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Federal Law and State Corporate Income Taxes

Charles E. McLure, Jr.

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FEDERAL LAW AND STATE CORPORATE INCOME TAXES

*Charles E. McLure, Jr.**

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I. INTRODUCTION

Beginning as early as 1959, when the Supreme Court handed down its decision in *Northwestern States Portland Cement* and *Stockham Valves,*[1] the business community has repeatedly asked

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1. Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450,

that federal legislation be enacted to restrict the scope of permissible state action in taxing corporate income. In the intervening quarter century, the only federal legislation on state corporate income tax was P.L. 86-272, which restricted the ability of states to tax a nondomiciliary company when the company's only activity in the state was the solicitation of sales. In 1983 following the Court's decision in *Container Corporation of America*,[2] foreign corporations and foreign governments joined United States multinationals in the protest against worldwide application of the unitary method of apportioning corporate income for state tax purposes.

In the wake of the *Container* decision, opponents of worldwide unitary combination strongly urged the Reagan Administration to introduce and actively support legislation that would restrict state use of the unitary method and also to support the Container Corporation's petition for rehearing before the Supreme Court. In response to this pressure, President Reagan asked Treasury Secretary Donald Regan to convene the Worldwide Unitary Taxation Working Group. The charge given to the Working Group was to reconcile the conflicting objectives of state governments, foreign governments, and domestic and foreign multinational corporations.

Many observers may have perceived that the purpose of the Working Group was to propose federal legislation that would outlaw the use of the unitary method "beyond the water's edge." These observers were likely confounded when, at its second meeting on December 6, 1983, the Working Group agreed to rule out — at least initially — restrictive federal legislation as a means of addressing the "unitary problem." Yet, at its last meeting on May 1, 1984, and in its Final Report issued on August 31, 1984, the Working Group endorsed federal legislation.[3] Rather than outlaw worldwide unitary combination, the federal legislation proposed by the Working Group would assist the states in the administration of corporate income taxes on the state level, provided the

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(1959) (the case was tried together with *Williams, State Revenue Commissioner v. Stockham Valves & Fittings, Inc.*).

2. Container Corporation of America v. Franchise Tax Board, 103 S. Ct. 2933 (1983).

3. U.S. DEPARTMENT OF THE TREASURY, THE FINAL REPORT OF THE WORLDWIDE UNITARY TAXATION WORKING GROUP: CHAIRMAN'S REPORT AND SUPPLEMENTAL VIEWS, August 1984 [hereinafter cited as FINAL REPORT].

states agreed to restrict application of unitary taxation to "the water's edge."

On July 8, 1985 the Treasury Department released for public comment a draft of the federal assistance legislation recommended by the Working Group. The proposed legislation would require many corporations to file along with their federal income tax return a "domestic disclosure spreadsheet" describing the calculation of tax liabilities reported to various states by them and their affiliated corporations.

Section II describes briefly the unitary method of taxing corporations, its rationale, and its application on a worldwide basis. Section III sets the stage for the discussion of the activities of the worldwide Unitary Taxation Working Group in sections IV to VI by summarizing the decision in the *Container* case and the reaction to it. Section IV summarizes the problems that are perceived to plague worldwide unitary combination and separate accounting, and section V describes the options considered by the Working Group. Section VI outlines the recommendations contained in the Final Report of the Working Group, and section VII elaborates on a crucial component of those recommendations, the "federal initiatives" that would assist the states in administering their corporate income taxes. Section VIII summarizes developments since the issuance of the Final Report of the Working Group and comments on prospects for future action at the state and federal level. The draft legislation that provides for a "domestic disclosure spreadsheet," a brief summary, and a technical explanation are included in the appendix to this article.

II. Salient Features of Worldwide Unitary Combination

States generally do not attempt a precise calculation of the income of an individual corporation that has its source in a particular state. Considering the many economic interactions among corporate activities carried on throughout the nation, a precise calculation is all but impossible. The states are not constitutionally required to determine the source of income in order to levy state income taxes. The Due Process and Commerce Clauses of the United States Constitution require only that the income tax levied by a state be reasonably related to activities in that state. Thus, the states commonly apportion income earned throughout the nation between the taxing state and the rest of the nation on the basis of a formula that reflects the importance of in-state and out-of-state activities. The most commonly used apportionment

formula accords equal weight to in-state fractions of payroll, property, and sales. It is generally agreed that the arbitrary formula results in a satisfactory apportionment of a given domestic firm's nationwide profits among the various states in which the firm operates. In addition, the courts traditionally have held that the formula is constitutionally permissible.

Imaginative taxpayers long ago discovered techniques of circumventing the income taxes that were levied on legally separate but affiliated firms by geographically limited jurisdictions such as the states. For example, if state A has an income tax and state B does not, it is a simple matter to establish separate but affiliated corporations in the two states. The common management of the two firms can use artificial transfer prices to shift income to the state B affiliate, thereby avoiding the income tax of state A. To prevent this type of manipulation of the attribution of income, state tax administrators have ruled that where two commonly owned corporations are engaged in a unitary business, the apportionment formula should be applied to the "combined" income and activities of the affiliated firms in order to calculate the taxable income of the corporation doing business in the taxing state.[4]

Various tests have been proposed to establish the existence of a unitary relationship. "[I]nterdependence and contribution" and the "three unities" of ownership, operation, and use have been employed by the courts to determine whether a unitary business exists. More recent court cases have emphasized centralized management and the flow of value. The present author has suggested that the definition of a unitary business is essentially tautological; a unitary business exists if (and only if) separate accounting does not adequately isolate the income of an individual corporate entity.[5] Economic interdependence and substantial transactions between affiliated corporations are generally recognized to be potentially important to such economic unity.[6]

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4. For an excellent review of the development and current application of the unitary concept, see Miller, *Worldwide Unitary Combination: The California Practice*, in C. McLure, Jr., ed. The State Corporation Income Tax: Issues in Worldwide Unitary Combination 132-66 (1984) [hereinafter cited as Issues in Worldwide Unitary Combination].

5. *See* McLure, *Defining a Unitary Business: An Economist's View*, in Issues in Worldwide Unitary Combination, *supra* note 4, at 89-124.

6. *See* McLure, *Operational Interdependence Is Not the Appropriate "Bright Line Test" of a Unitary Business—At Least Not Now*, 18 Tax Notes 107-10 (Jan. 10, 1983).

The same reasoning that justifies the combination of the activities of related entities operating across state borders can also be used to justify the combination of affiliated corporations in a multinational group. The result, worldwide unitary combination, is far different from separate accounting, which is the practice generally followed by national governments that deal with the international division of income among affiliated firms. Under separate accounting, the activities of affiliated firms that have no permanent establishment in a given country are ignored (at least, in the absence of manipulation of transfer prices) in the calculation of the affiliates' tax liabilities to that country.

III. REACTION TO THE *Container* DECISION

While recently there has been relatively little opposition to the domestic application of the unitary tax concept, except where inclusion of foreign-source dividends in apportionable income is at stake, both foreign and domestic multinationals have objected strongly to any extension of the unitary principle to foreign affiliates of corporations operating in the United States. The multinationals also have been joined in raising objections by foreign governments who view the application of worldwide unitary combination to firms headquartered in their countries as a form of extraterritorial taxation that is inconsistent with generally accepted principles of international law. Following the June 1983 refusal of the Supreme Court to rule against California's use of worldwide unitary combination in the *Container* decision, the general reaction of outrage was swift and vocal. President Reagan was asked to direct the United States Solicitor General to support Container's request for a rehearing before the Supreme Court and to support federal legislation that would prohibit worldwide unitary combination.

In the *Container* decision, the Supreme Court decided three issues of increasing specificity to the particular case at hand. First, the Court ruled that worldwide application of the unitary concept to a United States based multinational was not inherently unconstitutional. Second, it rejected Container's contention that it was not engaged in a unitary business with its foreign subsidiaries. Third, the Court decided that although the application of the unitary method may have resulted in some mismeasurement of Container's income attributable to California, the resulting mismeasurement failed to render unitary apportionment impermissible. Although the Supreme Court explicitly noted that it was re-

serving judgment on how it would settle a case involving a foreign-based multinational, the reservation gave little comfort to foreign governments and foreign companies.

Undoubtedly the Reagan Administration was in an awkward position. Worldwide unitary combination had become the source of considerable international tension. Yet, the Administration could not simply outlaw worldwide unitary combination, even had the President been so inclined. The states probably could have successfully resisted restrictive federal legislation, at least in one house of the Congress. The President, moreover, a former Governor of California and staunch supporter of states' rights, was not inclined, in any event, to favor federal legislation that would restrict state fiscal sovereignty. Faced with this uncomfortable situation, the President rejected the recommendation of a Cabinet Council group advocating such legislation and asked Treasury Secretary Regan to appoint the Worldwide Unitary Taxation Working Group. Besides Regan, the Working Group included the following: the governors of California, Illinois, and Utah; three state legislators; representatives of two organizations of state tax administrators (the National Association of Tax Administrators and the Multistate Tax Commission); eight business representatives (seven of whom were chief executive officers of major corporations); and representatives of the White House, State Department, and Advisory Commission on Intergovernmental Relations. The Working Group was charged with "producing recommendations . . . that will be conducive to harmonious international economic relations, while also respecting the fiscal rights and privileges of the individual states."[7] Given the great differences in viewpoints of its state and business members, the Working Group was given little chance of success.

IV. Perceived Problems

There is no totally satisfactory means of dividing the income of a multijurisdictional company (or group of companies) among the various jurisdictions in which it operates. During its deliberations, the staff-level Task Force of the Worldwide Unitary Taxation Working Group heard objections to the use of both unitary apportionment and separate accounting to achieve such a division. In its Final Report, the Working Group noted that the following

7. Final Report, *supra* note 3, at 3-4.

problems were perceived to exist with worldwide unitary combination:

> Compared to separate accounting, worldwide unitary combination may distort the measurement of taxable income. It may result in either over or undertaxation.
>
> Because of possible income and factor distortion for both U.S. and foreign-based companies, worldwide unitary combination may interfere with international trade and investment flows and harm the competitive position of U.S. industry.
>
> Because of a relatively larger proportion of foreign to U.S. activities, the income distortion may be greater for foreign-based multinationals than for domestic-based groups.
>
> Worldwide unitary combination departs from the internationally accepted standard of taxation, which is based on "arm's-length" or separate accounting principles.
>
> Worldwide unitary combination has given rise to vigorous objections by both foreign governments and foreign business and may lead to retaliatory actions.
>
> Worldwide unitary combination is administratively burdensome and complex, especially for a foreign-based multinational which must report its worldwide income and apportionment factors in U.S. dollars under tax accounting principles used by the unitary states. A U.S. subsidiary may not have access to the necessary information relating to the activities of its foreign parent and sister subsidiaries, and may be prohibited by foreign law from gaining access to that information.
>
> The absence of a consistent and appropriate definition of a unitary business gives rise to an unacceptable degree of taxpayer uncertainty and may discourage investment in the United States.
>
> The Congressional General Accounting Office concluded that the states use a "bewildering variety of rules" in taxing multistate and multinational corporations and that this raises issues of international tax policy and states' rights that should be resolved by the U.S. Congress.[8]

On the other hand, the Working Group reported that the following problems were perceived as characteristic of separate accounting:

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8. *Id.* at 7.

Compared to worldwide unitary combination, separate accounting may distort the measurement of taxable income; it may result in either over or undertaxation.

Because of possible income distortion, separate accounting may lead to undertaxation of multinationals. It may shift the corporate tax burden onto smaller business [*sic*] and put them at a competitive disadvantage.

Because of the economic interdependence created by shared expenses, economies of scale, and other factors within a multinational corporate group, separate accounting may fail, even in theory, to measure income accurately.

Separate accounting departs from the accepted method of taxation of a multijurisdictional unitary business, which is formula apportionment.

Provisions protecting the confidentiality of tax information in current exchange of information agreements between the United States and foreign governments may prevent the federal government from sharing with the states the information received from other countries which would assist the states in verifying the allocation of income between affiliated firms determined under separate accounting.

Separate accounting is administratively complex. Given the large number of transactions that must be reviewed in an "arm's-length" audit, it may be administratively burdensome for state revenue officials as well as taxpayers. States lack the resources to administer it effectively.

The absence of consistent and appropriate ways to determine "arm's-length" prices may create an unacceptable degree of taxpayer uncertainty.

Separate accounting has been criticized by Congress' General Accounting Office and others for failing to provide a consistent and equitable measurement of income.

While most industrial nations have signed tax treaties committing themselves to the "arm's-length" theory, the rules and levels of implementation of separate accounting are not uniform.[9]

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9. *Id.* at 8.

V. The Task Force Options

After prolonged negotiations, the Task Force was ultimately unable to settle on a single policy recommendation for submission to the Working Group. The lack of agreement on policy recommendations resulted from fundamental philosophical differences among the members over several key issues. Instead, at the final meeting of the Working Group, the Task Force submitted six options for consideration by the Working Group. Option One, an "activities tax," would be available only to domestic affiliates of foreign multinationals. Under this option, a tax would be levied directly on those activities in a state that are reflected in that state's apportionment formula (typically payroll, property, and sales). The tax rate applied to each activity would be calculated to approximate the average effective rate paid on those activities by United States based firms. This approach, opposed by business representatives on the Task Force, had little state support and probably would not have met foreign objections to worldwide unitary combination.

The remaining five options were variations of a theme. All contained a group of "common elements," but differed from each other in crucial ways, most notably in their treatment of two key issues: foreign-source dividends and United States corporations operating primarily abroad (so-called "80/20 corporations"). The most important of the common elements was a definition of the "water's edge" group of affiliated firms that could be subjected to domestic combination and a list of measures that should be undertaken by the federal government to help the states insure full disclosure and full accountability of corporate taxpayers. These elements are discussed further in section VII.

Option Two, the state "flagship" option, provided for full inclusion of foreign-source dividends in the taxable income of the water's edge group. It provided no adjustment of the formula used to apportion income among the states for the activities of the foreign corporation paying the dividends. Option Three, an alternative state option, would adjust the apportionment formula for the factors of the dividend-paying subsidiary, but would include in taxable income gross foreign-source dividends and, therefore, foreign income and withholding taxes. Both options would permit states to include 80/20 corporations in the water's edge group subject to domestic combination.

The primary business option, Option Four, would exclude dividends paid by foreign subsidiaries from apportionable income

subject to tax. Option Five, the alternative business option, would use a special rule to determine the fraction of foreign-sourced income (interest and royalties, as well as dividends) to be included in the state tax base. Both business options would exclude 80/20 corporations from the group subject to domestic combination.

Option Six, proposed by the representative of the Advisory Commission on Intergovernmental Relations, would allow each state to resolve the dividend issue on an individual basis, subject only to the proviso that foreign-source dividends would not be taxed more heavily than dividends received from domestic corporations. Under this option, 80/20 corporations would have been subject to domestic combination.

Throughout its negotiations, the Task Force operated under an oft-repeated caveat that "there is no deal until there is a deal." It also expressed this view to the Working Group:

> While Options Two through Six may contain many common elements, they differ in several areas, most notably in the proper state tax treatment of dividends received from foreign subsidiaries and of U.S. corporations with predominantly foreign business operations. All Task Force members believe that these issues are critical and that their resolution must be part of any solution to the problems at hand. The Task Force, in other words, believes that it would not be acceptable to settle solely on the Common Elements in Options Two through Six as the solution to the "unitary problem," but leave unresolved the issues of foreign dividends and U.S. corporations with foreign operations.[10]

In other words, the common elements were something the group could agree on, *provided* agreement could be reached on issues that had divided the Task Force. No one on the Task Force would endorse the common elements without regard to the treatment of dividends, 80/20 corporations, and various other issues on which the Task Force had been unable to reach agreement. Stated alternatively, "neither side should be able to attach the common elements to its favorite treatment of dividends and 80/20 corporations and say that the package had the blessing of the Task Force."[11]

At the final Working Group meeting, Governor Deukmejian of California proposed an approach that had not previously been

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10. *Id.* at 27.

11. *See* McLure, *Unitary Taxation: The Working Group's Contribution,* 24 TAX NOTES 882 (Aug. 27, 1984).

considered by the Task Force. He suggested that corporations be allowed to choose between a) Option Two, with its treatment of dividends and 80/20 corporations, and b) unitary combination, as currently practiced. This approach, of course, would satisfy the objections of most foreign multinationals and of our trading partners. Because the treatment of foreign-source dividends and 80/20 corporations is of little concern to foreign-based firms, they would simply choose the separate accounting treatment of Option Two. On the other hand, the availability of Option Two would provide little solace to domestic multinationals. This option, which provided for full taxation of foreign-source dividends and inclusion of 80/20 corporations in the domestic combination, potentially could be more costly than unitary combination for many domestic firms. Moreover, adoption of the Deukmejian approach would be politically disadvantageous for domestic multinationals because it would eliminate the concerns of the foreign multinationals and foreign governments who had been important allies in the fight against worldwide unitary combination.

VI. THE WORKING GROUP RECOMMENDATIONS

As with the Task Force, the Working Group was also unable to agree on a single option at its final meeting. Instead, it settled on three principles that should guide resolution of the unitary problem. These were as follows:

> 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.[12]

The questions of whether and how to tax foreign-source dividends and whether to include 80/20 corporations in the water's edge group were left for resolution at the state level, consistent with the third principle.

Both state and business representatives feared that the other group would seize on one principle (or, at most, two) and ignore the others. Thus both groups insisted that these three principles

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12. FINAL REPORT, *supra* note 3, at ii; *see also id.* at 4-5.

were to constitute a unit. In the words of the Final Report of the Working Group:

> The Working Group emphasizes that implementation of these three Principles is dependent on resolution of the issues involving foreign dividends and "80/20" corporations. The Working Group agrees that the three Principles form an indivisible package. The business group endorses the above Principles only with respect to those states whose tax practices are in compliance with Principles One and Three. The state group endorses the above Principles only on the understanding that Principle One is conditioned on compliance with Principles Two and Three.[13]

In a letter submitting the Chairman's Report of the Working Group to President Reagan, Secretary Regan stated that:

> [i]f there are not sufficient signs of appreciable progress by the states in this area by July 31 of next year, whether by legislation or administrative action, I will recommend to you that the Administration propose Federal legislation that would give effect to a water's edge limitation patterned after that in the Chairman's Report.[14]

He noted, however, that "[p]rogress to date gives me reason to hope that it will not be necessary to enact Federal legislation in order to resolve this problem."[15] He also recognized that action in some states might be dependent on federal action to implement Principle Two: "In order to demonstrate the good faith and sincere intentions of the Federal Government, I am proposing at this time that the Treasury Department move immediately to implement the Federal assistance measures recommended by the Working Group to promote full disclosure and accountability."[16]

VII. THE DISCLOSURE SPREADSHEET[17]

Principle Two of the Final Report of the Working Group calls for the federal government to enact legislation that would require

13. *Id.* at 10.
14. *Id.* at iii.
15. *Id.*
16. *Id.*
17. This brief summary is intended only to indicate the broad outlines of the draft federal assistance legislation recommended by the Working Group; it is not intended to interpret or alter those recommendations. See Appendices B and C for the Treasury Department's technical explanation and nontechnical summary of the draft legislation.

many large corporations to file with the Internal Revenue Service a "domestic disclosure spreadsheet." On July 8, 1985, Secretary of the Treasury James A. Baker, III released for public comment draft legislation that would give effect to this recommendation. That draft legislation and the technical explanation thereof are reproduced as Appendices A and B; Appendix C is a brief non-technical summary of the legislation. The press release announcing the draft legislation (Appendix D) indicated that public comments would be received until August 15 and that legislation was expected to be introduced after the Congress returned from its August recess.

The spreadsheet would disclose the tax liability and its method of calculation for a corporation and its affiliates for each state in which they operate. The Internal Revenue Service would—subject to safeguards on unauthorized disclosure and treaty limitations—be allowed to share the spreadsheet information with "qualified states" and with common agencies (such as the Multistate Tax Commission) acting on behalf of four or more qualified states to assist in administration of their taxes. Qualified states would be those that do not require worldwide unitary combination, except in these circumstances: failure of the taxpayer to comply with requirements for filing the spreadsheet or with state legal and procedural requirements; failure of separate accounting, after necessary and appropriate adjustments, to prevent evasion of taxes and clearly reflect income; and failure to provide relevant information on a foreign-based parent or refusal of access to such information by a foreign government. A state would not have access to spreadsheet information on taxpayers filing on a worldwide unitary basis in that state.

In order to determine state eligibility to receive spreadsheet information, it is necessary to define permissible application of unitary combination. For a state to be a qualified state, its application of unitary combination must be restricted to the following "water's edge" corporations that are part of a unitary business: United States corporations included in the federal consolidated return,[18] United States possessions' corporations, companies incorporated in United States possessions or territories, domestic international sales corporations and foreign sales corporations,

18. The business options would exclude 80/20 corporations from the water's edge group.

corporations operating in tax havens,[19] foreign corporations with a threshold level of activity in the United States, and United States corporations not included in the federal consolidated return that are fifty percent or more owned or controlled by another United States corporation.

VIII. State Actions and Prospects

Since the Final Report of the worldwide Unitary Taxation Working Group was issued on August 1, 1984, five of the twelve states then using worldwide unitary combination have ceased to do so. Oregon, Florida, Indiana, and Colorado have repealed worldwide unitary combination, and the Massachusetts Supreme Court has ruled that the Commissioner of Revenue lacks the statutory authority to require the use of worldwide combination. In addition, Utah has issued regulations that would restrict application of unitary combination to the water's edge. Besides Utah, only Alaska, California, Idaho, Montana, New Hampshire, and North Dakota continue to employ worldwide unitary combination.

Despite these developments, multinational corporations and foreign governments continue to gauge success in their battle against worldwide unitary combination by what is done in California. On July 9, the British Parliament approved an amendment to the finance bill that would empower the Chancellor of the Exchequer to deny refunds of Advance Corporation tax to American firms doing business in states employing worldwide unitary combination.

Utah's regulations restricting unitary combination to the water's edge and proposed legislation in California provide that repeal of worldwide unitary combination be conditioned on substantial compliance with the Working Group's recommendations for increased federal assistance to the states. Thus the prospects for progress in California and the other states still using the worldwide unitary method may depend in part on passage of the federal legislation requiring the domestic disclosure spreadsheet.

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19. "Tax haven" is used in the generic sense, and not as the term of art in federal law. Because of the difficulty of relying on statutory tax rates for the purpose of defining a tax haven, the draft legislation for the domestic disclosure spreadsheet leaves the definition of at a tax haven corporation for this purpose—one not subject to substantial foreign tax on its net income—to regulations to be promulgated by the Secretary of the Treasury.

Passage of the spreadsheet legislation may help break the legislative log jam in California and render moot initiatives for restrictive federal legislation.

APPENDIX A[20]

PROPOSED UNITARY TAX LEGISLATION

Sec. 1. Subpart A of part III of subchapter A of Chapter 61 of the Internal Revenue Code of 1954 (relating to information returns) is amended by adding immediately after section 6039 the following section:
SECTION 6039 A. Information with Respect to Certain Multistate and Multinational Corporations —

(a) General Rule - A reporting corporation shall file, within 90 days of the due date (including extensions thereof) of its Federal income tax return for the taxable year, a return disclosing information relating to its State income tax returns for State taxable years ending with or within the taxable year of such corporation for Federal income tax purposes. Such return shall include the reporting corporation's income tax liability to each State in which it is liable to pay income tax, its income subject to tax in each State, the method of calculation by which the reporting corporation computed and allocated its income subject to tax by each State, each corporation in which the reporting corporation, or any corporation owning 50 percent or more of the outstanding voting stock of the reporting corporation, owns, directly or indirectly, more than twenty percent of the combined voting power of all classes of stock entitled to vote, and such other related information as the Secretary may by regulation prescribe.

(b) Reporting by Related Corporations—

(1) Reporting by Common Parent of Affiliated Group - If a reporting corporation is a common parent of an affiliated group of corporations, it shall file a return disclosing the information described in subsection (a) with respect to each includible corporation in such affiliated group. Such information shall be filed for the State taxable year of each includible corporation ending with or within the common parent corporation's taxable year for Federal income tax purposes.

(2) Reporting by Other Related Corporations— If a reporting corporation is a member of a controlled group of corpora-

20. This appendix contains the draft legislation as recommended by the Working Group.

tions that includes a foreign corporation that is described in section 6103(d)(4)(G) but is not required to file a Federal income tax return, then such reporting corporation shall, in filing the return required by this section, include the information that such foreign corporation would be required to file under this section if it were a reporting corporation. This paragraph shall not apply if such reporting corporation and such foreign corporation are included in a return described in paragraph (1).

(c) Definitions -

(1) Reporting Corporation -

(A) In general. For purposes of this section, the term "reporting corporation" means a corporation that is required to file a Federal income tax return for the taxable year and that:

(i) makes aggregate payments of at least $1,000,000 as compensation for services rendered in any single foreign country during the taxable year;
(ii) owns assets situated in any single foreign country with an aggregate fair market value of at least $1,000,000 as of the close of the taxable year;
(iii) has gross sales occurring in any single foreign country of at least $1,000,000 during the taxable year; or
(iv) owns assets with an aggregate fair market value, as of the close of the taxable year, of at least $250,000,000.

The Secretary shall have authority at any time to increase by regulation any dollar threshold set forth in this paragraph. The allocation of compensation payments, property, or sales to or among foreign countries shall be determined under regulations prescribed by the Secretary.

(B) Application of definition to Related Corporations. For purposes of applying subparagraph (A) to related corporations—

(i) compensation paid by, property owned by, or sales made by members of an affiliated group of corporations shall be treated as if paid, owned, or made directly by the common parent corporation; and
(ii) compensation paid by, property owned by, or sales made by members of a controlled group of corporations that are not members of the same affiliated group of corporations shall be consolidated and attributed to each member of such controlled group that is required to file a Federal income tax return.

(2) Affiliated Group - For purposes of this section, the term "af-

filiated group" means one or more chains of includible corporations connected through stock ownership with a common parent corporation which is required to file a Federal income tax return for the taxable year if:

(i) stock possessing more than 50 percent of the combined voting power of all classes of stock entitled to vote of each of the includible corporations (except the common parent corporation) is owned directly or indirectly by one or more of the other includible corporations within the affiliated group; and
(ii) the common parent corporation owns directly stock possessing more than 50 percent of the voting power of all classes of stock entitled to vote of at least one of the other includible corporations.

(3) Includible Corporation - For purposes of this section, with respect to any taxable year, the term "includible corporation" means (i) any domestic corporation, other than a corporation exempt from tax under section 501, (ii) any corporation incorporated in the Commonwealth of Puerto Rico, Guam, American Samoa or the United States Virgin Islands, (iii) any corporation defined in section 922, (iv) any foreign corporation that is required to file a Federal income tax return with respect to such taxable year, or (v) any other foreign corporation that is described in section 6103(d)(4)(G).

(4) Controlled Group - For purposes of this section, the term "controlled group" has the meaning given to such term by section 267(f)(1), except that the determination shall be made without regard to section 1563(b)(2)(C).

(d) Status of Return - If the information return filed pursuant to subsection (a), or any information reflected on such return, is disclosed or made available to a State tax agency (as defined in section 6103(d)(4)(C)), or to any common or designated agency (as defined in sections 6103(d)(4)(A) and (B)) in which a State participates, the return may thereupon be treated, if and to the extent provided by the laws of such State, as if originally filed with such State for purposes of the imposition of civil or criminal penalties under the laws of such State for negligence, fraud, or a material understatement of income or of tax liability.

(e) Dollar Penalty for Failure to Comply -

(1) In general - If with respect to any taxable year a reporting corporation fails to comply substantially with the requirement of subsection (a) on or before the due date specified in subsection

(a), such corporation shall pay a penalty of $1,000.

(2) Increase in penalty where failure continues after notification - If any failure described in paragraph (1) continues for more than 90 days after the date on which the Secretary mails notice of such failure to the reporting corporation, such corporation shall pay a penalty (in addition to the penalty imposed by paragraph (1)) of $1,000 for each 30-day period (or fraction thereof) during which such failure continues after the expiration of such 90-day period. The increase in penalty under this paragraph shall not exceed $24,000.

(3) Penalties in addition to any penalty that may be imposed under State law - Nothing in this subsection shall preclude any State from imposing any fines or penalties for negligence, fraud, or understatement of income or of tax liability in accordance with the laws of that State."

Sec. 2. Section 6103 of the Internal Revenue Code of 1954 (relating to confidentiality and disclosure of returns and return information) is amended by—

(a) revising subsection (d) to read as follows:

(d) *Disclosure to State Officials, Etc.*

(1) In general.— Upon compliance with the procedures and requirements of paragraph 2, returns and return information with respect to taxes imposed by chapters 1, 2, 6, 11, 12, 21, 23, 24, 31, 32, 44, 45, 51, and 52 and subchapter D of chapter 36, returns described in section 6039A, and return information obtained by the Internal Revenue Service from any foreign government, or agency or department thereof, under the exchange of information provisions of any income tax treaty, estate and gift tax treaty or agreement described in section 274(h)(6)(C), to which the United States is a party, shall be open to inspection by, or disclosure to, any State tax agency for the purposes of, and only to the extent necessary in, the administration of the tax laws of a State, including any procedures with respect to locating any person who may be entitled to a refund. Notwithstanding the preceding sentence:

(A) return information obtained under treaties or section 274(h)(6)(C) agreements shall be open to examination or disclosure only to the extent such examination or disclosure is permitted by, and shall be subject to any limitation imposed by, the relevant treaty or agreement; and

(B) neither section 6039A returns nor return information obtained under a treaty or section 274(h)(6)(C) agreement shall be disclosed to a State tax agency if:

(i) the State is not a qualified State within the meaning of section (d)(4)(E); or

(ii) any taxpayer included in the section 6039A return, or any taxpayer to which the return information relates, filed, or is part of a related group of corporations that files, State tax returns on a worldwide unitary basis in that State.

Returns and return information described in this paragraph (1) relating to any taxpayer that is a reporting corporation (within the meaning of section 6039A(c)(1)) or that is a member of an affiliated group (within the meaning of section 6039A(c)(2)) that also includes such a reporting corporation shall also be open to inspection by or disclosure to any common agency or the designated agency.

(2) Procedures and restrictions. —

(A) Persons to whom information may be disclosed—Except as the Secretary shall prescribe by regulation, inspection shall be permitted, or disclosure made, under paragraph (1) only upon written request by the head of the State tax agency, common or designated agency, and only to the representatives of such agency designated in such written request as the individuals who are to inspect or to receive the returns or return information on behalf of such agency. Such representatives shall not include any individual who is the chief executive officer of a State or who is neither an employee or legal representative of such agency nor a person described in subsection (n). Returns and return information shall not be disclosed under paragraph (1) to the extent that the Secretary determines that such disclosure would identify a confidential informant or seriously impair any civil or criminal tax investigation.

(B) disclosure of returns and return information relating to section 6039A reporting corporations by State tax agencies, common and designated agencies— A State tax agency, common agency or designated agency obtaining returns or return information that are described in paragraph (1) and relate to any taxpayer that is a reporting corporation (within the meaning of section 6039A(c)(1)) or that is a member of an affiliated group (within the meaning of section 6039A(c)(2)) that also includes such a reporting corporation, may disclose such returns and return information to a State tax agency of any other State, provided:

(i) the State to which the information is to be disclosed is a qualified State;

(ii) no taxpayer to which the return information relates, including each taxpayer included on a section 6039A return, files or is part of a related group of corporations that files, State tax returns on a worldwide unitary basis in that other State; and

(iii) the State tax agency of such other State has entered into an applicable nondisclosure agreement with the Secretary that satisfies the requirement of paragraph (2)(C).

(C) Nondisclosure agreement. — A State tax agency, common agency or designated agency obtaining returns or return information that are described in paragraph (1) and relate to any taxpayer that is a reporting corporation (within the meaning of section 6039A(c)(1)) or that is a member of an affiliated group (within the meaning of section 6039A(c)(2)) that also includes such a reporting corporation shall be required to execute a non-disclosure agreement with the Secretary prohibiting the disclosure of such returns or return information or of any data, information or conclusion extracted from or based upon such returns or return information, to any State tax agency if:

(i) the State is not a qualified State within the meaning of section (d)(4)(E), or

(ii) any taxpayer to which the return information relates, including each taxpayer included on a section 6039A return, files, or is part of a related group of corporations that files, State tax returns on a worldwide unitary basis in that State.

The agreement shall also prohibit any State tax agency obtaining such returns or return information from using the returns or return information in connection with its examination of any taxpayer which files on a worldwide unitary basis in that State. The required nondisclosure agreement shall contain such additional terms and conditions as the Secretary shall prescribe.

(D) Use of information obtained by State tax agencies— A State shall not use any section 6039A return or any return information obtained under a treaty or section 274(h)(6)(C) agreement in connection with its examination of any taxpayer that files on a worldwide unitary basis in that State.

(3) Disclosure to State audit agencies. — Returns or return information described in paragraph (1) obtained by any State tax agency may be open to inspection by, or disclosure to, officers and employees of a State audit agency for the purpose of, and only to the extent necessary in, making an audit of the State tax agency. Notwithstanding the preceding sentence, return information ob-

tained under treaty or section 274(h)(6)(C) agreement shall not be open to inspection by or disclosure to any State audit agency.

(4) Definitions.—

(A) Common agency. — For purposes of this section, the term 'common agency' means a joint or common agency, body, or commission which has been designated under the laws of four or more qualified States to represent such States collectively in the administration of the corporate income tax laws of those States and which has executed a non-disclosure agreement of the type described in paragraph (d)(2)(C).

(B) Designated agency. — For purposes of this section, the term 'designated agency' mean that agency which has been or may be designated under the laws of a plurality of all qualified States, to obtain from the Internal Revenue Service and process on behalf of such States returns and related return information, including returns described in section 6039A, and which has executed a non-disclosure agreement of the type described in paragraph (d)(2)(C).

(C) State tax agency. — For purposes of this section, the term 'State tax agency' means any agency, body, commission or other body charged under the laws of a State with responsibility for the administration of State tax laws.

(D) State audit agency. — For purposes of this section, the term 'State audit agency' means any State agency, body, commission, or entity which is charged under the laws of the State with the responsibility of auditing State revenues and programs.

(E) Qualified State. — For purposes of this section, the term 'qualified State' means a State that the Secretary determines does not require taxpayers to compute tax on a worldwide unitary basis, except where:

(i) a company fails to comply with the requirements of section 6039A or with the legal and procedural requirements of the income tax laws of such State;

(ii) neither the taxpayer nor the government of the relevant foreign country provides to the State, within a reasonable period after proper request, information sufficient to determine the arm's-length nature of transactions between any corporation described in section (d)(4)(F) and any other foreign corporation which is a member of the same controlled group of corporations (within the meaning of section 6039A(c)(4)); or

(iii) separate accounting, after necessary and appropriate adjustments, fails to prevent the evasion of taxes or clearly reflect income.

A determination by the Secretary under this paragraph shall be conclusive and not subject to review by any court.

(F) Worldwide Unitary Basis. — For purposes of this section, the term 'worldwide unitary basis' means that in computing state income tax a corporation or related group of corporations includes or is required to include in the income base on which the tax is calculated an allocated share of the income of corporations other than:

(i) domestic corporations more than 50 percent of the voting stock of which is owned directly or indirectly by a corporation that is a member of the affiliated group;

(ii) domestic corporations that have made an effective election under section 936;

(iii) corporations defined in section 922;

(iv) corporations organized in the commonwealth of Puerto Rico, Guam, American Samoa or the United States Virgin Islands;

(v) foreign corporations if (I) such corporation is subject to State income tax in at least one state by virtue of its business activities in that state; and (II) such corporation has (*a*) at least $10,000,000 in compensation payments for services rendered, sales or purchases during its most recent Federal taxable year or property with a fair market value of at least $10,000,000 as of the last day of its most recent Federal taxable year, assignable to one or more locations in the United States, or (*b*) the average of the percentages of such corporation's property (valued as of the last day of its most recent Federal taxable year), compensation payments for personal services (determined for its most recent Federal taxable year), and sales (determined for its most recent Federal taxable year) that is assignable to one or more locations in the United States is at least 20 percent.

(vi) foreign corporations described in section (d)(4)(G).

(G) Certain foreign corporations. — A foreign corporation is described in this subparagraph if such corporation —

(i) is a member of a controlled group of corporations (within the meaning of section 6039A(c)(4)) that includes at least one reporting corporation (within the meaning of section 6039A) that is not described in this subparagraph (G);

(ii) either carries on no substantial economic activity or makes at least

(*a*) 50 percent of its sales,

(*b*) 50 percent of its payments for expenses other than payments for intangible property, or

(*c*) 80 percent of all of its payments for expenses,to one or

more corporations that are described in clauses (i) through (v) of subparagraph (F) and that are within the controlled group of corporations referred to in clause (i) of this subparagraph; and

(iii) under standards established in regulations to be prescribed by the Secretary, is not subject to substantial foreign tax on its net income.

(b) Striking "subsection (e)(1)(D)(iii)" in subsection (a)(3) and inserting in lieu thereof "paragraph (1) of subsection (d), subsection (e)(1)(D)(iii)."

Sec. 3. The second sentence of section 274(h)(6)(C)(i) of the Internal Revenue Code of 1954 (relating to exchange of information agreements) is amended to provide as follows:
Except as provided in clause (ii), an exchange of information agreement shall provide for the exchange of such information (not limited to information concerning nationals or residents of the United States or the beneficiary country) as may be necessary and appropriate to carry out and enforce the tax laws of the United States, the tax laws of beneficiary country (whether criminal or civil proceedings) and if the parties to the agreement agree, the tax laws of the several States of the United States, including information which may otherwise be subject to nondisclosure provisions of the local law of the beneficiary country (such as provisions respecting bank secrecy and bearer shares).

Sec. 4. Effective Date. The amendments made by Section 1, Section 2 and Section 3 shall be effective for taxable years beginning after December 31, 1985.

APPENDIX B

TECHNICAL EXPLANATION OF UNITARY TAX LEGISLATION

The proposed legislation would implement the undertaking of the Department of the Treasury in the Final Report of the Worldwide Unitary Taxation Working Group (the "Working Group Report"). The Working Group Report contemplates that the Department of the Treasury will seek legislation requiring corporations to report certain information regarding their State

tax liability to the Federal Government and establishing procedures for sharing that information with qualifying States. The purpose of the proposed reporting and information-sharing provisions (new section 6039A and amended section 6103(d), respectively) is to permit the States to improve their taxation of multinational corporations.

A. *Section 6039A.*

1. In general. New section 6039A would require that a "reporting corporation" file an information return with the Internal Revenue Service. The information return would include the reporting corporation's income tax liability in each State, the amount of its income subject to tax in each State, and the method of calculation by which it computed its income subject to tax in each State (*e.g.*, the amount of property, payroll and sales allocated to each State and the allocation factors used in computing those amounts). It is contemplated that these items would be contained in a domestic disclosure spreadsheet developed by the Treasury in accordance with the Working Group Report. In addition to the spreadsheet information, a reporting corporation would be required to disclose the name of each corporation in which it or any corporation owning 50% or more of its voting stock owns a 20% or greater interest and any other information required to be reported under regulations promulgated by the Secretary.

2. Definition of reporting corporation. A corporation would not be required to file a section 6039A return unless it is a "reporting corporation" for the taxable year. In general, a corporation would be a reporting corporation if it is required to file a Federal income tax return for the year and satisfies any one of four business activity thresholds: (1) $1,000,000 in annual payments for compensation in a single foreign country; (ii) $1,000,000 in assets in a single foreign country; (iii) annual gross sales of $1,000,000 in a single foreign country; or (iv) total worldwide assets of $250,000,000, without regard to location. The principles for applying these tests would be developed under regulations; it is anticipated that in the case of tests (i) - (iii) these regulations would utilize the measurement and sourcing rules used for State tax purposes in the Uniform Division of Income for Tax Purposes Act.

A corporation required to file a Federal income tax return would not be able to utilize subsidiaries to avoid the requirements of section 6039A. Thus, in the case of an affiliated group of corporations with a common parent corporation, the numerical thresh-

olds would be applied on a consolidated basis by attributing payments of compensation, ownership of property, or sales made by subsidiaries directly to the common parent. This attribution rule would apply to all subsidiary corporations that are within the same controlled group of corporations (within the meaning of section 267(f)(1)), provided the common parent corporation is required to file a Federal income tax return for the year.

To prevent circumvention of the numerical thresholds of section 6039A by brother-sister corporations, similar rules would apply in cases where the common parent is not required to file a Federal income tax return. These aggregation rules would apply to the extent that 50 percent or more of the stock of each such corporation is owned, directly or indirectly, by the same person. In such a case, the corporations' property, payroll, and sales would be aggregated and attributed to each such corporation required to file a Federal income tax return for purposes of determining its status as a "reporting corporation" under section 6039A.

3. *Filing by affiliated groups.* Section 6039A(b) would require that any reporting corporation that is also the common parent of an affiliated group of corporations file the section 6039A return on behalf of all includible corporations in its affiliated group. In addition, the common parent corporation would be required to aggregate the property, payroll, and sales of the other includible corporations in the affiliated group in determining whether the threshold requirements for classification as a reporting corporation are met.

For purposes of section 6039A, an "affiliated group" would consist of a chain of "includible corporations" connected through voting stock ownership of at least 50 percent with a common parent corporation that is required to file a Federal income tax return for the year (and subject to reporting under section 6039A either directly or through attribution from its subsidiaries). Thus, a foreign corporation not engaged in a United States trade or business generally could not be the common parent of an affiliated group for purposes of section 6039A. Each reporting corporation would be included in only one affiliated group, either as the common parent or as a subsidiary; a first-tier subsidiary of one affiliated group would not be treated as a common parent with respect to the second- and third-tier subsidiaries for purposes of the section 6039A return requirements.

A corporation would be defined as an "includible corporation"

and therefore included within an affiliated group, if it is (i) a domestic corporation that is not exempt under IRC § 501; (ii) a corporation incorporated in the Commonwealth of Puerto Rico, Guam, American Samoa, or the United States Virgin Islands; (iii) a foreign sales corporation within the meaning of IRC § 922; (iv) any foreign corporation required to file a Federal income tax return with respect to the taxable year; or (v) any other foreign corporation that is not otherwise required to file a Federal income tax return if it carries on no substantial economic activity or if 50 percent or more of its sales are made to one or more members of the same affiliated group, or if 50 percent of its expenses (computed without regard to payments for intangible property) or 80 percent of all its expenses are incurred with respect to products or services acquired from one or more members of the same affiliated group. A foreign corporation would not be classified as an includible corporation under clause (v) proposed sections 6039A(c)(3)(v) and 6103(d)(4)(G)) unless, under standards established in regulations to be prescribed by the Secretary, it is not subject to substantial foreign tax on its net income. Under these definitions a foreign corporation engaged in a United States trade or business could constitute a reporting corporation, in which case it would be required to file a section 6039A return with respect to its United States subsidiaries, its foreign subsidiaries otherwise required to file a Federal income tax return, and any of its foreign subsidiaries falling within the definition of "includible corporation" by reason of section 6039A(c)(3)(v). It would not be required to report with respect to its other non-United States subsidiaries, although it would be required to disclose the existence of such subsidiaries.

4. Additional requirements for related corporations. In addition to the requirements that apply for corporations within one affiliated group, section 6039A would require that a reporting corporation related to a foreign corporation described in section 6039A(c)(3)(v) and 6103(d)(4)(G) include information pertaining to such foreign corporation on its section 6039A return. The information to be included would be the information that the foreign corporation would be required to file if it were a reporting corporation. Thus, if a reporting corporation has substantial dealings with a related foreign corporation that is not otherwise required to file a Federal income tax return but is described in section 6103(d)(4)(G), the reporting corporation's section 6039A return would include the spreadsheet information on the related

foreign corporation (assuming the two corporations are not members of a larger "affiliated group" for purposes of section 6039A). This requirement would not apply if the foreign corporation is required to file a Federal income tax return; in that case, the attribution of property, payroll, and sales between related corporations would ensure that the foreign corporation would constitute a reporting corporation in its own right, and it would be directly responsible for filing its own section 6039A return.

For purposes of this requirement, two corporations would be treated as owned by the same person if they are connected through ownership of 50 percent or more of their outstanding voting stock by the same person, whether directly or indirectly.

5. *Filing Deadlines.* A reporting corporation's section 6039A return would be due 90 days from the due date (including extensions) of its Federal income tax return. The information included on a reporting corporation's section 6039A return generally would deal with the corporation's Federal taxable year. In the unusual situation where the taxpayer's State and Federal taxable years are different, the section 6039A return would cover State taxable years ending within the taxpayer's Federal taxable year. If a reporting corporation is required to include on its section 6039A return State tax information pertaining to related corporations, such information would be required for the taxable years of the related corporations that end with or within the reporting corporation's taxable year. The section 6039A return filed by a reporting corporation on behalf of a related foreign corporation not otherwise required to file a Federal income tax return would reflect information for the foreign corporation for the year ending with the reporting corporation's taxable year or for the calendar year ending within the reporting corporation's taxable year.

6. *Penalties.* Section 6039A(e) imposes penalties for failure to substantially comply with the reporting obligation. As suggested by the Working Group Report, these penalties are identical to those currently imposed in connection with the information reporting required by section 6038, and are in addition to any fines or penalties that may be imposed under State law. Moreover, if a section 6039A return is disclosed to a State, the State may treat the return as originally filed with it for purposes of imposing any such State fines or penalties.

B. *Section 6103(d).*

The second portion of the proposed legislation would amend section 6103(d) of the Code to provide new rules regarding the

access of States to taxpayer information collected by and in the possession of the Internal Revenue Service. Although the legislation's primary purpose is to make available to States the information returns required by section 6039A, it also controls the availability to States of other taxpayer return information with respect to section 6039A reporting corporations gathered or generated by the Service, including information received under exchange-of-information agreements with other countries.

1. State access to return information. The proposed legislation would amend section 6103(d)(1) by adding the section 6039A information return to the return information to which States are permitted access. State access to section 6039A information returns would be subject to four significant qualifications. First, State access to a section 6039A information return would be subject to the same restrictions applicable under present section 6103 to the disclosure of Federal income tax returns to State governments. Second, section 6039A returns would not be disclosed to any State that is not a "qualified State." Third, a section 6039A return would not be disclosed to a State if the reporting corporation filing such return, or any other affiliated corporation included on such return, computes its income tax liability on a worldwide unitary basis in such State. Fourth, a section 6039A return would not be disclosed to a State unless the State has executed a nondisclosure agreement with the Department of the Treasury. In general, this agreement would permit information sharing between States, but it would prohibit disclosure of the section 6039A return to any State that would not otherwise be eligible to receive such information under the requirements contained in this paragraph. This agreement would also prohibit use of a section 6039A return to audit any unrelated taxpayer that computes its income tax liability on a worldwide unitary basis in the State receiving such return.

With respect to Federal income tax returns and other information to which the States already have access under section 6103(d), the legislation would amend current law to permit the sharing of such information between States. Such information sharing would be permitted only with respect to corporations that are "reporting corporations" within the meaning of section 6039A. Moreover, a State would not be permitted to share such information with another State unless such other State is a qualified State and the taxpayer to which such information relates does not compute its income tax liability in such State on a worldwide uni-

tary basis.

2. *State access to treaty information.* Section 6103(d)(1) also permits States to obtain access to returns and return information obtained by the Secretary under treaty exchange-of-information provisions. Treaty information would be disclosed to a State only to the extent permitted by the relevant treaty and would be subject to any limitations imposed by such treaty. In addition, disclosure of such information would be subject to the same restrictions and limitations applicable to the disclosure of section 6039A returns. Thus, if a corporation computes its State income tax liability on a worldwide unitary basis in a State, such State would not be entitled to receive any treaty-derived information with respect to such corporation.

3. *Definition of qualified State.* A State is not entitled to receive section 6039A return information or treaty information unless it is a "qualified State." Section 6103(d) would define a qualified State as any State that does not require taxpayers to compute State income tax liability on a worldwide unitary basis. Qualified States could require worldwide unitary apportionment under three limited circumstances. First, worldwide unitary apportionment could be required if the taxpayer materially fails to comply with the requirements of section 6039A and applicable State law. Incidental procedural failures by a taxpayer, standing alone, would not justify imposition of worldwide unitary apportionment. Second, worldwide unitary apportionment could be required by a qualified State if the State is unable to obtain the records necessary to audit the taxpayer's State tax returns. This would occur only if (i) the taxpayer refuses to provide information regarding transactions between members of its water's edge group and related companies outside the water's edge group, and (ii) treaty exchange-of-information procedures are not available to the State through the Internal Revenue Service. Third, a qualified State could require worldwide unitary apportionment if the State determines, after necessary and appropriate adjustments, that separate accounting by the taxpayer and its affiliates fails to clearly reflect income or to prevent the evasion or avoidance of taxes. It is expected that separate accounting will yield appropriate results in virtually all cases.

4. *Definition of worldwide unitary basis.* As discussed above, a State will not meet the definition of a qualified State unless its use of the worldwide unitary method of taxation is limited to specified circumstances. Moreover, even if the State is a qualified

State, its access to section 6039A return information and treaty-derived information is limited to those taxpayers that do not compute their State income tax liability on a worldwide unitary basis in that State.

For purposes of these rules, the term "worldwide unitary basis" would be defined by section 6103(d)(4)(F) in a manner consistent with the water's edge limitation contained in the Working Group Report. In general, a corporation will be considered as being taxed on a worldwide unitary basis if, in computing income subject to tax, it includes an allocated share of the income of corporations other than the following enumerated corporations: (i) domestic corporations more than 50 percent of the voting stock of which is owned, directly or indirectly, by a member of the affiliated group; (ii) domestic corporations eligible for the possessions tax credit under section 936; (iii) foreign sales corporations (FSC) within the meaning of section 922; (iv) corporations organized in the Commonwealth of Puerto Rico, Guam, American Samoa, or the United States Virgin Islands; or (v) foreign corporations described in section 6103(d)(4)(F)(v) or (G).

Under section 6103(d)(4)(F)(v), a State could include a foreign corporation in a unitary group without violating the worldwide unitary prohibition if the foreign corporation has at least $10,000,000 in compensation payments for services rendered, sales, or purchases during its most recent federal taxable year, or property with a fair market value of at least $10,000,000 as of the last day of its most recent federal taxable year, assignable to one or more locations in the United States, or if the average of the percentages of the corporation's property, compensation payments, and sales that are assignable to one or more locations in the United States is at least 20 percent. In either of these cases, inclusion of the foreign corporation in a water's edge unitary group is permissible only if the foreign corporation is subject to income tax in at least one State by virtue of its business activities in that State.

Section 6103(d)(4)(G) would permit the inclusion of a foreign corporation within a water's edge group if it is a member of a controlled group of corporations that includes at least one reporting corporation and if it has not substantial economic activity or has the requisite degree of economic dealings with other members of the water's edge unitary group. A foreign corporation otherwise subject to inclusion in the water's edge group under these rules would be excluded from such group if, under standards to be es-

tablished in regulations to be prescribed by the Secretary, it is subject to substantial foreign tax on its net income. Although the Working Group Report suggested that the determination of whether the corporation pays substantial foreign tax would be based on the nominal foreign tax rate, the Treasury Department does not believe that such a formulation is adequate and would expect to base required regulations on factors in addition to the applicable nominal foreign tax rate.

The proposed legislation takes no position on whether a so-called 80/20 corporation (defined in the Working Group Report as a United States corporation which has no more than 20 percent of its property or payroll attributable to sources within the United States) could be included in a water's edge group. Such corporations would be within the statutory definitions of "reporting corporation" and "includible corporation" in section 6039A, however, and the inclusion of such corporations in a unitary combination would not violate section 6103(d)'s restrictions against use of the worldwide unitary method. These provisions should not be viewed as an endorsement by the Treasury of the inclusion of such corporations in a unitary group.

In addition, the proposed legislation remains neutral on the question whether dividends received from a foreign corporation that is not a member of a permitted water's edge unitary group may be taxed to the recipient as part of its water's edge unitary group income. Again, the fact that the inclusion of such dividends in a group's consolidated income does not violate the restriction on the use of the worldwide unitary method should not be viewed as indicating that the Treasury believes the taxation of such dividends is appropriate.

5. Common agencies; designated agency. Any information with respect to a section 6039A reporting corporation that may be disclosed to a State under section 6103(d) may also be disclosed to a common agency or to the designated agency. A common agency is an agency designated by four or more qualified States to assist in the administration of the income tax laws of such States. At any given time, the designated agency is the agency designated by a plurality of the qualified States to assist in the administration of the income tax laws of such States. Only one designated agency will be recognized by the Federal government at any given time.

A common agency or the designated agency may obtain the section 6103(d) information only upon the execution of the nondisclosure agreement that qualified States are required to execute in

order to obtain such information. Thus, a common agency that obtains a section 6039A return or other Federal income tax return or treaty information would be precluded from making any such return or information available to any State if such State is not a qualified State or if any corporation covered by such return or information files, or is part of a group of related corporations that file, an income tax return on a worldwide unitary basis in such State.

The prohibition against disclosure would apply to any information made available to the common or designated agency pursuant to section 6103(d). Thus, a common agency receiving a copy of a taxpayer's Federal income tax return would not be permitted to make available any information reflected on such return to any State unless such State is a qualified State and the taxpayer does not compute its income tax liability on a unitary basis in such State. Moreover, a common or designated agency would not be permitted to make recommendations or suggestions regarding audits of taxpayers to any State tax agency based upon returns or return information in the common or designated agency's possession unless the State is a qualified State and the taxpayer does not compute its State income tax liability on a worldwide unitary basis in such State.

APPENDIX C

Summary of Proposed Unitary Tax Spreadsheet Legislation

The proposed legislation would:

> Require certain companies to file with the IRS a "domestic disclosure spreadsheet," an information return reporting the calculation of their State tax liability in each State.
>
> Permit State tax authorities in States not requiring worldwide unitary taxation and certain multistate tax agencies to obtain from the Federal government the domestic disclosure spreadsheet and other taxpayer information necessary to administer State tax laws.

The corporations required to report are those domestic and foreign corporations that (i) are required to file a United States corporate tax return and (ii) together with their affiliates have more than $1 million in sales, payroll, or assets in any foreign country or have in excess of $250 million in worldwide assets. United States subsidiaries of large foreign multinationals would be re-

quired to report, but the foreign parent corporation would not be required to report unless it is directly conducting business in the United States.

The taxpayer information available to qualifying States and certain multistate tax agencies from the Federal Government will include:

> The domestic disclosure spreadsheet information return.
> Information obtained from foreign countries under the exchange of information provisions of United States tax treaties if and to the extent treaties permit. In all cases treaties will need to be amended before treaty information will be available for disclosure to the States.
> Federal returns and other taxpayer information already available to States under existing law.

States and multistate tax agencies will be able to obtain this information directly from the Federal government or, in some cases and subject to appropriate safeguards, from other States or multistate agencies that have previously obtained the information from the Federal government pursuant to the legislation.

Spreadsheet returns and treaty information will be made available only to qualified States and certain multistate agencies acting on their behalf. (All States will continue to have access to the taxpayer information available under current law whether or not they are qualified States. A State, whether or not it is a qualified State, will not be entitled to spreadsheet returns and treaty information with respect to a taxpayer that actually files on a worldwide unitary basis in that State.

Following the Working Group Report definitions, the proposed legislation defines a qualified State as any State not requiring unitary reporting for operations beyond the water's edge. A qualified State, however, would be permitted to require worldwide unitary reporting if a corporation fails to provide the State with the information on its dealings with foreign affiliates necessary for the State to determine the corporation's tax liability on a separate accounting basis.

The definition of the water's edge group generally follows the recommendations contained in the Working Group Report. However, the definition of foreign tax haven companies which may be included in the water's edge group is largely left to Treasury regulations.

The Working Group left two major issues unresolved. These are whether a State can tax dividends received by a company within

the water's edge group from foreign corporations, including affiliates, and whether affiliated United States companies having more than 80 percent of their sales, payroll and assets attributable to operations outside the United States ("80/20 companies") should be included in the water's edge group. While the legislation does not explicitly take a position on these unresolved issues, a State would not fail to be a qualified State merely because it taxes the operations of 80/20 companies or because it taxes dividends paid by foreign subsidiaries.

APPENDIX D

TREASURY NEWS

Department of the Treasury • Washington, D.C. • Telephone 566-2041

FOR IMMEDIATE RELEASE
July 8, 1985

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TREASURY DEPARTMENT RELEASES PROPOSED UNITARY TAX LEGISLATION

The Treasury Department today issued for public comment draft legislation that would require certain corporations to file annual information returns with the Internal Revenue Service reflecting their computation of State income taxes in the various States. The draft legislation also would permit the Federal government to share the information return and other taxpayer information with State tax agencies. These information returns could be shared with states to aid in State tax enforcement activities provided the State does not require the corporation to compute State income taxes under the worldwide unitary method of apportionment.

The draft legislation is patterned after the recommendations of the Worldwide Unitary Taxation Working Group organized by the Treasury Department to resolve conflicts among State taxing authorities, multinational corporations, and foreign governments. The Final Report of the Working Group was released on August 31, 1984.

The Treasury Department requests interested parties to provide written comments on the draft legislation prior to August 15, 1985. After reviewing comments, the Treasury Department will seek to have the legislation introduced in Congress when it convenes after its August recess. In addition, the Treasury Department indicated that it will request approval through the Office of Management and Budget to seek a supplemental appropriation as suggested in the Working Group's Final Report to strengthen Internal Revenue Service enforcement activities related to international business operations and to implement the State tax enforcement assistance program.

Written comments on the proposed spreadsheet reporting legislation should be directed to the Office of Tax Policy, Room 3108, U.S. Treasury Department, Washington, D.C. 20220.

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