ALASKA STATE LEGISLATURE
HOUSE RESOURCES STANDING COMMITTEE
April 6, 2012
1:04 p.m.

MEMBERS PRESENT

Representative Eric Feige, Co-Chair
Representative Paul Seaton, Co-Chair
Representative Peggy Wilson, Vice Chair
Representative Alan Dick
Representative Neal Foster
Representative Bob Herron
Representative Cathy Engstrom Munoz
Representative Berta Gardner
Representative Scott Kawasaki

MEMBERS ABSENT

All members present

COMMITTEE CALENDAR

DISCUSSION(S): 7-DAY COMMERCIAL FISHING CREWMAN'S LICENSE

- HEARD

HOUSE BILL NO. 328
"An Act relating to the oil and gas corporate income tax; relating to the credits against the oil and gas corporate income tax; making conforming amendments; and providing for an effective date."

- HEARD & HELD

SENATE BILL NO. 192
"An Act relating to the oil and gas production tax; and providing for an effective date."

- SCHEDULED BUT NOT HEARD

PREVIOUS COMMITTEE ACTION

BILL: HB 328
SHORT TITLE: OIL AND GAS CORPORATE TAXES
SPONSOR(s): REPRESENTATIVE(s) SEATON

02/17/12	(H)	READ THE FIRST TIME - REFERRALS
02/17/12	(H)	RES, FIN
02/29/12	(H)	RES AT 1:00 PM BARNES 124
02/29/12	(H)	Heard & Held
02/29/12	(H)	MINUTE(RES)
03/16/12	(H)	RES AT 1:00 PM BARNES 124
03/16/12	(H)	Heard & Held
03/16/12	(H)	MINUTE(RES)
03/28/12	(H)	RES AT 1:00 PM BARNES 124
03/28/12	(H)	Heard & Held
03/28/12	(H)	MINUTE(RES)
04/06/12	(H)	RES AT 1:00 PM BARNES 124

WITNESS REGISTER

MIKE MONAGLE, Director
Central Office
Division of Workers' Compensation
Department of Labor & Workforce Development (DLWD)
Juneau, Alaska
POSITION STATEMENT: Answered questions during the discussion on 7-Day Commercial Crewmember's License.

JOHANNA BALES, Deputy Director
Anchorage Office
Tax Division
Department of Revenue (DOR)
Anchorage, Alaska
POSITION STATEMENT: Answered questions during the hearing on HB 328.

ACTION NARRATIVE

1:04:20 PM

CO-CHAIR ERIC FEIGE called the House Resources Standing Committee meeting to order at 1:04 p.m. Representatives Feige, Seaton, Herron, P. Wilson, Kawasaki, Gardner, Dick, and Foster were present at the call to order. Representative Munoz arrived as the meeting was in progress.

DISCUSSION(S): 7-Day Commercial Fishing Crewman's License

1:05:19 PM

CO-CHAIR FEIGE announced the committee would hear discussion on an issue pertaining to the Fisherman's Fund Advisory and Appeals

Council. The issue deals with nonresident 7-day crewmember fishing licenses.

1:05:59 PM

CO-CHAIR SEATON directed attention to a letter in the committee packet dated 4/4/12 from James Herbert, representative of the Fishermen's Fund Advisory and Appeals Council. Mr. Herbert's correspondence was in response to the committee's inquiry as to the effect of $30, nonresident, 7-day commercial fishing licenses on the fees for insurance coverage collected by the Fishermen's Fund, Division of Workers' Compensation, Department of Labor & Workforce Development. An attachment to the letter provided analysis from 2004-2011, which showed the growth in the number of nonresident, 7-day crewmember licenses to 2,296 sold in 2011. Representative Seaton explained the issue is whether revenue to the state from the sale of short-duration licenses is sufficient to pay the cost of insurance coverage, which is the same as for a full-price license. The original intent of the 7-day license was to provide an economic incentive for "dude fishing" aboard a commercial fishing vessel. Although that economic potential has not been realized, over 2,000 short-term licenses have been sold in lieu of full-price licenses. In fact, in a short season fishery like Bristol Bay, a nonresident commercial fisherman could buy consecutive 7-day licenses and avoid paying the intended price. He concluded that this discussion is to inform the committee, the public, and state agencies of this situation, and no action is recommended at this time.

REPRESENTATIVE GARDNER referred to the attachment and asked how sales expenses are calculated.

CO-CHAIR SEATON expressed his belief that the sales expense is about 10 percent and goes to the vendor selling the license.

1:11:13 PM

MIKE MONAGLE, Director, Central Office, Division of Workers' Compensation, Department of Labor & Workforce Development (DLWD), informed the committee he is also the commissioner's designee and chair of the Fisherman's Fund Advisory and Appeals Council. Mr. Monagle said he did not know the answer to Representative Gardner's question, however, the Fisherman's Fund gains one percent of each commercial crewmember license issued and of each Commercial Fisheries Entry Commission (CFEC) permit renewed. Having only been made aware of Mr. Herbert's letter

this morning, he said he could not speak to the veracity of the data attached thereto, although the balance of the fund is almost $12,000,000, against claims in the range of $700,000-$800,000 per year. Mr. Monagle offered his belief that the sale of the licenses under discussion has not been a significant impact to fund revenues.

CO-CHAIR SEATON recalled that at the time the legislature approved the sale of this license, the legislation was changed to allow one person to purchase the license more than once in a year. He asked Mr. Monagle to research whether the 7-day license is a way to avoid paying the full nonresident commercial fee, which is intended to pay for administration of the fund, and to cover liability to the state. He further asked Mr. Monagle to provide data on how many licenses were purchased by the same person.

MR. MONAGLE said that the Alaska Department of Fish & Game (ADFG) does not capture specific information on each license sold, but he agreed to research the performance of the Fisherman's Fund prior to the passage of this legislation in 2005, and afterward.

1:15:23 PM

CO-CHAIR FEIGE asked whether it is possible to differentiate what class of license was held by a crewmember who filed a workers' compensation claim.

MR. MONAGLE answered that his division could identify whether a crewmember was a resident or a nonresident. He was unsure about information on the type of license.

CO-CHAIR SEATON requested that the division, on behalf of the Fisherman's Fund, request analysis by ADFG on whether the licenses being sold are purchased serially - to avoid paying the full, nonresident fee - or if they are purchased individually.

MR. MONAGLE agreed.

1:16:43 PM

HB 328-OIL AND GAS CORPORATE TAXES

1:16:48 PM

CO-CHAIR FEIGE announced that the final order of business would be HOUSE BILL NO. 328, "An Act relating to the oil and gas corporate income tax; relating to the credits against the oil and gas corporate income tax; making conforming amendments; and providing for an effective date."

[Before the committee was Version I, which was adopted as the working document on 3/28/12.]

1:17:31 PM

JOHANNA BALES, Deputy Director, Anchorage Office, Tax Division, Department of Revenue (DOR), expressed her understanding that the committee wished to hear discussion regarding the 4/3/12 letter to Representative Seaton from Bruce Tangeman, Deputy Commissioner, DOR.

CO-CHAIR SEATON stated the proposed committee substitute (CS) for HB 328, Version I, was offered by the committee to address the questions raised earlier by DOR and industry. He said his goal was to hear DOR's response to Version I, and how the bill can efficiently implement policy. He asked Ms. Bales to review the letter in an orderly fashion.

MS. BALES advised that as requested, the letter is a review of the CS by DOR, and also identifies previously-discussed issues. She cautioned that the issues identified in the letter are not all-encompassing. Beginning with paragraph (A), she noted DOR's first concern that there is a requirement for companies to make estimated tax payments, but there is no penalty for noncompliance. The department suggested that the language of the proposed CS include the penalty provisions of Internal Revenue Code Sec. 6655. She pointed out that the penalty provisions under the Production Tax that are included in the CS do not belong, cause confusion, and conflict with the Internal Revenue Code provisions. The remedy recommended by DOR is that the Production Tax penalty provisions are taken out and the penalty provisions of the Internal Revenue Code are adopted.

CO-CHAIR SEATON surmised adequate language under the penalty provision would read:

> Penalties would be those as under the Internal Revenue Code Sec. 6655, using Alaska interest rates.

MS. BALES opined DOR is "fairly certain" those provisions would work. Right now under the corporate income tax structure, DOR

adopts the Internal Revenue Code and all of the provisions apply.

1:21:49 PM

CO-CHAIR FEIGE, in response to Co-Chair Seaton's request, encouraged the drafter of the bill to interject, if necessary.

MS. BALES directed attention to paragraph B of the letter, concerning the language in Sections 3 and 5 of the bill. She advised that a corporation operating in Alaska would not be subject to separate accounting provisions until it was actually producing oil. Therefore, DOR is concerned that if there were an exploration corporation operating in the state, it would not be subject to separate accounting, but would have to compute its taxable income using a water's edge formulary apportionment, because it is not an oil and gas company under that provision. In that case, when the exploration corporation began producing oil and gas, it would be subject to separate accounting, and any losses carried forward from its exploration phase would have to be dealt with in the separate accounting provision. Ms. Bales remarked:

> The way that this language is written doesn't get us there, because the problem you have is that the language that allows any type of losses to be carried into [AS 43.21] are in 43.21, and yet you're not subject to that until you're actually producing. ... There needs to be some very straightforward language, probably not even within 43.21, that basically says that if you're an oil and gas exploration company and ... you incur losses, and then you are subject eventually to 43.21, that those losses incurred during those exploration and development phases get to be carried forward into 43.21.

CO-CHAIR SEATON asked whether having the aforementioned provision in AS 43.20 or in AS 43.21 would take care of DOR's concern.

MS. BALES explained language needs to be in either AS 43.20 or AS 43.21 that addresses when a corporation is subject to tax under another provision, if that provision relates to oil and gas. She turned attention to paragraph C of the letter, saying this is similar to the concern in paragraph B that there is a provision that allows for lease acquisition payments, property taxes, and interest incurred prior to production; those items

would not be allowed to be deducted against future production income, because the methodology that gives those deductions is in AS 43.20. This also causes confusion and is a "disconnect." Ms. Bales continued to explain that in addition to the loss items discussed in paragraph B, capital expenditure items need a provision to carry them into AS 43.21 when a corporation starts producing.

CO-CHAIR SEATON clarified that if in AS 43.20 there were a provision that expenses could be carried forward into AS 43.21 and used against taxes - if they had not been previously offset by credits - that would take care of the situation.

MS. BALES said DOR requires language that talks about ensuring that capitalized items, and any remaining basis in those properties and capitalized items, are carried forward into AS 43.21.

CO-CHAIR SEATON repeated for the benefit of staff from Legislative Legal and Research Services, Legislative Affairs Agency.

1:27:50 PM

CO-CHAIR FEIGE passed the gavel to Co-Chair Seaton.

MS. BALES turned to paragraph D of the letter, and observed that there is no language in AS 43.21 that requires property to be capitalized and depreciated; there was an attempt to do that in AS 43.21.210 (c)(5) but that language allows a company to write-off the direct cost of purchasing a piece of equipment, and also allows the company to take depreciation on the same equipment. Although the intent here was to require that property be capitalized and not taken as a direct expense, that is not what this language says. Again, specific language is needed that says property must be capitalized and depreciated.

CO-CHAIR SEATON asked Ms. Bales to restate the language needed in Section 5.

MS. BALES advised there are many provisions in the Internal Revenue Code that deal with these issues and it is extremely complex. In further response to Co-Chair Seaton, she acknowledged it was possible to adopt a provision in the code, but cautioned that the code has lots of different ways to handle property, and adopting the provisions in the Internal Revenue Code makes sense. She clarified that the capitalization

provisions that talk about capitalization, and how to determine basis for depreciation, are in Section 1231. The provisions within the Internal Revenue Code are various and different code sections may be relevant. It is difficult for DOR to pinpoint that a specific code section is relevant, because the department needs to know the full intent of the legislation.

CO-CHAIR SEATON explained that the intent is to get property capitalized, using the current capitalization depreciation schedules. He asked whether there exists in Alaska Statutes such a regulation.

1:33:23 PM

MS. BALES said under the current corporate income tax, DOR adopts the entire Internal Revenue Code - including all of the regulations, revenue rulings, and court cases - which gives DOR a broad basis of guidance. She summarized that the biggest issue is that because AS 43.20 is "stand alone" and does not adopt the Internal Revenue Code, many situations are not addressed. Furthermore, the proposed bill requires a corporation's oil and gas production activity to be taxed under AS 43.21, but other activity to be taxed under AS 43.20, and DOR anticipates problems bringing those two activities together.

CO-CHAIR SEATON suggested the language could say, "Property will be capitalized under 43.21 in the same manner that it's capitalized in 43.20."

MS. BALES opined that language would help for the capitalization of property, but there would still be questions on provisions in AS 43.21 related to previous deductions, the depreciation of assets, and timing.

CO-CHAIR SEATON recommended adopting the depreciation schedule currently used by the Internal Revenue Service (IRS).

MS. BALES observed that currently oil and gas companies do not calculate their depreciation the same way as for their federal taxes, because they are required to use the Internal Revenue Code as of 1981. Again, in the bill there remains separate accounting for oil and gas, but worldwide apportionment for other activities. In fact, DOR is highly concerned because it cannot look to the Internal Revenue Code for guidance pertaining to intercompany transactions, and capital gains and losses, since those transactions are now being accounted for significantly differently. Moreover, the capital gains and

losses provisions in the Internal Revenue Code are even more numerous than the consolidated corporation rules. Ms. Bales then directed attention to paragraph E of the letter, noting again that the provision in AS 43.21.210(c)(7) has no related language in AS 43.20. Paragraph F addresses AS 43.21.210(c)(8), which allows expenses that were incurred on dry holes, abandoned wells, and unsuccessful exploration, to be written off; however, those expenses would have already been deducted under AS 43.20 as part of an operating loss. Needed is language that allows the calculation of operating loss under different methodology.

1:39:40 PM

CO-CHAIR SEATON inferred there could be a restriction so that the state would not pay a tax credit on an expense, and then allow the expense to be deducted. In response to Ms. Bales, he said he was referring to a production tax credit.

MS. BALES surmised Co-Chair Seaton intended that a company that received a credit in its production tax means that the value of that expense in corporate tax should be reduced.

CO-CHAIR SEATON said yes, the tax should be reduced, or the tax credit should be declared as income.

MS. BALES advised that is a definite departure from the Internal Revenue Code, so there would need to be specific language to that affect. Ms. Bales continued to paragraph G, and questioned whether the intent was to disallow the film production tax credit.

CO-CHAIR SEATON indicated the committee would further discuss the film production tax credit.

MS. BALES, as an aside, pointed out that the Internal Revenue Code credits are adopted under AS 43.20, thus federal credits are allowed for expenses incurred in Alaska or elsewhere, but would not be under AS 43.21.

1:44:07 PM

CO-CHAIR SEATON confirmed that those federal credits are allowed to be used anywhere in the U.S.

MS. BALES said yes. She returned attention to paragraph H, saying that this provision is probably DOR's biggest concern; as a matter of fact, DOR is unsure as to whether adopting the

Internal Revenue Code in its entirety provides the solution. As the bill directs, intercompany transactions would only be allowed when they are to the benefit of an oil and gas producing activity in Alaska. Under the Internal Revenue Code, many intercompany transactions are not recognized - they negate themselves - thus adopting the Internal Revenue Code does not necessarily put the issue to rest. She said DOR would need specific language that identifies what type of transactions a corporation in Alaska has with a sister company that provides a benefit to the oil and gas production activity in Alaska. In response to Co-Chair Seaton, she gave the example of an oil and gas parent company that has a subsidiary which is a production company producing oil and gas in Alaska. If the parent company creates a sister company which supports the production activity of the subsidiary, the parent company is required to calculate its tax under water's edge formulary apportionment. Furthermore, based on the language of the bill, the sister company would no longer be an oil and gas company, and not part of the consolidated group conducting predominately oil and gas activity. In this case, DOR is unsure how to deal with the sister company's activities and expenses.

REPRESENTATIVE GARDNER asked whether companies divide up their activities for tax purposes; if so, are services by a subsidiary - which may have other partners - that are paid by the parent company, direct costs.

MS. BALES agreed that subsidiaries are often created for tax or geographical purposes. Common problems dealing with billings that are all going to be paid for by the parent corporation are transfer pricing, overpricing, and switching income from one jurisdiction to another. She recommended that DOR and the bill sponsor have further discussions related to sister corporations.

1:50:20 PM

CO-CHAIR SEATON suggested language as follows:

> Intercompany expenditures must be calculated on a commercially reasonable rate

MS. BALES acknowledged the aforementioned language would be helpful; however, during an audit one of the biggest issues the IRS deals with is when a domestic corporation transfers income offshore to a foreign corporation with the same parent corporation. An additional concern about this legislation is that companies will learn to legally "income shift" within the

confines of this proposed statute. Returning attention to the letter, Ms. Bales explained that paragraph I is a list of issues incongruent with the Internal Revenue Code such as certain fines and penalties that are not deductible against corporate income tax, but are deductible under AS 43.21. Also, subchapter S corporations are not taxed as corporations under Alaska corporate income tax, but are - in certain cases - taxable under AS 43.21.

CO-CHAIR SEATON asked whether there are subchapter S corporations in Alaska that are engaged in oil and gas production.

MS. BALES said she would provide that information. Continuing with the list of issues from paragraph I, she informed the committee intangible drilling costs are required to be capitalized and depreciated under current Alaska corporate income tax, but are not under AS 43.21, and dividend income may or may not be taxable. In response to Co-Chair Seaton, she explained dividend income may be interest income from investments or from operations by a parent corporation. At this time, HB 328 dividend income is separated from oil and gas production activity. The fifth issue in paragraph I was that the bill does not require an amended return if there is a federal audit or federal amended return. The sixth issue in paragraph I was that charitable contributions made by a corporation solely engaged in oil and gas production activity do not appear to be deductible. In response to Co-Chair Seaton, she explained that this issue would arise because a corporation whose only activity is oil and gas production is currently allowed to deduct its contributions.

1:58:44 PM

MS. BALES continued to the seventh issue in paragraph I, noting that under federal law, gains and losses are separated into many types, but it is unclear to DOR as to how gains and losses should be treated under the proposed bill. The eighth issue in paragraph I was that as the bill is written, everything comes under AS 43.21, and the Internal Revenue Code needs to be adopted to maintain consistency. In conclusion, Ms. Bales reiterated there are likely other issues and items that DOR did not consider and, although most issues could be taken care of by adopting the Internal Revenue Code, DOR must look at the effect of different segments of the legislation on corporations, and at the intent of the legislature.

CO-CHAIR SEATON thanked Ms. Bales for her helpful presentation. He spoke of the legislature's responsibility to create policy with few questions, and the value of cooperation from agencies. He also noted that a policy call on separate accounting is especially relevant in light of the announcement by ConocoPhillips that it has split into two corporations: Phillips 66 will have all of the downstream operations, most of which are outside of Alaska, and ConocoPhillips will retain upstream operations.

There followed discussion about ConocoPhillips, and Co-Chair Seaton recommended a recent article in Petroleum News on the organization of integrated companies.

REPRESENTATIVE P. WILSON observed there was another letter included in the committee packet from DOR dated 3/16/12.

CO-CHAIR SEATON explained that CS Version I was created in response to the issues brought forth in DOR's letter of 3/16/12. The letter discussed today, dated 4/3/12, would be the basis for further refinement of the bill.

2:08:54 PM

[HB 328 was held over.]

ADJOURNMENT

There being no further business before the committee, the House Resources Standing Committee meeting was adjourned at 2:09 p.m.