FISCAL NOTE

STATE OF ALASKA
2003 LEGISLATIVE SESSION

Fiscal Note Number: 1
Bill Version: CSHB 90(FISH)
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Revision Date/Time (Note if correction):
Title: Tax credit for salmon development
Sponsor: Representatives Stevens and Wolf
Requester: House Fisheries Committee

Dept. Affected: Revenue
BRU: Revenue Operations
Component: Tax Division
Component No. 2476

Expenditures/Revenues (Thousands of Dollars)

Note: Amounts do not include inflation unless otherwise noted below.

OPERATING EXPENDITURES	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009
Personal Services	22.0	22.0	22.0	22.0	22.0	22.0
Travel		4.0	4.0	4.0	4.0	4.0
Contractual	1.1	2.1	2.1	2.1	2.1	2.1
Supplies	1.0	1.5	1.5	1.5	1.5	1.5
Equipment	5.0					
Land & Structures						
Grants & Claims						
Miscellaneous						
TOTAL OPERATING	**29.1**	**29.6**	**29.6**	**29.6**	**29.6**	**29.6**
CAPITAL EXPENDITURES						
CHANGE IN REVENUES ( )	**(500.0)**	**(750.0)**	**(1,200.0)**	**(1,200.0)**	**(1,200.0)**	**(50.0)**

FUND SOURCE (Thousands of Dollars)

1002 Federal Receipts						
1003 GF Match						
1004 GF	29.1	29.6	29.6	29.6	29.6	29.6
1005 GF/Program Receipts						
1037 GF/Mental Health						
Other (Specify Type--Do not abbreviate)						
TOTAL	**29.1**	**29.6**	**29.6**	**29.6**	**29.6**	**29.6**

Estimate of any current year (FY2003) cost: 0.0

Check this box (X) if funding for this bill is included in the Governor's FY 2004 budget proposal: [ ]

POSITIONS

Full-time						
Part-time	0.5	0.5	0.5	0.5	0.5	0.5
Temporary						

ANALYSIS: *(Attach a separate page if necessary)*

This legislation would allow taxpayers to take a Salmon Product Development Tax Credit against their tax liability for 50% of a qualified investment in new property.

The projected state tax revenue loss is based on the assumption that taxpayers will claim investment credits totaling $2 million in Fiscal 2004, increasing to $3 million in Fiscal 2005 and increasing to $4.8 million during 2005. The amount of credits generated are one half of qualified investments, totaling $4.9 million in credits during the life of this provision. We have assumed that tax liability limitations will hold taxpayers to using half of the credit generated in each year, with the remainder carried forward until fully absorbed. Use of the tax credit would expire on January 1, 2009.

The projections assume that certain technical corrections are incorporated into the bill.

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Approved by: Larry Persily, Deputy Commissioner | Date 3/4/2003
Agency: Department of Revenue

(Revised 9/2002 OMB)

<u>Operating Expenditures</u>

The Department of Revenue is requesting operating funds to cover the costs of one-half of a Tax Technician II position. The department anticipates that the 50% rate of credit for qualified investments totaling several million dollars will attract aggressive positions by taxpayers that, without enforcement activities, will inappropriately reduce revenue and crowd out targeted investment. The department will require additional Tax Technician resources to coordinate credits and limitations between returns of taxpayers with multiple facilities.

<u>Technical Analysis</u>

The most significant technical comment is in fact a question regarding the intent of the bill. The Fisheries Business Tax is focussed on the processing facility, whether it is a shore-based plant or a vessel. A taxpayer may own and operate several taxable facilities, each with its own licensing and tax filing requirements. Each requirement, limitation and allowance should be deliberately drafted to apply to the individual facility, or to the taxpayer and all its facilities, because the options will produce significantly different results.

As a case is point, the fundamental limitation for the credit is 50% of the *taxpayer's* Fisheries Business Tax on salmon. We interpret taxpayer to refer to the legal entity. Thus, a taxpayer that operates more than one processing facility has the flexibility to offset excess credits generated from its investment in one facility against tax from other processing facilities. The taxpayer-level limitation therefore offers more opportunity to fully utilize the credit and may generate investment that would not be economical under a facility-based limitation. The result, however, may conflict with other policy goals because the taxpayer-based limitation will favor large, established taxpayers.

<u>Comments and Recommendations</u>

Section 1
AS 43.75.035(b) limits the credit to 50% of the taxpayer's tax on salmon and includes a sunset provision of December 31, 2005.

Recommendation: The 50% limitation (based on taxes for salmon) can be applied at the facility level or at the taxpayer level. A facility-level limitation will restrict the amount of credit to 50% of the tax paid on salmon processed at *that facility* during the year of investment and the following three years. A taxpayer-level limitation will allow the credit to offset taxes on salmon processed or exported by the taxpayer anywhere in the state. We interpret subsection (b)(1) to be a taxpayer-level limitation. If a facility-based limitation is desired we recommend that subsection (b)(1) be amended to read:

(1) exceed 50 percent of the fisheries business tax reported on the return of the licensed facility or vessel with respect to salmon; or

Comment: The bill would allow credit to be claimed against taxes paid on salmon that is exported for processing outside of Alaska. This will maximize the potential use of the credit but appears contrary to the purpose of the credit. Adding "processed by the facility or vessel" after "salmon" in either version of (b)(1) would remove the tax on unprocessed exports from the pool of tax available for credit.

AS 43.75.035(c) provides a mechanism to provide partial credit for qualified property used on a vessel both inside and outside of Alaska.

Comment: This provision establishes the qualified portion of an investment on a vessel based on the *weight* of raw salmon processed on the vessel during the year that the property is first placed in service. An alternative would be to determine the ratio using the *value* of salmon processed within Alaska and everywhere. The weight ratio will be favorable to vessels whose in-state processing is focussed on salmon of a lower value relative to salmon processed outside of Alaska. A value ratio will favor vessels whose Alaska processing is focussed on salmon with a high value relative to salmon processed outside of Alaska.

AS 43.75.035(d) allows credits in excess of the current year limitation to be applied against taxes on salmon in the three subsequent tax years.

Recommendation: The bill should specify for clarity the order in which credits are taken. If the intent is to maximize the amount of credit actually used, the statute should specify that credits are applied on a first-generated, first-applied basis and before other credits.

AS 43.75.035(f) prohibits the use of the credit if the taxpayer is delinquent on its unemployment insurance contribution or taxes under AS 43.

Recommendation: This provision merely requires the taxpayer to pay delinquent taxes before filing a return on which the credit is claimed. A delinquent taxpayer can pay its tax the day before the next year's tax return is due and still claim a credit against that delinquent tax liability. This taxpayer therefore would be paid up for just a single day each year. To be effective, this provision should prohibit both the creation of credits and their use on a return if a delinquency occurred between the first day of the tax period and the later of the due date of the return or the date the return was actually filed and the tax paid. The provision can be further strengthened by reducing any credit carryover by the amount that would have been applied against taxes in the absence of the delinquency.

Comment: This is an area in which it is necessary to retain a taxpayer-level view. The rules have little meaning if a taxpayer merely pays its taxes for those facilities that are generating credits but is delinquent on taxes for other fisheries facilities.

AS 43.75.035(g) defines key terms that effectively spell out the requirements for the credit.

AS 43.75.035(g)(2) restricts the credit to investment in new property. This limitation will increase investment in new technology. Investment to re-use existing equipment is not covered by this credit. This restriction avoids tax motivated transfers of property that do not increase the level of value-added processing in the state. However, the restriction does not attract legitimate investment in used property that would increase the level of value-added salmon processing in Alaska.

Recommendation: Consider modifying this restriction in coordination with AS 43.75.035(a) to allow credit for new and used equipment that is placed into service *in Alaska* for the first time. This approach would provide more flexibility for processors seeking to initiate or expand value-added salmon processing, while preventing tax motivated transfers of equipment already in use in the state.

Recommendation: The bill should include anti-churning rules to prevent tax motivated transactions if the credit is made available for investment in used property that is already situated in the state.

AS 43.75.035(g)(3) provides the core definition for the credit – qualified investment. The definition contains an initial qualifier – depreciable tangible personal property. It goes on to add a compound qualitative attribute: that it be used *predominantly* to produce *value-added salmon products*. All three of these qualifications deserve their own definition within the statute. It will be necessary to carefully define them in order to retain any control and direction over the nature of investment for which the credit is awarded.

Recommendation: The useful life of an asset is a subjective determination that could produce unintended consequences. We recommend referring to "7-year property as that term is defined in 26 U.S.C 168(e)(1)". This definition will more effectively isolate equipment and avoid potential claims for ancillary items such as computers, automobiles and filet knives.

Recommendation: Qualified investments must be used *predominantly* to produce value-added salmon products. We interpret the term predominant in this context to mean more than half, or if no one productive use is more than half, the most prevalent use. The bill does not provide a standard with which to determine the predominant use of the investment. We recommend that the bill specify the standard to be employed such as value or weight and whether the standard is for inputs or finished product.

Comment: Predominant use will be difficult and controversial in cases where value-added salmon products are less than half of the activity. In these instances, a finding of predominance will depend on how finely the non-qualifying activity can be cut up. This may be a costly and acrimonious exercise that is best avoided. Based on a 50% credit the committee should consider abandoning the concept of *predominantly* and going with a more than half standard based on weight or value.

Recommendation: The phrase *value-added salmon products* represents the core of the credit and must be defined clearly. The phrase is a combination of two qualifying terms: *value-added* and *salmon product*. The term *value-added* is subjective and requires a clarifying benchmark to be meaningful and provide context for other requirements. For example, the list of value-added processing equipment refers to specific value-added processes and functions such as skinning, mincing and smoking. These appear to be clear examples of value-adding activity compared to headed-and-gutted frozen product. However, the list goes on to reference various processes and functions that are common to the production of non-value-added salmon products and value-added products of other species as well as salmon. The processes of portioning, preserving, packaging and blast-freezing are common to many, if not all, fish products. As written, the processor who blast freezes individual headed-and-gutted salmon and throws them in a container has performed all of these functions. In the absence of a clarifying definition, the examples themselves define *value-added* such that the equipment used in this minimum value adding operation qualify for the credit.

We recommend that the definition of *value-added* be carefully drafted as a separate definition representing the type of investment being targeted. We suggest using a separate and coordinated definition of *salmon product* to generate an effective definition of *value-added salmon products*. For example, define salmon products negatively to exclude products that you believe should not qualify as a value-added salmon product. In this way, the definition of salmon product acts as a safety net for the more subjective definition of value-added. This definition method leaves room for unforeseen value-added salmon products without allowing non-targeted activity to sneak in through the cracks. In the alternative we recommend that the committee remove the phrase *value-added salmon product* altogether and instead credit only equipment performing specific processing activities.

Comment: The listing of functions and/or processes like freezing, that are common to traditional and value-added salmon processing or common to processing of non-salmon species, will invite abuse and increase enforcement expenditures.

Recommendation: Investment credits are normally complimented by recapture provisions. Recapture, or "claw back" rules, reclaim all or part of the credit if the taxpayer does not follow through. Recapture normally occurs when the investment is later sold or diverted from the targeted activity. The existing bill merely requires instantaneous use of the property, after which it can be moved out of state or used for another species or process. For example, a taxpayer offloads processing equipment at its Alaska plant and runs a single salmon through it. The equipment itself, or a subsequent process, represents value-added processing. The equipment is immediately reloaded and shipped to Asia for sale or permanent use. This equipment qualifies for the credit.

We recommend adding a requirement that the property be used within the state, and for the targeted purpose, for a minimum number of years and that the credit be recaptured (perhaps with interest) when the requirements are not met. A simplified approach would be to require the qualified investment to remain qualified and in the state for a designated number of years and proscribe the percentage of credit that must be repaid based on the year that the property fails to qualify. We recommend credit recapture when the investment is sold, even if it continues to be used in the state. The automatic recapture at sale is absolutely necessary if the credit is expanded to cover purchases of equipment already in use in Alaska. Failure to recapture at sale will result in repeated credits for the same property potentially exceeding the cost of the property.

The recapture rules for floating processors will need to be customized.

Comment: The committee should consider the potential implications of awarding credit for freezers under the preserving or blast-freezing categories. Freezers installed on vessels will qualify for the credit. Shore-based freezers, however, may or may not qualify depending on whether the freezer is treated as real or personal property.

Section 4 – Retroactivity

The credit is retroactive for investments and property placed in service after January 1, 2003.

Comment: The retroactive application will represent an after-the-fact subsidy for qualified investment that has already occurred. The state will have gained nothing from its 50% investment in the property. The state will achieve more for its investment if the credit is restricted to prospective investments.

Recommendation: We recommend changing the effective date to January 1, 2004 and extending the life of the credit from December 31, 2005 to the end of 2006. This will avoid credits for historical transactions and allow taxpayers more time to incorporate the credit into their financial and operational plans.