

ALASKA LEGISLATURE COMMITTEE FILES 1997-1998 8672

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

it struck me that the changes in the tax laws that we've seen now in the last two or three years in a number of states, moving away from worldwide to waters edge, have served to substantially increase the cost of compliance for both taxpayers and tax agencies. We have reduced the tax base in

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<sup>8</sup>*State Policy Reports*, May 1989, p. 12.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Attachments

ATTACHMENT A  
State Treatment of Foreign-Source Dividends

**THE FOLLOWING PAGES MAY  
NOT FILM LEGIBLY BECAUSE OF  
THE POOR QUALITY OF THE ORIGINAL**

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

	Exemption			Treatment of Balance		Statute(s)
	Exempt	Conditional	Partial	Allocate	Apportion	
ALABAMA				X		§§40-18-34, 40-18-35(14), Reg. 810-3-31.02
ARIZONA	X					§43-1122(B), L. 1985, c. 109, eff. for taxable years beginning from/after 12-31-83
ARKANSAS		If 95% ownership of payor.			X	§84-2008(2)(J)
CALIFORNIA 1)		If more than 50% ownership of payor, 75% exclusion of base period dividends (greatest amount of dividends received in any one of 1984, 1985 or 1986 income years); exclusion of foreign dividends in excess of base period amount dependent upon increase or decrease in foreign payroll factor.			X	§§24271, 24402
2)					X	§24411, L. 1986, c. 060, eff. for tax years beginning on/after 1-1-88
COLORADO			Amount of exclusion of all foreign-source income dependent upon election of federal foreign tax deduction or credit.		X	§§19-22-304, §19-22-303(10); L. 1985, H. 3010, eff. for tax years beginning on/after 1-1-86
CONNECTICUT	X					§12-217(d)(B)
DELAWARE	X					§1903(a)(2)
FLORIDA	X					§220.13(1)(b)2.a, ch. 84-549, Laws of Florida, eff. for tax years beginning on/after 9-1-84
GEORGIA	X					§40-7-21(b)(9)
HAWAII					X	§235, 7(c)
IDAHO 1)			85% exclusion.		X	§63-3022
2)					X	§63-3027C, L. 1986, c. 342 (HB 669), eff. for tax years beginning 1-1-88
ILLINOIS		If 80% ownership of payor.	Otherwise, 85% exclusion.		X	§2-203(b)(2)(O), L. 1982, P.A. 82-1029, eff. for taxable years ending on/after 12-31-82
INDIANA 1)		If 80% ownership of payor.	Otherwise, 85% exclusion if ownership of payor is less than 80% but at least 50%, or 50% exclusion if less than 50% ownership of payor.		X	§5(b)
2)					X	§5(b), L. 1987, P.L. 383, eff. for taxable years beginning after 12-31-87
IOWA					X	§422-35
KANSAS 1)					X	§79-32, 138
2)			80% exclusion.		X	§79-32, 138(c)(vi), L. 1987, c. 386, eff. for taxable years beginning after 12-31-87
KENTUCKY	X					§141.010(12)(b)
LOUISIANA				X		§§42.A, 63, 242(1)(d), 243.A(4)

	Exemption			Treatment of Balance		Statute(s)
	Exempt	Conditional	Partial	Allocate	Apportion	
MAINE	1) 2)		1989: 10% exclusion. 1990: 20% exclusion. 1991: 30% exclusion. 1992: 40% exclusion. 1993: 50% exclusion.		X X	§5102.8 §5200-A, Subd. 2. G; §5244, L. 1988, c. 841, eff. for taxable years beginning in 1989
MARYLAND MASSACHUSETTS	1) X (Unless less than 15% ownership of payor.) 2)	If 50% ownership of payor.			X	§280A(c)(5) §38(a)(1)
MINNESOTA	1) X 2) 3)		95% exclusion. 80% exclusion. 80% exclusion if 20% ownership of payor, otherwise 70% exclusion.		X X X	§38(a)(1), L. 1988, ch. 202, eff. for tax years ending on/after 12-31-88 §290.21 Subd. 4(e), L. 1984, c. 502, eff. for taxable years beginning after 6-30-85 §290.21 Subd. 4(a), L. 1987, c. 268, eff. for tax years beginning on/after 1-1-87 §290.21 Subd. 4, L. 1988, c. 719, eff. for taxable years beginning after 12-31-87
MISSISSIPPI					X	§§27-7-15(1), 27-7-15(4)(1), 27-7-23(c)(2)(B)
MISSOURI	X					§143.431, Union Electric Co. v. Coale, 347 Mo. 175 (1940)
MONTANA	1) 2)		80% exclusion.		X X	§15-31-113(1) §15-31-3, L. 1987, c. 616, eff. for tax years beginning after 12-31-87
NEBRASKA	X					§77-2716(7), L. 1984, LB 1124, eff. for taxable years beginning on/after 1-1-84
NEW HAMPSHIRE	1) 2)		Amount of exclusion determined by formula modified to include payor's foreign dividend-related property, payroll and sales.		X X	§§77-A:1.III(a), 77-A:1.VI §77-A:3.II(b), L. 1986, c. 153, eff. for tax years beginning after 6-30-86
NEW JERSEY NEW MEXICO NEW YORK NORTH CAROLINA NORTH DAKOTA	1) 2)	If 80% ownership of payor. If 50% ownership of payor.	Otherwise, 50% exclusion. Otherwise, 50% exclusion.		X X X X	§54:10A-4(k)(1) §§7-2A-2.M & N §§208.9(a)(1) & (2) and (b)(2) §§105-130.7, 105-130.4(f) §57-38-01.8
			1989-1994: 50% exclusion or, if at least 25% increase in "threshold activity", 70% exclusion. 1995: 70% exclusion.		X X	L. 1987, H.B. 1064, effective for tax years beginning after 12-31-88
OHIO OKLAHOMA OREGON	X				X X	§5733.04(1)(2) §2358.A.4.b §317.267(2), c. 1, Oregon Laws 1984, eff. for tax years beginning on/after 1-1-86
PENNSYLVANIA	X					§57401(3)1.(A) & (B)

	Exemption			Treatment of Balance		Statute(s)
	Exempt	Conditional	Partial	Allocate	Apportion	
RHODE ISLAND SOUTH CAROLINA 1)		If 80% ownership of payor.		X		§§44-11-11, 44-11-12 §12-7-700(15) repealed L. 1985, S351, eff. for tax years beginning after 12-31-84; §12-7-1120(2)
2)				X		§§12-7-415, 12-7-430 added L. 1985, S351, eff. for tax years beginning after 12-31-84; §12-7-1120(2)
TENNESSEE UTAH		If 80% ownership of payor.	50% exclusion.		X	§67-2704(b)(2)(A) §59-12-5(2)(d), L. 1988, c. 89 (HD 178), eff. for tax years beginning on/after 7-1-88
VERMONT VIRGINIA WEST VIRGINIA 1) X		If 50% ownership of payor.		X		§6011(10) §150-151.032(a), §151-037 §11-24-6(c)(3), L. 1985, H1693, limited to taxable years beginning before 7-2-87
2)					X	§11-24-6, 11-24-7(d)(3)
3) X					X	§11-24-6(c)(10), L. 1988, HB 4475, eff. for taxable years ending after 7-1-88
WISCONSIN DISTRICT OF COLUMBIA		If 80% ownership of payor.			X	§71-04(4) §47-1810.1
<u>Worldwide Combination States*</u>						
ALASKA						§47-20.065

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

ATTACHMENT B

Larry Ledebur and William W. Hamilton, "The Failure  
of Tax Concessions as Economic Development Incentives," in  
*Reforming State Tax Systems*, ed., Steve Gold, NCSL, December 1986

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# The Failure of Tax Concessions as Economic Development Incentives

by

Larry C. Ledebur

William W. Hamilton

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On October 7, 1985, the *Washington Post* reported:

**Chrysler, Mitsubishi Set Joint U.S. Venture**  
Chrysler Corp. and Mitsubishi Motors Corp. last night signed a \$500 million agreement to build 180,000 subcompact cars a year in the United States, beginning in 1989, according to industry sources. . . .

The plant is to be built in the Bloomington-Normal, Ill. area, according to the Associated Press. . . . To attract the plant, the AP reported, the state of Illinois and Bloomington-Normal offered the automakers about \$10 million worth of land, \$20 million in local real estate tax breaks over 10 years and various other incentives valued conservatively at more than \$100 million.

The joint venture between Chrysler and Mitsubishi is expected to yield 2,500 production jobs and 9,000 jobs in related industries when the plant is operating on two shifts, the sources said.

Announcements such as that of the Chrysler-Mitsubishi joint U.S. venture have ripple effects throughout state legislatures and other state bodies involved in economic development policy and programs. The clear implication of the article is that the new facility was "attracted" to the Bloomington-Normal area because of the package of incentives offered by the state and locality. As a consequence of this type of information, or misinformation, states and local governments have joined the race to provide broad and expensive packages of industrial assistance.

Since 1975, state subsidies/incentives to business have proliferated. States now offer a broad array of incentives to firms locating, expanding, or agreeing to remain in their jurisdictions. These include loans, loan guarantees, direct interest subsidies, land write-downs, tax-exempt financing, and equity and near-equity investments, and in a few cases, outright grants (Table 1).<sup>1</sup> The centerpiece of most state industrial finance programs, however, is tax concessions in the form of exemptions, deductions, credits, and abatements.<sup>2</sup> This array of state and local subsidies to industry has been described as a "well-stocked candy store."<sup>3</sup>

This rapid proliferation of state and local programs testifies to the widespread belief among policymakers and practitioners that an arsenal of development incentives is considered critical to inter-jurisdictional, interstate, and regional competition for industry

and jobs. Despite the creativity demonstrated by state and local governments in providing sophisticated financial assistance packages to firms involving both public and private funds, subsidization of private enterprise to achieve public objectives remains a malnourished art form. The effectiveness of interstate business incentives in exerting any significant influence on firm location decisions, however, is undemonstrated.

Table 1.  
State Industrial Incentives

Incentive	Number of States
Grants	4
Debt Instruments	
Direct Interest Subsidies	3
Loans	
Direct State Loans	21
Private Development Credit Corporation	17
Industrial Revenue Bonds	
State-Issued	22
Locally Issued	45
General Revenue Bonds	4
Umbrella Bonds	10
Loan Guarantees	11
Industrial Revenue Bond Guarantees	11
Equity and Near-Equity Financing	
State-Chartered Equity/Venture Capital Corporations	8
Tax Exemptions, Credits, Deductions, and Special Treatment	
Job Creation Tax Credits	19
Investment Tax Credits	23
Property Tax Abatements	31
Business Inventory	35
Goods in Transit	43
Research and Development	43
Pollution Control Equipment	37
Industrial Fuels and Raw Materials	45
Energy and Fuel Conservation Measures	41

Source: William Hamilton, Larry Ledebur, and Deborah Matz, *Industrial Incentives: Public Promotion of Private Enterprise* (Washington, D.C.: Aslan Press, 1985), pp. 4-5.

The United States Office of Management and Budget, after a two-year study, concluded:

The relative effectiveness of different forms of assistance such as grants, loans, and risk assumption for meeting different types of program objectives has not been systematically reviewed in public literature. In the light of the scope, magnitude and importance of assistance as a tool of national leadership, much more needs to be known.<sup>4</sup>

The significance of this deficiency in the literature has been emphasized by Lester Salamon:

The widespread use of tools like loans, loan guarantees, social regulation, insurance, government corporations, tax incentives, various types of grants and others—many of which involve the pervasive sharing of governmental authority with a host of "third parties" . . . has significantly altered the practice of public management. . . . To come to terms with the new reality, it will be necessary to change the unit of analysis in public management and implementation research from the individual programs or agencies to the generic tools of government action and to develop a systematic body of knowledge about the dynamics and characters, the distinctive "political economies," and resulting advantages and disadvantages of different tools through which the public sector now acts.<sup>5</sup>

## Existing Evidence

Variations in business tax liabilities among states and municipalities are unlikely to play a major role in business site selection, location, or relocation decisions. Existing studies, with a striking degree of consistency, have failed to demonstrate a significant relationship between taxes and location decisions of business firms.<sup>6</sup>

### Studies

Major reviews of literature on tax concessions document this

No empirical analysis has been able to find a significant relationship between local taxes and economic development.<sup>7</sup>

Only 3.3 percent of the new firms [in a survey], none of the expansions, and 6.3 percent of the new branch plants indicated they would have located in another state in the absence of tax incentives.<sup>8</sup>

Tax levels are either not applicable or of low concern to the typical relocating plant. . . . [O]nly about a quarter to a third of the relocating plants actually move to new locations with lower property tax rates. The bulk, 40 to 50 percent, move within the same taxing jurisdiction or to locations in towns with similar tax rates. Another quarter move to jurisdictions with higher property tax rates.<sup>9</sup>

Despite the perception among policy makers that taxes matter and, therefore, a good incentive package should contain tax concessions, the overriding conclusion from previous research is that taxes do not play a significant role in a firm's choice of location among regions. Research also has shown that the other nontax controllables contained in state and local industrial incentive packages play little or no role in a firm's interregional choice of location. But as the geographical area diminishes, the importance of taxes and fiscal incentives increases. Transportation, energy, labor cost and market differentials tend to decrease as the area under consideration diminishes, making taxes a more significant locational determinant.<sup>10</sup>

Further, it has been argued that the availability of special subsidies for business has increased to the point that most states now offer standard types of business location incentives.<sup>11</sup> To the extent that this is the case, the usefulness of these subsidies in affecting interstate cost differentials is "washed out."

### Surveys

Corporations do not identify tax concessions as significant factors in location, relocation, or expansion decisions. Roger Schmenner, in a far-reaching examination of determinants of behavior of large firms, identified the most important influences in national plant location decisions (Table 2).<sup>12</sup> The seven conditions viewed as

"musts" center on proximity to markets and supplies, labor conditions and costs, and amenities. "Ease in obtaining environmental permits" is the only "must" directly amenable to government action in the short term.

A survey of influences on plant location decisions in Michigan produced similar results (Table 3). Among the most important factors are access to markets and suppliers, local cost considerations, and labor supply and quality. Local property taxes are important, ranking fifth. Tax concessions, on the other hand, ranked 16th among the 23 most important influences.

Finally, a 1981 survey of 500 of the 1,000 largest U.S. industrial corporations assessed the importance of factors in locating plants in the continental United States (Table 4). In this study, "state and local attitude toward taxes and business and industry" (i.e., tax structures and rates) ranked fourth in order of importance. "Financing inducements" ranked 15th, with 77 percent of the responding firms indicating that these inducements were "fairly" (29 percent), "quite" (32 percent), or "extremely" (16 percent) important. It appears, therefore, that some forms of financial incentives, although not necessarily tax concessions, are important in the site location decisions of a majority of large corporations in the United States.

Table 2.

Influences on Plant Location Decisions-National  
Plant Openings in All Industries

Factors Viewed as "Musts"	Percent of Plants Citing Factor
Favorable labor climate	76%
Proximity to market	55
Attractive place for engineers/managers to live	35
Proximity to supplies, resources (including energy)	31
Low labor rates	30
Proximity to existing facilities or division/company	25
Ease in obtaining environmental permits	17

Source: Roger Schmenner, "Location Decisions of Large Firms: Implications for Public Policy," *Commentary*, January 1981.

Table 3.

Influences on Plant Location Decisions Michigan  
(Establishment Weighted)

Criterion	Total Sample
Access to markets	1
Land, building, rent cost	2
Labor cost	3
Skilled labor pool	4
Local property taxes	5
Transportation	6
Specialized suppliers	7
Quality of living	8
Raw materials	9
Energy	10
Qualified professionals	11
State taxes on business	12
Financing and capital	13
Labor/management relations	14
Unemployment compensation cost	15
Tax incentives	16
Attitude of state government	17
Crime rates	18
Workers compensation cost	19
Licensing and state regulations	20
Water	21
State and local government services	22
Access to universities	23

Source: Patricia A. Braden and Susan R. Rideout, "Location Decision-Making in Export-Oriented Business and Industry" (Ann Arbor: Division of Research, Graduate School of Business Administration, University of Michigan, 1978), p. 111-13.

*Recent Experience*

Three examples of site selection decisions of major corporations that received national attention, Microelectronics and Computer Technology Corporation (MCC), General Motors' Saturn Plant, and Volkswagen, provide additional evidence on the possible role of tax concessions.

Both MCC and General Motors were vigorously courted by states and cities, many of which offered extremely generous packages of financial incentives to attract the new facilities. After

Table 4.

**Fortune Survey**  
**Comparative Importance of Factors in Locating Next Mainland**  
**U.S. Plant**

(1981 Rank Order) 1981 Rank	Factor	Weighted Score*		
		1981	1976	Notable Changes
Figures in ( ) are 1976 ranks				
1.	Productivity of workers (1)	82	82	
2.	Efficient transportation facilities for materials and products (1)	79	82	
2.	Community receptivity to business and industry (3)	79	80	
4.	State and/or local attitude toward taxes on business and industry (5)	77	79	
5.	Availability of energy supplies (3)	75	80	-5
6.	Ample area for future expansion (8)	71	70	
7.	Costs of property and construction (6)	70	71	
7.	Availability of skilled workers (11)	70	65	+5
7.	Quality of life for employees (n/a)	70	n/a	
10.	State and local posture on environmental controls and processing of environmental impact reports (6)	69	71	
11.	Water supply (9)	66	68	
11.	Calm and stable social climate (14)	66	62	+4
13.	Adequate civic waste treatment facilities (14)	63	62	
14.	Availability of technical or professional workers (22)	62	53	+9
15.	Financing inducements (23)	61	51	+10
15.	Fiscal health of state and/or city (12)	61	63	
15.	Proximity to customers (12)	61	63	
15.	Availability of unskilled or semi-skilled workers (10)	61	66	-5
19.	State and/or local personal income tax structure (17)	60	60	
20.	Proximity to raw materials, components, or supplies (16)	59	61	
20.	Proximity to services (17)	59	60	
20.	Efficient transportation facilities for people (20)	59	55	+4

(1981 Rank Order) 1981 Rank	Factor	Weighted Score*		
		1981	1976	Notable Changes
Figures in ( ) are 1976 ranks				
23.	A growing regional market (20)	57	55	
24.	Availability of clerical workers (24)	49	47	
25.	Personal preferences of company executives (26)	42	36	+6
26.	Proximity to other company facilities (25)	37	37	

n/a: not asked.

\* Weighted Score: Respondents were asked to rate each of 26 possible factors as to their importance in locating the company's probable next new plant. The rating scale had five points, ranging from "extremely important" to "not at all important." For ease of interpretation, the answers were presented in the form of "weighted scores" so that if every respondent had said "extremely important," the weighted score would be 100, and if every respondent had said "not at all important," the weighted score would be 0.

Source: Fortune Market Research Survey, *Why Corporate America Moves Where* (New York, N.Y.: Time, Inc., 1982), p. 9.

national site selection processes, MCC chose Austin, Texas, and General Motors announced its intention to locate in Springhill, Tennessee. In neither case did tax concessions play a role in the site selection process. The state of Texas and city of Austin made a commitment to provide ongoing support to the state's education system, a commitment benefiting all firms and residents, and to assist employees in locating satisfactory housing. The Saturn decision was made on the basis of traditional location factors, primarily access to market, labor quality and costs, and local amenities.

The Volkswagen case provides an unfortunate example of corporate behavior in the site selection process. Most knowledgeable observers agree that Volkswagen made its decision primarily on the basis of access to market, access to resources and supplies, and labor considerations. Having made, but not announced, the decision to locate in Pennsylvania, the corporation proceeded to play

Pennsylvania and Ohio off against one another to obtain the best possible deal from Pennsylvania. The state responded by offering increasing costly tax concessions to lock up the decision. The characterization of this spectacle as "the Rabbit that ate Pennsylvania" is descriptive.

### *Summary of Existing Evidence*

There appears to be little or no evidence that tax concessions play a major or even significant role in the site selection processes of firms. The business facility location decision-making process is complex and driven primarily by economic considerations beyond the capacity of state and/or local governments to affect, particularly in the short term.

This dichotomy between the belief of many policymakers and practitioners in the efficacy and need for tax concessions and the findings of existing research literature is paradoxical. It appears that what are "good business practices" for state and local governments and sound public policy are in conflict with what is viewed as "good" or "expedient" politics.

Tax structures and rates and forms of financial incentives, other than tax concessions, however, do appear to be important considerations in the site selection process of corporations. This suggests that states (and localities) (a) should be concerned about the effects of taxes on the competitiveness of businesses in their jurisdictions, and (b) should consider more cost-effective industrial incentives if seeking to offer firms financial assistance to influence their behavior to achieve some specified public purpose.

### **Cost-Effectiveness of Industrial Incentives**

Cost-effectiveness, for present purposes, is defined as the ratio of actual benefits received by the assisted firm to the real cost of the assistance to the administering government. Use of this measure would permit state and local governments to identify the benefit derived by the firm per dollar of public expenditure and to allocate scarce development resources to their most cost-effective uses.

Actual benefit to the firm of any form of public assistance is the difference between operating costs in the absence of the government award and these costs in the presence of this assistance. "The value of a financial incentive to a firm is reduced by cost-offsets.

The major offsetting cost is the loss of tax benefits for which the firm would have been eligible in the absence of the development incentive or tax-offsets. Firms pay both state and federal corporate income taxes on net revenues, the effective rate of tax ratio varying with the level of profitability and the tax policies of the state. An incentive treated as revenue for tax purposes is directly taxed, reducing the benefits to the firm of the assistance. For example, if a firm's marginal tax rate under current federal rates is 46 percent, the actual value of a dollar of public assistance to a firm making a profit is 54 cents. Incentives that reduce operating costs of firms that otherwise would be tax deductible if incurred by the firm from its own resources decrease the value of assistance in the same manner. For example, forms of assistance that subsidize depreciable assets such as a plant and its equipment reduce the amount of depreciation deductible from the firm's income.

Costs to government of development incentives include direct outlays and revenues forgone. When the subsidy involves a flow of government commitments over time, as in the case of tax abatements, the present value of the cost is determined by discounting the time stream of direct costs. The net cost to government, however, may be less than the gross outlay because subsidies increasing firm revenues or reducing operating costs also raise the tax liability of the firm.

*A minimum condition of sound state and/or local government business practice in providing incentives to business is that the ratio of benefits received by the firm from the assistance exceed the cost to the administering government.* There appears to be no justification for providing assistance to private firms from public coffers where government costs are greater than private benefits.

Some will argue that measuring only direct benefits to firms in terms of effects of assistance understates the real value of the incentive. This line of argumentation takes two tacks. First, there are benefits to a community or state of the location or expansion of economic activity that are not readily quantifiable (such as the image of the business climate, importance of the facility as a turnkey or catalyst in the economic development process, contributions to the community, and so on). Second, the baseline measurement ignores secondary benefits generated through the employment and income multiplier processes as new incomes are spent and respent in the economy.

The logic of these arguments cannot be denied. The first category of benefits, however, is essentially intangible and, in the absence of quantification, can be used to justify almost any undertaking. While these intangible benefits should be recognized, past abuses in using intangible benefits to justify otherwise inefficient

public expenditures argues for extreme caution in weighing these factors.

Secondary income and employment benefits can be quantified. The cost-effectiveness model can build in income and employment multipliers. Application of the expanded model, however, has demonstrated that projects that are not cost-effective in terms of direct benefits to the recipient firm seldom become cost-effective even when secondary benefits are included. Further, multipliers used by state and local governments are, at times, somewhat unrealistic. Absurdly large multipliers have been used to justify projects that otherwise would not meet a reasonable test of benefits to costs. Therefore, one should be cautious in the application of secondary benefit tests of cost-effectiveness.

Calculating the cost of development incentives is complicated by the multilevel structure of the U.S. federal system. Changes in tax revenues resulting from incentives—both positive and negative—may accrue to both state and federal governments, and the full public sector cost of a development subsidy is the combined federal and state cost. For example, the most cost-effective instrument of industrial finance available to state and local governments, by far, is industrial development bonds. Costs of IDBs are borne by the federal government in the form of tax expenditures resulting from the tax-exempt nature of these bonds. The cost to the state is a relatively modest tax expenditure, while the benefits to the firm may be great. This situation results in a low (that is favorable) cost-to-government/benefit-to-firm ratio from the state and local government perspective. Consequently, use of IDBs has proliferated. Inclusion of federal tax expenditures in the IDB cost-effectiveness calculations, however, reduces the effectiveness of this instrument below several other tools of industrial finance.

Cost-effectiveness ratios for selected interest subsidies, subsidies for production inputs, and state and local tax abatement are presented in Table 5. Cost-effective incentives will have ratios of less than one. Negative ratios indicate the most cost-effective incentives. A general principle emerging from this table is that the federal system diminishes the cost-effectiveness of many forms of development incentives. Whenever a form of assistance raises profits or lowers costs, the aided firm faces an increased income tax liability. Since the federal government receives most income tax revenues, the states, in effect, subsidize the federal government when they assist business firms.

Tax concessions are not cost-effective. State and local government revenues forgone through tax expenditures are greater than benefits received by recipient firms. It is unlikely that any form of

tax concession can be cost-effective. One application of the cost-effectiveness methodology examined the benefits to firms and cost to governments of business income taxes, property taxes, and employment tax credits in one state. The cost-effectiveness of these tax concessions was examined for large and small firms in four industries: (1) capital-intensive manufacturing, (2) labor-intensive,

Table 5.

Cost-Effectiveness Ratios for Selected Development Incentives

Incentive	Cost to Government/Benefit to Firm		
	Federal	State	Combined
<b>Low-Profit Firms<sup>a</sup></b>			
Interest Subsidies			
Industrial revenue bonds <sup>b</sup>	2.01	0.18	2.19
Subsidized direct loan	-0.33	1.47	1.14
Loan guarantee <sup>c</sup>		0.79	.079
Subsidized Production Inputs			
Equipment	-1.11	2.36	1.25
Land	-0.53	1.58	1.00
Plant	-1.40	2.40	1.00
Tax Abatement	-0.42	1.42	1.00
<b>High-Profit Firms<sup>d</sup></b>			
Interest Subsidies			
Industrial revenue bonds <sup>b</sup>	2.24	0.25	2.49
Subsidized direct loan	-0.84	1.82	0.98
Subsidized Production Inputs			
Equipment	-0.53	1.71	1.18
Land	-0.58	1.58	1.00
Plant	-1.40	2.40	1.00
Tax Abatement	-0.85	1.85	1.00

- Notes: a. Low-profit firms face a federal corporate income tax rate of 20 percent and an average state corporate income tax of 5 percent. The combined tax rate is 24 percent under the assumption that states do not allow the deduction of federal income taxes.
- b. Industrial revenue bonds are federally funded via tax expenditures.
- c. Assumes a default rate of 22 percent.
- d. High-profit firms face the maximum federal corporate tax rate and an average state corporate income tax of 5 percent. The combined tax rate is 48.7 percent under the assumption that states do not allow the deduction of federal income taxes.

Source: David Rasmussen, Marc Bendick, and Larry Ledebur, "A Methodology for Selecting Economic Development Incentives," *Growth and Change*, Vol. 15, January 1984, pp. 5.

high-technology manufacturing, (3) wholesale supply, and (4) a business supply service industry. Two primary findings emerged:

- Although numerators and denominators of the cost-effectiveness ratios varied widely across type of tax concession, firm size, and industry, none of the ratios exceeded one; i.e., *in no case were the tax concessions cost-effective.*
- In every case, even where tax concession ratios approached unity, there is always some more cost-effective instrument for pursuing the public purpose.

The importance of tax incentives lies primarily in psychological effects on businesses. They often are viewed as measures of a jurisdiction's business climate and willingness to work with business to improve their operating environment. This viewpoint argues that state and local governments should offer a small set of tax concessions that are relatively inexpensive in terms of tax revenues forgone.

Cost-effective industrial incentives are those that leverage investment from commercial lending and investing institutions. Among these are loan guarantees, direct interest subsidies, and incentives targeted to nondepreciable assets.

Loan guarantees to small businesses are the most cost-effective of all industrial incentives evaluated. At a default rate of 22 percent, the cost-effectiveness ratio of this form of assistance to small firms is 0.79. This ratio is highly sensitive to the ex-post default discount rate. Estimates indicate that default rates can be as high as 40 percent before loan guarantees are no longer a cost-effective instrument of industrial finance.

## Conclusion

State and local governments' rush to provide tax concessions to business is paradoxical in the absence of any substantive evidence that these incentives influence firm decisions and behavior in ways that contribute to the public purpose. Proliferation of tax incentives occurs, in part, because of the failure of researchers to effectively communicate the inadequacies of concessions as tools of public policy and the penchant of policymakers to dismiss research as being "academic" and not an accurate representation of the "real world." Also, it occurs, in part, because legislators voting

against business tax concessions risk being labeled "antibusiness," a pejorative reference, presumably entailing political risk. But it also occurs because business has learned to play the game, and to play it well. Site location decisions are made primarily on the basis of considerations that lie beyond the capacity of state and local governments to influence. Once the decision is made, however, many businesses appear quite willing to pressure state and local governments for tax breaks and to play governments off against one another to increase their leverage in obtaining reductions in their tax liabilities. Where these tax concessions are granted, businesses are subsidized for undertaking actions that are in their own financial self-interest and that would have been undertaken in the absence of public assistance.

Throughout the United States, state and local governments are being subjected to pressures to provide special tax concessions in the name of "economic development." Subnational governments must become increasingly sophisticated in dealing with these issues and develop the capacity to sit at the bargaining table with industry as informed, equal partners. Two initial steps are necessary. First, state and local governments should understand the cost-effectiveness of various tools of government for assisting business enterprise. Second, they should establish a consistent decision-making framework and guidelines for evaluating the desirability of awarding incentives to firms and avoid the trap of making these decisions on an ad hoc case-by-case basis.

Nine basic guidelines are recommended to the state and local governments as central pillars in a decision-making framework:

- (1) The primary responsibility of local government is to provide the level and quality of public services and public infrastructure consistent with the preferences and requirements for basic welfare of its citizens, and to ensure the revenue base necessary to this end.
- (2) The appropriate concern of local government is the overall tax structure, its capacity to generate necessary revenues, equity in the distribution of tax burdens between citizens and businesses, and the effect of business taxes on the competitiveness of the local business environment.
- (3) Subsidization of business enterprise lies beyond the conventional scope of responsibilities of local government and should be considered only in exceptional circumstances in which the essential welfare of the jurisdiction is at issue.

- (4) Revenues forgone through tax concession should be regarded as costs to the local government no less real than direct expenditures.
- (5) Industrial subsidies should not be awarded to businesses for actions undertaken in pursuit of their own financial self-interests.
- (6) Local government should establish overall policies on industrial subsidies and avoid operating on an ad hoc or case-by-case basis. These policy guidelines should be overridden only in exceptional circumstances.
- (7) Industrial incentive programs should operate within carefully specified budget constraints. All too often incentive programs are administered with no clear account of their costs, especially those resulting from off-budget programs and tax expenditures. Adherence to budget constraints encourages the careful targeting of resources and the use of the most cost-effective instruments to achieve public development objectives.
- (8) Jurisdictions should use the most cost-effective instrument for accomplishing their purposes. In most cases, there will be little justification for using less effective incentives. Two possible exceptions to this general rule can be identified. First, the use of limited tax concessions with firms considering relocation from other jurisdictions or relocation to another jurisdiction may be justified because of the psychological dimensions of concessions to businesses. Even in these cases, jurisdictions will want to ensure that they are not being "blackmailed" by the possibility or threat of relocations simply to "sweeten" a move that the firm would undertake in any case. Second, in some cases, jurisdictions might be justified in using an incentive of lesser cost-effectiveness that delivers a higher effective value to the firm in order to achieve the necessary leverage with the firm.
- (9) Cost-effectiveness ratios should be used to rank applicant firms and determine priorities for allocating limited state and local industrial development resources. These ratios measure the efficiency of state expenditures in providing financial assistance to firms. They are, therefore, the appropriate reference for guiding decisions on allocating industrial development resources.

## Notes

1. For information on state industrial incentives and recent innovations, see William Hamilton, Larry Ledebur, and Deborah Matz, *Industrial Incentives: Public Promotion of Private Enterprise* (Washington, D.C.: Aslan Press, 1985); and Deborah Matz, *An Analysis of Innovative State Economic Development Financing Programs* (Washington, D.C.: National Association of State Development Agencies, 1985).
2. *Exemptions* exclude particular items or actions from taxation. *Deductions* reduce the base upon which a tax is computed. *Credits* are subtracted from the tax due, thereby reducing the actual tax payment. *Abatements* are reductions in, or forgiveness from, taxes (usually property taxes) provided for a specified period of time. For a more detailed discussion of forms of tax concessions, see *Industrial Incentives: Public Promotion of Private Enterprise*.
3. John Gray and Dean Spina, "State and Local Industrial Location Incentives—A Well-Stocked Candy Store," *Journal of Corporation Law*, Spring 1980, pp. 517-687.
4. U.S. Office of Management and Budget, *Managing Federal Assistance in the 1980s* (Washington, D.C.: Office of Management and Budget, 1980).
5. Lester Salamon, "Rethinking Public Management: Third Party Government and Changing Forms of Government Action," *Public Policy*, Summer 1981, pp. 255-275.
6. For reviews of these studies, see Larry C. Ledebur and David W. Rasmussen, "State Development Incentives" (Urban Institute Report, May 10, 1983); and George A. Reigeluth and Harold Wolman, "The Determinants and Implications of Communities Changing Competitive Advantages: A Review of Literature" (Urban Institute Report, January 9, 1979).
7. Michael Kieschnick, *Taxes and Growth: Business Incentives and Economic Development* (Washington, D.C.: Council of State Planning Agencies, 1981).
8. Roger Vaughan, *The Urban Impacts of Federal Policies: Vol. 2, Economic Development* (Santa Monica: The Rand Corporation, June 1977).
9. Roger Schmenner, "The Location Decisions of Large, Multi-Plant Companies," mimeographed, 1980.
10. Conclusions of Barry M. Rubin and C. Kurt Zorn, "Sensible State and Local Economic Development," *Public Administration Review*, March/April 1985, pp. 333-339. As sources supporting these conclusions, the authors cite Michael Wasylenko, "The Location of Firms: The Role of Taxes and Fiscal Incentives," in *Urban Government Finance*, ed. Roy Bahl (Beverly Hills, California: Sage Publications, 1981), pp. 155-190.
11. Jerry Jacobs, *Bidding for Business* (Washington, D.C.: Public Interest Research Group, 1979).
12. Roger W. Schmenner, *Making Business Location Decisions* (Englewood Cliffs, N.J.: Prentice-Hall Inc., 1982).
13. Calculation of the value of benefits to firms requires identification of the flow of gross benefits from the incentive, the appropriate discount rate to compute present values of flows accruing over time, and any offsetting costs of accepting the assistance.

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# Reforming State Tax Systems

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THE SUPREME COURT OF THE STATE OF ALASKA

STATE OF ALASKA, DEPARTMENT  
OF REVENUE,

Appellant,

v.

OSG BULK SHIPS, INC.,

Appellee.

Supreme Court No. 6-7498

Superior Court No.  
3AN-93-7815 CI

OPINION

[No. 4951 - February 20, 1998]

Appeal from the Superior Court of the State of  
Alaska, Third Judicial District, Kodiak,  
Donald D. Hopwood, Judge.

Appearances: Stephen C. Slotnick, Assistant  
Attorney General, and Bruce M. Botelho,  
Attorney General, Juneau, for Appellant. Ann  
M. Brunar, Brian W. Durrell, Bogle & Gates,  
Anchorage, and D. Michael Young, Bogle &  
Gates, Bellevue, Washington, and Walter  
Hellerstein, University of Georgia, Atlanta,  
Georgia, for Appellee. Susan A. Burke and  
Avrum M. Gross, Gross & Burke, Juneau, for  
Amicus Curiae Alaska Visitors Association.  
Kenneth Klein, Cadwalader, Wickersham & Taft,  
Washington, D.C., and Ronald L. Baird,  
Anchorage, for Amicus Curiae North West  
CruiseShip Association.

Before: Rabinowitz, Matthews, Eastaugh, and  
Fabe, Justices. [Compton, Chief Justice, not  
participating.]

EASTAUGH, Justice.

I. INTRODUCTION

This appeal raises questions about the tax payable under  
the Alaska Net Income Tax Act, AS 43.20.011-43.20.350 (ANITA), for

tax years 1981 through 1988 on income derived by the taxpayer from domestic and foreign shipping operations and investments. The State of Alaska, Department of Revenue (DOR) assessed additional income taxes against the taxpayer, OSG Bulk Ships, Inc. The superior court reversed DOR's decision and DOR now appeals. We now reverse in part and remand for further proceedings.

## II. FACTS AND PROCEEDINGS ...

### A. Facts

OSG Bulk Ships, Inc. (OBS), a New York corporation, is a wholly-owned first-tier subsidiary of Overseas Shipholding Group, Inc. (OSG), a Delaware corporation. OBS and OSG both have their commercial domiciles in New York. OSG has more than a fifty percent ownership interest in over one hundred subsidiaries and partnerships, most of which are shipping companies. The shipping companies collectively own approximately sixty-five ocean-going vessels used in different types of trade throughout the world. OBS owns all of the domestic shipping companies; OSG International, Inc., which is also a first-tier subsidiary of OSG, owns most of the foreign shipping companies.

OSG, including its subsidiaries, is engaged in the ocean transportation of liquid and dry bulk cargoes in both the worldwide and U.S. domestic markets. It owns the largest independent fleet of unsubsidized U.S.-flag tankers, and is a major participant in the Alaskan oil trade. The rest of OSG's fleet is registered under foreign flags. OSG also owns several other companies, including

holding companies, financial companies, service companies, and an insurance company.

OBS is the taxpayer. It owned corporations that in turn owned or chartered tanker vessels entering Alaska waters during audit years 1981 to 1988.<sup>1</sup> OBS and its domestic shipping companies reported their Alaska taxes on a unitary basis (as if they were a single taxpayer engaging in a single business). OBS did not include in the unitary group the foreign corporations related by ownership to OSG. Nor did OBS include the investment subsidiaries because OBS claimed they had no connection with Alaska and were not part of OBS's unitary business. OBS also claimed investment tax credits for new vessels.

#### B. Proceedings

Following audits by DOR's Income and Excise Audit Division (Audit Division), DOR assessed OBS additional income taxes for tax years 1979 through 1981, 1985 through 1986, and 1988.

The Audit Division included approximately ninety foreign corporations in OBS's unitary group, determining that "OSG and all its more-than-50-percent-owned subsidiaries, including OBS, were engaged in a single, unitary business during the period under audit." This had the effect of including in the "worldwide unitary

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<sup>1</sup> These corporations were: Cambridge Tankers, Inc.; Juneau Tanker Corporation; San Diego Tankers, Inc.; San Jose Tankers, Inc.; Santa Barbara Tankers, Inc.; Santa Monica Tankers, Inc.; and Lake Michigan Bulk Carriers, Inc. DOR treated these corporations as one taxpayer for audit purposes, and referred to them as "OSG Bulk Ships, Inc." because that is how the taxpayer referred to itself in its consolidated Alaska Corporation Net Income Tax Returns. We follow the same convention here.

income<sup>2</sup> of OBS's corporate group the income of the foreign corporations and all of the subsidiaries in which OSG had more than fifty percent ownership. The taxable corporate income attributable to the group's Alaska business was then calculated by multiplying the worldwide unitary income of the entire group by an "apportionment fraction" derived by dividing the value of the group's Alaska business activities by the value of its worldwide business activities. See AS 43.19.010 art. IV, § 9. This adjustment increased OBS's income taxable in Alaska, and the Audit Division assessed additional taxes.<sup>2</sup>

OBS protested the assessments. Following administrative proceedings, DOR's hearing officer issued a recommended decision which DOR's Commissioner adopted. In pertinent part, the decision held that (1) income earned by OBS's foreign subsidiaries from operation of foreign flag vessels was not exempted by 26 U.S.C. § 883 and was therefore includable in OBS's apportionable income; (2) DOR did not exceed its statutory authority by promulgating 15 AAC 20.110(d), a regulation that reduced OBS's investment tax credit; and (3) OBS's investment income was properly treated as business income for Alaska tax purposes. As of July 1993 OBS's tax assessments totaled \$789,495.

OBS appealed to the superior court, which reversed each of these three rulings.

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<sup>2</sup> OBS states in its brief that while it does not agree with DOR's inclusion of approximately ninety foreign corporations in OBS's unitary group, it does not contest this issue on appeal.

DOR now appeals the superior court's rulings on these three issues.

### III. DISCUSSION

#### A. Whether Internal Revenue Code Section 883 Exempts OBS's Foreign Shipping Income from Taxation by Alaska

The Alaska Net Income Tax Act (ANITA), AS 43.20.011-43.20.350, taxes a corporation's "entire taxable income . . . derived from sources within the state." AS 43.20.011(e). When OBS filed its 1981-88 Alaska tax returns, it excluded from its tax base all income derived from vessels owned by the foreign subsidiaries in its unitary group. In doing so, OBS reasoned that AS 43.20.021(a) had incorporated subsection 883(a)(1)<sup>3</sup> of the

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<sup>3</sup> The version of section 883 in effect after amendment in 1986 provided:

(a) Income of foreign corporations from ships and aircraft. -- The following items shall not be included in gross income of a foreign corporation, and shall be exempt from taxation under this subtitle: (para.) (I) Ships operated by certain foreign corporations. -- Gross income derived by a corporation organized in a foreign country from the operation of a ship or ships if such foreign country grants an equivalent exemption to citizens of the United States and to corporations organized in the United States.

26 U.S.C. § 883(a)(1) (1988).

Prior to its amendment in 1986, subsection 883(a)(1) stated:

(a) Income of foreign corporations from ships and aircraft. -- The following items shall not be included in gross income of a foreign corporation, and shall be exempt from taxation under this subtitle: (para.) (1) ships under foreign flag. -- Earnings derived

(continued...)

federal Internal Revenue Code (IRC), codified at 26 U.S.C. § 883(a)(1), into ANITA, and that section 883 exempted foreign shipping income.

Alaska Statute 43.20.021(a) incorporates sections of the IRC into the ANITA and the Multistate Tax Compact (MTC), AS 43.19.010-43.19.050,<sup>4</sup> unless the IRC provisions are "excepted to or modified by" other ANITA provisions.<sup>5</sup> The sections adopted by reference encompass IRC section 883.

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<sup>3</sup>(...continued)

from the operation of a ship or ships documented under the laws of a foreign country which grants an equivalent exemption to citizens of the United States and to corporations organized in the United States.

26 U.S.C. § 883(a)(1), amended by Pub. L. 99-514, § 1212(c)(3)-(5), 100 Stat. 2538 (Oct. 22, 1986).

The amendments to subsection 883(a)(1), effective for tax years after December 31, 1986, simply change the focus for the exemption from the country of the ship's documentation to the country of the corporation's organization. This change does not affect the section 883 analysis for OBS because all of OSG's foreign shipping subsidiaries that the auditor included as part of the unitary group both are organized under the laws of a foreign country that grants an equivalent exemption and own or operate ships documented under a country that grants an equivalent exemption.

<sup>4</sup> The MTC is a restatement of the Uniform Division of Income for Tax Purposes Act (UDITPA), which was adopted in Alaska in 1959, but was then repealed in 1975. See State Dep't of Revenue v. Amoco Prod. Co., 676 P.2d 595, 598 & n.3 (Alaska 1984).

<sup>5</sup> AS 43.20.021(a) provides that "[s]ections 26 U.S.C. 1-1399 and 6001-7872 (Internal Revenue Code), as amended, are adopted by reference as a part of this chapter. These portions of the Internal Revenue Code have full force and effect under this chapter unless excepted to or modified by other provisions of this chapter."

DOR disallowed the exemption, finding that OBS had not proven that its foreign shipping income was exempt from OBS's apportionable tax base. Reversing, the superior court held that AS 43.20.021(a) had incorporated subsection 883(a)(1) into Alaska law, thus exempting OBS's foreign shipping income.

DOR contends on appeal that subsection 883(a)(1) is "excepted to or modified by" the ANITA, given differences in the methods employed by the State of Alaska and by the federal government for determining taxable income.<sup>6</sup> OBS argues that Alaska's income tax scheme is "entirely consistent" with the section 883 exemption.<sup>7</sup>

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<sup>6</sup> We independently review the merits of an administrative decision. Handley v. State Dep't of Revenue, 838 P.2d 1231, 1233 (Alaska 1992). No deference is given to the superior court's decision when that court acts as an intermediate court of appeal. *Id.*

The interpretation of a tax statute is a question of law for which we have articulated two standards of review. We have distinguished between the rational basis test for questions of law involving agency expertise, and the substitution-of-judgment standard for questions of law that do not involve agency expertise. Earth Resources Co. v. State Dep't of Revenue, 665 P.2d 960, 964-65 (Alaska 1983).

In this case, we must determine whether a particular IRC provision is excepted to or modified by the ANITA. This is a matter of pure statutory construction which is not within the particular expertise of the agency and which requires us to exercise our independent judgment. We have previously held that where the issues to be resolved "turn on statutory interpretation, the knowledge and expertise of the agency is not conclusive of the intent of the legislature in passing a statute." Tesororo Alaska Petroleum Co. v. Kenai Pipe Line Co., 746 P.2d 896, 904 (Alaska 1987) (citation omitted). We therefore substitute our judgment for that of DOR.

<sup>7</sup> Two amici curiae, the Alaska Visitors Association (AVA) and North West Cruiseship Association (NWCA), filed briefs (continued...)

This is not the first time we have considered whether Internal Revenue Code provisions, ostensibly adopted by reference by AS 43.20.021(a), were "excepted to or modified by" other ANITA provisions. In Gulf Oil Corp. v. State Department of Revenue, 755 P.2d 372, 380 (Alaska 1988), we held that a portion of the IRC dealing with the foreign tax credit was "excepted to or modified by" AS 43.20, which allowed neither a deduction nor a credit for foreign income taxes. In so holding, we noted that "[t]hat is not to say that Alaska law incorporates no Code provisions and no federal regulations having to do with the foreign tax credit. Future cases may reveal that it is desirable to conform our law to certain aspects of those federal provisions." Id. The source of the exception in Gulf Oil was the absence in AS 43.20 of any provision for a deduction similar to that provided by the IRC.

In this case, we must decide whether the tax scheme employed by the ANITA implicitly excepts to or modifies application of "section" 88J. We first compare the different methodologies applied by the United States and the State of Alaska to determine taxable income.

When a state seeks to tax the income of a multinational business, it must determine the income properly allocable to in-state activities. Id. at 374. At all relevant times, Alaska has employed the worldwide formula apportionment method to calculate a multinational or interstate corporation's income earned in Alaska.

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<sup>7</sup>(...continued)  
supporting OBS's position on this issue.

AS 43.20.065; AS 43.19.010, art. IV, § 9. Under that method, in-state income is determined by multiplying a corporation's worldwide income by an "apportionment fraction." AS 43.19.010, art. IV, § 9.<sup>8</sup> A taxpayer's apportionment fraction is the numerical average of three factors -- its "property factor," its "payroll factor," and its "sales factor" -- which compare its in-state business activities with its worldwide business activities.<sup>9</sup>

The United States does not utilize the "formula apportionment" method when it calculates the federal taxable income of multinational corporations. Instead, it uses "sourcing" provisions to allocate income to the United States or to other sources, depending upon where the income is earned. 26 U.S.C. §§ 861-65; see also 26 C.F.R. § 1.861-1 (1996). Income that cannot reasonably be "sourced" to the United States is deducted from the

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<sup>8</sup> A corporation's "worldwide" income is all of its business income, whether it was earned inside or outside of Alaska; in essence, worldwide income is pre-tax income (determined without deducting income taxes assessed by other jurisdictions). AS 43.20.065; see Gulf Oil Corp. v. State, Dep't of Revenue, 755 P.2d 372, 375 (Alaska 1988).

<sup>9</sup> These three factors are fractions; each is calculated by dividing the in-state amount of the taxpayer's subject business activity by the worldwide amount of the taxpayer's subject activity. AS 43.19.010, art. IV, §§ 10, 13, 15. For example, the property factor is calculated by dividing the average value of the taxpayer's property owned or rented and used in Alaska during the tax period by the average value of all of its property owned or rented and used during that period. AS 43.19.010, art. IV, § 10.

The formula apportionment method is based on the assumption that an effective way to fairly measure the locally taxable income of a multinational business is to compare the value of its local and worldwide business activities and attribute income on the basis of that comparison. Gulf Oil Corp., 755 P.2d at 374-75.

taxpayer's gross income and is not included when a taxpayer's U.S. income is calculated. Id.

There is consequently a fundamental difference in the way these governments calculate the taxable income of a multinational corporation. Alaska accomplishes its calculation by applying to all income an apportionment fraction that separates the local income from that earned elsewhere. The key to proper separation under this method is the apportionment fraction; it is in the calculation and application of this fraction that the separation is made. In comparison, the United States makes this separation when it first allocates income to sources inside and outside the United States.

OBS and DOR agree that Alaska's adoption of the worldwide apportionment method in AS 43.19 establishes an exception to IRC sections 861 through 865, which relate to the "sourcing" of income for tax purposes. They disagree, however, about whether IRC section 883, which is contained in the same IRC subchapter, is a "sourcing" provision. OBS claims and the superior court held that it is not, because it grants an exemption, and consequently there is nothing in AS 43.20 that excepts to adopting IRC section 883 into Alaska's corporate tax scheme.

The ANITA does not expressly except to or modify the provisions of IRC section 883. Nonetheless, the scheme of allocation and apportionment provided in the MTC, AS 43.19, is fundamental to the ANITA in the context of taxation of taxpayers

with foreign income. See AS 43.20.065.<sup>10</sup> Several circumstances convince us that, in the context of OBS's claim that its foreign shipping income should be exempted from taxation in Alaska, subsection 883(a)(1) is impliedly excepted to by the ANITA.

We first note that the MTC provides a comprehensive methodology for the allocation and apportionment required by the ANITA, AS 43.20.065. As seen above, the key to that methodology is the apportionment fraction. In our view, it is inconsistent with the MTC, and therefore the ANITA, to exempt an entire class of foreign-earned income from the taxpayer's worldwide income for purposes of attempting to distinguish between locally taxable and nontaxable income. Under the MTC, this separation is accomplished through the application of the apportionment fraction, not the calculation of worldwide income. The legislative history of section 883 demonstrates that it was enacted to eliminate the "double taxation" of shipping income. M/V Nonsuco, Inc. v. Commissioner of Internal Revenue, 234 F.2d 583, 587 (4th Cir. 1956) (citing S. Rep. No. 275, 67th Cong., 1st Sess. (1921), 1939-1 (Part 2) C.B. 181, 191). The danger of multiple taxation in that context arises because multinational shipping activities subject the taxpayer to taxation by more than one nation. Avoidance of

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<sup>10</sup> AS 43.20.065 provides:

A taxpayer who has income from business activity that is taxable both inside and outside the state or income from other sources both inside and outside the state shall allocate and apportion net income as provided in AS 43.19 (Multistate Tax Compact), or as provided by this chapter.

multiple taxation is the same purpose served by the MTC through the apportionment fraction.

DOR contends that allowing the section 883 exemption would have the effect of doubly protecting foreign shipping income. It reasons that because the denominator of a taxpayer's apportionment fraction is based on the value of all property, sales, and payroll, wherever and however derived, the inclusion of the values relating to foreign-flag vessels when calculating those factors under AS 43.19.010 art. IV, §§ 9, 10, 13 & 15, reduces the apportionment factor. If section 883 also applied, thus reducing the taxpayer's worldwide income, it would cause a further reduction when the already-reduced apportionment fraction is multiplied by the newly reduced worldwide income. DOR concludes that this result would understate the taxpayer's Alaska taxable income. We agree that this would be the effect of granting the section 883 exemption.

It is also significant that the ANITA contains a statute that appears to deal specifically and comprehensively with the problem of multiple taxation of foreign or multistate water transportation carriers. See AS 43.20.071. That statute provides for apportionment of all business income of water transportation carriers in accordance with the MTC's apportionment formula methodology by modifying the property, payroll, and sales factors from which the apportionment fraction is calculated, by applying a

"days-in-port" fraction.<sup>11</sup> This method further reduces the three statutory MTC factors, and thus the MTC's apportionment fraction. The result is a reduction in taxable income.

OBS argues that AS 43.20.071 is compatible with statutory exceptions like that provided by section 883, because section .071 simply applies the apportionment method for water transportation carriers after their apportionable tax base is determined by eliminating exempt income. We reach a contrary conclusion. We think the reference in AS 43.20.071(a) to "all business income" of water transportation carriers is more consonant with finding the section 883 exemption inapplicable. Reading "all business income" at face value suggests that it encompasses all income of a business origin, without reduction for any class of income of foreign

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<sup>11</sup> AS 43.20.071 is entitled "Transportation carriers" and provides, in pertinent part,

(a) All business income of water transportation carriers shall be apportioned to this state in accordance with AS 43.19 (Multistate Tax Compact) as modified by the following:

.....

(4) the portions of the numerator of the property, payroll, and sales factors which are directly related to interstate mobile property operations are determined by a ratio which the number of days spent in ports inside the state bears to the total number of days spent in ports inside and outside the state; the term "days spent in ports" does not include periods where ships are tied up because of strikes or withheld from Alaska service for repairs, or because of seasonal reduction of service; days in port are computed by dividing the total number of hours in all ports by 24.

origin. Further, it appears that in the federal scheme, section 883 uses separate accounting methodology to avoid the problem of multiple international taxation of transportation carriers by assigning income to a source through reciprocal exemptions. The days-in-port ratio adopted by AS 43.20.071 avoids multiple taxation of transportation carriers by formula apportionment. As DOR argues in its reply brief, "Alaska has no need to incorporate a reciprocal exemption to avoid possible unfair double taxation of foreign or domestic vessels." More fundamentally, there is no reason to think that the legislature which adopted AS 43.20.071 to provide for sophisticated adjustments to the MTC apportionment fraction, specifically to prevent multiple taxation of water transportation carriers, contemplated that any other unspecified adjustments would be needed to avoid misallocation of this class of business income.<sup>12</sup>

OBS argues that the exemption provided by section 883 is not inconsistent with AS 43.20.011, which taxes "the entire taxable income of every corporation derived from sources within the State." It also argues that section 883 income can be earned either within or outside Alaska waters, and that AS 43.20.011, which geographically limits taxation to income derived from "sources within the State," operates alongside and independently of section 883. It similarly interprets AS 43.20.065 to provide for apportionment of income after reductions for applicable exemptions.

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<sup>12</sup> We note that all of OBS's ships that called in Alaska were registered under the U.S. flag; therefore, none of the property, payroll, or sales of OBS's foreign flag ships was included in the numerator of the property/payroll/sales apportionment fraction.

OBS also argues that section 883 is not inherently incompatible with the general apportionment provisions of the MTC, and notes that DOR does not object to applying other exemptions, such as IRC section 103, which exempts interest.

DOR responds that provisions such as section 103 do not have the effect of assigning income to a foreign or domestic source, unlike section 883. We agree with that distinction.

We conclude that the arguments for finding that AS 43.20 impliedly excepts to section 883 are stronger than those to the contrary.<sup>13</sup> If we were to accept OBS's position, it would

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<sup>13</sup> In so holding, we reject arguments, advanced by OBS and AVA, that legislative events in 1991 and 1992 establish that the legislature did not intend to except to section 883. In 1991 and 1992, the Alaska legislature proposed, but ultimately rejected, amendments that would have expressly excepted to incorporation of section 883. OBS and AVA rely on comments at committee and subcommittee hearings regarding the proposed legislation in support of their position that the legislature realized section 883 had already been incorporated into Alaska law. Such comments, provided in context of legislation which was not adopted, offer no insight into the thinking of the legislature when it enacted AS 43.20.021 in 1975. See Hillman v. Nationwide Mut. Fire Ins. Co., 758 P.2d 1248, 1252 (Alaska 1988) ("While the legislature is fully empowered to declare present law by legislation, it is not institutionally competent to issue opinions as to what a statute passed by an earlier legislature meant."). See also Wright v. Hept, 505 U.S. 277, 295 n.9 (1992); William N. Eskridge, Jr., The New Textualism, in 2A Norman J. Singer, Sutherland Statutory Construction 568, 576 (5th ed. 1992) (noting the U.S. Supreme Court's "occasional willingness to consider 'subsequent legislative history,'" but also noting that the Court has "often iterated that 'the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one'").

Our holding on the exemption issue makes it unnecessary for us to consider DOR's alternative argument that incorporating section 883 into Alaska law would discriminate against interstate commerce.

inevitably result in understating OBS's Alaska taxable income in a way not intended by the Alaska legislature.

B. Whether DOR Exceeded Its Statutory Authority by Adopting 15 AAC 20.110(d)

DOR next argues that the superior court erred in holding that DOR exceeded its authority by promulgating a regulation limiting the statutory investment tax credit.<sup>14</sup>

The legislature enacted the investment tax credit as part of the ANITA by adopting 26 U.S.C. § 38 by reference. AS 42.20.021(a). Section 38 provided an investment tax credit for taxpayers who invested in tangible personal property used in a trade or business.<sup>15</sup>

The legislature adopted several statutory limitations on the credit. It limited the credit for corporations to eighteen percent of the federal credit which was "attributable to Alaska." AS 43.20.021(d).<sup>16</sup> It also limited the credit to the amount of federal credit on "the first \$20,000,000 of qualified investment

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<sup>14</sup> DOR claims that the regulation's "first use" requirement is not at issue here because OBS was not denied a credit on this basis. It appears, however, that DOR applied this limitation in disallowing the credit for OBS ships that did not visit an Alaska port on their initial voyages.

<sup>15</sup> Because the Tax Reform Act of 1986, P.L. 99-514, generally repealed the credit for property placed in service after December 31, 1985, the credit is not applicable to all tax years that are the subject of this appeal.

<sup>16</sup> AS 43.20.021(d) states, "[w]here a credit allowed under the Internal Revenue Code is also allowed in computing Alaska income tax, it is limited to 18 percent for corporations of the amount of credit determined for federal income tax purposes which is attributable to Alaska."

. . . put into use in the state for each taxable year." AS 43.20.036(b).<sup>17</sup>

DOR promulgated an investment tax credit regulation, 15 AAC 20.110, and in doing so cited as authority AS 43.05.050, AS 43.20.021, and AS 43.20.036. Subsection (d) of that regulation treated transportation equipment "first used" in Alaska as "new property."<sup>18</sup> It also prorated qualified expenditures by comparing the number of days the property was used in Alaska and the number of days it was used elsewhere.

OBS claimed investment tax credits, calculated as eighteen percent of the first \$20 million of qualified investments

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<sup>17</sup> AS 43.20.036(b) states, "[f]or purposes of calculating the income tax payable under this chapter, the taxpayer may apply as a credit against tax liability the investment credit allowed as to federal taxes under 26 U.S.C. 38 (Internal Revenue Code) upon only the first \$20,000,000 of qualified investment . . . put into use in the state for each taxable year."

<sup>18</sup> 15 AAC 20.110(d) states:

For purposes of this section, "placed in service in the state" means that the first use of the qualified investment is in this state. If the property is used elsewhere in the taxable year of acquisition and brought to this state during that same year, that property is considered used property and is subject to the limitations as provided in the Internal Revenue Code. If the property is to be used elsewhere during the taxable year of acquisition and brought to this state in another taxable year, the property does not qualify for the investment credit. Transportation equipment used within and outside of this state whose use commences in this state is considered new property. The qualified expenditure for interstate transportation equipment must be based on a prorated formula of days used in this state compared to days used elsewhere.

put into use for each taxable year, and prorated under 15 AAC 20.110(d) by comparing days of in-state and out-of-state use. The auditor disallowed any credit for vessels that had not visited Alaskan ports on their initial voyages, per 15 AAC 20.110(d). On appeal by OBS, the superior court held that DOR had exceeded its authority by promulgating a regulation containing first use and pro rata apportionment limitations in addition to the limitations imposed by AS 43.20.021(d) and AS 43.20.036(b).

When reviewing the validity of an agency's regulations, we initially determine whether the agency had the authority to adopt such regulations. This determination is a question of law to which we apply our independent judgment. See Warner v. State, Real Estate Comm'n. 819 P.2d 28, 31 (Alaska 1991).

To be within the agency's grant of rulemaking authority, a regulation must be "consistent with and reasonably necessary to carry out the purposes of the statutory provisions conferring rule-making authority on the agency." State, Dep't. of Revenue v. Cosio, 858 P.2d 621, 624 (Alaska 1993) (citations omitted). This test ensures that in promulgating the regulations the agency did not exceed the power delegated to it by the legislature. Id. We next determine "whether the regulation is reasonable and not arbitrary." Id.

"We accord an administrative regulation a presumption of validity; the party challenging the regulation bears the burden of demonstrating its invalidity." Anchorage Sch. Dist. v. Hale, 857 P.2d 1186, 1188 (Alaska 1993) (citations omitted). Further, we

will not "substitute our judgment for that of the agency with respect to the efficacy of a regulation nor review the 'wisdom' of a particular regulation." *Id.* (citation omitted). However, we will apply the substitution of judgment standard of review when reviewing the validity of an administrative regulation because this is a question of statutory interpretation. *Id.* at 188 n.3.

Whether 15 AAC 20.110(d) is valid depends here on whether it is consistent with the tax credit statutes and reasonably necessary for their enforcement. See AS 43.05.080; AS 44.62.030.<sup>19</sup> See also *Spasig*, 858 P.2d at 624.

Citing the plain language of AS 43.20.036(b), its legislative history, and canons of statutory construction, DOR contends that 15 AAC 20.110(d) is consistent and necessary because the regulation simply clarifies when a credit is allowed for transportation property not used exclusively in the state.

OBS argues that 15 AAC 20.110(d) is unnecessary and inconsistent with the statutes providing for the credit. It asserts that the regulation's pro rata apportionment requirement results in a double reduction of the credit, because the statutes already limit the credit to property used in Alaska. Implicit in OBS's argument is the assertion that a taxpayer is entitled to the

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<sup>19</sup> Even though AS 43.05.080 grants DOR authority to adopt regulations, it limits that authority to regulations "necessary for the enforcement of the tax . . . laws administered by it." Likewise, if a department has authority to adopt regulations, a regulation is not valid "unless consistent with the statute and reasonably necessary" to carry out the statutory purposes. AS 44.62.030.

full credit regardless of the amount of time the property is used in Alaska.

a. Legislative history

Before it was amended in 1981, AS 43.20.036(b) provided a credit for any "section 33" property, and did not limit the credit to property put into use in Alaska. The 1981 amendments were introduced in Senate Bill 524, and added the requirement that the equipment or property be put into use "in the state." Senate Bill (S.B.) 524, 12th Leg., 1st Sess. (1981). The House Finance Committee also adopted a letter of intent which stated that "HCSSB 524(Fin) provides an increase in the investment tax credit allowed for in-state investments for corporations doing business in Alaska." 1981 House Journal 2009 (June 8, 1981). Thus, the legislature intended to encourage commercial investments in Alaska in order to benefit Alaska's economy.

b. Statutory construction

The tax credit statutes have two features salient here:<sup>20</sup> Alaska Statute 43.20.021(d), a subsection of the statute that adopted the IRC section 38 investment tax credit by reference, limits the state credit to a percentage of the federal credit "which is attributable to Alaska." Alaska Statute 43.20.036(b) limits the credit to a qualified investment "put into use in the state for each taxable year."

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<sup>20</sup> "Statutory construction begins with an analysis of the language of the statute construed in view of its purpose." Borg-Narver Corp. v. AYCO Corp., 850 F.2d 628, 633 n.12 (Alaska 1993) (citation omitted). "The plainer the language of the statute, the more convincing any contrary evidence must be." Id.

The latter statute can reasonably be read to require that the equipment first be used in Alaska as a qualification for the credit. Both statutes can reasonably be read to require a determination of the extent to which the credit "is attributable to Alaska" or the investment is "put into use" in Alaska. Such a determination necessarily involves distinguishing use in Alaska from use elsewhere. Absent such a determination, a taxpayer would be entitled to a full tax credit in Alaska even though the property received little use in Alaska.

From the legislative history and the statutory language "put into use in the state," it is clear that the legislature intended the credit to apply to property put into use within the state during the taxable year. The amendment was adopted in order to benefit Alaska's economy by encouraging investment in the state. Thus, DOR's interpretation of the language "put into use in the state" as "first use" clarifies an ambiguity left by the statutory language -- the meaning of "put into use in the state" -- in a manner consistent with legislative intent. The "first use" requirement guarantees that the equipment or property is not used up outside the state, and is not brought just momentarily to the state at the end of the taxable year.<sup>21</sup> DOR has interpreted the

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<sup>21</sup> Furthermore, while DOR could have employed a test other than first use to effectuate legislative intent, this court will not "substitute [its] judgment for that of the agency with respect to the efficacy of a regulation nor review the 'wisdom' of a particular regulation." Anchorage Sch. Dist. v. Hale, 857 P.2d 1186, 1188 (Alaska 1993) (citation omitted); see also State, Dep't of Revenue v. Conio, 858 P.2d 621, 624 (Alaska 1993).

first use requirement for transportation equipment to mean an initial voyage in which Alaska was a port of call.

DOR's adoption of the pro rata apportionment formula for transportation equipment and property is also consistent with the statutory purpose. Without such a requirement, owners of interstate transportation equipment could receive a full tax credit from every state in which their property was used in a given year. The limited tax credit based upon days in port also fairly determines the "contribution" the taxpayer is making to Alaska without giving credit for investment outside of the state.

We find that 15 AAC 20.110(d) is consistent with and reasonably necessary to implement the provisions of AS 43.20.021(d) and AS 43.20.036(b).<sup>22</sup> Our conclusion is also consistent with the following canon of construction: Exemptions are narrowly construed against the taxpayer. State Dep't of Revenue v. Alaska Pulp Am., Inc., 674 P.2d 268, 276 (Alaska 1983). In effect, DOR's regulation interpreted the tax credit statutes. DOR did not exceed its

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<sup>22</sup> OBS tersely asserts in a footnote in its brief that the regulation is potentially unconstitutional, on the theory that it burdens interstate transportation property. It also asserts that the statutes should be interpreted to avoid unconstitutionality. Although this cursory treatment does not justify our substantive consideration of the issue, it appears to us that the regulation and the statutory scheme are internally consistent, and would not result in taxation of more than all of a unitary business's income if every taxing jurisdiction adopted identical provisions. See Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159 (1983). In that case, the Court defined "internal consistency," stating, "[t]he first, and again obvious, component of fairness in an apportionment formula is what might be called internal consistency -- that is, the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed." Id. at 169; see also Trinova Corp. v. Michigan Dep't of Treasury, 498 U.S. 358, 380 (1991).

authority in doing so. We conclude that the superior court erred in holding to the contrary.

C. Whether OBS's Apportionable Income Should Include the Income of the Related Investment Companies

The DOR hearing officer concluded that OBS had not proven that investment income (consisting of interest, dividends, and capital gains) earned by corporations within OBS's unitary group was not operational business income. The hearing officer therefore included that income in OBS's apportionable tax base. The superior court reversed, holding that the investment income was not "business income" because it was not used as operating capital in OBS's shipping business and because it was earned through investment activities unrelated to Alaska. DOR argues on appeal that the investment income should be included in OBS's apportionable tax base.<sup>23</sup>

Two tests govern our resolution of this issue: (1) the statutory test set out in the Alaska tax statutes to determine if the investment income was "business" income, and (2) the constitutional test adopted by the United States Supreme Court in Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768, 787-88 (1992), to determine if the income was used for an investment or an operational purpose.<sup>24</sup>

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<sup>23</sup> The only investment income in dispute is that of the investment companies. The taxpayer confirms in its brief that it does not assert on appeal that any part of its own investment income is not apportionable income.

<sup>24</sup> Whether DOR properly characterized particular investment income of OBS's investment companies as "business" or operational (continued...)

OBS states that the only investment income at issue is that of its related investment companies which the auditor included in OBS's unitary group.<sup>25</sup> DOR contends that at the hearing before DOR, OBS argued that none of its investment income was apportionable. Neither the DOR hearing officer nor OBS segregated the investment income of the shipping companies from the investment income of the investment companies within OBS's unitary group.

1. The statutory standard: business vs. nonbusiness income

Taxing a corporation's "entire taxable income . . . derived from sources within the state," see AS 43.20.011(e), in part requires allocation and apportionment of income to in-state and out-of-state sources in accordance with AS 43.19, the Multistate Tax Compact (MTC). See AS 43.20.065 ("A taxpayer who has income from business activity that is taxable both inside and outside the state or income from other sources both inside and outside the state shall allocate and apportion net income as

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<sup>24</sup> (...continued)

income subject to apportionment presents a mixed question of law and fact. The legal question raises issues of constitutional and statutory interpretation which we review with our independent judgment. See Allied-Signal v. Director, Div. of Taxation, 504 U.S. 768 (1992); Earth Resources Co. v. State, Dep't of Revenue, 665 P.2d 960, 965 n.8 (Alaska 1983). We will uphold an agency's findings of fact if they are supported by substantial evidence. Handley v. State, Dep't of Revenue, 838 P.2d 1231, 1233 (Alaska 1992). Substantial evidence is "such relevant evidence as a reasonable mind might accept as adequate to support a conclusion." Id. (citation omitted).

<sup>25</sup> OBS concedes that its shipping companies had certain "short term" investments that produced operating capital and long term investments of non-operating capital. The auditor also included the income from those investments as business income. OBS does not argue in this appeal that it was error to do so.

provided in AS 42.19 (Multistate Tax Compact), or as provided by this chapter." The MTC classifies corporate income from intangible property into two categories, "business income" and "nonbusiness income." AS 43.19.010, art. IV, § 1(a), (c). The MTC states that "business income" includes:

[I]ncome arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

AS 43.19.010, art. IV, § 1(a). A taxpayer's taxable Alaska income is its business income as apportioned according to the three-factor formula apportionment method. AS 43.19.010, art. IV, § 9.<sup>26</sup>

"Nonbusiness income" encompasses "all income other than business income." AS 43.19.010, art. IV, § 1(e). Under the MTC, nonbusiness income from capital gains from the sale of intangible property, interest, and dividends must be allocated to the taxpayer's commercial domicile; thus, if the taxpayer's commercial domicile is outside Alaska, the taxpayer's apportionable Alaska tax base does not include income generated from these sources. AS 43.19.010, art. IV, §§ 4, 6(c), 7. The taxpayer's commercial domicile is "the principal place from which the trade or business of the taxpayer is directed or managed." AS 43.19.010, art. IV, §

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<sup>26</sup> AS 43.19.010, art. IV, § 9 states, "All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three."

1(b). If the income from dividends, interest, or capital gains from intangibles is "business income" as it is defined above, it is properly included in the taxpayer's apportionable tax base. Thus, whether ANITA taxes a corporation's out-of-state income depends in part on whether it is "business income" under the MTC.

We must determine whether the hearing officer correctly applied Alaska's statutory tax standards to OBS's investment income. The Oregon Supreme Court in Sperry & Hutchinson Co. v. Department of Revenue, 527 P.2d 729 (Or. 1974), was the first state supreme court to determine whether a corporation's interest income from investments constituted business income under UDITPA. See 1 Jerome R. Hellerstein & Walter Hellerstein, State Taxation § 9.10(1)[a], at 9-48 (2d ed. 1993). The court there concluded that earnings from short-term securities held to satisfy the corporation's needs for liquid capital in its Oregon operations constituted business income, but that earnings from short-term securities held pending acquisition of other companies or favorable developments in the long-term money market, and long-term securities held for investment purposes, were non-business income. Id. at 730-31. See also Lone Star Steel Co. v. Dolan, 668 P.2d 916 (Colo. 1983) (following Sperry & Hutchinson and holding that under UDITPA, interest income on short-term loans made by Lone Star to its parent company from surplus funds not immediately needed for Lone Star's operations was business income); Cincinnati New Orleans and Tex. Pac. Ry. v. Kentucky Dep't of Revenue, 684 S.W.2d 303 (Ky. App. 1984) (holding interest income earned by railroad company from

short-term securities purchased with surplus cash from its railroad operations was business income).

In the instant case, although the disputed income was generated from investments and New York is the domicile of OBS and the related investment corporations, the hearing officer found the disputed income was business income on the theory that the acquisition, management, and disposition of this intangible property (dividends, interest, and capital gains) constituted integral parts of the taxpayer's regular trade or business operations. The payors of this income were not members of OBS's unitary group, but were generally major, publicly-owned business entities, including AT&T, BankAmerica Corporation, Northwest Bancorp, Sears, Roebuck & Co., and Citicorp. The hearing officer reached her conclusion by examining OSG's annual reports to its stockholders; the affidavits of Alan Carus,<sup>27</sup> OSG's controller; and the minutes from OSG's board meetings.

According to Carus, earnings totaling over \$200 million were the primary source of investment funds OSG accumulated before it commenced its Alaska shipping activities. Proceeds, totaling about \$17 million, from public stock offerings in 1970 and 1972

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<sup>27</sup> DOR asserts that Alan Carus's supplemental affidavit submitted to the DOR hearing officer was untimely and was filed "over the objection of the division." However, as OBS correctly notes, OBS requested permission to supplement the record and to file a post-hearing brief after the Supreme Court decided *Allied-Signal*, 504 U.S. 760, and the hearing officer granted that request. DOR initially objected to this request, but later retracted its objection and chose not to file a responsive brief. Thus, DOR did not preserve its contention that Carus's supplemental affidavit was untimely.

were another source. Carus also affied that the investments are not operationally related to OBS's Alaska shipping business, and that "shipping income of the shipping subsidiaries, rather than investment income, was generally used to cover the costs of operation of the shipping operations." Carus stated that OBS intended to make these investments for investment purposes only, and that the income generated did not serve an operational function. Carus conceded that because "dollars are fungible," it was impossible to say that no investment income strayed into use for OBS's operating costs; however, he also stated that it was highly unlikely that any significant amount of the investment income was invested in the companies' vessels that called in Alaska. He also affied that the "overwhelming majority" of the investment income was reinvested, and that the cost basis of the investment assets grew from \$97 million at the beginning of the audit periods to \$261 million at the end of the audit periods. "The shipping subsidiaries that called in Alaska were self-sufficient, i.e., they generated sufficient revenues from their own operations to cover their expenses." He also affied that "[n]one of the stocks, bonds, or other investment assets was used as collateral for any debt of the shipping subsidiaries."

In determining that OBS's investment income was "business income" under AS 43.19.010, art. IV, § 1(a), the hearing officer found that "concrete evidence" did not support Carus's statements that the investments were made for an investment function and that the shipping companies covered their operating costs with operating

revenue (rather than investment income).<sup>28</sup> The hearing officer focused upon Carus's fungibility admission. Based in part upon that admission, the hearing officer concluded that OBS had not carried its burden of showing that its investment income constituted nonbusiness income.

The Audit Division also relied on OSG's 1996 annual shareholders report. That report stated that OSG's "strong and highly liquid financial condition provides a sound foundation for future progress . . . . [OSG's] significant cash flow has enabled [it] to reduce its long term debt to equity ratio to its lowest level . . . and to continue to upgrade its fleet and to pursue opportunities as they arise." From this, the hearing officer concluded that "[i]t is clear that building its financial strength was a key component of [OBS's] overall strategy to be in a position to pursue opportunities for expansion when they arose." The hearing officer therefore concluded that the "acquisition, management and disposition of [OBS's] investments was an integral part of [OBS's] business" since the investment decisions were "obviously aimed at building its financial strength overall."

In our view it is unwise to construe the two MTC categories, "business income" and "nonbusiness income," without reference to the constitutional standard which has been established by decisions of the United States Supreme Court. The compatibility of these standards has been suggested by the Court in Allied-

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<sup>28</sup> The weight given to statements made in an affidavit is determined by the trier of fact. See Gregor v. City of Fairbanks, 599 P.2d 743, 746 n.10 (Alaska 1979).

Signal. To avoid confusion and needless separate discussion of the MTC and constitutional standards, we will consider that one requirement for finding that income is "business income" under the MTC is that it is income which is taxable under the constitutional standard. We now discuss that standard.

2. The constitutional standard: investment income versus operational income

"The principle that a State may not tax value earned outside its borders rests on the fundamental requirement of both the Due Process and Commerce Clauses" of the U.S. Constitution that "some definite link, some minimum connection" must exist "between a state and the person, property or transaction it seeks to tax." Allied-Signal, 504 U.S. at 777 (quoting Miller Bros. Co. v. Maryland, 347 U.S. 340, 344-45 (1954)). The Commerce Clause imposes this limitation because corporations would be subjected to severe multiple taxation which would negatively affect the national economy if each state were permitted to tax values earned outside its borders. Allied-Signal, 504 U.S. at 777-78.

The "minimum connection" requirement of the Due Process Clause requires that when a state seeks to tax income earned by a multistate or multinational corporation from a particular activity, there must be a connection between the state and the activity, rather than a connection only to the actor whom the state seeks to tax. Id. at 778. The Supreme Court has held that when a nondomiciliary corporation doing some business within the state receives dividends from a subsidiary having no other connection with the state, the state may not constitutionally tax the dividend

income unless the recipient taxpayer corporation and its underlying subsidiary payor were engaged in a unitary business. ASARCO Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 (1982).

In Allied-Signal the Supreme Court reaffirmed the unitary business principle as the linchpin for determining whether a state may constitutionally tax the dividend income of a nondomiciliary corporation.<sup>29</sup> The Court went on to hold, however, that a unitary relationship between the payor of the intangible income (there, a corporate dividend) and the payee is not invariably a necessary prerequisite for apportionment of income to a nondomiciliary state. 504 U.S. at 787. The test is whether the "capital transaction serve[s] an operational rather than an investment function." Id. As an example of an "operational" function, the Supreme Court cited short-term investments that provide working capital for a corporation, such as "the interest earned on short-term deposits in a bank located in another state if that income forms part of the working capital of the corporation's unitary business." Id. at 787.

The hallmarks of an acquisition that is part of the taxpayer's unitary business continue to be functional integration, centralization of management, and economies of scale. Container Corp. clarified that these essentials could respectively be shown by: transactions not

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<sup>29</sup> The U.S. Supreme Court in Allied-Signal rejected New Jersey's request to adopt the UDITPA definition of business income as the constitutional test. 504 U.S. at 786-87. The Court also made it clear that if stock on whose sale a taxpayer realizes a capital gain served only an "investment" function and not an "operational" function, the gain is not subject to apportionment for purposes of that state's corporate tax, even though it may constitute "business income" under the UDITPA. Id. at 787-88.

undertaken at arm's length; a management role by the parent that is grounded in its own operational expertise and operational strategy; and the fact that the corporations are engaged in the same line of business.

Allied-Signal, 504 U.S. at 789 (citing Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 178, 180 (1983)) (citations omitted).

The taxpayer must prove by "clear and cogent evidence" that the state is seeking to tax extraterritorial values. See Container Corp. of Am., 463 U.S. at 175. In Container Corp. the Supreme Court noted that "[t]his burden is never met merely by showing a fair difference of opinion which as an original matter might be decided differently. . . . [W]e will [not] re-examine, as a court of first instance, findings of fact supported by substantial evidence." Id. at 176 (quoting Norton Co. v. Department of Revenue, 340 U.S. 534, 537-38 (1951)). See also Allied-Signal, 504 U.S. at 794 (O'Connor, J., dissenting) (citing Container Corp. and asserting that the taxpayer had not met its "heavy burden" of proving by clear and cogent evidence that its capital gains were not operationally related to its in-state business).

The Court held in Allied-Signal that the "mere fact that an intangible asset was acquired pursuant to a long-term corporate strategy of acquisitions and dispositions does not convert an otherwise passive investment into an integral operational one." Id. at 788.

Applying Allied-Signal to the OBS evidence in context of the statutory business/nonbusiness income distinction, the hearing officer concluded that the income generated by OBS's related investment companies was operational and properly includable in OBS's apportionable tax base.<sup>30</sup>

The DOR hearing officer also rejected assertions found in the supplemental Carus affidavit that the purpose of making the investments was for an investment function and not an operational function. The hearing officer stated that OBS's claims were not "supported by any concrete evidence." The hearing officer found that given the fungibility of dollars, "investment" monies may have been used to fund the shipping companies within the unitary group, and that OBS had failed to meet its burden of showing that its income from investments clearly constitutes investment income.

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<sup>30</sup> The hearing officer stated:

[OBS's] annual reports are replete with exaltations regarding its strong and highly liquid financial condition. It is clear that building its financial strength was a key component of its overall strategy to be in a position to pursue opportunities for expansion when they arose. Its substantial financial resources, including its investment income, allowed it to secure long-term borrowing and to incur capital lease obligations to finance vessel additions, thereby strengthening its competitive position in both domestic and worldwide bulk shipping markets.

Under these circumstances, it would be difficult to conclude that the investment transactions at issue did not serve an operational function, as required under Allied-Signal.

(Citation omitted.)

OBS contends that the facts relied upon by the hearing officer do not satisfy Allied-Signal's "operational" income test. It argues that evidence of commingling some investment income with income used for shipping operations is insufficient to show that the investment income is "operational."

Although Allied-Signal provides examples of the types of income that can properly be characterized as "operational income," the Court there noted that determining whether income serves an operational or investment function is fact intensive. Id. at 785. In the case at bar, any commingling by OBS of investment income of its nondomiciliary investment companies with income used for the operational expenses of the shipping companies with vessels that called in Alaska appears to have been de minimis. See generally F.W. Woolworth Co. v. Taxation and Revenue Dep't, 458 U.S. 354, 363-64 & n.11 (1982) ("All dividend income -- irrespective of whether it is generated by a 'discrete business enterprise' -- would become part of a unitary business if the test were whether the corporation commingled dividends from other corporations . . . ." (citation omitted) (emphasis omitted)).

The Court held in Allied-Signal that out-of-state investment income may be taxed only when the investment amounts to the acquisition of capital for the corporation's unitary business, or when the investment is so short-term that it amounts to a bank account for the unitary business. 504 U.S. at 789-90. The hallmarks of an investment that becomes part of the unitary business are "functional integration, centralization of management,

and economies of scale." Id. at 789. The Court there concluded that the petitioner corporation's investment in the stock of a second corporation did not qualify as operational because the two corporations' activities were unrelated, and the first corporation did not even acquire a controlling stake in the second corporation. Id. at 788. The Court was careful to reiterate that how the investment income is used is irrelevant; it noted that even if those proceeds are used to acquire capital that becomes part of the unitary business, out-of-state investment income cannot be taxed unless the investment itself "was run as part of [the] unitary business." Id. at 789.

Income from investments that are not part of the unitary business may still be taxed if the income accrues from "short term deposits in a bank" and "that income forms part of the working capital of the corporation's unitary business." Id. at 787. The Court found in Allied-Signal that stock held "for over two years" could not amount to "a short term investment of working capital analogous to a bank account." Id. at 790.

The hearing officer concluded that OBS's "investment decisions were obviously aimed at building its financial strength overall." In our view, the hearing officer's definition of "operational income" would swallow the distinction between operational and investment income. See Allied-Signal, 504 U.S. at 784-85 (rejecting New Jersey's argument that since "multistate corporations . . . regard all of their holdings as pools of assets, used for maximum long-term profitability, . . . any distinction

between operational and investment assets is artificial"). Further, Carus explicitly affixed that none of the investment assets was used as collateral for any debt of the shipping subsidiaries. Because the hearing officer applied a standard that the Supreme court rejected in Allied-Signal, and because we cannot say as a matter of law that OBS met its burden of proving that the investment income was not operational, we reverse the determination made by the DOR hearing officer. We remand so that OBS's investment income may be segregated as between investment or operational functions. On remand, the corporation's out-of-state investment income may be apportioned for state taxation only if either (1) the investment itself constitutes part of the corporation's unitary business (where unitariness is indicated by functional integration, centralization of management, and economies of scale), or (2) the investment is short term and the income is used to fund the unitary business, such that the investment is analogous to a bank account for the unitary business.

#### IV. CONCLUSION

For these reasons, we REVERSE the superior court judgment to the extent it is based on that court's holdings that the section 883 exemption applies to OBS here and that DOR exceeded its statutory authority when it promulgated 15 AAC 20.110(d). We REVERSE the superior court's holding that OBS's investment income was nonbusiness income, and we REVERSE and REMAND for a redetermination by the DOR hearing officer whether OBS's income is

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operational or investment income pursuant to the constitutional  
test announced in Allied-Signal.

## Order Regarding Fees and Costs

State of Alaska, Dep't of Revenue v. OSG Bulk Ships, Inc., et al.

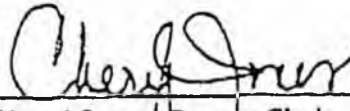
Supreme Court No. S-07498

Date of Order: 2/20/98

Under Appellate Rules 508(e) and (f)(1), attorney's fees of \$ 1,000.00 are awarded to the Appellant. On or before March 2, 1998, the Appellant shall serve and file with this court an itemized and verified bill of costs.

Entered at the direction of Justice Eastaugh on February 20, 1998.

Clerk of the Supreme Court

  
Cheryl Jones, Deputy Clerk

cc: Authoring Justice Eastaugh  
Trial Court Appeals Clerk

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DEPARTMENT OF THE TREASURY  
WASHINGTON

March 14, 1957

James Metzler, Commissioner  
State of New York  
Department of Taxation and Finance  
W. A. Harriman Campus  
Albany, NY 12227

Dear Jim:

Thank you for your letter concerning the New York State corporate franchise tax as it applies to airline corporations. I apologize for the lengthy delay in answering.

As you point out there is a question as to whether such a tax conflicts with the ability of the United States to speak with one voice, as described in the JAPAN LINES CASE. I do not wish to express a view on the constitutional issue at this time. It is clear, however, that New York's practice may frustrate Federal policy in this situation. As a technical matter, the provisions of U.S. income tax treaties and the Internal Revenue Code which exempt foreign airlines from U.S. taxation on the basis of reciprocity apply only to Federal taxes. Nevertheless, their effectiveness depends to a large extent on a parallel exemption from subnational income taxes. If that does not exist on the part of both countries, the objective of the Federal provisions, and the reciprocity they obtain for U.S. companies operating abroad, is not fully achieved.

The objective of the reciprocal exemptions is to reserve the taxation of income from international (shipping and) airline transportation to the country of residence of the operator. That country can aggregate the global income and expenses and best determine the net income to be taxed. If each country visited imposes a tax, over-taxation of the net income is almost inevitable, given the difficulty of determining the income and expense attributable to each portion of the voyage, it is a common practice to impose tax on gross receipts or, like New York State, to use a formula to assign the net base. In addition, the imposition of multiple levels of taxation involves a substantial compliance burden for the affected companies.

The exemption of U.S. airlines from foreign taxation is conditioned on reciprocity. Other countries frequently object to our not providing an exemption from state and local, as well as Federal, tax in our tax treaties or in exchanges of notes under the Code. To date, we have been able to persuade them to provide exemption based on current practice, i.e., the absence of state taxes in such cases. California, by statute, follows Federal practice in this case, and I believe that Hawaii does also. To

My knowledge, no state (with the important exception of New York) imposes tax on a foreign affiliate which is exempt from Federal income tax.

Some foreign countries that agree to exempt U.S. affiliates from their subnational taxes (as well as their national taxes) by treaty have included an explicit statement in the treaty that conditions their exemption from subnational taxes on continued exemption by the states of the United States. This was an important issue in our income tax treaties with France and Japan, for example. I am enclosing copies of the notes attached to those treaties on this issue. Even where our treaty partners have not insisted on an explicit statement, the issue of subnational taxes is a common concern. The imposition of tax by even one state is likely to make it more difficult for us to obtain an exemption in New or revised agreements because of the absence of full reciprocity.

I recognize that New York may have different interests. I am troubled, however, that a measure which is of limited revenue significance in terms of over-all state finances may have a disproportionate effect on the ability of the Federal government to implement a policy which is approved by Congress, accepted by our 40 treaty partners, and consistent with sound tax policy.

Moreover, to the extent that the long-standing and widespread policy of reciprocal exemptions breaks down, there could be a revenue cost to the U.S. Government, as we give a credit for a foreign income tax, including subnational income taxes, against the U.S. tax on foreign income.

I hope, in light of these concerns, that it will be possible for New York State to follow the Federal policy in this area and impose tax only on foreign affiliates of countries which do not provide a reciprocal exemption to U.S. affiliates, whether by treaty or domestic law. Please let me know your reaction.

Sincerely,



Philip D. Morrison,  
International Tax Counsel

Enclosures

AN ALASKA TAX ON FOREIGN FLAGGED  
SHIPS AND AIRCRAFT:  
A CRITICAL ANALYSIS

prepared by

David M. Reaume  
March 7, 1997

under contract to the North West Cruiseship Association.

**Alaska Economics, Inc.**

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**AN ALASKA TAX ON FOREIGN FLAGGED SHIPS AND AIRCRAFT:  
A CRITICAL ANALYSIS  
David M. Reaume**

A few years ago the Alaska Department of Revenue surprised the owners of foreign flagged ships and aircraft operating in Alaska by telling them that the Alaska Corporation Net Income tax applied to their past, present and future net operating income. In a stroke, Alaska became the only state in the union levying such a tax. Indeed, not even the federal government does so, and for good reason. One such owner (OSG Bulk Ships Inc.) challenged the Department of Revenue in court and won, but the decision is still in doubt because the State of Alaska has appealed the lower court's ruling to the Alaska Supreme Court.

Taxing foreign flagged ships and aircraft will soon become a hot topic because the Alaska Legislature will soon be petitioned by one side or the other for a revision to the tax statutes. However the Supreme Court rules, the losing side can be expected to take its case to the capital where the economic pros and cons will be weighed and not just the legalities. Placed on that set of balances the decision should be no contest because this is a very bad tax for Alaska.

Three reasons why it is a bad tax are: (1) it will deter future private sector investment far more than the dollars involved might suggest, (2) it will be paid largely by Alaskans, not by foreign corporations and (3) it can fairly be described as "arbitrary and capricious" because any revenue which is raised is unlikely to be related to the true net operating income of the corporation which is taxed. (Which, of course, it should be if DOR's purpose is to tax net operating income!)

**WILL DETER INVESTMENT** An aggressive move to tax business income not only impacts the industries which are directly subject to the tax but also sends a message to prospective investors in other industries. The message is that Alaska will seek to close its "fiscal gap" by raising taxes on businesses before it considers other options which are at the disposal of policy makers. For that reason a tax on foreign flagged ships and aircraft may have much farther reaching effects on new business formation than seem likely at first glance. Indeed, one of DOR's own consultants (Pedro Van Meurs) has made this very point with regard to the Alaska natural gas pipeline project. He talked about the need for a "coherent long range fiscal plan," but his meaning and mine are much the same.

**WILL BE PAID BY ALASKANS** Because most Alaska residents and businesses lack market power relative to most foreign corporations, much of the burden of paying the tax will fall on Alaskans. In effect many of the foreign corporations upon whom the tax is initially levied will act as tax collectors for the Alaska Department of Revenue, simply passing the tax onto Alaskans via higher transport fees (e.g. LNG, minerals) or lower purchase prices (e.g. seafood, timber products). For example, a tax on the ships which transport red salmon to Japan will almost certainly be paid by the harvesters in the form of a lower dockside price for their catch.

**ARBITRARY AND CAPRICIOUS** For at least twenty years the federal government has made it clear that it does not wish to see Alaska or any other state levy such a tax. There is some question as to how much cooperation could be expected from the federal government if the State of Alaska intrudes into an area that is not taxed under the U.S. Internal Revenue Service code. If DOR were unable to gain access to all relevant corporate accounting records, (a not so improbable happening) the amount finally levied on each foreign corporation would not necessarily be determined by applying statutory rates to the true Alaska net operating income of the corporation but would instead be determined by either (a) what the corporation deigns to pay or (b) what is determined via negotiation and litigation. This is the very definition of "arbitrary and capricious."

The following analysis of the effects of taxing foreign flagged ships and aircraft under the Alaska Corporation Net Income Tax proceeds in a question and answer format and is supplemented by five technical appendices. This format was chosen because complex topics are better understood if they are broken down into smaller, self contained topics.

[1] What is Section 883 Income ?

The business income which a foreign corporation derives from the international operations of its ships or aircraft. (See section 883 of the U.S. Internal Revenue Service code) A foreign corporation is one which is domiciled in a country other than the United States.

Section 883 of the Internal Revenue Service code exempts such income from the U.S. Corporation Income Tax provided the country in which the corporation is domiciled "grants an equivalent exemption to corporations organized in the United States," and also provided certain conditions of ownership are fulfilled.

In particular, section 883 applies only if the stock of the corporation in question is publicly traded on an established securities market in either the United States or its country of domicile or, in the case of corporations whose stock is not publicly traded, if 50 percent or more of its shares are owned by a resident of the United States or the country of domicile.

[2] Why is it that a provision of federal tax law also applies to the Alaska Corporation Net Income Tax ?

Sections of the I.R.S. code have been adopted by Alaska statute into Alaska tax law (Alaska Statutes, Chapter 43.) The issue of the applicability of section 883 is the principal point of contention in OSG Bulk Ships Inc. vs State of Alaska, Department of Revenue (3An-93-7851 civ.) This case is awaiting a decision from the Alaska Supreme Court.

Corporations which do business in Alaska and which benefit from section 883 in determining their federal income taxes may face higher Alaska taxes if that section is ultimately deemed not to apply to the Alaska tax. Moreover, they may face these higher taxes for past tax years as well as current and future tax years.

[3] Suppose that the section 883 exemption is deemed not to apply for purposes of determining a foreign corporation's Alaska taxable income. Must the ships or aircraft in question do business in Alaska in order for the income derived from their operations to be included in Alaska taxable income?

This is an issue in the OSG case cited earlier with respect to tax years prior to 1992. In order to be covered under section 883, a foreign corporation must do business in the United States. However, nothing in section 883 requires that the ships or aircraft themselves service the United States.

If the section 883 exemption is deemed not to apply to the Alaska Corporation Net Income Tax, a foreign corporation which did business in Alaska prior to 1992 (when Alaska adopted a "water's edge" edge method of determining Alaska taxable income for most corporations) and which operated ships or aircraft in other parts of the world might belatedly find that the income derived from those ships and aircraft should have been included in their worldwide income for purposes of determining their pre-1992 Alaska tax. If so, they may be required to file an initial Alaska tax return or an amended return for those years (as was OSG Bulk Ships, Inc.). For tax years 1992 and after this particular issue does not arise except in the case of oil and gas producers or pipeline operators. However, there still remains the issue of taxing the income derived from foreign flagged ships and aircraft which do operate in Alaska.

[4] Which corporations doing business in Alaska have income which is exempt from the U.S. Corporation Income Tax under section 883 of the I.R.S. code?

This information is not publicly available. However we do know that most cruise ships are foreign flagged as are virtually all of the cargo ships which carry minerals, seafood and timber products from Alaska to foreign countries. In addition, foreign flagged air carriers operating out of or stopping over in Alaska airports may come under the provisions of section 883 and may, therefore, pay additional Alaska taxes if the section 883 exemption is deemed not to apply to the Alaska Corporation Net Income Tax. In general, any item which is transported by air or sea in either direction between Alaska and a foreign country is likely to be carried in a ship or aircraft which is owned by a foreign corporation. All of these corporations are what might be called "section 883 vulnerable," in that they may be faced with higher Alaska tax bills should section 883 be deemed not to apply to the Alaska Corporation Net Income Tax.

Finally, certain corporations which transport oil and gas between ports entirely outside Alaska and which also do business in Alaska report income on a worldwide basis rather than on a water's edge basis. These corporations may also be subject to higher Alaska taxes for both current and past tax years should section 883 be deemed not to apply.

[5] Please name some names.

We cannot be sure without going beyond information which is publicly available. However, the following partial list of companies may suggest the potential scope of the tax. These are some of the companies doing business in Alaska which may either be subject to the tax or which may have the tax shifted onto them by others who are subject to the tax.

CRUISESHIP LINES: Holland America Line Westours, Princess Cruises, Cunard Steamship Lines, Norwegian Cruise Lines,

Celebrity Cruise Lines, Carnival Cruise Lines, Royal Caribbean Cruise Lines

INTERNATIONAL AIR COURIERS: Airborne Express, United Parcel Service, Federal Express, DHL Airways

INTERNATIONAL AIRLINES: Korean Air, Japan Air, China Airlines, Aeroflot

SEAFOOD PROCESSORS: Trident Seafoods, Unisea, Peter Pan Seafoods, Oceantrawl, Ocean Beauty Seafoods

MINING COMPANIES: Cominco Alaska, Usibelli Coal Mine, Greens Creek Mining, Placer Dome, Fairbanks Gold, Coeur-Alaska

OILFIELD SERVICE COMPANIES: Nabors Drilling, Parker Drilling, Rowan Drilling

TIMBER COMPANIES: Kake Tribal Corp., Sealaska Timber Corp., Klukwan Forest Products

OTHERS: Yukon Pacific Corp (natural gas pipeline), Ketchikan Pulp (sawmills division)

[6] How would Alaska businesses and individuals be affected if section 883 income were subject to the Alaska Corporation Net Income Tax?

Any additional taxes which are levied for tax years prior to 1992, would fall as a lump sum burden on the foreign corporation and for that reason are unlikely to have much of an effect on the current and future price/wage decisions of corporations which are already doing business in Alaska. It would be as if the corporation suddenly incurred an additional one time fixed cost of doing business.

This is not to say, however, that raising taxes retroactively would have no impact on Alaska. Almost certainly, a relatively aggressive move such as this would send a message, so to speak, and would thereby influence future investment by causing investors to increase the amount of tax they expect to pay on future ventures in Alaska. In other words, investor expectations of future profitability would be lowered. For this reason, new business formation could be reduced even in industries which are not directly affected by section 883. This point is discussed in some detail in Appendix A, below.

An increase in present and future Alaska corporation income taxes will not only alter investor expectations of future profitability, but will also have an impact on present and future prices and wages. When a firm finds that its present and future income tax has been increased it has two options. It can simply pay the higher tax and realize lower profits or it can attempt to shift the tax onto another player (i.e. another

individual or firm). In general, the ability of a firm to shift a tax onto other players differs on a case by case basis depending upon a number of factors. However, because Alaska players are usually not in a strong market position relative to the foreign corporations upon whom the higher tax would initially be levied, it seems likely that most of the additional revenue which is raised would ultimately be paid by Alaskans and not by the foreign corporations from whom it is collected. Appendices B, C, and D examine four cases in point. The common ingredient in all of the cases which are discussed is a marked difference in market power between the foreign corporation which initially pays the tax and the Alaska firms and individuals who ultimately pay it.

In summary, even if the higher taxes are ultimately borne by the foreign corporations upon whom they are levied they will reduce investor expectations of future profitability and may thereby significantly reduce new business formation in Alaska from what it would otherwise be. To the extent the foreign corporation is able to shift the higher tax onto other Alaska players, the tax becomes a "hidden" tax on Alaska residents with immediate impacts on Alaska employment and income.

[7] Is the tax likely to be shifted onto Alaska players?

Yes, at least in part, possibly in large part. The second of three principal conclusions we have reached is that in the cases identified in appendices B, C, and D, the bulk of the tax is very likely to be paid by Alaska individuals and resident businesses. There are two reasons for this. First, as emphasized in Appendix B the tax may be better viewed as a value added tax than as a tax on corporate profits. Value added taxes are more readily shifted than are corporation profit taxes. Second, in general, Alaska players lack market power relative to the foreign corporations which own the vessels whose income is to be taxed. The degree to which a tax on one side of a market can be shifted onto the other side of the market is determined largely by differential market power. (In textbooks of the 1950's and 1960's the same point was couched in terms of relative price elasticities of supply and demand.)

[8] What are the dollar amounts involved?

An overall total is not at hand because the required information is simply not publicly available. Case by case estimates in all or even a majority of cases could not be made in the available time. The difficulty involved in preparing such estimates is illustrated in appendices B and C. The Alaska Department of Revenue would experience similar difficulties in responding to a fiscal note from the Alaska Legislature on this matter. This means that the requisite information on tax impacts could not be available to decision makers without a considerable expenditure of time and effort. Some preliminary conclusions we have reached (appendices B and C) are as follows.

-- Bristol Bay limited entry permit holders can expect to experience lower ex-vessel prices for sockeye salmon which may cost them up to \$ 1,000 per permit holder. (taxation of foreign flagged vessels carrying salmon to Japan)

-- The proposed Alaska natural gas pipeline can expect to pay approximately \$ 22 million to \$ 28 million annually in higher LNG tanker costs. (taxation of foreign flagged LNG tankers)

One major problem involved in estimating the dollar yield of the tax is its potentially arbitrary and capricious nature. In order to accurately determine a foreign corporation's Alaska net operating income, the State of Alaska would need to audit not only the books of the corporation upon whom the tax is levied but also its parents and its affiliates. At the present time the Alaska Department of Revenue relies on the voluntary cooperation of the foreign corporations which it audits. In virtually all of these cases, the information given to the State of Alaska is the same as that given to the U.S. Internal Revenue Service.

In contrast, there is some question as to how much cooperation could be expected if the State of Alaska intrudes into an area that is not taxed under the U.S. Internal Revenue Service code. (The federal government does not wish to see the states extend their reach in this manner and is unlikely to pressure foreign governments to comply with State of Alaska information requests. See [10] below.) If DOR were unable to gain access to all relevant accounting records, foreign corporations could easily reduce their net operating income to zero through judiciously determined inter-group transfer prices. Under such circumstances, the amount finally levied on each foreign corporation would not necessarily be determined by applying statutory rates to the true Alaska net operating income of the corporation but would instead be determined by either (a) what the corporation deigns to pay or (b) what is determined via negotiation and litigation. This is the very definition of "arbitrary and capricious."

[9] How many jobs are at stake?

Time constraints precluded making a detailed estimate. When and if such an estimate is made the answer will turn rather heavily on the number of jobs which are never created and the number of investments which are delayed. Such an aggressive move to raise taxes on business can be expected to send a clear message to prospective investors that they may be next in line for higher taxation. Under these circumstances these investors can be expected to revise downward their estimated returns. (That the move to tax foreign flagged ships and aircraft is aggressive cannot be denied because it will have been made despite opposition from industry, the federal government and foreign

governments and also because Alaska will be the only state in the union which levies such a tax.)

More to the point, not all impacts are well measured solely in terms of lost jobs. As shown in Appendix B, the main impact resulting from levying higher taxes on Japanese shippers of seafood products is almost certain to come in the form of lower prices paid to fishers at dockside and a resultant drop in their harvest incomes. Because many of these fishers can compensate (at least in part) by increasing their subsistence harvesting efforts, the impact on published employment figures may be less than it would otherwise be. Even so, the total impact may still be severe.

[10] Are there any intergovernmental repercussions to be expected?

Repercussions may be subtle and indirect. It is well known that foreign governments and the U.S. federal government strongly disapprove of state taxation of foreign corporations in this way. (Recall the major opposition put forward by the federal government in the 1970's and 1980's when the State of California attempted to levy taxes on a worldwide unitary basis. Many of the issues are the same.)

Attached as Appendix E is a copy of a letter sent on March 19, 1980 to the U.S. Department of State by the Italian ambassador to the United States. In it the ambassador expresses the Italiangovernment's deep concern:

"about the application to US subsidiaries of foreign companies of the unitary basis of taxation as applied in California and in varying degrees by certain other states."

Although the unitary method of taxation is not an issue for tax years 1992 to date, it is an issue for prior tax years. (The Alaska Department of Revenue levied pre-1992 taxes on OSG Bulk Ships Inc.) Furthermore, at least two of the reasons for the Italian government's concern are an issue for tax years both before and after 1992. These reasons are: (a) the potential intrusion by non-Italian governments into the affairs of Italian companies, and (b) the potential for double taxation of company earnings. Both of these problems could arise if the State of Alaska is allowed to tax the operating income of foreign flagged ships and aircraft.

One foreign government that may show particular concern is Canada. Mines in Yukon and Northern British Columbia have used the port of Skagway and have considered the use of other Southeast Alaska ports. Any concentrate shipped out of these ports is virtually certain to be transported in foreign flagged vessels which would be subject to a tax on section 883 income.

Should it happen that Alaska levies such a tax, the Alaska Department of Revenue could be faced with a serious information gap. In particular, in order to determine if a foreign corporation accurately reports its section 883 income the state would need to be in a position to audit the books of not only the corporation immediately involved, but also any parents or affiliates. Although DOR receives such cooperation now, there is a real question as to whether or not it could expect similar cooperation from the owners of foreign flagged ships and aircraft if the federal government did nothing to help and if the ship owner's country of domicile did nothing to help.

## APPENDIX A

### The Effect of Higher Taxes On Investor Expectations

*SUMMARY: In an uncertain world any government action which raises the threat of higher future taxes may reduce investment more than what might seem likely given the size and scope of the threatened tax increase. The reasons for this are (1) that governments capture a portion of the gains from a successful investment but do not always share in the losses and (2) that the government action may not only cause an upward revision in the subjective probability which investors assign to higher future taxes but may also cause investors to increase the effective risk premium which they demand from the project.*

Investment decisions are made in light of a forecast of risk-adjusted after tax income over the life of the investment. A sophisticated investor assigns a probability to the different levels of tax which might be paid in the future. If the investor is risk averse, a risk premium is demanded from the project.

An income tax not only lowers a project's expected return but also raises the risk premium demanded from the project. In part this happens because an income tax allows government to share in the profit from a successful investment, but not always in the losses should the investment fail. In particular, business losses can only be offset against other business income. Many prospective Alaska investors have no prior Alaska income and many would have no future Alaska income should the investment fail.

Although the forecasts made by some investors are crude and may even fail to take proper account of an uncertain future, more often we find that at least some attempt is made to account for a range of outcomes. If enough is at stake, informed professional investors construct formal probabilistic models which deal explicitly with the uncertainty which attends proposed investments. The best known and most widely used of these models is the Bayesian Expected Utility Decision Model which was developed by Howard Raiffa and Robert Schlaifer at the Harvard Business School (references upon request). A simplified version of that model is used here to show how the threat of higher future taxes impacts investment decisions both by raising the probability assigned to a higher tax rate and by leading investors to demand a greater risk premium from the project.

#### Risk Premium

Suppose you are faced with an equal chance, a coin toss, of either winning \$ 15,000 or losing \$ 10,000. You own the rights to this lottery and can either sell these rights to another player or toss the coin and accept the outcome. If you toss the coin you and the bank must settle accounts on the spot. You do a little calculation and find out that the expected value of this

lottery is \$ 2,500. You know that this means that if the lottery were to be played a large number of times your expected winnings would equal \$ 2,500 multiplied by the number of times you played the lottery. However, you also know that the lottery will only be played one time. What do you do?

The answer will differ among persons. A person who is risk averse would be willing to sell the rights to someone else for a price less than the \$ 2,500 expected value. (For example, if you would gladly give these rights away you are demonstrating risk averse behavior. Considering that you face a .50 probability of having to write a \$ 10,000 check, this could hardly be viewed as irrational behavior!) A person who is a risk lover would demand more than \$ 2,500 for these rights. Finally, someone who is just indifferent between tossing the coin and selling the rights for exactly \$ 2,500 is said to be risk neutral.

If a person is risk averse we define that person's risk premium for this lottery to be the difference between the \$ 2,500 expected value and the smallest dollar amount this person would take for the rights to the lottery. If for example, you would be willing to sell the rights for \$ 1,000 but would not accept a penny less, then your risk premium for this lottery is \$ 1,500. The \$ 1,000 you would accept for the rights is called your "certainty equivalent" value of the lottery. In other words,

$$\text{RISK PREMIUM} = \text{EXPECTED VALUE} - \text{CERTAINTY EQUIVALENT}$$

Risk averse investors make decisions on the basis of a project's certainty equivalent returns, given the project's expected returns and the risk premium which they demand. For this reason the previous equation is often expressed as:

$$\text{CERTAINTY EQUIVALENT} = \text{EXPECTED VALUE} - \text{RISK PREMIUM}$$

#### An Example: Simple, Informative and Contrived

A particular investment opportunity requires that your corporation pay \$ 7,000 up front. If the investment is successful, your corporation's net income after all expenses but before tax will equal \$ 1,000 a year in perpetuity. If the investment fails you not only lose your initial \$ 7,000 but also incur a liability for future damages that just happens to equal \$ 1,000 per year in perpetuity. The applicable income tax rate is presently a flat 10 percent of your \$ 1,000 annual income if the venture succeeds. If it fails, you have no other business income against which to deduct your losses. (Which is to say that government shares in the gains but not in the losses.) You believe that with probability of 0.90 the tax rate will remain at this level for the life of the investment and that with probability .10 it will increase to 15 percent next year and then remain constant at that new level. After gathering all of the information you can, you determine that apart from tax

considerations the investment has a 0.75 chance of succeeding and only a 0.25 chance of failing. You are risk averse. Should you make the investment?

A little calculation shows that the certainty equivalent value of after tax annual income under these conditions is equal to the following:

$$CE = 421.25 - (.9*RP10 + .1*RP15)$$

where 421.25 is the expected annual after tax income (in dollars) and where RP10 and RP15 are the annual risk premia associated with tax rates of 10 percent and 15 percent, respectively. The quantity  $(.9*RP10 + .1*RP15)$  is the risk premium. If the annual certainty equivalent is capitalized at 5 percent, the present discounted value is equal to:

$$PDV = 8,425 - 20*(.9*RP10 + .1*RP15)$$

Note that there is no need to add a risk premium to the 5 percent discount rate because risk is already accounted for by the inclusion of RP10 and RP15 in the equation.

Now suppose that  $RP10 = \$ 42.50$  and  $RP15 = \$ 77.50$ . In general, a higher risk premium is associated with a higher tax rate because the higher tax rate lowers income in the event of success but does nothing to reduce the loss in the event of failure. In keeping with this RP15 is greater than RP10. We can then calculate that:

$$CE = 421.25 - .9*42.5 - .1*77.5, \text{ or}$$

$$CE = 375.25$$

Discounting to present value at 5 percent (in perpetuity for ease of calculation) we have:

$$PDV = 8,425 - 20*(.9*42.5 + .1*77.5), \text{ or}$$

$$PDV = 7,505$$

Because the risk adjusted present discounted value exceeds the \$ 7,000 initial investment the project is worth doing for this investor. A more risk averse investor might decide otherwise, but for this investor the project is a "Go."

#### The Threat of Higher Taxes

Now suppose that state government aggressively raises taxes on some other industry, say by declaring section 883 of the U.S. Internal Revenue Code to be inapplicable for purposes of calculating taxable income under the state corporation income tax. Further suppose that this causes your corporation to revise

upward the probability that the applicable tax rate will be 15 percent next year instead of 10 percent. In particular, suppose that the probabilities go from (.90, .10) to (.50, .50) meaning that now your corporation thinks that there is a fifty-fifty chance that the applicable rate will be 15 percent.

Leaving everything else unchanged, it can be shown that the revised annual certainty equivalent value of the project's income stream drops to:

$$CE_{\text{new}} = 406.25 - .5*RP10 - .5*RP15, \text{ or}$$

$$CE_{\text{new}} = 346.25$$

and that the revised present discounted value of the income stream (in perpetuity at a 5 percent discount rate) is:

$$PDV_{\text{new}} = 8,125 - 20*(.5*RP10 + .5*RP15), \text{ or}$$

$$PDV_{\text{new}} = 6,925$$

The project is now not worth doing because its revised present discounted value is below the \$ 7,000 investment.

The effect of the higher annual risk premium associated with the higher tax rate is crucial in this example. If the risk premium were the same regardless of the tax rate (that is to say, if  $RP10 = RP15 = \$ 42.50$ ), we would have a present discounted value of \$ 7,275 after the government action rather than the \$ 6,925 shown above. The higher risk premium accounts for \$ 230 of the \$ 580 decline in present discounted value caused by the government action. In other words, the effect is nearly doubled.

APPENDIX B  
THE IMPACT OF HIGHER SECTION 883 TAXES ON ALASKA FISHERIES

*SUMMARY: The main impact of higher Alaska taxes on the foreign flagged vessels and aircraft which transport seafood to other countries from Alaska harvesting areas is likely to come in the form of lower prices paid to harvesters at dockside and a resultant drop in their harvesting incomes. The reason for this is an imbalance of market power between the large corporations which control foreign wholesale seafood markets, on the one hand, and the domestic processors operating in Alaska harvesting areas, on the other. In turn, these domestic processors are in a strong market position relative to the large number of independent harvesters who work in the fishery. We use the Bristol Bay sockeye salmon fishery as a case in point. The average reduction in annual net income per permit holder in one representative fishery (Bristol Bay sockeye salmon) is on the order of \$ 1,000.*

The analysis presented here centers on the Bristol Bay sockeye salmon fishery for two reasons. First, it helps to clarify the analysis if the focus is narrowed. Second, a 1993 memorandum released by the Alaska Attorney General's office identified the Bristol Bay sockeye salmon fishery as one in which large Japanese trading companies are likely to hold a disproportionate share of the market power. This document is unique in terms of its information content. (See the memorandum from Assistant Attorney General James Forbes to Attorney General Charles E. Cole, dated June 7, 1993 entitled "Bristol Bay Salmon Investigation".)

The Setting

Bristol Bay is the location of Alaska's largest volume sockeye salmon fishery. On the order of one-fourth of the world's supply of sockeye comes from Bristol Bay and over 60 percent of the harvest is resold to Japanese wholesalers. Prior to 1979, 90 percent or more of the Bristol Bay sockeye harvest was canned, with less than 10 percent sold fresh or frozen. Since 1979 the situation has reversed. In recent years frozen sockeye have averaged in excess of 50 percent of the harvest. In brief, the Bristol Bay sockeye harvest is large, large relative to the market, largely frozen, and sold largely in Japan.

Commercial sockeye salmon fishers in Bristol Bay must either own a limited entry permit, lease a permit from the owner, or hire out as a crew member to an owner or lease holder. Sockeye are harvested with either drift gillnets or in-shore setnets. Since 1974 when limited entry was instituted an average of 2,700 permits have been validated per season with a peak of 2,980 in 1975 and a low of 2,485 in 1976. Since 1979 no fewer than 95 percent of the validated permits have been fished each season.

There are two domestic markets for frozen/fresh sockeye in Bristol Bay, the ex-vessel market in which harvesters sell to domestic processors, and the wholesale market in which the domestic processors sell to Japanese buyers. The buyer side of the ex-vessel market consists of fewer than six relatively large domestic processors and (historically) up to sixty-five smaller processors. Since 1987 the number of smaller processors has declined. According to information collected by the Alaska Attorney General's office during its 1991-1993 investigation of price fixing by Bristol Bay processors, the six firm buyer concentration ratio in the ex-vessel market over the years 1985 through 1990 never fell below .51 and on occasion rose as high as .67. The six firm buyer concentration ratio gives the share of the total harvest purchased by the six largest processors. Concentration ratios greater than 0.50 indicate significant market power.

The domestic processors, in turn, sell to any of a number of Japanese buyers who then ship the fish to wholesale markets in Japan. One point which was emphasized in the Alaska Attorney General's 1993 memorandum (identified above) is that the many Japanese buyers of frozen and fresh sockeye are likely to be only nominally independent. Based on evidence gathered during a three year investigation the memorandum offered the following informed judgement:

"We believe that the evidence, when examined in light of the conventional practices of the large Japanese trading companies, strongly suggests that for policy purposes Alaska would be well advised to act as if the buyer's side of the Bristol Bay (wholesale) market were oligopsonistically controlled." (page 7)

Suppose that the Alaska Department of Revenue notifies the Japanese buyers of Bristol Bay sockeye salmon that henceforth the Alaska Corporation Net Income Tax was to be applied to income derived from the ships which transport the fish to Japan. How would the tax be determined? How much revenue would be raised? Who would ultimately pay the tax?

#### How Would the Tax Be Determined?

One major problem involved in estimating the dollar yield of the tax is its potentially arbitrary and capricious nature. In order to accurately determine a foreign corporation's Alaska net operating income, the State of Alaska would need to audit not only the books of the corporation upon whom the tax is levied but also its parents and its affiliates. At the present time the Alaska Department of Revenue relies heavily on the voluntary cooperation of foreign corporations for such information. In virtually all of these cases, the information given to the State of Alaska is the same as that given to the U.S. Internal Revenue Service. There is some question as to how much cooperation could

be expected if the State of Alaska intrudes into an area that is not taxed under the U.S. Internal Revenue Service code. If DOR were unable to gain access to all relevant accounting records, foreign corporations could easily reduce their reported net operating income to zero through judiciously determined inter-group transfer prices. Under such circumstances, the amount levied on each foreign corporation would not necessarily be determined by applying statutory rates to the true Alaska net operating income of the corporation but instead by either (a) what the corporation deigns to pay or (b) what is determined via negotiation and litigation.

Without attempting to predict a precise sequence of events, at some point both the foreign corporation and the Department of Revenue will impute a wholesale transfer price for salmon, calculate imputed net income from the foreign corporation's shipping operations and then apply the Alaska Corporation Net Income Tax to imputed income. The language in the Alaska Corporation Net Income Tax instructional booklet which requires such imputations is:

"Make or reverse adjustments necessary to reflect intercompany profit on transactions between corporations within and outside of the water's edge combined group."  
(1995 instruction booklet, instructions for schedule H.)

In the case of Bristol Bay operations the imputed wholesale transfer price is the price for transportation services which would have been paid in an arm's length transaction by a representative Japanese wholesaler to a representative independent shipper. Just how DOR would arrive at such a figure is an open question should the shipping companies and their affiliates decline to cooperate and should DOR be unable to mandate an outside audit of a vertically integrated Japanese trading company. One possibility is for DOR to simply accept the price imputed by the corporation. But one point is clear. However the transfer price is computed, its reasonableness will be judged by the reasonableness of the tax burden which results.

The importance of this discussion is simply this. Under circumstances which may well arise, the Alaska Corporation Net Income Tax on foreign flagged ships and aircraft cannot be analyzed as a tax on corporate profits. The possible need to impute a wholesale transfer price and to then judge the reasonableness of the tax by comparison to some other standard means that the tax may be more like an ad valorem sales tax or a value added tax than a profit tax. This has implications for the issue of who will ultimately pay the tax.

# CORRECTION

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### How Much Revenue Would Be Raised?

This is impossible to estimate with any degree of certainty given the difficulty in obtaining accurate data on Japanese shipping costs and given the high degree of guesswork that would necessarily attend the imputation of a wholesale transfer price by DOR. However, the test of reasonableness which might need to be applied to the tax returns prepared by the foreign corporation allows one to make an informed guess.

There are at least two time-tested ways to come up with a rough estimate of what the yield of the tax should be.

(1) Apply a percentage to the estimated market value of the cargo ships themselves on the assumption that net operating income from shipping will amortize the investment in the vessel over a given period of time.

(2) Set the imputed transfer price so that taxable net operating income yields Alaska tax revenue which is judged to be fair by comparison to some standard.

Time constraints precluded the use of method (1) in this study. Information on construction costs for a "typical" Japanese seafood carrier could not be quickly obtained. The application of method (2) suggests an annual revenue yield of up to 3 percent of the ex-vessel value of the salmon which are shipped frozen or fresh from Bristol Bay. The 3 percent is not only the rate levied against raw fish under the Alaska fishery resource landing tax, but can also be derived by applying statutory tax rates to a vessel's net operating income, as long as this income is approximately equal to one-third of the ex-vessel value of the cargo. (These are the kind of relatively loose tests of reasonableness which have been used by other governments faced with similar information problems.)

In recent years the annual ex-vessel value of sockeye salmon harvested in Bristol Bay has fluctuated between \$ 125 million and \$ 200 million. The midpoint of this range is approximately \$ 160 million. A conservative estimate of the volume shipped frozen or fresh to Japan is on the order of 55 percent of the total harvest, with the remainder either canned or smoked.

A tax of 3 percent on 55 percent of an annual harvest value of \$ 160 million comes to \$ 2.64 million per year. If DOR is forced to judge the reasonableness of the revenue raised from foreign flagged shippers in Bristol Bay by such a standard (when judging the reasonableness of the foreign corporation's imputed wholesale transfer price of the sockeye) then \$ 2.64 million may not be completely unuseable as a first pass estimate of the maximum amount of revenue to be raised in this fishery each year by extending the Alaska Corporation Net Income Tax to foreign flagged seafood carriers.