REPORT# 521

TAX SECTION

New York State Bar Association

Report on S. 1974 and H.R. 3980
(Prohibiting State Taxation on a Worldwide Unitary Basis)
by
Committee on Interstate Commerce

April 15, 1986

Table of Contents

REPORT # 521

TAX SECTION

New York State Bar Association

Attached letter date 4/15/86 enclosing Report on S. 1974 and H.R. 3980 sent to the following:

The Honorable Dan Rostenkowski
cc: The Hon. John J. Duncan
Robert J. Leonard, Esq.

The Honorable Bob Packwood
Chairman
Senate Finance Committee
cc: The Hon. Russell B. Long
John Colvin, Esq.

The Honorable David H. Brockway
Chief of Staff
Joint Committee on Taxation

J. Roger Mentz, Esq.
Assistant Secretary (Tax Policy)
United States Treasury

The Honorable James A. Baker, 111
Secretary of Treasury
United States Treasury

The Honorable Donald T. Regan
Chief of Staff to the President

The Honorable Pete Wilson
U.S. Senate

REPORT # 521

TAX SECTION

New York State Bar Association

April 15, 1986

The Honorable Dan Rostenkowski
2232 Rayburn Building
Washington, DC 20515

Dear Representative Rostenkowski:

It is my pleasure to submit to you a report of the Tax Section of the New York State Bar Association supporting S. 1974 and H.R. 3980.

S. 1974 and H.R. 3980 (1) prohibit states from imposing income tax on any taxpayer on the worldwide unitary combined report basis without the taxpayer's consent, with certain limited exceptions, (2) restrict state taxation of foreign source intercorporate dividends, (3) require certain corporations to report annually to the Internal Revenue Service information relating to their state tax liabilities and state tax returns, and (4) provide for disclosure of this information to state tax agencies.

The Tax Section supports S. 1974 and H.R. 3980 primarily because they deal, in a sensible and sound way, with matters of extreme importance to foreign governments, to investments in the United States by foreign businesses, to investments in foreign countries by United States businesses, and to the ability of United States businesses to compete in world markets. The bills simplify state taxation of foreign commerce and significantly reduce the risk of duplicative taxation. They conform state tax laws to federal and generally accepted practice in the field of international taxation and remove an impediment to the free movement of international direct investment capital.

The Tax Section hopes that the 99th Congress will give consideration to the important topics addressed by S. 1974 and H.R. 3980.

Sincerely,

Richard G. Cohen

Enclosure
cc: The Hon. John J. Duncan) with
Robert J. Leonard, Esq.) enclosure

REPORT #521

NEW YORK STATE BAR ASSOCIATION
TAX SECTION

Report on S. 1974 and H.R. 3980
(Prohibiting State Taxation on a Worldwide Unitary Basis)

by
Committee on Interstate Commerce

General Comments

On December 18, 1985, Senator Pete Wilson of California introduced Senate Bill S. 1974, for himself and Senators Mathias and Hawkins. Concurrently, Representative Duncan introduced H.R. 3980, which is textually identical to S. 1974. The bills (1) prohibit states from imposing an income tax on any taxpayer on a worldwide unitary combined report basis without the taxpayer's consent, unless the taxpayer materially fails to comply with the reporting provisions of the bills or the taxpayer or the government of a foreign country ignores a proper request for information on certain transactions between the taxpayer and a member of the same controlled group of corporations, (2) restrict state taxation of intercorporate dividends, (3) require certain corporations to report annually to the Internal Revenue Service information relating to their state tax liabilities and state tax returns, and (4) provide for disclosure of this information to state tax agencies.

S. 1974 and H.R. 3980 deal with matters of extreme importance to foreign governments, to investments in the United States by foreign businesses, to investments in foreign countries by United States businesses, and to the ability of United States businesses to compete in world markets. The bills simplify state taxation of foreign commerce and significantly reduce the risk of duplicative taxation. For these reasons, the Tax Section supports S. 1974 and H.R. 3980. A more detailed statement of the reasons for the Tax Section's support and suggestions for improving the bills are set out in the analysis of the major provisions of S. 1974.

On two prior occasions, the Tax Section submitted reports on interstate taxation legislation.* Those reports addressed comprehensive legislation and stated the views of the Tax Section on a variety of issues relating to state taxation of businesses engaged in interstate and foreign commerce. Although fully supporting S. 1974 and H.R. 3980, the Tax Section continues to believe that the enactment of comprehensive federal legislation is, desirable to alleviate major problems concerning matters of jurisdiction to tax, attribution of income to taxing jurisdictions and treatment of related domestic corporations.

The Tax Section supported S. 1688 in the 97th Congress, although that legislation was limited to prohibiting states from using worldwide unitary combined reporting and from taxing all or a portion of foreign

---

* Report on Proposals for Improvement of Interstate Taxation Bills (H.R. 1538 and S. 317), reprinted in 25 The Tax Lawyer 533 (1972); and Report on Supplementary Proposals 27 The Tax Lawyer 213 (1974).

source dividends.* The Tax Section stated that S. 1688 represented an important first step toward comprehensive legislation and proposed a sensible solution to the major problems in the sensitive and troublesome area of state taxation of foreign commerce. The Tax Section urged the Congress to take prompt action on S. 1688.

Inaction by Congress during the years following the introduction of S. 1688 can be attributed largely to the presence in the Supreme Court of a constitutional challenge by Container Corporation of America to California's use of worldwide unitary combined reporting. On June 27, 1983, the Court upheld California's right to apply the worldwide unitary combined report method to United States based multinational businesses.** The court reserved judgment on the question of whether the worldwide unitary combined report method could be applied constitutionally to foreign based multinational businesses. In arriving at its decision, the Court refused to apply the more stringent tests it had laid down in Japan Line Ltd. v. County of Los Angeles, 441 U.S. 434 (1979), for scrutinizing state taxation of instrumentalities of foreign commerce; i.e., such taxation must not enhance the risk of double taxation and must not impair federal uniformity in an area where federal uniformity is essential. Although Container was able to demonstrate the same double taxation that

---

* Statement in Support of S. 1688 before the Senate Committee on Finance, Subcommittee on Taxation and Debt Management (December 10, 1980).

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

prompted the Court to invalidate the property tax in Japan Line, the Court found such evidence unpersuasive in determining the validity of an income tax. Also, the Court rejected Container's suggestion that the Court prescribe a bright-line test for determining the existence of a unitary business. On the contrary, the Court gave its blessing to several nebulous definitions of a unitary business, leaving the states great leeway in reaching the income of foreign corporations that are related to corporations doing business within their boundaries.

In the wake of the Container decision, members of the business community and major trading partners of the United States renewed their objections to the worldwide unitary combined report method and urged the President to: (1) file a memorandum with the Supreme Court as amicus curiae in support of a rehearing in the Container case; and (2) support federal legislation that would limit or prohibit worldwide unitary combined reporting. The proponents of the worldwide unitary combined report method urged the Administration to oppose federal restrictions on state use of the method.

The Administration responded to these requests by establishing, in mid-July, 1983, a Cabinet Council on Economic Affairs (CCEA) Working Group to identify the federal and state government interests in the worldwide unitary method of taxation and to develop possible options. The CCEA study group was chaired by the Treasury Department and had representatives from the following departments and agencies: Council of Economic Advisors, Commerce, Housing and Urban Development, Justice, Labor, Office of Policy Development (White House), State, Transportation, and the U.S. Trade Representative. Based on their review, a series of options were developed and forwarded to President Reagan for decision. On September 23, 1983, Treasury Secretary Regan announced President Reagan's decision to refrain from supporting the motion for rehearing in Container and to establish a Working Group composed of representatives of the federal government, state governments, and the business community to recommend solutions to the international economic relations problem created by worldwide unitary combined reporting.

At its first meeting, the Working Group established a technical-level Task Force composed of representatives of the Working Group members to thoroughly review the issues and develop options for decision by the Working Group. At the second meeting of the Working Group, it instructed the Task Force to focus on options for voluntary state action and to defer consideration of restrictive federal legislation. Nevertheless, Secretary Regan indicated that the Working Group would still be free to consider a federal legislative alternative if it failed to arrive at a suitable consensus.

During its tenure, the Task Force held 145 hours of meetings on 20 separate days, received the views of 47 witnesses at a series of open and closed hearings, and reviewed 30 written statements of interested persons, governments, and private organizations. The Tax Section appeared before the Task Force of the Working Group and set forth its position, to which it continues to adhere, that:

(1) comprehensive federal legislation is needed to provide uniformity in the many areas in which the states follow conflicting rules (such as jurisdiction to tax, the taxation of income from intangibles, the construction of apportionment factors, and the definition of a unitary business);

(2) the power of the states to tax foreign corporations ought to be restricted to taxing only income that is subject to tax under the Internal Revenue Code and applicable tax treaties; and

(3) the federal government should prevent the states from taxing domestic corporations on their receipt of foreign source dividends, at least to the extent that they are not effectively taxed by the federal government.

The Working Group held its third and final meeting on May 1, 1984, to receive and discuss the options developed by the Task Force. The Working Group was not able to agree on any of the options developed by the Task Force. It did agree, however, on a set of principles to guide the formulation of state tax policy. They were:

> Principle One: Water's-edge unitary combination for both U.S. and foreign based companies.
>
> Principle Two: Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability.
>
> Principle Three: Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses.

In Secretary Regan's letter transmitting the Working Group's Report to the President, he mentioned that state and business representatives were unable to reach agreement on the proper state tax treatment of foreign source dividends and of corporations with primarily foreign operations, popularly known as “80/20 corporations.” He explained that those issues were left for resolution at the state level in accord with Principle Three. He noted that the Report included a summary of arguments on those issues that were presented by both the state and business representatives. The letter concluded by stating that if there were not sufficient signs of appreciable progress by the states by July 31, 1985, whether by legislation or administrative action, Secretary Regan would recommend to the President that the Administration propose federal legislation that would give effect to a water's-edge limitation patterned after that in the Report.

The water's-edge unitary combined report method agreed upon by the Working Group was limited to the following corporations engaged in a unitary business:

(1) U.S. corporations included in a consolidated return for federal corporate tax purposes.
(2) U.S. possessions corporations;
(3) companies incorporated in U.S. possessions or territories;
(4) domestic international sales corporations (DISCS) or foreign sales corporations (FSCs);
(5) certain tax haven corporations presumed to be part of the unitary business;
(6) foreign corporations with at least a threshold level of business activity in the United States; and
(7) U.S. corporations not included in (1) and having more than 50 percent of their voting stock owned or controlled, directly or indirectly, by another U.S. corporation.

State members of the Working Group issued a statement in which they declared their willingness to accept water's-edge combined reporting based on the following conditions

- implementation of the specified steps to improve federal compliance and cooperative efforts;
- comprehensive definition of water's-edge, including retention of the right to include “80/20 corporations;”

- retention of the states' right to include foreign dividends in their tax bases.

State members took issue with the Secretary's statement that he would recommend federal legislation if there were not appreciable progress by July 31, 1985, saying that such a new and unnecessary deadline ignored the fact that legislative and executive action by both the federal and state governments may well require More than 11 months to complete. They reiterated their opposition to federal legislation.

On the other hand, business members of the Working Group issued a statement in which they indicated that their support for Principle Two depended upon support by the states for Principle One and Principle Three. They interpreted Principle One as excluding foreign source income from the definition of water's edge. Accordingly, they asserted that a water's-edge combined report should not include “80/20 corporations.” They argued that only in rare instances should foreign corporations be included in the water's-edge group and a foreign bank doing business through a branch in the United States should be taxed as though the United States branch were a separate corporation. They insisted that foreign source dividends should not be converted into domestic income belonging to the water's-edge group.

The business members believed that Principle Three would be violated if states taxed foreign source dividends. They pointed out that one of the largest categories of foreign source income is dividends paid to domestic corporations by their foreign subsidiaries. They argued that unless such dividends were excluded, the combined state and foreign tax burden on such income would normally exceed the total tax burden on foreign subsidiaries owned by foreign based Multinational corporations. Thus, they concluded, the foreign subsidiaries of domestic based multinational corporations would be placed at a competitive disadvantage in the foreign marketplace, which in turn would eventually reduce or eliminate United States participation in overseas markets. In a similar vein, they argued that taxing foreign dividends placed domestic based multinational businesses at a competitive disadvantage to foreign based multinational businesses in United States markets. In addition, they stated that the taxation of foreign dividends will increase the state tax burden of many domestic based multinational businesses over that which they would have incurred under worldwide combined reporting, the source of the controversy in the first place. The business members concluded their statement by calling for federal legislation if time shows that states will not adjust their taxing policies to eliminate worldwide unitary combined reporting and the taxation of foreign source income.

On July 8, 1985, the Treasury Department released a draft of proposed legislation ostensibly to implement the decisions of the Working Group. The draft legislation (1) required certain corporations to file annual information returns with the Internal Revenue Service reflecting their computation of state income taxes; (2) generally permitted the Service to share this information (as well as certain information received from foreign tax authorities) with states that do not require taxpayers to compute tax on a worldwide unitary basis; and (3) prescribed penalties for failure to comply with the reporting requirements.

The Tax Section commented on the proposal, acknowledging that it was a step toward confining the combined report method to the water's edge but at the same time emphasizing that such legislation should mandate, not just encourage, water's-edge treatment.[*] In addition, the Tax Section stated its belief that legislation should mandate the exclusion from unitary income of foreign dividends and the income of “80/20 corporations.”

In regard to the information to be reported, the Tax Section stated that a more meaningful body of information would be the reporting corporation's apportionment factors and income subject to tax computed according to a prescribed body of uniform rules adopted by the Secretary of the Treasury. Those rules could be similar to the provisions of the Uniform Division of Income for Tax Purposes Act. The determination of apportionable income subject to tax could follow the Federal tax laws and the business, non-business rules of the Uniform Act. Each state would then be assured that the reporting corporation is following consistent procedures for establishing the situs of its property,

---

[*] Statement of the Tax Section of the New York State Bar Association before the Task Force appointed by the Worldwide Unitary Taxation Working Group (November 29, 1983).

payroll, and sales for apportionment purposes and for determining income subject to apportionment. Each state would be able to make the adjustments necessary to reconcile the income and apportionment factors used on the corporation's return as filed to ensure compliance with the state's tax laws.

The Tax Section asserted that there is an additional advantage to its proposal - it will encourage uniformity in state income tax laws. The Tax Section maintained that the federal rules would resolve doubtful areas in the application of the Uniform Act, which is in effect in whole or substantial part in most states, and would serve as a guideline for state tax agencies and state courts. Also, the Tax Section pointed out that the value of the reporting :required of multijurisdictional corporations would be enhanced if state tax laws followed the uniform rules for information reporting, thus making it advantageous for states to adopt the uniform reporting rules. The Tax Section believed that in this way, the cause of uniformity would be aided.

S. 1974 was prepared by the Treasury Department in response to the President's statement of November 8, 1985, calling for legislation that would limit state taxation of multinational businesses to income derived from the United States and that would address the question of equitable taxation of foreign source dividends. The statement instructed the Secretary of the Treasury to pursue enactment of legislation to promote full taxpayer disclosure and accountability similar to that which had been proposed by the Treasury Department and made public on July 8, 1985. The statement also instructed the Secretary of the Treasury to enter into negotiations to amend double taxation agreements with foreign nations.

In the news release announcing the introduction of the S. 1974, Senator Wilson referred to the United Kingdom's adoption of enabling legislation permitting serious retaliatory measures against United States companies and the threats of Canada, Germany, Belgium, Italy, Switzerland, Japan, and the Netherlands to enact similar retaliatory measures. The United Kingdom has delayed action under its retaliatory law until December 31, 1986, in order to give congress, or the states, time to act.

The news release indicates that seven states currently require worldwide unitary combined reporting. They are California, Utah, Alaska, Montana, Idaho, North Dakota, and New Hampshire.* The California legislature is considering several bills limiting worldwide unitary combined reporting, and Utah has taken administrative action to confine unitary combined reporting to domestic corporations and certain other corporations doing business in the United States or its possessions.

---

* Subsequent to the issuance of the news release, Idaho and Utah enacted legislation prohibiting worldwide unitary combined reporting and limiting the taxation of foreign source dividends. New York does not require or allow worldwide combined reporting but may require a combined report that includes “80/20 corporations”, possession corporations, DISCS and FSCs.

Prohibition of Worldwide Unitary Combined Reporting

S. 1974 amends the Internal Revenue Code by adding a new section (section 7518) that generally prohibits a state from imposing an income tax on a taxpayer on a “worldwide unitary basis.” “Worldwide unitary basis” is defined to mean that a corporate taxpayer includes in its income base a share. of the income of any corporation other than a corporation that is a member of the same controlled group of corporations and is: (1) a domestic corporation (including a corporation that has made an effective election under section 936); (2) a corporation described in section 922; (3) a corporation organized in the Commonwealth of Puerto Rico, Guam, America Samoa, or the U.S. Virgin Islands; (4) a foreign corporation having compensation payments, sales, purchases, or property of at least $10 million assignable to one or more locations in the United States or at least 20% of its property, compensation payments, and sales assignable to one or more locations in the United States; and (5) tax haven corporations.

The Tax Section recognizes that the unitary combined report method is a logical extension of the apportionment scheme used by states to determine their respective shares of the taxable income of a multistate unitary business. The apportionment process is intended to satisfy constitutional restraints on state taxation of interstate and foreign commerce by taxing only that income which is related in some manner to activities and property in the taxing state. The usual method is a three-factor formula of property, payroll, and sales. The efficacy of this apportionment scheme rests on the assumption that each of the individual factors of the formula produces essentially the same profit. This is seldom the situation, however, with respect to corporations doing business in widely separated parts of the world where wages, productivity, property values, and cost of money differ widely.

A combined report is in the nature of an information return. The taxpayer member(s) of a unitary business group attaches to its return a report which combines the net income and apportionment factors of the members of the group and eliminates intercorporate transactions. The taxpayer member(s) computes its taxable income based on the ratio of its own factors within the state to the combined factors of the unitary group. The purpose of the combined report method is to insure that the income of a unitary business conducted partly within and partly without the taxing state is determined and apportioned in the same manner regardless of whether the unitary business is conducted by one corporation or by two or more affiliated corporations.

The Tax Section believes that it is sound tax policy to prohibit states from imposing tax on a worldwide unitary combined report basis for the following reasons. First, income earned in many foreign countries does not bear the same relationship to the factors of the formula used to apportion that income as the income earned in the United States bears to the factors that will apportion that income. For this reason, distortion is created when foreign source income is combined with

United States source income and apportioned by a common formula. Second, wage rates in the United States tend to be significantly higher than wage rates in many foreign countries. As a result, this factor apportions an excessive amount of income to the United States assuming that the different wage rates do not reflect different levels of productivity. Third, the worldwide unitary system creates severe administrative burdens. Among these are (1) the need to translate foreign currencies into united States currency; (2) the unavailability of information needed to construct the apportionment formula; (3) laws of foreign countries often prevent the disclosure of information needed to complete a return; and (4) different accounting systems in use in different countries must be conformed to a United States tax accounting system. Fourth, the worldwide unitary method is a significant international irritant. The method is perceived by foreign based companies and trading partners of the United States as being contrary to accepted international standards of taxation. Fifth, the deficiencies described above appear to be intractable and have not been cured by any state using worldwide combined reporting. For these reasons, Congress should act now to remedy the problems in this most sensitive area of foreign commerce.

S. 1974 contains two exceptions to the prohibition against using the worldwide unitary basis. They are: (1) the taxpayer materially fails to comply with the reporting provisions of S. 1974 or with the legal or procedural requirements of the income tax laws of the taxing state; or (2) neither the taxpayer nor the government of the relevant foreign country provides the taxing state material information relating to the determination of taxpayer's income from transactions between the taxpayer and any corporation outside the water's-edge group which is a member of the same controlled group of corporations.

It appears to make sense to allow a state to require worldwide unitary combined reporting if a taxpayer materially fails to comply with the information reporting requirements of the bill. The information reporting requirements are designed to protect the state from manipulation or inequitable income attribution resulting from its inability to require worldwide unitary combined reporting. If the state is denied this protection, worldwide unitary combined reporting is the logical solution.

On the other hand, a worldwide unitary combined report does not appear to be an appropriate remedy when a taxpayer fails to comply with the legal or procedural requirements of state income tax laws. A mathematical error on a return, or the failure to timely file a report of federal audit adjustments, might be considered a failure to comply. Those failures will result in a taxpayer having to file a worldwide unitary combined report. As presently written, the exception is extremely broad, and with respect to the legal or procedural requirements of state income tax laws, is inappropriate.

Exclusion of Foreign Source Dividends

S. 1974 restricts state taxation of foreign source intercorporate dividends. A state which is not the commercial or legal domicile of the taxpayer may tax only an equitable portion of foreign source dividends. This is defined to mean that: (1) at least 85% of such dividends are excluded from the income base subject to apportionment; or (2) the portion of the dividends that effectively bears no federal income tax after application of the foreign tax credit is excluded from the tax base subject to apportionment; or (3) the state adopts a method of taxation that, considering all the facts and circumstances, results in an equitable apportionment of the dividend to the state substantially similar to (1) or (2), pursuant to regulations to be promulgated by the Secretary.

The Tax Section supports the limitations placed on state taxation of foreign source dividends.* States, other than states in which a corporate taxpayer has its legal or commercial domicile, can lay claim to taxing only that income earned or from activities conducted in the state. Accordingly, income earned abroad should not be taxed by a state having no direct connection with that income. Also, the taxation of intercorporate dividends creates a troublesome duplicative taxation problem that is exacerbated when the corporations involved are under common ownership - the usual case with respect to foreign source dividends. If it does not make sense to combine

* New York taxes intercorporate dividends only to the extent of the dividend payor corporation's allocation percentage for New York tax purposes.

the income of foreign subsidiaries with the income of their United States parent, it makes even less sense to combine dividends paid by foreign subsidiaries with operating income of the United States parent and apportion that combined income on the apportionment factors of the parent. That approach simply supplants one form of distortion with a worse form of distortion.

Although there is probably no sound theoretical justification for excluding only 85% of dividends received from foreign corporations, it may serve as a rough equivalent to an equitable apportionment. Foreign source dividends represent income earned from foreign activities, and states other than those in which activities directly related to the dividend income were conducted (generally the state of commercial domicile) have little or no connection with the dividend income in question. If the state insists on taxing this dividend income, the most logical apportionment method is one that includes the factors of the payor corporation in the same relation as the dividends bear to the income of the payor corporation. Nevertheless, this method contains the same problems of comparability and distortion that does combined reporting.

The second method of taxing dividends is that provided for in Senate Bill 1113, introduced by Senator Mathias. The Mathias Bill would permit a state to tax no greater portion of dividends received from a foreign corporation than the federal government effectively taxes. The excluded portion of any dividend would be determined by multiplying the amount of the dividend by a fraction. The numerator of the fraction is the total amount of tax withheld at the source on all such dividends plus the total amount of taxes which, by application of section 902 and section 960 to all such dividends, the U.S. parent corporation is deemed to have paid. The denominator of the fraction is 46 percent of all such dividends. For the purpose of applying this fraction, the amount of the dividend includes the amount of any gross-up under section 78.

<u>Example</u>

1. Amount of dividend actually received	$115.50
2. Grossed-up dividend to reflect 23 percent foreign tax rate	$150.00
3. Grossed-up dividend x 46 percent	$ 69.00
4. Foreign taxes paid (23% x $150)	$ 34.50
5. Item 4 divided by Item 3	50 percent
6. Excluded portion of dividend ($150 x .50)	$ 75.00

The rationale for this exclusion of a portion of a foreign source dividend is the same as the rationale for the foreign tax credit -- the avoidance of double tax. However, the result is not to require the states to allow a credit for foreign taxes which would tend to wipe out all state tax on foreign source dividends because the national tax rates in most foreign countries exceed the rates of tax imposed by the states. Instead, the result of the exclusion is to permit the states to tax, at whatever rate they apply to other income, only that portion of a foreign source dividend which the federal government effectively taxes after taking into account the foreign tax credit.

“80/20 Corporations”

S. 1974 defines the term “worldwide unitary basis” to include a tax that takes into account the income of a domestic corporation having less than $10 million in compensation payments for services rendered in the United States, sales or purchases of less than $10 million to or from unrelated parties in the United States, or property (other than stock or securities of a corporation) with an aggregate original cost of less than $10 million assignable to the United States; and the average of the percentages of the corporation's property (based on original cost), compensation payments for personal services, and sales that are assignable to the United States is less than 20% (so-called “80/20 corporations”). This represents a major departure from the original Treasury proposal which permitted a state to include the income of “80/20 corporations” in a combined report and remain a “qualified state.”

The Tax Section believes that “80/20 corporations” should be treated as foreign corporations because their business activities occur primarily overseas. The place of incorporation should not be determinative of exclusion or inclusion in a water's-edge combined report.

Information Reporting

S. 1974 incorporates the information reporting provisions of the Treasury draft legislation in modified form in new section 6039A of the Internal Revenue Code. The information submitted will be available to all states. Returns must be filed within 180 days of the due date (including extensions) of a reporting corporation's federal income tax return. The information to be reported is similar to that required by the Treasury draft and the Secretary may require the reporting of “such other related information” as he deems appropriate. The Tax Section continues to believe that the required information is meaningless in furthering the purpose of the legislation and grants overly broad authority to the Secretary to require additional information.

The definition of “reporting corporation” differs in several respects from that contained in the draft legislation. The “threshold” dollar amounts of compensation paid, assets owned, or gross sales occurring outside the United States is $10 million for each category, whereas the key amount under the draft legislation was $1 million. Whereas the draft legislation included within the definition of reporting corporation a company which met one of the threshold tests “in any single foreign country,” S. 1974 requires the tests to be met merely “outside the United States,” thus broadening the scope of the definition. The fourth threshold test, described in the draft legislation as ownership of assets with a fair market value of at least $250 million, has been augmented to require that the company also be subject to tax in at least two states, with at least $10 million of' its minimum $250 million in assets located in the United States. Whenever the draft legislation referred to the “fair market value” of assets, S. 1974 refers to “aggregate original cost.”

Local Governments

S. 1974 does not prohibit political subdivisions of states from using the worldwide unitary basis in imposing an income tax, or limit political subdivisions in the manner in which they can tax foreign source dividends, or provide for the disclosure of information required by the bills or obtained under treaties or exchange of information agreements with foreign countries to political subdivisions. Since there is no logical reason to exclude state political subdivisions from the provisions of S. 1974 (or H.R. 3980), the exclusion most likely was an oversight.

Authority of Congress to Limit State Taxation

S. 1974 raises the issue of the power of Congress under the Commerce Clause of the Constitution to limit the sovereign power of the states to tax. Following the Supreme Court's decision in Garcia v. San Antonio Metropolitan Transit Authority, 53 U.S.L.W. 4136 (Feb. 19, 1985), it would appear that the power of Congress to regulate interstate commerce, where employed as a basis for the affirmative establishment of national policy over interstate commerce, is so complete and paramount in character that Congress may supersede state action even in areas which admittedly are local or intrastate. Thus, the Commerce Clause is viewed as granting to Congress plenary power to regulate state action that affects interstate or foreign commerce.

The Court has repeatedly called upon Congress to act in the field of state taxation of interstate commerce. In Northwestern States Portland Cement Co. v. Minnesota, U.S. 450 (1959), Justice Frankfurter declared that Congress alone can provide for a full and thorough canvassing of the multitudinous and intricate factors which compose the problem of the taxing freedom of the states and the needed limits on such state taxing power. He asserted that the problem of state taxation of interstate commerce calls for a Congressional solution. Later in Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978), the Court indicated that the legislative power granted to Congress by the Commerce Clause of the Constitution would amply justify the enactment of legislation requiring all states to adhere to uniform rules for the division of income.

The Tax Section believes that the exercise of the power to restrict state taxation by Congress should balance the interests of the needs of the states for revenue against the national interests for interstate and foreign commerce. Harm to commerce and the impact on the ability of states to raise revenue are elements that enter into the determination of the authority of Congress to limit the taking power of the states. Defenders of worldwide unitary combined reporting argue that only income earned in the taxing state by the taxpayer member(s) of the unitary group is taxed. Indeed, that is the only income that state tax laws subject to tax. Opponents of worldwide combined reporting claim that, in practice, the system does not work properly in a worldwide context, resulting in the taxing of foreign source income.

The Administration and sponsors of the legislation have emphasized the problems created by worldwide combined reporting when applied to foreign-based businesses and in regard to the dealings of the United States with its major trading partners. They have been less emphatic about the detrimental impact on domestic corporations engaged in foreign commerce. The Tax Section believes that United States based multinational businesses are adverseley affected by the worldwide unitary combined report method of state taxation.* A record should be established by Congress reflecting the extent to which worldwide combined reporting impedes and burdens United States companies in their conduct of foreign commerce. If such a record is made, it is not likely, in light of the previous pronouncements of the court, that a bona fide attempt by Congress to protect such foreign commerce and nurture its growth would be struck down.

The power of Congress to limit state taxation of dividends received by a corporation engaged in interstate commerce is a closer issue. It can be argued that investing in the stock of a foreign corporation is not engaging in foreign commerce. Nevertheless, the proposed limits in S. 1974 primarily pertain to dividends received from foreign unitary subsidiaries. Such investments are not passive ones, rather they represent a method of doing business overseas. Accordingly, the taxation of the intercorporate dividends in question has a direct affect on foreign commerce. Furthermore, the limitation is a partial one, keyed to the concept of equitable taxation

---

* See pp. 14-16 *supra*

by states other than the state(s) in which the taxpayer corporation has its legal or commercial domicile. The state of legal or commercial domicile is not limited in its taxation of intercorporate dividends. For these reasons, the Tax Section believes that S. 1974 does not unduly restrain state taxation of foreign source dividends.

Specific Comments

1. Section 2 of S. 1974 amends the Internal Revenue Code by adding section 7518. In accord with the preceding General Comments, the Tax Section suggests that so much of paragraph (1) of subsection (a) as begins with the word “or” on line 6 of page 2 and concludes with the word “State” on line 8, be stricken. Section 7518(a)(l) would read:

> “(1) the taxpayer materially fails to comply with the requirements of section 6039A or”

2. New section 7518 does not exclude section 78 (gross-up) dividends. Those dividends are a function of the foreign tax credit mechanism in the federal tax law. State tax laws do not contain a similar credit and section 78 dividends do not represent income for state tax purposes.

3. New section 7518(b)(l) excludes at least 85 percent of foreign source dividends. In addition, it should prohibit states from setting off expense deductions against excluded dividends.

4. New section 7518 defines “worldwide unitary basis” to apply to a combined report that includes corporations beyond the water's edge: “80/20 corporations” are considered to be beyond the water's edge and are treated as foreign corporations. Subsection (c)(4) of new section 7518 contains a two-pronged definition of an “80/20 corporation.” To qualify as an “80/20 corporation,” a corporation must have less than 20 percent of its property, compensation payments, and sales assignable to the United States and less than $10 million in property, or compensation payments, or sales, or purchases assignable to the United States. Accordingly, large “80/20 corporations” are included within the water's-edge group. There is no apparent reason why size alone should require different treatment with respect to which corporation are to be included in a combined report.

5. Section 3 of S. 1974 amends the Internal Revenue Code by adding section 6039A. Paragraph (a) of section 6039A requires a corporation to file a return disclosing certain information relating to its State income tax returns. For reasons set out in the General Comments, the Tax Section believes that the required information will be of little help to the states and places a considerable burden on taxpayers. If the Tax Section's suggestion with respect to the type of information to be reported is not acceptable, the reporting requirements should be limited to the factors used by the taxpayer to apportion its income and, perhaps, a copy of all state income tax returns filed by the taxpayer. At the very least, there should be no

requirement for the taxpayer to reconcile the figures contained on returns as filed and figures computed on a hypothetical basis as suggested by the “Spreadsheet” format in Annex E of the Working Group Report.

6. New section 6039A(a) requires a reporting corporation to report data with respect to corporations in which it, or any corporation owning 50% or more of the outstanding voting stock of the reporting corporation, owns directly or indirectly more than 20% of the combined voting power of all classes of stock entitled to vote, and which during the reporting corporation's taxable year has engaged in transactions with the reporting corporation and its includible corporations aggregating $1 million or more. Since a combined report is applicable to corporations only where more than 50% of the voting stock is owned by an affiliated corporation, it appears logical to confine the reporting obligation to situations where the reporting corporation, or any corporation owning <u>more than</u> 50% of the voting stock of the reporting corporation, owns more than 20% of the voting stock of another corporation that has engaged in transactions with the reporting corporation.

7. New section 6039A(c) defines “reporting corporation” to include a corporation that owns total assets having an aggregate original cost of at least $250 million, regardless of its activities outside the United States. Since the reporting requirements are designed to aid the states in enforcing their tax laws in the absence of worldwide combined reporting, there is no reason to impose a heavy reporting burden on taxpayers that do not

engage in foreign commerce. In addition, there appears to be no reason why a taxpayer that files on a worldwide unitary basis in all states in which it does business must file the information return required by section 6039A.