distinctly minority practice. In an environment in which separate accounting is the generally accepted rule, state taxation on a worldwide unitary basis creates a clear risk of double taxation. Because labor costs, property values, and profitability can vary greatly among countries, an income measurement system based on formula apportionment is in open conflict with the international standard of separate accounting. This is because formula apportionment assumes all parts of a unitary business are equally profitable whereas separate accounting acknowledges that individual corporations can earn different rates of return. Double taxation will result if the relative profitability of the investment in the unitary tax state is less than that of the affiliated overseas operations that are taxed abroad on a separate accounting basis.

State use of the worldwide unitary method also creates administrative burdens for taxpayers. There are substantial costs associated with collecting and converting accounting data generated by the various foreign affiliates of the unitary group to a form consistent with U.S. standards. These burdens can be particularly acute for foreign-owned companies which are not required to keep data under U.S. tax and financial accounting rules on their non-U.S. operations for any other purpose.

The use of the worldwide unitary method by some states may also inhibit and distort the international flow of investment capital. In the words of one foreign government, "the (unitary tax) method can chill international investment and decrease efficient allocation of resources and employment opportunities. In particular, the unitary method can impede foreign entry into the United States market." Consequently, according to a group of foreign governments, worldwide unitary tax constitutes "... a serious obstacle to the further development of our trade and investment relationships." (Note signed by the Ambassadors of fourteen of our major trading partners). The United States is strongly committee to encouraging the free movement of international direct investment capital across national boundaries. State use of the worldwide unitary method is unacceptable because it can adversely affect this clearly articulated federal policy. The United States, as the country hosting the largest amount of foreign direct investment, has gained enormously from the inflow of foreign investment. If the use by some of our states of the worldwide unitary method inhibits the flow of capital, the economic well-being of the country as a whole would suffer. Some states may be in a position in which their use of the unitary method causes foreign investors to turn away from the United States altogether (rather than shift investments to other U.S. states).

In September 1983, in response to complaints raised by both the U.S. and foreign business community and foreign governments over the Supreme Court decision in Container Corp. v. Franchise Tax Board, President Reagan asked then Treasury Secretary Donald Regan to establish and chair a Worldwide Unitary Taxation Working Group. This group was composed of representatives of the federal government, state governments, and the business community and was asked to provide recommendations suitable for resolving the issues raised by worldwide unitary taxation.

At its final meeting on May 1, 1984, the Worldwide Unitary Taxation Working Group agreed on three principles that should guide state taxation of the income of multinational corporations:

Principle 1: "Water's edge" unitary combination for both U.S. - and foreign-based companies.

Principle 2: Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability.

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Principle 3: Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses.

While the first and third principles were to be adopted voluntarily on a state-by-state basis, Principle 1, in particular, represented a clear recognition by the Working Group that the separate accounting method was superior to the worldwide unitary method in the international context. The Administration was very hopeful that the state would be able to resolve the worldwide unitary problem along the lines advocated by the Working Group on a voluntary basis without resort to federal legislative intervention.

Since the adoption of the Working Group Report some states have changed their laws to conform to the Working Group principles. Florida, Colorado, Indiana and Oregon have ceased taxing on a worldwide unitary basis. A Massachusetts court decision imposed limitations on that state's use of the worldwide unitary method and the state legislature has to date refrained from taking any action that would permit application of that method in the face of the judicial decision. However, seven other states continue to use the worldwide unitary method. In particular, efforts in California to enact legislation limiting worldwide unitary taxation have foundered in the past two legislative sessions, most recently when the California legislature adjourned for the year in September, 1985 without taking action on the issue.

In transmitting the report of the Working Group to the President, Secretary Regan indicated that he would recommend restrictive federal legislation if substantial voluntary progress had not been made on the worldwide unitary issue at the state level by July 31, 1985. That date has long since passed. We now believe that the time has come for Congress to act to finally resolve this serious international economic problem.

## III. State Taxation of Foreign-Source Dividends

The taxation of foreign-source dividends is directly related to the issue of worldwide unitary taxation. A limited resolution of the worldwide unitary issue - such as an agreement by states not to impose worldwide unitary tax but with no restriction on the taxation of foreign-source intercorporate dividends - would cause other serious problems. In effect, this would be a "foreign only" situation, freeing foreign-owned multinationals from the yoke of worldwide unitary taxation while subjecting U.S. based multinationals to full taxation on their foreign dividend income. Such a "foreign only" solution, if adopted, would disadvantage domestically controlled businesses. The Working Group's third principle recognises the need for competitive balance for domestic multinationals, foreign multinationals, and purely domestic businesses. That principle requires that legislation restricting state unitary taxation also address the question of equitable state taxation of foreign-source dividends. Unrelieved state taxation of foreign dividends is not consistent with Principle 3.

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Unrestricted state taxation of foreign dividends would subject domestic businesses to serious double taxation of foreign income. Federal tax policy has long been characterised by its commitment to avoid international double taxation. Indeed, the United States has been a leader in a worldwide effort to establish taxing rules under treaties and commonly accepted principles that minimise international double taxation. If a clear federal policy is not to be undercut by state action, states must comply with this policy of eliminating double taxation and therefore be limited to taxing some equitable portion of foreign source dividends.

The legislation does not mandate that any specific method of dividend taxation be imposed on the states. In our view, arguments of state fiscal sovereignty strongly indicate that states should have leeway to tailor their own systems of taxation to the extent that they do not cause serious foreign commerce difficulties by resulting in systematic overtaxation and double taxation of U.S. business in contravention of established federal and international policy. The legislation therefore provides in broad terms for the equitable taxation of dividends and suggests certain guidelines that states could follow in satisfying that standard. As an illustration of the flexibility of the approach, the legislation would accept as appropriate the treatment of dividends in such states as Colorado, Oregon, Florida and Illinois, states which have been intimately involved in the worldwide unitary tax controversy.

IV. Information Reporting and Other Federal Assistance

States have legitimately contended in the Working Group and elsewhere that they lack the resources and ability to monitor adequately transactions between members of a water's edge unitary group and related foreign companies outside that group. The Treasury Department agreed with recommendations of the Working Group to provide appropriate federal assistance to the states in order to assure proper working of the separate accounting method. The Working Group suggested that an annual information return be filed with the Internal Revenue Service by multinational companies. This return would in turn be shared with the states and with multistate audit agencies and would provide states with some assurance that corporations had allocated and apportioned the appropriate share of the corporation's income to each state. The report would also identify those related companies with which serious income shifting would be most likely to arise. In the summer of 1985, the Treasury Department published for comment a draft of legislation implementing this reporting system. Section 3 of the bill is based upon that draft after taking into account the many comments received from affected businesses and the various states. We believe that the information reporting system provided for in the bill is an integral part of the solution to the worldwide unitary problem.

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In order to provide states with greater assistance the Treasury Department also indicated in the Working Group an intention to increase the resources devoted to the IRS's administration of tax laws applicable to foreign operations of multinational companies. I urge your assistance in approving the increased budget appropriations that are being requested for this purpose.

*Will it attract foreign investment?*

# Changes in Alaska's "unitary" tax: Pro and con

Legislation changing Alaska's "unitary" corporate income tax to allow domestic and foreign corporations to use "water's edge" accounting for state income taxes is now in House Labor and Commerce, having passed earlier from its initial committee, House International Trade and Tourism. HB-12, sponsored by Rep. Tom Moyer of Fairbanks, is being pushed mainly to enhance foreign investment in Alaska by removing what many see is a disincentive in the state corporate income tax, although the tax advantages incurred would be shared with domestic U.S. as well as foreign corporation. The bill passed the Senate last year, but failed in the House. Essentially, the bill permits multinational U.S. corporations or foreign-owned U.S. subsidiaries, except oil and gas producers, to pay their Alaska income tax based on a pool of income earned in the U.S. (with tax jurisdiction stopping at 'water's edge.') Under current Alaska law, domestic and foreign-owned corporations must use their world-wide income as a base for income taxes. Many states once had state income tax laws similar to Alaska's, but have repealed them at the urging of foreign companies looking to invest in the U.S. Alaska is the last state requiring income tax to be based on worldwide income.

## *Unitary tax was a big problem in states like California*

This was a much more serious problem in states like California, where hundreds of foreign firms have domestic operations. In Alaska, for foreign companies doing business in the state, the issue seems to involve both principle and practicality. As for principle, foreign corporations just don't like the prospect of state auditors poking through their worldwide books. For practicality, the sheer cost of compliance — translating Japanese into U.S. accounting standards, for example — often exceeds the amount of income tax due the State of Alaska, some Japanese firms have complained. As it was originally introduced last year, the bill to allow use of 'water's edge' accounting would have applied only to foreign-owned companies. Domestic corporations would have still been required to use world-wide income. That was changed in Senate Finance Committee last year, so that both U.S. and foreign corporations can base their Alaska tax on U.S. income. HB-12, as it was introduced this year, is similar to the bill that passed the Senate last year.

While it is being sold as a bill that will encourage foreign investment in Alaska (by removing the disincentive of requiring world-wide income reporting) the bill will reduce state corporate income taxes by an estimated $1 to $3 million, the Department of Revenue estimates. *Proponents of HB-12 in its expanded form argue the small revenue loss will be more than offset by new foreign investment, jobs and taxes paid to the state treasury.* But some critics doubt that: Alaska is in a different league, they say, than states like California, Oregon or Washington, who compete with each other for foreign investment, mainly in manufacturing. Foreign firms come to Alaska mainly for natural resources, the presence of which weigh more heavily in the investment decision than the unitary tax.

## *Is discriminatory effect a constitutional issue?*

Another potential problem is a constitutional one. Oil companies are not being allowed to use 'water's edge' accounting, under the bill. Alaska's supreme court, in the ARCO "separate accounting" decision, approved use of a different formula (separate accounting vs. the traditional 'appotionment' method) for a different class of taxpayers, like oil producers, under special circumstances. But discriminating among taxpayers required to use the same formula (oil and non-oil companies now use apportionment) could run afoul of the constitution, some people argue. *One feature that troubles Dept. of Revenue, which in the end will support the bill, is the exclusion of 80 percent of dividends earned by a foreign subsidiary of the U.S. company, or of 80 percent of any royalty earned by an overseas franchisee. That leaves 20 percent of dividends and royalties to be included in U.S. taxable income.* Revenue feels there's no basis for the 80-20 split, and that the share of foreign dividends or royalties including in the U.S. pool of income could be larger than 20 percent.