

ALASKA LEGISLATURE COMMITTEE FILES 1991-1992 8672
7217 HOUSE RULES

DIVISION OF LEGAL SERVICES

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MEMORANDUM

February 13, 1991

SUBJECT: House Bill 12, relating to the water's edge
method of calculating taxes

TO: Representative Tom Moyer, Chair
House Special Committee on International
Trade and Tourism

FROM: Jack Chenoweth
Legislative Counsel 

This is by way of response to several comments and questions made during the course of Monday's testimony on House Bill 12.

I

Representative Robin Taylor and Carl Meyer, speaking for the Department of Revenue, raised the possibility that the legislation is unconstitutional. Their comments about the constitutional implications of the measure went to whether proposed AS 43.20.073(f), exempting from the proposed water's edge modifications the income taxes imposed on oil and gas producers and pipeline transporters, would pass muster when examined against the equal protection clauses of the Alaska and federal constitutions.

I am satisfied that the Alaska Supreme Court's decision in Atlantic Richfield Company v. State, 705 P.2d 418 (Alaska 1985), cited by Susan Burke in her testimony, puts their concerns to rest. In that decision, the court upheld the separate accounting method of the oil and gas corporation income tax (imposed, until 1982, by AS 43.21) against a constitutional challenge on various grounds. The tax, you may recall, substituted a different methodology, separate accounting, for the formula apportionment method then generally in place to ascertain the taxable income of production and pipeline transportation companies for the period 1978-1981. Against the taxpayers' assertions to the contrary, the court specifically found that the tax did not violate state and federal equal protection.

The court's analysis under state equal protection involved a three-step process:

First, in order to ascertain the appropriate level of review, the nature of the constitutional interest affected must be identified. Next, the validity of the statutes' purpose must be analyzed in light of the interest impinged. Lastly, the means chosen must be examined, also in light of the interest, to insure that they are sufficiently related to the goals of the statute.

Atlantic Richfield, at 437 (citations omitted). Examining the constitutional interest affected, the court declared that the taxpayers' asserted right to be free of "disparate taxation" was to be found at the low end of the continuum of interests deserving of the guarantees of equal protection. As to the Oil and Gas Tax statutes' purpose, the court found evidence that the legislature had passed the measure "to rectify a perceived underestimation of oil production and pipeline transportation income that occurred with the application of the apportionment formula." Id. The differential treatment of the oil companies, the court said, was an attempt "to prevent disparate treatment," and the court determined that the corrective effort embodied in the Oil and Gas Tax served a valid purpose. Id. On the final point, the relationship between the means chosen and the goals of the legislation, the court found the necessary correlation, noting that the choice of a different method of taxation "more fairly represented the extent of the business activities of the oil companies in Alaska." Id.

Under the court's federal equal protection analysis, it declared that the imposition of the tax affected no fundamental interest nor did it contain a suspect classification. Absent these factors, federal equal protection analysis requires only that the tax distinction shall have been rationally related to a legitimate state interest. The court then observed:

The rational basis standard is particularly easy to meet in the area of taxation. The United States Supreme Court has stated that "[l]egislatures have especially broad latitude in creating classifications and distinctions in tax statutes." Regan v. Taxation with Representation of Washington, 461 U.S. 540, 547, 103 S.Ct. 1997, 2002, 76 L.Ed.2d 128, 138 (1983). [Alaska's] Oil Tax clearly bore a rational relationship to the state's goal of correcting a perceived inequity in the tax structure.

Atlantic Richfield, at 437.

Would HB 12, establishing a water's edge method of taxation but incorporating an exception or exclusion for oil and gas producers and pipeline transporters, survive similar analysis?

Representative Tom Moyer

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It is uncontroverted that Alaska is the only state that continues to levy a worldwide combined tax under which all the income of a corporation is combined and taxed, regardless of the location of the taxpayer's affiliates. Perceived inequity in the tax structure--in this case, the perception expressed to legislators by foreign companies, particularly, to the effect the state's current worldwide combined tax method overreaches and discourages foreign investment in the state--is, like the separate accounting initiative of the Oil and Gas Tax of a decade ago, a principal motivating factor underlying HB 12.

Under state equal protection analysis of the proposed tax and its exemption or exclusion, the court would examine (1) the importance of the right involved, (2) the validity of the exemption's purpose, and (3) the relationship between the means chosen and the objectives of the proposed statute.

First, as it did in Atlantic Richfield, I assume that the court would readily find that the water's edge exception or exclusion for certain producers and pipeline transporters--the inability of these taxpayers to use the water's edge method--would fall at the low end of the spectrum of interests for which the state's equal rights clause provides protection.

Justification of the validity of the exemption's purpose is relatively more difficult, albeit possible. First, unlike the circumstances underlying the challenge to the Oil and Gas Tax discussed in Atlantic Richfield, perceived underestimates of taxpayer income do not motivate this proposed tax change. Rather, the committee heard from Ms. Burke, Ron Garzini, and Scott Hawkins, among others, about the need to diversify the state's economic and revenue base away from its heavy dependency on exploration for and production of crude oil. The witnesses have all suggested that the legislature ought to establish a climate more conducive to foreign investment in the state's other resources. As I understand the measure's purpose, you and your committee are seeking to amend state tax policy in an attempt to find a balance between attracting additional foreign investment by eliminating what has been identified as a principal obstacle to encouraging foreign corporations to do business in the state--the state's worldwide combined method of taxation--without risking a substantial loss of revenue from the state's major revenue source, the income tax paid by the oil and gas producers, at a time when state finances should be stabilized. Moreover, while the water's edge initiative is an attempt to remove what you perceive as a major barrier to entry of foreign investment into the state particular for, especially, the development of renewable resources, there is no evidence to suggest to you and the committee that the exploration and production of oil and gas in place or its transportation to ports and markets is significantly limited by the state's continued reliance on the worldwide combined method. In short, you and the committee are apparently satisfied that current tax policy may be a real barrier to entry of new capital and methods that might expand interest in recovery and development of many state resources, but the continued levy and collection of the

income tax on oil and gas producers using the worldwide combined tax method has not discouraged--does not seem to be a factor to discourage--continued exploration and development activity by that industry.

The third point--the relationship between the choice of method and the objectives of the statute--is eminently defensible: in recent years, the water's edge approach has been the preferred method of tax modification put in place by states to diminish the broad administrative reach of the worldwide unitary tax system previously imposed, and is more nearly consistent with federal efforts to encourage the states to shift toward a separate accounting approach to taxation of international activities.

Clearly, the exemption of the proposed water's edge levy of the taxable activities of certain oil and gas producers and pipeline transporters that would meet the requirements of state equal protection would also meet the rational basis test of federal equal protection analysis set out in *Atlantic Richfield*.

For these reasons, it is, in my judgment, more likely than not that the measure proposed--incorporating as it does an exclusion for oil and gas producers and pipeline transporters--would be found to meet the tests of equal protection.

II

The Department of Revenue's representative questioned the inclusion of proposed AS 43.20.073(b), excluding, for purposes of water's edge computation, 80 percent of the dividend and royalty income received by the taxpayer's foreign affiliates. In other words, 20 percent of the taxpayer's dividend and royalty income from its foreign subsidiaries is taxable. As I understand, the department suggests elimination of the provision, thereby making all dividend and royalty income from the taxpayer's foreign operations subject to taxation under water's edge.

The portion of my December analysis discussing proposed AS 43.20.073(b) sets out the rationale for inclusion of the provision. Its retention or elimination--and the determination of the actual amount of the exclusion--is a policy call, but as I understand, elimination or substantial reduction of the percentage excluded may raise a question as to whether the state has provided even-handed treatment as between foreign-based and domestic-based multinationals subject to the tax.

III

The representative of the Department of Revenue suggested that the bill should give attention to any affected provisions of the Multistate Tax Compact, AS 43.19, to which the state is a party.

The text of the Multistate Tax Compact is set out in AS 43.19.010. Paragraph 18 of article IV of the compact provides:

If the allocation and apportionment provisions of this Article do not fairly represent the extent of the taxpayer's business activity in the state, . . . the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (a) separate accounting;
- (b) the exclusion of any [one] or more of the factors;
- (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
- (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

What the "tax administrator" may require, so, too, it seems to me, may the legislature by law. Consequently, this paragraph, in my view, provides sufficient authority for the state to make any adjustments to its taxation practices consistent with the compact without the necessity of cross-referencing the provisions of the compact into the substantive change and without the necessity of amending the compact (AS 43.19) to incorporate specific exceptions.

IV

Finally, the department's representative raised a question about the computation and application of the three-factor formula set out in proposed AS 43.20.073(a) at p. 1, line 13-p. 2, line 1, and at p. 2, line 10. Mr. Meyer was uncertain whether each of the three factors--property, payroll, and sales--determined under the affiliated corporation's tax return needed to meet the threshold 20 percent or whether the threshold would be satisfied by an average of the three factors.

The measure contemplates an averaging of the factors. In both instances, at the lines cited, the threshold speaks in terms of the "factors . . . average." I see no uncertainty on the point. If the department believes clarification is necessary for proper administration of the tax provision, the committee should ask the department to prepare and submit suggested language.

If the committee considers an amendment or committee substitute, I would ask consideration of one additional provision.

As was mentioned in Monday's hearing, proposed AS 43.20.073(e) establishes a "default" or "penalty" imposable against a taxpayer who files a water's edge return but

Representative Tom Moyer
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who fails to file necessary supporting information. The commissioner may require the taxpayer who fails to provide the information to "file a worldwide combined report." See page 3, line 4. Nowhere else in AS 43 do the statutes refer to "worldwide combined report." For clarity, then, the committee should consider changing the reference to "a report under AS 43.20.065 - 43.20.072 made without regard to this section" or, alternatively, add a definition of "worldwide combined report" to the short list of definitions set out in subsection (g).

*

I trust this is responsive on the points requested.

JBC:pl
91-077.plm



ALASKA MINERS ASSOCIATION, INC.

501 W. Northern Lights Blvd., Suite 203, Anchorage, Alaska 99503 FAX: (907) 278-7997 Telephone: (907) 276-0347

February 8, 1991

Representative Tom Moyer
P.O. Box V Mailstop 3100
Juneau, AK 99811

RE: HB 12 Unitary Tax

Dear Representative Moyer:

We have reviewed HB 12 regarding Unitary Tax and we support passage of this bill.

The Alaska Miners Association has supported the intent of this bill in past years including Senate Bill 119 in the previous legislature which passed in the Senate on a vote of 14 to 5.

We feel that this bill will help to remove some of the roadblocks that discourage investment in Alaska. This bill will provide an encouragement to both domestic and foreign corporations to locate in Alaska. This will in turn help to diversify our economic base.

Sincerely,

Steven C. Borell, P.E.
Executive Director

Xerox Corporation
4241 B Street
Anchorage, Alaska 99503
(907) 561-8200

February 7, 1991

XEROX

Honorable Tom Moyer
Representative
Alaska State Legislature
Juneau, Alaska 99801

Dear Mr. Moyer:

The Xerox Corporation supports increased business investment in the state. Accordingly, House Bill 12 applied equally to both domestic and foreign corporations should make Alaska a more attractive place to invest. We definitely recommend its passage.

Sincerely,

XEROX CORPORATION



Ann Laurence
Manager, Xerox Alaska



Larry Imhof
Manager, Xerox Alaska



Anchorage Star of the North
Chamber of Commerce

January 23, 1990

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

Reference: House Bill 281


Dear Fran:

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

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

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

Sincerely,
ANCHORAGE CHAMBER OF COMMERCE


Dave Harbour
Chairman

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



ALASKA STATE CHAMBER OF COMMERCE

October 16, 1989

Regional Office
901 B Street, Suite 404
Anchorage, Alaska 99501
(907) 278-2722
FAX 278-6643

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

Re: Finance Subcommittee on Unitary Tax

Dear Representative Ulmer:

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

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

Thank you for the opportunity to provide these comments.

Cordially,


George Kautz
President

GK/el



ALASKA MINERS ASSOCIATION, INC.

501 W Northern Light Blvd., Suite 200, Anchorage, AK 99503 (907) 276-0347

October 10, 1989

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

Dear Governor Cowper:

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

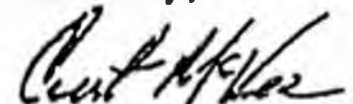
Last year the Alaska Miners Association presented testimony on Senate Bill No. 119 concerning reporting methods for corporate income tax. We supported the bill, but with an amendment which puts our domestic multi-national corporations on the same tax footing as foreign corporations.

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

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

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

Sincerely,


Curtis McVee
Executive Director



FEB 28 1990

ASSOCIATED GENERAL CONTRACTORS of ALASKA

4041 B STREET • ANCHORAGE, ALASKA 99503
P.O. BOX 240409 • ANCHORAGE, ALASKA 99524-0409
TELEPHONE (907) 561-3354 • FAX (907) 562-6118

February 22, 1990

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

Dear Senator Uehling:

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

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

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

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

Sincerely

ASSOCIATED GENERAL CONTRACTORS
OF ALASKA

F. Michael Swalling

F. Michael Swalling
President

XEROX CORPORATION
4341 B Street
Anchorage Alaska 99503
(907) 561-8200

XEROX

December 28, 1989

Representative Fran Ulmer
House Finance Committee Member
P.O. Box V
Juneau, Alaska 99811

RE: House Bill 281

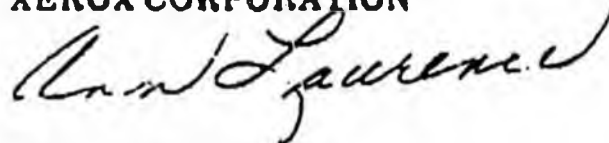
Dear Representative Ulmer:

It is our understanding that House Bill 281 proposes to repeal the worldwide unitary tax for foreign-based corporations. As such, the proposed legislation would benefit only foreign corporations and would put domestic corporations such as Xerox at a tax and competitive disadvantage.

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

Sincerely,

XEROX CORPORATION



Ann Laurence
Alaska Manager

AL:eg

**Brown & Root U.S.A., Inc.**5900 Arctic Blvd.
Anchorage, Alaska 99507

April 28, 1989

Senator Rick Uehling
Pouch V
Juneau, Alaska 99811

Re: Senate Bill 119

Dear Senator Uehling:

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

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

Truly yours,

H. C. Hunt
Brown & Root U.S.A., Inc.HCK:lp
R4:89



FLUOR DANIEL

Fluor Daniel Alaska, Inc.
P.O. Box 1000
Juneau, Alaska 99801
(907) 586-1000

April 24, 1989

Senate Finance Committee
Pouch V
Juneau, Ak 99811

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

Gentlemen:

PROPOSED SENATE BILL 119
An Act Relating to Corporate Income Taxes

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

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

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

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

Very truly yours,


George P. Wuerch
President and Regional Manager

GPW:jnr

91141.116



ANCHORAGE
ECONOMIC
DEVELOPMENT
CORPORATION

The Ship Creek Opportunity

A Panel Discussion

PREFACE

On February 7, 1991, the Anchorage Economic Development Corporation (AEDC) held a pre-proposal conference for the Ship Creek Waterfront Development Project. The two-hour conference provided general information on the Anchorage waterfront project and specific economic reports from specialists in real estate, international trade, tourism and architecture.

The baseline document for the project is the AEDC's Request for Proposal which was printed and distributed in December, 1990. Developers who had received the RFP and who sought more information on the project were in attendance at the pre-proposal conference both physically and electronically by means of a telephone conference call arranged by the AEDC.

The agenda for the meeting, handouts from the participants and other current information on the project is included at the end of this report.

Anyone interested in more information about the Ship Creek Waterfront Development Project should contact the AEDC at 550 West 7th Ave., Suite 1130, Anchorage AK 99501 or at (907) 258-3700.

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CONFERENCE SUMMARY

General

AEDC Board Chairman Ron Duncan introduced panelists and outlined the program for the two-hour session. He described the Ship Creek Waterfront Development an excellent example of the type of project the AEDC was created to foster. It involves significant public and private interest, new jobs and economic expansion in the tourism industry, one of Anchorage's growth targets.

Alaska Railroad Perspective

The project area was briefly described by Marvin Yetter, Alaska Vice President for Finance and Real Estate. The area is a clean industrial zone which has been used primarily for freight storage. It already attracts over half of the 800,000 tourists who visit Alaska annually. The Alaska Railroad seeks to attract year-round visitor business. Tax exempt financing is expected to be available from the Alaska Railroad Corporation.

Local Government

Anchorage Assembly Member Heather Flynn described the local government's commitment to the area and to the project. Within the Ship Creek basin there are two zones: the industrial port area and the project area for the Ship Creek Waterfront Development Project. The creek itself is the dividing line between the industrial and the commercial zones. The project is supported both by the public sector and by the private sector.

The Ship Creek RFP

The Alaska Railroad has been quite supportive of commercial development of its property since the railroad was transferred to the State of Alaska in 1985. AEDC staff member Tyler Jones described the Ship Creek RFP as being designed to respond to the development community's creative ideas for the area. The project is the best available opportunity to create a convenient and focused international visitor attraction that will become the prime jumping-off place for visitors to the 49th State.

Components of the Deal

AEDC President Scott Hawkins summarized the six components of the RFP offering: 120 acres of fully assembled downtown waterfront ground under a single owner; environmental protection; tenants on the ground covering ground rent payments; capital improvement credits; infrastructure grants; and tax exempt financing.

The Economic Opportunity

The Anchorage economy has recovered from the 1986-88 recession and shows strong signs of continued growth. Alaska's growth rate since the late 1960s has been triple the national average. Alaska's and Anchorage's global location are becoming appreciable commodities, particularly for global transportation concerns like Federal Express and United Parcel Service, both of which have established international air cargo hub facilities in Anchorage.

Commercial Real Estate

Real estate occupancy has increased in all areas, real estate broker Chris Stephens reported. In the Anchorage business community there is a sense of optimism and a sense that economic recovery has taken place. Compared to other cities hurt in the mid-80s recession, Anchorage's market was never as overbuilt. All our buildings were occupied at one time or another. Consequently, for Anchorage rates to return to amortization values we need only regain the economic strength we had in 1986.

International Trade

The acting director of the Alaska Office of International Trade, Ginna Brelsford, said the administration of Gov. Walter J. Hickel considers the timing excellent for an innovative and challenging project like the Ship Creek Project. It conforms well with Gov. Hickel's "owner state" strategy for development of Alaska.

Tourism

Katelyn Carrigan of the Alaska Department of Commerce reported that of the 820,000 visitors to Alaska in 1990 over half came to Anchorage. The Ship Creek Project has all five of the "five A's of tourism success:" attractions, accommodations, access, advertising and attitude.

The Site

John Burns, architect for the Alaska Railroad's Original Townsite project within the Ship Creek Project Area, explained why, if Ship Creek is such a good idea, the opportunity is still available. He explained it as a convergence of changes: a new and ambitious railroad leadership, a cooperative Municipality of Anchorage and a strong interest within the private sector to locate in and develop the Ship Creek area.

CONFERENCE PARTICIPANTS

Ron Duncan, Chairman
Anchorage Economic Development Corp. Board of Directors

Marvin J. Yetter, Vice President
Alaska Railroad Corp.

Heather Flynn, Anchorage Assembly Member

Tyler Jones, Transportation Projects Director
Anchorage Economic Development Corporation

Scott Hawkins, President
Anchorage Economic Development Corporation

Chris Stephens
Jack White Company

GINNA BRELSFORD, Acting Director
Alaska Office of International Trade

KATELYN CARRIGAN
Alaska Office of International Trade

John Burns
Burns & Peterson Architects

TELECONFERENCE PARTICIPANTS

Michael Whalen
Callison Partnership

Bill Price
Northwest Properties

Jean Gorton
Trillium Corporation

Dave Taylor/Larry Nielson
Skinner Development Company

Tandy Lofland
Intergroup Development Company

Bob Baron
Enterprise International Development Corporation

Keiko Kameda
Frontier West Properties

Hudson Brett/Chris McDonald
Brett & Company

CONFERENCE ATTENDEES

Roy Whitten
West Cook Inlet

Robert T. Griffin
Anchorage Port Commission

Tim Wiekping
Municipality of Anchorage

John Klepac
Sverdrup Corp.

Mike Stone
KPMG Peat Marwick, Anchorage Economic Development Corp. Board of Directors

Ed Musgrove
ECI Hyer

Mary Ann Keller
ECI Hyer

Bill Blessington
Municipality of Anchorage

Betty Adkison
University Area Community Co.

Greg Branch
Anchorage School District

Ted Trueblood
Tryck, Nyman & Hayes

John G. Burns
Burns & Peterson Architects

William Elmer
Reid Middleton, Inc.

Steve Agni
Development Managers

Karen Skurig
National Bank of Alaska

INTRODUCTION

MR. DUNCAN: Good afternoon. I'm Ron Duncan, President of GCI and Chairman of the Board of Directors of the Anchorage Economic Development Corporation. Now that we have our communications links to the Lower 48 we're ready to get under way with the pre-proposal conference for the Ship Creek Waterfront development project.

As AEDC Board Chairman it's my pleasure to moderate this discussion of the Ship Creek Project. The Ship Creek Project is a wonderful example of what the AEDC was designed to do: bring together different interests in support of economic development and job formation. In this case the players include the Municipality of Anchorage and the administration of Mayor Tom Fink; the Alaska Railroad Corporation, represented today by Marvin Yetter, Vice President for Finance and Real Estate; the Port of Anchorage and numerous private concerns which favor expansion of our community's commercial offerings and tourism amenities.

Today we intend to do three things: first we'll listen to a few minutes of history and background on the project. Then we will hear from a panel of specialists who will present their impressions of the Ship Creek Project from their special vantage point. Finally we will entertain and respond to questions about the project from anybody in the audience or any of those with us by conference call.

The first segment of the meeting will provide general background information on the project. Marvin Yetter, the vice president for finance of the Alaska Railroad, will describe the Railroad's view of Ship Creek. Then we'll hear from Heather Flynn, one of the members of the Anchorage Assembly, the equivalent of our city council for some of you in the Lower 48. Heather will discuss the Ship Creek project committee, of which she is a member, and the links between the Ship Creek project and the Municipality, through both the assembly and the administration. Tyler Jones, who is the staff person on the AEDC responsible for the Ship Creek project, will run briefly through the RFP and the process of developer selection. Then Scott Hawkins, president of AEDC, will discuss the nature of the proposed

deal that will be available to the successful developer.

At that point we will break for questions from the people on the conference phone and from those here in Anchorage. We'll take a short break before continuing on with the second half of the meeting. The second half will be a panel discussion concerning the economic opportunity at Ship Creek Point. That discussion will be moderated by Scott Hawkins. He will introduce the panel at that time.

Just one note on protocol before I turn this over to Marv. Because we're on a conference phone system, and we're trying to record this meeting to create a record of it, we request during the question and answer period and during the panel discussion period that only one person at a time speak. We will poll each of the conference call participants individually for questions. If there are multiple people talking at once, the phone will cut out the conference call participants, they won't be able to hear effectively, and we'll have a difficult time with the transcript.

With that I will turn it over to Marv Yetter, the vice president for finance of the Alaska Railroad.

ALASKA RAILROAD PERSPECTIVE

MR. YETTER: My name is Marv Yetter. I'm vice president of finance at the Alaska Railroad Corporation. One of the areas I manage, in addition to the administration/finance area, is the real estate area.

Before I get into the Ship Creek project, let me give you a little bit of background on the Alaska Railroad and what the last six years have brought the Railroad and Alaska.

Many of you recall from reading some of the material that the State of Alaska bought the Alaska Railroad in January of 1985. The citizens of the State of Alaska are the stockholders. They're the only stockholders. The railroad corporation operates as a private, independent corporation most of the time, and we try to maintain autonomy from the State of

Alaska. In the transfer the State-owned Alaska Railroad received about 40,000 acres of land, three deep-water ports (Whittier, Seward, and Anchorage) and about 550 miles of track right-of-way. Our rail bed and right-of-way in Alaska covers an area that includes about two-thirds of the State's population. We also received numerous major buildings, including a historic railroad depot and a lot of junk.

During the last six years the Alaska Railroad spent \$81 million investing in capital upgrades, all in the area of freight and passenger service. We financed that from our profits, and through some bank borrowing. We have about \$24 million in debt at this time. Through this six-year period we've been able to average a rate of return of about 10-1/2 percent, close to 11 this year. We've been able to do this, thankfully, during one of Alaska's worst recessions. Don't ask me how we did it; we're still trying to figure it out. One thing you may hear is that we don't pay taxes. You could say, "Well, that's how you do it," and that's not correct. We don't pay taxes, but if we did pay taxes our tax bill would be about \$1.2 million to \$1.5 million each year. We actually give about three million dollars a year in dividends back to the State in free use of our facilities, properties and right-of-ways. We charge the private sector for those services.

We spent the early years overhauling the freight and passenger business. Now we've been looking at the real estate side, and we're ready to start major development. The Ship Creek waterfront development, as you've all heard, is 120 acres of prime waterfront land that we're concentrating on in this first phase.

A couple unique things about this 120 acres. We only have three small leases on it today. Most of it's used for car storage -- new car storage, not junkyards. Environmentally I like to call it virgin. Our lawyers have a problem with that, but I think it's in pretty good shape compared to what you would find in most industrial properties. Most of the acreage has been unused for many years. Some of it is tidelands that will be filled. We feel that it's pretty good property from an environmental standpoint.

The Railroad has funded a Coastal Zone Management study of the area that's going to be completed probably in the next two months. So within two months that study should be

done, which will outline the uses in the tidelands portion of the property.

In looking for a master developer to assist us, we've done a lot of research from the standpoint of what we thought Anchorage and the Railroad would like to see on the waterfront next to downtown. Because we're a winter city environment

The Railroad has already secured a few good major tenants in the project area. We feel we've made a good start at redeveloping the area even before we get the major developer selected.

We want to be very careful that whatever we do here has advantages for the community during the shoulder seasons and during the off months. During our four or five summer months we have enough traffic in the project area that we feel just about anything would work. But we want to concentrate on year-round attractions, such as an aquarium or a planetarium, or some similar special attraction that would bring people to the area in the off season. It could be tied to the University of Alaska and to the local school district to be used as an educational medium in the winter-time. But in the summertime it would be a fine tourist attraction.

The Railroad has already secured a couple of good major tenants in the project area. One is ourselves. We're in the process of receiving and reviewing bids on a new Railroad headquarters building. It will be about a 38,000-square-foot building on one of the arterials in the project area, Warehouse Avenue. Glacier Brewery's brew-pub/microbrewery project is also scheduled to begin construction in the spring. Another office building on Warehouse Avenue will be hopefully leased by that time. These three projects will completely change the use of a street that's about a half mile long. Today there's 50 employees on Warehouse

Avenue. Two years from now when the Railroad's office building is completed and the other two facilities are completed, there'll be 400-500 employees on Warehouse Avenue. We feel we've made a good start at redeveloping the area even before we get the major developer selected.

There are many positive attributes to this project from the Railroad's standpoint. Our railroad depot in the center of the project area handles about 450,000 passengers in a four-month period in the summer. Most of these are tied into the tour companies like Princess Tours, via cruise ship from Whittier and Seward. There is also Anchorage's local traffic.

The Railroad would like to participate as an equity owner in some of the proposed projects. We also have rent credits available, and may have rent abatement, depending on the situation.

The infrastructure is being handled by state grants. This includes streets, sidewalks, curbing, lighting and those kind of things. Last year the State funded a grant for \$2.5 million for some street extensions, lighting, a new bridge over Ship Creek and a footbridge. This year we've requested \$10 million.

We have preliminary word from our bond counsel that tax exempt financing will be available for a project of this nature. We have a regular \$10 million annual cap that we use with banks today to arrange tax-exempt financing. But it appears we will have available a tax-exempt bonding capability. That has to be approved by our board of directors and the state legislature, of course, but if the project makes sense the approvals shouldn't be a problem. We feel the high probability of tax-exempt financing is a big plus.

LOCAL GOVERNMENT PERSPECTIVE

MS. FLYNN: I'm Heather Flynn. I'm a member of the Anchorage Assembly and I want to talk to you just a little bit about our committee process and structure. However, I first want to give you just a little bit of Local Government 101.

We have a community here which is about half again the size of the entire state of Rhode Island, and about two-thirds the size of the state of Connecticut. We are bounded on the east by some of the most fantastic mountains you've ever seen. I can look out the window and see a 20,000-foot mountain to the north, and, of course, to the west and coming around to the north is what you're interested in, a whole bunch of water.

We feel the high probability of tax-exempt financing is a big plus.

We have about a quarter of a million people here, a strong mayor form of government, and 11 elected assembly members from six different districts. We are a unified government. We're called a unified city and borough, but for those of you from New York, we're not like New York boroughs. Our borough is something akin to a county, but not quite. We have a single government and we also have a single taxing authority. That means you don't go out for levies every other month like you do in most places. In fact, we don't have to go out for levies at all. That's one small advantage we have.

A little bit about our planning process as well. We have, of course, a planning department which is just now completing a unified plan which integrates transportation, commercial, industrial and recreational opportunity as it deals specifically with the land that you are looking at, as well as some additional lands.

If you are looking at your map, there's a very natural division along Ship Creek. To the north is the traditional industrial port area. To the south is the area we are addressing today, the more people-oriented and the less industrially-oriented area.

The Ship Creek Project Committee process began several months ago with a three representatives: Marv Yetter from the Railroad, AEDC Board of Directors member Ken Gain, and myself, representing the Municipality of Anchorage. We since added Mayor Tom Fink to the committee.

The proposal went through many drafts, and the committee had input from more people than you can possibly believe. We feel it has the support of the entire community of Anchorage. The committee process is so dedicated and so tight that the most highly ranked proposal must receive unanimous approval from all four committee members in order for it to go forward.

This is a project with heavy commitments from not only the public sector, but also from the private sector. This is a very unique opportunity in that sense. We have a remarkable collection of opportunity here. We have land, land which is free and clear, most of it belonging to the Railroad, some of it under lease by the Municipality. In addition to that, it is in a fantastic setting. It's a very beautiful area. The basic infrastructure is in place: there are roads, and there are utilities. There is a plan for, and, indeed, a financial plan, for upgrading both the roads and the utilities, and that will be primarily at public expense. In addition, as Mr. Yetter has indicated to you, we are one of the few places left on the face of the earth, and certainly in this country, where there is bonding and financial capacity which makes this project much more financially feasible.

This is an opportunity for a real coordinated development with a great deal of support from the entire community here in Anchorage, from the state legislature in session in Juneau right now, and certainly from the private community, which is very well represented in this room today.

RFP SUMMARY

MR. JONES: I would like to do a quick run-through on the request for proposal. For those who have had their copy for awhile, this may seem redundant. We'll try to make it brief. For those who are newcomers to the process, this'll be too brief, and we'd like you to raise any questions you might have about it with us later, so that we can make you comfortable with the document and explain it in all the detail you'd like.

Generating the request for proposal, as has been stated by previous speakers, has been a long effort of various enterprises to put together a collective and cooperative develop-

ment plan for this area. This area is the origins of Anchorage, Alaska. The name Anchorage is derived from the actual anchorage for marine vessels that existed at the mouth of Ship Creek shortly after the turn of the century when the Alaska Engineering Commission was building the Alaska Railroad. The Ship Creek basin has

The request for proposal is designed to respond to the development industry's ideas. It is our goal to satisfy the developer's interest in new information, and to bring to the table a qualified master developer for the project.

been under the control of the Alaska Railroad in its federal and its state manifestations since then.

The inland half of the project area has been filled over the years. The waterfront half of the project is approximately one-third filled and ready to receive additional fill.

The transfer of the Railroad from the federal government to the State of Alaska has been addressed previously. The change in the demeanor of the Railroad toward development, toward expansion of economic activity in the state, has been quite striking in the period since the transfer.

The development of the project area, in particular, has had three phases. Originally with the development of the Alaska Railroad the original townsite area was for freight sheds, transfer structures, transfer activities, and track. Since then, in the early 1980s, the Port of Anchorage, an agency of the Municipality, acquired an interest in the waterfront portion for port expansion, and more recently there have been commercial plans, as reflected in the request for proposal, along the banks of Ship Creek, particularly near the Ship Creek dam, which is at the east end of the project area. The Ship Creek property that we're looking at today has the capacity to serve as a site for a

mixed-use development without having to satisfy the port's marine industrial requirements as once suggested by the Port's 1983 Master Plan.

In 1988, the Municipality received a concept plan for the Ship Creek project. The plan set out the mixed-use and commercial project concept. More recently, as has been described in some detail, the Municipality, the Railroad, the Economic Development Corporation, and assorted private interests have generated an overall redevelopment plan, which is reflected in the request for proposal.

The Municipality is engaged in ongoing work to resolve all planning and zoning issues. The coastal zone plan, which Mr. Yetter referred to, is in the process of being completed. It follows a lengthy period of environmental concern over the project area that is now being resolved. Additionally, the Municipal planning department is conducting a process of waterfront zoning and planning which is expected to be resolved in the next couple of months.

The request for proposal is designed to respond to the development industry's ideas. It is our goal to satisfy the developer's interest in new information, and to bring to the table a qualified master developer for the project. The RFP is organized to help people understand the area, its history and its potential.

The selection criteria in the request for proposal also reflect the submission requirements. Since the selection criteria spell out the percentage and ratings that the developers must consider, I will cover that exclusively at this time. Two of the criteria are rated at 40 points each of 100 total points. Those are the concept plan and the developer's qualifications and experience. The concept plan element is intended to determine the mix of uses proposed by a developer, to identify project economics, to lay out a marketing plan and strategy for the project, to include a design proposal, and to deal with the responsiveness to the request for proposal in detail. The project committee is not taking a bottom-line approach to the project exclusively. The members are interested in long-term benefits of the project to the community. We are paying special attention to those proposals that suggest new economic activities for Anchorage.

In particular, we anticipate that there is international interest in visiting Alaska that has not been brought to Alaska in quite the scope or scale we imagined yet. Ship Creek is the best opportunity to create that focused or invented attraction for Alaska to be a jumping-off place for the scenic 49th state. The Ship Creek Basin has its own attractions that can be packaged into an exciting project, for that matter, which would be attractive to an international tourist. These include our huge tidal

The Ship Creek Basin has attractions that can be packaged into an exciting project which would be attractive to international tourists.

range of roughly 30 feet, beluga whales in the summer, and king and silver salmon which spawn in the creek, and for which sportfishing is allowed, and bald eagles in the area.

The developer's experience and qualifications are standard elements for any RFP response. The Ship Creek Project Committee is looking at breaking down the experience and qualifications category to developer experience, private design experience, financial capability of developer, the organization and management approach, and the qualifications of the key personnel.

Finally, the last two items in the request for proposal's criteria section is the investment schedule, and the gross revenue sharing plan. These are rated at 10 points each, and need to be clearly understood by proposers. We are interested in private and public investment schedules, and also in the percentage that a developer intends to pay out of project gross revenue to the lessor.

Proposals are due on August 1, 1991. They will be reviewed and ranked by the project committee. We will be negotiating a contract with the recommended proposer at that time, and recommending that contract's approval by the Alaska Railroad board of directors, and the Municipality of Anchorage. The schedule requires approvals by year's end.

DEVELOPER CULTIVATION

MR. HAWKINS: I'm Scott Hawkins, president of the Anchorage Economic Development Corporation. First, I'd like to just run down our view of what is being offered to developers.

First and foremost is 120 acres of fully-assembled downtown/waterfront ground under a single ownership. Second is environmental protection. You'll see in the appendices to the RFP that although this has been utilized as a light industrial area in the past, the Railroad has accepted the liability for any environmental cleanup costs that may arise in the future that would have occurred prior to the developer taking control of the ground.

Third, there do exist tenants on the ground now. We understand that over time the developer will probably wish to move those tenants to other locations, but what it does provide is interim cash flow which will help defray the carrying costs of the ground in the early developmental stages. Fourth are capital improvement credits that, as investment is put in place, credits against the ground rent, which again makes the project more forgiving in the early developmental stages.

Fifth are infrastructure grants. I'd like to elaborate a little bit that the Economic Development Corporation, with the support of both the City and the Railroad, is asking the Alaska legislature to appropriate this year a sum of approximately \$10 million to be used for access and tidelands fill, and to a lesser extent utilities, but I think the bottom line is that there's a very good chance that at least \$10 million in infrastructure, in addition to what's already been put in place in the area, may very well be available even before the developer takes control of the ground.

The final thing that is being offered is financing potential. The Railroad, of course, has the capacity to do the tax-exempt financing. In addition to that, we do have an industrial bonding authority here in Alaska called the Alaska Industrial Development and Export Authority. AIDEA has also expressed an interest and a willingness to participate in the project. So from our point of view that's what's being offered.

In terms of the developer cultivation process, I'd like to observe a couple of things. As it currently stands, the process is wide open. Any developers that feel that they would qualify and would offer a responsive proposal are free to submit one. All proposals will be accepted. We do, however, maintain the right at some point to amend the RFP process, if necessary, to limit the number of developers that we're working with. That's an option that remains open, but as of this time and, I guess, for the foreseeable future, the process will remain wide open.

What is being offered to developers is 120 acres of fully-assembled downtown/waterfront ground under a single ownership, environmental protection, tenants on the ground, capital improvement credits, infrastructure grants and financing.

The AEDC maintains files on potential participants. Those that are interested in participating in one component of the development, but may not be interested in taking on the whole thing, may wish to be associated with other developers. We will maintain files and make those files available to other developers interested in partnership approaches. We also intend to serve as a facilitation resource, putting people, firms, and other project players, together with others to help facilitate specific proposals.

Finally, we are available, ready and willing, for questions, feedback, input, response to ideas, and any other assistance that we can provide to help make easier the process of putting together your proposal.

We're looking for final proposals August 1. Our goal as a development corporation in this

whole process is to have one or more solid responsive proposals involving substantial private investment and job creation at that time. That will give us approximately four months to put the development agreement together and have it ratified by the end of the year. The drop-dead date on this project is the end of 1991. In assembling the ground for this project, the AEDC has put together two lease option agreements which we currently hold and which we intend to assign to the successful respondent. Those lease options expire on December 31. If there is not a development agreement in place and ratified at that time, and if those lease options are not assigned to the successful respondent by that time, then we have to go back to square one. I don't know that we'd have to start the process over, but it would certainly complicate things; the commitments that we have in place now would no longer be binding commitments.

FINANCING Q&A

QUESTION: Would it be possible for us to get some further parameters or details about the tax-exempt financing? I think that's going to be a key issue for anybody involved in the process. What types of projects apply, what sort of debt and equity ratios are sought, what other qualifications in terms of the borrower might exist? Are such regulations in existence now for the tax-exempt financing that you mentioned, or are they being developed? I might want to get a little more educated on that.

MR. YETTER: Yes, we can respond to that. The regulations are not in place. We have not had to use any bonding capability to this point because our \$10 million tax-exempt bank financing that the Transfer Act allows has been adequate. We haven't had to use any more than that in any particular year. The rates that we were getting through that method were as low from the banks as we could get in the bonding process, so we have not used that. However, we can put those parameters and procedures together.

We have been informed by our bond counsel that all types of development in this area can be considered. We have a very broad authority, we feel, at this time. But we'll confirm that.

MS. FLYNN: We can send them AIDEA statutes and regulations. That's all easy to put together.

We have been informed by our bond counsel that all types of development in this area can be considered. We have a very broad authority

MR. HAWKINS: I'd like to elaborate on it a little bit. This will be the first time that the Railroad's tax-exempt financing authority under the Railroad Transfer Act has been utilized. We'll be breaking new ground. For that reason there aren't any institutional parameters in place as of yet, or even any precedent, for that matter. It's pretty wide open.

MR. YETTER: Let me give you an example of why we haven't had to use anything like that until now. Right now in a 13-month period, essentially, we can do \$20 million of tax-exempt financing. We can do 10 million through 12 months, and in January turn around and do another 10 million. So the Alaska Railroad Corporation has a capability right now in that short period of time to do \$20 million. So we just have not had to consider other types of financing.

MS. FLYNN: On behalf of the Municipality, of course, we have port revenue bonds. We also have General Obligation bonds, some of which have been spent. It's not envisioned at this point that the available five-plus million dollars in the balance of that bonding capacity will be made available to this project, but please do understand that we have an exceptionally good bond rating. Anchorage is certainly in a position where we can do general obligation bonds, as well as directly port-related revenue bonds.

QUESTION: What do you foresee as the means of title conveyance of the land itself? Will everything in the future as far as individual projects be on long-term ground leases, or is there a possibility of fee ownership?

MR. YETTER: It basically will be a ground lease. We have the capability to have a 35-year lease with two 35-year options, so that's 105 years. We have on occasion written into a lease a first option to purchase if the Railroad was sold. But it would essentially be a ground lease.

ECONOMIC OPPORTUNITY PANEL

MR. HAWKINS: We're ready to get started with the panel discussion on the economic opportunity at Ship Creek. I'll give you a quick briefing on the Anchorage economy, what makes it tick, where it's been and some general observations about it. Then we'll move to other folks who can give you some perspective on commercial real estate, international trade, tourism and site specific information.

After me will be Chris Stephens, who is a commercial real estate broker with the Jack White Company, one of the Jack White Company's principal commercial agents. Chris has handled a large volume of sale and lease transactions and is an acknowledged expert in the commercial real estate field here in Anchorage. He's also got a banking background, is a columnist for the Anchorage Daily News, and we're happy to have him to tell you about the real estate perspective as far as where the Anchorage market is.

After Chris, we'll go to Ginna Brelsford, the Acting Director of the Alaska Office of International Trade within the State Department of Commerce and Economic Development. She will give you some perspective on the international interests in Alaska, particularly those involved with tourism-related developments of late.

Following her will be Katelyn Carrigan with the Alaska Office of International Trade. Katelyn will give you some perspective on international tourism and tourism in general. John Burns with Burns & Peterson Architects will conclude the panel presentations by giving you some perspective on the redevelopment of the Ship Creek Basin. John has been the principal architect on what development has occurred at Ship Creek so far. In fact, it's been

his brain child, essentially, that launched this process to begin with.

In terms of the economic perspective, I'd like to first just make some general observations. Alaska and Anchorage in particular over the long term reflect a high-growth economy. The growth of Alaska since the early 1960's, since statehood, has averaged about triple the national average in terms of its rate of growth. It is a small economy, and it could be characterized, I guess, as a frontier type of economy. As such its rate of growth could be expected to be greater than the national average. The economic base of Anchorage is really made up of two essential things. One is natural resources, and the other is location.

The growth of Alaska since the early 1960's has averaged about triple the national average.

Under resources we have the petroleum industry, easily the largest single industry in Alaska. We have a growing minerals industry, which includes gold, as well as some of the base metals. We have some of the largest mining operations in the world under way in Alaska right now.

Of course, Alaska is easily the leading fish and seafood-producing state in the union. Fisheries is a major part of the economic base. And, finally, tourism is a large and rapidly growing component of the economy. That comprises the resources.

From the standpoint of location, many people in the world don't think of Alaska as being centrally located. They see it on the edge of maps, sometimes even down in a little box where it's not even supposed to be. But when you look at a globe, Alaska's location comes into perspective very quickly. It's because of our location vis-a-vis the Soviet Union, and vis-a-vis the Pacific Basin that Alaska has had large military bases and populations. The Army settled Anchorage in the 'teens. The military buildup before and during World War

It doubled Anchorage's population. Since the 1940s the military has been a substantial part of the economic base here because of our proximity to the Soviet Union and Pacific Asia.

More recently, private industry has recognized Alaska's unusual location as well. We have two major air cargo hubbing operations under development right now, one by the Federal Express Corporation, the other by United Parcel Service. They are taking advantage of our location as an air crossroads on the air routes. Anchorage's location within the state has made it a headquarters city.

Since the 1960s the economy would have to be characterized as historically cyclical. Now, we have had our ups and downs. Those ups and downs, however, tend to run counter to the national trend. I prepared a graph which shows the growth of Anchorage employment since 1970 compared to U. S. GNP growth. It documents that Anchorage tends to run countercyclical to the national average. What that means is that as the U. S. economy has turned down in recent months, Anchorage is entering its third year of economic recovery. We're two years into the recovery that followed our slump in the mid-1980s.

The recession was a severe one. It began in 1986, ended about the middle of 1988, or at least it stabilized in the middle of '88. The economy during that time downsized by approximately 10 percent, as measured by population and employment. As I said, the economy stabilized in late 1988 and turned the corner and began growing again in early 1989. In fact, that growth shows up as coming back fairly strong in the early months of 1989, and then when we had the Exxon Valdez tragedy in March of 1989, the oil spill cleanup impact associated with that further accelerated the recovery, at least temporarily.

Total employment here in Anchorage will reach its pre-recession peak again this year. We're almost back to our 1985 levels as of right now. The growth in our first two years of recovery has been moderate, and it continues to be moderate, and we have not really seen any actual impacts here in Anchorage of the recent situation in the Middle East. Our growth at this time is not being driven by events in the Mideast. What it has been driven by is renewed oil field activity, continued development in the mining industry, which

really resurged just in the past two or three years. We're seeing some further growth in our military presence here in Anchorage as the U. S. pulls back on some of its forward commitments on the Pacific Rim. We're seeing that the Pentagon is pulling back to U. S. soil. Alaska is the beneficiary of that pullback in terms of economic impact.

In the business community in Anchorage there is a sense of optimism. There's a sense that the readjustment has taken place.

Just in the past 18 months we've seen substantial air cargo-related development as it pertains to international air cargo hubbing, sorting and customs clearance. We've also observed some light manufacturing growth as our cost structure has dropped relative to the U. S. average. Finally, it's been just continued, consistent growth in the tourism industry, military expansion and some recent growth in state government which has driven the recovery for the last couple of years.

In terms of an economic outlook for our basic industries, the outlook for private basic industry development is very bright, particularly in the tourism industry. You'll hear a little bit more about that shortly. During the 1990s our state government will be downsizing as the surplus revenue from the Prudhoe Bay oil field gradually declines during the 1990s. We will be looking for private basic economic development to fill that gap for state government and for the economy.

I'd have to say that in the business community here in Anchorage there is a sense of optimism. During the mid-1980s recession the business community was hammered fairly hard, as you can imagine in the context of a 10-percent drop in population and employment. But there's a sense now that the readjustment has taken place, the petroleum industry and some of the other basic industries are coming back, the petroleum industry in particular has adjusted to where it can develop

fields in the new lower oil price environment that we're in, and there is a sense of optimism out there.

COMMERCIAL REAL ESTATE MARKET

MR. STEPHENS: I'll give a very brief overview of the commercial market in Anchorage. During the question and answer session if you want specific information I can give it then, or perhaps at another time. But right now I want to give you a feel as to where the commercial market is now and where it's going.

The commercial real estate market in Anchorage is bigger than you might think for a city of 250,000, if you're not familiar with Anchorage. We are the commercial hub for the state of Alaska and as a result we have a larger commercial sector than a city of this size would warrant anywhere else. So our commercial market I think you'll find is perhaps more like that of a city of 350 or 400,000, perhaps, rather than the population size we have now.

Our market certainly was hurt tremendously in the crash that we experienced in 1986. I know some of you are familiar with the Anchorage market, and are aware of the downturn that we had. Paralleling the economy, we are now on a definite recovery. We have increased occupancy across the board in all areas and we're beginning to see our lease rates beginning to inch up significantly.

To give you some idea, I think in the Class A office market you would say it's probably 10 percent vacancy overall, or 10 to 12 percent vacancy. It's as low as five-percent vacancy in our midtown area, which if you're familiar with office real estate, that's a very, very low vacancy rate. In industrial, I think it's more like a 12-percent vacancy. Retail has a substantially higher vacancy right now, probably overall 18 to 20 percent, but a year ago it was 30 percent. That sector is beginning to come back also.

I'm going to talk about Class A office rates in particular. Class A rates here on the top end will run from \$1.50 to \$2.00. It's interesting that replacement for Class A I would say is 2.35

to 2.50, so you can see we're substantially below amortization rates at this time. Industrial rates are running between 45 and 60 cents. Industrial here is with the tenant paying their own utilities. Replacement in the industrial is probably about 85 cents. Retail strip centers are running a dollar or less. Replacement's about \$1.60. The malls run around 2.50 a foot. In the malls I think vacancy is only about 10 percent.

Compared to other cities that were hurt in the crash, our market was never overbuilt to the extent that theirs were. For us to get our rates back to an amortization value, we only have to get our economy really back to where it was.

The recovery that I'm seeing is from businesses coming to Anchorage, as a matter of fact. I also see tremendous expansion in some of the cases of expanding existing business.

You'd be interested from a broker's standpoint in selling and leasing real estate that the first people to recognize our recovery was not the Alaskan. It was primarily people outside of the state. I think we were so traumatized by the downturn we didn't recognize the recovery when it started to happen. But we have had a large number of West Coast investors coming up from Seattle, California, Hawaii, and investing. They started in 1987, some of them, and in 1988. We also have some foreign investors. There's some Hong Kong money here, we've got some Canadian money coming in, and I think some others, so there have been people outside the state of Alaska recognizing opportunity coming in buying primarily developed properties at bargain basement prices. We are also beginning to see them pick up undeveloped pieces of land now.

An interesting difference that Anchorage has compared to other cities that were hurt in the crash -- for example, Denver, Dallas, Hous-

ton, Oklahoma, and so forth -- is that our market was never overbuilt to the extent that theirs were. As a result, all the buildings that we have were occupied at one time or another pretty much. So for us to get our rates back to an amortization value, we only have to get our economy really back to where it was. We don't have to go beyond where we were before. I think in those other cities that I mentioned they're going have to go a lot further to absorb the space that they have available.

I think one of the obvious keys is the availability of financing with the Ship Creek project. It's been talked about already so I'll just touch on it. As we get back to amortization value on rents and people start looking at additional development, the biggest stumbling block is going to be finance. The history of Alaska has been one of a shortage of capital, a shortage of money for development. The only time that I'm aware of that we didn't have that problem was the early 1980s. Those who participated then were hurt so badly that a lot of them say they're not going to come back.

For the Ship Creek development that means a developer should be able to come on line and take advantage of the market opportunity, while the rest of the market, because financing is not available, won't be able to come in as quickly. That's going to provide a significant advantage to whoever's here first. Ship Creek has the potential of doing that.

Also, at Ship Creek, because it's a redevelopment project, the public services are in place to a large degree in that area. In the light industrial zones in South Anchorage, those utilities are not in place. The roadways aren't in place, the power, sewer and water are not in place. So the differential in development costs will give some significant advantage to Ship Creek.

In summary, with our market recovering the timing for this project is good. Financing is a very key factor, and I think the redevelopment opportunity adds greatly to the Ship Creek potential.

INTERNATIONAL TRADE

MS. BRELSFORD: Before I get into what the international trade situation is here in Anchorage, I'd like to lay out some of the

political and international trade elements of Alaska's landscape. Anybody who's going to bid on a project of the magnitude and diversity of this type of project inherently takes on a number of risks. I would like to say that I'm here today explicitly to lend the support from the State Commerce and Economic Development International Division to this specific project.

*The perspective for Alaska
and the international scene is
nothing short of extraordinary.
We have seen our state exports
triple within the last three
years.*

Allow me to set the political stage, as I understand it. It is early in a new State of Alaska political administration. As Assemblywoman Heather Flynn mentioned, this project presents a remarkable collection of opportunities. From a state perspective there couldn't be a more exciting time to be involved in an innovative and challenging project like the Ship Creek waterfront development effort.

Governor Walter Hickel took over the governorship of Alaska this past December. You may have seen him last weekend on the Good Morning, America television show. He's been a speaker at the National Press Club in Washington, he's a familiar figure in Washington, having served as secretary of the interior under President Nixon, and the Sunday New York Times featured him two weeks ago. All this exposure tends to focus on his particular view and vision of Alaska which has a lot to do with opening it up to responsible development. A project like the Ship Creek Project fits into the new administration's view quite nicely.

Governor Hickel is carving out a strategy for development of Alaska that reflects Mr. Hawkins' previous comments concerning our strategic location. The fact that we sit halfway between Asia and Europe and the

Lower 48 places us in a very, very unique position, not only for transportation and air cargo types of development, but for international tourism. It's much easier to get on a plane and fly from Anchorage to Tokyo. You get off in five hours. Try to go from here to the Lower 48 and you're eight, 10 or 12 hours away, and lord knows how many missed planes in between. So the comfort factor alone, due to our excellent commercial airline connections and direct flights, is a significant contributing factor to Alaska's international environment.

Probably the cornerstone of Governor Hickel's vision for Alaska, and, therefore, the political climate that any respondent to this RFP would encounter at some level, has to do with the very strong commitment to something called an owner state. This is not to try to pick up where the Soviet Union's failures have left off. It's a very different perspective. It has to do with the terms of Alaska's statehood a mere 32 years ago and some very serious fiduciary responsibilities included in the executive powers of this state. It has to do with the way land is developed and our wealth is managed.

There is now an opportunity and a hospitable environment here in Alaska. Those of you who invest abroad or deal with foreign investments, know that in foreign affairs the first question you always look at besides the general economics is the political climate. What's the host environment? How many various bureaucracies and machinations am I going to have to go through on a political level that may or may not have anything to do with an economic level? Asking these questions in Alaska at this time leads one to conclude that this is the right time for investment in Alaska.

In terms of our foreign affairs, we can now see an international picture when before we limited our perspective to development to the domestic arena. Alaska's been on the forefront of setting its own foreign economic policies since the early 1960s. Sometimes Washington likes that, and sometimes they don't, but that's the way that it is.

Beginning in the 1960s we opened an office in Tokyo, Japan, 20 years before any other state developed a foreign office. It was primarily in reference to fish and fisheries, but tourism and air cargo are fast gaining on that track. In 1965, that office opened. It was

followed by, 20 years later, an office opening in Seoul, Korea, and Taipei, Taiwan.

We've taken the opportunity with this project to use our foreign offices to seek foreign direct investment in the Ship Creek Project. Many offshore firms may be interested in this project. I'm pleased to report that the Anchorage Economic Development Corporation was delivered a file of over 100 potential investment firms yesterday from our Tokyo office, with more to follow from some Scandinavian contacts and other Asian entities.

Governor Hickel is carving out a strategy for development of Alaska that reflects our strategic location. We sit halfway between Asia and Europe and the Lower 48.

We've seen a notable escalation in foreign investment in the state of Alaska. Again, it's primarily in terms of fisheries, timber, tourism and mining.

I think that one of the points or themes that tends to run through a lot of our marketing efforts abroad is that Alaska is maturing. You don't start a state in 1958 and not have some startup problems, some identity problems. Now what we have is a rather sophisticated environment where people have learned to deal with foreigners, and to figure out ways to host them here, and to market ourselves abroad with a great deal of success. Seibu Corporation has purchased Alyeska Ski Resort, for example. To illustrate another point that's been brought up before, the State has exhibited a strong commitment to investing in infrastructure for the Seibu project. It's a good case study.

Seibu employs roughly 75 people full time in Alyeska, a short drive from Anchorage. Another 175 are seasonal or part time. Seibu itself invested seven million dollars in the resort, and has plans to spend an additional \$50 million. I might add that the Alyeska Resort is close enough to any development that would

occur on the Ship Creek waterfront that you might see some very nice tourism tie-ins: People come in to Anchorage for the Ship Creek project, and get on a bus and go down to one of the world's greatest outdoor ski facilities. The hotel there is expected to create roughly 250 full-time, year-round jobs. Tax revenues generated by the resort were not available to us. However, we have seen a number of other advantages to the state from this area. Its presence, as I mentioned, has made Alaska a very attractive tourism destination site. The resort provides first class recreational opportunities. Hotel and tram development mean construction jobs. The expected influx of Japanese skiers means more resort employment and improved area ski facilities as well.

We've seen charter flights from both Korean Airlines and JAL, that bring literally planeloads of tourists destined for Alaska. We'd like to see that expanded to planeloads of skiers in the winter.

Alaska does have a number of investment incentives. We've got the Alaska Railroad Corporation bonding authority that you've heard about. We've got the industrial development and export authority --AIDEA-- that has been referred to, which is a publicly-held state corporation which assists in securing long-term financing at moderate interest rates.

The perspective for Alaska and the international scene is nothing short of extraordinary. Without trying to overdo it I have to acknowledge that we have seen our state exports triple within the last three years. That's a fairly phenomenal growth pattern by any measure. So it's with a great deal of interest and support that we are represented here today.

TOURISM POTENTIAL

MS. CARRIGAN: Tourism is Alaska's shining star for the future. Historically the visitor industry in Alaska has been one of the most resilient and stable sectors of the Alaska economy. From its beginnings in the late 1800s until the early 1950s, tourism grew at a slow and somewhat sporadic rate with new attractions, delivery modes, and infrastructure improvements creating irregular increases in the number of visitors to the state. As these

new attractions came on line, new businesses were established, cementing tourism's place in the Alaska economic mix. By 1959, few would have predicted the extent to which tourism would color the new state's economic picture.

In 1990, 820,000 people visited Alaska. Over 50 percent of them visited the Anchorage area to enjoy the sights and activities this area has to offer.

The establishment of the state's cooperative marketing program with the private sector, and a significant increase in the level of commitment by the State of Alaska to promote Alaska as a destination in the '70s and early '80s, accelerated the growth of the industry. By the mid-'80s, tourism had become one of Alaska's three largest industries, topped only by the petroleum and fisheries industries. Worldwide Alaska's growth has paralleled tourism expansion. Advances made in transportation and communication have, in effect, shrunk the size of the world. Estimated to generate more than two trillion dollars in revenues, tourism will become the world's largest business activity by the year 2000.

In 1990, 820,000 people visited Alaska. Over 50 percent of them visited the Anchorage area to enjoy the sights and activities this area has to offer, such as Portage Glacier, Alyeska Ski Resort, and the Columbia Glacier. Anchorage is a hub for many tourism activities. Sportfishing enthusiasts use Anchorage as a jumping-off point before going to the Kenai Peninsula, or Bristol Bay to indulge in the world-class fishing opportunities there. Climbers interested in challenging Mt. McKinley, or those interested in viewing the wildlife in Denali National Park, usually start their venture in Anchorage, and Anchorage is also the gateway to Alaska for Asians who visit Fairbanks in the winter and spring to view the aurora borealis dancing in the sky.

Currently, Alaska's primary consumer market for Alaska's tourism opportunities is

the continental United States, specifically the West Coast states. Approximately 92 percent of Alaska's visitors are domestic, and statistics show this market will remain strong for years to come. The remaining eight percent of our visitors come from overseas, with Japan and German-speaking Europe delivering nearly half of the total overseas visitors. Overall in recent years, in terms of percentage growth, overseas markets have shown a larger growth trend than those domestically, and we hope that that will continue upward.

The Division of Tourism's five-year strategic plan calls for emphasis on overseas markets. In recent years, foreign currencies have risen in value, travel restrictions have been eased, and residents of economically booming countries have spent more of their income on travel, creating a frenzy of promotional and development activities by destinations throughout the world. Alaska's efforts to develop overseas markets have been focused on Japan and German-speaking Europe, with secondary markets including Australia, Korea, Taiwan, and Britain.

When discussing overseas tourism promotion, the primary problem the State of Alaska faces is the lack of international air seats on flights to Anchorage. Alaska is well-known domestically and abroad for its beauty, wildlife, vast, open space, and moderate temperatures in the summer. Direct flights can fly from Tokyo to Alaska in the same amount of time it would take for that same flight to fly from Tokyo to Hawaii, and from Alaska to Europe is actually about the same amount of time, from five to seven hours.

As mentioned, the lack of air seats is the first stumbling block, but as most economists will tell you, this problem is demand driven. If there is a demand, the seats will be allotted. The Division of Tourism is currently working with wholesalers in Japan and Korea on charter flights to Alaska. In fact, there has been a total of nine successful 747 charter flights from Korea over the past two summers, and plans are on for an additional five this upcoming summer.

The Ship Creek development project is a development in which creativity can play a major role, especially in terms of what this project can do for the tourism industry in adding another attraction to the Anchorage area.

Although development projects will not be the primary force for bringing people to Anchorage, it will enhance their stay dramatically while here. Made in Alaska shops, tours of a brewery, marine viewing facilities, boat-launching access, and other ideas you may put into your plan are all attractions for visitors and locals alike. There is also a need for a new first-class hotel in Anchorage, and if added to this project, would not only enhance the project, but would keep visitors in the area of Ship Creek using the other facilities.

You might ask yourself why this opportunity is still available. The answer is that we are at a conjunction of several significant changes in the elements of the project.

In the tourism industry when you talk about development, reference is always made to the five A's of tourism success: attractions, accommodations, access, advertising, and attitude. Alaska, and getting more specific, Anchorage and the Ship Creek project, have all the makings for a successful tourism development. In terms of attitude, the mystique and wonderment of Alaska is real. The State of Alaska, the private sector within Alaska, and local convention and visitor's bureaus will continue to promote Alaska as a destination for years to come. The 1990s will be a decade of both risk and opportunity for Alaska tourism. Travel will become the world's largest business activity by the year 2000, giving Alaska the opportunity for significant tourism growth. Competition will be stiff and unparalleled, but the State will focus for the future on promoting Alaska as a destination. The State is extremely committed to that proposition.

I encourage you to join us in promoting investment in the Ship Creek development project.

PROJECT SITE OPPORTUNITY

MR. BURNS: Since I'm batting cleanup there's a number of things I'd like to touch on. As the architect planner involved with this project over the last two to three years for the Railroad, I'm gratified to see it come this far this fast. I'd like to touch on a couple of aspects that I believe are of interest to the developers here, or listening to this panel.

I would expect after the encouraging presentations that preceded me you might ask yourself why this opportunity, if it's so wonderful, is still available. The answer is that we are at a conjunction of several significant changes in the elements of the project.

A number of years ago our firm was starting to do a project here in Anchorage called the Coastal Trail. We had to deal with the federal railroad, and the federal railroad was less than interested in things like pedestrian trails, public access, and the like. Then the State bought the railroad, and we have seen a very dramatic turnaround in their interest as a member of the community, and as an owner of substantial properties throughout Alaska.

So first of all we've had an awakening of interest on the part of the Railroad. Second, at the same time we entered our economic downturn. Essentially Sleeping Beauty has come awake here in the 1990s. Our economy is up, the interest remains high on the part of the City, on the part of the Railroad, and on the part of the public. Now is the first time that all these things have come together.

There is substantial documentation of the public interest. The Municipality has funded many studies for projects such as trails, green-belt projects, parks at Ship Creek Point, and so forth. The public has expressed its support by supporting the General Obligation bond for the original Ship Creek project, and I really can't overemphasize the comprehensive extent of the support that you would find if you came here to pursue this project.

Moving to a couple of physical items that merit attention, the area is effectively physically part of downtown. Anchorage is organized by several north-south arterials, and then has major crossing east-west collectors that or-

ganize it into the midtown-downtown segments. What we have been doing over the last several years is essentially creating this area as the northernmost flank of downtown, with the benefit of the physical attraction of Ship Creek as a boundary.

The economy is, in fact, strong, and quite substantial for a community of our size. We enjoy several aspects of being a small city, one aspect being that this particular project would become the terminus of one of four east-west bike trail systems crossing the Municipality, and is within extremely short walking distance of the majority of the downtown hotels. It's just a very accessible and desirable location.

As we have looked at this project for two years we've anticipated certain kinds of uses. Among those uses are probably a hotel for which there is documented demand; a combination of retail, destination retail, general retail for office space, and recreational opportunity both in terms of physical adult features; parks; and natural amenities for the residents of Anchorage themselves. Anchorage is clearly not overbuilt in any of the categories I've mentioned.

The availability of financing this project and its emergence from very low land value make it a tremendous opportunity economically for a developer with vision.

GENERAL Q & A

QUESTION: I've got two questions for Chris Stephens. How many full floors are available in Anchorage right now, number one. And number two, what do you anticipate the annual absorption to be for 1991 and 1992?

MR. STEPHENS: At this moment there are two full floors available in Anchorage, one in the NBA building, and one in Peterson Tower. For absorption for the next two years we're at five percent in Class A. I don't know how you can get any fuller than that, and I think in the next 12 months we're going to hit zero, and then the rates are going to respond, obviously, and depending on financing, we'll see where we go from there.

QUESTION: I would like to add my thanks for the presentation; it's very well done. And a question: are there any proposed density,

height, or other kinds of restrictions that are on the site?

MR. BURNS: I'll speak to that. We have drafted, or had drafted over 18 months ago, an outline of some covenants for the original core district. It is intended that they be considered in that district, and perhaps, as we go forward, with the balance. However, they are not finalized at this time, and we, frankly, have not presumed to finalize them, knowing that we might well have a master developer with some important thoughts for us.

There is a current height limitation that would speak to three or four stories, for several reasons. If you're familiar at all with Anchorage, our earthquake activity up here is subject to interpretation as to how severe it might be based upon the soils that you are sitting on. This area is generally a fill area. Deeply below it is some of the Bootlegger's Cove clay that is involved in the region, and, frankly, four stories is a very conservative of avoiding any special engineering for the district. Greater height could be entertained with some proper engineering.

MR. JONES: One thing that we've stressed in the request for proposal, which has the concurrence of the Municipality and the Railroad Corporation, is the establishment of site criteria, covenants, restrictions and limitations is intended to wait for the recommended development proposal. We want to know what the successful developer proposes, and then make that satisfactory to the community in whatever ways zoning and planning and engineering require. But it's key to know what people want to build, notwithstanding our natural limitations.

MR. BURNS: To perhaps bring it a little more specifically to an answer, you should be aware that the current zoning is I-2, which has few limitations, certainly, but the proposed zoning is in two districts, one waterfront related, and the other through the bulk of the district would be B-2, which is the designation in Anchorage essentially for downtown. So it opens up the possibility of some fairly reasonable densities, and I think a lot of flexibility for the suggestions that you might make.

QUESTION: In talking about the proposed zoning, does the Anchorage Economic

Development Corporation have zoning authority, or is that retained by the City?

MR. JONES: That is a function of the Municipality of Anchorage. They are in the process of completing a waterfront land use task force report, which is intended to include zoning recommendations. Among those recommendations is the creation of a new mixed commercial zoning classification for this area, and that is one of the aspects which is sort of in suspended animation awaiting developer responses to the RFP.

In the absence of further questions from our telephonic participants as well as those present, we'll conclude this conference. A printed record of this conference will be supplied participants and others interested in the project. Thank you for your participation.



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CORPORATION**

SHIP CREEK WATERFRONT DEVELOPMENT

PRE-PROPOSAL CONFERENCE - FEBRUARY 7, 1991- 2 P.M.

ALASKA RAILROAD CORP. CONFERENCE ROOM

Introduction - Ron Duncan, Chairman
Anchorage Economic Development Corp. Board of Directors

Alaska Railroad Corp. Perspective - Marvin J. Yetter, Vice President
Alaska Railroad Corp.

Ship Creek Project Committee Report - Anchorage Assembly Member Heather Flynn

Summary of Request for Proposal - Tyler Jones, Transportation Projects Director
Anchorage Economic Development Corp.

Developer Cultivation Process - Scott Hawkins, President
Anchorage Economic Development Corp.

Questions and comments

Economic Opportunity at Ship Creek - Panel Discussion

Scott Hawkins, moderator
Economic trends

Chris Stephens, Jack White Company
Commercial Real Estate Market

Ginna Brelsford, Director, Alaska Office of International Trade
International Interests in Alaska

Katelyn Carrigan, Alaska Department of Commerce
International tourism in Alaska

John Burns, Burns & Peterson Architects
Redevelopment of the Ship Creek Basin

Questions, comments, discussion

Developer Cultivation Process

A. What is being offered

- 120 acres, fully assembled
- Downtown/waterfront location
- Environmental protection
- Existing tenants - interim cash flow
- Capital improvement credits
- Infrastructure grants
- Financing vehicles (ARRC & AIDEA)

B. Cultivation Process

- Process is Open; all proposals accepted
- AEDC will maintain files on potential participants
- AEDC will serve as a facilitation resource
- AEDC is available to developers for questions, feedback and input, and any other assistance we can provide.

C. Final Proposals by August 1

D. Goal Is To Have One or More Solid, Responsive Proposals Involving Substantial Private Investment and Job Creation.



Economic Trends

A. Introductory Comments

B. General Observations

- Alaska and Anchorage high growth areas
- Economic base of Anchorage: resources and location
 - Resources: petroleum, minerals, fisheries, tourism
 - Location: military, air transport, headquarters
- Economy historically cyclical
- Tends to run counter to national trend

C. Entering Third Year of Economic Recovery

- Recession was severe, oil related
- Economy downsized approximately 10% from 1986 - 1988
- Stabilized in 1988; began growing in 1989
- Oil spill clean-up accelerated recovery temporarily
- Employment should reach pre-recession peak again this year
- Growth has been moderate in pace, not influenced by mideast
- Growth has been driven by:
 - Renewed oilfield activity
 - Renewed mining activity
 - Growth in military presence
 - Air cargo development
 - Growth in tourism
 - Some light manufacturing

D. Economic Outlook

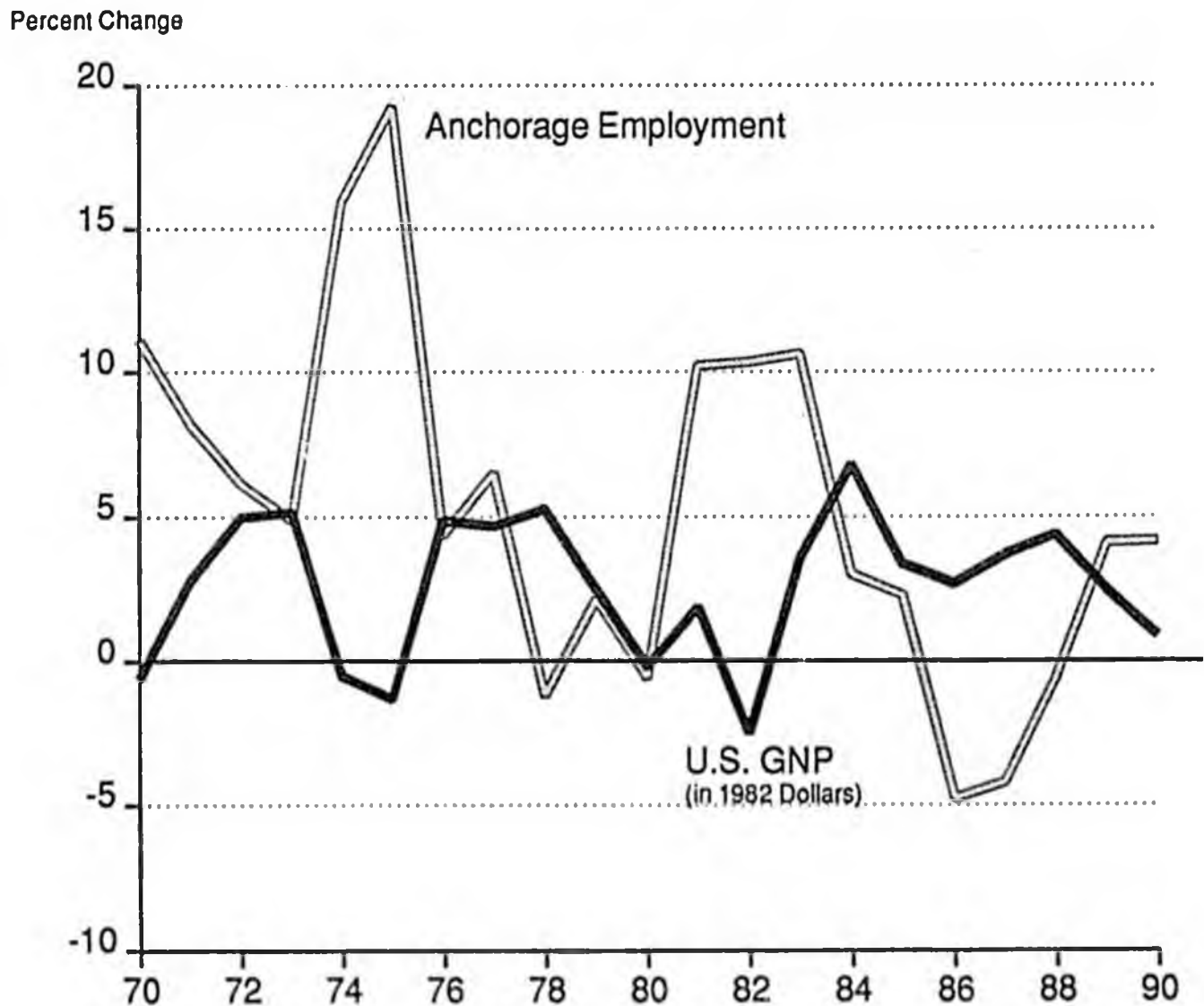
- Basic industries look bright - especially tourism
- State government to downsize
- Sense of optimism





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Anchorage Employment Growth vs. U.S. GNP Growth 1970 - 1990

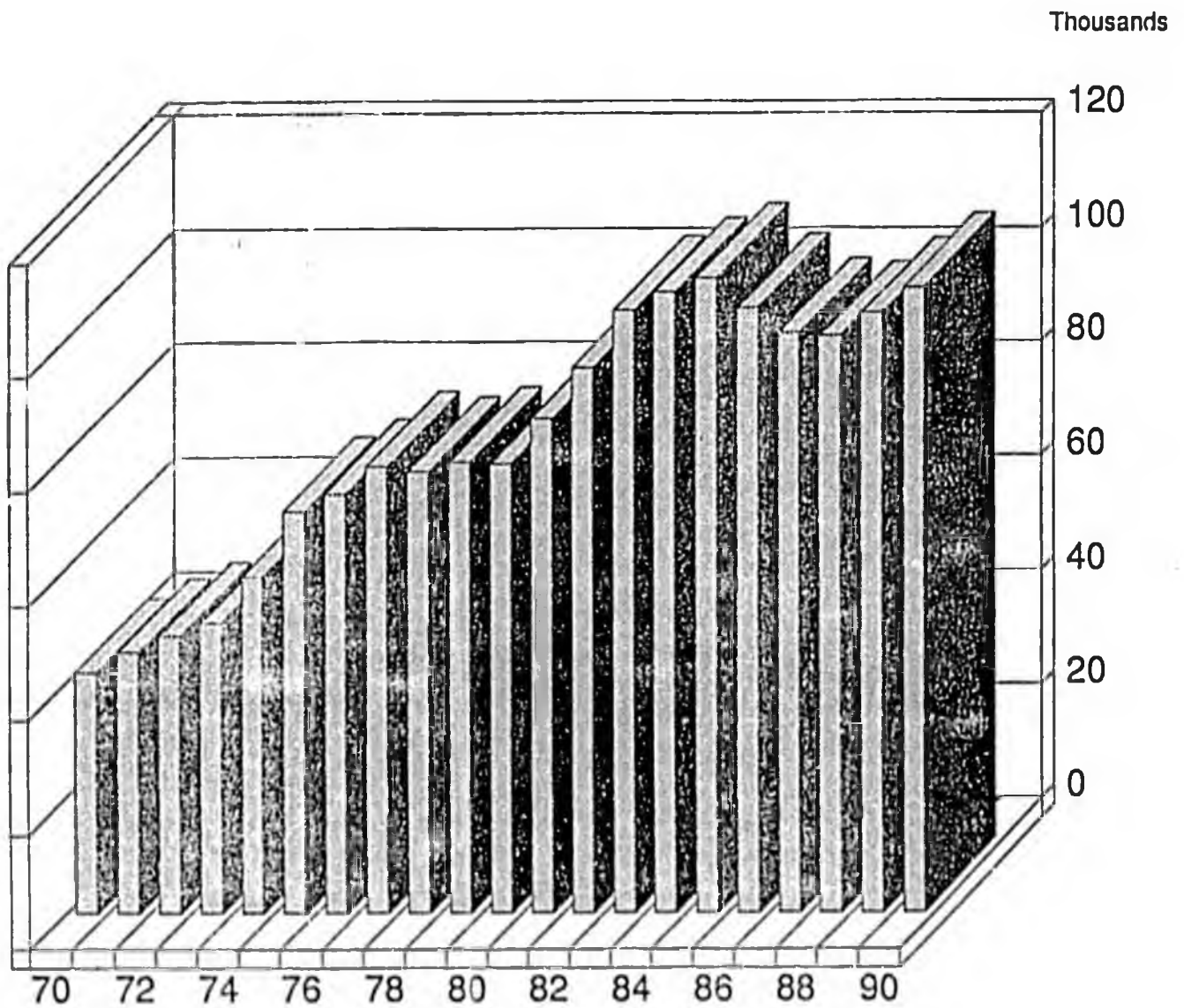


Source: AK Dept. of Labor and *Statistical Abstract of the United States*.



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Anchorage Employment 1970 - 1990



Source: AK Dept. of Labor

Alaska's Travel Outlook, 1990 and Beyond

*Alaska Visitors Association
40th Annual Convention*

Juneau, Alaska
October 12, 1990

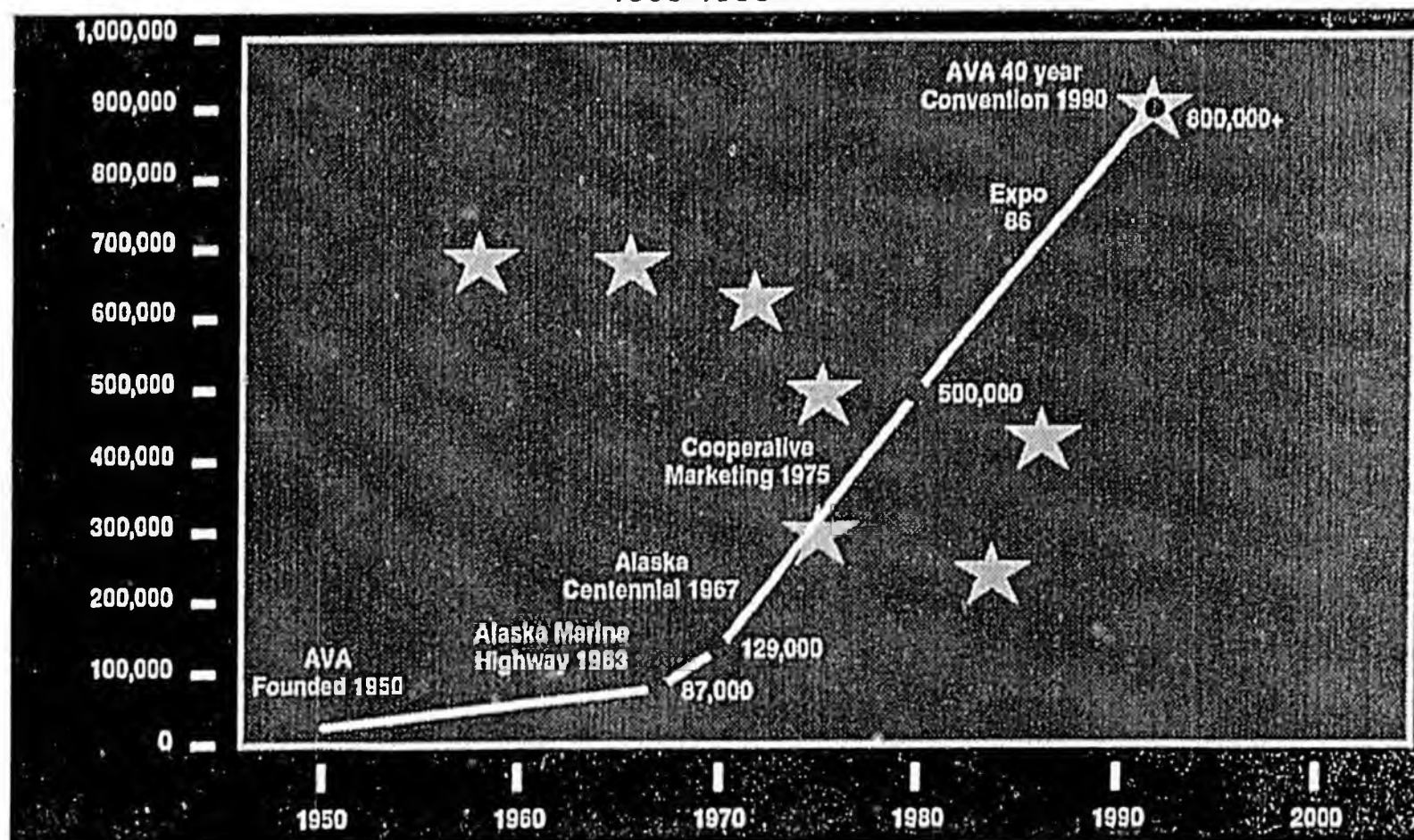
Presented by the



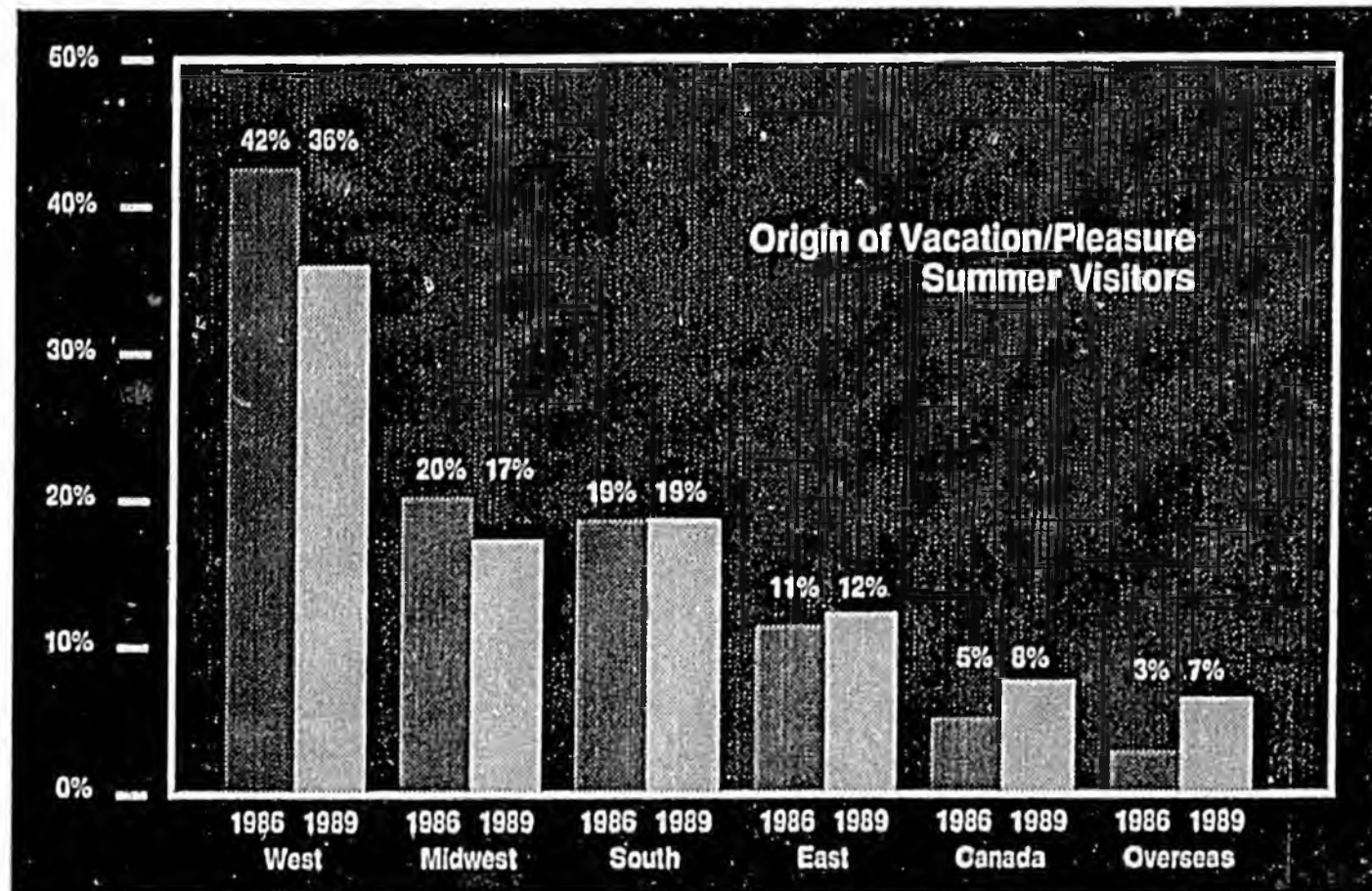
Forty Years of Progress

Alaska Visitor Growth

1950-1990



Where Are They From?



- Europeans account for over 60% of all Overseas Vacation/Pleasure visitors

Who Spends The Most Among Vacation/Pleasure Visitors?

<u>Type of Visitor</u>	<u>Spending per person per trip</u>
Average Vacation/Pleasure Visitor	\$ 619
Germans/Swiss/Austrians	1,483
Other Package Tour Visitors (includes fishing)	1,459
International Air Users	1,194
Ferry Users	963
Cruise/Tour Package Visitors	944
Japanese	942
Independents buying Instate tours	867
Domestic Air Users	814
Southerners	794

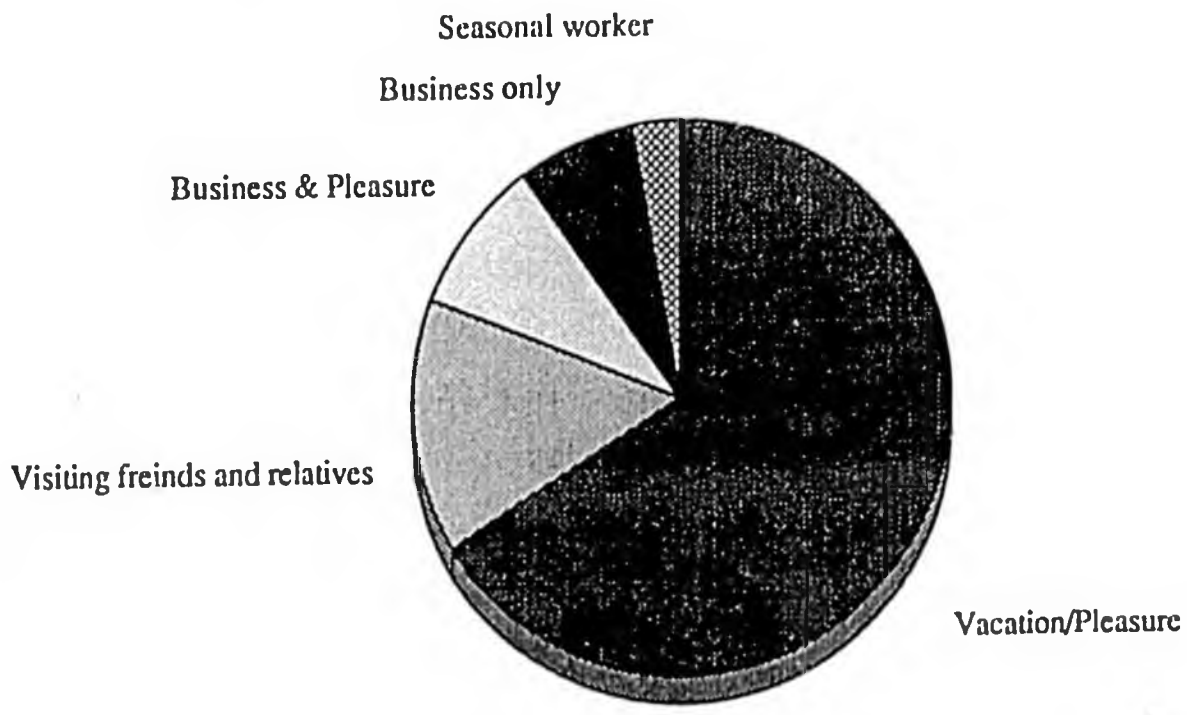
Visitors to Alaska in 1990

Full Year

820,000

Summer

590,000



[Sec. 481(d)—Repealed]

Amendments

P. L. 96-471, § 2(b)(3).

Repealed Code Sec. 481(d), effective for dispositions made after October 19, 1980, in taxable years ending after that date. Prior to repeal, Code Sec. 481(d) provided:

(d) EXCEPTION FOR CHANGE TO INSTALLMENT BASIS—This section shall not apply to a change to which section 453 (relating to change to installment method) applies.

[Caution: Code Sec. 482, as amended by P. L. 99-514, applies to tax years beginning after 1986.]

[Sec. 482]

SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

In the case of any transfer (or license) of intangible property (within the meaning of section 936(h)(3)(B)), the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.

Amendments

P. L. 99-514, § 1231(e)(1).

Act Sec. 1231(e)(1) amended Code Sec. 482 by adding at the end thereof a new sentence to read as above.

The above amendment applies to tax years beginning after December 31, 1986. However, see Act Sec. 1231(g)(2)(4), below.

Act Sec. 1231(g)(2)(4) provides:

(2) SPECIAL RULE FOR TRANSFER OF INTANGIBLES—

(A) IN GENERAL—The amendments made by subsection (e) shall apply to taxable years beginning after December 31, 1986, but only with respect to transfers after November 16, 1983, or licenses granted after such date (or before such date with respect to property not in existence or owned by the taxpayer on such date).

(B) SPECIAL RULE FOR SECTION 936—For purposes of section 936(h)(3)(C) of the Internal Revenue Code of 1986, the amendments made by subsection (e) shall apply to taxable years beginning after December 31, 1986, without regard to when the transfer (or license) was made.

(3) SUBSECTION (f)—The amendment made by subsection (f) shall apply to taxable years beginning after December 31, 1982.

(4) TRANSITIONAL RULE—In the case of a corporation—

(A) with respect to which an election under section 936 of the Internal Revenue Code of 1986 (relating to possessions tax credit) is in effect,

(B) which produced an end product form in Puerto Rico on or before September 3, 1982,

(C) which began manufacturing a component of such product in Puerto Rico in its taxable year beginning in 1983, and

(D) with respect to which a Puerto Rican tax exemption was granted on June 27, 1983, such corporation shall treat such component as a separate product for such taxable year for purposes of determining whether such corporation had a significant business presence in Puerto Rico with respect to such product and its income with respect to such product.

Amended 1954 Code by substituting "Secretary" for "Secretary or his delegate" each place it appeared. Effective February 1, 1977.

[Sec. 483]

SEC. 483. INTEREST ON CERTAIN DEFERRED PAYMENTS.

[Sec. 483(a)]

(a) AMOUNT CONSTITUTING INTEREST.—For purposes of this title, in the case of any payment—

- (1) under any contract for the sale or exchange of any property, and
(2) to which this section applies.

there shall be treated as interest that portion of the total unstated interest under such contract which, as determined in a manner consistent with the method of computing interest under section 1272(a), is properly allocable to such payment.

[Sec. 483(b)]

(b) TOTAL UNSTATED INTEREST—For purposes of this section, the term "total unstated interest" means, with respect to a contract for the sale or exchange of property, an amount equal to the excess of—

- (1) the sum of the payments to which this section applies which are due under the contract, over

Internal Revenue Code

Sec. 483(b)

EXHIBIT A

and separate orientations on each other's organizational structure, philosophy, and procedures.

Since the training, we have successfully completed over 40 cases under the joint procedures. None have reached impasse. An unexpected benefit of the agreements is the tendency of taxpayers to cooperate with us both once they realize that the federal and state authorities are no longer stumbling over each other. In the past, failure to reach agreement often resulted in neither taxing authority being effective, with the taxpayer or third party creditors reaping the benefits. We now have effective alternatives.

Growth

Our successes have encouraged us to explore new cooperative opportunities. We resumed discussions this May on real estate redemptions and joint bankruptcy motions. These areas offer further opportunities for increasing revenues and strengthening taxpayer compliance. In closing, we wish to reiterate our belief that the keys to an enduring, productive federal-state relationship are finding common ground for mutual benefit and demonstrating a genuine interest in the other agency's success.

AUDITS USING IRC SECTION 482 APPROACH

KATHY SOMMERS

Manager, International Audit Section
California Franchise Tax Board

I think everyone will readily agree that §482 is one of the most difficult code sections to apply in practice. The section itself is amazingly short, containing only two sentences. The first sentence states that the Commissioner can allocate items of income and expense between commonly controlled entities to prevent evasion of tax or to clearly reflect income. The second sentence, added with the Tax Reform Act of 1986, states that the compensation received by the transferor of an intangible asset must be commensurate with the income stream generated by the intangible. This is the new so-called super royalty provision. Before discussing §482 audit concerns, it would be beneficial to consider the reason this section is needed.

Background

In any setting other than the worldwide unitary method of taxation, multinational corporations have both the incentive and the opportunity to shift income from high to low tax jurisdictions. Under the worldwide unitary method, the income of related corporations that are part of a unitary business is combined to determine the total income of the unitary corporate group. A share of this combined income is then assigned or apportioned to the taxing jurisdiction on the basis of relative levels of business activity of the combined group. Since the income attributable to the taxing jurisdiction is determined by reference to the combined income of the group, there is no opportunity for shifting of income.

The alternative to combined reporting is separate accounting. The separate accounting method determines the income of related corporations on a corporation-by-corporation basis and does not take into consideration the income of related corporations not doing business within the taxing jurisdiction. The separate accounting method allocates income among related corporations according to the "arm's-

length" principle. Under this principle, the prices or charges on transactions between related parties should be the same as if the transactions occurred between unrelated parties. The opportunity to arbitrarily shift profits under the separate accounting method can be demonstrated by the following example.

Assume that a foreign company manufactures personal computers for a per unit cost of \$500. The computers are then sold to the company's U.S. subsidiary for \$2,000 each, which resells them in the U.S. market for \$3,000 each. In this example, the parent will have earned \$1,500 per unit and the subsidiary will have earned \$1,000 per unit. By only changing the intercompany transfer price the parent can shift the group's profits to whichever jurisdiction it prefers. For example, if the parent charged the subsidiary \$3,000 each for the computers, the foreign parent would report per unit profits of \$2,500 and the subsidiary would report no profits.

For tax purposes, the intercompany transfer price can obviously have a significant impact on the overall tax liability of the group. If the U.S. can only tax the subsidiary and it pays \$3,000 per unit, it has no income to tax. If the effective tax rate is significantly higher in the U.S. than it is in the foreign country, the related group's total tax liability can be reduced by the parent overcharging its subsidiary.

Section 482 and the Issues

It is this arbitrary shifting of profits that §482 is aimed at preventing. The objective of a §482 audit is to determine if the related parties have charged an "arm's-length" price, and if not, what the "correct" price should be. This is commonly referred to as transfer pricing. The IRS considers transfer pricing issues to be the most difficult audit specialty in the Service. Typically, only the most experienced agents are



selected to work on these cases. Economists, engineers, industry specialists, and other experts must also participate in the audits because of the significant amount of nontax knowledge needed to perform the detailed functional analysis vital to the determination of an appropriate transfer price. Based on discussions with international examiners (IE's), the IRS typically spends about 3,000 audit hours on a pricing case. In comparison, based on California's experience, even the most complicated unitary audits rarely take more than a 1,000 hours to complete, and typically take only 300 to 400 hours. Add on the substantial hours spent on pricing cases at the appeals and litigation levels, coupled with the often limited success in court, and it becomes clear that pricing audits represent a very speculative and resource-intensive proposition.

The five most significant transfer pricing issues relate to interest on loans, use of property, performance of services, transfers of intangible property, and transfers of tangible personal property. Audits involving interest and use of property are comparatively easy to perform. The regulations under §482 provide clear-cut methodologies or safe haven rules for resolving the pricing issue.

With respect to services and transfers of tangible and intangible personal property, the §482 regulations rely heavily on finding comparable transfer prices or transactions. In the case of services and intangibles, there is little or no guidance in the regulations for determining what the arm's-length price should be in the absence of direct comparable transactions with unrelated third parties. With respect to transfers of tangible property, the regulations set forth three detailed pricing methods, with a priority of use. These methods, which also rely on finding comparable transactions, are the comparable uncontrolled price method (CUP), the resale price method, and the cost plus method. If none of these methods can be used, the regulation calls for the use of some "other appropriate method"—the so-called "fourth method". There is no guidance in the regulations in terms of how to construct another appropriate method. In practice, the fourth method has included profit splits, rates of return, and customs valuations.

It should be noted that in spite of the rigid hierarchy of rules set forth in the regulations, the trend in the more recent §482 cases has been to use CUP whenever possible; however, if a CUP cannot be found, the courts skip over the intermediate methods and go right to the fourth method. The method favored by the courts in the more recent cases has been profit split.

Both taxpayers and the government agree that the practical problems encountered in applying the current §482 regulations are unacceptable. As a result of the growth and increasing sophistication of multinational corporations, both groups have for some time criticized the regulations as largely unworkable in the modern economic climate. The search for comparables is a complicated, resource-intensive

burden. Further, comparables are difficult to find, especially in the case of unique, high-profit intangibles. The failure of the regulations to provide guidance in the absence of comparables creates unacceptable levels of uncertainty and significant administrative burdens for both taxpayers and the government. Taxpayers, the IRS, and the courts have been forced to devise ad hoc fourth methods to resolve pricing disputes.

Because of these concerns, the Tax Reform Act of 1986 amended §482 to add the commensurate-with-income standard with respect to intangibles. Congress also directed IRS to make a comprehensive study of the intercompany pricing rules and to consider whether the existing regulations under §482 needed to be modified. On October 18, 1988, Treasury issued an approximately 200-page discussion draft entitled "A Study of Intercompany Pricing" (commonly referred to as the "White Paper"). The White Paper is a generally well-considered analysis of the problems in the §482 area, and should be read by those interested in intercompany pricing issues. It proposes a new system of intercompany pricing rules, putting heavy emphasis on the role of intangibles in intercompany pricing.

Study of Intercompany Pricing

Although the White Paper is merely a discussion draft and taxpayers do not have to follow its recommendations, it is a clear indication of Treasury and IRS thinking in this area. It will undoubtedly be the basis for regulations implementing the commensurate-with-income standard. One important conclusion of the White Paper is that the IRS needs more complete and timely information from taxpayers on intercompany pricing. It recommends that taxpayers be required to document their pricing at the same time they file their returns, report their methods of pricing on their returns, and make the documentation available to IE's within a reasonable time after request. It also recommends that IRS economists and counsel become more involved in the audits and that IE's more aggressively pursue noncompliant taxpayers by making more use of the administrative summons and §982 (access to foreign documents) procedures. Some commentators have called these recommendations incredibly unreasonable and overly burdensome. It seems doubtful, however, that Treasury and IRS will back down too much in this area.

The White Paper also concludes that the commensurate-with-income standard is merely a clarification of prior law and is consistent with the arm's-length principles. Based on this conclusion, it argues that the standard should not increase the incidence of double taxation. The legislative history of the 1986 Act indicates that Congress enacted the commensurate-with-income standard because of concerns that the existing rules had not focused appropriate attention on actual profits generated by the intangible in situations where comparables do not exist. As is the case with the current pricing standards, application of the commensurate-with-

income standard will require a detailed functional analysis of the respective entities so that the income generated by the intangible can be allocated on the basis of the relative economic contributions of the related parties.

A further important conclusion reached by the White Paper is that intercompany prices may have to be periodically adjusted to reflect substantial changes in the profit attributable to the intangible, or change in the activities and risks borne by the related parties. In order to implement the commensurate-with-income standard, the White Paper suggests important changes to the existing rules of the §482 regulations. The regulations applicable to services and tangible and intangible property will probably be completely rewritten. The resale price and cost plus methods will probably be deleted, as will the rigid hierarchy of rules contained in the current regulations applicable to tangible property. The White Paper approach would coordinate the rules for services, tangible, and intangible property, recognizing that all three types of transfers are often bundled into a single economic transaction. It recommends four alternative methods, each applicable under a prescribed fact pattern. Those methods are exact comparables, inexact comparables, basic arm's-length return (generally referred to as the ballroom method), and profit split analysis. The first two methods look to an arm's-length price, while the second two methods look to an arm's-length rate of return.

The White Paper states that the ballroom method should have wide application and will probably be the appropriate method for most manufacturing affiliates and many marketing affiliates. The White Paper recommends that the exact comparable method have priority over all other methods. However, there would be no priority among the other methods although each method is designed to be used under a specific fact pattern. Therefore, the determination of which method applies would be based on the underlying facts and circumstances.

The White Paper also considers and rejects several proposed safe harbor methods, most notably several profit split approaches. While not totally rejecting the possibility that useful safe harbors could be developed, the White Paper generally concludes that no safe harbor has yet been proposed that would be useful without being subject to potential abuses. The White Paper also rejects, without much discussion or analysis, the possibility of a formula or unitary approach as opposed to the arm's-length separate accounting method.

Criticism of the White Paper

While there seems to be general acceptance that the current system has to go, there is a good deal of controversy over the White Paper recommendations. Commentators and major U.S. trading partners such as Japan, Canada, and Britain, have disagreed with the conclusion that the commensurate-with-income standard, particularly the periodic adjustment provision, is consistent with the arm's-length

principle and therefore will not increase the incidence of double taxation. International acceptance of these conclusions is probably requisite to the successful adoption of the key recommendations set forth in the White Paper. Pricing cases are often resolved by negotiations between the U.S. and foreign government competent authorities. A serious potential for disputes with treaty partners over the proper allocation of income would exist if the commensurate-with-income standard were perceived as a violation of the arm's-length standard. As a result, negotiations with the major trading partners will undoubtedly be a high priority for those working on regulations implementing the commensurate-with-income standard. Obtaining a bilateral solution to this problem may seriously delay the regulations.

The proposed ballroom method has also drawn a lot of criticism. The main criticism is that ballroom is not a method, but simply another name for "contract manufacturing", the current "aggressive" IRS examination and litigation position with respect to foreign manufacturing subsidiaries. Commentators argue that contract manufacturing/ballroom relies on industry statistics, an approach which has been expressly rejected by the courts in a number of cases. Although Treasury and IRS initially seemed unmoved by this criticism, the recent tax court decision in *Bausch & Lomb* (92 TC No. 33, Dec. 45,547), which soundly rejected the IRS' contract manufacturing argument, will undoubtedly force them to be more responsive to the criticism. Although there probably are cases where ballroom is an appropriate method, it is unlikely that the method will have the wide application suggested by the White Paper. This may leave profit split analysis as the primary method for resolving pricing cases.

While on the surface it might seem that profit split would solve the major difficulties in this area, neither the White Paper analysis nor the recent court cases applying a profit split approach provide much guidance on how to determine the appropriate profit split. For example, in the *Bausch & Lomb* decision, the court rejected the testimony of the expert witnesses for both the taxpayer and the government and determined the appropriate royalty rate based on "our best judgment" that Bausch & Lomb's Irish subsidiary would have been willing to accept as little as 50 percent of the projected profits from its manufacturing activities. This "best judgment" approach was also used by the court in the *Lilly* case. As noted by the Court of Appeals in the *Lilly* decision, no unassailably precise methodology exists for determining the appropriate profit split. The court stated that "these judgments must rely largely on intuitions informed by an understanding of the business in which the affiliated companies are engaged." It is one thing for the courts to determine an appropriate profit split using "our best judgment" but it is quite another for a taxpayer or an auditor to hope to sustain their "best judgment" in the absence of any empirical data or documentation.

Noticeably missing from the White Paper analysis is any serious discussion of inbound pricing problems and issues.

In light of the well-publicized settlement of the Japanese auto company cases last year for over \$600 million in U.S. taxes, this is pretty astounding. The study seems to have been overly influenced by outbound transfer pricing problems and the outcomes of the *Lilly* and *Searle* pharmaceutical cases. Indeed, the new super royalty provisions and White Paper recommendations will very likely provide foreign taxpayers with an opportunity to reduce their U.S. taxes on inbound transfers of intangibles.

Issues for States

So where does all of the above leave the states? The potential for the arbitrary shifting of income between taxing jurisdictions is obviously an important issue at the state level. Only a small handful of states still require the use of the worldwide unitary method. In California, for example, legislation passed in 1986 provides taxpayers with an election to file on a domestic only, or so-called water's-edge, basis for income years beginning on or after January 1, 1988. If it does anything, the White Paper reaffirms that pricing audits present enormous practical problems and involve very speculative and very large commitments of audit resources. It certainly offers very little encouragement in this area. Anyone who had hoped that the White Paper would solve the §482 application problems should be pretty disheartened. To a large extent the White Paper merely prescribes what has become IRS practice in pricing audits: contract manufacturing and profit split. The search for comparables, the most difficult and time-consuming part of transfer pricing examinations, was largely skimmed over by the White Paper.

Whether it is a search for a comparable price, a search for a comparable rate of return, or a search for an appropriate profit split, a detailed functional analysis—the most time-consuming and resource intensive aspect of §482 audits—is still required. As discussed above, such an analysis requires a considerable amount of expertise and nontax knowledge on the part of the auditor, coupled with the assistance of economists, engineers, and industry specialists. The federal government has experienced some difficulty in retaining and recruiting such resources. To retain this kind of expertise is even more difficult for the states, given their necessarily smaller resources and tax base.

Clearly, §482 audits represent a tremendous resource burden for the states. However, while the states will necessarily have to be highly selective in choosing potential audits, from a tax policy perspective it would be difficult to simply ignore the issue. Because of these resource problems, one imperative requirement in developing a viable international audit program at the state level is establishing a working relationship and channel of communication with the Internal Revenue Service. The states should obviously rely on the IRS international audit program as much as possible. However, while some reliance can be placed on the IRS' program to police potential pricing abuses between U.S. corporations

and their foreign affiliates, from the states' perspective the federal program is limited in certain respects, specifically with regard to both the number of taxpayers subjected to a detailed examination and the applicability of the federal audit results for state purposes.

Further, even applying the results of IRS audits will not be easy. While the IRS does provide Revenue Agent's Reports to the states, such reports do not contain the kind of detail needed to make the appropriate adjustment at the state level. The international examiners' report and underlying audit workpapers will need to be obtained from the IRS. Coordination with all of the IRS regions and districts to obtain such information may be a major undertaking.

Franchise Tax Board Activities

In response to the passage of California's water's-edge legislation, the Franchise Tax Board has established an International Audit Program to plan and implement a §482 audit program. The IRS has provided invaluable assistance in establishing this program. Initially, we participated in a two-week training course on international issues conducted by the IRS. The training, although helpful, was fairly basic and was not primarily devoted to transfer pricing, the most important issue in the international program. Therefore, we requested and received advanced international issues training from the IRS. Approximately 20 to 30 of our more experienced auditors and staff counsel have attended the five-week training course provided by the IRS to new international examiners. About a dozen of these people have also attended the more advanced three-week course given to IE's after a year of on the job training. Selected auditors have also been permitted, under the information exchange program, to observe international audits in progress.

Using the IRS courses as a starting point, we are in the process of developing our own international issues training course, modified to address unique issues raised by the California legislation. We have established an Industry Specialization Program (ISP), patterned somewhat after the federal ISP. Special industry teams have been established, comprised of individuals with extensive audit knowledge and experience in designated key industries. The special industry teams will audit taxpayers in their respective industry, develop training materials, and provide assistance and training to other auditors working on cases in the industry. It is hoped that with this program we will be able to develop in-house expertise in important industries. Management also anticipates a need to recruit outside experts in this field.

We are also making a concerted effort to keep open a channel of communication with IRS to enable exchanges of information on international issues on a fairly consistent basis. For example, IRS has agreed to provide us with copies of the International Program Digests. These digests are published periodically by IRS and discuss innovative audit techniques developed by IE's, unusual issues which have

arisen during the course of field examinations, and suggestions for resolving those issues. The IRS has also provided us with a copy of a training class on financial statement analysis for international examiners developed by Prof. Wheeler, a highly regarded commentator in the international area and the government's expert accounting witness in the *Lilly* case. Using the Wheeler class as a basis, we plan on providing our staff with a class in financial statement analysis.

Because of the invaluable assistance the IRS has provided us, we make a concerted effort to find ways to assist their compliance efforts. We have on occasion, for example, provided agents in the Western Region with access to copies of state returns in instances where they were having difficulty obtaining the federal return from the service center. On a

quarterly basis, we also provide magnetic tape data to the Western Region on foreign incorporated taxpayer filings in the state. Finally, although it is difficult at this point to assess how large our International Audit Program will become, we do anticipate conducting some transfer pricing audits with respect to tangible and intangible goods. From California's perspective, relying solely on the federal government to police this area is simply not a viable option in light of the fiscal implications of transfer pricing abuses.

In conclusion, we believe it is possible, with the assistance of IRS, for a state to develop a meaningful international audit program. Only time will tell how successful California's efforts have been.

WHAT CONSTITUTES INCOME DERIVED FROM WITHIN A STATE FOR PERSONAL INCOME TAX PURPOSES?

JAMES W. BRUCE

Assistant Chief Counsel

Pennsylvania Department of Revenue

Introduction

During my flight to Portland, I nodded off and had a dream. I dreamt that all of the states I was flying over were going to assess me for their fair share of my income. As I look over this group, I have to assume you are here either because you also have had this frightful nightmare or because you are a tax administrator from one of these states. For those of you who are here for reassurances, I will give you what I can.

First, the bad news. The Supreme Court in its 1920 *Shaffer v. Carter* decision made it clear that a state may impose an income tax on "incomes accruing to nonresidents from their property or business within the state or their occupations carried on therein" and thus subject a nonresident to a duty to pay taxes to the extent of his property held or his occupation of business carried on therein.

The good news is that a state's right to tax nonresidents is limited in extent. Of course, both taxpayers and revenueurs have been trying to find a yardstick to measure property, occupation, and business "extents" for 69 years.

Related Matters

Nexus Arising from Residency. First, before we start trying out our yardsticks, let me step back. Again, according to the U.S. Supreme Court, a state has authority to impose a tax on an individual that is apportioned to the ability of the individual to bear it when the economic interest realized bears a direct legal relationship to protection afforded to the recipient of the income by the state in his person, in his right to receive the income, and enjoyment of it when received.

By definition, that economic interest and that protection are each incident and attendant to the other if you are dealing with a domiciliary. Thus, you do not need a property yardstick, business yardstick, or occupation yardstick if you are dealing with a domiciliary.

The Supreme Court was not suggesting, however, that domicile is a necessary condition of a state's authority to tax an individual on income from intangibles and property and income-producing activity outside that state. It suggests only that the individual's connection with that state must show that the economic interest of that individual realized by the receipt of income or represented by the power to control or enjoy that income must bear a direct legal relationship to the protection afforded to the recipient of the income by the state, in his person, in his right to receive the income, and in his enjoyment of it when received.

In applying these abstract concepts to particular individuals, every state has struggled to define exactly what evidence is primary, fundamental, and determines "residence." The results are not pretty. Because each state has its own rules and interpretations, taxpayers end up being either a resident of more than one state or a resident of none or somewhere in between. Reciprocal agreements and tax credits help—in masking the symptoms if nothing else. Probably no perfect solution exists but achieving some degree of uniformity between the states would be a good start.

Estates, Trusts and Beneficiaries. Every trust and estate seems to have earnings comprised primarily of interest, dividends, and gains derived from intangible personal prop-

Tax Havens and Their Use By United States Taxpayers -An Overview

A report to the
Commissioner of Internal Revenue
the
Assistant Attorney General (Tax Division)
and the
Assistant Secretary of the Treasury (Tax Policy)

Submitted by:
Richard A. Gordon
Special Counsel for
International Taxation

January 12, 1981

Publication 1150 (4-81)



Fraudulent use has also included forming sales companies that are structured to appear to deal only with unrelated parties but that in fact are dealing with related parties, forming corporations to appear to be banks, hiding the fact of ownership of tax haven corporations, the use of a Cayman Islands corporation by a United States person to hide corporate receipts and corporate slush funds.

Tax havens may be used to commit crimes that violate tax as well as other laws. The most serious fraudulent use of this kind is by narcotics traffickers to accumulate or launder large sums. Often phony shelter schemes violate securities as well as tax laws. Shell banks established in St. Vincent have been used to defraud United States banks and other businesses.

The provisions of the tax law that apply to international transactions in general and to tax haven transactions in particular are among the most complex in the Internal Revenue Code. The two most important provisions affecting tax haven transactions are subpart F, which taxes United States shareholders of a United States controlled foreign corporation on certain categories of income, and section 482, which authorizes the Commissioner to reallocate income among related entities to properly reflect their income. Both of these provisions are primarily transactional in nature, that is, each separate transaction must be analyzed to determine its tax effect. Also, the foreign personal holding company provisions and the foreign trust provisions may apply.

The proper administration of subpart F and §482 often requires IRS access to detailed books and records which are not always available. The complexity coupled with information gathering problems makes the law in this area extremely difficult to administer.

Income tax treaties with tax havens are often used by residents of nontreaty countries to achieve a reduction in United States tax. The United States has a large and growing network of income tax treaties mostly with other high tax countries, but about 16 treaties are with tax havens. Many of the tax haven treaties are the result of the extension of the old United States-United Kingdom treaty to former United Kingdom colonies. The treaty with the Netherlands Antilles is in force as a result of the extension of the United States-Netherlands income tax treaty. United States treaties with Luxembourg, the Netherlands and Switzerland were independently negotiated.

There is significant use of tax haven treaties for investment in the United States. In 1978, 43 percent of the gross income paid to all nonresidents of the United States was paid to claimed residents of tax havens. Forty-six

Multistate Tax Commission



RESOLUTION URGING THE FEDERAL GOVERNMENT
TO ADDRESS THE TRANSFER PRICING ISSUE

WHEREAS, in 1983 the federal government established a Worldwide Unitary Taxation Working Group, whose members consisted of representatives of multinational businesses, the states and the federal government to develop voluntary, cooperative solutions to disputes concerning state use of the worldwide unitary combination apportionment method of determining the taxable income of multinational corporations; and

WHEREAS, in an effort to resolve the controversy over the use of the arm's length method versus the worldwide unitary method of accounting, the state members of the working group agreed to support "water's edge" unitary combination if certain conditions were fulfilled, including specific improvements in federal tax compliance and cooperation with the states; and

WHEREAS, the majority of states previously employing the worldwide method of accounting have implemented water's edge combination methods; and

WHEREAS, the federal government has not fulfilled the commitments it made in the worldwide working group for improving federal tax administration in the transfer pricing area and for increasing cooperation and support for the states; and

WHEREAS, recent hearings by a House Ways and Means Subcommittee chaired by Rep. J.J. Pickle revealed that the federal government may be losing up to \$50 billion annually in revenue due to uncorrected transfer pricing abuses; and

WHEREAS, the estimate of federal revenue losses attributable to transfer pricing abuses does not include the state revenue losses that result from the same abuses; and

WHEREAS, the states are largely dependent on the federal government to correct these transfer pricing abuses and to determine the proper share of the income of multinational corporations to be assigned to the United States; and

NOW THEREFORE BE IT RESOLVED, that the Multistate Tax Commission respectfully urges Congress, the Department of the Treasury, and the Internal Revenue Service to address effectively the problem of substantial under reporting of income earned in the United States by multinational corporations, and

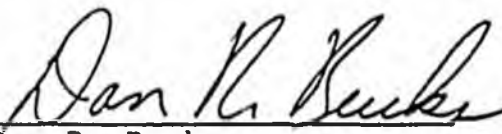


BE IT FURTHER RESOLVED, that the Multistate Tax Commission respectfully urges the federal government to fulfill the commitments it made in the Report of the Worldwide Unitary Taxation Working Group to increased federal compliance efforts and assistance to the states with respect to correcting transfer pricing abuses, and

BE IT FURTHER RESOLVED, that the Multistate Tax Commission requests the Executive Committee to review the federal response to evidence of widespread transfer pricing abuses, to communicate to all appropriate federal officials the interests and concerns of the states concerning these problems, and to recommend such further measures as it deems appropriate to resolve these issues.

Adopted this 31st day of August, 1990, by the Multistate Tax Commission.

Attest:



Dan R. Bucks
Executive Director



Legislative Update
Hearings On Transfer Pricing
By The
House Ways And Means Oversight Subcommittee

July 10 & 12, 1990

EXECUTIVE SUMMARY

The House Ways and Means Oversight Subcommittee held two days of hearings on the problem of federal income tax avoidance due to transfer pricing by foreign-controlled U.S. subsidiaries. The hearing focused in three areas: 1) defining the extent of the problem of underpayment under Code Section 482; 2) solutions to non-compliance with strong emphasis on the need for more resources for the IRS; and 3) non-compliance creating competitiveness problems between U.S.-controlled and foreign-controlled U.S. subsidiaries.

These subsidiaries pay inflated prices for goods purchased from overseas parents as a means of reducing their taxable profit. The Oversight Subcommittee just completed a nine month investigation of 36 foreign-controlled companies in the automobile, motorcycle and electronics equipment industries to study underpayment of federal taxes. The results of the investigation found that over half of the 36 companies investigated paid little or no federal income tax. These same companies had more than \$35 billion in retail sales in the U.S. in 1986. Potential underpayment by foreign-controlled U.S. companies is estimated to run as high as \$50 billion.

It is interesting to note there was little discussion of the need to look at alternative methods to the arm's-length standard. The IRS is committed to the use of the arm's-length standard to enforce Section 482. However, one former IRS employee testified that arm's-length would never work even with adequate funding and information.

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LEGISLATIVE UPDATE
HEARINGS ON TRANSFER PRICING
BY THE
HOUSE WAYS AND MEANS OVERSIGHT SUBCOMMITTEE

July 10 & 12, 1990

Background:

Representative J.J. Pickle (D,TX), chairman of the Oversight Subcommittee of the House Ways and Means Committee conducted two days of hearings on the problem of non-compliance with Code Section 482 by U.S. subsidiaries of foreign-controlled companies. Briefly, Section 482 gives the IRS the authority to distribute, apportion, or allocate gross income, deductions, credits, or allowances between related entities in order to prevent tax evasion. Section 482 is intended to prevent the artificial transfer of taxable income (such as transfer pricing) to foreign affiliates outside the U.S. The IRS uses the arm's length standard to measure compliance.

The Hearings:

The hearings focused on the problem of transfer pricing practices used by some foreign-controlled U.S. companies. These U.S. subsidiaries pay inflated prices for goods purchased from overseas parents as a means of reducing their taxable profit. The Oversight Subcommittee just completed a 9 month investigation of 36 foreign-owned companies in the automobile, motorcycle and electronics equipment industries to study underpayment of U.S. income taxes.

The results of the investigation found that over half of the 36 companies investigated paid little or no federal tax. These same companies had more than \$35 billion in retail sales in the U.S. in 1986. Potential underpayment by foreign-controlled U.S. companies is estimated to run as high as \$50 billion.

Witnesses:

Witnesses from the Treasury Department and the IRS dominated the two day hearing. Those witnesses included: IRS Commissioner Fred Goldberg; Ken Gideon, Assistant Secretary of the Treasury for Tax Policy; other high level IRS officials, IRS field agents, and former IRS Commissioners Lawrence Gibbs and Roscoe Egger. Other witnesses included Stuart Brown, Deputy Chief of Staff for the Joint Committee on Taxation; Michael Lane, Deputy Commissioner,

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U.S. Customs Service; Barbara McLennan, Deputy Assistant Secretary, International Trade Administration; Frank Sailer Deputy Assistant Secretary, International Trade Administration; Michael Granfield, Associate Vice-Chancellor, UCLA; and James Wheeler, Professor of Accounting, University of Michigan. Several members of Congress testified including Senator Jesse Helms (R,NC), House Majority Leader Richard Gephardt (D,MO), and Representatives David Bonior (D,MI) and Duncan Hunter (R,CA).

Testimony:

IRS Commissioner Fred T. Goldberg, Jr. was the dominant witness on the first day of the hearing. His testimony, aided by numerous graphs and tables requested by the subcommittee, established that in 1987 U.S.-controlled domestic corporations reported net income (less deficit) as a percentage of total receipts of 3.1 percent, while foreign-controlled domestic corporations had a 0.9 percent net income as a percentage of total receipts for the same period.

Goldberg repeatedly asserted that the aggregate data did not conclusively establish a pattern of wide-spread abuse by foreign companies of the arm's-length pricing standard under Section 482. He stated that the figures might be skewed by a disproportionate number of start-up companies which typically do not show a net profit. Rep. Pickle reminded the Commissioner that all of the 36 companies investigated were well-established corporations.

Goldberg's testimony highlighted four main areas of concern:

1. The IRS budget must be increased to allow expanded enforcement efforts;
2. Congress should allow the IRS to directly obtain independent experts without the burdensome authorization requirements currently imposed on the Service;
3. Pending legislation (H.R. 4308) should be passed to further assist the IRS in obtaining taxpayer information; and
4. Locality-based pay (pay scales tailored to the cost of living in a particular location) should be implemented as a means to recruit and retain qualified personnel.

The remainder of the first day of testimony raised many of the same issues addressed by Commissioner Goldberg. Stuart Brown, Deputy Chief of Staff of the Joint Committee on Taxation, frequently referenced a pamphlet issued by the JCT for the

hearings.¹ The pamphlet briefly addresses formulary apportionment as an alternative to the arm's-length standard. While the unitary or formulary approach is described in the publication as one which, "...having certain disadvantages of its own, avoids numerous allocation problems of present law", both the Treasury Department and the OECD (Organization for Economic Co-operational Development) are quoted in the document, dismissing this alternative because it is "necessarily arbitrary" and disregards market conditions. Aside from this written report, none of the witnesses at the hearings raised the issue of formulary apportionment or world-wide combination as an alternative to the arm's-length standard.

The conclusion of nearly every witness was that Section 482 will work if the IRS is able to obtain the necessary information from the taxpayer. Various obstacles to gathering the information were described. In most instances, the records or documents sought by the international examiner were exclusively controlled by the foreign company which either flatly refuted IRS authority to review the documents, or which employed various tactics to indefinitely delay the examiner from receiving the information. Even when the records and documents were obtained, IRS representatives testified that the information was frequently written in a foreign language and had to be translated. In several cases the companies utilized foreign accounting methods which could not be reconciled with generally accepted accounting principles.

The IRS representatives maintained that these problems are the primary impediment to a successful implementation of Section 482. In addition, the Service is handicapped by a lack of funds from competing with taxpayer representatives, such as the "Big Six" accounting firms, in retaining top-flight economic and legal experts to assist in the development and prosecution of the cases.

However, a former IRS examiner testified that in her experience, obtaining the information was not only extremely difficult, but of almost no assistance in determining what the arm's-length price of a transaction should be. She stated that the arm's-length standard exists in a world of "smoke and mirrors" where no one knows what the phrase means and that market place assumptions clearly do not work where the market place is controlled. She indicated that in one situation the only value of the information gathered was that it "froze" the facts for litigation purposes, but it did not tell her what the arm's-length price should be. She also testified that IRS managers are often more concerned with closing cases than with raising or resolving difficult issues such as transfer pricing. It was the "lack of consistency and integrity" in administering Section 482 that contributed to her decision to leave the IRS.

¹Joint Committee on Taxation, Present Law and Certain Issues Relating to Transfer Pricing (Code sec. 482) (JCS-22-90), June 28, 1990.

The first day of testimony concluded with Michael H. Lane, Deputy Commissioner, U.S. Customs Service, reporting on the Service's enforcement program, Operation RAP (Rebate and Adjustment Program). This operation targeted foreign corporations suspected of overstating the cost of insurance and freight which are "nondutiable" charges. The Customs Service faces many of the same difficulties as the IRS in determining what constitutes an arm's-length transaction between related companies in the area of import duties.

Ken Gideon, Assistant Treasury Secretary for Tax Policy was the key witness at Thursday's hearing. Mr. Gideon disagreed that transfer pricing is widespread among foreign-controlled U.S. companies. He suggested that other factors may account for low profitability including start-up expenses and the skill of management. At one point, Rep. McGrath (R,NY) asked Mr. Gideon if the arm's-length method is working. Gideon ducked the question by saying if the IRS had the data, arm's-length would work. He also suggested that taking action away from arm's-length enforcement could encourage U.S. investment abroad as well as invite foreign retaliation.

House Majority Leader Richard Gephardt's testimony focused on the competitiveness issue created when foreign-controlled corporations do not pay their fair share of federal income taxes. He has introduced H.R. 4308, the Foreign Tax Equity Act, which would enhance the ability of the IRS to investigate tax returns of foreign-controlled U.S. subsidiaries, extend reporting requirements for open tax years, and extend the statute of limitations for up to 6 years. Rep. David Bonior (D,MI), a cosponsor of H.R. 4308, provided similar testimony.

The hearing closed with a panel of witnesses including James Wheeler, accounting professor from the University of Michigan, who suggested that a new alternative minimum tax (AMT) could be a solution. Michael Granfield, Vice-Chancellor, UCLA, supported establishing a "Blue Ribbon" panel to review the whole Section 482 area. Chairman Pickle also supported the idea of establishing some type of commission or working group to study the problems associated with Section 482.

Prepared by:

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Multistate Tax Commission

REVIEW

Former Treasury Insider Debunks Claims that an International Arm's-Length Norm Exists

by Eugene F. Corrigan
General Counsel, MTC

The U.S. Treasury Department and many multinational corporations have long insisted that the arm's-length method of attributing income on a geographical basis is the normal internationally recognized method and that it works well. This country's state tax administrators have disputed such claims and have received support from IRS career staff personnel who must deal with the problems to which the arm's length method must theoretically be addressed; but such personnel cannot come forth and publicly oppose the position of their superiors in Treasury.

Solomon himself would have great difficulty in making sense out of, and trying to live with, the variety of tax systems and tax practices to which international businesses must submit around the world and within this country. On the other hand, the legitimacy of concern over such difficulties should not blind one to the facts concerning either American or foreign tax practices.

That the arm's-length method does not work well can be established by anyone who takes the time to

discuss it with IRS auditors. Absent such diligence, a mere review of the manner in which the method is supposed to be applied should make transparently clear the fact that the procedure *cannot* work, as indeed it *does not*. (See the series of three McCray articles on the subject starting in the November issue of the MTC Review, continuing in the February issue, and concluding in this issue.) IRS staff auditors, a 1972 Conference Board study, a 1973 Treasury study, a 1976 article in the Harvard Law Review, a 1980 *Journal of Taxation* article, and a 1981 GAO report have all confirmed the fact that IRS auditors must, and do, utilize formulary apportionment to accomplish results which they cannot reach by means of arm's-length adjustments alone.

Now comes new and unanticipated support for unitary apportionment from a former attorney in the Office of International Tax Counsel of the Treasury Department. Stanley Langbein served in that capacity from 1978 to 1980. In the February 17, 1986 issue of *Tax Notes*, he reviews the history of the development of what he calls the "radical" arm's-length method, analyzes the manner in which the federal government applies it, concludes that it is unworkable both theoretically and practically, demonstrates that the arm's-length method is not the international norm, maintains that unitary apportionment represents the true norm in most instances, and advocates both governmental and business support for unitary apportionment as the most widely-used, most effective and most practical means of attributing income on a geographical basis. Indeed, he recommends that the federal government itself adopt that regime. His article is entitled "The Unitary Method and the Myth of Arm's Length."

He thinks that, where comparable uncontrolled prices (CUPs) are available, they should take primacy in income calculations; but that, since they are

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Volume 1986 Number 2



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available and useful in only an extremely limited number of instances and primarily with respect to intermediate product transactions, the unitary method must remain available. He believes that the states would greatly strengthen their hand if they would amend their statutes to allow a taxpayer to make a CUP election to determine income on the basis of such transactions. This would ensure fairness to the taxpayer under those circumstances in which unitary apportionment might really produce an unfair result; but the limited number of such circumstances would protect the states against what he calls "the evisceration of the revenue base" which, he says, characterizes the separate enterprise arm's-length system.

Langbein attributes the popularity of the arm's length method with the multinationals to the fact that it establishes a presumption of correctness on the part of a return as filed and places upon the government the burden of establishing otherwise, a burden which is heavy since the taxpayer itself initially is the sole possessor of pertinent materials and information. On the other hand, he says that the unitary method places upon the taxpayer the burden of establishing that the unitary results are unfair and unreasonable. He believes that the burden is properly placed in the latter instance except under those circumstances in which it is appropriate to give precedence to comparable uncontrolled prices.

Langbein contends that, in the mid-1960s, Treasury first began its efforts to foist upon the world a "radical"

arm's-length system which has not worked, and that Treasury and the multinational business community are now falsely claiming that that system is the international norm. Treasury thus fell into the trap of quoting itself as proof for its assertions. While such overstatement may have been understandable as part of its efforts to establish some norm, its effect has been to box Treasury into an unfortunate position; a position in which Treasury finds itself unable to admit, as a matter of theory, to a practice in which its staff engages on a regular basis. Langbein concludes that a true international norm would give primacy to CUP's in those few instances in which they are pertinent and available, and would then rely on the unitary system of formulary, or fractional, apportionment in nearly all remaining matters. He contends that this would not only be theoretically respectable but would accurately reflect current international and federal practice.

He also states flatly that pending federal legislation aimed at prohibiting the states from using the worldwide unitary method "should be shelved." (Hearings on that legislation, S. 1974, are expected in May.) He maintains that British retaliation against U.S. firms, because of continued use of the method by the states, would constitute a clear violation by the British of the U.S.U.K. double taxation convention. And he says that it would be appropriate for the U.S. to retaliate against such retaliatory measures by enacting the Symms-Baucus Bill (S. 1845).

Excerpts from Article by Stanley I. Langbein

In a long and complex review of the history of the development of the arm's-length method, Stanley Langbein's *Tax Notes* article sets forth a series of perceptive observations, statements of historical fact, knowledgeable opinions, and constructive recommendations. The following are some of its highlights:

1. "I believe that the [arm's length] method is unsound in theory. . . [and] has problems, perhaps fatal problems in practice."

2. No definable or enforceable arm's-length standard exists as an international norm. "Therefore, I do not believe [that] the state unitary systems offend any international norm." (p. 642)

3. The U.S. "first embraced and then promoted a radical arm's-length notion" in the form of the arm's-length method. (p. 643)

4. The section 482 regulations provide for the "radical comminution of shared factor relationships" under which "different components of an integrated enterprise share a factor of production. . . in connection with the several functions of the components." (p. 645)

5. Even when Assistant Treasury Secretary Surrey first sought to internationalize the radical arm's-length regime twenty years ago, he was proposing it as an alternative to a regime which was "void of

rules. . . . What he attacked was not formulary systems, but the fiscal 'no man's land' which the area at that time constituted." The internationalization effort "was not conceived as an attack on formulary methods, or as involving real contradistinction between separate-enterprise and formulary-unitary rules. . . . [Professor Surrey] never used the 'arm's length' system as a stick to beat 'formulary' systems. . . ." (p. 647)

6. Treasury spokesmen seeking to internationalize the arm's-length method in the 60s "tended quite typically to speak in tones which created the impression that (1) 'arm's length' was the standard adopted 'everywhere'; and (2) that the categories and provisions of the American system constituted something of a science, that they related almost to a naturally occurring set of phenomena, which had to be deeply studied to be understood. Both of these impressions, of course, embodied substantial untruths." (p. 648)

7. "The 'new' [1965] section 482 regulations were an experiment, which involved certain radical departures from prior theory and practice. It was immediately obvious to their sponsors that they could not work, under existing legal authority, without international cooperation. So those sponsors sought to export, to internationalize the standard. In undertaking this, they embraced a rhetorical device, assimilating the standard they sought to impose to a generally defined standard; and, by dint of shadings and generalizations, assimilating other, different approaches utilized elsewhere to the same general definition. This accomplished, they then sought to transform the general definition into their particular system, and thus to persuade the international community that conformance to the general definition required basic conformity to their particular system. . . . But the only concrete achievement has been the adoption of the system, administratively but explicitly, by one foreign country, and a series of hortatory, general agreements among administrators to principles based on the system. That does not establish any international norms. . . ."

"In short, the international norm is what it ever was: the use of comparable prices when they are available, and some blend of intuitive, informal ad hoc methods when they are not—primarily an examination of the reasonableness of the profit of the component in question, or a fractional division of the integrated entity's profit." (p. 653)

8. The lack of comparable uncontrolled prices "drives any arbiter of the matter—an examining agent, or, in the litigation context, the judge—to abandon the rules of law directing use of the single component method and to seek a method which justifies a definite assignment of the entirety of the combined income. Most often this is a fractional [formulary apportionment] method." (p. 654)

9. "When the single component methods are abandoned, as to make sense of the system they must be, there is nowhere to go but back to fractional methods. This means that arm's length, defined as an antithesis of fractional apportionment, not only is not a norm, it is not even meaningfully a concept." (p. 655)

10. The 1981 GAO report "expressly suggested, as one of its major conclusions, that the Treasury seriously consider adopting a unitary method along the lines of the state systems by amendment to the regulations under section 481." (p. 657)

11. Among the major objections to the section 482 regime are: (1) that it creates uncertainty. . . ; (2) that it creates great administrative and litigation burdens. . . ; (3) that it creates the potential for overtaxation (double taxation). . . ; (4) that it creates the potential for undertaxation (double nontaxation). . . ; and (5). . . that it establishes a legal regime with nominal laws which are not enforced. . . ." (p. 657)

12. "[T]he tendency to generate skewed results is inherent in the underlying idea of a 'separate enterprise' or 'arm's length' system. The Tax Director of International Business Machines has recently stated in these [Tax Notes] pages that 'economic reality is arrived at' by recognizing 'the fact that companies consist of separate profit centers which are separately managed.' But the 'arm's length' and 'separate enterprise' approaches do not ask how the prudent business manager allocates profits among divisions, subsidiaries, components; the manager does not necessarily construct hypothetical market transactions. To cast the rules on how a manager would divide profits uses a *separate accounting* method, but not a separate enterprise standard; it is rather a *unitary* method which uses separate accounting." (p. 663)

13. "[T]he undertaxation potential of a 'separate enterprise' standard, dependent as it necessarily is upon 'single component' methods, is simply too great for any set of administrative or international rules to counteract. The logic of the system, and the rules [that] that logic generates, appears to mandate undertaxation, and that inevitably generates tax minimizing opportunities for businesses which their managers in many circumstances will not be able responsibly to decline to take." (p. 665)

14. "I do not think [that] the longstanding antipathy of the international business community to fractional methods, even if those methods increase taxes in the short run, and expose the businesses to additional international information reporting, is altogether wise." (p. 666)

15. "In sum, I believe [that] the difficulties [that] the United States 'arm's length' system has encountered are not failures of implementation, but grow out of an inherent conceptual defect in the 'separate enterprise' standard. That standard implies the use of 'single component methods,' which in turn generate the 'continuum price problem.' This sets the system oscillating back and forth between multiple taxation and base evisceration, and makes uncertainty, administrative burdens, and a world of rules without clear application inevitable. The salvation of the system is the resurrection of a fractional approach." (p. 666)

16. "[W]here there are not comparable transactions—a method must be sought which is fair, but which will not attempt the pointless task of localizing the nonlocalizable factor, to which by inference is attributable a major portion of the earnings of the entire enterprise. Fractional methods. . . fill this bill." (p. 670)

17. "[T]he method of using comparable prices, when demonstrably available, and fractional methods, otherwise, is the true, descriptive, prescriptive, and theoretically desirable *substantive* international norm. . . ." [The international norm is] "formulary apportionment, because of the

predominance of formulary features, invariably as expense allocation measures and because, given that comparable prices are ordinarily available in only a trivial range of cases, its status as a backup method does not mean that it is other than the method most frequently used." (p. 670)

18. "[T]he unitary system is very close to the true international norm. In substance it differs only in not starting with comparable uncontrolled prices. But comparable uncontrolled prices exist in only a trivial range of cases anyway. . . so this deviation should as a practical matter not be of great concern." (p. 670)

19. A basis for major corporate concern is the fact that "the application of the fractional system . . . constitutes a reporting *obligation* and constitutes a basis for *compulsory information disclosure*. . . [and that the] unitary method . . . sets forth determinate, universally applicable criteria which leave little [room] for conjecture, or manipulation." (p. 670)

20. The separate enterprise standard even when backed up by the fractional standard, as in the case of the "fourth method" used so widely in applying section 482 arm's-length adjustments, is preferable to the multinationals because it lets the taxpayer "report on the basis of single component methods without penalty, and thus place on the audit and litigation process the entire burden of avoiding wholesale base evisceration." (p. 670)

21. "[T]he arm's length system is a formula for undertaxation of international income. . . [and there exists] the suspicion that the concomitant of 'separate enterprise' is massive worldwide base evisceration. . ." (p. 671)

22. "[T]he state unitary methods. . . simply offend no norm." (p. 671)

23. "[F]ormulary methods are inevitably used, whatever the *nominem* given the overall system—fractional methods are the real, rather than the nominal, norm." (p. 671)

24. The states would greatly strengthen their hand if they would "amend their statutes to provide a 'CUP election' to taxpayers. . . to determine income on the basis of comparable uncontrolled transactions on *intermediate product transactions* only." Made available under a strict standard of comparability such as that nominally used by the federal system so that the use of third party transactions would be confined to cases of commodities or other properties which are regularly traded on an open market; and made available subject to the requirement that the taxpayer making the CUP election identify on his return the comparable uncontrolled transactions which form the basis for his allocation, such an amendment might well insulate the state

systems from the attacks to which they have been subject, and with a minimal revenue cost. "It would be difficult to distinguish such a statutory regime from the regime mandated by Article 7 of the OECD Model. . . . The CUP elections will be available in relatively few cases, so that the revenue loss. . . should be containable. (p. 671)

25. S. 1974 "should be shelved." (p. 672)

26. "The federal government negotiates the conventions, participates in the discussions of international organizations, and has written the regulations that embrace the radical 'separate enterprise' notion. It did this without state participation. . . [I]f the federal government. . . feels it necessary to secure to foreign governments and their nationals the benefit of a bargain the federal government thinks the foreign governments made, it can do so by funding the amount necessary to make them whole. . . This amount could be determined by a . . . direct federal. . . foreign tax credit. . . for the state tax on that portion of the base determined under the unitary method over that determined under whatever 'arm's length' method the federal government wants to permit the state to use." (p. 672)

27. "As to the threat of United Kingdom retaliation, I am thoroughly comfortable with the Symms-Baucus bill, and other proposals, which would retaliate in turn against the threatened retaliation. The Gryllis Amendment [in the House of Commons] would clearly violate the double taxation convention with the United Kingdom; the unitary methods clearly do not violate the convention, whatever the state of international norms." (p. 672)

28. "I believe [that] it is none too early to start thinking of ways to dismantle the 'separate enterprise' notion at both the federal and international levels. . . [N]ational legislation needs to move toward a 'unitary' method." (p. 672)

29. "The United States has spent the last 20 years as the apostle of the 'new' arm's length system, which it is not extreme to say the United States has to a substantial extent forced upon the world. . . [A]t some point we must be candid with ourselves and the international community about the nature of our experience with the comminution of shared factor relationships, the creation of income and the single component methods. At a minimum we should address whether the progressive degeneration of procedural principles and method priorities in the cases is evidence that the use of fractional methods in the absence of comparable prices is inevitable regardless [of] whether one calls one's system a 'separate enterprise' approach or not." (p. 673)



ALASKA STATE LEGISLATURE
HOUSE OF REPRESENTATIVES
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June 8, 1989

MEMORANDUM

TO:

ATTN:

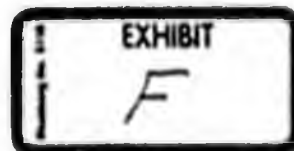
FROM: Ginny Fay
Legislative Analyst

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

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

Background

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



In recent years, the unitary tax principle has come under considerable attack--largely as a result of efforts to apply scientific exactness to a concept which is relatively broad and is, by its nature, impervious to exactness.¹ In applying the unitary tax principle in the context of corporate income taxation, the courts have focused on whether a state was making a reasonable effort to effect a fair division of the income of a multi-state taxpayer.² Toward this end, the U.S. Supreme Court avoided endorsing any particular method of unitary apportionment as the preferred method. In *Container*, the Court noted that variations on the theme of unitary apportionment can be acceptable as long as those variations "are logically consistent with the underlying principles motivating the unitary approach." The fact that another approach, such as separate accounting, might produce a different result is irrelevant: adherence to reasonable principles is the standard against which the courts have measured tax methods.

All states that use the unitary tax must determine the corporate income that is to be apportioned. Alaska is the only state that uses a method called worldwide combined reporting. Worldwide combined reporting totals all of the income from all subsidiary and affiliated corporations engaged in a unitary business even if they are located outside of the United States.³ Other states use a waters edge approach which apportions only the income earned by the unitary business within the United States.

During the 1980s, worldwide combined reporting has been criticized by the United States government and both foreign and domestic multinational corporations. The federal government opposes worldwide combined reporting because of fear of 1) state interference in foreign trade and 2) reprisal by foreign nations whose multinational corporations are taxed by states using this method. Because states' application of worldwide combined reporting to domestic multinational corporations has been upheld by the Supreme Court, federal action to date has been limited to persuading states to stop using this version of the unitary tax.

Domestic and foreign multinational corporations oppose the use of worldwide combined reporting because they do not believe that states have the right to tax business activities that occur outside the United States. In addition, these corporations claim that state taxation of foreign activities constitutes

¹Gene Corrigan, "A Unitary Primer," Multistate Tax Commission, Volume 1988, Number 1, May 1988, p. 1.

²*Container Corporation of America v. Franchise Tax Board*, 463 U.S. 159, 169 (1983).

³Alaska uses a modified formula apportionment method for computing taxable income of oil and gas corporations. For information on apportionment formulas, see House Research Agency Memoranda 85.012 and 89.303.

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

Alternatives to Worldwide Combined Reporting

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

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

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

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

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

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classification would not change tax liabilities of foreign corporations. Critics also claim that U.S. based multinational corporations may pay higher taxes than foreign corporations on similar income.

This alternative is similar to Senate Bill 119, introduced by Governor Cowper in the 1989 legislative session. The governor's bill, which applied to nonpetroleum corporations, would exempt foreign multinational corporations from worldwide combined reporting and tax them with a waters edge approach. Because the bill would result in a competitive disadvantage for domestic corporations, it was stridently opposed by U.S. industry and made little headway in the legislature.

Waters Edge Combination Including Dividends and 80/20 Corporations. This alternative to worldwide combined reporting includes limiting the unitary group to the waters edge and including all foreign source dividends in the calculation of income, and treating all 80/20 corporations as if they were within the waters edge. Only dividends generated by foreign subsidiaries that are significantly related to the activities of the unitary group would be included in income of domestic multinational corporations.

Supporters of this option claim that it would reduce foreign criticism of states' application of worldwide combined reporting and it would result in equitable taxation of all taxpayers. Proponents claim that even though worldwide income of domestic multinational corporations is taxed (through taxation of dividends) by the states, while worldwide income of foreign multinationals is not, foreign government taxation of dividend income repatriated to the home country of the parent corporation equalizes any inequities. Opponents of this option disagree and claim that this method of taxation would put U.S. multinationals at a considerable competitive disadvantage in the world economy. Furthermore, opponents claim that fully taxing foreign source dividends is identical to taxing the income of their foreign subsidiaries and yields the same result as worldwide combined reporting.

Waters Edge Combination Excluding Foreign Dividends and 80/20 Corporations. This alternative to worldwide combined reporting limits the income of the unitary group to those corporations within the boundaries of the United States. However, this option excludes all or at least a high percentage of foreign source dividend income, depending on the particular option chosen. In addition, 80/20 corporations are considered to be foreign corporations and are excluded from the unitary group. This option is generally favored by both foreign and domestic multinational corporations. Foreign multinational corporations and governments support this alternative because it eliminates worldwide combined reporting. Domestic multinational corporations like this option because it keeps them competitive in the world economy by not taxing foreign source dividends. Opposition comes mainly from state governments that fear a serious erosion of their tax base if foreign source dividends and 80/20 corporations are excluded from taxation.

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

In general, business leaders would like to have all states determine taxable income by using separate accounting because it uses information directly related to traditional accounting income. Opponents, which include many states, claim separate accounting makes states vulnerable to manipulation of income to reduce tax liabilities by corporations that do business in more than one state. However, under the separate accounting method Alaska imposed on the petroleum industry under AS 43.21, revenues from the corporate income tax were considerably higher than under either the standard apportionment formula applied before 1977 or the modified formula used after 1981.⁵

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

Alaska Revenue Sources and Relationship to Unitary Taxation

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

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

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

Table 1 shows the contribution to total state revenues of each of these types of revenue in FY 88.

TABLE 1
CONTRIBUTIONS TO TOTAL STATE REVENUE BY TYPE OF REVENUE, FY 88
(Millions of Dollars)

TYPE OF REVENUE	DOLLAR CONTRIBUTION	PERCENT OF TOTAL
Unrestricted Revenue	\$2,305.8	63.7
Restricted Revenue	475.2	13.1
Special Funds	836.4	23.1
TOTAL	\$3,617.4	100.0

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

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

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

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

^aIncludes \$694.8 million in royalty income, \$132.6 in investment earnings, and \$6.0 million in rents. Petroleum resource revenues are shown in more detail in Table 3.

^bOuter Continental Shelf "8(g)" or Dinkum Sands settlement partial payment.

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

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

Table 3 provides a breakdown of the contribution to FY 88 unrestricted revenues by the various petroleum revenue sources.

TABLE 3
CONTRIBUTION OF PETROLEUM REVENUE SOURCES
TO STATE UNRESTRICTED REVENUES, FY 88
(Millions of Dollars)

SOURCE OF REVENUE	CONTRIBUTION	PERCENT OF TOTAL
Corporate Income Tax	\$158.0	8.1
Severance Tax	818.7	42.0
Royalties	694.8	35.6
Property Tax	96.2	4.9
Bonus Sales	5.6	0.3
Rents	5.7	0.3
Intergovernmental Receipts	8.7	0.4
Special Settlements	161.9	8.3
TOTAL	\$1,949.6	100.0

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

Description of Unrestricted Revenue Sources

Corporate Income Taxes. Alaska Statute 43.20 imposes a unitary income tax on the entire corporate income derived from sources within Alaska, and apportions this income under graduated rates. In FY 88, the corporate income tax generated a total of \$181.4 million, of which \$158.0 million, or 87 percent, was collected from petroleum corporations.

Gross Receipts Taxes. A variety of taxes are collected under this general heading. A business license tax of \$25 is assessed annually on any business operating in the state. The license fee for each state and national bank, trust company and savings and loan association is seven percent of net income. In FY 88, a total of \$1.4 million was collected from this source.

In addition to the business license tax, gross receipts taxes are levied on various seafood production activities. Taxes on commercial fishing (AS 43.75) include a raw fish tax of 4.5 percent of the value of salmon canned at shore-based canning facilities, a three percent tax on the value of all other fish canned by shore-based facilities and a five percent tax on the value of fishery resources processed by floating processors. Developing commercial fisheries are taxed at lower rates. In FY 88, these taxes contributed \$22.5 million to state revenues.

Salmon enhancement taxes (AS 43.7⁶) are levied on limited entry fishing permit holders within qualified regional aquaculture associations. Rates are two or three percent of the value of the salmon caught, depending on the vote of the aquaculture association. In FY 88, total Salmon Enhancement Tax receipts were \$5.8 million. In effect, this is a pass-through program, since the legislature appropriates these tax revenues to the regional associations from whose members they were collected.

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

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

Severance Taxes. Oil production taxes are levied upon oil producers for all oil produced from each lease or property in the state, less any part of production exempt from taxation (AS 43.55). The tax is 15 percent of gross value (except 12.25 percent for the five-year period following commencement of new oil production after June 30, 1981) adjusted by the Economic Limit Factor (ELF) for mature oil fields. The ELF, however, was repealed effective January 1, 1989.⁶ Gross value is calculated as the sales price minus transportation costs at the point of production. Gas production taxes (AS 43.55) are levied at the greater of a rate of \$0.64 per thousand cubic feet of taxable gas or ten percent of the gross value of taxable production calculated at the point of production, multiplied by the ELF. During FY 88, \$816.4 million was collected in oil and gas production tax revenues.

The oil and gas regulation and conservation tax (AS 43.57) is levied upon oil and gas producers at the rate of four mills per barrel (oil) and four mills per 50,000 cubic feet (gas) of oil and gas removed or sold from each lease or property in the state, less any tax exemptions. Gross value is calculated as for the production taxes. This tax contributed \$2.3 million to state revenues in FY 88.

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

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

property as the state, a state credit is given for the tax paid to the municipality. Oil and gas property taxes generated \$96.2 million in FY 88.

Sales and Use Taxes. Fuel taxes (AS 43.40) are levied at the rate of four cents per gallon for aviation fuel and 2.5 cents per gallon for jet fuel, eight cents per gallon for gasoline and diesel fuel, and five cents per gallon for marine fuel. Sixty percent of the revenues from aviation fuel taxes are returned to municipalities that operate municipal airports. Gross receipts from fuel taxes contributed \$33.6 million to state revenues in FY 88.

Alcoholic beverage taxes (AS 43.60) are assessed based on alcoholic content: malt beverages (one percent or more of alcohol) \$0.35 per gallon, wine (21 percent or less alcohol) \$0.85 per gallon, hard liquor (more than 21 percent alcohol) \$5.60 per gallon. Contributions from this tax are shared with political subdivisions of the state. The FY 88 gross revenue from this source was \$11.9 million.

Cigarette taxes (AS 43.50) are levied at the rate of eight mills for each cigarette imported into or acquired in the state; this is equivalent to 16 cents per pack. Two and a half mills are dedicated to school construction and 5.5 mills are paid to the general fund. In FY 88, the cigarette tax generated \$8.7 million, of which \$2.7 million was dedicated to school construction and \$6.0 million was deposited into the general fund. Those revenues were from the sale of over 54 million packages of cigarettes, down from 62 million packs in FY 87. The 1989 legislature increased the undedicated portion of the cigarette tax to 12 mills per cigarette, resulting in a total tax of 29 cents per pack.

In addition, the Cigarette Tax Act requires annual licensing by the Department of Revenue of the following: cigarette manufacturers (\$5), distributors and wholesale distributors (\$50), vending machine operators (\$25), and others who import cigarettes into Alaska (\$25). These license fees generated \$3,225 in FY 88, the majority from \$25 licenses.

Licenses and Permits. Business license taxes on alcoholic beverage licenses, commercial fishing licenses, professional and occupational licenses, and various regulatory permits contributed \$8.6 million (including the alcoholic beverage fees mentioned above) in FY 88.

Nonbusiness license taxes include receipts from hunting, trapping, and sports fishing licenses, and motor vehicle instruction permits, title transfers, registration fees, and drivers' licenses. In FY 88, these fees totaled \$19.7 million.

Investment revenues include the investment earnings from the state's various investment portfolios and interest on bank deposits. Investment earnings totaled \$132.6 million in FY 88.

State Resource Revenues. State royalty payments (AS 38.05) include royalties from minerals and oil and gas. Depending on the type of resource, royalty payments can be taken in kind. Revenues from royalties are apportioned between the permanent fund and the general fund. General fund royalty revenues totaled \$594.8 million in FY 88.

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

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

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

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

Revenue Implications of Changing Alaska's Corporate Income Tax

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

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

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

combined reporting form of the unitary tax, but faced opposition from U.S. multinational corporations on the grounds that the result would be better tax treatment of their foreign competitors. The compromise in California was to drop worldwide combined reporting for companies that complied with a variety of requirements but to leave it for those which did not.⁸ These cases are likely to answer a number of unresolved issues regarding the uniformity of treatment of foreign-source dividends and 80/20 corporations by the waters edge and the worldwide combined reporting approaches to taxation.

In a parallel case, a California state court ruled that California's use of worldwide combined reporting during the tax years 1970 through 1973 was contrary to the national policy favoring waters edge taxation, as expressed by the executive branch of the federal government.⁹ The case is under appeal.

In summary, there are three reasons most often stated for considering a change from worldwide combined reporting:

- worldwide combined reporting reduces the ability of the state to attract foreign investment,
- the federal government strongly discourages state use of worldwide combined reporting, and
- there is potential for the application of worldwide combined reporting by foreign multinational corporations to be declared unconstitutional by the U.S. Supreme Court.

The remainder of this section analyzes these reasons and discusses implications to Alaska of changing the corporate income tax structure.

Effect on Foreign Investment. This is the most important reason that several states have recently changed from worldwide combined reporting to a waters edge approach. The verdict on whether these changes have affected foreign investment, however, is not clear. John LaFaver, Montana's director of Revenue, who moderated a panel on unitary taxation at the Multi-State Tax Commission in 1988, said

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 waters edge, have served to substantially increase the cost of compliance for both taxpayers and tax agencies. We have reduced the tax base in

⁸ *State Policy Reports*, May 1989, p. 12.

⁹ California Superior Court; Gardner, J.; *Colgate-Palmolive Co. v. Franchise Tax Board*, No. 319715, December 12, 1988.

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

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

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

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

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

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

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

Alaska Revenue Implications. From a revenue standpoint, Alaska's corporate income tax accounted for \$181.4 million, or 7.9 percent of state unrestricted revenues in FY 88. Of this \$181.4 million, \$158.0 million (87 percent) was paid by petroleum companies. Petroleum corporations in Alaska include foreign multinational, U.S. multinational, and U.S. domestic corporations. Therefore, any change in corporate tax law is likely to result in a shakeup of the petroleum industry. The \$23.4 million in nonpetroleum corporate income taxes was one percent of Alaska's FY 88 unrestricted revenues. A change in the corporate tax structure would affect the tax liability of nonpetroleum corporations, but the impact on state revenue is about 1/10th of one percent.

According to information from the Office of the Governor and oil industry officials, the oil industry does not have a problem with Alaska's use of worldwide combined reporting. The oil industry considers worldwide combined reporting preferable to separate accounting.¹¹ Because of problems related to the shifting of income to minimize tax liabilities, returning to separate accounting might not be in Alaska's long-term best interest. Given these considerations, there is little compelling reason for Alaska to change corporate taxation of petroleum corporations unless required to do so as a result of court decisions.

It is extremely difficult to determine the revenue impacts of changes to corporate tax laws. Before changing its tax law, the State of California spent two years and \$1.0 million to analyze the effects--and their results were off by \$250 million.¹² The Alaska Department of Revenue (DOR) indicates that they are not able to determine the revenue impact of applying waters edge taxation to petroleum corporations in Alaska. However, the DOR estimated (in the fiscal note for SB 118) that applying waters edge unitary taxation to foreign multinational corporations would not decrease state revenues by more than \$60,000 and would be revenue neutral. The DOR also concluded that applying the waters edge unitary approach to all nonpetroleum corporations would cost approximately \$3 to \$4 million annually in foregone tax revenues. As a result of this potential loss in revenues, the governor's bill would apply only to foreign corporations.

Given the potential benefits of modifying Alaska's tax structure--pacifying foreign criticism, encouraging foreign investment, complying with federal government opposition to the use of worldwide combined reporting, and

¹¹Specific industries and corporations vary in their position on corporate income tax treatment based on how changes will affect their tax liability in a particular state. For example, petroleum corporations prefer worldwide combined reporting over separate accounting in Alaska but take the opposite position in California.

¹²Steve Kettel, director, Alaska Department of Revenue, Income and Excise Tax Division, personal communication, February 7, 1989.

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

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

* * *

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

Attachments

ATTACHMENT A
State Treatment of Foreign-Source Dividends

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

	Exemption			Treatment of Balance		Statute(s)
	Exempt	Conditional	Partial	Allocate	Apportion	
ALABAMA				X		§149-18-34, 40-18-35(14), Reg. 810-3-31.02
ARIZONA	X					§43-1122(d), L. 1938, c. 109, eff. for taxable years beginning from/after 12-31-83
ARKANSAS		If 95% ownership of payor.			X	§84-2003(2)(j)
CALIFORNIA 1)		If more than 50% ownership of payor, 75% exclusion of base period dividends (greatest amount of dividends received in any one of 1984, 1995 or 1986 income years); exclusion of foreign dividends in excess of base period amount dependent upon increase or decrease in foreign payroll factor.			X	§24271, 24402
2)					X	§24411, L. 1988, c. 630, eff. for tax years beginning on/after 1-1-88
COLORADO			Amount of exclusion of all foreign-source income dependant upon election of federal foreign tax deduction or credit.		X	§39-22-33, §39-22-305(10), L. 1985, H. 3018, eff. for tax years beginning on/after 1-1-83
CONNECTICUT	X					§12-217(d)(D)
DELAWARE	X					§1503(a)(2)
FLORIDA	X					§220.13(1)(b)2.a, ch. 84-549, Laws of Florida, eff. for tax years beginning on/after 9-1-84
GEORGIA	X					§48-7-21(b)(9)
HAWAII					X	§235.7(c)
IDAH0 1)			85% exclusion.		X	§3-3022
2)					X	§3-3027C, L. 1966, c. 342 (HB 669), eff. for tax years beginning 1-1-88
ILLINOIS		If 80% ownership of payor.	Otherwise, 85% exclusion.		X	§2-203(b)(2)(D), L. 1932, P.A. 82-1029, eff. for taxable years ending on/after 12-31-82
INDIANA 1)		If 80% ownership of payor.	Otherwise, 85% exclusion if ownership of payor is less than 80% but at least 50%, or 50% exclusion if less than 50% ownership of payor.		X	§1-1-15(b)
2)					X	§1-1-15(b), L. 1987, P.L. 383, eff. for taxable years beginning after 12-31-87
IOWA					X	§422-35
KANSAS 1)			80% exclusion.		X	§79-32.138
2)					X	§79-32.138(c)(vi), L. 1987, c. 386, eff. for taxable years beginning after 12-31-87
KENTUCKY	X					§141.010(12)(b)
LOUISIANA					X	§442.A, 63, 242(1)(d), 243.A(4)