

Worldwide Unitary Taxation: Federal and State Developments

In December 1985, the Treasury Department released a legislative proposal that dramatically affects the controversy concerning the worldwide unitary method of taxing corporate income. This development is the result of concerns expressed by major trading partners and multinational corporations, and it places additional pressure on California to change its tax law. This article describes the major events that have occurred at the state and federal levels since the *Container*¹ decision. It also discusses the principal features of the federal proposal and their implications for the international business community.

I. Working Group on Worldwide Unitary Taxation

An analysis of the *Container* decision and a description of the unitary method, as well as the problems it causes corporate taxpayers, was published in the 1985 spring issue of THE INTERNATIONAL LAWYER.² In the wake of the *Container* decision, President Reagan refused to support federal legislation that would restrict the taxing powers of the states. Instead, he asked then Secretary of the Treasury, Donald Regan, to appoint a committee to try to resolve the controversy in a voluntary manner.

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

2. Allen, *The Container Corp. Case: The Unitary Tax in the United States and as Perceived by the International Community*, 18 INT'L. LAW. 127 (1985). The "worldwide unitary method" treats a parent corporation and all of its subsidiaries as a single economic unit, and it assigns income to a state in proportion to the percentage of the group's property, payroll and sales located in the state. Generally, a "water's edge" limitation excludes corporations with more than 80 percent of their property, payroll and sales located outside of the United States.

This led to the formation of the Working Group on Worldwide Unitary Taxation.³

The Working Group, which consisted of eighteen governors, chief executive officers, state legislators and other officials, and its Task Force considered the problems caused by the unitary method, the reasons for its use, and whether there could be an agreed upon alternative. After ten months of deliberation, a final report was issued in August 1984.⁴ Rather than reaching an agreement on one of six options, the report recommended three principles which should guide the formulation of state tax policy.⁵ Among other things, this left the taxation of dividends received from foreign corporations to be decided on a state-by-state basis. In two letters transmitting the report to the President, Secretary Regan stated that if the states did not make appreciable progress in adopting these principles within a year, he would recommend proposing federal legislation that would make the use of the unitary method subject to the water's edge limitation.⁶

II. Reaction of the British Government

While many countries have expressed their disapproval of the worldwide unitary method, the United Kingdom has had the longest history of opposition and has taken the most definitive actions.⁷ On July 8, 1985, the British Parliament passed an amendment to the 1985 Finance Act which granted the Government discretionary authority to deny certain refunds of the Advanced Corporation Tax.⁸ This would affect dividends paid by U.K. subsidiaries to U.S. parent corporations that had significant activity in worldwide unitary states. It is a retaliatory measure which is

3. For a comprehensive review of the formation and deliberation of the Working Group, see Miller, *A State Perspective on the Worldwide Unitary Taxation Working Group and Task Force*, (Part 1 of 3), 1985 MULTISTATE TAX COMMISSION REVIEW, 1-9 (November 1985).

4. U.S. Department of the Treasury, *THE FINAL REPORT OF THE WORLDWIDE UNITARY TAXATION WORKING GROUP: CHAIRMAN'S REPORT AND SUPPLEMENTAL VIEWS* (August 1984).

5. Those principles are: "(1) water's edge unitary combination for both U.S. and foreign based companies; (2) increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability; and (3) competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses." *Id.* at 9-10.

6. *Id.* letters dated July 31, 1984 and August 31, 1984.

7. In 1978, the U.S.-U.K. income tax treaty was ratified by the Senate only after a reservation to Article 9(4) was included. The Article 9(4) reservation prevented the treaty provisions from limiting the taxing authority of state and local governments in the United States. See Dexter and Nolan, *The U.K. Tax Treaty: A Debate*, TAX NOTES, Vol. 6, No. 16 at 403-16 (April 17, 1978).

8. See Fiamma, *U.K. Retaliation Against Unitary Taxation*, TAX NOTES, Vol. 28, No. 10 at 1137-38 (Sept. 2, 1985).

intended to pressure those states or the federal government into enacting legislation that prohibits the worldwide method.

The amendment has already done more than simply affect the debate in California and within the Treasury Department. Sen. Baucus (D-Mont.), has introduced legislation that would double to 30 percent a U.S. withholding tax on dividends paid to U.K. firms.⁹ Also, interest has been awakened in a provision of the Internal Revenue Code that would double the tax rates on corporations of foreign countries that levy discriminatory taxes against American corporations.¹⁰

III. Action in State Legislatures

At the time the Working Group Report was issued, twelve states imposed the worldwide unitary method. Since that time, the law has been repealed in Colorado,¹¹ Florida,¹² Idaho,¹³ Indiana,¹⁴ New Hampshire,¹⁵ Oregon,¹⁶ and Utah.¹⁷ A judicial decision in Massachusetts found the practice to be unauthorized.¹⁸ In a sixth state, Utah, an administrative regulation was promulgated that would adopt a "water's edge" approach but only if the federal government carries out the second principle of the Working Group Report.¹⁹

There have been attempts to repeal the worldwide method in the remaining states of Alaska, California, Idaho, New Hampshire, North Dakota and Montana. Of these states, California is by far the most pivotal. The California Senate passed in 1985 a bill sponsored by Sen. Alquist, SB 85, which permits the water's edge method upon the payment of an election fee.²⁰ The General Assembly's Ways and Means Committee did

9. Wall St. J., Nov. 13, 1985, at 1, col. 5.

10. Perris, *A Suggested American Response to U.K. Retaliation Against Worldwide Unitary Taxation: Awakening Section 891 of the Code*, TAX NOTES, Vol. 29, No. 10 at 1071-73 (Dec. 9, 1985).

11. COLO. REV. STAT. § 39-22-203, (8-12) (1985); See 2 [Colo.] ST. TAX. REP. (CCH) 94-618(c) through (g).

12. FLA. STAT. § 220.135 (repealed), § 220.03, § 220.131, and § 220.12(b). See 2 [Fla.] ST. TAX. REP. (CCH) ¶ 184-005.

13. BNA Daily Tax Rep. No. 59, G-1 (Mar. 27, 1986).

14. IND. CODE §§ 6-3-2(o), 6-3-2-2.4(a) (1985); See 2 95-149(a), and 95-150 (1985). [Ind.] ST. TAX. REP. (CCH) ¶ 95-149(a) and 95-150.

15. BNA Daily Tax Rep. No. 96, G-1 (May 19, 1986).

16. OR. REV. STAT. §§ 317.010(3), 314.363. See 2 (Or.) ST. TAX REP. (CCH) ¶ 199-010.

17. BNA Daily Tax Rep. No. 39, G-4 (Feb. 27, 1986).

18. Polaroid Corp. v. Commissioner of Revenue, 393 Mass. 490 (1984).

19. Utah State Tax Commission Rule No. A 12-01-F8A, 1 11-712 (1985). See [Utah] ST. TAX. REP. (CCH) ¶

20. *Unitary Method Legislation Moves in California*, TAX NOTES, Vol. 28, No. 1 at 21-2 (July 1, 1985).

not pass this measure before it adjourned September 14, 1985, apparently due to the lack of a deduction for foreign dividends and to the inclusion of an amendment relating to divestiture in South Africa.²¹

On May 15, 1986, the California General Assembly amended the Alquist bill by substituting the provisions of a bill sponsored by Assemblyman Vasconcellas. These provisions phase in the water's edge method on the basis of additional investment in California and they exclude domestic and foreign dividends as well as tax haven corporations. The Senate rejected the amendment so that a conference committee could attempt to draft an acceptable compromise which the Legislature would consider in August.²²

IV. The Federal Legislative Proposal (S. 1974)

On August 16, 1985, the Treasury Department issued a statement that it was deferring consideration of whether to recommend federal water's edge legislation.²³ This was in response to the changes in the six states noted above. However, after seeing the California legislature adjourn without passing a water's edge bill and with the increasing frustration of the British Parliament, the Reagan Administration announced a change in position. On November 8, 1985, the President asked the Treasury Department to draft federal legislation that would prohibit the worldwide unitary method and that would address the question of equitable taxation of foreign source dividends.²⁴

On December 18, 1985, the Treasury Department released its proposal,²⁵ and Sen. Wilson (R-Calif.) announced that he would be its sponsor.²⁶

According to the letter transmitting the Treasury Department proposal to Congress:

The legislation would (i) prohibit states from imposing corporate income tax on a worldwide unitary basis; (ii) limit the ability of states to tax dividends received by U.S. companies from foreign corporations; and (iii) provide states with federal assistance in gathering information necessary to administer their tax laws relating to multinational businesses.²⁷

21. *Unitary Method; Domestic Multinationals Win Another Round*, TAX NOTES, Vol. 28, No. 13 at 1424-25 (Sept. 23, 1985).

22. BNA Daily Tax Rep., No. 245, G-4 (Dec. 20, 1985), No. 97, G-3 (May 20, 1986) and No. 132, G-1 (July 10, 1986).

23. BNA Daily Tax Rep., No. 160, G-1 (Aug. 19, 1985).

24. BNA Daily Tax Rep., No. 218, G-5 (Nov. 12, 1985).

25. BNA Daily Tax Rep., No. 244, J-1 (Dec. 19, 1985).

26. *Id.* at G-2.

27. Letter from James A. Baker, III, Secretary of the Treasury, to the Honorable Thomas P. O'Neill, Jr., December 18, 1985.

A. PROHIBITION OF THE WORLDWIDE UNITARY METHOD

The legislation would permit a state to include in a unitary group only those domestic and foreign corporations that have more than \$10 million of their property, payroll or sales or more than 20 percent of their business activity within the United States.²⁸ However, a state could also include "tax haven corporations" that have significant economic ties to corporations within the water's edge and that are not subject to substantial foreign tax on their net income. In addition, a state could offer taxpayers an unconditional election to be taxed on a worldwide unitary basis. The only other times the worldwide method could be used would be if a taxpayer materially fails to comply with the spreadsheet filing requirements or state tax laws or if the state is unable to obtain material information concerning transactions between certain members of a controlled group of corporations.

B. LIMITATION FOR FOREIGN SOURCE DIVIDENDS

The legislation would not allow a state to tax more than an "equitable" portion of any dividend received from a corporation that cannot be included in the water's edge group.²⁹ A state would have to exclude either 85 percent of such dividends or the portion of the dividend that effectively bears no federal income tax after application of the foreign tax credit or a similar amount that is permitted by regulation. The proposal explicitly does not expand the current right of the states to tax foreign dividends.

C. FEDERAL ASSISTANCE TO STATE TAX ADMINISTRATION

The legislation would require related corporations with substantial foreign activities to file an information return with the Internal Revenue Service.³⁰ This domestic disclosure "spreadsheet" would include the income subject to tax in each state and the method of apportioning and allocating income to each state. It would also disclose the identity of corporations that are more than 20 percent owned and have significant transactions with the reporting corporations. In addition, taxpayer information obtained by the IRS from consenting foreign countries could be

28. See *supra*, note 25; *Text of S. 1974*, TAX NOTES, Vol. 29, No. 13 at 1331-34 (Dec. 30, 1985). See § 7518(a), (c).

29. *Id.* See § 7518(b).

30. *Id.* See § 6039A and amendment to § 6103.

disclosed to the states. Also, taxpayer information could be disclosed to agencies that conduct audits for four or more states.

In addition to the legislative proposal, the IRS has provided training for state tax personnel on international issues, and it has increased its staff for examining international transactions.³¹

V. Implications for the International Business Community

Domestic and foreign multinationals generally view these developments from different perspectives. Their interests are not irreconcilable, but they do complicate any legislative change. Foreign multinationals are primarily concerned about the repeal of the worldwide unitary method. Domestic multinationals are also concerned about a deduction for foreign dividends. This arises from the fact that, as part of the unitary calculation, dividends are eliminated as an intercompany transaction. When a foreign subsidiary is excluded from a unitary group, any dividend it pays can be taxed as income to the U.S. parent, and, in some cases, this produces a higher tax liability than if the subsidiary was included in the unitary group.

For these reasons, foreign multinationals generally supported the Alquist bill in California, and they may be somewhat opposed to the Vasconcellos bill because of the phased-in relief.³² Domestic multinationals claim that a repeal of the worldwide method without a deduction for dividends will place them at a competitive disadvantage.³³ They will generally support the Vasconcellos bill. Both groups will support the federal legislative proposal since it addresses both concerns.

The federal assistance measures were included in the legislative proposal primarily to enable state tax officials to make sure that all of the income earned within the water's edge was properly attributed among the states. This is to be accomplished through the disclosure of more information and an expansion of the exchange of information agreements with the IRS. While tax administrators are hopeful that this will eliminate "nowhere" income, many in the business community are concerned that the spreadsheet requirements will be complex and burdensome and that they will lead to increased audit activity.

31. *Treasury Reacts to ACIR's Objections to Federal Unitary Initiative*, TAX NOTES, Vol. 30, No. 1 at 62 (Jan. 6, 1986).

32. Foreign multinationals also claim that the worldwide method violates the Foreign Commerce Clause of the U.S. Constitution even though U.S. multinationals have not been successful in this regard. See *supra*, note 2, at 141-51.

33. Mattson, *Setting Straight the Unitary Working Group Record*, TAX NOTES, Vol. 30, No. 1 at 57-61 (Jan. 6, 1986).

With regard to foreign corporations, there are three situations in which the federal proposal will have a significant impact—being included in a water's edge group, having to file a spreadsheet, and being included in another corporation's spreadsheet. There are different thresholds or tests for each of these situations.

If a state adopted the standard permitted by the federal proposal, a foreign corporation could be included in a water's edge unitary group if it is subject to tax in at least one state and, if it has assignable to the U.S. annually at least \$10 million in compensation, or sales or purchases of at least \$10 million to or from unrelated parties, or property (other than stock or securities of a corporation) with an original cost of at least \$10 million, or if the average of the percentages of its compensation, sales and property assignable to the U.S. is at least 20 percent.³⁴ A foreign corporation could also be included if it is a "tax haven corporation." This provision applies to a member of a controlled group of corporations that includes at least one corporation that is required to file a disclosure spreadsheet and either carries on no substantial economic activity or makes at least 50 percent of its sales or payments for expenses (other than payments for intangible property) or 80 percent of all payments to one or more corporations included in a water's edge group.³⁵ Furthermore, the company must not be subject to "substantial" foreign tax on its net income. With regard to commercial banks (and perhaps other specified industries), a domestic branch of a foreign corporation would be treated as a separate corporation that is incorporated in the United States.³⁶

A foreign corporation would have to file a domestic disclosure spreadsheet if it is required to file a federal income tax return and if its payments for compensation, assets (valued at original cost) or sales outside the U.S. exceed \$10 million or if its total assets (valued at original cost) exceed \$250 million of which at least \$10 million are located in the U.S.³⁷ With regard to members of affiliated or controlled groups, their compensation, assets and sales will be attributed to the parent corporation or other members of the controlled group.

Information concerning a controlled or subsidiary foreign corporation would have to be included in any spreadsheet filed by its parent if the foreign corporation is required to file a federal income tax return or if it is a tax haven corporation as described above.³⁸

34. *See supra*, notes 25 and 28. § 7518(c)(2)(D).

35. *Id.* § 7518(c)(3).

36. *Id.* § 7518(c)(6).

37. *Id.* § 6039A(c)(1)(A)–(B).

38. *Id.* § 6039A(b), (c)(3).

VI. Conclusion

During the last few months, the unitary taxation issue has been debated more intensely in the California legislature than in Congress. If California repeals the worldwide method, the Reagan Administration will have to decide whether the change conforms to the federal proposal (or is a reasonable alternative) or whether Congress should be asked to override the California state legislature. The Administration may be forced to decide whether the Alquist bill, with its tax on foreign dividends, or the Vasconcellos bill, with its phased-in relief, is a reasonable alternative. Another possibility is that a new proposal may surface such as a deduction for dividends coupled with a disallowance of the interest expense related to investments in subsidiaries.³⁹ If California passes a bill that is acceptable to the Administration, and if the three remaining worldwide states do likewise, the restrictive features of the federal proposal may be eliminated and only the assistance features enacted.

If California does not repeal the unitary method, there will certainly be pressure on Congress to enact preemptive legislation. The British Government has said that it is deferring retaliation on the understanding that the federal proposal will be enacted by December 31, 1986.⁴⁰ Also, the embassies of sixteen industrialized countries and the Commission of the European Communities have sent a letter to administrative and legislative leaders expressing their support for the federal proposal.⁴¹ However, advocates of states' rights are expected to oppose the federal proposal since it would limit the ability of states to determine their tax policy. If this opposition is restricted to the dividend provisions, the foreign multinationals may find this acceptable while the domestic multinationals would not.

In any event, there is at least one more year of twists and turns for the worldwide unitary issue.

39. McLure, *State Exemption of Foreign Source Dividends and Disallowance of Interest Expense*, TAX NOTES, Vol. 30, No. 1 at 55-56 (Jan. 6, 1986).

40. See *supra*, note 26.

41. BNA Daily Tax Rep., No. 91, G-3 (May 12, 1986).