THE STATE of ALASKA
GOVERNOR BILL WALKER

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May 11, 2016

The Honorable Mark Neuman and the Honorable Steve Thompson
Alaska State Representatives
Co-chairs, House Finance Committee
State Capitol Rooms 505 and 515
Juneau, AK 99801

Dear Co-Chairs Neuman and Thompson:

The purpose of this letter is to provide you with responses to the questions asked of the Department of Revenue during our presentation to the House Finance Committee on May 3, 2016, regarding the fish tax legislation House Bill 251, and on May 4, 2016, regarding the mining tax legislation House Bill 253. Please see questions in italics and our responses immediately below the questions.

Fisheries Tax Questions from May 3, 2016

1. *Can the Department of Revenue provide a cost-benefit analysis of the credits offered against fish taxes?*

   Currently the state offers three tax credits specific to fish taxes:

   - The Salmon and Herring Product Development Credit, established in 2003 for salmon and established to include herring in 2014. It encourages expenditures on equipment for producing "value-added salmon and herring products". In recent tax years (since 2012), total credits claimed have ranged between $2 and $4 million per year.

     The Alaska salmon fishing industry has experienced a strong rebound since the early 2000s. Average ex-vessel prices (across all salmon species) rose from roughly 25 cents to 80 cents per pound between 2002 and 2012. The total value of Alaska commercial salmon fishing permits rose from $200 million to $700 million in the same period. The period has also coincided with an increase in sales of value-added salmon products such as frozen pink salmon (as opposed to cans) and fresh and filleted sockeye salmon (as opposed to frozen and canned). It is impossible to know how much of the rebound is a result of tax credits as opposed to other factors, especially aggressive marketing efforts by the Alaska Seafood Marketing Institute (ASMI) to differentiate wild Alaska salmon from farmed salmon.

- The Community Development Quota (CDQ) credit, which is for contributions to an Alaska nonprofit corporation dedicated to fisheries industry-related expenditures. The credit is only available for fishery resources harvested under a CDQ. In recent years about $500,000 worth of CDQ credits have been claimed each year. The credits are a direct benefit to fisheries-related nonprofits and local communities.

- The A. W. "Winn" Brindle Scholarship credit, which is for donations to the memorial scholarship loan fund that offers loans at favorable rates for Alaska students planning to enter the fishing industry. In recent years, between $100,000 and $250,000 worth of Winn Brindle credits have been claimed per year. DOR does not currently have data on the number of students who have benefited from the Winn Brindle loans or how many of them returned to work in the Alaska fisheries industry.

There are also two credits applicable to both fish taxes and a variety of other taxes: the Education Credit and the Film Production Credit. The Education Credit applies to donations to a wide variety of educational institutions, and its impact on fish tax revenue has been roughly $1.5 million per year in recent years (since 2012). The Film Production Credit is being phased out and has not been claimed against fish taxes in recent years (since 2012).

In a cost-benefit analysis, it is important to consider the other options—for example, appropriating funds for another purpose or investing money in state savings accounts instead of using it to reduce fish tax liability. One also has to consider the extent to which investments or donations may have taken place even without the credits. Between tax years 2012-14, the state granted an average of $4 million per year in credits against the fisheries taxes. Over the period 2009-14, the average return on funds invested in the CBRF was 4.25% per year; this represents one possible alternative use of the funds. Time and resource constraints would make it difficult to provide a full cost-benefit analysis of fisheries tax credits this legislative session.

2. *How is the municipal share of fisheries taxes determined? Can the Department provide a breakdown of taxes shared with municipalities?*

Fish taxpayers report on their tax returns where each fishery resource was processed. The municipal share is half of the tax due on the given fishery resource. For example, if a company named ABC Fisheries processed $100,000 worth of salmon at a shore-based facility in Juneau, then the Fisheries Business Tax rate is 3%, the total tax owed is $3,000, and $1,500 of that amount would be shared with the City and Borough of Juneau. If the processing location is inside both a borough and a separate incorporated city, then the municipal share is split equally between the borough and the city. If the processing location is in neither a borough nor a city, then the municipal share goes to an allocation program managed by the Department of Commerce, Community and Economic Development.

Note that the municipal share is based on tax returns, but the exact timing of when the money is received by the state and the municipalities can vary. Also, any tax credits are taken only against the state share of revenue and do not impact municipal shares. Therefore, cash flow for a given fiscal year will not reflect an exact 50-50 split.

The 2015 report on shared taxes is attached. This report includes all state tax revenue (both fish and other taxes) shared with municipalities in fiscal year 2015, which we hope will be helpful to the committee.

3. *Can the Department of Revenue look into a separate fish tax rate for factory trawlers?*

The Fishery Resource Landing Tax is essentially a tax on factory trawlers. The Landing Tax is intended to compensate the state for the burdens that catcher/processor vessels impose on state and local communities by fishery resources that are harvested and processed in federal waters and brought into Alaska for transshipment. The Landing Tax is both designed and intended to complement the Fisheries Business Tax, which applies to fish harvests and processing that occurs within Alaska.

In theory, a catcher/processor could avoid the Alaska Landing Tax by operating solely in federal waters and transiting elsewhere to offload their product. In practice, this is unlikely. The length and complexity of the fishing seasons, combined with the holding capacity of the vessels and other logistical needs, means the vast majority of the fishery resources harvested and processed in federal waters are indeed offloaded in Alaska and are subject to the Landing Tax. Moreover, under federal law, all catcher/processor vessels that are qualified to fish for Bering Sea walleye pollock under the American Fisheries Act (AFA), are required to pay the Landing Tax on walleye pollock, irrespective of where the walleye pollock might be offloaded. Walleye pollock represents the majority of the harvest by AFA-qualified vessels.

As a related fisheries tax matter, the committee asked about the possibility of a tax on fisheries bycatch. Earlier this year, House Bill 358 was introduced. The bill proposed to modify statutes (mainly AS 43.75.016) to establish a fisheries bycatch tax. The bill was referred to the House Fisheries Committee.

To be successful, a tax on fisheries bycatch would have to address some problematic characteristics of Alaska fisheries. Foremost is the accounting of bycatch. Although many large vessels that fish in state and federal waters are required to employ fishery observers, most vessels are either excluded from observer coverage, or are required to employ observers only part-time. Bycatch amounts for non-observed vessels are extrapolated based on bycatch rates from the observed portion of the fleet and are attributed to the sector, not individual vessels. For sectors with limited observer coverage, a new tax assessment method would be required such as a sector-wide tax rather than a tax paid by individuals. A second problem arises with establishing the value of bycatch species, if that is how the tax is structured. Much of the bycatch consists of fish that is either low-value or nearly impossible to market; examples include grenadiers, lesser-known species of crab, starry flounders, or under-sized juvenile salmon, crab, or halibut. Much bycatch is discarded at sea and the minor portion of the bycatch that does come ashore (mainly salmon and halibut) is typically passed on as a donation – no sale of the species occurs. Again, it would be challenging to establish a market fair value on these deliveries, if that was the intention of the tax.

Mining Tax Questions from May 4, 2016

4. *How much does the state collect in mining tax and corporate income tax combined from the six largest mines?*

   Both mining tax and corporate income tax revenue are highly volatile due to commodity prices. In FY 2015, the state collected about $38 million in mining taxes and about $17 million in corporate income taxes from the mining sector. A very large majority of this revenue came from the six largest mines. However, note that a given mining operation—large or small—is not guaranteed to be profitable in any given year, and a mine with less than zero net income does not pay either of these taxes.

   Previous years of corporate income tax from the mining sector are shown in the attached CIT Sector Report. Previous years of mining tax revenue are shown in the Tax Division Annual Report at
   http://www.tax.alaska.gov/programs/programs/reports/Annual.aspx?60610&Year=2015.

5. *(a) How much do the state's large mines pay in local taxes in addition to the state mining tax?*
   (b) What is the definition of a severance tax?

   (a) Please see the attached letter dated February 15, 2016, and addressed to the chair of the Senate Resources Committee. The letter includes a description of local taxes paid by the six large mines.

   (b) A severance tax is a tax imposed on the removal of a non-renewable resource. The tax base of a severance tax can vary. Some, such as Alaska's Mining License Tax and Oil & Gas Production Tax, use a profits base. Others, such as the Denali Borough's severance tax on coal, are charged at a flat rate per ton or ounce of material removed. The distinguishing feature is that severance taxes only apply to operations that remove non-renewable resources from the ground, not other businesses that earn income. A list of state severance taxes is included in the aforementioned letter to the Senate Resources Committee.

6. *What are the total costs of mining permitting operations, and does current mining tax revenue cover these costs?*

   As mentioned by the Deputy Commissioner of Natural Resources, mining companies directly reimburse the state for most permitting costs, so mining tax revenue is not necessary to pay for those. According to a report by the University of Alaska prepared for the Department of Commerce in 2015, the average revenue (from 2010 through 2014) to the state from mining (taxes, large mine project fees, rents and royalties, and other fees) was $96.4 million. The average cost to state agencies for this same period was $10.7 million. The majority of this ($6.6 million) was for DNR. Chapter 4 of the report, which deals with mining, is attached. Table 12 in the report breaks out the costs by department and division. Table 11 gives more detail on the revenue sources. The full report is available at http://www.iser.uaa.alaska.edu/Publications/2015_12-FiscalEffectsOfCommercialFishingMiningTourism.pdf

7. *How much state land is available that could be opened to mining exploration?*

   Of the 100 million acres of land the state has in hand, 92 million acres are open to mineral entry. A map of Alaska's land status is attached, with state land shown in blue.

8. *Is there any metal mining in Wisconsin?*

   According to the Wisconsin Department of Natural Resources web site, Wisconsin has several historic iron mines and one known iron ore deposit that may be mined in the future (the Gogebic District). Wisconsin also has four known deposits being evaluated for exploration: the Bend Copper-Gold Deposit; the Crandon Deposit containing zinc, copper, lead, gold, and silver; the Lynne zinc and silver deposit; and the Reef gold deposit. However, the Wisconsin DNR does not show any currently active metal mines. According to the web site: "Today, most mining in Wisconsin occurs as nonmetallic mining, producing rock, stone, sand, gravel, limestone and other materials used for industry, construction, road building, agriculture and many other purposes. These mines are often called quarries or pits."

   For more information, see http://dnr.wi.gov/topic/Mines/.

9. *Please explain how the Exploration Incentive Credit works.*

   Please see the attached explanation from the Department of Natural Resources.

10. *Provide a walkthrough of how a company's mining tax liability is calculated and how this affects royalties.*

    The Mining License Tax is structured as a tax on net income from each mining operation. The basic steps for calculating a mining operation's net income are as follows:

    1. Begin with gross income from selling materials mined and any royalties received.

    2. Subtract the depletion deduction. (See below for a brief explanation of the depletion deduction.)

    3. Subtract direct and indirect mining expenses for the year. (Note: This does not include expenses in previous years, such as exploration costs for which the mining company may have taken a credit.)

    4. Subtract the 3 ½-year exemption for new mining operation, if applicable. (Note: All current large mines in Alaska are more than 3 ½ years old.)

    5. The result is the mining operation's taxable income. Add together the taxable income for all mining operations owned by the same company. (Note: No two large mines in Alaska are currently owned by the same company, but a taxpayer may theoretically have any number of different mining operations.)

    6. Multiply the taxable income by the relevant tax rates to calculate the total tax.

7. Subtract off any credits, including Exploration incentive credit (as described in question 10), Mining business education credit, and Film production tax credit.

8. The result is the amount of tax the company owes.

The second part of the question is how the Mining License Tax relates to royalties. The answer is that when a mine is located on state land, the amount of royalties it owes to the state is equal to 3% of the "taxable income" amount mentioned in the bullet point 5 above. Royalties are separate from taxes but are calculated on the same basis.

Please note that Pogo is the only one of the six currently operating large mines located on state land. The other five large mines do not pay any royalties to the state. However, those located on private land do pay royalties to the landowner(s). The landowner(s) must then pay Mining License Tax on the royalty income, since it is income derived from the extraction of minerals.

Explanation of Depletion Deduction

The depletion deduction is similar to the exploration incentive credit in that it allows a mining operation to recoup some of its pre-production costs as a deduction against the income it earns once it begins production. In this case, the relevant costs are not the exploration costs described in the DNR handout, but the costs of purchasing and developing the property.

A mining operation may deduct its total purchase and development costs from its Mining License Tax liability in installments over the life of the mine. It may also take an alternative form of the depletion deduction called percentage depletion, which is a simple percentage of its gross income (set at 10% for coal mines and 15% for metal mines). In each given year, the mine may take whichever is greater, cost depletion or percentage depletion, but not both, and it may not take cost depletion once its total depletion deductions over the course of its life exceed its purchase and development costs.

I hope you find this information to be useful. Please do not hesitate to contact me if you have further questions.

Sincerely,

Jerry Burnett

Jerry Burnett
Deputy Commissioner

Attachments: CIT Sector Report FY 2015, Shared Taxes Report FY 2015, Letter to Senate Resources dated Feb. 15, 2016, DNR explanation of Exploration Incentive Credit, 2015 Mining License Tax Return, Chapter 4 of ISER report on state agency costs, Land status map