State of Alaska
Department of Revenue

Commissioner Bryan Butcher

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

April 3, 2012

Re: CS for House Bill 328 version I - Separate Accounting

Dear Representative Seaton:

As requested, we reviewed the CS to House Bill 328 which was drafted after taking into consideration our comments and concerns in our March 15, 2012 letter and further comments and concerns we voiced during meetings with you and your staff. The CS, as drafted, addresses some, but not all of our concerns and most of the policy issues we identified in our previous letter do not appear to be addressed at all. In addition, new language added in some areas of the bill have increased the bill's confusion and complexity. We have reiterated those items that we identified in our previous letter and discussions which we believe have not been addressed in the CS and identified other concerns we have because of new language inserted in the CS. We have also expanded on some of the issues that were discussed previously.

A. The previous version of the bill allowed the Department to require estimated tax payments, but there was no statutory penalty for failure to make those payments. We suggested adding language to impose a penalty, as under the Internal Revenue Code (IRC) Sec. 6655, using Alaska interest rates. Language has been added to require estimated tax payments per the IRC, but the estimated tax "penalty" was added by including substantially all of the language covering estimated payments and penalties from AS 43.55, the production tax. These provisions do not fit well together and cause additional confusion. Specifically, the use of a March 31 date conflicts with the IRC which specifies a tax payment due date of March 15. In addition, estimated tax payments are required to be made monthly for production tax whereas the IRC requires corporations to make quarterly estimated tax payments.

B. The language in sections 3 and 5 of the bill state that a corporation is subject to AS 43.21 (separate accounting) only if the corporation is engaged in the production or transportation of crude oil or natural gas. Our understanding of this language is that a company that is engaged in the exploration and/or development of an oil or gas lease in Alaska must calculate its taxable income based on water's edge formulary apportionment under AS 43.20.073. During discussions with you, we voiced our concerns with the fact that oil and gas exploration companies would not be able to write off expenses incurred in Alaska for those exploration and development activities conducted prior to production as there is no provision in this bill that allows net operating losses calculated under AS 43.20 to offset income under AS 43.21. This concern has not been addressed in the CS.

C. Lease acquisition payments, petroleum property taxes, and interest incurred prior to production would not be allowed to be deducted against future production income. Although language in AS 43.21.210(c)(6) allows amortization of lease acquisition payments, petroleum property taxes, and capitalized interest before commencement of commercial production, AS 43.21.210(d) specifically disallows a deduction for items that were expensed under AS 43.20. In addition, there is no language that requires these expenses to be capitalized and there is no language dictating how amortization is to be calculated.

D. There is no language that requires certain property to be capitalized and depreciated. AS 43.21.210(c)(5) allows depreciation on property required to be capitalized under the Internal Revenue Code, but this language does not require property to be capitalized for Alaska tax purposes. In the preceding paragraph, AS 43.21.210(c)(4), corporations are allowed to deduct all direct costs. As there is no language that requires property to be capitalized, corporations could deduct the entire cost of property used on a producing lease in the year the property was acquired and also take depreciation on that same property if the property was required to be capitalized under the IRC.

E. AS 43.21.210(c)(7) allows interest expense to be deducted provided the interest was not capitalized during construction. As there is no language in AS 43.21 that requires interest expense to be capitalized during construction, this language makes no sense. If it is the intent of the bill sponsor to require interest to be capitalized during the construction phase, language is needed. Additionally, if the construction phase of a project takes place prior to production, that activity is required to be reported under AS 43.20. There is no language in this bill that addresses how capitalized interest and other items, such as depreciable property that was reported while the company was subject to AS 43.20 is suppose to be treated once a company is subject to AS 43.21.

F. AS 43.21.210(c)(8) allows expenses that were incurred on dry holes, abandoned wells, and unsuccessful exploration to be deducted from gross income. However, those expenses would have already been deducted in the calculation of taxable income under AS 43.20 if they were incurred in a year prior to when the corporation began producing. AS 43.21.210(d) specifically prohibits expenses that were deducted on a return filed under AS 43.20 to be deducted in the computation of taxable income under AS 43.21. The real problem here is that there is no provision to address net operating losses that an oil and gas exploration company incurred prior to production.

G. The education tax and film production tax credits are not allowed as credits against the tax due under AS 43.21. Was this your intent?

H. Under current law, the Internal Revenue Code is adopted, which provides rules for intercompany transactions within the federal consolidated filing corporate group. It is our understanding from conversations with you that the intent is that all expenses incurred by a corporation or any member of the corporation's consolidated business that were for oil and gas production or transportation activity in the state will be allowed as a deduction. However, the way the language is constructed, only those corporations that derive income from oil or gas production or transportation in the state are subject to AS 43.21. If expenses are incurred by a sister corporation in support of the production company, but the sister corporation is not a producer, then the sister corporation must calculate its Alaska corporate income tax liability under AS 43.20. There is no mechanism in the language to allow these deductions in the computation of tax due under AS 43.21.

I. Decoupling from the IRC causes several uncertainties and potential unintended consequences. Following are some examples of unintended consequences. Please keep in mind that these examples are not all inclusive and many other unintended consequences could surface over time.

(1) Under IRC Sec. 162(f), fines and penalties paid by a corporation to a government for the violation of any law are not deductible in the calculation of taxable income. If fines and penalties incurred by a corporate income taxpayer under AS 43.21 are a direct lease expense, they are allowed as a deduction.

(2) Subchapter S Corporations engaged in oil and gas production in Alaska are not currently subject to Alaska's corporate income tax. They will be subject to Alaska corporate income tax under AS 43.21.

(3) Intangible drilling costs are required to be capitalized and depreciated under current Alaska corporate income tax. Under AS 43.21, these expenses will be allowed to written off in the year in which they are incurred. However, if these expenses were incurred prior to production, they will not be allowed to be written off at all.

(4) Dividend income received by a parent corporation from a subsidiary producing or transporting oil or gas in Alaska may or may not be taxable. We are uncertain as to the sponsors intent regarding this type of income.

(5) The bill does not require an amended return if there is a federal audit or federal amended return.

(6) Charitable contributions made by a corporation solely engaged in oil and gas production activity do not appear to be deductible.

(7) Federal law 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.

(8) 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.

We did our best to analyze this bill as quickly as possible and identified those issues of which we are most concerned. We will continue to analyze the bill and provide you additional feedback as our analysis continues. If you have questions about this letter or corporate income taxes in general, please contact Johanna Bales at 269-6628 or Robynn Wilson at 269-6634 of the Tax Division.

Sincerely,

Bruce Tangeman
Deputy Commissioner