State of Alaska
Department of Revenue
Commissioner Bryan Butcher

SEAN PARNELL, GOVERNOR
333 Willoughby Avenue, 11th Floor
P.O. Box 110400
Juneau, Alaska 99811-0400
Phone: (907) 465-2300
Fax: (907) 465-2389

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The Honorable Paul Seaton
Alaska State Legislature
State Capitol, Room 102
Juneau, Alaska 99801

Re: House Bill 328 - Separate Accounting

Dear Representative Seaton,

We were asked to provide suggestions to make the bill workable from a Tax Administration standpoint. I have listed five suggestions below (Items A-E). Unfortunately, there are several areas where we are unable to offer suggestions because the sponsor's intent is not known. I have listed those items below as Policy Issues (Items 1-6).

A. The bill mirrors old Chapter 21, which started with the same revenue point as Production Tax. However, Production Tax in 1978 was not a tax on net profits. At the current time, Production Tax is calculated with specific deductions as allowed under AS 43.55.165. The bill, as drafted, uses the original separate accounting deductions. The deductions, although similar, are not the same as those allowed for Production Tax. This potentially produces a mismatch of allowable expenses, and greatly increases complexity in administration.

Suggestion: Consider defining "Taxable income from oil and gas production" as Production Tax Value under Chapter 55

B. Sec. 43.21.340 allows the Department to require estimated tax payments, but there is no statutory penalty for failure to make those payments

Suggestion: Add language to impose penalty, as under the Internal Revenue Code Sec. 6655, using Alaska interest rates.

C. Sec. 43.21.330 requires the Department to calculate taxable income and send the taxpayer an "assessment" by August 15. This is generally not a workable mechanism for income tax; it is more commonly used in property tax.

Suggestion: Require the taxpayer to calculate its tax and file a tax return 30 days after the taxpayer files its federal return. (See current 43.20.030)

D. Page 3, line 17 requires depreciation be calculated on a "percentage depletion basis." It is unclear how such a depreciation method would work. This is not a customary depreciation method for either book purposes or tax purposes. Further, it is my understanding that Percentage Depletion allows recovery in excess of cost. We note that the old (repealed) Chapter 21 required the use of the Unit of Production method, which is an acceptable (though not common) method of depreciation.

Suggestion: If Suggestion A above is not adopted, then change "percentage depletion basis" to "unit of production method" (as in old Chapter 21) or on the basis of IRC Sec167, as it read on 6/30/81 (as in current 43.20.072) or simply on the basis of Sec. 167.

E. Because current 43.20.072 requires that an asset be capitalized and depreciated over its useful life, taxpayers will have unamortized basis at the point that Separate Accounting would be effective.

Suggestion: Provide a transition rule to allow a taxpayer to write off its remaining Alaska basis over a period of five years.

Policy Issues: As noted above, there are several other areas which will require a policy call, and so we are unable to make a workable suggestion until we understand the sponsor's intent:

In essence, the bill divides the corporate group into three baskets: Production activities, Pipeline activities, and Other. The taxable income of the "Other" group is Federal Taxable Income (under the Internal Revenue Code) while taxable income of the Production and Pipeline activities are accounted for under state-specific rules. This division of the corporate group yields several difficulties:

1. Under current law, the Internal Revenue Code is adopted, which provides rules for intercompany transactions within the federal consolidated filing corporate group. The bill, as drafted, de-couples certain parts (not even certain corporations) from the measurement of federal taxable income. It is unclear how any intercompany transaction should be accounted for where the transaction occurs between a company engaged in Production activities and a company engaged in Other (non-production) activities. This is true for revenue/expense items such as interest, engineering fees, and other services. It also applies to recognition of certain gains/losses on intercompany sales of assets within the corporate group. We are unable to determine sponsor's intent in this area.

2. Similar to Item 1 above, the Internal Revenue Code provides direction on the deduction of intercompany dividends. We are unable to determine the correct potential treatment of dividends paid between a company engaged in Production activities and a company engaged in Other (non-production) activities, under the bill, as drafted.

3. Federal law (currently adopted) requires that capital gains and losses be separated into specific "baskets" with specific rules for netting of those gains and losses. We are unable to determine the correct gain calculation where there are, for example, capital losses in the "Other" group and capital gains in Production or Pipeline group of activities.

4. If the "Other" group of activities includes a federal deduction for charitable contributions, it is unclear how "taxable income" will be calculated for purposes of properly limiting the charitable contribution. For federal purposes, this is calculated on the consolidated Federal Taxable Income amount. For current state purposes, it is calculated based on the taxable income of the unitary combined group.

De-coupling from the Internal Revenue Code will present other uncertainties from a policy standpoint:

5. If an asset is sold in, for example, Year 2 of its useful life, the Internal Revenue Code requires the calculation of a taxable gain, commonly known as "depreciation recapture." Since this bill appears to allow immediate write-off of Production activity assets, it is unclear whether the sponsor intends that there be a gain calculated and taxed.

6. The taxable income from "Other" activities is equal to the Federal Taxable Income, but the statute does not "adopt" the Internal Revenue Code, Treasury Regulations, and federal Rulings. It is unclear what the sponsor's intent is, with respect to application of tax accounting rules. In addition, I would also note that this also means that we would no longer adopt federal penalties, such as the Substantial Understatement penalty or the Erroneous refund penalty.

This list is not all-inclusive, but is intended to reach the big-picture items.

If you need further assistance, please contact Johanna Bales at 269-6628 or Robynn Wilson at 269-6634 of the Tax Division.

Sincerely,

Bruce Tangeman
Deputy Commissioner