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Backgrounder

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THE UNITARY TAX: OBSTACLE TO FOREIGN INVESTMENT

INTRODUCTION

Encouraging foreign investment in the U.S. long has been a priority of Republican and Democrat White Houses and of labor union leaders. To an impressive degree, they have succeeded. The number of American subsidiaries of foreign corporations, especially Japanese, has increased markedly, creating tens--if not hundreds--of thousands of jobs. This trend, however, is increasingly being threatened by individual states raising an obstacle called the Worldwide Unitary Combination Tax (WWUCT).

The WWUCT formula being used by some states imposes enormous burdens on the foreign multinational corporations. Among them:

- It distorts the measurement of taxable income and often leads to overtaxation.
- It lacks a clear and consistent definition of what comprises a unitary business and thus gives the state tax authority a chance to manipulate taxation policy, creating uncertainty for businesses.
- It imposes high legal and administrative expenses on business by requiring extensive and complicated accounting procedures and conversions of foreign currencies.
- It interferes with the federal government's tax treaties with developed nations.
- It has triggered angry objections and retaliatory threats by industrialized nations, while encouraging some developing nations to imitate it.

Paradoxically, the states are not collecting much revenues by the WWUCT method. This year, all the states using the method together may raise only about $15 million more than they would have by using conventional taxation of U.S. subsidiaries. In the long run, this modest gain could become a huge loss if foreign corporations stop investing in WWUCT states. Losses of such investment means less economic growth.

Despite these problems, the federal government has been reluctant to resolve the WWUCT issue, especially through federal legislative actions. The reasons:

- Since the Reagan Administration is a champion of New Federalism, the White House hesitates restricting the state's right to raise its revenue.

- American-based multinationals oppose exempting only foreign corporations from WWUCT because this would create a competitive disadvantage to the U.S. firms, which presumably still would be subject to other forms of unitary taxation.

- The Supreme Court refused to hear a case involving the WWUCT and foreign-based corporations. Foreign-based corporations lack legal remedy in the U.S.

Though there is mounting pressure at the state level to abolish WWUCT, and some states--most recently Florida--are considering repeal, it may require federal guidelines and action to convince foreign corporations that they will not be treated whimsically by state taxing authorities. For one thing, the Justice Department should encourage the Supreme Court to hear cases involving WWUCT and foreign firms. For another, Congress should pass a joint resolution stating that enactment of WWUCT affecting foreign-based corporations violates international treaties signed by the U.S. Finally, the federal government should encourage governors and other state officials to reject the WWUCT method.

JAPANESE DIRECT INVESTMENT IN THE U.S.

Ronald Reagan often has said that he welcomes Japanese investment in the U.S. and that Washington will do what it can to facilitate such investment. With the U.S. facing a swelling trade deficit, incipient unemployment and protectionist sentiment, U.S. political and labor leaders have encouraged Japanese companies to increase direct investment in the U.S. Japanese corporations have responded by markedly expanding their operations of U.S.-based manufacturing plants. According to the Japanese Finance Ministry, Japanese direct investment to the U.S. at the end of March 1984 totaled about $17 billion, of which over $5 billion was in manufacturing industries.

In a recent survey conducted by the Japan Economic Institute, the number of Japanese affiliated manufacturing companies in the

U.S. has increased from only 12 in the early 1970s to 334 in 1983; currently, 479 plants are operating or under construction.[1]

WHAT IS THE WORLDWIDE UNITARY COMBINATION TAX?

Many state governments in the U.S. long have employed the "unitary tax" method to calculate the state's share of taxable income of American corporations which operate in a number of states; such a firm is called a "unitary business" because it is actually one company even though it operates at various locations around the nation.

Most states levy their corporate income tax on the amount reported in the company's federal income tax form and apportioned by the IRS to the states. But other states use their own formula to increase their revenue.[2] Some of these states use a formula called Worldwide Unitary Combination Tax (WWUCT). Under the WWUCT method, a state calculates its share of the taxable income of multinational corporations, regardless of the place of incorporation, based on the worldwide profits of the parent company. This includes all profits derived from worldwide subsidiaries, affiliates, and sister companies of U.S. and foreign-based companies. This contrasts with the more traditional method of levying tax on the profits earned inside that state.

To calculate WWUCT, a state takes into account the size of a firm's sales, property, and payroll in the state, not merely the profit made in the state. As such, a firm which loses money in a state but makes a profit worldwide would be required to pay taxes to the state. This method was approved by the Supreme Court in 1983 when it upheld the right of California to enforce WWUCT in Container Corporation of America v. California Franchise Board.

As an example, take Kyocera Corporation of Japan, which established its subsidiary, Kyocera International, in San Diego, California. It began manufacturing ceramic packages for integrated circuits packages in 1971. Kyocera International made a profit of $22 million after tax from 1972 and 1983. Kyocera International paid $18 million in U.S. taxes and $350,000 in California taxes during those eleven years. Recently, however, California began applying WWUCT methods and charged Kyocera $21 million in

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1 "Japan's Expanding U.S. Manufacturing Presence: 1983 Update," JEI Report, No. 15A, Japan Economic Institute, April 13, 1984.

2 For a more detail categories of unitary taxation, see Norman E. Rusch and J. Lloyd Kennedy, "State Revenues That Would Be Lost By Prohibiting Worldwide Unitary Taxation Or The 'Flaky Data' Caper," Tax Notes, December 19, 1983, pp. 1035-1043. And Phil Krevitsky and the State and Local Tax Group of Arthur Young, Unitary Tax: The Corporate View (New York: Arthur Young for the Council of State Chambers of Commerce, June 1984), pp. 21-23.

back taxes (including interest), arguing that Kyocera and its parent are engaged in a unitary business. This means, said California, that California is entitled to tax the profits of the entire Kyocera Corporation, not just its subsidiary called Kyocera International. By this reckoning, California imposed a tax of $21,350,000 on Kyocera, or nearly 100 percent of the subsidiary's profits for those years. (With the federal deduction, the actual tax to Kyocera International would be about $10 million.)

WWUCT BURDENS ON FOREIGN-BASED MULTINATIONALS

Overtaxation

Foreign-based multinationals, such as Kyocera Corporation of Japan, obviously have to pay income tax to national and local governments in the various countries in which they operate. Japan's effective tax rate, for example, is about 53 percent (the sum of corporate tax, enterprise tax, and local tax), which Kyocera Corporation paid in Japan. Kyocera International in California also paid the federal and state tax rates which totaled about 51 percent. Thus applications of WWUCT to foreign-based multinationals, such as Kyocera Corporation, on top of these tax payments would impose a tax burden on Kyocera greater than that on firms not operating in WWUCT states.

Unfair Taxation

When state tax authorities apply WWUCT to a foreign parent corporation, they calculate the state's share on the basis of pre-tax worldwide income. They do not allow credits or deductions for taxes already paid in the firm's own country. Thus taxable income of foreign-based corporations can be assessed much higher than for U.S.-based companies.

Since foreign-based multinational corporations, such as Kyocera Corporation, generally have business activities in their own country that are much larger and usually more profitable than their subsidiaries in the U.S., application of WWUCT to foreign-based multinational corporations usually yields high revenue to the states.

On the other hand, application of WWUCT to American-based corporations, especially those which have profitable business operations within WWUCT states but less profitable enterprises outside these states, results in a substantial loss of revenue for the state government. As such, state governments do not always benefit from WWUCT. Standard Oil of Indiana economist James L. Johnston explains that "The multistate firms that gain from combined apportionment are those with higher average profitability [as measured by property, payroll, and sales] inside the state than outside the state. Firms that lose from combined apportionment, conversely, are those with higher average profitability outside the state."[3]

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[2] James L. Johnston, "Illinois' Unitary Tax: No Free Lunch," Heartland Policy Study No. 1, The Heartland Institute, October 10, 1984.

Finally, under the WWUCT foreign parent companies are forced to pay tax to the state even though they receive no services, such as roads and water, from the state government.

Inconsistent and Unclear Definition of "Unitary Business"

There is no clear, operational definition of what constitutes a "unitary business." Consequently, tax authorities of WWUCT states tend to assess the taxable income of foreign-based corporations arbitrarily and tend to manipulate the WWUCT formula. .

The generally accepted definition of a "unitary business" is when a company demonstrates the three unity factors of ownership, use, and operation. However, many Japanese-based firms are judged to be a part of a unitary business simply because they hold more than 50 percent of the stock of a U.S. subsidiary, even though there are no unities of use and operation among the parties involved. In other words, there are no exchanges of raw materials or goods between the Japanese parent and its U.S. subsidiary, no centralization of managerial and supervisory functions on the part of the parent, and no financing or loan guarantees provided to the subsidiary by the parent company in Japan.

High Administration Expenses

Foreign-based corporations, such as Shell Petroleum, N.V., have many subsidiaries or affiliates around the world. These subsidiaries keep their accounting books in the currency of the country they operate. Because currency exchange rates fluctuate daily and accounting standards and tax treatment vary among different countries, it is almost impossible for Shell to provide accurate information in U.S. dollars.

The complexity of the WWUCT method makes it extremely difficult for state tax officials and the foreign-based parent companies to agree on how to compute the taxable income and the apportioned share of the worldwide combined income. Consequently the state tax authorities exert very arbitrary judgment and force subsidiaries of foreign-based firms to hire extra legal and accounting professionals.

PROBLEMS FOR THE U.S. FEDERAL GOVERNMENT

Treaty Commitment to Foreign Governments

To prevent foreign countries from imposing some form of WWUCT on foreign subsidiaries of U.S.-based multinational corporations, Washington has concluded tax treaties with most developed nations. These treaties endorse what is referred to as the "arm's length method." Under this, the U.S. Internal Revenue Service considers subsidiaries of foreign-based corporations to be separate companies. As such, U.S. federal tax on the subsidiary is based only on the income earned in the U.S.; most states use

the information provided by the federal government to assess state liability of these subsidiaries.[4]

The "arm's length" method is by no means perfect, but is internationally accepted. Most foreign governments use this when taxing the subsidiaries in their country of American-based multinational companies. When U.S. states, therefore, employ WWUCT methods, they contradict Washington's treaty commitments and the internationally recognized norm of taxing corporate incomes. Washington seems powerless to assure a consistent policy. This may encourage foreign nations to negotiate tax agreements with individual states. In fact, Japanese groups have begun intensive lobbying activities in WWUCT state legislatures.

The U.S. government currently is negotiating tax treaties with Italy, Switzerland, Ireland, Sweden, Finland, Cyprus, Indonesia, and Thailand. And U.S. negotiators have begun talks with the Tokyo government on increasing bilateral investments in both countries. In these talks, frustrated foreign goverments could use the WWUCT issue as a bargaining chip.[5]

The United Kingdom, with $23 billion of direct investment in the U.S., is America's largest foreign investor; the Netherlands and Canada are next. London has protested strongly against WWUCT. Several retaliatory legislations were introduced in Parliament. Developing nations, meanwhile, may follow the U.S. states by establishing WWUCT-type tax systems. India, Nigeria, and other Third World nations apparently have already expressed interest in this.

THE STATES' REVENUE AND THEIR ECONOMIC GROWTH

States Using WWUCT

When the issue of abolishing WWUCT is debated, it is often argued that the states would lose significant revenue which they collect with the tax. Yet only six states tax foreign-based corporations using WWUCT. They are: Alaska, California, Florida, Idaho, Oregon, and North Dakota. Oregon, however, last year decided to abolish WWUCT in 1986. Just how much these states collect by WWUCT is questionable. No information, for example, is available for Oregon or Florida, which enacted WWUCT just this year and already is considering abolishing it. Alaska, Idaho, and North Dakota, meanwhile, have very modest WWUCT income. The potentially big WWUCT beneficiary is California. Its tax officials estimate 1980 WWUCT revenues at about $485 million from both U.S.-

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4 See George B. Javaras and James R. Browne, "Litigation Prospects After Container: The Foreign Parent Issue," Tax Notes, December 19, 1983, pp. 1029-1034.

5 Ibid.

based and foreign-based firms with subsidiaries in California. This estimate, however, is highly questionable.[6]

According to economist Steven M. Sheffrin of the University of California (Davis), only $87 million out of California's $2.5 billion corporate income revenues came from foreign-owned multinationals through the WWUCT in 1980. He said "the bulk of California's corporate tax revenue came from corporations that are not multinational and its share coming from foreign-headquartered multinationals is a very small part of the total."[7]

Eliminating WWUCT, of course, does not mean that California will lose all of the $87 million. Sheffrin estimates that if California enacts the "arm's length" tax method used by most states, it may lose only 10 to 20 percent of WWUCT's $87 million.[8]

LONG-TERM REVENUE LOSSES TO WWUCT STATES

If states persist in using the WWUCT method, foreign-based corporations, especially Japanese, understandably will not want to make further investments in those states. They even may want to shut existing plants and relocate to a non-WWUCT state. Foreign-based corporations contemplating initial investment in the U.S., moreover, are not likely to locate in WWUCT state. This has been confirmed in recent years. Examples:

Case #1. Japan's largest computer builder, Fujitsu Ltd., which has U.S. subsidiaries, Fujitsu America Inc. in San Jose and Fujitsu Microelectronics Inc. in Santa Clara, California, announced it will build two new plants in Portland, Oregon for $170 million. In selecting Oregon, Fijitsu Ltd. officials cited the reason that Oregon decided to drop the unitary tax on foreign-based multinationals.

Case #2. Nippon Electric Corporation (NEC) of Japan announced last May that it will build a $25 million fiber-optics communications equipment factory in Oregon. Japan's Suwa Seiko-sha Company also intends to invest in Oregon rather than California to build a large printer factory.

Case #3. Japan's Kyocera Corporation last August decided to build a new $30 million plant in Washington state rather than expanding its San Diego, California facility.

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6 See Rusch and Kennedy, op. cit., and Norman E. Rusch and J. Lloyd Kennedy, "Once Again, We Question Alleged Revenue Effects of Restricting Use of the Worldwide Unitary Tax," Tax Note, February 20, 1984, pp. 724-728.

7 "Foreign Governments Up In Arms Over State Taxation of Multinationals," National Journal, October 8, 1983, p. 2056.

8 Conversation with Steven M. Sheffrin, October 1, 1984.

Case #4. Sony Corporation has decided to build a new television factory in Alabama instead of in California or Florida. Sony also plans to build a new $20 million compact audio disc factory in Indiana rather than in California after Indiana Governor Robert D. Orr pledged to block the WWUCT system in his state.

Case #5. Officials of the Keidanren, Japan's leading business association, recently disclosed a survey revealing that 88 major Japanese corporations would invest more than $1.4 billion in California--and create some 11,000 jobs--if the state repealed the WWUCT.[9]

The losses of these potential investments in WWUCT states, particularly California, means the loss of the potential revenue in local property taxes on new corporate investment and in income tax. It also means higher welfare and unemployment expenditures. On the other hand, a state, such as Oregon, which repealed WWUCT, will enjoy increased revenue generated by increased investment from abroad.

WWUCT states may not only be chasing away foreign-based multinationals, but American-based multinationals as well. They will not want a share of their profits earned overseas to be taxed by WWUCT states. On the other hand, U.S.-based firms with losses from overseas operations actually benefit from WWUCT because they can use these losses to offset U.S.-based profits. In this sense, WWUCT rewards unsuccessful companies and penalizes the successful. According to Crain's Chicago Business, in a 1984 article, in Illinois where WWUCT was retroactively imposed for three years, the refunds have outstripped the new revenue by $290 million, and that may not be the full extent of the revenue drain.[10] Illinois in 1979 repealed WWUCT.

SOLVING THE WWUCT PROBLEM

Federalism, National Interests, and States' Rights

Alarmed that many other states would follow Florida in imposing WWUCT, legislation was introduced in both houses of Congress in 1982 to prohibit states from taxing corporations located and operating beyond the United States. Action has not been taken on the bills, however, mainly because the Reagan Administration has not supported it strongly. Since Reagan champions New Federalism, he has been reluctant to restrict the state's right to raise revenue. Yet the White House has estab-

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9 Asahi Shimbun, August 11, 1984.

10 See Jeff Brody, "Income Tax Surcharge to Die, But Not Illinois' Budget Woe," Crain's Chicago Busines, January 2, 1984; "Living Within the Budget," Crain's Chicago Business, March 19, 1984.

lished a Working Group on WWUCT, composed of representatives of the federal and state governments and the business community. This working group decided to encourage the WWUCT states voluntarily to abandon the WWUCT method. No federal legislation was recommended.

Fairness to American-based Multinationals

Abandoning the application of the WWUCT method to foreign-based multinationals does not mean that a state will not apply the WWUCT to the American-based corporation; the state will just use another form of unitary taxation, called Domestic Worldwide Combination (used in Colorado, Massachusetts, Montana, New Hampshire, Utah and Oregon in 1986) or Domestic Combination (used in Kansas, Maine, Minnesota, Nebraska and on a selective basis by North Carolina and Arizona). Under these methods, the dividends sent to the U.S. by the subsidiaries of the American firms abroad, which include "80/20" corporations (which do 80 percent or more of their business outside the U.S. or so-called Delaware corporations), would be included in total corporate income.

American-based corporations feel that the income they earn in foreign countries already has been taxed heavily by that country. Taxing dividends sent from abroad to the U.S., therefore, amounts to punitive multiple taxation. If the dividends sent back to American headquarters from their subsidiaries abroad are not exempted from U.S. taxation, the American multinational corporations would find itself at competitive disadvantage relative to foreign-based corporations.

No Clear Legal Position for Foreign-based Multinationals

Last year's Supreme Court decision, by a 5-3 vote, on Container Corporation of America v. California Franchise Board, which upheld the state's right to enforce the WWUCT, applied only to U.S.-owned multinational corporations, but left open the question of whether the state governments can apply this to foreign-owned U.S. subsidiaries. The Supreme Court has refused to hear a case that challenges the validity of applying WWUCT to the foreign corporations.

So far foreign-based companies have no clear legal remedies available to them in the U.S. to challenge WWUCT. Shell Petroleum N.V., a Netherlands company, filed suit in federal court saying that the state of California is trying to tax its worldwide income through the U.S. subsidiaries. But the federal appeals court ruled in June 1983 that only the U.S. subsidiaries of the foreign corporation (Shell Oil Corporation) could challenge the tax in the U.S. federal courts, not the foreign parent company, Shell Petroleum, N.V. The appeals court also stated that the foreign-based subsidiaries in the U.S., such as Shell Oil Corporation, cannot invoke the treaties between the U.S. and the Netherlands upon which their legal claims rest, since the U.S.

subsidiaries of foreign parent corporations are the domestic corporation in the U.S.[11]

CONCLUSION

The recent developments of the individual WWUCT states, particularly the repeal by Oregon and the imminent repeal vote by Florida demonstrate that federal legislation restricting state use of WWUCT to foreign-based multinationals may not be necessary. Yet to encourage foreign corporations to continue investing in the U.S., the Reagan Administration should declare firmly that state taxation, such as WWUCT, interferes with the federal government's power to conduct foreign commerce. The Justice Department should encourage the Supreme Court to hear a case based on this.

Congress, moreover, should pass a joint resolution proclaiming that WWUCT violates international treaties and norms. The federal government, meanwhile, should encourage governors and other state officials not to propose WWUCT-type tax systems.

Unitary taxation of corporations, foreign-based or American-based, is bad tax and economic policy. Successful multinational corporations regardless of corporate nationality will avoid investing in states that apply unitary taxation or combined apportionment. So long as other states impose no unitary tax method or have no corporate income tax at all, the unitary tax states will forfeit economic growth. At a time when the U.S. should be trying to shrink its international trade deficit and create new jobs, states should not be erecting new obstacles to foreign plant investment.

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11 "Justices Refuse Shell's Appeal on State's Levy," The Wall Street Journal, December 6, 1983.