

ALASKA LEGISLATURE COMMITTEE FILES 1991-1992 8672  
7577 SENATE LABOR & COMMERCE

The Bristol Bay Buyback Coalition will be hiring independent scientists and economists to review and analyze the MMS studies. Also, since the Federal government has now released some preliminary data from the Valdez spill studies, the Coalition will also prepare a short study similar to the expected F&WS report. Coalition staff will be visiting Washington D.C. during April and May to urge Congress to support a continued moratorium on drilling and to work for a buyback of the leases.

The Coalition recognizes the fiscal constraints on a straight cash buyback of the leases and therefore has been advocating the use of crediting the value of cancelled leases either towards the purchase of leases in upcoming OCS sales or as a credit on royalty or lease rent payments. Another option would be for the Federal government to reimburse the oil companies over several years so as to minimize the impact on the budget process.

The Buyback Coalition is being assisted by the Alaska Conservation Foundation which has set up the Bristol Bay Protection Fund. Contributions to the Fund help support activities of the Coalition and are tax-deductible. Several member groups of the Coalition have already made significant contributions including the Bristol Bay Borough, the Pacific Seafood Processors Association, Concerned Area M Fishermen, the Alaska Crab Coalition and the Egegik Setnetters' Association. The Alaska Fisheries Development Foundation has also made a large contribution to the Fund.

Since its inception in October 1990, the Coalition has grown to include thirty-two member organizations:

Association of Village Council Presidents  
Bristol Bay Coastal Resource Service Area  
Cenaliurrit Coastal Resource Service Area  
Greenpeace Alaska  
Northern Alaska Environmental Data Center  
Southwest Alaska Municipal Conference

Bristol Bay Borough  
Bristol Bay Native Association  
Choggiung, Ltd.  
Lake & Peninsula Borough  
Nunam Kitlutsisti, Inc.  
Trustees for Alaska

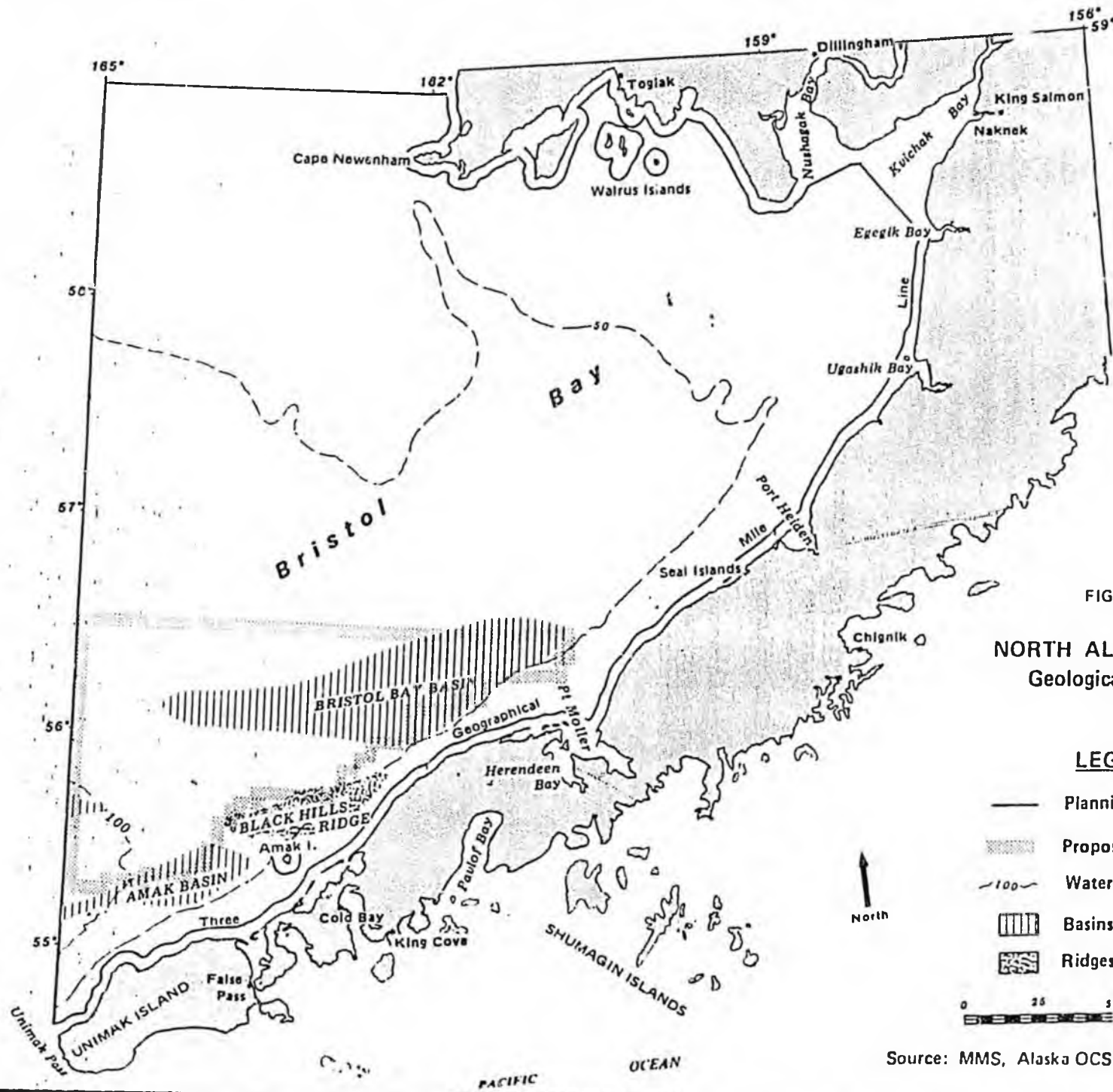


FIGURE III-1

**NORTH ALEUTIAN BASIN  
Geological Structures**

**LEGEND**

- Planning Area Boundary
- ▨ Proposed Lease Sale Area
- 100- Water Depth in Meters
- ▤ Basins
- ▦ Ridges



Source: MMS, Alaska OCS Region, 1983

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# Congress maintains drilling moratorium in Bristol Bay waters

By DAVID WHITNEY  
Daily News reporter

10/28/90  
WASHINGTON — Prohibitions on offshore oil drilling in Bristol Bay will be maintained for another year under a hard-fought compromise congressional leaders accepted Saturday.

The deal, part of a 1991 spending bill for the Interior Department and related agencies, means that the Bush administration also will be legally barred from selling new leases off the coasts of Oregon, Washington, California and Florida.

In another last-minute action, Congress approved reauthorization of the Magnuson Fishery Management and Conservation Act.

That measure bans the use of long driftnets by U.S. fishermen and directs the Bush administration to negotiate a similar worldwide ban with other fishing nations.

The act also creates a new mechanism for spreading the cost of federal observers on commercial fishing vessels throughout the industry.

Anch. News  
Until Saturday's compromise on offshore drilling, it appeared that that issue might turn into a hot battle holding up the adjournment of Congress.

The chief opponent of the ban was Sen. J. Bennett Johnston, a Louisiana Democrat whose hefty campaign contributions from the oil and gas industry helped finance his re-election victory this month over former Ku Klux Klan grand dragon David Duke.

Johnston is chairman of the Senate Energy and Natural Resources Committee. He argued that his committee, and not congressional appropriators, had jurisdiction over issuing drilling bans.

But Johnston was criticized because his committee, despite hearings on offshore development, had failed to produce legislation telling the Bush administration which offshore areas could be developed and which could not.

The impasse was broken

Please see Page B-3,  
CONGRESS

## CONGRESS: Moratorium maintained for Bristol Bay

Continued from Page B-1

when Rep. Les AuCoin, D-Oregon, offered the Senate a deal allowing another year of drilling bans in exchange for the House agreeing not to raise grazing fees that critics claim are so low that federal lands are being ruined by livestock at taxpayer expense.

The deal was an important political victory for coastal states.

One of the most ardent advocates of the House drilling ban was Rep. Bill Lowery, D-Calif., who argued that Bush's June announcement was based on determinations by the National Academy of Sciences that the federal Minerals Management Service didn't have the necessary scientific analysis to support its offshore drilling program.

Sen. Ted Stevens was caught in the middle of the controversy.

Commercial fishermen and the Gov. Steve Cowper don't want Bristol Bay drilled. The area is among the most productive fishing grounds in the world. The annual wholesale value of the Bristol Bay fishery is about \$1 billion.

Federal studies are now under way to determine whether the the federal gov-



ernment should buy back Bristol Bay oil leases worth \$95 million. Those studies were ordered after the Exxon Valdez tanker dumped nearly 11 million gallons of crude oil into Prince William Sound last year.

Stevens said that while he supported the ban on Bristol Bay development for another year, he was not content with the moratoriums in other areas because of the pressure it placed on offshore development in his state.

"My state has 80 percent of the outer continental shelf," Stevens said, referring to those federally owned areas where oil development could occur.

In the end, however, it was Stevens who moved for the Senate to cave in and accept AuCoin's offer.

"Senator Stevens has saved our bacon," said C. Deming Cowles, a lobbyist for the Alaska commercial fishing industry.

"Six weeks ago he told us he would get us another moratorium," Cowles said. "This morning he did it."

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STEVE COWPER  
GOVERNOR



7

STATE OF ALASKA  
OFFICE OF THE GOVERNOR  
JUNEAU

September 7, 1990

The Honorable Jamie L. Whitten  
Chairman  
House Committee on Appropriations  
H-218 Capitol Building  
Washington, D.C. 20515

Dear Mr. Chairman:

As you know, the Interior Appropriations Subcommittee has included a moratorium on oil and gas exploration in Bristol Bay in its markup of the House appropriations bill. I am writing to urge you to retain this important protective measure during the full Committee's deliberations.

We anticipate that, given the upheaval in the Persian Gulf, Congress will carefully scrutinize any budget action that has the potential to affect our energy position. For your information, I have included a copy of my recent remarks before a hearing on National Energy Strategy conducted in Fairbanks, Alaska, by Deputy Energy Secretary W. Henson Moore. You will see that Alaska is now, and will continue, doing its share to contribute to the nation's energy security. We now provide 20% of total U.S. domestic production, have more offshore areas under lease than the entire OCS combined, and have taken recent action to enable exploration and development of additional North Slope fields.

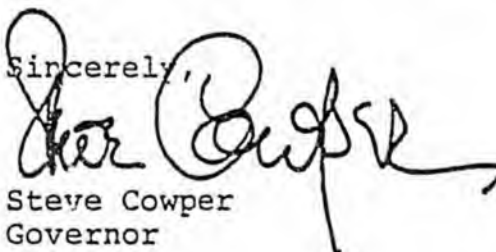
Bristol Bay is the only area where we have ever opposed oil and gas development, and we continue to oppose such development today.

As you know, the report accompanying the FY 1990 appropriation to the Department of the Interior called for studies on contingency planning and response technology for the North Aleutian Basin, an assessment of the applicability of Exxon Valdez oil spill findings to a potential spill in Bristol Bay, and an examination of the possible repurchase of the leases from Sale 92. The conclusion of those studies is not expected until March 1, 1991. It seems logical to us that the moratorium should be extended through the next fiscal year to enable Congress to have the benefit of those studies before deciding whether exploration and development should go forward.

In our view, of course, the known value of the fish and wildlife resources of the North Aleutian Basin clearly outweighs the low potential of the area's hydrocarbon resources, and that view is not changed by the present world situation. For more than a decade, Alaskans have expressed their concern at risking this biologically productive area to the chance of an oil spill. We have consistently opposed oil and gas development in Bristol Bay and continue to believe that the best resolution of the matter is an eventual repurchase of the leases there.

Thank you for your consideration of my views on this important matter.

Sincerely,

A handwritten signature in black ink, appearing to read "Steve Cowper", written over the word "Sincerely,".

Steve Cowper  
Governor

Enclosure

Identical letter sent to all members of the House Committee on Appropriations

cc: Senator Ted Stevens  
Senator Frank Murkowski  
Congressman Don Young

ROBERT C. BYRD WEST VIRGINIA CHAIRMAN

DANIEL K. INOUE HAWAII  
ERNEST F. HOLLINGS SOUTH CAROLINA  
J. BENNETT JOHNSTON LOUISIANA  
QUENTIN N. BURDICK NORTH DAKOTA  
PATRICK J. LEAHY VERMONT  
JIM SASSER TENNESSEE  
DENNIS DECONCINI ARIZONA  
DALE BUMPERS ARKANSAS  
FRANK R. LAUTENBERG NEW JERSEY  
TOM HARKIN IOWA  
BARBARA A. MIKULSKI MARYLAND  
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BROCK ADAMS WASHINGTON  
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MARK O. HATFIELD OREGON  
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JAKE GARN UTAH  
THAD COCHRAN MISSISSIPPI  
ROBERT W. RASTEN JR. WISCONSIN  
ALFONSO M. DAMATO NEW YORK  
WARREN RUDMAN NEW HAMPSHIRE  
ARLEN SPECTER PENNSYLVANIA  
PETE V. DOMENICI NEW MEXICO  
CHARLES E. GRASSLEY IOWA  
DON NICKLES OKLAHOMA  
PHIL GRAMM TEXAS

# United States Senate

COMMITTEE ON APPROPRIATIONS  
WASHINGTON, DC 20510-6025

8

JAMES H. ENGLISH, STAFF DIRECTOR  
J. KEITH KENNEDY, MINORITY STAFF DIRECTOR

February 9, 1990

The Honorable Fred Zharoff  
Alaska State Senate  
Box V  
Juneau, Alaska 99811

Dear Fred:

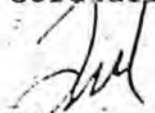
Knowing of your interest in drilling in the North Aleutian Basin, I thought you'd like copies of the Interior Appropriations bill addressing that issue. You'll find the relevant sections on pages 25-26. President Bush signed the measure into law on October 23rd. I know my staff called your office after the Congress passed the bill, but I thought you'd like to see the provisions for yourself.

The budget the President sent to Congress the end of January did not include a North Aleutian Basin moratorium for FY91. The reports required in the FY90 conference report -- the review of contingency plans, the analysis of the impacts of the Prince William Sound spill on fisheries resources, and the buy-back options -- will not be completed until March 1, 1991. Therefore, Don and I will work to impose another one-year moratorium in the FY91 Interior Appropriations bill while we wait for those studies to be completed. A one-year moratorium is the maximum delay possible under this bill since it applies only to the 1991 budget year. We're announcing that decision today at the UFA Convention, but wanted to give you a heads up.

Thanks for sharing your views on this important issue to the people Southwest Alaska. Your comments were helpful as we developed our language. We'll continue to keep you posted as we continue to work on this important issue to Western Alaska.

With best wishes,

Cordially,

  
TED STEVENS.

Original mailed with enclosure

MAKING APPROPRIATIONS FOR THE DEPARTMENT OF THE INTERIOR  
AND RELATED AGENCIES FOR THE FISCAL YEAR ENDING SEPTEMBER  
30, 1990, AND FOR OTHER PURPOSES

lower:

In:

Октябрь 2, 1989.—Ordered to be printed

Mr. YATES, from the committee of conference,  
submitted the following

CONFERENCE REPORT

[To accompany H.R. 2788]

The committee of conference on the disagreeing votes of the two Houses on the amendments of the Senate to the bill (H.R. 2788) making appropriations for the Department of the Interior and related agencies for the fiscal year ending September 30, 1990, and for other purposes, having met, after full and free conference, have agreed to recommend and do recommend to their respective Houses as follows:

That the Senate recede from its amendments numbered 17, 19, 40, 42, 46, 51, 52, 53, 65, 66, 67, 68, 69, 73, 77, 80, 89, 90, 99, 101, 103, 108, 109, 115, 116, 117, 127, 130, 147, 154, 155, 156, 157, 158, 159, 160, 161, 162, and 163.

That the House recede from its disagreement to the amendments of the Senate numbered 2, 3, 4, 5, 6, 7, 20, 29, 30, 36, 56, 74, 75, 78, 82, 119, 125, 126, 141, 148, and 151, and agree to the same.

Amendment numbered 1.

That the House recede from its disagreement to the amendment of the Senate numbered 1, and agree to the same with an amendment, as follows:

In lieu of the sum proposed by said amendment insert \$442,084,000; and the Senate agree to the same.

Amendment numbered 8:

That the House recede from its disagreement to the amendment of the Senate numbered 8, and agree to the same with an amendment, as follows:

In lieu of the sum proposed by said amendment insert \$5,961,000; and the Senate agree to the same.

Amendment numbered 9:

That the House recede from its disagreement to the amendment of the Senate numbered 9, and agree to the same with an amendment, as follows:

the Senate instead of \$10,000,000

## SURVEY

### ON, AND RESEARCH

\$484,709,000 for surveys, investigations, and research as proposed by the House and \$486,931,000 as proposed by the Senate. The decrease in the House consists of \$67,000 for the Louisiana barrier island program, \$100,000 for offshores geologic surveys, \$100,000 for roadless and RARE II studies, and \$100,000 for dissemination of water data.

Surveys are expected to continue

to receive priority consideration. Aerial Photography Program

the existing site selection procedure for the side-looking airborne photography, if priority considerations in Mississippi, and Alabama and Louisiana could be completed;

studies for coastal studies should include eastern Texas as part of options

a feasibility study on alternate marine research facility, including the Marine Science Center in Newport,

of Tualatin River pollution as part of the joint Federal/State program, and should not be undertaken without participation;

the possibility of assisting the State through the Federal/State Cooperation to locate a water supply for use

\$1.5 million appropriated for the study of roadless areas on work identified in the Idaho State Wilderness Act. The State and the Idaho Geologic Survey will coordinate their field operations with the Idaho Geologic Survey.

## MENT SERVICE

### MANAGEMENT

\$178,525,000 for leasing and \$15,066,000 as proposed by the House and \$173,459,000 by the Senate.

The net increase over the amount proposed by the House includes increases of \$1,000,000 in outer continental shelf lands for second year funding of a three-year cost-shared oil spill research initiative and \$3,600,000 in royalty management to initiate a project to place audits on a more timely schedule using additional in-house and State and tribal auditors.

The increases are partially offset by decreases of \$1,000,000 in outer continental shelf lands for the environmental studies program and in royalty management of \$100,000 for systems development and \$41,000 for refunds on Indian allottee lease overpayments.

The managers agree that the MMS should coordinate and cooperate in the Northwest OCS Task Force which was established to assist in identifying and resolving OCS issues specific to that region. The managers expect the MMS to work closely with the task force on identifying and conducting needed environmental studies and on scheduling the prelease steps leading to Sale 132. The Federal government and the States are urged to appoint high level management officials, authorized to make commitments on behalf of their respective organizations, to the task force.

The managers agree that the focus of the oil spill research initiative should be on containment, cleanup and mitigation measures including those associated with spills from tanker accidents.

Elsewhere in the bill there are restrictions on OCS oil and natural gas leasing activities. None of these restrictions apply to the non-fuel minerals leasing program on the OCS.

The grounding of the Exxon Valdez on March 24, 1989 in Prince William Sound has led to concern among many people, including the fishermen of Bristol Bay, over the possible impact oil and gas exploration and development in the North Aleutian Basin could have on fisheries resources. The managers recognize that these concerns should be addressed before oil and gas exploration in Bristol Bay goes forward. For that reason, the managers have included a one-year moratorium on exploration and development in the North Aleutian Basin.

The managers agree that the Secretary of the Interior should conduct a three-pronged study to address concerns related to oil and gas exploration in the North Aleutian Basin and report to the Committees by March 1, 1991 as follows:

1. Within available funds, the Fish and Wildlife Service, in cooperation with the National Oceanic and Atmospheric Administration and the State of Alaska, is to conduct a study of the effects of the March 24, 1989 oil spill on the Prince William Sound fisheries. The Service may draw upon the results of the fisheries research projects being conducted as part of the damage assessment process under the Clean Water Act and the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA). These studies are already funded through the CERCLA process. The study should also address the applicability of its findings to reasonable potential threats to the Bristol Bay fisheries if OCS exploration and production were to occur in the North Aleutian Basin.

2. In order to better assess the risk in the North Aleutian Basin, the Secretary is to determine if:

(i) contingency plans for the North Aleutian Basin are acceptable and based on the best available technology;

(ii) the technology, equipment and personnel will be in place and personnel will be adequately trained to implement the contingency plans; and

(iii) the contingency plans together with the technology, equipment and personnel in place to implement them are capable of containing a maximum volume spill during the exploration phase. A maximum volume spill shall be determined by potential spill volume and without reference to the probability of such a spill occurring.

3. The Secretary is to examine the possible repurchase of leases currently held in the North Aleutian Basin, including alternative options for compensating lease holders in the North Aleutian Basin, assuming the compensation procedures outlined in 43 U.S.C. 1334 and applicable court decisions. These options should include, to the extent practicable, credits in lieu of appropriations, such as credits on Federal royalties on producing OCS leases. Based on the results of the Fish and Wildlife study and the North Aleutian Basin risk assessment study, the Secretary is to recommend whether the repurchase options should be exercised. No such option may be exercised, however, without an Act of Congress addressed to this issue.

In directing the Department to conduct these studies, the managers' action should not be construed as support by the Congress for either continuing or discontinuing the moratorium in the North Aleutian Basin. Nor should it be construed as taking a position on whether the leases should be repurchased.

In other matters, the managers endorse the concept of a more timely audit cycle using in-house and State and tribal auditors. The managers caution the MMS to proceed at a reasonable pace in implementing the contemporaneous audit initiative. Candidates for in-house auditing positions should be carefully screened and interviewed to ensure that a high quality and enduring program is maintained. Hiring through term appointments for the audit program should be minimized and used only to the extent that highly qualified candidates are available for such appointments. Routine attrition in the staffing of permanent positions should permit the MMS to manage an orderly reduction of the additional auditors hired to support the project as the contemporaneous audit objectives are achieved.

Amendment No. 33: Earmarks \$56,060,000 for royalty management instead of \$52,601,000 as proposed by the House and \$56,796,000 as proposed by the Senate.

Amendment No. 34: Reported in technical disagreement. The managers on the part of the House will offer a motion to recede and concur in the amendment of the Senate with an amendment as follows: In lieu of the matter proposed by said amendment, insert: *Provided further, That of the above enacted amounts, up to one-half of the increase over the fiscal year 1989 funding provided for mineral royalty audits may be used to compensate States and Indian tribes for audit activities under the provisions of sections 202 and 205 of the Federal Oil and Gas Royalty Management Act of 1982 (30 U.S.C. 1732, 1735): Provided further, That for fiscal year*

# Bill includes oil lease buy-back

By DAVID WHITNEY  
Daily News reporter

WASHINGTON — The Interior Department would study buying back about \$95 million worth of oil leases in Bristol Bay under an agreement reached Thursday by House and Senate negotiators working on a 1990 spending bill.

The provision also prohibits any oil drilling in the bay for a year.

The development was a victory for Alaska fishermen and the state. They had long protested any oil development in the bay, one of the world's richest fishing grounds.

The state lost a federal court suit to block leasing in the bay. Those leases were awarded late last year.

Concern about Bristol Bay oil development was heightened after the March 24 oil spill in Prince William Sound, which closed several commercial fishing districts.

Alaska fishermen, joined by national environmental organizations, lobbied the House for a buy-back provision as part of its one-year moratorium.

During the House debate, Alaska Rep. Don Young was equivocal on a lease buy-back and several House members cit-

ed him as being opposed.

When the spending bill reached the Senate, Alaska Sen. Ted Stevens offered a provision that required the Interior Department only to study the impacts of the March 24 oil spill and to evaluate whether oil-spill contingency plans for Bristol Bay development would be adequate.

Young said Thursday that strong support from the state and fishermen for repurchasing the leases caused him and Stevens to fight for the House-passed provision.

The Interior Department report must be approved by both

houses before President Bush may sign it.

What was finally agreed to was a melding of the House and Senate provisions, with some modifications that give plenty of room for the Interior Department to conclude that repurchasing the leases is not warranted.

Any buy-back decision will be tied directly to the results of the oil-spill impact study. Only Congress could authorize the lease repurchases, which probably would be paid for with credits on royalties owed for other offshore oil developments.

Please see Page D-4, BRISTOL

## BRISTOL BAY: Bill will include oil lease buy-back

Continued from Page D-1

Besides studying the oil-spill affects, the Interior Department would review oil-spill contingency plans for Bristol Bay, oil-spill technology and equipment that would be in place, and the oil industry's capability of responding to "a maximum volume spill during the exploration phase."

Based on these studies,

the department would have to recommend whether buying back the leases should be authorized.

The reports, and any agency recommendations, are due by March 1991, meaning that no development in Bristol Bay is likely for at least that long.

At the time Stevens' provision was approved by a Senate Appropriations Com-

mittee panel in July, the Republican lawmaker said he would base a decision on whether to support buying back the leases on the oil industry's track record.

"It depends on the credibility of the oil industry at the time," Stevens said. "Today, that credibility is at a low ebb. I would not want Alaska to become again a proving ground for that credibility."

But Stevens said Thursday he will use the Interior Department studies to make up his mind.

"If research shows that the oil spill has caused irrevocable damage to Prince William Sound fisheries and that the impact of a similar incident would be the same in Bristol Bay, I will support buying back the (Bristol Bay) leases," he said.

# NEWS RELEASE

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STATE OF ALASKA

OFFICE OF THE GOVERNOR  
P.O. BOX A  
JUNEAU, ALASKA 99811

STEVE COWPER,  
GOVERNOR



FOR INFORMATION CONTACT:

DAVID RAMSEUR  
PRESS SECRETARY

TERENCE O'MALLEY  
DEPUTY PRESS SECRETARY

(907) 465-3500

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FOR IMMEDIATE RELEASE  
April 26, 1989  
No. 89-74

## COWPER PROPOSES BUY BACK OF BRISTOL BAY LEASES

JUNEAU--Gov. Steve Cowper has called on the federal government to buy back from the oil industry more than \$114 million worth of leases bid for oil development in fisheries-rich Bristol Bay in the aftermath of the Exxon oil spill.

The Governor, in a letter to the chairman of the U.S. House subcommittee with jurisdiction over Alaska off-shore development, said oil development in the bay should be cancelled and the bid money refunded.

"It is no longer assurance enough to delay exploration and development in Bristol Bay for six months or one year or one year at a time for an indefinite period," Cowper told Rep. Sidney Yates, D-Ill., and chairman of the House Subcommittee on Interior and Related Agencies.

"Studies during such a period would confirm what Alaskans have long contended: the relatively low probability of finding commercial deposits of oil in Bristol Bay does not justify the risk to one of the most biologically productive offshore areas in the world. In our opinion, it is time to cancel the sale and refund the bid money. The risks are too high and the potential benefits too low to pursue any other course."

-MORE-

Despite opposition to oil development in Bristol Bay by Cowper and his two predecessors, the federal government has proceeded with collecting \$114.7 million in leases in the area. The state has challenged the sale in federal courts and plans to appeal the issue to the U.S. Supreme Court if necessary.

In the meantime, Cowper said the specter of an oil spill similar to the March 24 Exxon spill in Prince William Sound is "unthinkable."

"Alaskans already have had to face the closure of this year's multi-million dollar Prince William Sound salmon herring fishery and black cod fishery and the attendant loss of jobs and community stability," the Governor said. "We face the potential of losing a portion or all of the Prince William Sound salmon fishery. The loss of seabirds, marine mammals and the coastal environment is not yet measurable, but likely immense."

The salmon fishery in Bristol Bay is worth about \$1 billion annually and the region is home to one of the world's largest collections of marine mammals.

Cowper noted that in 1976 the state bought back leases in Kachemak Bay following an oil spill. The federal buy-back he proposed could include tax credits or credits for future leases.

Cowper's proposal comes on the heels of his request to President Bush that a moratorium be imposed on Bristol Bay pending a federal review.

Chairman Yates has not yet formally responded to the Governor's proposal.

SJR

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Rod's understanding was that there was a 10% tax on all travel fares. There was a \$6.00 departure tax on top of that (\$6.00 each way).

My understanding from what the people at DOT said (see attached) and my talks with Alaska, Delta, and Markair is:

There is definately a \$6 departure tax.

There is another tax (Federal U.S. Transportation Tax) but it is pro-rated and is less than 10% if you are traveling between Alaska the rest of the country. For example: according to AK Airlines, the tax amount between Seattle to Juneau is .0409.

The tax is 10% if you are just traveling within Alaska.

If you are travelling in the lower 48 you also pay 10%.

I faxed this portion to Randy Simmons (DOT) to make sure I knew what I was talking about and he said I did. They don't want to write a position paper against your resolution . . . but they don't really think it's a good idea . . .

ok -  
we won't  
keep it

---

Plz share this  
info w/ Rod

KATY THE FOLLOWING WAS A MESSAGE I GOT FROM GENNY AT STATEWIDE AVIATION. SJR WAS BY LABOR AND COMMERCE IF THE MESSAGE IS CORRECT : DON'T THINK WE WOULD WANT THE THINGS CHANGED  
MESSAGE WAS AS FOLLOWS:

i called usdot to verify what the \$6.00 federal excise tax is. usdot indicates that there is indeed a \$6.00 excise tax for travel between the lower 48 and points in Alaska. However, the tax is actually less than the 10% domestic ticket tax assessed for travel within the lower 48 states. the \$6.00 tax was originally proposed as a mechanism to encourage travel to alaska and hawaii by reducing the cost of travel here. here is how it was explained to me..... for travel solely between points within alaska (just like points within the lower 48), a 10% tax is assessed on the ticket price, i.e. a \$500.00 round trip ticket from Anch to Barrow would be assessed a \$50.00 tax. For travel between an Alaska point and the lower 48, however a \$6.00 "international departure fee" is charged for each way, plus a portion of the domestic tax. For example, let's say a round trip ticket between Fai and Seattle is \$500.00. A passenger would pay the \$12 departure fee plus a reduced domestic tax of \$10.90 ( $\$500 \times .0214$  (from a tax table) ). that means the passenger saves \$27.10 in taxes. USDOT assumes that elimination of the \$6.00 tax would put Alaska and Hawaii in the "domestic " category, subject to the full %10 tax on all travel within and outside Alaska. In other words, the alternative doesn't look too attractive. i'll be out tomorrow morning at a seminar, but will be in at 9:30 to discuss further. jenny  
p.s. quick mail is fun.



APR 13 14:23 DOT&PF COMM. OFFICE JUNEAU

FAX NO. 9072431512

P.3/8 02

01-16-92 03:55 PM FROM US/DOT AK AVIATION

701/04



U.S. Department of  
Transportation  
Office of the Secretary  
of Transportation

Phone (907) 271-5147  
FTS 868-5147

FAX (907) 271-5146  
FTS 868-5146

**ALASKA AVIATION FIELD OFFICE**

222 W. 7TH Avenue #27  
Room 545  
Anchorage, Alaska 99513

DATE 1/16 NUMBER OF PAGES 6 + COVER

TO JENNY OLENDORFF

FROM DIANNA STRAIN

HERE'S EVERYTHING YOU EVER WANTED TO KNOW ABOUT TRANSPORTATION TAXES. SELECT THE APPROPRIATE CODE FOR YOUR ALASKAN CITY FROM THE TABLE ON PAGE F173. THEN SELECT THE DOMESTIC U.S. CITY FROM THE ALASKAN/HAWAII TAX TABLE ON PAGES 174-176. MULTIPLY THE RATE FROM THE APPLICABLE COLUMN BY THE FARE. THE \$6 INTERNATIONAL AIR TRANSPORTATION TAX IS APPLICABLE TO BOTH INCOMING AND OUTGOING FLIGHTS i.e. \$12 ON A ROUND TRIP TICKET.

*This is passed from  
local U.S. DOT office*









01-16-92 03:55 PM FROM US/DOT AK AVIATION

P01/04



U.S. Department of Transportation  
Office of the Secretary of Transportation

Phone (907) 271-5147  
FTS 868-5147

FAX (907) 271-5146  
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**ALASKA AVIATION FIELD OFFICE**

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Anchorage, Alaska 99513

DATE 1/16 NUMBER OF PAGES 6 + COVER

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*This is person from local U.S. DOT office*

HB

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# REPRESENTATIVE TOM MOYER

DISTRICT 19 • 119 N. CUSHMAN ST., SUITE 203 • FAIRBANKS, AK 99701 • (907) 456-8161

International Trade & Tourism, Chair • State Affairs, Vice Chair • Resources, Member

## MEMORANDUM

To: Senator Drue Pearce  
Chair, Senate Labor and Commerce

May 15, 1991

From: Representative Tom Moyer *TCM*

Re: HB12, An Act relating to the water's edge method of calculating income taxes for certain corporations; and providing for an effective date.

Pending referral by the Senate president, I would like to request the Senate Labor and Commerce Committee to hear HB 12 as soon as possible because of the short time remaining in the legislative session. The House voted 34-5 to approve the bill last night and it is vitally important for at least one Alaska economic development project that it be passed this session.

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

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

Attached are materials about the bill and I am happy to provide additional information or testify about the legislation at your convenience.

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## Questions About House Bill 12, relating to the water's edge tax

### • What is the purpose of HB12?

The bill would change Alaska's corporate income tax system to encourage additional investment to Alaska and increase the state's share of the international marketplace.

### • How does HB12 work?

The bill would replace Alaska's corporate unitary tax with a so-called "water's edge" tax system for both foreign and domestic owned companies. Under a unitary system, all the activities of a corporation worldwide are subject to taxation in Alaska. Under this water's edge proposal, the domestic activities would be subject to Alaska taxes as well as 20 percent of the dividends and royalties from foreign income.

### • Why make the change?

Alaska remains the only state with a unitary system on the books. Since 1984, 11 states have altered their worldwide unitary tax system, including such leaders in international trade as California, Florida and Oregon. International corporations dislike the unitary tax because they consider it double taxation and are reluctant to invest in states which have unitary tax systems. Alaska in April earned a "D" from the Corporation for Enterprise Development, a private research group, for economic performance, in part for lack of diversity.

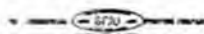
### • What's the cost of changing from unitary to water's edge?

The Alaska Department of Revenue estimates an initial annual revenue loss of between \$500,000 and \$3 million. In addition, the Department estimates it would need an additional auditor. However, bill supporters believe the new investment the change would attract to Alaska would offset any revenue loss. As economist Gregg Erickson told the House Finance Subcommittee: "There is a correlation between corporate income taxes and business location decisions, and perceptions by businesses about a jurisdiction's taxing attitude also affect those decisions."

-MORE-

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**• Who supports the bill?**

The bill is supported by many businesses and business groups including the Anchorage, International and Alaska State Chambers of Commerce, Alaska Miners Association, Associated General Contractors of Alaska, IMB, Xerox and Keidanren, the Japan Federation of Economic Organizations.

U.S. Sen. Frank Murkowski told a joint session of the Alaska Legislature in March: "The legislature should discard Alaska's outdated unitary tax system. By attracting capital we will fulfill our potential as a natural jumping-off point for corporations doing business in our part of the world."

**• What is Barclays and what's the connection to HB12?**

Barclays refers to a 1990 California Court of Appeals decision holding that, as applied to foreign-based unitary groups, the California worldwide combined reporting method of corporate income taxes violates the foreign commerce clause of the U.S. Constitution. The case should have no direct bearing on Alaska until it reaches the U.S. Supreme Court. But if Barclays is upheld by federal courts, Alaska's current unitary tax could be found unconstitutional. That's why Section 2 of the bill was added in House Finance and appears in the Rules CS.

**• Does the bill result in a tax on the cruise ship industry?**

No. The Finance CS did propose to remove a federal tax exemption for the cruise ship industry. However, the Rules CS dropped this provision because its applicability may have been broader than initially intended and the fiscal impact was impossible to calculate in a relatively short period. Additionally, the administration is addressing the issue in a more comprehensive form.

**• Why doesn't HB12 apply to oil and gas companies?**

This is an economic development incentive bill. The sponsors feel that oil and gas companies operating in Alaska pay adequate taxes and especially after the 1989 Economic Limit Factor change, feel a change in the tax structure for those companies is not necessary at this time. Several court cases including the 1985 separate accounting case in *Arco v. Alaska* upheld the right of Alaska to impose different tax methods to different industries in the state. Alaska applied a standard apportionment formula before 1977 and a modified formula after 1981. The oil and gas industry has not asked to be included or excluded from HB12.

*--By Representative Tom Moyer  
May 14, 1991*

**FISCAL NOTE**

**STATE OF ALASKA  
1991 LEGISLATIVE SESSION**

**BILL NO. CSHB12**

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

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

COMPONENT SERIAL NO. | 1 | 1 | 3 |

**EXPENDITURES/REVENUES: (Thousands of Dollars)**

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

**FUNDING: (Thousands of Dollars)**

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

**POSITIONS:**

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

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

ANALYSIS: Attach a separate page for analysis.

ATTACHED

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

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

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

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

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

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



ANCHORAGE  
ECONOMIC  
DEVELOPMENT  
CORPORATION

## Proposal to Reform Alaska's Worldwide Unitary Method of Taxation

### Executive Summary

**GOAL:** To reform Alaska's worldwide unitary method of taxation by adopting a "water's edge" combined method that applies equally to domestic and foreign multinational corporations.

**PROBLEM:** Alaska is the only state that requires worldwide unitary taxation. In addition, no country in the world uses this method of taxation. Why? Worldwide unitary taxation can distort a company's taxation relationship to states and cause double taxation of income earned in another governmental jurisdiction.

**BENEFITS:** A reform of the worldwide unitary system should make Alaska a more attractive place to invest if it is applied equally to domestic U.S. and foreign corporations.

**ACTIONS:** The AEDC will support and recommends your support of the committee substitute for Senate Bill 119 (Finance) which was approved 14 to 5 by the Senate in the 1990 session. The bill, to be reintroduced, provides for a "water's edge" combined reporting method of taxation for both domestic and foreign multinational corporations.

### UNITARY TAX

The following are examples of unitary & illustrate the typical distortion produced by unitary

		<u>Unitary Principle</u>			
		<u>Seperate Acctg. (arm's length)</u>	<u>Domestic (water's edge)</u>		<u>Worldwide</u>
			<u>High</u>	<u>Low</u>	
SALES	<u>In-state</u> Everywhere		$\frac{100}{1000} = .10$		$\frac{100}{2000} = .05$
Property	<u>In-state</u> Everywhere		$\frac{200}{4000} = .05$		$\frac{200}{6667} = .03$
Payroll	<u>In-state</u> Everywhere		$\frac{120}{2000} = .06$		$\frac{120}{3000} = .04$
Average Factor			.07	.07	.04
Income			40	40 + 30	100
Apportioned Income			2.80	4.90	4.00
Distortion				75%	43%

SYNOPSIS OF CSSB 119 (Finance)

Senate Bill 119, as originally introduced, provided for water's edge reporting for only for corporations having foreign parents. That bill contained no definition of a water's edge reporting method, however, and left it largely to the discretion of the Department of Revenue to prescribe the method that taxpayers would be required to use. The proposed CS does two things. First, it expands the coverage of the bill to include domestic multinational corporations; second, it sets out in some detail the provisions that will govern tax returns under a water's edge combined reporting method.

The proposed CS contains only one substantive provision, contained in sec. 2 of the bill. \*/ Section 2 adds a new section to AS 43.20 -- AS 43.20.073. That provision is divided into seven subsections. Subsection (a) sets out the kinds of affiliated corporations that are to be included in the taxpayer's water's edge combined tax return. These consist only of (1) corporations that do substantial business within the United States (regardless of whether

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\*/ Section 1 of the proposed CS sets out the purpose of the Act -- to promote investment and trade opportunities in the state. Sections 3 and 4 are effective date sections, providing that the water's edge method will apply to tax years beginning after December 31, 1989.

they are incorporated in the United States or elsewhere), \*\*/  
(2) domestic and foreign sales corporations (which are essentially paper corporations formed for the purpose of obtaining special federal tax treatment under the Internal Revenue Code), and (3) so-called "tax haven" corporations (which have been formed for the purpose of avoiding taxes in the United States).

Subsection (b) provides that certain income received from foreign corporations will be excluded from the taxpayer's total taxable income -- specifically, 80 percent of dividends and royalties as well as all amounts that are treated as dividends under Sec. 78 of the Internal Revenue Code. \*\*\*/ Foreign dividends and royalties are in actuality nothing more than income earned outside the United States that happens to be returned to

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\*\*/ Specifically, a corporation is considered to be part of the taxpayer's water's edge "family" (and its income taxable in Alaska) if 20 percent or more of its average property, payroll and sales factors are within the United States. An affiliated corporation with less than 20 percent of its property, payroll and sales factors within the United States will also be considered part of the water's edge group if that corporation does not meet the requirements of sec. 861(c) of the Internal Revenue Code; that is, if 20 percent or more of the corporation's gross receipts are from sources within the United States.

\*\*\*/ Under the Internal Revenue Code, a corporation is permitted to take a tax credit for income taxes paid by certain affiliated foreign corporations. Section 78 provides that if a corporation does take a foreign tax credit, an amount equal to the tax credit will be "deemed" to have been received as taxable income by the taxpayer corporation as a dividend from the foreign corporation. Alaska does not allow corporations to take a foreign tax credit. Thus in Alaska there is no justification for including any amount of these "deemed" dividends in the corporation's taxable income.

the domestic parent in the form of dividends or royalties. Since the purpose of a water's edge method is to tax a corporation based only on income derived from its United States operations, foreign income in the form of dividends and royalties must be excluded. At the same time, a certain amount of the total expenses that a domestic parent incurs inevitably go towards supporting the income producing activities of its foreign subsidiaries. The expenses attributable to foreign operations should not be deductible from income that is earned within the United States. For that reason, the proposed CS provides that 20 percent of dividend and royalty income received from a foreign corporation will remain taxable. The actual expenses of a particular corporation in a given year may, of course, be greater or less than 20 percent of its foreign dividend and royalty income. However, it would be extremely difficult for the Department of Revenue to determine precisely which expenses of a corporation are actually attributable to foreign operations. The simplest way to deal with the concern that expenses related to foreign operations will be deductible from domestic income is simply to require corporations to include each year a fixed percentage of their foreign dividends and royalties as taxable income.

Subsection (c) is borrowed from Minnesota's water's edge statutes, and addresses a concern that the Minnesota tax administrators had that a taxpayer might attempt to claim the 80 percent exclusion for dividends or royalties received from a

foreign corporation that is not part of the taxpayer's unitary business -- in other words, purely passive investment income. This provision ensures that corporations will not be able to exclude any portion of passive investment income received from foreign corporations.

Subsection (d) simply recognizes that the 20 percent of foreign dividends and royalties that are included in taxable income are included for the purpose of offsetting the expenses of the parent corporation attributable to its foreign operations.

Subsection (e) provides that if taxpayers do not provide the Department of Revenue with the information it needs to properly audit a water's edge return, then the department may require the taxpayer to file a worldwide combined return instead.

Subsection (f) makes it clear that the water's edge reporting method is not applicable to taxpayers subject to AS 43.20.072, who are engaged in the production or transportation of oil or gas.

Subsection (g) contains definitions of the terms "affiliated corporation," "affiliated group," "foreign corporation," and "water's edge combined reporting method."

Offered; 3/26/90  
Referred: Rules

P 82  
go0179sE

Original sponsor(s): Rules/Governor

1 IN THE SENATE

BY THE FINANCE COMMITTEE

2

CS FOR SENATE BILL NO. 119 (Finance)

3

IN THE LEGISLATURE OF THE STATE OF ALASKA

4

SIXTEENTH LEGISLATURE - SECOND SESSION

5

A BILL

6 For an Act entitled: "An Act relating to the water's edge method of cal-  
7 culating income taxes for certain corporations other  
8 than corporations engaged in the production of oil or  
9 gas from a lease or property in the state or in the  
10 transportation of oil or gas by regulated pipeline in  
11 the state; and providing for an effective date."

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

13 \* Section 1. It is the purpose of this Act to promote investment and  
14 trade opportunities in the state.

15 \* Sec. 2. AS 43.20 is amended by adding a new section to read:

16 Sec. 43.20.073. AFFILIATED GROUPS. (a) A corporation that is a  
17 member of an affiliated group shall file a return using the water's  
18 edge combined reporting method. A return under this section must  
19 include the following corporations if the corporations are part of a  
20 unitary business with the filing corporation:

21 (1) an affiliated corporation that is eligible to be in-  
22 cluded in a federal consolidated return under 26 U.S.C. 1501 - 1505  
23 (Internal Revenue Code) if the corporation's property, payroll, and  
24 sales factors in the United States average

25 (A) 20 percent or more; or

26 (B) under 20 percent, if the corporation does not meet  
27 the requirements of 26 U.S.C. 861(c);

28 (2) a domestic international sales corporation; in this  
29 paragraph, "domestic international sales corporation" has the meaning

1 given in 26 U.S.C. 992(a);

2 (3) a foreign sales corporation; in this paragraph,  
3 "foreign sales corporation" has the meaning given in 26 U.S.C. 922(a);

4 (4) a corporation, regardless of the place where the corpo-  
5 ration was incorporated, if the corporation's property, payroll, and  
6 sales factors in the United States average 20 percent or more;

7 (5) a corporation that is incorporated in or does business  
8 in a country that does not impose an income tax, or that imposes an  
9 income tax at a rate lower than 90 percent of the United States income  
10 tax rate on the income tax base of the corporation in the United  
11 States, if

12 (A) 50 percent or more of the sales, purchases, or  
13 payments of income or expenses, exclusive of payments for intan-  
14 gible property, of the corporation are made directly or indirect-  
15 ly to one or more members of a group of corporations filing under  
16 the water's edge combined reporting method;

17 (B) the corporation does not conduct significant  
18 economic activity.

19 (b) When computing taxable income for a corporation under (a) of  
20 this section, the following amounts shall be excluded:

21 (1) 80 percent of dividend income received from foreign  
22 corporations;

23 (2) an amount treated as a dividend under 26 U.S.C. 78;

24 (3) 80 percent of the royalties accrued or received from a  
25 foreign corporation.

26 (c) In (b)(1) and (3) of this section, a payment is considered  
27 to be received from a corporation that is part of the unitary business  
28 if the payment is received

29 (1) by a member of an affiliated group included in a

1 water's edge combined report filed under this section; and  
2 (2) from a corporation in which the recipient owns 50  
3 percent or more of the stock of the corporation.

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

7 (e) The department may require a corporation that files under  
8 (a) of this section to file a worldwide combined report instead, if  
9 the corporation or an affiliated corporation

10 (1) fails to comply with regulations adopted under this  
11 chapter, including domestic disclosure spread sheet filing require-  
12 ments; or

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

16 (f) This section does not apply to taxpayers subject to AS 43.-  
17 20.072 engaged in the production of oil or gas from a lease or proper-  
18 ty in the state or engaged in the transportation of oil or gas by  
19 regulated pipeline in the state.

20 (g) In this section,

21 (1) "affiliated corporation" means a member of an affili-  
22 ated group to which the taxpayer filing a return under (a) of this  
23 section belongs;

24 (2) "affiliated group" means a group of two or more corpo-  
25 rations, in which 50 percent or more of the voting stock of each  
26 member of the group is directly or indirectly owned by one or more  
27 corporate or noncorporate common owners, or by one or more of the  
28 members of the group;

29 (3) "foreign corporation" means a corporation created or

1 organized outside of the United States, the District of Columbia, the  
2 Commonwealth of Puerto Rico, or a possession of the United States;

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

7 \* Sec. 3. This Act applies to tax years beginning after December 31,  
8 1989.

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

## INTRODUCTION

States have the power to levy taxes in accordance with their own laws, subject to the restrictions imposed principally by the Due Process Clause of the 14th Amendment and the Commerce Clause of the U.S. Constitution. Under the Due Process Clause, a minimal connection must exist between a corporation's activity and the taxing state, and the income attributed to the state for taxing purposes must be rationally related to income-generating values within the taxing state. Under the Commerce Clause, a state is prohibited from adopting a taxing scheme which discriminates against, or places an undue burden on, interstate commerce.

In complying with these restrictions, states impose apportionment methods for determining the income of a multinational corporation within their borders.

### WHAT IS UNITARY TAXATION

All states imposing an income tax on the multi-state business activities of a corporation use apportionment generally by a variation of a three factor formula comprised of the average of sales, property and payroll in the state divided by the average of to sales, property and payroll everywhere. Most states apply this formula only to the total U. S. income from business activities conducted by the specific company located in their state. This is generally referred to as the "separate accounting" or "arm's length" method. The "arm's length" method is used for federal income tax purposes, and is the international standard. Some states have adopted the "unitary principle", under which they combine the income of the company located in their state, with the income of all related companies (parent, subsidiaries, and brother-sister corporations). The combined income is then apportioned to these states using a combined factor representing sales, property and payroll of all unitary companies.

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

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

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

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

## WHY DID STATES USE WORLDWIDE UNITARY?

On an emotional level, business felt that states used unitary simply to increase tax revenues; states, by contrast, saw worldwide unitary as a weapon against what they perceived as wide-spread cheating by multinational corporations shifting of income from the United States to tax havens. Fortunately, these purely emotional responses on both sides have been ameliorated considerably through the unitary reform process, and the issues have become amenable to a more objective analysis.

For instance, in the Container case, the U. S. Supreme Court had a more reasoned explanation for the unitary principle:

"One way of deriving locally taxable income is on the basis of formal geographical or transactional accounting. The problem with this method is that formal accounting is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise."

## OBJECTIONS TO WORLDWIDE UNITARY

Despite the continued lack of uniform guidance or "bright line" tests, most integrated multinational corporations would concede that they are unitary with their related companies, at least with those engaged substantially in the same line of business. The real question is the necessity and desirability of extending the unitary principle to foreign operations.

It is the very nature of the three factor apportionment formula<sup>3</sup> that income automatically migrates to high price/high wage jurisdictions. When the formula is applied to U.S. operations, the everywhere base is relatively homogeneous and distortions between states is insignificant. However, as a

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3. Most states use an income apportionment method by means of a three factor formula---they assume that their state's proper share of a multi-state income is their state's percentage of in-state property, payroll, and sales compared to the corporation's total domestic (U.S.) property, payroll, and sales.

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

TABLE 1.

	SALES -----	PROPERTY -----	PAYROLL -----	INCOME -----	APPORTIONED INCOME -----
DOMESTIC:					
In-State	<u>100</u>	<u>200</u>	<u>120</u>		
Everywhere	1,000	4,000	2,000		
Factor	.10	.05	.06		
Income				40	
Average Factor			.07		
			(equals .07 times income of 110)		2.80
WORLDWIDE:					
In-State	<u>100</u>	<u>200</u>	<u>120</u>		
Everywhere	2,000	6,667	3,000		
Factor	.05	.03	.04		
Income				100	
Average Factor			.04		
			(equals .04 times income of 100)		4.00
DISTORTION					43% <sup>1/4</sup>
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4. The distortion percentage (43%) is calculated by comparing the difference between the domestic apportioned income and the worldwide apportioned income.

In this example, 60% of total income was earned outside of the U.S., but foreign operations employed only 40% of the income-producing factors.<sup>/5.</sup> This disparity produces a distortion of 43%.

The question inevitably arises, if the unitary group is limited to "water's edge", how should foreign income repatriated in the form of dividends be treated? In the above example, taxation of foreign dividends repatriated, for instance, at a 50% rate would result in:

TABLE 2.

Domestic Unitary Income	40
Foreign Dividends (50% of 60)	30
	-----
Total	70
Domestic Factor	X .07
	-----
Apportioned Income	4.90
	=====

Obviously, including as much as 50 percent of foreign dividends in a "water's edge" method in a corporation's total U.S. taxable income produces even greater distortions than those produced by the "pure" worldwide unitary method.

In testimony on unitary taxation,<sup>/6.</sup> Robert N. Mattson IBM Assistant Treasurer, has emphasized this point:

"LET NO ONE MISUNDERSTAND THIS POINT: INCLUSION OF FOREIGN DIVIDENDS IN THE STATE'S TAX BASE IS CLEARLY AN EXPANSION OF THE WORLDWIDE UNITARY TAX AND NOT AN ADOPTION OF A WATER'S-EDGE APPROACH.

My company, along with many others, is rethinking its entire employment and investment strategy in all states using the worldwide unitary method. Just recently, we have ranked our investments by states and have found, for example, that it cost us about five million dollars a year more in income taxes to locate a new plant in California instead of in Texas, Indiana, New York, Ohio, Alabama or 11 other states. In addition business pays only about 20 percent of their state taxes in Corporate income taxes. Taxes other than

- 
5. Ironically, as foreign productivity increases, or domestic productivity decreases, tax in unitary states increases!
  6. Robert N. Mattson Statement, 1984 Congressional Conference on Unitary Taxation, September 14, 1984.

2-17-81

Fairbanks Daily News-Miner, Fai

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

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

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

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



Fred Pratt

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

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

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

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

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

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

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

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

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

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

(See PRATT, Page B-6)

## PRATT: Changing

(Continued from Page B-1)

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

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

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

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

But when Moyer brought HB 12 out for its first hearing last week, it

## formula

drew support from the Anchorage Chamber of Commerce, the Alaska State Chamber of Commerce, the Alaska Miners Association, and the Anchorage Economic Development Corp.

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

■ Freelance journalist Fred Pratt has been covering Alaska business and politics for the past 14 years.

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

NEW WORLD ORDER

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

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

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



# 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  
4341 B. Street  
Anchorage, Alaska 99503  
(907) 561-8200

February 7, 1991

**XEROX**

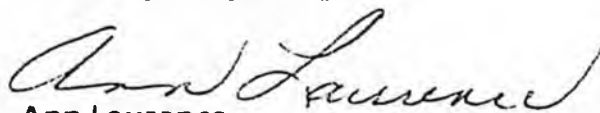
Honorable Tom Moyer  
Representative  
Alaska State Legislature  
Juneau, Alaska 99801

Dear Mr. Moyer:

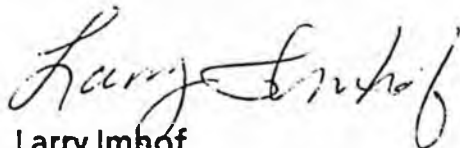
The Xerox Corporation supports increased business investment in the state. Accordingly, House Bill 12 applied equally to both domestic and foreign corporations should make Alaska a more attractive place to invest. We definitely recommend its passage.

Sincerely,

**XEROX CORPORATION**



Ann Laurence  
Manager, Xerox Alaska



Larry Imhof  
Manager, Xerox Alaska



## GREATER PALMER CHAMBER OF COMMERCE

March 14, 1991

Representative Tom Moyer  
P O Box V  
Juneau, AK 99811

Dear Representative Moyer:

Our Board of Directors has reviewed House Bill No. 12 per your request to Sara Horner, immediate past president.

The decision was made to support the Alaska State Chamber of Commerce position on this legislation. They feel the legislation will be good for Alaska.

We appreciate your requesting our input.

Sincerely

Delores Prickett  
Executive Director

cc: Rep. Larson & Carney  
Sen. Kerttula & Menard

RECEIVED MAR 2 1991

April 1, 1991

21688/01012

TO: House Finance Committee Members

FROM: Brian W. Durrell *BWD*

RE: Water's Edge Tax Legislation

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

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

April 1, 1991

Page 2

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

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

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

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

Memorandum to House Finance Committee Members  
April 1, 1991  
Page 3

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

cc: David P. Harlow

1. Barclays Bank International Limited v. Franchise Tax Board, 275 Cal. Rptr. 626 (Cal. Ct. App. 1990)
2. Container Corp. v. Franchise Tax Board, 463 U.S. 159, 103 S.Ct.2933, 77 L.Ed.2d 545 (1983)
3. Atlantic Richfield Company v. State of Alaska, 705 P.2d 418 (Alaska 1985)

《JAPAN FEDERATION OF ECONOMIC ORGANIZATIONS》

9-4, OTEMACHI 1-CHOME, CHIYODA-KU, TOKYO 100, JAPAN

Cable: KEIDANREN TOKYO  
Telephone: 03-3279-1411  
Telex: 222-3188 KDRTOX J  
Facsimile: 03-3246-2573

March 1, 1991

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

Dear Governor Hickel:

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

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

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

Sincerely yours,

Kazuo Nukazawa  
Managing Director

Attachment

September 7, 1988

On the Worldwide Unitary Taxation

Keidanren Investment Mission

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

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

We oppose the worldwide unitary taxation for the following reasons.

- 1) It results in taxing the foreign-source income of foreign entities beyond the jurisdiction of the individual state, causing what amounts to double taxation and giving rise to arbitrary application of the tax.
- 2) It deviates from international customs and practices on taxation based on separate accounting.
- 3) It requires an inordinate amount of time and cost to translate documents, convert figures, and revise their financial statements to meet complicated requirements for disclosure of information.

(3)

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

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

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

# How U.S. States Can Lose Business Investment

## Keidanren Statement on Worldwide Unitary Taxation

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

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

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

These factors hamper foreign companies' will-

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

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

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

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

### *Beyond tax jurisdiction*

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

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

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

#### *Inevitable double taxation*

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

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

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

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

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

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

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

had previously paid under the separate accounting system."

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

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

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

#### **Worldwide unitary taxation is impractical**

##### *Vague concept*

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

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

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

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

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

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

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

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

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

#### *Intolerable paperwork and costs*

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

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

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

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

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

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

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

Worldwide taxation is detrimental to the sound development of capital exchange

#### *Negative impact on investment*

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

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

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

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

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

Corporation N is considering pulling out of California.

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

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

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

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

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

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

#### *Confusion in the international tax system*

Because nations have grown more economically interdependent and international transactions have

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

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

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KEIDANREN (Japan Federation of Economic Organizations) is a private nonprofit economic organization representing all branches of economic activity in Japan. While maintaining close contact with economic sectors at home and abroad, Keidanren endeavors not only to find practical solutions to economic problems but also to contribute to the sound development of the economies of Japan and other countries around the world. As of January 28, 1984, Keidanren's membership numbered 117 associations and 832 corporations. The association members include trade associations and regional economic organizations. The corporate members are leading Japanese enterprises and foreign companies operating in Japan.

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HOUSE OF REPRESENTATIVES  
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October 25, 1984

MEMORANDUM

TO:

FROM: Jay Livey <sup>2</sup>  
Legislative Analyst

RE: Unitary Taxation: An Examination of Alternatives  
Research Request 85-012

You asked that we examine the unitary tax laws of Alaska and other states and present alternatives to the method of collection currently used in Alaska. This memorandum responds to your request. It begins with an explanation of the unitary tax and worldwide combined reporting, including supporting and opposing arguments. An explanation of Alaska's current corporate taxation method is followed by a discussion of alternatives to worldwide combined reporting as developed by a national task force. Issues which the task force were unable to resolve are also identified. Four alternatives to worldwide combined reporting are then discussed, and states' experience with the alternatives are examined. The memorandum concludes with an analysis that focuses on the implementation of the options in Alaska.

SUMMARY

Alaska currently taxes corporate income by using a form of the unitary tax called worldwide combined reporting. The unitary tax is based on the concept that the total income of a corporation or of an affiliated group of corporations engaged in a unitary (related) business activity can be apportioned among states based on the portion of total corporate business activities that occur in each state. Business activity in the state is generally measured by the level of corporate payroll, property and sales. This apportioned income is the taxable income subject to particular state tax rates. Approximately forty states currently use some form of the unitary tax to apportion corporate income for state income tax purposes.

All states that use the unitary tax must determine the corporate income that is to be apportioned. Eleven states use a method called worldwide combined reporting to do this. Worldwide combined reporting

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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. The balance of unitary tax states use a waters edge approach which apportions only the income earned by the unitary business within the United States.

Worldwide combined reporting has recently 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 state interference in foreign trade and fear of 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 of the United States. Also, these corporations claim that state taxation of these foreign activities constitutes double taxation because this income has already been taxed by foreign governments. Foreign multinational corporations have been especially vocal in their criticism of worldwide combined reporting. Recently, several Japanese corporations announced that they would make no further investments in states that used worldwide combined reporting.

As a result of federal government opposition and the threats of economic reprisal by foreign corporations, several states have considered changes to worldwide combined reporting. The following alternatives are discussed in this memorandum:

1. Worldwide combined reporting for domestic corporations with an alternative tax levied on foreign multinational corporations;
2. A waters edge method that includes foreign source dividends in taxable income and includes 80/20 corporations within the definition of waters edge;<sup>1</sup>

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<sup>1</sup>80/20 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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3. A waters edge method that excludes foreign source dividends from income and excludes 80/20 corporations from the definition of waters edge; and
4. Separate accounting.

The corporate tax in Alaska generates approximately \$260 million annually, of which \$230 million or 90 percent comes from the petroleum industry. It is interesting to note that the petroleum industry in Alaska is comprised of foreign multinational corporations, domestic multinational corporations and largely domestic corporations. This diversity of interest will have to be considered as alternatives to worldwide combined reporting are proposed.

Foreign multinational corporations in Alaska would be likely to support either of the waters edge options or separate accounting. Foreign corporations were instrumental in supporting alternatives to worldwide combined reporting that were adopted in Illinois and Oregon and proposed in California. All of these methods would mean that the worldwide income of these corporations would escape taxation by the states.

Domestic multinational corporations generally support alternatives that repeal worldwide combined reporting, but not at the expense of giving a competitive advantage to foreign multinationals. Domestic multinational corporations generally support a waters edge option if foreign source dividends are excluded from taxable income. Representatives of Exxon noted that their corporation would be opposed to any alternative to worldwide combined reporting that included the taxation of these dividends. This position is consistent with that of domestic multinational corporations that opposed the passage of a bill in California that would have repealed worldwide combined reporting.

Although the Department of Revenue was unable to provide revenue projections for the various alternatives to worldwide combined reporting, revenue would probably decline under all options. A waters edge approach that included foreign dividends in income determination would not effect revenues as much as the other options.

#### INTRODUCTION

The form of corporate taxation commonly known as the 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. Formula apportionment divides the corporate income of a unitary business among the states in which the corporation does business in proportion to the amount of corporate activity in the

state. Most states determine the level of corporate activity by applying formulas that compare the corporate payroll, sales and property within the state to the total corporate payroll, sales and property.<sup>2</sup> For example, if a state determines that 10 percent of a corporation's business activity (as determined by examining payroll, sales and property factors) occurs within its borders, then 10 percent of the total corporate income is subject to state taxation.

Arguments Supporting Unitary Taxation

Formula apportionment is based on the concept that corporate activity in a state is a better measure of the state contribution to corporate income than accounting income based only on in-state operations. Two arguments are used by proponents of the tax to support this view. First, corporate transactions across state lines can be used to manipulate income to reduce corporate tax liability. Second, the integrated nature of corporate activities makes it difficult and irrelevant to separate in-state activities from the activities of the corporation as a whole.

As an example of the first argument, consider a business that manufactures a product in one state but sells it through a subsidiary corporation located in another state. Both states have contributed to total corporate profit; however, taxable income in both states depends on the price at which the product is sold to the subsidiary. By adjusting this sales price, the corporation can transfer profit between states so that total tax liability is minimized. To accurately determine the corporate income that should be taxed in the manufacturing state, the selling price of the product must be established as if there were no special relationship between the two corporations. This very difficult and expensive pricing process would have to be applied to all interstate corporate transfers for a state to levy the corporate tax efficiently.

The second argument for formula apportionment claims that the use of subsidiary and affiliate corporations does not mask the fact that all the corporate entities may be engaged in related business activities. As long as the corporate activities relate to this unitary business, the contribution that each state makes to the corporate whole is the equitable base upon which to apportion taxable income.

$$\frac{\frac{\text{Payroll In State}}{\text{Total Payroll}} + \frac{\text{Property In State}}{\text{Total Property}} + \frac{\text{Sales In State}}{\text{Total Sales}}}{3} \times \text{Total Income} = \text{Income Apportioned To State}$$

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Much of the controversy surrounding the application of formula apportionment stems from its extension to multinational corporations. The concept of a unitary business has been applied to groups of affiliated corporations doing business in more than one state or nation. Consequently, a group of affiliated corporations performing different functions (manufacturing, distributing, selling) but engaged in the same unitary business are treated as if they were a single corporation. The extension of this concept to all worldwide subsidiaries engaged in a unitary business is known as worldwide combined reporting. Currently, forty-five states apply formula apportionment to domestic corporations and 11 states (including Alaska) use worldwide combined reporting.

#### Opposition to States Use of Worldwide Combined Reporting

Although some critics of the formula apportionment method maintain that accounting income should be the only basis upon which states should be allowed to tax, most criticism of the unitary tax is reserved for worldwide combined reporting. The most vocal of these critics are domestic and foreign multinational corporations and the United States government.

Multinational corporations claim that state taxation of foreign affiliates and subsidiaries results in double taxation because income is taxed by the foreign nation in which it was earned. Also, multinationals question the basic right of the states to tax activities that occur outside of the borders of the United States. A third criticism claims that the use of the unitary method of formula apportionment, as opposed to traditional accounting methods, causes severe administrative burdens and duplication of accounting and reporting efforts. Many multinationals are also concerned that income distortion occurs because of the factors used to apportion income. Because payroll, property and sales costs in the United States are generally higher than similar costs in other parts of the world, states are able to claim a disproportionate share of the total worldwide income.

The federal government opposes the use of worldwide combined reporting by the states for two main reasons. First, the federal government claims that application of this method of income distribution is a state intrusion into foreign policy considerations that are reserved for the federal government. As a result of this intrusion, the government is not able to establish a consistent policy of taxation with its trading partners. Second, the federal government fears retaliation against United States based multinational corporations by nations whose corporations have been subject to states' application of worldwide combined reporting.

The federal government opposition to worldwide combined reporting is based on policy rather than legal arguments. Several recent United

States Supreme Court cases, most recently Container Corporation versus the Franchise Tax Board of California, have upheld the legality of state use of worldwide combined reporting.

Container presented two issues to the court: the definition of a unitary business and the constitutionality of worldwide combined reporting. On the first issue, the court held that states should be allowed to define unitary business as long as the state decision is "within the realm of permissible judgment." Basically, this means that the Supreme Court did not define "unitary business" but allows states to apply their own definitions of unitary as long as they are based on reasonable criteria.

The court went on to rule that worldwide combined reporting is constitutional because it does not violate either the due process clause or the commerce clause of the United States Constitution. Under the Due Process Clause of the 14th amendment, a minimal connection must exist between the corporation's activity and the taxing state, and the income attributable to the state for taxing purposes must be rationally related to income generating values within the taxing state. The Commerce Clause stipulates that a state is prohibited from adopting a taxing scheme which places an extraordinary burden on interstate commerce.

It is important to note, however, that the Container case involved a foreign subsidiary of a domestic corporation. According to some legal analysts, the constitutionality of applying the unitary tax to foreign-based corporations is an issue that may be litigated in the future. However, until another Supreme Court case determines otherwise or until Congress acts to outlaw the unitary tax, states can legally apply it on both a worldwide and domestic basis.

#### Alaska Corporate Taxation

According to the Department of Revenue, Division of Audit, the State of Alaska collects about \$260 million annually in corporate income taxes. Of this total, approximately \$230 million (90 percent) is paid by the petroleum industry. Although projections of future taxes indicate that corporate income tax revenue will increase, the share paid by the petroleum industry is expected to remain at about 90 percent.

Alaska Statute 43.20.065 provides that corporations with income both inside and outside Alaska must apportion their income for tax purposes according to the Multistate Tax Compact. This compact, which has been adopted by 20 states including Alaska (AS 43.19), attempts to provide states with a uniform method of applying corporate income taxes.

Generally, Alaska law requires that all "business income" is subject to apportionment and that an Alaska taxpayer conducting a unitary business

inside and outside the state must combine all income from all members of the unitary group. This combination may be on a domestic or international basis, depending on the particular configuration of the business [15 AAC 20.300 (b)]. For most businesses in the state, income is apportioned using the basic three factor formula. However, the income from four industries--land transportation, airlines, construction and petroleum--is apportioned based on formulas designed specifically for those industries. It should also be noted that business activities related to petroleum production occurring more than three miles offshore are not included as in-state activity for income apportionment.

The starting point for calculating the tax liability of a domestic corporation is consolidated Federal Net Income as reported for federal income tax purposes. Any taxes that are paid by the corporation to state or local jurisdictions and are allowed as federal tax credits must be added back to the federal net income figure. However, any interest income received from federal government obligations (treasury bills or bonds) may be subtracted from federal net income because this is not considered to be business income. Other nonbusiness income items are subtracted from the federal net income total. The result after these adjustments is the Alaska apportionable income.

If the corporation is part of a domestic multinational corporation, these same adjustments are made. In addition, the federal net income of all unitary foreign subsidiaries and affiliates is added. As with the domestic income, all taxes that had been deducted to arrive at the net income figure are added back. However, any dividends received from unitary subsidiaries whose income is already included in the combined income total should be subtracted. The same method is used for multinational corporations that have a foreign parent. In these cases, adjustments can be made for gains or losses from currency fluctuations.

#### ALTERNATIVES TO WORLDWIDE COMBINED REPORTING

Although we mentioned earlier that some business leaders would like to see all applications of formula apportionment abandoned by the states, most efforts by business and the federal government have been directed toward the repeal of worldwide combined reporting by the states that currently use it. After the Supreme Court declared worldwide combined reporting to be legal in the Container case, a task force of business leaders and state and federal government officials was appointed by President Reagan to develop alternatives to worldwide combined reporting. The task force was able to agree on the following three principles to guide the states in taxing the income of multinational corporations:

1. Foreign and domestic corporations should only be taxed on income that is earned by the unitary group within the "waters edge".
2. Federal administrative assistance and cooperation with the states should be increased to promote full taxpayer disclosure and accountability.
3. A competitive balance between U.S. multinational corporations, foreign multinational corporations and purely domestic businesses should be encouraged.

Waters Edge Unitary Combination. This principle restricts the definition of unitary combination to U.S. corporations included in a consolidated return for U.S. tax purposes. It would exclude foreign subsidiaries and affiliates of domestic multinational corporations and the United States based subsidiaries and affiliates of foreign multinational corporations. This waters edge approach can be contrasted with worldwide combined reporting, which includes all income from all foreign subsidiary and affiliate corporations determined to be part of the unitary business.

Increased Federal Administrative Assistance. In return for the states' agreement to restrict the use of worldwide combined reporting, the federal government would agree to the following activities to assist the states implement alternative taxation policies:

1. The federal government would require corporate taxpayers to file a domestic disclosure spreadsheet that would detail the corporate tax liability and method of calculation for each of the states in which the corporation operates.
2. The federal government would require states to retain a variety of tax and income information that would be made available to state tax auditors.
3. Corporate tax and income information received by the Internal Revenue Service from other nations would be available to the states.
4. The federal government would assist states in their examination of foreign transactions through training of state tax instructors and examination of taxpayer returns as well as increasing federal international auditing resources.

Competitive Balance. This principle promotes the philosophy that state tax policy should maintain the competitive balance among all business taxpayers, including foreign multinationals, U.S. multinationals and

purely domestic businesses. Specific arguments relating to competitive advantages under various forms of taxation will be examined as we present alternatives to worldwide combined reporting later in this memorandum. It is important to note, however, that, although the task force adopted this principle, the group made no recommendations as to how competitive balance should be achieved aside from expecting state policies to reflect the principle.

#### Unresolved Issues

In spite of the consensus reached by the task force concerning these three principles, two important issues relating to foreign dividends and 80/20 corporations were not resolved. It is the treatment of these issues that provides the basic distinctions and controversy among the various alternatives to worldwide combined reporting.

Dividends from foreign subsidiaries. The issue of the taxation of dividends received by U.S. based multinational corporations from foreign subsidiaries becomes critical to states that replace worldwide combined reporting with the waters edge method. Worldwide combined reporting means that the worldwide income of all subsidiary and affiliated corporations that comprise the unitary business are combined to determine the income to be apportioned for state taxation. Under this scheme, there is no need to tax dividends sent to the parent corporation from foreign subsidiaries because the income from which the dividend is paid has already been included in the combined income. However, if waters edge restrictions are applied, foreign source income to the parent corporation will not be included in the income to be apportioned unless dividends are added to the domestic income.

State representatives on the task force presented several arguments for the inclusion of foreign source dividends. Four of these arguments are presented below:

- Dividends paid by any foreign corporation to any other taxpayer are taxable by the state. To exempt dividends paid to U.S. corporations and not those paid to other taxpayers is discriminatory. The exclusion of foreign dividends as taxable income would favor foreign investment because purely domestic businesses are taxed on 100 percent of their income.
- State representatives point out that because the income from which foreign dividends are paid may have already been taxed by a foreign government is no reason to exempt them from state taxation. Both state and federal governments tax incomes of individuals and businesses.

- Foreign source dividends are an important part of the waters edge income of U.S. based multinational corporations. Expenses incurred by the U.S. parent corporation for research, capital formation and management all contribute to the income of foreign corporations as well as domestic ones. As long as these expenses are deductible for state tax purposes, the foreign source dividend income generated by those expenses should be taxable.
- Excluding foreign dividends would significantly reduce state revenues.

Business representatives cite the following reasons for not including foreign source dividends as part of waters edge income to be apportioned by the states:

- State taxation of foreign source dividends is double taxation because the foreign nation in which the subsidiary is located has already taxed the income from which the dividends are paid. The federal government allows income deductions based on foreign taxes and the states should do the same.
- Taxation of foreign source dividends is an income tax on worldwide income that domestic multinational corporations pay but foreign multinational corporations would not. Domestic multinationals claim that this would put them at a competitive disadvantage with foreign multinational corporations.
- Foreign source dividends should not be taxed by states just to offset revenues lost through the repeal of worldwide combined reporting. Other less offensive methods could be used by states to maintain revenues.

80/20 Corporations. 80/20 corporations are U.S. corporations with at least 80 percent of their property and payroll outside of the United States. The issue surrounding these corporations is their inclusion within the definition of waters edge. State representatives on the task force maintain that all U.S. corporations should be included within the waters edge while business representatives claim that these corporations should be excluded. Generally, the arguments used to support these claims are similar to those used in the dividend controversy and will not be repeated here.

#### ALTERNATIVES TO WORLDWIDE COMBINED REPORTING--OTHER STATES EXPERIENCE

A number of technical changes could alter the way in which states utilize worldwide combined reporting: examples include applying different weights to the payroll, property and sales factors and redefining unitary. However, this memorandum will concentrate on taxation options that offer significant alternatives to Alaska's current use of worldwide combined reporting. The experience of several states that have recently proposed alternatives to worldwide combined reporting will also be examined. The following four taxation alternatives will be considered:

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

#### Worldwide Combined Reporting That Excludes Foreign Multinationals

This alternative to traditional worldwide combined reporting allows United States subsidiaries of foreign corporation 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 unitary tax task force recommended that the tax be based on in-state property, payroll and sales and 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 retaliation against U.S. corporations recently made by foreign governments. Proponents also claim that this option is a fair way to exclude foreign multinational corporations from worldwide combined reporting while at the same time protecting the competitive advantage of U.S. multinational corporations and purely domestic businesses. This option would protect state revenues and could be relatively easy to implement.

Opponents of this option claim that foreign governments and corporations may not view this alternative as an adequate solution to worldwide combined reporting because a corporate tax based on industry standards

would continue to tax the foreign corporations at current levels. Also, critics maintain that U.S. based multinational corporations may, in some cases, pay higher taxes than foreign corporations pay on similar income. This could occur because domestic multinationals would pay taxes on worldwide combined income while foreign multinationals would choose to pay the alternate tax if it reduced their tax liability. In the cases in which the alternate tax was chosen, U.S. multinational corporations would be at a competitive disadvantage with respect to foreign multinational corporations.

The State of Massachusetts has a taxation policy that is similar to this option. Massachusetts uses worldwide combined reporting to determine income subject to state taxation, but excludes the income of foreign parent corporations. Effectively, the income of foreign multinational corporations is not subject to apportionment, however, the worldwide income of U.S. multinational corporations is subject to apportionment.

According to Nick Metaxas, general counsel for the Massachusetts Department of Revenue, this method of formula apportionment was adopted to avoid potential legal problems resulting from state application of worldwide combined reporting to foreign multinational corporations. Although the U.S. Supreme Court decision in the Container case upheld the constitutionality of states' application of worldwide combined reporting to domestic multinational corporations, Mr. Metaxas expressed doubts that a similar decision would be reached if worldwide combined reporting was challenged by foreign multinationals. Massachusetts' method of applying worldwide combined reporting is designed to reduce the states' vulnerability to such a decision.

Mr. Metaxas noted that opposition to this form of worldwide combined reporting has come from both U.S. multinational corporations and purely domestic corporations in the form of efforts to repeal worldwide combined reporting in favor of a waters edge method. Both of these groups claim that foreign multinational corporations have been given a competitive advantage because portions of the income of these foreign corporations escapes apportionment by the state. However, Mr. Metaxas also points out that it is difficult to determine whether the support of proposals for waters edge are based on problems with the existing tax or because waters edge is more attractive to domestic corporations.

#### 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. Dividends must be generated by foreign subsidiaries that are significantly related to the activities

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of the unitary group to be included as part of the income of the domestic multinational.

Supporters of this option claim that it would quiet foreign government and foreign corporation criticism of states' application of worldwide combined reporting. Supporters also claim that this option would result in equitable taxation among all taxpayers. Even though worldwide income of domestic multinational corporations is taxed (through dividends) by the states and worldwide income of foreign multinationals is not taxed by the states, foreign government taxation of dividend income repatriated to the home country of the parent corporation equalizes the apparent inequity. Also, analysts argue that a large portion of the corporate taxes collected by states come from foreign dividends. To exclude this source of state income would put additional tax pressure on purely domestic corporations and individuals.

Opponents of this waters edge option disagree with this conclusion and claim that this method of taxation would put U.S. multinational corporations at a considerable competitive disadvantage in the world economy. They claim that fully taxing foreign source dividends is identical to taxing the income of their foreign subsidiaries and therefore yields similar results to worldwide combined reporting. In fact, some analysts suggest that this method would likely result in higher tax liabilities for some multinational corporations because foreign source income is included in income determination but the factors that produced that income are not included in state apportionment formulas. Additionally, the income that is earned by foreign multinational corporations outside of the borders of United States escapes all state taxation. Therefore, under this option, domestic multinational corporations could pay more tax than foreign multinational corporations with the same level of income.

California, a state that currently uses worldwide combined reporting to determine income subject to apportionment, recently debated a proposal to adopt a unitary tax law similar to this option; including a waters edge limitation to the unitary group, taxation of foreign source dividends and inclusion of 80/20 corporations within the definition of waters edge. The law also gave an option to foreign multinational corporations to pay taxes based on worldwide combined reporting and stipulated that the law was to be in effect only so long as the United States government supported the audit and administration of state taxation policies.

According to Ben Miller of the California Franchise Tax Board, the major supporters of the proposed change were foreign multinational corporations and foreign governments. Japanese corporations were especially vocal in their threats that if California did not replace worldwide combined reporting, the state would be bypassed by these corporations in future investment decisions.

According to Mr. Miller, annual revenue loss to California was estimated to be \$200 million if the proposed legislation were passed. However, because California also levies other types of taxes, including property, sales and income taxes, it was assumed by proponents of the bill that this lost revenue would eventually be recouped through increased foreign investment. Mr. Miller was unaware of any analysis that projected future foreign investment in California if the bill were passed.

Opposition to the bill was led mainly by U.S. multinational corporations that feared that the proposed law would put them at a competitive disadvantage with foreign multinational corporations. As discussed earlier in this memorandum, a competitive disadvantage is perceived when the foreign source dividends paid to domestic multinational corporations are included in taxable income to be apportioned by the state. Because the waters edge approach excludes all income of foreign multinational corporations except income earned in the state, domestic multinationals claim they pay more tax than foreign multinationals on similar levels of income earned worldwide.

#### 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 a foreign corporation and are excluded from the unitary group.

This option is generally favored by both foreign and domestic multinational corporations. Foreign multinational corporations and foreign governments support this alternative because it eliminates worldwide combined reporting. Domestic multinational corporations like it for the same reason but also because, in their view, it keeps them competitive in the world economy by not taxing foreign source dividends. Unlike the previous option, this alternative treats foreign subsidiaries of U.S. based multinational corporations and foreign corporations outside of the United States identically, by taxing only their operations within the waters edge.

Opposition to this alternative 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. Revenue analysis done for the states by the Presidential task force on alternatives to worldwide combined reporting supports this conclusion. Opponents of this option also argue that this alternative would shift the tax burden from foreign and U.S. multinational corporations to purely domestic

corporations. This could encourage U.S. corporations to increase foreign investment at the expense of domestic investment.

The State of Illinois recently passed a law that repealed the use of worldwide combined reporting in favor of a taxation policy similar to the option described above. The Illinois law limited unitary combinations to the waters edge, excluded 80/20 corporations and excluded foreign dividends from income if the foreign subsidiary that makes the dividend payment is 80 percent owned by a U.S. based corporation. If the subsidiary corporation is less than 80 percent owned by a U.S. based corporation, then 15 percent of the foreign source dividend is included in the income to be apportioned.

According to Fred Montgomery, Assistant Attorney General for the Illinois Income Tax Division, this tax change was supported by most of the Illinois business community as well as foreign multinational corporations. He noted that even corporations that in the past supported worldwide combined reporting (Caterpillar is the most obvious one) desired this change. As Mr. Montgomery pointed out, as long as foreign source dividends are excluded from income, there is no reason for a multinational corporation to withhold support of a waters edge option.

Much of the support for the repeal of worldwide combined reporting resulted from the hope that this action would encourage more foreign investment in Illinois. Although predictions estimated that Illinois could lose from \$100 to \$174 million annually as a result of adopting the new method of taxation, the State hopes to earn some of this back through other forms of taxation applied to new investment lured into the state. Illinois also levies sales, property and personal income taxes. Mr. Montgomery also noted that during the debate over Illinois' future taxation policy, there was no clear evidence introduced on either side that defined the true effect of worldwide combined reporting on foreign investment in Illinois.

Oregon has also recently repealed worldwide combined reporting in favor of a waters edge approach. The Oregon law includes only domestic corporations in the unitary group, treats 80/20 corporations as foreign corporations and taxes 15 percent of foreign source dividends of domestic multinational corporations. As in Illinois, support for the bill came from foreign and domestic multinational corporations. According to Tom Everall, Director of Corporate Audit for the state of Oregon, additional support came from the Oregon Department of Economic Development which viewed worldwide combined reporting as an obstacle to attracting foreign investment into Oregon.

Mr. Everall noted that estimates of the annual tax loss to the state were in the \$18 million a year range. However, as in Illinois, there was a general perception that this revenue would be recouped through other forms of taxation on the new business attracted to the state.

Mr. Everall did not know of any studies that attempted to estimate the additional investment that would come to Oregon as a result of the new taxation policy. He did acknowledge the heavy lobbying effort of various Japanese corporations and their claims that they would not locate in Oregon unless worldwide combined reporting was repealed. He was unable to conclude to what extent their investment decisions were dependent on the repeal of worldwide combined reporting. He did note, however, that one Japanese corporation that recently announced plans to invest in Oregon because of the repeal of worldwide combined reporting had been doing site reconnaissance in Oregon for the past three years.

#### 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 taxation purposes. This method is also called arms length accounting because for taxation purposes, all transactions between related corporations are supposed to be priced as if no special relationship existed (such as a subsidiary corporations supplying a parent corporation) and the market determined the price.

In general, business leaders would like to have all states determine taxable income by using separate accounting. This method uses information directly related to traditional accounting income and therefore is relatively easy to use. Also, business leaders claim that using this method results in less chance of states taxing more than 100 percent of total profits than if formula apportionment is used. Also, states' use of separate accounting allows the business or corporation more flexibility in developing corporate policies that reduce the tax liability of the company. This method also appeases foreign nations and corporations because it replaces worldwide combined reporting.

Opponents of separate accounting include many states, including those that have chosen to use the unitary tax. Critics of separate accounting claim that it leaves the state vulnerable to manipulation of income by corporations that do business in more than one state. Because income depends upon the cost of goods, related corporations can sell products at less than the market price to shift income to states that have lower tax rates. Developing an audit system to monitor corporate tax returns to detect pricing manipulations is very expensive and inefficient. Moreover, federal auditors provide no assistance because the Internal Revenue Service does not audit transfers between related corporations. As a result of the audit problem, it is generally assumed that most states would lose significant revenue using separate accounting to determine taxable income.

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In two of the three states that we contacted, Illinois and Oregon, separate accounting was discussed as an alternative to worldwide combined reporting. However, representatives of both states noted that although separate accounting was desired by some business leaders within the state, most business representatives were willing to support waters edge unitary taxation as long as foreign source dividends were excluded. This position is based on the recognized reluctance of most states' governments to forego the income and administrative efficiency of the unitary tax. According to representatives of the state of California, separate accounting was never seriously considered as an alternative to worldwide combined reporting.

#### ALASKA ALTERNATIVES TO WORLDWIDE COMBINED REPORTING

In the previous section of this memorandum, we presented several options to the traditional use of worldwide combined reporting. We will now: 1) analyze the reasons other states have given for consideration of alternatives to this method; and 2) discuss the implications to Alaska of implementing the various options to worldwide combined reporting.

#### Reasons for Replacing Worldwide Combined Reporting

As we discussed the unitary tax with various state and industry representatives, the following three reasons for considering a change from worldwide combined reporting were mentioned most often.

1. Worldwide combined reporting reduces the ability of the state to attract foreign investment.
2. The federal government strongly discourages state use of worldwide combined reporting.
3. There is a potential for the application of worldwide combined reporting by foreign multinational corporations to be declared unconstitutional by the U.S. Supreme Court.

Effect on Foreign Investment. This issue is without a doubt the most important reason that several states have recently considered alternative taxation to worldwide combined reporting. As mentioned in the previous section of this memorandum, both Illinois and Oregon repealed worldwide combined reporting because they concluded that it would improve their chances to attract foreign investment. Although the repeal of worldwide combined reporting did not pass the California legislature, the legislative proposal was prompted by the fear that worldwide combined reporting was hindering foreign investment in California. In all three of these states, representatives of foreign corporations

and governments were actively lobbying for the repeal of worldwide combined reporting. The most notable example of this effort is Japanese business consortia declarations to avoid future investments in states that use worldwide combined reporting.

Although the threat of foreign corporations withholding investments was a strong incentive for the states that repealed worldwide combined reporting, several state and business representatives noted that Alaska's resource-based economy may not be vulnerable to these threats of economic retaliation.

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 interchangeability of location that makes states fearful of foreign threats of economic reprisal.

Foreign corporations that wish to invest in resource extraction must go to the resource location. As one oil company representative put it, "we have no choice but to go where the oil is." The investor corporation does not generally have the option of choosing one location over another. Also, 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 costs 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 (in the near future) Alaska will be able to compete with other states for manufacturing that does not depend on natural resources. We mentioned several factors that are usually important considerations in choosing a location for foreign investment including cheap land and utilities, skilled labor, access to suppliers and markets and low living costs. Generally, Alaska would have trouble competing with other locations based on these criteria.

It should also be noted that there was some doubt among both government and business representatives about the actual importance of worldwide combined reporting in decisions by foreign corporations to invest in a state. Although these representatives acknowledged that it was a factor to be considered, it was still only one of many factors that go into an investment decision. There is a feeling among these representatives that foreign corporations are engaged in a media campaign to influence states to repeal worldwide combined reporting. For example, when a recent Japanese corporation announced that it would

invest in Oregon if worldwide combined reporting was repealed, the implication was that the decision was based on the repeal. In fact, that corporation had been doing site location studies in Oregon for years prior to the introduction of legislation to change the tax laws.

Federal Action to Ban the Use of Worldwide Combined Reporting. The second reason mentioned by states for implementing alternative taxation policies is the fear that unless states voluntarily stop using worldwide combined reporting, the federal government will impose a ban on its use. In Treasury Secretary Regan's report to the President on the progress of the task force established to study options to worldwide combined reporting, the Secretary noted that states would be given two years to move away from worldwide combined reporting. If this was not done, he implied that some type of federal government action would be taken to impose repeal on the states that have not complied.

As with the previous question of the impact of worldwide combined reporting on foreign investment, the actual danger of this threat is unknown. There is no doubt that the administration would like to see states impose taxes only to the waters edge, thus eliminating worldwide combined reporting. However, some analysts think that the Reagan administration, which has claimed to stand for states rights, would have trouble dictating tax laws to the states. So far, there has been very little indication on the part of the Congress that this is an issue in which they want to become involved.

Supreme Court Action. The states' use of worldwide combined reporting was found by the Supreme Court to be constitutional in the Container case. However, Container was a domestic multinational corporation and some legal analysts do not feel that the decision extends to state taxation of foreign multinational corporations.

Massachusetts applies worldwide combined reporting to domestic multinational corporations but not to foreign multinational corporations. As a representative of that state reported, this tax policy is to avoid potential legal problems should the courts declare the application of worldwide combined reporting to foreign multinational corporations to be unconstitutional. At this point, it is difficult to assess the chances of the court taking this action. However, there seems to be a consensus among legal analysts that at some point the question of state use of worldwide combined reporting to tax foreign multinational corporations will be heard by the Supreme Court.

In summary, the recent action by states to repeal the use of worldwide combined reporting has generally been a reaction to threats of economic retaliation by foreign corporations if the tax was not repealed.

The recent actions in Oregon and Illinois were direct attempts by those states to attract foreign investment. Although many foreign corporations claim that investment in a state is conditional on the repeal of worldwide combined reporting, some analysts maintain that the state tax policy is only one of several important considerations in choosing investment locations. Because Alaska's economy generally depends on resource development rather than manufacturing, threats of economic retaliation do not seem as credible here as in other states. Regardless of Alaska's taxation policy, it is unlikely that Alaska could compete with other states for manufacturing investments. Consequently, the tactic used by foreign multinational corporations in Oregon, the threat of withholding manufacturing investments, may not be critical to Alaska.

The other two reasons that states gave for considering changes in worldwide combined reporting pose more potential than immediate problems. There is currently no action pending in Congress that would hinder state use of worldwide combined reporting. Similarly, the threat of a Supreme Court declaration banning the application of worldwide combined reporting to foreign multinational corporations is years away as the court has not yet agreed to hear such a case.

#### Implications of Taxation Options for Alaska

We previously identified four options proposed by other states as alternatives to worldwide combined reporting. These options will now be examined in the context of their applicability to Alaska. The four options to be considered are:

1. Modifications to traditional worldwide combined reporting;
2. Waters edge taxation including foreign dividends and 80/20 coporation;
3. Waters edge taxation excluding foreign dividends and 80/20 corporations; and
4. Separate accounting.

As evidenced by the experience of other states, any proposed change in Alaska taxation policy will be opposed or supported depending on the particular self interest of the parties affected. Foreign multinational corporations would likely support any proposal that would repeal worldwide combined reporting. Three of the options that we presented, the two waters edge options and separate accounting, would do this. Illinois and Oregon both adopted waters edge options and both laws had the blessing of foreign multinational corporations. In California, the proposed waters edge option, although it failed to pass, was supported by Japanese business consortia and other foreign multinational corporations.

Foreign multinational corporations would probably support the separate accounting option because this approach would tax only their in-state activities and not their worldwide activities. In addition, separate accounting uses traditional accounting income and therefore the tax information is easier to generate. Foreign multinational attitudes toward alterations in the traditional worldwide combined reporting are more difficult to predict. States using this option would tax foreign multinational corporations using alternate methods that depend upon existing taxes for similar industries. Generally, the uncertainty surrounding the exact nature of the tax and the partial taxation of foreign units would probably make this option less popular than waters edge or separate accounting alternatives.

Domestic multinational corporations, which include oil and gas producers in Alaska, support alternatives that repeal worldwide combined reporting but not at the expense of giving a competitive advantage to foreign multinational corporations. For this reason, domestic multinational corporations support waters edge unitary taxation but only if foreign source dividends are excluded from income and 80/20 corporations are not included in the unitary definition. Representatives of Exxon corporation noted that their corporation would be adamantly opposed to a waters edge option that taxed foreign source dividends. This position is consistent with the position of domestic multinational corporations that ultimately opposed the bill repealing worldwide combined reporting in California.

It is interesting to note that some corporations' opposition to worldwide combined reporting is not consistent. Oil company representatives told us that although their corporate policy is to oppose worldwide combined reporting, the tax as it is applied in Alaska is not a critical problem because of the extent of their activities in the state. As one representative noted, worldwide combined reporting is a problem in California, but in Alaska it is acceptable and the alternative may be more offensive than the current method.

Several representatives of petroleum producing corporations who did not want to be identified because of the current lawsuit with the state over previous state taxation policies, noted that separate accounting would be difficult for Alaska to implement. One representative noted that because Alaska is primarily a resource extraction state, very few "sales" actually occur in Alaska. Therefore, unless the state closely audited the transfer prices of extracted resources, income could be transferred outside of the state resulting in avoidance of state corporate taxation. Another oil industry representative noted that the state's previous use of separate accounting may have actually hindered investment in the state. It is this separate accounting law that is currently being challenged in the state courts. Until this case is decided and guidelines are established concerning

the implementation of separate accounting, it will be difficult to determine if this option is workable in Alaska.

### Conclusion

Corporate attitudes toward the repeal of worldwide combined reporting are fairly straightforward; if the tax change results in a positive contribution to the economic position of a business, then the proposed change is worthwhile. We have mentioned several times that oil companies in Alaska pay 90 percent of the corporate income tax. The domestic multinational corporations in this industry would adamantly oppose any tax change that they perceived as benefitting foreign multinational competitors.

The position of the state is not so straightforward as it must address conflicting objectives. In its role as the collector of revenues to be used to purchase goods and services for residents, the State would oppose several of the options discussed because tax revenue would decline. Although the Department of Revenue was unable to provide a breakdown of corporate income tax revenues between a worldwide combined reporting method and waters edge method, the department was able to predict revenue declines if worldwide combined reporting were repealed. The revenue decline would be more severe if a waters edge option that excluded foreign source dividends were implemented. A separate accounting method would be difficult to implement in light of the current lawsuit concerning Alaska's previous use of this method. If a method of taxation reduced revenues, the state would be faced with the dilemma of increasing other taxes to maintain state revenues or reducing state services.

The State also assumes a role as promoter of economic growth and diversity. In this position, the State must consider the threats made by foreign corporations to ban investments in states that use worldwide combined reporting. Although there is some question among analysts concerning the seriousness of this threat in general, and, especially the magnitude of the threat to Alaska's resource extraction economy, this threat deserves consideration. If the threat of withholding foreign investment is determined to be a deciding factor and worldwide combined reporting is repealed, State revenues would probably decline. If a waters edge method that excluded foreign dividends was chosen, the State would lose considerably more revenues, possibly requiring an adjustment of other taxes or a reduction of services. If a waters edge method that included foreign dividends were adopted, state revenues would be maintained, but domestic multinational corporations in the state would probably oppose the proposal.

We have not enclosed copies of the unitary tax law amendments in Oregon and Illinois, nor the proposed amendment in California. These amendments

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only contain the changes in the law and not the complete taxation statute, and therefore, are not self-explanatory. However, the agency has compiled several articles and documents which address the unitary taxation issue in detail. If you have further questions or would like additional information, please do not hesitate to contact us.

JL



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October 30, 1984

MEMORANDUM

TO: Representative Joe Hayes

FROM: Jonathan Sherwood, Legislative Analyst

RE: Unitary Taxation in Alaska: Its History and the Effects of  
Potential Changes  
Research Request 85-014

You requested that we examine the history and the use of the unitary tax in Alaska. We were also asked to describe the effects of potential changes to the tax and determine what changes other states have made recently to their own unitary tax laws. This information is to be provided in conjunction with research performed by Mr. Michael Gay, who is to consider the impact of unitary taxation and possible alternatives on Korean investment in Alaska.

This memorandum begins with a brief discussion of unitary taxation and alternatives to the method presently used by Alaska. Then, the history and use of unitary taxation in Alaska is presented. Finally, the effects on Alaska of the changes discussed in the first section are considered.

SUMMARY OF FINDINGS

The two principal features of the unitary method of corporate taxation are: 1) the application of the tax to a commonly owned group of corporations engaged in interrelated business activities, only one of which may operate in the taxing state; and 2) its use of a formula to apportion a taxpayer's income to an individual state based on the portion of the taxpayer's business activity which is located in the state.

States which use worldwide combined reporting define the unitary group to include corporations that operate outside the United States. The waters edge method includes only those corporations which do business in the United States.

The U.S. Supreme court has upheld most challenges to state unitary taxation. While the court has sustained the use of worldwide combined

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reporting when applied to U.S. based multinational corporations, it has not ruled on whether states may apply the method to foreign-based multinational corporations.

Worldwide combined reporting is opposed by foreign governments and multinational corporations. Critics claim that it imposes substantial administrative burdens on corporations, results in double taxation of foreign income, and deters foreign investment in U.S. enterprises.

One alternative to worldwide combined reporting is the waters edge-foreign dividend method. This excludes foreign corporations from the unitary group but does count income from foreign-source dividends and U.S. 80/20 corporations (a corporation with 80 percent of its property and payroll outside of the U.S.).

The waters edge-foreign dividend approach is supported by many state officials as the alternative to worldwide combined reporting which best maintains state revenue bases. It is opposed by U.S. multinational corporations who object to having to apportion foreign-source income while foreign-based multinationals do not. An attempt to institute a waters edge-foreign dividend tax in the California Legislature failed because of opposition by U.S. multinational corporations.

Another alternative is the waters edge-no foreign dividend method, which excludes all foreign-source income from apportionment. This method is favored by U.S. multinational corporations. Opponents of this method argue that it substantially reduces state revenue bases and places purely domestic corporations, which must apportion all income, at a competitive disadvantage to multinationals, which apportion only U.S. income. Illinois and Oregon have adopted versions of waters edge-no foreign dividend taxation.

Separate accounting may be used to replace unitary taxation altogether. Transactions between in-state and out-of-state segments of a business are valued as if they occurred between independent companies. Proponents of the method argue that it is more precise than apportionment. Opponents of the method argue that it is difficult both to administer and audit, and that businesses will use the method to shift income to jurisdictions with lower taxes.

Alaska has had a unitary tax since before Statehood. Alaska ratified the Uniform Division of Income for Tax Purposes Act in 1959 and the Multistate Tax Compact in 1970; both measures were intended to increase uniformity to states' corporate income tax laws. Alaska adopted worldwide combined reporting when it implemented the Multistate Tax Compact.

# **CORRECTION**

**THIS DOCUMENT  
HAS BEEN REPHOTOGRAPHED  
TO ASSURE LEGIBILITY**



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