**ALASKA STATE LEGISLATURE**
**HOUSE SPECIAL COMMITTEE ON WAYS AND MEANS**
April 8, 2005
8:30 a.m.

**MEMBERS PRESENT**

Representative Bruce Weyhrauch, Chair
Representative Norman Rokeberg
Representative Ralph Samuels
Representative Paul Seaton
Representative Peggy Wilson
Representative Max Gruenberg
Representative Carl Moses

**MEMBERS ABSENT**

All members present

**COMMITTEE CALENDAR**

HOUSE JOINT RESOLUTION NO. 12
Proposing amendments to the Constitution of the State of Alaska relating to the repeal of the budget reserve fund.

- HEARD AND HELD

HOUSE BILL NO. 235
"An Act excepting from the Alaska Net Income Tax Act the federal deduction regarding income attributable to certain domestic production activities; and providing for an effective date."

- HEARD AND HELD

OVERVIEW AK CORPORATE INCOME TAX

- SCHEDULED BUT NOT HEARD

**PREVIOUS COMMITTEE ACTION**

BILL: HJR 12
SHORT TITLE: CONST. AM: BUDGET RESERVE FUND REPEAL
SPONSOR(S): REPRESENTATIVE(S) HARRIS

| | | |
|---|---|---|
| 02/18/05 | (H) | READ THE FIRST TIME - REFERRALS |
| 02/18/05 | (H) | W&M, STA, JUD, FIN |
| 04/01/05 | (H) | W&M AT 8:30 AM CAPITOL 106 |

| | | |
|---|---|---|
| 04/01/05 | (H) | Heard & Held |
| 04/01/05 | (H) | MINUTE(W&M) |
| 04/08/05 | (H) | W&M AT 8:30 AM CAPITOL 106 |

BILL: HB 235
SHORT TITLE: DECOUPLING FROM FED TAX DEDUCTION
SPONSOR(S): RULES BY REQUEST OF THE GOVERNOR

| | | |
|---|---|---|
| 03/29/05 | (H) | READ THE FIRST TIME - REFERRALS |
| 03/29/05 | (H) | W&M, FIN |
| 04/08/05 | (H) | W&M AT 8:30 AM CAPITOL 106 |

**WITNESS REGISTER**

TOM WRIGHT, Staff
to Representative John Harris
Alaska State Legislature
Juneau, Alaska
POSITION STATEMENT: Offered information on HJR 12.

REPRESENTATIVE JOHN HARRIS, Sponsor HJR 12
Alaska State Legislature
Juneau, Alaska
POSITION STATEMENT: Offered information on HJR 12.

DAN DICKINSON, Director
Tax Division
Department of Revenue
Anchorage, Alaska
POSITION STATEMENT: Offered information on HB 235.

CHUCK HARLAMERT, Juneau Section Chief
Tax Division
Department of Revenue
Juneau, Alaska
POSITION STATEMENT: Offered information on HB 235.

JUDY BRADY, Executive Director
Alaska Oil and Gas Association
Anchorage, Alaska
POSITION STATEMENT: Testified in opposition to HB 235.

MICHAEL HURLEY, Chair
ConocoPhillips Alaska, Inc.
POSITION STATEMENT: Offered information on HB 235.

## ACTION NARRATIVE

**CHAIR BRUCE WEYHRAUCH** called the House Special Committee on Ways and Means meeting to order at 8:30:14 AM. Representatives Weyhrauch, Samuels, Seaton, and Moses were present at the call to order. Representatives Rokeberg, Wilson, and Gruenberg arrived as the meeting was in progress.

HJR 12-CONST. AM: BUDGET RESERVE FUND REPEAL

CHAIR WEYHRAUCH announced that the first order of business would be HOUSE JOINT RESOLUTION NO. 12 Proposing amendments to the Constitution of the State of Alaska relating to the repeal of the budget reserve fund.

REPRESENTATIVE SAMUELS moved to adopt the proposed committee substitute (CS) HJR 12, Version 24-LS0485\G, Cook, 4/4/05, as the working document.

8:31:59 AM

CHAIR WEYHRAUCH explained that Version G changes HJR 12 such that it establishes a capital construction fund that uses the constitutional budget reserve (CBR) essentially for "capital projects."

8:32:49 AM

TOM WRIGHT, Staff to Representative John Harris, Alaska State Legislature, related that the sponsor likes the idea of a capital construction account.

8:33:31 AM

CHAIR WEYHRAUCH highlighted that Version G still doesn't provide a budget cushion.

8:34:03 AM

REPRESENTATIVE SEATON pointed out that Alaska has a constitutional provision requiring that a third of the budget be in capital for which there has been no way in which to do it. Since [Version G] provides that mechanism, he said he supports the idea of a capital construction fund.

8:34:42 AM

REPRESENTATIVE WILSON reminded the committee that Alaska's deferred maintenance lists amount to over $1 billion. Therefore, the [capital construction fund will provide relief for many communities in need].

8:35:38 AM

REPRESENTATIVE SEATON turned to subsection (b), lines 11 through 15, which says:

> Money may be appropriated from the capital construction fund for maintenance of facilities of the State or a subdivision of the state. Money may be appropriated from the fund for payment of the principal and interest on general obligation or revenue bonds issued for the construction of capital projects by the State of a subdivision of the State, including a public corporation.

REPRESENTATIVE SEATON said the aforementioned subsection could be problematic because it doesn't specify whether the procedure is to have an ongoing annual source of revenue for capital construction. Therefore, it seems that one legislature could appropriate all the funds and obligate those funds for decades to come.

CHAIR WEYHRAUCH surmised that the aforementioned concern is "no doubt a risk."

8:37:29 AM

CHAIR WEYHRAUCH, in response to Representative Wilson, said the funds would come from the CBR and there wouldn't be any refunding of the CBR with settlement money.

REPRESENTATIVE WILSON charged that such an amount won't be adequate because it will require reliable sources to regenerate the fund.

8:38:23 AM

REPRESENTATIVE SAMUELS mentioned that he has spoken with the sponsor regarding HJR 12 including a percent of market value (POMV) methodology to ensure cash flow during market fluctuations. He related that Mr. Wright has indicated the aforementioned can be worked on in the next committee of

referral. Representative Samuels said his concerns were similar to those of Representative Seaton in that "all you're doing is issuing bonds off it." Representative Samuels opined that he would be more comfortable with language that allows use of the POMV.

MR. WRIGHT related the sponsor's intent is not to spend "one lump sum." The sponsor is also interested in the POMV methodology, he added.

8:39:55 AM

REPRESENTATIVE SEATON related he is in favor in the POMV and limiting it to capital projects.

8:40:59 AM

REPRESENTATIVE WILSON opined that the $2 billion currently available in the CBR should be set aside for emergency purposes because the state needs that protection.

8:42:47 AM

REPRESENTATIVE GRUENBERG opined that many Alaskans would support the concept of a "capital permanent fund" that protects the fund's principal. He turned to the appropriation limit in Article IX, Section 16, which has a one-third requirement and said it isn't unworkable and should be repealed. He noted that the proposed fund has no source of funding aside from the transfer of funds from the CBR. He inquired as to the possibility of endowing this proposed fund with a certain percentage of funds from certain things. Representative Gruenberg then related his belief that the POMV approach is attractive, but it's essential to ensure the fund's principal not be invaded. He highlighted if the intent of this proposed fund is to "finance bonds," setting forth the language to allow the principal to be used to capitalize or finance those bonds is appropriate. He reiterated that in order to "sell" this constitutional amendment to the legislature and the public it should be entitled, "capital permanent fund."

8:47:32 AM

REPRESENTATIVE SAMUELS highlighted that if the POMV mechanism is used there will be no principal earnings or interest. He asked what will serve as the state's cash flow if oil drops to $15 per barrel.

MR. WRIGHT explained that options for a cushion during the transition are still being discussed. Such options could include placing a portion of [the proposed fund] into a statutory budget reserve. However, in the event that oil drops to $15 per barrel, the CBR wouldn't serve as a cushion to cover the deficit and thus the state would be forced to find alternative measures for revenue. He related his understanding that currently if oil prices fall below $35 per barrel, the state will have to dip into it's reserve accounts.

8:49:15 AM

REPRESENTATIVE ROKEBERG recalled, with the exception of three years during his time with the legislature, it has utilized the CBR to balance the budget. He proposed a hypothetical situation in which the state had a $1 billion deficit, and said that neither the CBR or any amount of taxation could cover that debt. Therefore, he didn't believe there are many alternatives without some type of reserve. Representative Rokeberg inquired as to the discussions the sponsor has had with regard to the cushion and the necessity to fill fiscal gaps in the future.

MR. WRIGHT related that the sponsor is also concerned about the transition period that would occur until the state adopts a fiscal plan. The main purpose of HJR 12 is to force the legislature to develop a long-range fiscal plan. He offered that a statutory budget reserve could be utilized during a transition period. However, there are alternative options such as the earnings reserve from the permanent fund, which are available by a simple majority vote albeit a political decision.

8:51:59 AM

CHAIR WEYHRAUCH explained that HJR 12 would have simply eliminated the CBR with a vote of the public, while Version G offers several options into which the CBR could be appropriated. He informed the committee that he wanted to discuss Representative Rokeberg's proposal to repeal Section 17(c) in order to move both resolutions in tandem.

8:53:41 AM

REPRESENTATIVE ROKEBERG said that although he supports the concept of a long-range fiscal plan, he expressed concern with the proposal of including the CBR as an integral part of such a plan for the future. He referred to the concept of "triggers"

in which the state could manage cash flow around the CBR by having a tax regime which was triggered when the CBR hit a particular floor. Some have even suggested having a ceiling for the CBR such that once it reaches that ceiling the collection of [certain] taxes would stop. From a political standpoint, perhaps more public buy-in could be generated [with the aforementioned]. In order to accomplish something such as the aforementioned, he opined that there must be a corpus of a fund to reassure the state it can pay its "bills when appropriate." The CBR provides that core cash amount, and therefore he related his reluctance to get rid of it, particularly in the context of creating a long-range fiscal plan.

REPRESENTATIVE GRUENBERG said he doesn't support eliminating [Article IX], Section 17(c) because it provides balance between the minority and majority. He related his belief that Representative Rokeberg's concept is an interesting use of the CBR. He suggested that [HJR 12] and Representative Rokeberg's concept be reviewed together as part of the committee's planning for the state.

8:56:47 AM

REPRESENTATIVE SEATON suggested that [Section 18, subsection (b)], line 11 should be amended to read, "Money may be appropriated by the POMV method from the capital construction fund."

CHAIR WEYHRAUCH indicated that all amendments should be brought before the committee at the next meeting.

REPRESENTATIVE SEATON added that he will offer an amendment to [Section 18, subsection (b)], line 12 through 15, to delete "bonding" so the fund is only used for capital construction and maintenance.

8:59:15 AM

REPRESENTATIVE ROKEBERG, in response to Representative Wilson, said $400 million was needed as a cash flow cushion.

REPRESENTATIVE WILSON opined that a fiscal plan is essential in order for the legislature to be responsible and set enough aside for cash flow reasons.

CHAIR WEYHRAUCH related his belief that this resolution doesn't address [cash flow issues] but rather diverges from it.

9:01:29 AM

REPRESENTATIVE SEATON recalled that previous testimony from the Department of Revenue related other options to address the cash flow account without the CBR.

REPRESENTATIVE GRUENBERG commented this resolution should explicitly state this money can be used for bonding, therefore, he discouraged any deletion of the term.

CHAIR WEYHRAUCH added that the committee needs to review potential alternatives to meet the long-term fiscal problem.

9:02:55 AM

REPRESENTATIVE SEATON related his problem with paying off obligation bonds is that one legislature has the potential of tying up the entire revenue stream for the next 20 years. The idea of the capital construction fund is to have the ability to use an amount to be used for projects and maintenance. If one legislature can bond for large projects and dedicate the funding stream to pay off the debt, then there is a one-time capital bond and a mechanism to pay off the bonded indebtedness. These are two different philosophies.

REPRESENTATIVE GRUENBERG said that is not the way he interprets the language. He related his belief that the bonds wouldn't be dedicated revenue bonds, but rather they would be used for "financing." Therefore, one legislature couldn't tie-up the vast majority of the fund in perpetuity but rather those bonds could serve as a financing source for projects. The state uses a similar system for floating general obligation (GO) bonds or other financing or lease bonds, he added.

9:05:30 AM

REPRESENTATIVE JOHN HARRIS, Alaska State Legislature, speaking as the sponsor of HJR 12, related this CS does not offer the same "bipartisan spirit" originally proposed. The purpose of HJR 12 was to eliminate the CBR, its three-quarter vote and reverse sweep principle. He offered that a constitutional fund could be established as a cash flow mechanism by allocating $500 million from the CBR. Furthermore, the legislature could also capitalize on the earnings on the fund with a POMV methodology if it so chooses. The [idea behind this] is to generate $100-

$150 million annually for capital. He noted that he has another draft [version] to bring to the committee.

9:08:33 AM

REPRESENTATIVE WILSON inquired as to how the [capital construction] fund would be replenished on a regular basis.

REPRESENTATIVE HARRIS pointed out that the POMV would do that. He explained that high interest rates will allow the fund to grow. Furthermore, the legislature could deposit money into the account [during times of surplus] similar to what is done with the permanent fund. If the state receives some infusion of cash, it's probably not a bad idea to place it into a constitutionally protected fund such that the legislature can use its earnings regularly.

9:10:27 AM

REPRESENTATIVE WILSON related that she had the notion that it would grow more than from the interest. Perhaps a certain percentage of the [earnings] from the gas pipeline could be placed into the fund. She suggested that the fund should have additional revenue sources in order to meet the states ongoing needs, which amount to more than $100 million annually for maintenance alone.

9:11:27 AM

CHAIR WEYHRAUCH, in response to Representative Rokeberg, relayed that the intent of the resolution is to provide the money for revenue bonds. However, it's problematic because the entire principal could be obligated at one time, which he didn't believe to be good policy.

REPRESENTATIVE ROKEBERG mentioned that this resolution could be problematic in that it obligates future legislatures. Representative Rokeberg highlighted the difficulties the CBR has faced due to its short-term horizon of the cash management principles. Therefore, the proposal [encompassed in Version G] is that a longer term horizon policy similar to the Alaska Permanent Fund's policy could be utilized. Therefore, a statutory constitutional draw could generate higher yields.

REPRESENTATIVE GRUENBERG opined that if there's a constitutional capital fund then there will be political choices annually as to

whether the legislature wishes to deposit excess funds solely into the permanent fund or into a combination of the two funds.

CHAIR WEYHRAUCH added [that the legislature could also appropriate those excess funds] into a statutory reserve fund.

REPRESENTATIVE HARRIS opined that the aforementioned situation "is a good problem to have."

9:15:54 AM

REPRESENTATIVE GRUENBERG opined this is an important issue, and therefore he urged the chair to take the time necessary to focus on this matter.

HB 235-DECOUPLING FROM FED TAX DEDUCTION

9:17:18 AM

CHAIR WEYHRAUCH announced that the final order of business would be HOUSE BILL NO. 235, "An Act excepting from the Alaska Net Income Tax Act the federal deduction regarding income attributable to certain domestic production activities; and providing for an effective date."

9:17:32 AM

REPRESENTATIVE SEATON moved that the committee adopt CSHB 235, Version 24-GH1137\F, Kurtz, 4/7/05, as the working document. [No objection was stated, and Version F was treated as adopted and before the committee.]

9:17:46 AM

DAN DICKINSON, Director, Tax Division, Department of Revenue, noted that the committee should have a packet of information from the department. He explained that effective January 1, 2005, Alaska's tax laws relating to corporate income tax had fundamentally changed so that under federal law taxpayers may exclude a portion of their qualified production activity income (QPAI) when calculating the gross taxable income. The QPAI includes income from extraction, production, and manufacturing within the U.S. In Alaska the affected industries include: oil and gas production, refining and marketing, construction, fish and fish processing, and mining. In 2005, the deduction is 3 percent of QPAI, thereafter the deduction rises over time to 9 percent. He explained that when calculating federal income tax

one subtracts his or her expenses from his or her revenue. [With the new tax laws] now a portion of income earned can also be deducted from one's actual expenses. This impacts Alaska because Alaska automatically adopts federal income tax laws, although the legislature has the ability to not adopt any specific rule. For example, the state hasn't adopted the federal depreciation methods. The impact to Alaska is more dramatic compared to most other states due to the dominance of natural resources in Alaska. He highlighted that one of the problems is that under the rules established by the legislature, when calculating taxable income of Alaska's major industry, the oil and gas industry, the calculations begin with the worldwide income of the oil and gas corporations. Mr. Dickinson opined that although the federal law only applies to the QPAI within the U.S., the department believes that due to Alaska's tax structure the calculation would have to include worldwide activity.

MR. DICKINSON turned to the impact of these rules. In fiscal year (FY) 04, if the full 9 percent QPAI deduction had been in place, there would've been $24.7 to $27.4 million less in revenue collected under Alaska's corporate income tax. He estimated the projected corporate revenue loss over the next decade to be approximately $100 million as a consequence of this deduction. Mr. Dickinson specified that without HB 235 decoupling Alaska from the federal law, the department will face the burden of determining the QPAI-like activity outside of Alaska.

9:24:45 AM

REPRESENTATIVE SAMUELS asked what are the circumstances used to differentiate between a foreign and a domestic corporation.

MR. DICKINSON explained that for tax purposes the term "foreign" often describes anything outside Alaska, however, in this context it's used in a broader sense. A domestic corporation is one headquartered in the U.S. while a foreign corporation is one headquartered outside the U.S.

9:25:25 AM

REPRESENTATIVE WILSON asked what percent of Alaskan corporate income is foreign.

MR. DICKINSON replied, "None of it, we only tax income in Alaska. But the way we calculate it is we look at the worldwide

income and figure out what percentage of that is Alaskan and that’s of course all we can tax."

CHUCK HARLAMERT, Juneau Section Chief, Tax Division, Department of Revenue, clarified that the percentage of the aforementioned base assigned to Alaska is hard to calculated because the state has 12,000 taxpayers. He related that in 2003 Alaska's largest three taxpayers generated roughly two-thirds of their profits overseas. Therefore, he estimated that approximately two-thirds of the QPAI activity is non U.S.

9:26:48 AM

REPRESENTATIVE GRUENBERG related his belief that this is an "attractive bill." He asked if there are any other new wrinkles in federal law that should be decoupled.

MR. DICKINSON highlighted that although the law passed in 2004 is "massive" and proposes many changes, this is the only one the department suggests is appropriate to decouple.

9:27:44 AM

MR. DICKINSON returned to his presentation. He explained the reasoning for the federal tax policy was to advantage manufacturing or activity within the U.S. relative to that which is foreign. He said the governor views this as an unfunded federal mandate. However, some will argue that the state will be the beneficiary of this federal initiative because when companies, such as oil companies, bring money back home Alaska will benefit. However, he highlighted the need to realize that it's not just exploration and production that's advantaged but also refining and marketing of any refined products that create QPAI. He clarified that the total revenue of the company affected because the [companies] earn income in every state. The administration believes "that the system that existed before January 1, 2005, worked just fine" and now Alaska needs to take steps to decouple from the federal tax law on this point.

MR. DICKINSON turned to a chart entitled, "Projected State Revenue Loss from QPAI Deduction", which shows after 10 years of [this new federal tax law] the loss will average approximately $100 million. He continued with a page entitled, "Status of QPAI in Other States", which details that other states are attempting to decouple on this particular issue. In fact, Massachusetts has actually passed decoupling legislation.

9:31:46 AM

CHAIR WEYHRAUCH asked if the QPAI is only that within the U.S.

MR. HARLAMERT responded that under the federal law the aforementioned is exactly the definition; the federal government can and does draw a line around U.S. Therefore, for federal purposes, the QPAI for oil companies includes exploration and production as well as all the refining and marketing whether the crude came from a domestic well or abroad because refining is manufacturing. However, Alaska cannot simply adopt a federal discriminatory provision because of an established ruling by the U.S. Supreme Court. Alaska cannot discriminate against interstate or foreign commerce. He specified that the basic definition of discrimination is the different treatment, for tax purposes, of economic interests in a state versus those out-of-state.

9:33:04 AM

CHAIR WEYHRAUCH surmised then that the state's position is it's required, by the constitution, to look at potential QPAI worldwide, not just in Alaska.

MR. HARLAMERT replied, "Absolutely."

9:33:11 AM

REPRESENTATIVE ROKEBERG asked if the aforementioned ruling was a U.S. Supreme Court Case.

MR. HARLAMERT replied, yes.

9:33:15 AM

REPRESENTATIVE GRUENBERG related his belief that the CS merely combines subsections (a) and (b).

MR. DICKINSON indicated agreement. In further response to Representative Gruenberg, Mr. Dickinson replied that the state would have the same effective date as the federal mandate, January 1, 2005, and therefore there would be no revenue loss.

9:34:18 AM

MR. HARLAMERT, in response to Representative Gruenberg, replied that there are states that automatically adopt the federal law

and have to affirmably accept it, while other states don't automatically adopt and have to affirmably adopt rules. In general, it's sound tax policy to conform with the federal government, particularly with regard to minor timing differences. He acknowledged that the aforementioned does turn over some of the state's policy making authority to the federal government, and therefore the state needs to decide which policies are appropriate. The department, he noted, has never asked the legislature to address minor timing differences. This QPAI deduction, line 26 for corporate federal tax returns, is a permanent difference.

REPRESENTATIVE GRUENBERG clarified that the department would not recommend "flipping it around."

MR. HARLAMERT answered, "No, we would not."

9:36:39 AM

REPRESENTATIVE SEATON posed a situation in which a fishing company pays corporate tax. He related his understanding that if the state decouples, there is nothing in this legislation that would reduce the fishing company's corporate tax break from the federal government.

MR. DICKINSON confirmed Representative Seaton's understanding, and added that this legislation has no effect on federal taxes.

REPRESENTATIVE SEATON surmised that if the state doesn't decouple, the corporate tax for the state would be reduced by 9 percent over the years.

MR. HARLAMERT said it depends on the individual company because the QPAI calculation could be a subset of overall taxable income or it could exceed net taxable income. However, the federal statute limits the deduction to the percentage to the lesser of QPAI or taxable income, so it will never exceed 9 percent of taxable income. Although it could exceed 9 percent of [a company's] tax because it reduces tax and then has credits, the percentage reduction of net tax liability will be greater than the percentage reduction of taxable income. He added the question is difficult to answer, and thus the department has estimated a rough range of percentages. In further response to Representative Seaton, Mr. Harlamert explained that [coupling] essentially allows a multistate or multinational business entity to take the QPAI wherever it's earned, regardless of geological boundaries, and have the exact impact and deduction in the

calculation of Alaska income. At the federal level it's an incentive because it can be restricted to U.S. profits while at the state level it cannot be restricted. Therefore, it offers no incentive.

9:39:49 AM

JUDY BRADY, Executive Director, Alaska Oil and Gas Association (AOGA), said AOGA opposes this legislation for two reasons. First, the justification for this legislation has been misstated, and therefore the fiscal impacts have been significantly overstated. Second, the [oil] industry views this legislation as yet another tax increase to the [oil] industry. She explained that Congress passed the federal Jobs Act creating, among other things, a tax incentive to bring more manufacturing and production to the U.S. because Congress believed that many companies were disadvantaged overseas. Furthermore, this federal legislation applies to all companies that manufacture and produce in the U.S. and doesn't just target the oil and gas industry. This tax incentive makes it unequivocal that the QPAI has to come from manufacturing activity occurring in the U.S., not overseas. The purpose of [the Act] was to give advantage to companies in the U.S. This legislation, HB 235, proposes to undo the automatic adoption of Section 199 and prevent it from taking effect for state income tax purposes. In the fiscal note for this legislation, the Department of Revenue claims that letting Section 199 take effect for Alaska purposes would cost the state between $95 million and $105 million from now until fiscal year 2013. Furthermore, the department charges that it could cost more than $500,000 annually to administer Section 199 if it takes effect. However, AOGA believes the aforementioned estimates are "severely overstated because of a faulty premise in DOR's analysis." She said this premise is stated in the fiscal note as follows:

> In order to avoid impermissible discrimination against economic activity outside of the state, taxpayers will be allowed the QPA [Income] deduction on their Alaska return for all production wherever the activity occurred in Alaska, another state, or in a foreign country. Production activity conducted in-state, domestic out-of-state, or in a foreign country will be awarded an equal deduction.

MS. BRADY opined that if the aforementioned statement was true AOGA would not oppose this legislation. In assessing the state

revenue impact of letting Section 199 take effect, the Department of Revenue looked at potential "production activity income" everywhere in the world, because Alaska's corporate income tax is worldwide. However, the Department of Revenue did not look just at the "qualified production activity income" as defined by Congress, which is only that income which comes from production activity inside the U.S. Ms. Brady said:

> Despite what DOR asserts to the contrary in its fiscal note, when Alaska passively adopts a limited federal deduction, it does not legally or logically follow from this fact that DOR must, or even can, under the Foreign Commerce Clause of the U.S. Constitution, completely remove the limitation in the course of administering the deduction for state tax purposes. And there is, in fact, ample precedent when a geographically limited federal provision remains limited in precisely the same way when it is applied under the Alaska income tax. For instance, expenditures for enhanced oil recovery (EOR) give rise to a federal tax credit that Alaska also allows, and the federal tax credit is limited to expenditures for EOR projects in the United States – administering the EOR credit for state purposes, DOR does not impute a hypothetical credit for EOR projects outside the U.S. Instead, DOR uses the same domestic territorial limitation as the federal credit has. We [AOGA] do not see how the domestic territorial limitation in the new QPA income deduction would be any different for the one for EOR in terms of its potential for impermissible discrimination. In other words, since the DOR isn’t applying the EOR credit on a worldwide basis, it is inconsistent for DOR to say it must apply the QPA income deduction on a worldwide basis. Because of its faulty premise about how broadly the QPA income deduction must be applied for state purposes, DOR's estimated revenue impacts are overstated by at least a factor of two or three times, depending on how much QPA income it foresaw from non-U.S. production activities ... they [DOR] believe that about 40 percent of the production activity ... or two-thirds is non-U.S. Similarly, the estimated administrative cost of $500,000 is entirely a result of this same faulty assumption. The IRS will audit taxpayers' QPA income from activities in the U.S., and there will be nothing left for the DOR to audit and

enforce. The $500,000 a year then should disappear, in terms of a fiscal issue.

MS. BRADY continued:

We [AOGA] also disagree with DOR's conclusion in the fiscal note that the anticipated beneficial effects of the QPA income deduction at the federal level cannot be replicated at the state level. At least with respect to oil and gas, the two principals of qualified production activity in the United States are the deep-water Gulf of Mexico and Alaska. With only two hot spots for the action to occur in, it seems likely that Alaska would be ahead of the game when the incentive works if it attracts new production to the U.S. We believe that given DOR's contrary conclusion about any benefit accruing to Alaska as it becomes more competitive, it seems improbable that DOR made any serious attempt to estimate and include increases in state tax revenues from the new production activities ... because this is indeed a tax incentive. Thus, both on policy grounds as well as potential fiscal impacts, the justification that DOR has given for this legislation has been overstated and misstated.

And the second reason is that ... to the industry this represents yet another tax increase on the oil industry from this administration. It is a tax increase because Section 199 of the Internal Revenue Code was automatically adopted for state purposes as of January 1, when it took effect. This section, in other words, is already the status quo. HB 235 proposes to change the status quo by undoing the adoption of the section, and raising income tax for our industry and every other industry in the state having qualified production activity. I think most of you have seen DOR's just released spring revenue sources book, which talks about the need for literally tens of billions of dollars of new investment to keep oil production steady, and they have decreased the kind of production they think they're going to get in the next years. What we all know, and fortunately for us, Alaska is one of the two places in the United States and one of the 30 or 40 places in the world that's considered to have good rocks. We still have good enough potential reserves so that large

companies, like Shell ... are still interested in coming up here.

MS. BRADY concluded by highlighting that companies are always looking to determine where their investment money will have the most advantage.

9:50:44 AM

CHAIR WEYHRAUCH indicated that AOGA's letter would be entered into the record.

9:51:30 AM

MICHAEL HURLEY, Vice Chair Tax Committee, ConocoPhillips Alaska, Inc., in response to Representative Rokeberg, answered that the federal government accounts for the EOR credit at the federal level, audits it, and then that's part of the total federal income which is apportioned to Alaska versus other states.

9:53:13 AM

REPRESENTATIVE SEATON related his understanding that AOGA believes [the impact of decoupling] would result in $33 million in corporate income taxes as opposed to the aforementioned projected $100 million.

MS. BRADY replied that AOGA's valuation is based on what it believes the production outside Alaska, outside the U.S., and Inside the U.S. However, antitrust laws prevent companies from knowing [exact amounts].

REPRESENTATIVE SEATON reiterated that if one takes DOR's two-thirds of non-U.S. QPAI would result in [a loss of] $33 million rather than $100 million.

MS. BRADY added the aforementioned amount would be over a 10-year period.

9:54:45 AM

MR. HURLEY, in response to Representative Rokeberg, added that the Department of Revenue includes the foreign impact, which makes the state revenue loss less by roughly two-thirds. In further response to Representative Rokeberg, Mr. Hurley said it's hard to estimate [the exact figure] but from ConocoPhillips Alaska, Inc. perspective it would be at least half.

9:56:05 AM

REPRESENTATIVE ROKEBERG related his understanding that ConocoPhillips Alaska, Inc. has less international activity than other oil companies. According to Ms. Brady, the enactment [of HB 235] would be the removal of an incentive for the industry to invest in Alaska, but the effect is "de minimis." He asked whether this is a "hard number" issue or a policy call.

CHAIR WEYHRAUCH commented that the first part of AOGA's testimony was hard number and the second part was policy call.

MS. BRADY mentioned that oil companies are concerned with both the cost of business and policy issues in an area.

9:58:14 AM

REPRESENTATIVE WILSON inquired as to the impact if every state decouples.

MS. BRADY relayed that the federal law is intended to make places more attractive to do business in the U.S. rather than overseas. She related her belief that the oil industry gets hit the hardest because the oil industry pays most of the tax. Even $30 million over a 10-year period is a lot of money. She highlighted the need for all sides to address this matter from the perspective of competition.

10:00:47 AM

REPRESENTATIVE SEATON expressed concern that Alaska doesn't have the ability to discriminate, and therefore Alaska will be giving tax breaks for QPAI earned in any U.S. location. The fishing industry provides many examples of this, he noted.

MR. HURLEY said Representative Seaton's analysis is correct because the purpose is to keep manufacturing and production within the U.S.

10:02:08 AM

REPRESENTATIVE ROKEBERG highlighted that within the U.S. 14 states export oil and gas. He recalled that AOGA's testimony was that adoption of this legislation would raise taxes and deviate from the status quo. However, he opined that this

legislation would maintain the status quo that existed prior to January 1, 2005, and therefore not raise taxes.

MS. BRADY replied the deduction is in place now.

10:04:12 AM

REPRESENTATIVE GRUENBERG highlighted the importance of the governor's opinion that this deduction hoisted upon the states is the same effect as an unfunded federal mandate.

**ADJOURNMENT**

10:04:52 AM

There being no further business before the committee, the House Special Committee on Ways and Means meeting recessed at 10:04 a.m. to April 11, 2005.