

OIL AND
GAS
TAXATION

SENATE RESOURCES COMMITTEE

HOUSE RESOURCES COMMITTEE

Testimony of Lawrence L. Wilson

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My name is Lawrence L. Wilson, Associate Tax Counsel, Union Oil Company of California. I shall be speaking today on a number of bills which cover income taxation, severance taxation and property taxation. Specifically, these will be SB 105 and its companion bill, HB 145 and HB 322, all of which deal with income taxation along with SB 202 which is the "net proceeds" tax. I will also cover SB 103 and HB 321 and its companion bill HB 144, which deal with severance taxation. Finally, there will be remarks covering HB 323 dealing with property taxation and HB 328 dealing with the Reserves Tax. Where appropriate, my remarks will also comment on testimony that has already preceded my testimony. The first bill I wish to comment on is SB 105. No reference is made to HB 145 since it is an identical bill.

SB 105

SB 105 is a bill which purports to determine income to Alaska through the "separate accounting" method. The prefatory language in Section 1 states that the present method of apportioning income under the three-factor formula embodied in the Multistate Tax Compact does not fairly represent the extent of

the business activities in Alaska for corporations engaged in the production and pipeline transportation of crude oil and natural gas. Section 1 goes on to state that the legislature, therefore, intends that section 18 of Article IV of the Compact, which allows separate accounting, shall be adopted for determining income derived from the production and pipeline transportation of oil and gas.

Richard Kilgore of Walter J. Levy and Associates and Professors Jerome Zeifman and Kenneth Ainsworth have commented on "separate accounting" as a method of determining income with Mr. Kilgore defending it and Messrs. Zeifman and Ainsworth attacking it. Even Mr. Kilgore acknowledged that the administrative problems of determining "value" for a product transferred out of the state and of allocating expenses to Alaska were troublesome. Messrs. Zeifman and Ainsworth painted a picture of corporate maneuvering by astute managers to deliberately operate Alaska affiliates at a low profit through such means as selling property to the affiliate at high prices to get high depreciation and by allocating excessive overhead.

However, none of these witnesses have provided this Joint Committee with the really significant reasons why separate accounting is an unsatisfactory method of determining income within a state. First, even if one could overcome the administrative problems of valuing production and allocating overhead, separate accounting simply cannot adequately and properly determine how much profit of a business is derived from within a

state where the overall business has parts which are dependent upon one another and which are located in more than one state. It was for this very reason that the "unitary business" concept was developed along with apportionment formulas to determine how much of the total income of the total multistate business should be apportioned to a state. This is precisely the procedure which Alaska uses today, as well as most taxing jurisdictions, i.e., the total income of the total business of a multistate company is determined and then apportioned.

The other reason why separate accounting should not be adopted is that it exposes the taxpayer to multiple taxation. Income which would be fully taxed in Alaska would also be apportioned to other states using the apportionment method, which looks to the total income of the taxpayer as a taxable apportionment base. Conversely, Alaska's or any other state's adoption of separate accounting could cause it to lose tax from an overall profitable multistate company -- specifically, where the in-state separate accounting calculations produce an in-state loss for such overall profitable company. As Mr. Bonney of EXXON will demonstrate ^{LATER,} this would have been his company's case had Alaska been on separate accounting during the development years of the North Slope. Instead, Alaska received income tax by using the current apportionment method, apportioning a part of that company's overall profit into Alaska.

Turning to the provisions of SB 105, it is clear that the bill is not even the form of separate accounting which any of the witnesses were debating. Rather, it is a hybrid form of

separate accounting. It seeks to determine income by simple reference to the wellhead value of oil and gas used for severance tax purposes and then allows only seven deductions while totally ignoring any other legitimate deductions which represent business expenses allowable under established principles of income taxation. Five of the seven allowed deductions relate to costs closely associated with production. Another category is for unsuccessful exploration costs incurred in Alaska. The only out-of-state cost allowed is for interest expense "not capitalized and capitalizable", but this expense would be severely limited for most companies through the use of a ratio of the book value of the fixed assets associated with the field to the total book assets held by the corporation and of its affiliates. All interest expense related to a company's operations within the state should be recognized as a current operating expense, without the limitation described in this bill.

It is clear that SB 105 would introduce new concepts of taxing an oil and gas producer which radically depart from concepts found under the existing Alaska corporate income tax structure. The traditional concepts established over decades of experience and which are contained in that corporate income tax structure would in large part not apply, yet the producer would be taxed at the same 9.4% corporate rate of tax.

One of the seven deductions is for "severance taxes actually paid." This provision may appear to be without problems until one analyzes it in connection with the reserves tax.

Unless the statute is amended, the reserves tax will likely result in nearly \$240-250 million dollars paid to the state next June 30th. With the \$220 million paid on June 30, 1976, the aggregate of nearly \$500 million represents, in essence, prepaid severance taxes because the reserves tax may be used as a credit against future severance taxes payable. Hence, the word "actually" in the clause "severance taxes actually paid" takes on significance, and it appears that the authors' intent is to allow as a deduction only that amount of severance tax "actually" paid over after the credit with the result that some \$500 million would be denied as a deduction.

Depreciation is allowable but only on facilities closely associated with production, but the amount of depreciation is simply left to the Department of Revenue to handle by regulation. Depreciation is a vastly complex subject under income tax laws and can be handled in many ways to provide fair and equitable results to a taxpayer. The bill provides little or no guidance on a subject of such importance to a taxpayer.

As noted earlier, SB 105 does not fit within the category of the "separate accounting" method of determining income. What it really seeks to do is draw a ring around successful oil and gas operations and allow as expenses only those that are literally tied to the lease, plus expenses for unsuccessful exploration efforts and a severely limited amount of interest expense. The resulting amount is supposed to be net income, but in fact, would represent a level of income much higher than would occur under regular principles of income taxation.

In addition to the tax received by Alaska based on an inordinately high level of income, the authors of SB 105 would, under Section 43.20.014, still seek to reach, through apportionment, the taxpayer's out-of-state income, including its oil and gas and pipeline income as well as all other income. In short, SB 105 would allow Alaska to fully, or, rather, more than fully, tax directly all of the Alaska income from oil and gas and pipeline transportation and would also require the taxpayer to apportion to Alaska all of its other income except the income already taxed by SB 105. And, of course, the final effect to the taxpayer would be that other states where it does business would also apportion income to themselves under their tax laws and included in that apportionment to them would be the Alaska income already fully taxed by Alaska.

A state may constitutionally tax only that income of a taxpayer which is derived from within its borders. That fundamental rule applies irrespective of the method used to determine income. SB 105 seeks to reach all income from oil and gas and pipeline transportation in Alaska and at the same time, through apportionment, seeks to reach the taxpayer's other income including its non-Alaskan oil and gas and pipeline income, thereby raising the constitutional question of the taxation of extraterritorial value in violation of the Fourteenth Amendment of the U. S. Constitution.

With respect to income from pipeline transportation of oil, Sec. 43.20.013 simply provides that where such a pipeline is regulated by the Interstate Commerce Commission (ICC), the

annual taxable income "shall be eight percent of the valuation." There are no guidelines to determining income under any set of rules, and items of income and expense are not even considered. Obviously, this provision is aimed at the Trans Alaska Pipeline and, in effect, says that the tax shall be valuation times 8% to get around \$600 million of "annual income" which, when taxed at 9.4%, produces a tax of about \$60 million.

Attempting to tax a business in this manner would be similar to a law which says that an individual shall be deemed to have annual income equal to a certain percentage of the assets he owns. For example, suppose such a law says that a person's annual income is deemed to be 50% of his assets and the person owns an apartment house worth \$200,000 but has a \$150,000 mortgage against it. His annual income would be \$100,000 to be taxed irrespective of his costs. It would not matter that the person may, in fact, show very little profit.

A taxing scheme which deems "income" to be a percent of value of assets without regard to actual income and expenses is, in effect, nothing more than a property tax under the guise of an income tax and raises serious legal and constitutional problems.

The authors, however, have attempted to provide a form of "escape hatch" to the foregoing method of taxation by providing in Section 43.20.013(c) that the corporation operating such an ICC-regulated oil pipeline may elect to have taxable income from the pipeline determined under rules and regulations of the

Alaska Pipeline Commission. Thus, the idea seems to be that if the corporation does not like the percent-of-value method of determining annual income (which would deem annual income to be at a very high and fictitious level), then it can be economically forced to submit to the rules and regulations of the Alaska Pipeline Commission whose rules may or may not be parallel with the ICC rules. In fact, section 6 of the bill contains an amendment to Section 42.06.041 by adding new provisions which require the Alaska Pipeline Commission to give the Department of Revenue a certificate that the pipeline corporation so electing has complied with the Commission's rules and regulations. Subsection (c) of Section 041 provides that the Commission shall by regulations establish an accounting procedure to define net income to "coincide as nearly as possible with the net income definition used by the Commission in establishing rates and measuring rate of return."

What is happening under these provisions seems clear enough. The idea seems to be to put such an onerous tax burden on the ICC-regulated pipeline that it would be forced to elect to comply with all applicable regulations and orders of the Alaska Pipeline Commission concerning accounting methods and reports. In short, the Commission would set the rules for income determination notwithstanding that the pipeline company remains subject to the primary jurisdiction of the ICC. Thus, there would be four parties involved in determining income: the taxpayer, the ICC, the Alaska Pipeline Commission, and the Commissioner of Revenue who is interpreting the Alaska Commission's rules.

AGO 547513

Use of the tax laws to achieve the apparent goal of regulation by the Alaska Pipeline Commission is an abuse of the taxing power. Further, the scheme raises obvious legal and constitutional questions and with so many parties that would be involved in the income determination process, the stage would be set for endless controversies.

The foregoing discussion relates to ICC-regulated oil pipelines. Where an oil pipeline does not yet have a value established by the ICC or where the oil pipeline is strictly an intrastate oil pipeline, the bill provides that such a corporation having one of these pipelines shall have its income determined under the rules and regulations of the Alaska Pipeline Commission. Here again, as would be the case of an ICC-regulated pipeline corporation which was forced to elect to have income determined by the Commission (discussed above), the income determination is left to another agency under rules and regulations as it chooses. In essence, the whole matter of determining income to tax under an income tax law is left to the vague guidelines of another governmental agency. This, in itself, raises questions whether there has been an unconstitutional delegation of legislative authority. But even if one gets over that hurdle, the fact remains that whatever rules would finally apply, those rules would not accord with general principles of income taxation which ought to apply to pipeline operations just as they apply to any other type of operation.

As to gas pipelines regulated by the Federal Power Commission (FPC), SB 105 provides in Section 43.20.013(d) that

AGO 547514

taxable income shall be determined in accordance with reporting procedures established by the FPC. Here again, there is a departure from normal application of income tax principles because a gas pipeline, though regulated, is really no different from any other taxpayer insofar as having income tax principles applied to its operations. The regulation and rate-making process of the FPC fully takes into account a gas pipeline's handling of its operations where that pipeline utilizes the provisions of the Internal Revenue Code to achieve tax savings for the benefit of not only its customers but also its shareholders.

Finally, I would like to say a word about Section 43.20.015 which deals with "Public Reporting." Under that provision the Commissioner of Revenue is to compile and transmit to the legislature each year an annual report which shows the tax paid under SB 105 together with the itemized deductions that have been allowed and how much tax revenue was not collected because of the deductions. Further, the report is to provide a summary of the total amount of oil and gas produced by each taxpayer, the taxable income as calculated under Section 12 and 13 relating to oil and gas income and pipeline transportation in Alaska, and the out-of-state income of the taxpayer apportioned to Alaska.

In short, SB 105 would open up for general scrutiny without safeguards of confidentiality the whole operation of the oil and gas producers and pipeline operators in Alaska. I would hope that we haven't progressed to the point in this country where a

taxpayer's returns have become a matter of public record. I doubt if anyone would consent to having their tax return information bundled up by the tax collector to be laid bare for anyone to review. There are strict rules in all states and at the federal level covering disclosure of tax return information, and there are ways whereby certain limited groups of people having a legitimate interest can obtain that information on a strictly confidential basis with criminal sanctions imposed for violations. But under SB 105, the information could be made available to a large number of people where there are no guidelines whatsoever over disclosure. Such a provision is one that simply should not be tolerated no matter who the taxpayer may be.

HB 322

The next bill I wish to discuss is HB 322. This is the Department of Revenue's bill which adopts the recommendations of Professors Zeifman and Ainsworth. Essentially, this bill has the following features:

1. Impose a franchise tax on oil and gas producers operating in Alaska who have gross receipts of \$250 million or more.
2. The income base to be taxed would be the higher of (1) pre-tax book income as reported to stockholders before any reduction by reason of taxes on income, or (2) taxable income under the Internal Revenue Code.

AGO 547516

3. Apportion the pre-tax book income under item 2 by means of a three-factor formula where the property and payroll factors are the same as now contained in the Multistate Compact but the sales factor in the Compact would be replaced by an extraction factor. Such extraction factor would be the ratio of oil and gas produced in Alaska (expressed in BTU's) to total production of the taxpayer everywhere.

Thus, there are two main themes to HB 322: tax base changes and apportionment factor changes. Such changes are the same changes discussed and recommended by Professors Zeifman and Ainsworth in their testimony earlier this week.

Professors Zeifman and Ainsworth would reject federal taxable income as a tax base because the Federal Internal Revenue Code contains many deductions, credits and exclusions which they allege have diluted revenue-raising potential through subsidization of of some activities while discouraging others.

In their report, though not mentioned except briefly in their testimony, the professors attempted to demonstrate how the revenue raising potential has been eroded and referred to the concept of "tax expenditures" which, in essence, is simply a listing of those items or categories constituting deductions, credits, or exemptions found in the Internal Revenue Code, together with the estimated effect they have on revenue collected. This listing is required to be published each year under the

Congressional Budget Act of 1974. However, instead of discussing and commenting on the more than 75 general categories of items in the published list as they apply to both individual and corporate taxpayers, the professors chose only to extract in their report but six categories, and only one of the six (expensing of exploration and development costs) applies specially to the petroleum and mining industry.

I have here the complete listing of "tax expenditures" for the Fiscal Year 1978 which also shows those "tax expenditures" for years 1976 and 1977. A copy of this listing is attached. There are two columns for each year, one for corporations and one for individuals. A review of both the number of categories listed as well as dollar amounts will reveal that individual taxpayers indeed have fared very well compared with corporate taxpayers. It will also be noted that there are only two items relating specially to the petroleum industry. One deals with the expensing of exploration and development costs, which, from the testimony of the professors as well as Mr. Kilgore, one would think was the major provision in the Internal Revenue Code but which in reality represents a rather small item compared to other items in the listing. In fact, that item has a revenue loss effect about equal to the loss from the credit allowed for buying new homes. The other category deals with the excess of percentage depletion over cost depletion. But this latter item applies to over 100 different minerals which involve percentage depletion--oil and gas being but one category. In any event, percentage depletion has

negligible application to major oil companies because of the severe restriction of percentage depletion for oil and gas resulting from the 1975 Tax Reform Act. The professors' attempt in their paper to show the petroleum industry as a highly favored industry that receives a major share of tax benefits is simply incorrect.

After leveling a finger at corporate taxpayers generally, the professors then recommended that one special group--namely oil companies--be singled out for tax "reform". However, the professors failed to discuss either in their paper or their testimony the inequity or possible legal problems of proposing a "book income" base for major oil companies which would be far different than would apply to any other class of taxpayers. They did not even mention in their report that no state in the country has a law utilizing "pre-tax book income" as a tax base though questioning by the Committee did bring out this information.

Even if one were to agree with the novel approach suggested by Professors Zeifman and Ainsworth and embodied in HB 322, a true advocate of their theory could not logically propose its use with one set of taxpayers and then ignore its applicability to the vast majority of other taxpayers. If such a radical change in tax approach is to be made, then it should apply to all taxpayers under all income tax laws at the same time, with corresponding adjustments of tax rates for all.

An approach which uses the higher of book income before taxes or taxable income can lead to distorted results. Mr. Bonney of EXXON will demonstrate through a simple example how the use of one versus the other could prevent a full recovery of a capital investment and yet tax phantom or non-existent income. Further distortion may result from the inclusion of earnings of non-controlled companies in pre-tax income, as required by generally accepted accounting principles. While the oil companies may be required to report the earnings of their investments in non-controlled companies, they do not determine if or when the earnings of these entities are distributed. Yet HB No. 322 provides for immediate taxation of this income because it would be included within the pre-tax book income reported to stockholders.

Professor Zeifman emphasized the fact that book income is invariably larger than taxable income, thereby showing that big corporations have tax benefits. However, of what real significance is it that a corporation's management chooses to adopt a conservative book accounting method as long as it is consistent in doing so year after year to avoid distortions? Differences between book and tax income due to different treatment has existed for decades under generally accepted accounting principles. For tax purposes the Internal Revenue Service, as well as a company's own auditors, will require a full reconciliation of the taxable income back to the book income and there are extensive schedules in tax returns which do this every year.

The only point Professor Zeifman is making is that under the Internal Revenue Code corporations are permitted certain deductions, or credits, or exclusions which, if taken advantage of, show a lesser "taxable" income than shown on the books if the management chooses to use a consistent method which treats the item differently. But the same thing can be said for all taxpayers, i.e., all taxpayers receive some form of tax treatment which causes their taxes to be less than if the tax law simply taxed the gross dollars received at a specified rate. This can be seen from the "tax expenditures" listing referred to earlier. Pointing the finger at one group of taxpayers as ones who should first go on the chopping block of reform while ignoring others who are not so treated is asking a lot of any legislative body whose duty it is to play fair with its citizens, whether they be corporate citizens or individuals.

Substitution of an "extraction" factor for the "sales" factor

The second main point of HB 322 deals with deleting the sales factor and substituting an extraction factor.

Before plunging into this subject, I believe it would be helpful to give the Committee some background about the traditional three-factor formula utilizing property, payroll and sales, where it came from and why it is used today by most states which tax corporate income. Another reason why this will be helpful is that Professors Zeifman and Ainsworth gave their testimony recommending a change strictly on the basis

that its use will apportion more income and, therefore provide more tax. However, the matter is not quite as simple as the professors have indicated.

When states began taxing corporate income over 50 years ago, there were various formulas used to divide the income. Because there were different formulas, it was not long before disputes arose between states and taxpayers, usually involving the question whether the state was reaching for too much of the taxpayer's income. It is very important to bear in mind all the way through the discussion of this subject that a state can constitutionally tax only that income of the taxpayer which is derived from within the state's borders. Thus, the search has always been to find a formula which gives both the taxpayer and the state fair treatment. But as to the taxpayer who operates in more than one state, the problem has also been to utilize a method of dividing income which does not subject the taxpayer to multiple taxation.

It is not difficult to see how multiple taxation can occur. Suppose X corporation operates in states A, B, and C, each of which has the same standard three-factor formula of property, payroll, and sales and each of which has an 8% income tax rate. It would be rare if X corporation had exactly the same mixture of property, payroll, and sales in each state. However, when each of the three states apply their tax laws and divide the income under their uniform formulas, X's total tax to all three states will be no more than 8% of its total income.

But let's vary the example just slightly and assume that in state A, X corporation has a heavy concentration of property and payroll but not many sales and that state A decides to delete its sales factor and have only a two-factor formula. In such a case state A will apportion to itself a greater amount of X's income but apportionment to States B and C will remain the same. The result will be that an amount greater than X's total income will be apportioned in the aggregate to all three states and X will have been subjected to multiple taxation because State A broke the uniformity.

The foregoing is a simplified example but nevertheless demonstrates how multiple taxation can result. As noted earlier, disputes over income taxation existed for decades and it was not until 1957 when the Commissioners on Uniform Laws in conjunction with the tax section of the American Bar Association and many other interested parties finally wrote a model law known as the "Uniform Division of Income for Tax Purposes Act" (UDITPA) in the hope that states would adopt it and thus put an end to the chaotic condition that existed. The apportionment formula settled upon utilized property, payroll and destination sales. Underlying this three-factor theory of apportionment is the concept that the employment of capital in the form of property, labor as reflected in payrolls and ultimate sales to generate the sustaining revenues for the business are all vital factors to be given equal weight in determining income. Thus, the theory recognizes that in a true economic sense some part of taxable income is earned at every stage of the business process.

To date, about one-half of the states (including Alaska) have adopted UDITPA and all but two states which impose an income tax use the three-factor formula of property payroll and sales.

The UDITPA model law only deals with apportionment of income and does not contain provisions setting forth rules or procedures whereby a state cooperates with other states to administer income taxation on a joint basis. In an effort to promote uniformity of tax rules and cooperation, a number of states formed what is now called the Multistate Tax Compact. However, a state which adopts the Compact also adopts the three-factor division of income formula based on the UDITPA model law. Alaska adopted the Compact in 1970 but followed the UDITPA formula before 1970. Hence, states which have adopted the Compact and states which simply follow the UDITPA rules have compatible laws.

With this brief background let me turn to the proposal to delete the sales factor and impose an extraction factor. The nub of the professors' argument is that the sales factor is low due to destination sales which causes lesser apportionment of income to Alaska and this can be cured by substituting an extraction factor. Thus, the sales factor is dismissed by the professors and the reader of their paper and the audience to their testimony is simply left with a conclusion void of any reasoning except maximizing revenue.

There was a sound reason for the UDITPA and Compact treatment of sales on a destination basis for purposes of the "sales" factor. A destination sale is one which occurs in a state if goods are

delivered in that state or services are performed in that state. Suppose a manufacturer has its plant in Illinois and has a large payroll at that plant. From this plant the manufacturer ships most all of his products to purchasers in other states. If this is the only plant, the property and the payroll factor to Illinois

will be high and if the sales are attributed to the Illinois plant as the origination point of the sale, then Illinois would apportion nearly all the income for taxation in Illinois. As can be seen from this simplified example, the major manufacturing states would receive an unreasonably high proportion of apportioned income to the detriment of non-manufacturing states. Hence, the "destination" sales concept is one which not only affords protection to less populated, non-manufacturing states, such as Alaska, but also gives legitimate recognition to sales activity in consumer states by deeming the sale to "occur" where the purchase takes delivery.

What the professors have proposed as a factor change is no different from what they might propose in any state based upon simple reasoning to get more revenue, the only difference being that in such other states it might be a different factor which provides the key. For example, they might shift their proposal to Illinois or Pennsylvania to point out that its sales factor also is destination-oriented and because most products are shipped out-of-state, the ratio of sales in either of those states will be lower. The professors could then recommend that the "destination" sales factor be changed to an "origin" sales factor or that the sales factor be deleted in favor of one based on manufactured units (e.g., television sets) in the state to total units manufactured everywhere. By such changes, those states could then command most of the apportioned revenue since, being manufacturing states, they already have the bulk of property and payroll and, through the sales factor change, they could prevent

dilution of the total factor to be used by the taxpayer.

But suppose it was some state which did not have heavy manufacturing (i.e., low property and payroll in the state)? Under the professors' reasoning this might call for use of only a sales factor -- i.e., destination sales and not origin sales because only the former would help the state (in contrast to what was said above as being in the "best interests" of Illinois or Pennsylvania). By so limiting the formula to a single factor, the non-manufacturing state maximizes apportionment of income to the state.*

The foregoing are only two examples out of many one could establish to tailor apportionment formulas for various states if the only objective is simply maximizing revenue without concern for inequitable or unconstitutional consequences. However, the problems with the examples are parallel to the same problems that are contained in the professors' proposal for an extraction factor. In each instance there is a break in the uniformity of treatment by a state which inevitably results in the taxpayer being subjected to multiple taxation. The state breaking uniformity will tax a larger part of the income by use of its advan-

* Recently the Iowa courts struck down as unconstitutional that state's use of a single factor of sales because it was not an adequate measure of the taxpayer's income derived from within Iowa. (Moorman Mfg. Co., Polk Cty. Dist. Ct. No. CE 3-1595 (12-17-76)). Similarly, in General Motors Corporation vs. Dist. of Columbia, 380 U.S. 512 (1965), the United States Supreme Court struck down use of a single sales factor by the District of Columbia.

tageous apportionment factors. Unfortunately, part of that same income will also be apportioned to and taxed by the other states having the uniform apportionment formula.

As noted, the professors have given no reason for use of the extraction factor except that it will raise revenue. Missing is the reasoning why the present factors are not a proper measure of a taxpayer's income within Alaska or, conversely, why use of the extraction factor will give a more accurate measure of that income. Merely saying that oil goes out of the state and does not count as a "sale" in Alaska to its detriment is not good enough because, as shown earlier, any state could analyze its economic position and make the same argument when it observes a resource material or manufactured item being shipped out of the state. If that happened, then clearly the states and taxpayers would be back to the same chaotic situation that existed before the uniform rules of UDITPA and the Multistate Tax Compact were formulated and adopted.

To satisfy constitutional requirements, an apportionment formula must fairly and reasonably measure a taxpayer's net income in the particular state since a state has jurisdiction to tax only that income derived within its borders. The professors and some Alaskan critics of the present three-factor formula have simply looked at the oil production aspects of the business of a multistate oil company operating in Alaska but apparently wish to ignore the other part of the business where that oil has to be transported, refined into products, distributed and sold.

In fact, the bulk of such a company's employees and a large portion of its investment lie in these phases of the business. Moreover, the revenue which pays for the expenses of company operations is generated mainly out of the sales of refined products.

The concept of income taxation is the taxation of the overall profits of an enterprise which may have many parts in many states but all of which contribute to the ultimate profit or loss. In devising a formula to measure income for apportionment, the drafters of the UDITPA model law were not being arbitrary when they settled upon use of property, payroll and "destination-oriented" sales. They were looking for a formula which not only contained elements reflecting as many aspects or segments of the business as possible but also for a formula which could be easily and uniformly administered and which provided equitable treatment to states as well as taxpayers. Using these guidelines, the drafters found that property, payroll and sales provided a balance of factors reaching and reflecting the essential elements of any manufacturing or mercantile business.

There can be no doubt that the author's solution fails to protect the taxpayer from multiple taxation but, rather, actually creates it. While this is reason enough to reject use of the extraction factor, it also is clear that use of this form of factor in place of a sales factor reduces the segments or sectors contained within a business whose operations are reflected in the formula. Sales from all phases of the integrated business are the sustaining element of the business without which the business fails, and such sales reflected in the sales factor

are drawn from the total business. Units of petroleum extracted are important to the business too but represent operations pertaining to only one segment or phase of an integrated petroleum company's total business.

While crude oil extracted may have a value at the point of production, that value exists only because of consumer demand for products produced within other equally important phases of the business consisting of refining, product transportation and marketing distribution. In this regard, oil production in the case of the oil industry is not unique and the same reasoning can be applied for iron ore in connection with steel making, for raw timber in connection with finished wood products, or even for grapes grown for winemaking since in each of these cases the raw product can be viewed as having been "extracted". In all these cases, as well as with the oil industry, the "extracted" material undergoes a complex transformation into products resulting in sales revenues only after having been acted upon by other necessary phases of the business containing most of the taxpayer's employees and containing facilities representing a substantial part of the taxpayer's invested capital, both of which are distinct from the "extraction" phase yet still a part of the overall operation of the enterprise.

By using an extraction factor in place of a sales factor the whole element of sales which sustain the business for its survival are disregarded. Units of oil and gas produced is simply not a proper measuring factor and, as will be pointed

out in an example by Mr. Bonney of EXXON, the substitution of an extraction factor can result in a distorted attribution of "downstream" income from transportation, refining, marketing, etc. to Alaska which can result in the taxpayer having income taxed twice.

From the foregoing it can be seen that substituting an "extraction" factor for the "sales" factor actually distorts rather than improves the measurement of net income of the total enterprise attributable to or derived from within a particular state. What it does is provide a change to "maximize" revenue which is not a goal of formula apportionment when done at the expense of sacrificing the other principles which lie behind the concept of apportionment.

I would like to say a word about the provision in HB 322 which the professors recommend as being a basis for Alaska including OCS property, payroll and extracted oil and gas as its own factors when the OCS property is dependent upon on-shore Alaska operations. The professors were certainly correct in saying that there may be problems. However, they failed to point out that section 1333 of Title 43, which deals in part with state laws applicable to the CCS area, contains rather troublesome language for a state attempting to extend its tax laws to the OCS area. Section 1333(a)(2) contains the following sentence:

"State taxation laws shall not apply to the
Outer Continental Shelf."

At least one state, California, has looked deeply into this matter of whether California, could consider the OCS developed area as providing property, payroll and sales factors for use by California, i.e., the same consideration being recommended by Professor Ainsworth. The California Franchise Tax Board in Legal Ruling No. 366 has held that California cannot claim property, payroll and sales in the OCS area for California's benefit, i.e., California cannot put these factors in the numerator for California. There is attached to my testimony copies of the pertinent federal statute referred to above, along with a copy of Legal Ruling No. 366 of the California Franchise Tax Board.

SB 202

SB 202 is basically the same bill which was considered in the 1976 session as SSSB 620. The main difference between the bills is that under SSSB 620 the net proceeds tax was a credit against regular corporation income tax insofar as that corporation income tax would represent tax on income from oil production taxed under SSSB 620; under SB 202, the taxpayer also remains subject to the Alaska corporation income tax but is deemed to be exempt only to the extent of income earned from production of oil in the state. In short, under SSSB 620 there was an actual credit against the Alaska corporation income tax but the net proceeds tax credit was only applicable against that part of the corporation income tax which was applicable to income from Alaska oil operations. Under SB 202 there is no credit as such but the taxpayer who apportions income to Alaska is simply not

taxed on income deemed to come from Alaska oil production.

As some of the members of this Committee know, I testified on SSSB 620 last year and pointed out what I believed to be the deficiencies of that bill. That testimony is no doubt still available in the Committee files and I do not propose to go into all the details of the bill again. Rather, I shall have some general comments on the bill and point out how this bill impacts on the taxpayer, as well as point out some of the legal problems with its operation.

The "net proceeds tax" contemplated by its proponents has features of an income tax in that it attempts to reach a level of "income" or "profitability" from successful oil and gas production operations with a tax rate applied which is equal to (or higher than) the regular Alaska corporation income tax rate (i.e., 9.4%). Essentially, the tax would be determined by subtracting from the wellhead value of oil and gas production certain limited costs and expenses directly associated with production and multiplying the difference by the corporation income tax rate of 9.4%.

Proponents of the "net proceeds" tax have chosen to label it as an "ad valorem" tax rather than an "income" tax. However, in substance and operation the tax is unquestionably a form of income tax and merely calling it by another name cannot change that fact.

Because the "net proceeds" tax approach is itself a form of separate accounting, taxpayers will be exposed to multiple

taxation under that approach for the same reasons as discussed in connection with SB 105. In fact, the economic effect to a taxpayer would be even more adverse since the goal of the "net proceeds" tax is simply to isolate successful Alaskan oil and gas producing operations, allow a very limited amount of deductions closely and directly associated with production, and tax the resulting "net proceeds" at the corporation income tax rate (9.4%) as though those "net proceeds" constituted net income of the taxpayers.

Proponents of the "net proceeds" tax in the past have admitted that the "net proceeds" to be taxed would represent a tax base which is higher than would occur under regular principles of income taxation applicable to other taxpayers. Hence, the economic effect is that Alaska would place a tax (at the 9.4% corporate income tax rate) on a level of income (but called "net proceeds" instead of "income") which is much higher than would result under regular income tax principles, and that same income (or at least a certain level of that income) would be included in the base subject to apportionment to other states and taxed by them because they use the standard three-factor apportionment formula.

But the adverse effect of the "net proceeds" tax approach would not stop there because under that approach the same taxpayer would still be subject to the regular Alaska corporation income tax. SB 202 would still require the taxpayer to apportion to Alaska under the three-factor formula all of the tax-

payer's income from outside Alaska, including its non-Alaska oil and gas income. Thus, SB 202 would provide Alaska with the best of all worlds: it would receive a tax at the 9.4% corporate income tax rate on Alaska "net proceeds" which would constitute a tax base much higher than under regular income tax principles and, through apportionment, it would also seek to reach all of the taxpayer's income from outside Alaska as well as any non-oil and gas income from within Alaska.

The concept of the "net proceeds" tax which would operate in substance like an income tax raises a legal question whether the method would permit the state to tax a greater amount of net income than reasonably could be attributed to Alaska.

Proponents of the "net proceeds" tax have claimed that a "precedent" exists for such form of tax and have cited the states of Nevada, Utah, Colorado, Idaho, Montana, and New Mexico as examples. However, a review of the statutes in those states reveals that the "net proceeds" tax has nothing whatsoever to do with a scheme to tax income such as that being advanced by the proponents of the "net proceeds" tax. Rather, the "net proceeds" involved in the states referred to are simply convenient and simplified means of arriving at a value on mining or oil properties for purposes of applying property tax rates by local county assessors in order to provide property tax revenue in the local counties. Such a method is essentially a substitution for the rather sophisticated and complex valuation procedure that would otherwise occur each year, such as the complex

valuation of the Prudhoe Bay field for purposes of applying the reserves tax in Alaska.

It is safe to say that no state in the country imposes a "net proceeds" tax of the type the proponents in Alaska have in mind.

I would now like to direct my comments to the Legislative Council's proposed production tax changes incorporated in the identical bills, SB 103 and HB 144.

DESCRIPTION OF THE BILL

As discussed yesterday, the proposal would:

- a. Change the point where the taxable value of oil is determined from the "well" to the point where "oil is first metered or measured in a condition of pipeline quality".
- b. Realign the stepped tax rates, lowering the tax on the first 1,000 bbls per well per day and substantially raise the tax on all production over the first 1,000 bbls with a high rate of 14% on all production exceeding 3,500 bbls per day.
- c. Use lease or property averaging in determining each well's daily production.
- d. Tax flared gas at 5 times the normal rate.
- e. Advance the monthly tax due date to the 20th day of the month following production.

COMMENTS

1. Adoption of lease or property averaging of daily bbl. per well production is a step in the right direction in properly ascertaining the stepped tax rates applicable to a field. The change, of course, will aid both the taxpayer and the state administratively.

2. The resultant increase in the overall industry tax burden (estimated by the Legislative Affairs Agency to be about \$180 million per year by 1980) is completely unwarranted, considering the question of need which others have already addressed and considering the fact that Alaska oil is already being taxed at virtually the highest level in the nation. The limited benefit given to the lower producing fields in Cook Inlet in no way should be considered as justification (or a basis of consistency) for placing such a harsh extra tax burden on high producing wells in the North Slope or any other location. This approach portrays the concept of taxing the taxpayer at a high level, not on the basis of state governmental need, which we believe to be grossly unfair.
3. Retention of the alternate cents-per-barrel rate floor with its wholesale price index adjustments more than counteracts any true benefit out of reduced rates given low Cook Inlet producing wells through percentage rate reduction. As Levy Associates has maintained, this minimum price-setting device has created an artificially high value on the old Cook Inlet oil for tax purposes, resulting in an effective tax rate well in excess of what we believe was intended by the legislature on such oil. The last time I reviewed the situation--which was about a year ago--the cents-per-barrel feature of the severance tax had caused Union and other companies for which it reports severance tax to pay about

\$5 million more than would have been paid under the percent-of-value method. We view this amount as simply an unintended windfall benefit to the State since January 1, 1974, the date the current cents-per-barrel tax took effect.

4. We do not see any justification for imposing a penalty rate (5 times normal rate) for flared gas, considering the fact that such flaring controls are best placed with regulatory agencies, not taxing agencies. If proper regulatory authority exists to flare gas, such as for safety purposes, there is no justification for adding tax at a confiscatory rate to a product that the producer loses through flaring where that flaring is done for reasons of safety.
5. Moving the point of measurement of production value downstream to the point of metering in a condition of pipeline quality could unjustly place a substantial tax on transportation costs on some fields which for a variety of reasons require movement of oil significant distances before measurement. Since the Alaska Production Tax is an occupation tax on the privilege of severing oil and gas, it would be more appropriate to continue measuring it by its value at the point of severance, i.e., the wellhead, instead of adding on to it incremental values of gathering, transportation and field treatment.
6. Advancing the delinquent date for payment from the first of the month following the month of production to the 20th day of the month following the month of production would place

an undue administrative strain on the reporting groups within the various producing companies. In most cases, the production data to calculate tax liability and prepare returns must be transmitted to offices outside Alaska. Advancing the delinquent date by 10 days will simply make worse an already short time open to comply with the law. By advancing the reporting time 10 days, the State, overall, only gains a total of 10 days for revenue collection which seems inconsequential compared with the added administrative burden on producers.

My next comments pertain to HB 321 and SB 238, identical bills, which contain the Administration's recommended changes to the oil and gas production tax.

Briefly, the bills would replace the present stair-stepped tax rates on oil production per well with a single rate of 10% on value or one alternative minimum cents-per-barrel rate of 75 cents (adjusted for gravity and for changes in the "Gross National Product Deflator").

Also, the 4% rate on gas would increase to 10% with a new alternative minimum tax of 6.4 cents per MCF. The new percentage rate and cents-per-unit rates would be adjusted by an "economic limit factor (ELF) discussed later.

The proposal also makes other changes, including changing the point of measurement from the wellhead to the point of measurement of pipeline quality. The proposal also imposes a double rate of tax on flared gas.

We strongly oppose perpetuation of cents-per-barrel floor prices and expansion of it to gas production, as well as increasing the minimum price to which it relates, that is, \$7.50 per barrel. As Milton Lipton has advised, the current floor as escalated by the National Wholesale Crude Price Index has worked in unintended ways on Cook Inlet Crude, creating an artificial taxing value well in excess of the value permitted by the FEA on old oil. Now the Administration not only recommends continuance of the minimum price concept but also proposes to increase the minimum price to \$7.50 per barrel.

The Administration supports this course with the argument that the FEA price is artificially low. But the oil companies producing such "old" oil nevertheless suffer the economic realities of federal pricing. Accordingly, we believe it is unfair that in addition to bearing such economic loss in price, the Cook Inlet producer must also bear an increase in production tax because of an arbitrary floor of \$7.50 per barrel used as the measure of tax. This, of course, would be equally true on the North Slope if the FEA placed a value below \$7.50 on that production. We fail to see any justification for the State to arbitrarily burden the production with such a heavy production tax through an artificially set value because of the possibility that FEA pricing decisions may not be favorable.

As mentioned above, HB 321 introduces the concept of an Economic Limit Factor (ELF) as an adjustment to the percentage rate of tax applied to both oil and gas. According to the Department of Revenue's February 1977 study, the Department believes that the present "stair step" rate schedule does not adequately take into account differences in the economic conditions existing from field to field, e.g., a well producing 1,000 bbl/day at one location may be marginal while such a producing rate at another location may be profitable. In short, the stair-step approach is deemed defective because it does not adequately protect against excessive taxation as a well approaches its economic limit.

To correct this, the Department proposes an ELF, the calculation of which begins by determining a fraction the numerator of

which is the "monthly production rate at the economic limit" and the denominator of which is the production during the month for which the tax is to be paid. Under HB 321, the numerator is by statute deemed to be 100 barrels times the number of well-days. Well-days are by definition the number of days a well is operating. Thus, if there were 10 wells on a lease operating for 28 days each, the numerator would be $100 \times 10 \times 28 = 28,000$ bbls. If the total monthly production on the lease was 280,000 bbls, the ratio would be 10%, or expressed as a decimal, .10. The next step in determining the ELF is to reduce "unity", i.e., 1.00, by the ratio expressed as a decimal. Thus, $1.00 \text{ less } .10 = .90 = \text{ELF}$.

The best way to explain how the HB 321 mechanism works is through a simplified example, a copy of which is attached. The example uses Cook Inlet production of 35° oil at a \$4.85 per barrel controlled price. Under the bill, one of the adjustments is a half-cent for each degree above 27°, so 4 cents is added to the 75 cents. The GNP Deflator adjustment is ignored. The statutory presumption of 100 barrels is the numerator and 1,600 barrels is the denominator which gives a decimal of .0625, and when subtracted from 1.00 gives an ELF of .9375. Both the cents per barrel of 79 cents and the 10% rate are multiplied by .9375 to find the adjusted cents-per-barrel and percent-of-value rates. Next, the royalty of 200 barrels is subtracted to find 1,400 non-royalty barrels. Finally, the 1,400 barrels are multiplied by the value of \$4.85 and then by 9.375% to find the tax under the percent-of-value method, and are multiplied by \$.7406 to find the tax under

the cents-per-barrel method. Since the tax of \$1,036.84 is the higher (i.e., under the cents-per-barrel), that tax is the one that would be payable.

At the bottom of the example the tax under HB 321 is compared with the tax produced on the same production if it occurred this month (March 1977) under current law. As shown, the increase is about 60%. Also at the bottom of the example it is shown that the effective rate of the production tax under current law would be 9.5% but 15.3% under HB 321. While not shown, if the production rate had been 800 bbls/day instead of 1,600, the increase in tax over the current tax would have been around 75% instead of 60%.

As mentioned earlier and used in the example, the monthly production rate at the economic limit is, by statute, presumed to be 100 barrels times well-days unless the producer in a formal hearing proves by "clear and convincing evidence" that it is otherwise. However, in proving this, HB 321 contains some rather curious and questionable ground rules which do not track with reality. These provisions are found in subsections (b), (c), and (d) of Section 43,55,013. In essence, the "average monthly direct operating cost" (based on at least 4 consecutive months) is divided by the value at the point of production of oil which is produced from the lease, but this "value" is not the value the producer actually gets but, rather, that value which is deemed to be the value of comparable crude at West Coast refineries for imported oil which is then "backed out" to the wellhead.

Translated, the "value" used to divide into the monthly operating costs is, for Cook Inlet, Indonesian Crude laid into Los Angeles at about \$14.50 per barrel. When the \$14.50 is "backed out" to the wellhead, the value at the wellhead is about \$13.50. Thus, it is not the \$4.85 real price used to calculate "monthly production rate at the economic limit" but, rather, \$13.50.

While that is bad enough, with regard to the "direct operating expenses allowed", the bill only allows four: drilling supplies, fuel, routine maintenance and wages and benefits of employees working on production operations. Specifically excluded are capital expenditures, tangible or intangible drilling expenses, costs of well workovers, costs for repairs or replacements (other than routine maintenance), depreciation or amortization, taxes, insurance, overhead, or monies paid or set aside to cover the cost of terminating operations, i.e., abandonment costs.

Allowing only four listed costs is not realistic because there are cash operating costs not allowed but which are tied to operations versus no operations. Any cash cost which would be affected by a decision to operate or not operate is the realistic approach and more in line with the way it would actually be approached by a producer in a true situation. HB 321 would even deny severance taxes on the production itself and property taxes on the equipment. In short, "economic limit" is that point at which actual revenue and actual costs are equal.

I requested Union Oil's oil and gas division engineers to run some calculations using real data as a test. Doing it in the

normal way, our people used the realistic value of about \$4.85/bbl for value and the real operating costs to get an ELF of about .67. But by using \$13.50 per barrel as a value and limiting the costs to the four categories the ELF was around .92. We also made a rough comparison of the taxes under HB 321 compared with taxes paid in 1976 and found that the tax on oil production would have been increased by about 50% if HB 321 had been in effect in 1976.

HB 321 also contains an ELF for gas production though it is not totally clear under the bill language how this is computed. In any event, the principle is the same and the same four direct operating costs are used but the value used for gas is the highest price in the field or within 100 miles.

With respect to gas production, the minimum of 6.4 cents per MCF is especially onerous, since gas is customarily sold under long term contracts and those contracts may not permit the seller to receive a value which happens to be the highest price on the lease on "within 100 miles". The 6.4 cents minimum tax is equal to 64 cents gas at a 10% rate, but there are contracts of sale for gas where the price is much less than 64 cents. Hence, the effective rate of tax on gas is much higher. For example, if gas were sold at 42 cents, the tax would nevertheless be the minimum of 6.4 cents (assuming no ELF applied) which would equate to an effective rate of tax of 15.2%.

With respect to the proposed gas rate increase--while admittedly the gas tax rate might warrant some degree of increase, the severity of this proposal is overreaching. We would suggest that any value tax on gas be based on actual sales price at the

sales meter. We would discourage taxation governed by an artificial floor price or by what some other producer may be receiving for his gas in some other field.

For flared gas, the rate is doubled, i.e., 12.8 cents. Even gas used for safety flaring necessary to safe operations would be taxed, which cannot be justified by any standard. We oppose this double tax for the same reasons as stated in the discussion under SB 103.

In summary, while there is merit to the concept of an economic limit factor, the manner in which it is determined under this bill is unrealistic and virtually meaningless. It seems to me a lot more thought has got to go into it before it can be a worthwhile mechanism. The way it is set up now--with questionable use of phantom values and restricted costs--an ELF so determined could have other consequences beyond just severance tax because the concept of economic life of a field is one used in valuation for property tax too. If economic lives of oil or gas properties as used for property valuations are to be determined using the methods for the ELF for severance tax purposes, then the stage is further set for endless arguments and disputes over property values as well as in connection with the ELF itself.

I would next like to comment on the Administration Sponsored Bill, HB 323.

This bill proposes several amendments to the so-called "20-Mill Hardware Tax", and certain provisions of Title 29, governing municipal taxing limitations.

Section 1 would add to the statute a highly controversial amendment to regulation 15 AAC 05.840 which was issued by the Department of Revenue in June 1976. This provides that any municipal tax levy, say for bonded debt, which is in excess of the \$1,500 per capita limitation is not creditable against the 20-mill tax.

We take direct exception to this provision in that AS 43.010(a) quite clearly provides for a maximum tax of 20 mills on our state-assessed properties. This issue is presently being litigated in a case involving the 1976 tax levy of the North Slope Borough. It would seem appropriate to let the court rule on this important issue rather than to amend the statute at this time.

Heretofore, the state 20-mill tax has applied to exploration, production, and pipeline transportation properties. HB 323 would extend this tax to refineries, liquefaction or processing plants, plants manufacturing oil or gas products and also to tankers and other marine equipment used in the transportation of oil and gas.

We believe it inadvisable to enact any further extension of this special state property tax imposed upon oil and gas producers.

The taxable basis on the marine equipment is specified as replacement cost less depreciation based on useful life multiplied by a fraction of days in Alaska ports over days in port both within and without the state. This proposal raises serious questions in

that it is believed that only the home port, under long standing case law and practice, has taxing jurisdiction over ocean-going vessels.

Aside from the "home port" doctrine, and assuming that Alaska could legally assess these properties, we would suggest a more equitable formula. One possibility would be use of days in Alaska ports versus days in the year.

Due to the controversial nature of this issue, however, we would respectfully urge that this section of the bill be stricken, irrespective of what action is taken on the remainder.

HB 323 additionally would delete the existing provision for using straight line depreciation of historical cost on pipeline assessable values in those instances where the physical life of the pipeline materially exceeds the economic life of reserves committed thereto. As a consequence, pipelines would be assessed with regard to "economic" value based on the economic life of committed reserves.

This issue is being litigated in the Cook Inlet Pipeline Co. case and it would seem appropriate to let the court rule on the issue rather than amending the statute. It is further believed that the existing law and Regulation 15 AAC 05.890 pertaining thereto are sufficiently workable to develop assessments for operating pipelines which will be fair and reasonable, both for the state and the taxpayer.

Section 8 of the bill provides that the municipal taxing limitation of \$1,500 per capita shall be adjusted each year in accordance with changes in the Consumer Price Index for Anchorage.

Assuming that the \$1,500 per capita levy is reasonable, it would likewise be reasonable to key it to an inflation index.

Section 12 makes the provisions of HB 323 retroactive to January 1, 1977, except for tanker assessments which begin January 1, 1978. This retroactive provision seems peculiarly unreasonable in view of the fact that the 1977 tax returns have been filed and assessment notices have been issued by the Department.

I will now turn to House Bill Number 328, the Administration's proposal on the Oil and Gas Reserves Tax.

The Reserves Tax was enacted for a two year period, 1976 and 1977, for the purpose of meeting anticipated revenue shortfalls for Fiscal Years 1976 and 1977. The statutory tax rate for 1976 was 20 mills (2%) and the 1977 tax rate was set by the 1976 legislature at the same rate -- 20 mills. Reserves Taxes paid in 1976 were \$223 Million and in 1977 are expected to total approximately \$270 Million.

In Fiscal Year 1976, because of the Reserves Tax revenues and increases in other revenue sources, unrestricted general fund revenues exceeded expenditures by approximately \$125 Million, leaving a surplus of \$505 Million, of which \$338 Million was available for appropriation at 6/30/76. Revenues in FY 1977 are also expected to exceed expenditures, thereby increasing the surplus.

HB No. 328 proposes to reduce the 1977 tax rate from 20 mills to 12 mills, reducing the revenue from this tax from \$270 Million to about \$170 Million, but subject to the following:

- (1) If on October 1, 1977, TAPS thru-put is less than 600,000 bbls/day, an additional 8 mills would be levied, payable November 30, 1977.
- (2) If on December 15, 1977, TAPS thru-put is less than 1.2 Million bbls/day, the Reserves Tax would be extended another year.

While the prospect of a reduced tax rate is always welcomed, we question the propriety of the limitations mentioned, which limitations are so specific and restrictive.

Present indications are that the Prudhoe Bay Field will start delivering oil to TAPS reasonably close to schedule at mid-1977. It seems unreasonable that some minor variance from the restrictive provisions of this bill could cause the tax rate to be increased and possibly for the Reserves Tax to be extended another year.

Accordingly, we believe that the Reserves Tax should expire, as scheduled in the existing statute, at the end of 1977. However, we certainly agree that the 1977 tax rate can be reduced to 12 mills, since the 1978 budget can be met with no difficulty and the 1979 budget as well unless there were some serious, prolonged delay in TAPS startup. This reduction would certainly be consistent with the original intent of the reserves tax which was to help the state over a potential period of deficit in the General Fund.

ATTACHMENTS TO TESTIMONY

OF

LAWRENCE L. WILSON

AGO 547553



**SPECIAL
ANALYSES
BUDGET OF THE
UNITED STATES
GOVERNMENT**

FISCAL YEAR

1978

repeal of all itemized deductions resulting in tax expenditures. This hypothetical revenue gain would be \$21.2 billion in 1978, whereas the simple sum of the tax expenditures for each separate item is \$31.3 billion. The estimate for the combined effect of all such deductions was derived from a model of the tax system that accounts for the interaction between tax expenditure provisions and the provisions of the normal structure. In particular the model provides that individuals would take the standard deduction if itemized deductions were repealed. No comparable estimate can reasonably be made for the combined effect of a hypothetical repeal of all exclusion provisions.

A few aggregations of related tax expenditure items are presented and discussed in the next section. These aggregates have been specially estimated so as to account for the interactions referred to above but do not consider the effect of changes in behavior. Where tax expenditures for both individuals and corporations result from the same tax code provision, such as the investment tax credit, the two estimates may appropriately be added together.

TAX EXPENDITURES BY FUNCTION

Estimates of tax expenditures are grouped together by functional category and presented in table F-1. The estimates are shown separately for individuals and corporations. Wherever possible, particular tax expenditures have been classified according to the functional categories used for budget outlays. Many tax expenditures do not, however, fit into these categories and for this reason three special functional categories have been added: business investment; personal investment; and other tax expenditures.

A brief description of each of the special tax provisions for which a tax expenditure estimate is shown in table F-1 follows.

National defense.—The supplements to salaries of military personnel, including provision of quarters and meals on military bases and quarters allowances for military families, and virtually all salary payments and reenlistment bonuses to military personnel serving in combat zones, are excluded from tax. Disability-related military pensions received by current retirees are largely excluded from taxable income. The Tax Reform Act of 1976 terminated the exclusion of noncombat related disability pensions for those who entered the armed services after September 24, 1975.

International affairs.—Prior to 1976, a U.S. citizen was generally able to exclude up to \$20,000 a year of foreign earnings if the taxpayer were a bona fide resident of a foreign country. After 3 years of foreign residence a taxpayer could exclude up to \$25,000 a tax year of foreign earnings. The Tax Reform Act of 1976 modified these provisions, limiting the exclusion to \$20,000 only for employees of U.S. charitable organizations and reducing it to \$15,000 for all others, denying tax credits for foreign taxes paid on excluded income, and taxing income beyond the amount eligible for exclusion at the higher bracket rates which would apply if the excluded income were also subject to tax. The estimates also reflect the tax-exempt status of certain allowances received by Federal employees working abroad.

Table F-1. TAX EXPENDITURE ESTIMATES BY FUNCTION¹

(In millions of dollars)

Description	Corporations			Individuals		
	1976	1977	1975	1976	1977	1975
National defense:						
Exclusion of benefits and allowances to Armed Forces personnel.....	-----	-----	-----	1,020	1,025	1,260
Exclusion of military disability pensions.....	-----	-----	-----	90	105	115
International affairs:						
Exclusion of gross-up on dividends of LDC corporations.....	40	-----	-----	-----	-----	-----
Exclusion of income earned abroad by U.S. citizens.....	-----	-----	-----	145	120	135
Deferral of income of domestic international sales corporations (DISC).....	1,220	1,030	1,150	-----	-----	-----
Special rate for Western Hemisphere trade corporations.....	50	35	25	-----	-----	-----
Agriculture:						
Expensing of certain capital outlays.....	85	80	70	455	370	440
Capital gain treatment of certain income.....	10	10	15	315	330	350
Natural resources, environment, and energy:						
Exclusion of interest on State and local government pollution control bonds.....	110	170	220	50	75	100
Exclusion of payments in aid of construction: Water and sewage utilities.....	-----	15	10	-----	-----	-----
Expensing of exploration and development costs.....	640	610	600	150	105	150
Excess of percentage over cost depletion.....	1,010	1,035	1,060	285	275	300
Pollution control: 5-year amortization.....	10	-80	-130	-----	-----	-----
Capital gain treatment of royalties on coal and iron ore.....	15	20	20	40	45	50
Capital gain treatment of certain timber income.....	290	300	325	95	95	100
Commerce and transportation:						
Exemption of credit unions.....	145	165	165	-----	-----	-----
Exclusion of certain income of cooperatives.....	410	455	490	-155	-165	-170
Corporate surtax exemption.....	4,170	4,650	4,250	-----	-----	-----
Deferral of tax on shipping companies.....	110	90	70	-----	-----	-----
Railroad rolling stock: 5-year amortization.....	-25	-35	-40	-----	-----	-----
Financial institutions: Excess bad debt reserves.....	485	560	645	-----	-----	-----
Deductibility of nonbusiness State gasoline taxes.....	-----	-----	-----	710	795	850
Community and regional development:						
Housing rehabilitation: 5-year amortization.....	15	10	5	25	20	10
Education, training, employment, and social services:						
Exclusion of scholarships and fellowships.....	-----	-----	-----	195	250	285
Parental personal exemptions for students, ages 19 and over.....	-----	-----	-----	720	750	770
Deductibility of contributions to educational institutions.....	190	215	240	510	540	565
Deductibility of and credit for child and dependent care expenses.....	-----	-----	-----	250	810	870
Credit for employing AFDC and public assistance recipients.....	10	15	15	-----	-----	-----
Health:						
Exclusion of employer contributions to medical insurance premiums and medical care.....	-----	-----	-----	4,100	5,195	5,840
Expensing of removal of architectural barriers to the handicapped.....	-----	5	10	2,315	2,585	2,870
Deductibility of medical expenses.....	-----	-----	-----	-----	-----	-----
Income security:						
Exclusion of social security benefits: Disability insurance benefits.....	-----	-----	-----	330	330	450
OASDI benefits for aged.....	-----	-----	-----	2,775	3,125	3,460
Benefits for dependents and survivors.....	-----	-----	-----	645	730	795

See footnote at end of table.

Table F-1. TAX INFE

Description
Income security—Continued
Exclusion of railroad retiree
Exclusion of sick pay.....
Exclusion of unemployment
Exclusion of workmen's com
Exclusion of public assista
Exclusion of special ben
miners.....
Net exclusion of pension
ings:
Employer plans.....
Plans for self-employed
Exclusion of other employ
Premiums on group-term
Premiums of accident
insurance.....
Income of trusts to finan
employment benefits.....
Meals and lodging (eth
Employer contributions
plans.....
Employee stock owners
through investment in
Exclusion of capital gain
Excess of percentage stand
income allowance.....
Additional exemption for
Additional exemption for
Retiree income credit
Earned income credit.....
Veterans benefits and serv
Exclusion of veterans disa
Exclusion of veterans pen
Exclusion of GI bill benef
General government: Credit
litical contributions.....
Revenue sharing and gene
ance:
Exclusion of interest on g
local debt.....
Credit for corporations in
Deductibility of nonbusin
(other than on owners
line).....
Interest: Deferral of intere
Business investments:
Exclusion of interest on
development bonds.....
Excess first-year deprecia
Depreciation on building
Rental housing.....
Other.....
Expensing of research ai
tutes.....
Expensing of construct
taxes.....
Capital gain: Corporate
(timber).....
Investment credit.....

See footnote at end of table.

Table F-1. TAX EXPENDITURE ESTIMATES BY FUNCTION—Continued
(In millions of dollars)

Description	Corporations			Individuals		
	1976	1977	1978	1976	1977	1978
Income security—Continued						
Exclusion of railroad retirement system benefits.....				190	200	205
Exclusion of sick pay.....				195	50	55
Exclusion of unemployment benefits.....				3,335	2,745	2,445
Exclusion of workmen's compensation benefits.....				590	705	810
Exclusion of public assistance benefits.....				95	100	105
Exclusion of special benefits for disabled coal miners.....				50	50	50
Net exclusion of pension contributions and earnings:						
Employer plans.....				7,290	8,715	9,940
Plans for self-employed and others.....				1,060	1,305	1,535
Exclusion of other employee benefits:						
Premiums on group-term life insurance.....				765	800	835
Premiums of accident and accidental death insurance.....				65	70	75
Income of trusts to finance supplementary unemployment benefits.....				10	10	10
Meals and lodging (other than military).....				310	330	350
Employer contributions to prepaid legal expense plans.....					5	10
Employee stock ownership plans (ESOP) funded through investment tax credits.....	25	245	255			
Exclusion of capital gain on home sales if over 65.....				40	40	70
Excess of percentage standard deduction over low-income allowance.....				1,140	1,285	1,410
Additional exemption for the blind.....				20	20	20
Additional exemption for over 65.....				1,145	1,220	1,250
Retiree income credit and credit for the elderly.....				110	495	440
Earned income credit.....				220	215	205
Veterans benefits and services:						
Exclusion of veterans disability compensation.....				595	655	690
Exclusion of veterans pensions.....				30	30	35
Exclusion of GI bill benefits.....				305	255	200
General government: Credits and deductions for political contributions.....				35	40	35
Revenue sharing and general purpose fiscal assistance:						
Exclusion of interest on general purpose State and local debt.....	2,845	3,105	3,470	1,520	1,680	1,850
Credit for corporations in U.S. possessions.....	240	285	310			
Deductibility of nonbusiness State and local taxes (other than on owner-occupied homes and gasoline).....				7,255	8,095	8,950
Interest: Deferral of interest on savings bonds.....				550	565	625
Business investment:						
Exclusion of interest on State and local industrial development bonds.....	150	195	235	75	90	110
Excess first-year depreciation.....	40	45	45	140	135	145
Depreciation on buildings in excess of straight line:						
Rental housing.....	100	100	100	405	405	425
Other.....	225	210	200	200	160	175
Expensing of research and development expenditures.....	1,325	1,395	1,450	25	30	30
Expensing of construction period interest and taxes.....	415	475	500	215	150	140
Capital gain: Corporate (other than farming and timber).....	545	555	550			
Investment credit.....	7,655	8,640	9,670	1,810	1,970	2,205

See footnote at end of table.

Table F-1 TAX EXPENDITURE ESTIMATES BY FUNCTION—Continued
(In millions of dollars)

Description	Corporations			Individuals		
	1976	1977	1978	1976	1977	1978
Personal investment:						
Dividend exclusion.....				430	455	480
Capital gain: Individual (other than farming and timber).....				7,320	7,030	7,360
Exclusion of interest on life insurance savings.....				1,655	1,815	1,995
Deferral of capital gain on home sales.....				845	890	935
Deductibility of mortgage interest on owner-occupied homes.....				4,870	5,435	6,050
Deductibility of property taxes on owner-occupied homes.....				4,030	4,500	4,925
Deductibility of casualty losses.....				310	345	380
Credit for purchase of new home.....				650	100	
Other tax expenditures:						
Deductibility of charitable contributions (other than education).....	350	400	445	4,360	4,900	5,475
Deductibility of interest on consumer credit.....				2,105	2,310	2,565
Maximum tax on earned income.....				605	730	855

MEMORANDUM

Combined effect of provisions disaggregated as follows:

Capital gains.....	865	885	905	7,770	7,500	7,860
Exclusion of interest on State and local debt.....	3,110	3,475	3,925	1,645	1,850	2,090
Deductibility of State and local nonbusiness interest.....				10,865	12,125	13,460
Deductibility of charitable contributions.....	540	620	635	4,870	5,440	6,040

† All estimates are based on the tax code as of Dec. 31, 1976.

The 1976 Act repealed a special provision for U.S. firms operating in a less developed country (LDC). When a foreign subsidiary of a U.S. corporation operating in a LDC repatriated dividends to its parent corporation, that income could, under prior law, be reported net of foreign income taxes paid. U.S. tax liability was then calculated on that net amount and the foreign tax taken as a credit. For non-LDC corporations, foreign source income must now be "grossed up" by adding back in an amount equal to foreign taxes paid. Under prior law the failure to "gross up" dividends by the amount of the foreign taxes paid to LDCs resulted in a tax expenditure.

The profits of a domestic international sales corporation (DISC) are not taxed to the DISC but instead are taxed to the shareholders when distributed to them. This deferral was available for 50% of the export income of a DISC prior to 1976. The Tax Reform Act of 1976 permits DISC benefits to the extent that current export gross receipts exceed 67% of the DISC's average for a 4-year moving base period (initially 1972-75) which will move forward year-by-year after 1979. DISCs with less than \$150,000 of taxable income are exempt from the incremental rule. The Tax Reduction Act of 1975 denied DISC benefits to exporters of energy products and the 1976 Act terminated DISC benefits for 50% of military sales.

The 1976 Act phases out the 14-percentage-point tax rate reduction provided under prior law for domestic corporations qualifying as Western Hemisphere trade corporations.

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§ 1333. Laws and regulations governing lands—Constitution and United States laws; laws of adjacent States; publication of projected States lines; restriction on State taxation and jurisdiction

(a) (1) The Constitution and laws and civil and political jurisdiction of the United States are extended to the subsoil and seabed of the outer Continental Shelf and to all artificial islands and fixed structures which may be erected thereon for the purpose of exploring for, developing, removing, and transporting resources therefrom, to the same extent as if the outer Continental Shelf were an area of exclusive Federal jurisdiction located within a State: Provided, however, That mineral leases on the outer Continental Shelf shall be maintained or issued only under the provisions of this subchapter.

(2) To the extent that they are applicable and not inconsistent with this subchapter or with other Federal laws and regulations of the Secretary now in effect or hereafter adopted, the civil and criminal laws of each adjacent State as of August 7, 1953 are declared to be the law of the United States for that portion of the subsoil and seabed of the outer Continental Shelf, and artificial islands and fixed structures erected thereon, which would be within the area of the State if its boundaries were extended seaward to the outer margin of the outer Continental Shelf, and the President shall determine and publish in the Federal Register such projected lines extending seaward and defining each such area. All of such applicable laws shall be administered and enforced by the appropriate officers and courts of the United States. State taxation laws shall not apply to the outer Continental Shelf. ✓

(3) The provisions of this section for adoption of State law as the law of the United States shall never be interpreted as a basis for claiming any interest in or jurisdiction on behalf of any State for any purpose over the seabed and subsoil of the outer Continental Shelf, or the property and natural resources thereof or the revenues therefrom.

ederal regulation invalid or the regulation itself is changed. Accordingly, until such time, retirement benefits payable to disabled San Francisco policemen and firemen, after such personnel has applied

for service retirement under the new Charter provisions, are not excludable from gross income under the sickpay formula contained in Revenue and Taxation Code Section 17139(d).

[¶ 205-026] Legal Ruling No. 366.

Franchise Tax Board, December 14, 1973.

Franchise—Corporation Income—Allocation and Apportionment—Taxation of Income Generated by Offshore Oil Operations.—The activities of a unitary enterprise conducting offshore oil operations under federal jurisdiction by reason of the Outer Continental Shelf Lands Act can only be reflected in the denominators of the three-factor apportionment formula. Under the Act, California lacks jurisdiction to tax the revenues derived from the Outer Continental Shelf since it is under exclusive federal jurisdiction. By including the Continental Shelf factors only in the denominators of the formula, no income is apportioned to California.

However, the operation of a drilling barge within California's jurisdiction must be reflected in the California numerators of the apportionment formula denominator.

See § 12-414.

Facts:

Advice has been requested as to the treatment to be accorded to the income earned by unitary businesses, taxable in California, from oil operations beyond the three mile continental limit. The operations considered are:

1. The actual operations of an offshore oil well, beyond the three mile continental limit, conducted from a fixed drilling platform; and
2. The exploring and drilling operations beyond the three mile continental limit conducted from floating drilling barges.

Questions:

For California franchise tax purposes, what is to be included in the numerator and denominator of the apportionment formula with respect to:

1. Activities conducted from fixed drilling platforms which are under federal jurisdiction by reason of the the Outer Continental Shelf Lands Act?
2. Activities conducted from fixed drilling platforms which are within the jurisdiction of a foreign country?
3. Activities conducted from floating drilling barges?

Decision:

See discussion.

Discussion:

1. In 1953 the United States Congress passed the Outer Continental Shelf Lands Act (67 Stat. 462, 43 U.S.C. §§ 1,331 et seq.) which extended the Constitution and laws of the United States to the Outer Continental Shelf; i.e., that property located beyond the three mile limit of state jurisdiction which was established by the Submerged Lands Act (43 U.S.C. §§ 1,301 et seq.). The outer limit of the continental shelf is not established with precision, but rather is marked only by a steep drop of the continental mass toward the ocean depths. (1953 U.S.

Code Congressional and Administrative News, p. 2,178). In some cases this may occur several hundred miles from shore.

Section 1333(a)(1) of the Outer Continental Shelf Lands Act extends federal jurisdiction to all artificial islands and fixed structures erected on the Outer Continental Shelf:

... to the same extent as if the Outer Continental Shelf were an area of exclusive Federal jurisdiction located within a State. ...

It is a matter of settled law that no state has jurisdiction to tax in an area of exclusive federal jurisdiction located within a state. *Surplus Trading Co. v. Cook*, 281 U.S. 647; *Standard Oil Co. v. California*, 291 U.S. 242; *James v. Dravo*, 362 U.S. 134. Since Congress extended federal jurisdiction to the Outer Continental Shelf "to the same extent" as if it were an area of exclusive federal jurisdiction within a state, this body of settled law applies with equal force to the Outer Continental Shelf and effectively prohibits the imposition of any state tax on revenues derived therefrom.

The lack of jurisdiction in a state to tax in areas of exclusive federal jurisdiction applies not only to direct taxes but to indirect taxes as well. In *James v. Dravo, supra*, the United States Supreme Court was faced with the question of whether "annual privilege taxes" measured by profits from "business and other activities" could be imposed by West Virginia on a contractor working on government-owned land. The Supreme Court stated that this depended upon, "... whether the United States has acquired exclusive jurisdiction over the respective sites. Wherever the United States has such jurisdiction [the Court added] the state would have no authority to lay the tax."

In the Buck Act, 4 U.S.C.A., §§ 101-110, Congress did provide the states with jurisdiction to levy certain specified taxes within federal enclaves. The

Buck Act cannot be construed, however, to apply to the Outer Continental Shelf. Section 1333 provides:

State taxation laws shall not apply to the Outer Continental Shelf. . . .

The provisions of this section for adoption of State law as the law of the United States shall never be interpreted as a basis for claiming any interest in or jurisdiction on behalf of any State for any purpose over the seabed and subsoil of the Outer Continental Shelf, or the property and natural resources thereof or the revenues therefrom. . . . (Emphasis added.)

In view of the well settled law establishing the absence of state jurisdiction to tax in federal enclaves, the provisions of Section 1333(a)(1) extending federal jurisdiction to the Outer Continental Shelf by reference to such enclaves, the provisions of Section 1333 negating any possible application of the Buck Act to the area in question, it is clear that California tax laws cannot reach revenues derived from the Outer Continental Shelf.

Before considering the formula it should be mentioned that the income to be apportioned is the total business income including that derived from the Outer Continental Shelf. When a corporation doing business solely within California commences operations on the Outer Continental Shelf, outside California, it becomes subject to Section 25101 and its business income will be apportioned in a like manner with other unitary businesses as follows.

Property Factor: All real and tangible personal property owned by the taxpayer everywhere must be included in the denominator. But the numerator can include only those properties with sufficient California connections. In this situation, any such contacts appear to be minimal.

Although some suggestions have been made to exclude the property from both the numerator and the denominator, if such is done, there will be an indirect apportionment of additional income to California contrary to federal law.

However, it may be noted that, under the rule set forth in *Montgomery Ward & Co., Inc. v. Franchise Tax Board*, 6 Cal. App. 3d 149 (1970), that oil in transit to a California location would be considered California property includible in the numerator of the property factor.

Payroll Factor: Regulation 25132 provides that the payroll factor shall include the total amount paid by the taxpayer in the regular course of its trade or business for compensation during the tax period. Subdivision (b) further provides that the denominator of the payroll factor is the total compensation paid everywhere during the income year. Accordingly, compensation paid to employees whose services are performed entirely in a state where the taxpayer is exempt from taxation, for example by Public Law 86-272, is included in the denominator of the payroll factor. In other words, there is no throwback of the payroll to the California numera-

tor even though the taxpayer is exempt from taxation in the state in which the services are performed. Where the services are performed partially within California and without California, the tests set forth under Regulations 25132(c) and 25133 apply. Payroll shall be included in the California numerator in accordance with the provisions of Section 25133 and the regulations thereunder.

Sales Factor: In view of the express federal ban against any state taxation of revenues derived from the Outer Continental Shelf, none of the sales, if any, which take place in the Outer Continental Shelf area will be includible in the sales factor numerator. Furthermore, in order that there be no indirect taxation of income from such sales, the sales factor denominator must include these sales. And, of course, if the natural resource is placed on the driller's own ships, no sale has occurred. On the other hand, if the natural resource is piped or brought into California, then the sale can be included in the numerator thereafter (assuming that it is subsequently sold in California).

It should be recognized that there are two fundamental considerations involved in this question. There is first the mandate that, under California law, the income of a unitary business must be apportioned by formula. *Edison California Stores v. McColgan*, 30 Cal. 2d 472 (1947). *John Deere Plow Co. v. Franchise Tax Board*, 38 Cal. 2d 214 (1951). Secondly, there is the federal prohibition against state taxation of revenue derived from the Outer Continental Shelf.

It is established that while formula apportionment is inherently incapable of attaining exactitude, so long as the formula employed produces a reasonable result its use will be sustained. *El Dorado Oil Works v. McColgan*, 34 Cal. 2d 731 (1950). It is submitted that the formula factors set forth above take into account both fundamental considerations. They provide formula apportionment to California of the income reasonably attributable to California sources, and by including the Continental Shelf factors only in the denominator, they do not apportion income to California, thereby giving effect to the federal law.

Section 25120(f) of the California Revenue and Taxation Code provides that the definition of "state" includes a foreign country. A basic purpose of the Uniform Division of Income for Tax Purposes Act (UDITPA), which is codified in Sections 25120-25139, is to insure that 100 percent of income, no more or no less, would be subject to tax. See *Pierce*, *The Uniform Division of Income for Tax Purposes Act*, 35 *Taxes* 7-17.

It therefore seems clear that where another state has jurisdiction to tax and the taxable activity has no connection whatever to California, the factors associated with the activity may not be reflected in

the California numerator. These factors, however, are income producing and must be included in the denominator. *McDonnell Douglas Corporation v. Franchise Tax Board*, 69 Cal 2d 306 (1968).

3 The Outer Continental Shelf Lands Act extends federal jurisdiction (and prohibits state taxation) "To the subsoil and seabed of the Outer Continental Shelf and to all artificial islands and fixed structures which may be erected thereon. ..." (43 U.S.C. §§ 1333).

It has been established by a number of decisions that a drilling barge or rig is neither an artificial island nor a fixed structure within the contemplation of the Act, but rather is properly classified as a vessel.

Offshore Company v. Robison, 266 Fed. 2d 769 (1959); *Producers Drilling Co. v. Gray*, 361 Fed. 2d 432 (1966); *Marine Drilling Company v. Autin*, 363 Fed. 2d 579 (1966). Although the cited cases arose in the context of wrongful death or injury under the Jones Act (46 U.S.C. § 688), rather than a tax context, they hold squarely that drilling barges or rigs

are vessels and not within the ambit of the Outer Continental Shelf Lands Act. It therefore follows that the Act likewise does not exempt the activities of such barges or rigs from state taxation and California can apply its usual rules to tax the income earned from the operations of the barges.

Under the Submerged Lands Act (43 U.S.C. §§ 1301 et seq.) California's jurisdiction to tax extends offshore for three miles. There can therefore be no question that, to the extent that the drilling barges are within the three mile limit their presence and activities must be reflected in the California numerators of the apportionment formula. Similarly, the activities of drilling barges not present within California's jurisdiction will only be reflected in the denominator of the factors of the apportionment formula.

When, during a taxable year, the drilling barge is both within and without California waters, its operations and presence shall be reflected in the California numerator in accordance with the rules set forth in Cal. Adm. Code, tit. 18, Regs. 25128 to 25136, inclusive.

[§ 205-027] Legal Ruling No. 367.

Franchise Tax Board, December 14, 1973.

~~Franchise—Corporation Income—Sales Factor of the Apportionment Formula—Advertising Receipts.—Receipts from sales of advertising space in magazines and periodicals are included in the numerator of the sales factor of the apportionment formula in the same ratio as the sales of magazines and periodicals in California bears to total sales.~~

~~Sec § 12-442~~

~~Advice has been requested regarding the inclusion of advertising revenue in the sales factor of the apportionment formula under the Uniform Division of Income for Tax Purposes Act (UDITPA) for publishers of magazines and periodicals.~~

~~Receipts from the sales of magazines and periodicals and advertising space in such magazines and periodicals by publishers gives [give] rise to income from transactions and activity in the regular course of the taxpayer's trade or business constituting "business income" under Section 25120(a), Bank and Corporation Tax Law. Gross receipts from those transactions constitute "sales" as defined in Section 25120(e) which are required to be included in the sales factor (Section 25134) of the apportionment formula under UDITPA.~~

~~Tangible property is that which is visible and corporeal, having substance and body. *Roth Drug, Inc. v. Johnson*, 13 Cal App 2d 720, 734 (1936). It is evident that a magazine or periodical has~~

~~substance and body. Consequently, the sale of magazines and periodicals by the publisher to subscribers and newsstands are sales of tangible personal property. (cf. *Time, Inc. v. Hulman*, 201 N.E. 2d 374, 377, 31 Ill 2d 344.) Receipts from such sales are to be included in the sales factor in accordance with Section 25135 governing sales of tangible personal property.~~

~~The sale of advertising space in such magazines and periodicals is closely connected with the sale of the publication. The primary purpose of the advertiser is to reach the market provided by the publisher. The publisher in turn guarantees a particular circulation volume, or in other words, a market. Since advertising included in magazines and periodicals is inextricably connected with the sale of those publications, it is concluded that advertising receipts are to be included in the numerator of the sales factor based upon the ratio which sales of magazines and periodicals in this state bears to the total sales of magazines and periodicals everywhere.~~

[§ 205-028] Legal Ruling No. 368.

Franchise Tax Board, December 14, 1973.

California Tax Reports

§ 205-028

Tax Calculation

Under Current Law

=====

(a) % Of Value Method:

300 bbl X \$4.85 X 5% = \$72.75
 700 bbl X 4.85 X 6% = 203.70
 600 bbl X 4.85 X 8% = 232.80
509.25

Less 1/8 Royalty Portion 63.66

Tax = \$445.59
 =====

(b) Cents Per Bbl Method:

300 bbl X \$.3519 = \$105.57
 700 bbl X .4224 = 295.68
 600 bbl X .5632 = 337.92
739.17

Less 1/8 Royalty Portion 92.40

Tax = \$646.77
 =====

Tax Payable (higher of

(a) or (b) = \$646.77
 =====

Tax Calculation Under HB 321

Tax rate = 10% of value or \$.75 per bbl plus adjustments for gravity (up 1/2 cent for each degree above 27°) and for Gross National Product Deflator-- (1st Qtr. 1977 = base period).

Cents per bbl = \$.75 X .04 = \$.79

Percent of value rate and cents per bbl rate multiplied by Economic Limit Factor (ELF):

$$ELF = \frac{100 \text{ bbl}}{1600 \text{ bbl}} = .0625$$

$$1.000 - .0625 = .9375 = ELF$$

Cents per bbl adjustment:

$$$.79 X .9375 = $.7406$$

% of value adjustment:

$$10\% X .9375 = 9.375\%$$

Tax Calculation

1600 less royalty (200) = 1400 bbls

% of value method:

$$1400 X \$4.85 = \$6,790$$

$$\$6,790 X 9.375\% = \$636.56 \text{ (Tax)}$$

=====

Cents per bbl method:

$$1400 X $.7406 = \$1,036.84$$

=====

Tax Payable: \$1,036.84
 =====

Difference in tax between HB 321 and Current Law:

HB 321 = \$1,036.84
 Current law 646.77
\$390.07 = 60.3% increase in tax
 =====

Production tax burden as a % of producer's net share of \$6,790 (1400 bbls X \$4.85);

Under current law = 9.5%
 Under HB 321 = 15.3%

TO: CHAIRMAN, HOUSE RESOURCES COMMITTEE
AND ALL COMMITTEE MEMBERS

FROM: SUB-COMMITTEE ON OIL & GAS

During the week of march 21 - 26 the Joint Senate and House Resources Committees met to hear testimony relating to the various oil and gas taxation bills currently before us. Some of the bills under discussion, have not been refered to this committee.

Of the ones that have been, the Sub-committee on Oil and Gas recommends that H.B. 321, H.B. 322, C.S.H.B. 323, H.B. 328, and S.B. 274 be brought to the full committee's attention for consideration and that they be acted upon and passed out of committee no later than April 7.

Each of these bills have a further referral to House Finance and the Finance Committee has scheduled hearings and work sessions on these bills beginning early next week. Representatives from the oil companies and several nationally recognized economists will be present. We urge all members, who are able, to attend.

RECOMMENDED BILLS

H.B. 321 - SEVERENCE TAX

This tax, in our opinion, rates highest in priorities. It's timeliness is dependant upon the actions undertaken by the Federal Energy Administration in setting a recommended "well head" price by April 15, 1977, and further by actions later taken by the I.C.C. in recommending the transportation cost of North Slope crude. For other features of the bill, we refer the committee's attention to the Governor's transmittal letter for H.B. 321, included with this report.

H.B. 322 - ALASKA NET INCOME TAX OR FRANCHISE TAX

This tax bill, in our opinion, has several advantages over our present income tax collection system. It is easy to administer, is based upon the amount earned within the state, including OCS development, and would provide the State and the industry with a stable taxation policy for years to come. For other features, we refer you to the Governor's transmittal letter for H.B. 322, included in this report.

H.B. 323 - PROPERTIES AD VALOREM TAX

This tax bill, in our opinion, is premature. It would increase the scope of taxable property to include refining, liquefaction, and marine transportation. We believe that it would act as a "disincentive", at this time, for future development within our state, and of all the tax bills before us, meet with the most resistance. Accordingly, we have asked the Department of Revenue to place before this committee, a committee substitute for H.B. 323 which would reduce the bill to a "house-keeping" measure. This has been done and is before the committee for consideration.

H.B. 328 - RESERVE TAX

This tax bill amends the reserves tax bill to allow a credit reduction of tax levied 12 [20] if the oil flow through the Trans-Alaska Pipeline by October 1, 1977 has reached at least 600,000 barrels of oil on a daily average. Otherwise, the bill extends the reserve tax beyond the December 31, 1977 effective date of the original act. We urge its passage.

S.B. 274 - THE TAKING OF OIL AND GAS ROYALTY IN KIND

This bill requires that royalty oil and gas be taken "in kind" rather than in money unless deemed otherwise by the commissioner, the Alaska Royalty Oil and Gas Development Advisory Board, and the the Legislature. As an encouragement for future development within our state, we urge the passage of this bill.

7/11/77
*Are you taking up that bill tomorrow
that I supposedly studied part of?*

CONCLUSION:

The Sub-committee believes that the passage of these tax proposals, taken in conjunction with the desire to have the Alaskan Permanent Fund replace the eventual and inevitable passage of our nonrenewable resources, will produce a desired benefit for the State of Alaska. We further believe that they will not act as a disincentive for the oil industry and that their passage will ensure Alaska's "fair share" in the wealth of our state. Regarding this aspect, we urge committee members to read the Tanzer Report, "IMPACT OF INCREASED TAXATION ON OIL EXPLORATION AND DEVELOPMENT IN ALASKA", submitted to all members of the Alaskan State Legislature on March 25, 1977.

We have asked that Mr. John Messenger from the Department of Revenue be present to assist committee members in answering their questions and would, as this time, like to highly commend the staff of Senate and House Resources for providing the back-up material needed for the committee's deliberations.

Rep. Merle G. Snider
Rep. Hugh Malone
Rep. William Akers.

HOUSE BILL NO. 321 by the Rules Committee by request of the Governor, entitled:

HB 321

"An Act relating to the oil and gas properties production tax; and providing for an effective date."

was introduced, read the first time and referred to the Committees on Resources and Finance.

The Governor's transmittal letters appear following the bill to which it pertains: fiscal notes appear in House Supplement No. 31 to today's journal.

"March 8, 1977"

HB 321 The Honorable Hugh Malons Speaker of the House Alaska State Legislature Juneau, Alaska 99811

Dear Mr. Speaker:

Under the authority of art. III, sec. 18 of the Alaska Constitution, and in accordance with AS 24.30.060(b) and the Uniform Rules of the Alaska State Legislature, I am transmitting a bill relating to the oil and gas properties production tax.

As a result of a recent study of Alaska's oil and gas tax structure, the Department of Revenue has recommended several changes in the state's production or "severance" tax. This bill incorporates those specific recommendations.

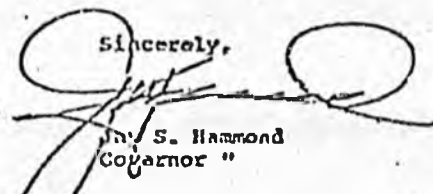
Currently the state's oil production tax is calculated according to "stair stepped" rates depending upon the level of production for the lease or property. As currently structured the tax may have an adverse impact upon a particular property as it reaches its economic limit. The "stair step" approach may not alleviate this adverse effect since the economic limit may vary substantially from one part of the state to another. This is because it may be more costly to produce and transport the oil in the more remote areas of the state. Accordingly, the bill contains an economic limit mechanism which automatically scales the tax rate down as the production nears its economic limit. This will insure that the tax will not unduly inhibit oil production as it reaches its economic limit.

One of the immediate dangers which face the state's revenue picture is the potential for artificially depressed pricing of the state's North Slope oil. This could result from federal pricing decisions or excessive tariff costs from the wellhead to the refinery. To insulate the state's petroleum revenues from these forces, the bill provides for a mechanism which would raise the cents-per-barrel floor to correspond to a mid-range market value for North Slope oil and tie that floor to an index which will let the floor keep pace with inflation.

One of the Department of Revenue's recommendations -- the oil and gas surtax -- which was designed to offset revenue losses due to depressed pricing of North Slope oil and which was to be imposed only on holders of state-owned leaseholds was deleted on the advice of this department because of the substantial legal problems involved.

The bill places the tax on gas at a parity with the tax on oil. Currently gas is taxed at only 4 percent while oil is taxed from 5 to 8 percent. The bill would tax both oil and gas at 10 percent. In addition, the bill sets a cents-per-Mcf floor for the gas tax similar to the cents-per-barrel floor for oil. This new floor for gas corresponds to the highest market price in the state, and it too is tied to an index to keep pace with inflation.

Sincerely,


Jay S. Hammond
Governor

HOUSE BILL NO. 322 by the Rules Committee by request of
the Governor, entitled:

HS
322

"An Act establishing an oil and gas corporate
franchise tax; and providing for an effective
date."

was introduced, read the first time and referred to the
Committees on Resources and Finance.

"March 8, 1977

The Honorable Hugh Malone
Speaker of the House
Alaska State Legislature
Juneau, Alaska 99811.

Dear Mr. Speaker:

Under the authority of art. XII, sec. 19 of the Alaska
Constitution, and in accordance with AS 24.50.060(b)
and the Uniform Rules of the Alaska State Legislature,
I am transmitting a bill establishing an oil and gas
corporate franchise tax.

The Department of Revenue, in its oil and gas tax
study, found two basic deficiencies with the corporate
income tax as it relates to oil and gas corporations.
This bill would correct those deficiencies.

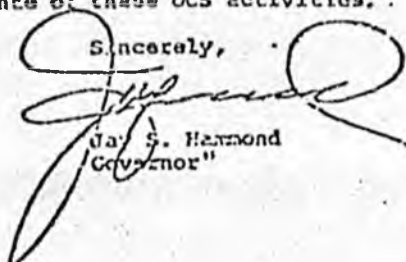
HS
322

The first problem is the eroded federal tax base. The
department found that the federal corporate tax base
which Alaska has adopted has been substantially eroded
by special exemptions, deductions, credits and other
accounting devices. The result has been that oil and
gas corporations pay an effective tax rate much smaller
than the statutory 48 percent. Accordingly, the bill
would enact a separate franchise tax on a corporation's
"book income." "Book income" is the net income which
the corporation reports to its stockholders. This
would eliminate all the special Congressional tax
provisions.

In addition, the department found that the present
apportionment formula does not fully represent the oil
and gas corporate activity in the state. The present
formula of property, payroll, and sales generally
measures corporate business activity in the state. For
natural resource companies, however, it does not. No
reflection in the present formula is made for the
scarcity value of the oil and gas produced. Accord-
ingly, the bill will substitute for the present sales
factor an extraction factor which will give weight
specifically to oil and gas production activity.

One of the advantages of this franchise tax is that it
will take into account elements of property, payroll,
and extraction located on the Outer Continental Shelf
which causes a resulting impact on the adjoining state.
Thus property, payroll, and extraction not located in
any state but which are located off the shores of an
adjoining state which is impacted by the oil and gas
production activity will be allocated to that state
suffering the impact. Although this latter provision
may raise some constitutional law questions, we believe
that the proposal comes within the limits of the state's
taxing powers given the impact on the coastal com-
munities of our state of these OCS activities.

Sincerely,


Jay S. Hammond
Governor

AGO 547569

HOUSE BILL NO. 328 by the Rules Committee by request of
the Governor, entitled:

HD
328

"An Act amending the oil and gas reserves
ad valorem tax; and providing for an
effective date."

was introduced, read the first time and referred to the
Committees on Resources and Finance.

" March 9, 1977

The Honorable Hugh Malone
Speaker of the House
Alaska State Legislature
Juneau, Alaska 99811

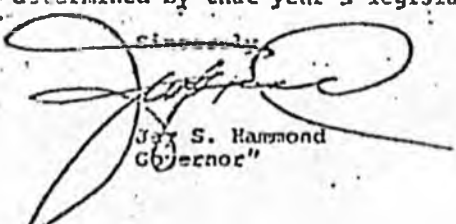
Dear Mr. Speaker:

Under the authority of art. III, sec. 18 of the Alaska
Constitution, and in accordance with AS 24.50.060(b)
and the Uniform Rules of the Alaska State Legislature,
I am transmitting a bill amending the oil and gas re-
serves ad valorem tax.

Section 1 of this bill proposes that the reserve tax
levy be reduced from 20 mills to 12 mills this year
with the condition that an additional levy will be
made if there is a delay in the start-up of the Trans-
Alaska Pipeline.

This amendment is proposed because the state has a
budget surplus for FY 1977. This surplus is somewhat
illusory, however, since the reserve tax payments may
be recouped by oil and gas producers by credits
against future severance tax. Accordingly, the adoption
of this measure would reduce the surplus for 1977 and
also reduce the amount "borrowed" from future revenues.

Section 2 provides for a contingent 1978 assessment
at a rate to be determined by that year's legislature.


Jay S. Hammond
Governor

AGO 547570

"An Act relating to the oil and gas exploration, production, and pipeline and marine transportation property tax; and providing for an effective date."

March 8, 1977

The Honorable Hugh Malone
Speaker of the House
Alaska State Legislature
Juneau, Alaska 99811

introduced, read the first time and referred to the
committees on Resources and Finance.

Dear Mr. Speaker:

Under the authority of art. III, sec. 18 of the Alaska Constitution, and in accordance with AS 24.30.050(b) and the Uniform Rules of the Alaska State Legislature, I am transmitting a bill relating to the oil and gas exploration, production, and pipeline and marine transportation property tax.

The Department of Revenue has recently completed its study of Alaska's oil and gas tax structure and has made several recommendations. One set of recommendations dealt with the state's 20-mill property tax imposed by AS 43.56. This bill would implement that set of recommendations.

The bill corrects four problem areas in the current property tax: the omission of certain important kinds of oil-and-gas-related properties from the definition of taxable property; present uncertainty about how pipelines should be valued; the static nature of the \$1500 per-capita limitation on municipal taxation, and the extent to which municipal property tax payments should be allowed as credits against the state tax. The bill's features are described below:

Section 1 of the bill makes clear that taxes paid to municipalities which exceed the statutory limitations in AS 29.53.045 and 29.53.050 are not creditable against the state tax.

Section 3 of the bill removes the current uncertainty on pipeline valuation by ensuring that pipelines will be valued on the basis of their full and true value with due regard to their economic value. This will eliminate the possibility of pipelines being valued under the depressed valuation method of actual cost depreciated.

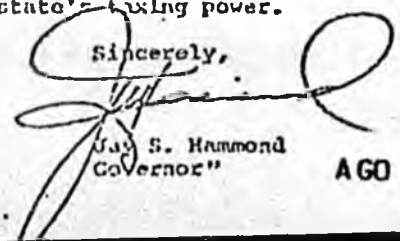
Section 4 of the bill defines full and true value of property used in refining or liquefying of gas or oil as replacement cost less depreciation. It also defines the value of taxable marine transportation property.

Section 7 adds new categories of taxable property including oil refineries, gas processing plants and liquified natural gas facilities. This will mean greater revenues to the state from these important oil and gas properties.

Section 8 and 9 of the bill tie the \$1500 per capita municipal limitation to the Anchorage cost-of-living index in order that the limitation would increase over time as inflation raises the cost to municipalities of providing services to its residents.

HB 323 In addition, Sections 2, 4, 5, 6, and 7 are aimed at amending the relevant provisions of AS 43.56 to provide for the taxation of marine transportation property (i.e. tankers) on an apportioned basis determined by the number of days spent on parts loading and unloading; gas and unrefined oil divided by the total number of days-spent-in-ports everywhere. Although these provisions raise close and difficult questions of constitutional law regarding the ability of the state and municipalities to impose an ad valorem property tax on such vessels in light of the traditional application of the "home port" doctrine, it is the view of the Department of Law that these vessels have sufficient nexus with the state to bring them within the constitutional parameters of the state's taxing power.

Sincerely,



Jay S. Hammond
Governor

AGO 547571

TESTIMONY OF MR. RICHARD KILGORE
OF WALTER J. LEVY CONSULTANTS CORP.
FOR THE JOINT SENATE AND HOUSE
RESOURCES COMMITTEE MEETING ON
OIL AND GAS TAXATION - MARCH 21, 1977

CHAIRMAN POLAND - We will bring the meeting of the Senate and House Resources Committee meetings to order. We have with us as our first witness this morning, our consultant from the firm of Walter J. Levy, Mr. Richard Kilgore. We have asked Mr. Kilgore to address us this morning on the net income tax bills and those closely associated thereto. We will break at 10:00 AM, and will resume again this afternoon at 1:30 PM.

For those who are sitting behind me, if you'll raise your hand so that Mr. Farleigh can notify me if you have a question, you will be recognized, and with that I'd like to welcome Mr. Kilgore back to Alaska and let him take over.

RICHARD KILGORE - Thank you Senator Poland. I think it is appropriate since I am the leadoff witness, that I present here this morning what I call an overview of tax legislation.

CHAIRMAN POLAND - Mr. Kilgore, for the record, would you identify yourself.

RICHARD KILGORE - Yes. I'm Richard Kilgore. I'm Director of Research for W. J. Levy, Consultants. I've been with the firm for about fourteen years.

What I'm going to attempt to do here this morning is to provide what we would call an overview. I'm not really going to go into very much detail about the individual pieces of legislation, at least the specific provisions of them, and concentrate more on the approaches, the alternatives, and so on. Most of my remarks will have to do with income taxation, but I also have some remarks on severance taxation if we have enough time; and I'd like to say a little bit in the end about a total tax package - total tax regime in Alaska because the whole thing is obviously more than a sum of these parts if it has to do with the impact of the total program.

I'd like to look at the major areas of taxation and really consider the alternatives presented to you because they are quite diverse, and give you our appreciation, really, of the major pros and cons this time of the major pieces of legislation, of the major approaches and the kinds of pros and cons, advantages and disadvantages which we think you legislators should be looking at and asking questions of witnesses as you go along. We will be available as I say, for specifics later.

As many of you may recall, our firm has been urging upon the legislature, for many years, that it review its corporate income tax, and especially to do this before Prudhoe Bay Production really comes on and you have major questions of taxation there. We have pointed out in the past, and I think it's fairly well known now the problems of apportionment under the present regulation, and I don't really think we have to get into that in detail. We ourselves did our own analysis of how the present system might work for Prudhoe Bay. Taking data submitted by SOHIO, in submission 1 at the request of the legislature, and very roughly what it turned up was that if one applies the present system, that is the three factor apportionment system with sales and property, and payroll, what you turn up in the way of income apportion to Alaska is roughly one quarter of what the producing income and the pipeline income would be. Saying that another way - if the present system were applied to Prudhoe, using as I say, data supplied by SOHIO, what you would get is an effective rate of taxation instead of something like 9.4% an effective rate of taxation, roughly a quarter of that, two to two and a half percent, so there are obviously problems with the present system, and as I say, I won't burden you with too much of that as I think by this time it's fairly well known by everyone.

Now, you at the present time have before you three different bills, basically two different approaches, but three different bills designed basically to deal with this problem of the inappropriateness of the present formula. The first is the bill submitted by the Governor, and this comes out of the work of Professors Zeifman and Ainsworth, and a report done by the Department of Revenue. This is SB 236, and HB 322. We basically feel that this is quite an imaginative and new approach, and involves basically two features: A change in the tax base, and a modification of the apportionment formula. I'll come back to that. Second, we have a bill on separate accounting introduced by the subcommittee on leasing and taxation, and third we have the net proceeds bill introduced again this year which reads to similar, and I guess even identical, to the net proceeds tax of last year. So we have three bills basically, I'm going to say, on two approaches, and lets look at some of the pros and cons of these. I should say at the outset that like many things in the field of taxation, no one approaches his ideal here, there's no magic answer to this that's going to come out, and one approach is not just going to stand out that is uniquely better than any other one. It's just not the case. So there's clearly room for debate, and for your careful look at these approaches. So first lets look at this Governor's bill coming out of the Zeifman and Ainsworth work.

Basically, as you see, there are two features to this legislation. One is a change in the tax base, and the second is a change, as I say, in the apportionment factors themselves. The present system as you probably know, uses federal taxable income. That's its base, and takes a portion of that federal taxable income. This new proposal involves a switch to book net income before income taxes as reported by oil companies to their stockholders. Now, there are certain clearcut advantages or pros for the State in this switch in tax base from taxable income to book net profits. First of all, figures are readily available from annual reports. This concept of income is reported by most companies or at least most of the major companies that will be operating as oil producers in Alaska. Second, as you will hear, I'm sure, from Professor Zeifman and from the Revenue Department, there are fewer so called erosions than in federal taxable income, that is under federal taxable income rules there are various kinds of generous accounting rules allowed to companies which works to reduce the amount of income on which they pay taxes, and you're fairly familiar with this too, I'm sure. Such things as intangible drilling expenses are under federal tax law, can be treated as expense items, not as capital items, and this involves large write-offs. The federal government allows accelerated depreciation and so on, and companies in their book accounting

rarely, if ever, expense intangibles or use accelerated. They use normal kinds of depreciation under normal accounting rules. So very clearly switching in this direction results in a higher tax base than federal taxable income, and this obviously throws up more income to the State of Alaska. But switching from taxable income to debt book income does have problems. It is not without problems. I'll just enumerate a few of these. Later we can talk about these in more detail. Even within acceptable accounting principals there's a certain flexibility, obviously, to companies in respect to how they report income, the kind of deduction and so on. Inventory gains and losses are often treated differently by companies, and they have some choice in this. Currency changes, how they are affected by currency changes, gains and losses, they are often treated differently by companies. Incidentally, some of these factors which resulted in different kinds of accounting don't always even show up in company annual reports. If they're not material, they may not even be stated within a company annual report. One would probably have to go beyond that, if one wanted to see the effect of these factors. There is also a certain amount of flexibility in accounting for write-offs. When does one realize a loss, if one has some sort of venture that is going bad, at what point do you write the thing off as a total loss? There is a certain amount of flexibility in this. Companies at times will use what is sometimes

called the "blood bath" approach to accounting. When things really go wrong, and you have a lot of losses, there is a tendency to just write it all off in one year, and take all the bad at one time. Of course, the company doing this, it would effect the tax base that Alaska would be looking to in this approach. But, I don't think any of these while they present problems in switching to book income are probably disabling. Revisions could also be a problem. Companies at times change accounting procedures, and will then revise their book income and various parts of this back through time, and this would cause problems also if one does this, if there's a later revision, do you then change your tax base, and so on. So this presents problems. I think perhaps, a more serious problem in going to pre-tax book income has to do with how one arrives at that. Now, normally pre-tax income, if you went to a company annual report, what you would do was take net income after taxes and add back all income tax payments, and that's apparently what is proposed here in this piece of legislation. That would include all income taxes including income taxes paid to foreign governments. This looks to us like it could really present problems, and it raises questions about what sort of a tax base you are really reaching when you look at pre-tax book net income. If you'll take the annual report of a company like EXXON which is going to be an operator in Prudhoe Bay, is going to be a producer there, also a company that has very large foreign operations and pays very large

foreign income taxes, it is very interesting to see what has happened in the past to those foreign income taxes, and then I would like to talk about what may happen in the future to foreign income taxes and how this might effect the tax base that you'd be using if you should go to net book income under your appropriate income tax.

If you look at the annual report of EXXON or any other oil company operating in the foreign field, what you will find is that over the past few years, and particularly the years '73 and '74, there was a very sharp buildup in foreign income tax payments. That is tax payments to foreign producing governments such as the Saudi-Arabs in Iran, and so on, and the result of this huge increase in foreign income tax payments this build up, as you all know, had to do with the increase in OPEC prices. OPEC dictated very substantially higher prices. These higher prices were obviously not intended to benefit the companies, but to benefit the producing governments themselves, and so what the producing governments did was take a large part of this income generated by the very much higher prices and tax it away from the oil companies in the term of income taxes. Some of it they called royalty, some of it they called income tax, but there was a very large income tax component to this, and this resulted in very large increases in foreign income tax payments

by oil companies. And, if Alaska had been on this system which involves using book income, what would have happened over these years is that Alaska would have benefited from a huge increase in pre-tax income from a company such as EXXON, and this would have resulted in large part not after tax profits EXXON earned, but because of its income tax payments to foreign government. So Alaska, over this period, would have benefited from a very short run up in pre-tax income because of income tax payments by oil companies to foreign governments. It would have worked to the benefit of Alaska, had Alaska been on this system. But now, if we look ahead, we find the concession terms are changing in the middle east and elsewhere, and almost all foreign areas. Foreign governments have increasingly taken control of producing operations themselves. When the companies remain, they remain as producers and operators, but they serve in increasingly different roles. They serve as contractors, not as concessionaires, and under this new type of system, payments to the producing governments tend not to be in the form of income tax, they tend to be in terms of purchase of oil, purchase at market prices with the companies being compensated in terms of service fees for their continuing operations in these countries. So what is beginning to happen is these huge payments to foreign producing governments are increasingly not called income tax payments, they are called purchases,

purchases of oil from the Saudi Arabian State Oil Company for example, and already if you look at the annual report of a company like EXXON, you will see that we have a decline already in 1975, and I guess when the 1976 annual report of EXXON is out, you will find another decline in foreign income tax payments, so what had happened in foreign oil markets would have worked to the benefit of Alaska over the past few years, but now would be working in the other direction. That is EXXON may have a relatively constant after tax profit on its foreign producing operations in countries such as Saudi Arabia, but its pre-tax will be going down. Why? Because it won't be making income tax payments to the Saudi's or other foreign governments. It will be purchasing oil and this would effect the pre-tax profit. So you could have a declining base from this kind of thing.

Now, I dwelled at some length on this because it's interesting. What it demonstrates is that when you use this approach, you do have some problems, and you have things happening outside Alaska which effects the tax base that you are going to reach an apportion part of, but it's very much affected by the things that have nothing to do with profitability in Alaska. And this, I think, the foreign income tax things, are a good illustration, and they are an important one,

and that's why I spent some time with this. So under this kind of system you would have things effecting net book income that really have very little to do with Alaska, and this is something of a problem, and one doesn't know for the future how these various kinds of changes would effect it, and what I'm talking in foreign income taxes probably will work to the disadvantage of Alaska. Other things that we may know nothing about could work the other way. So moving to book income as a concept had truly some advantages. You'll have obviously a higher income that you are trying to take a part of, but it's not without problems. We can discuss those more at some later point. The second part of this approach has to do with a change in the apportionment formula. What has been suggested here in the legislation is changing from sales to extraction, and there are some very clear advantages to Alaska in this obviously. The extraction isn't oriented measured and is production measured in Alaska, and is obviously more appropriate than a measure such as sales where a large part of sales of crude oil in Alaska are not made within Alaska, but they are made without Alaska. So this kind of a move will clearly apportion more income to Alaska, and is certainly a step in the direction of higher appropriate income tax receipts for the State of Alaska. Now here again, although this step obviously works in the direction of favoring Alaska and higher income tax payments to the State,

there are technical problems as well that you should be aware of, and especially in foreign areas. Net production of companies is not always so easy to define, and net production as set out in the annual reports of the oil companies may not quite match Alaska's definition. The legislation before you does define net income in certain specified ways. The production figures that you get from the companies may not always match, and there may be problems of meeting your definitions, especially in foreign areas such as Indonesia, for example, where companies work under contracts. The concept of net production is not the same as the simple system where one has the simple royalty that one takes off, and it may be difficult to define what really is net production. What is production of a company? What is purchased oil? So that moving in this direction has some benefits for the State, but it obviously is not without problems.

In general, we feel that this approach, this one and rather novel new approach for the State has certain advantages. I sum these up by saying it will clearly increase Alaskan tax revenues. It works better in a sense, and why it does is quite obvious. Book income is higher than taxable income. Extraction is a better measure than sales, so you throw up more income to Alaska. If you throw up more income it

obviously means you are moving closer, hopefully, to getting something like 9.4% of what will be the producing income in Alaska. And although the administration end of it is not quite so simple as it looks, initially, and for some of the reasons that I've set out here, it obviously has some administrative advantages over other approaches. It is somewhat simpler, and this is certainly an advantage in this approach. Now the real basic disadvantage that we feel to this whole approach is that while it would get higher income apportioned in Alaska, one doesn't really know out of this system, how close one would get to true profitability. That is, how much income in Alaska and how close that is to what seems to be extensively profitability in Alaska. This is very difficult to know, very difficult to know how close it is. In total and company by company, it's difficult to know how the thing will actually work.

We ourselves tried a very simple approach to try to see how close it would come, and what we did, and anyone can do this, if one takes the annual reports to say, the three major companies that will be producing on Prudhoe Bay, ARCO, EXXON, and SOHIO, takes the latest data available for them, and that's the 1975 annual reports of these companies, (the 1976 one is not out), and then simply adds to that data for Prudhoe Bay, profitability, production, and so forth for Prudhoe Bay, and rather than make our own estimates

for that, again we turn to the data submitted by SOHIO, in SOHIO submission 1, so what we attempted to do was simply combine the data for Prudhoe Bay/Alyeska as contained in SOHIO submission 1, with the company's latest annual report data, and then attempted to see how this new approach would work that is using as our tax base pre-tax book income and then using a property factor, payroll factor and an extraction factor, and this is a very rough approximation obviously, but what happens when one does that, you find out that this apportionment formula does not apportion all the income that is assumed for Prudhoe Bay and Alyeska. It does not apportion it all, and more interesting than that, what you get is if you look at the three companies, just to see how three companies of this type would fare under this system, you get quite different results for the different companies. That is, some companies, at least one of the companies, you would get a fairly high porportion of the income earned in Alaska by this approach. From another company, you would get quite low percentage of it, so that one could, at least this little illustration suggests, that one could have companies with exactly similar operations in Alaska such as for example ARCO and EXXON, and get very different tax liabilities for the two companies, and we think this looks to be a potential disadvantage. You say this is only an illustration and one doesn't know what would be thrown out of this approach, but it does suggest

that what you may be getting in the way of apportion income and income tax payments may be off the mark of what profitability really is. So, we receive that as kind of the key draw back to this. You go in the right direction, but you don't know where you really are. Some people could be underpaying income taxes, other people could be overpaying, and how it would balance out to the State as a whole, it's difficult to say.

We would make this suggestion. If the legislature decides that this new approach in the bill submitted by the Governor is the approach it wants, and it might well because of ease of administration or whatever reasons that one chose this, we would suggest that perhaps the legislature might want to consider at the same time that it did this, that it ask or require of the Department of Revenue that it provide every year, estimates of profitability on oil and gas production within Alaska, perhaps with input from company, I don't know, but estimates by Revenue, the best estimates they can make and how much is made on oil production, pipelining or whatever in Alaska, so that the legislature can take this information, set it against the income tax receipts it's actually getting, and try to get some measure of how this thing is really working, that is how well is it achieving its goal of identifying income in Alaska.

Perhaps such reports could even have data by company not identified or something of this sort so that one could also, so that the legislature could evaluate over time how well it was working company by company. So that if you take this approach, we suggest that you might want to consider also getting some sort of information estimates out of the Department so that you would be in a position to evaluate in subsequent years how well it seems to be working.

Moving from this approach to a second and quite different approach to income taxation, take a look at direct accounting. Now, in principal of course, direct accounting is getting around some of these problems of apportionment. It's going directly at a measure of how much income there is from oil and gas operations in Alaska, so that in principal at least, if it can be done in a reasonable way, it does not suffer from the defects of this other approach. It is trying to measure directly what you really want to tax, in total in company by company, and we've always felt if it was legally possible to do this, and it were administratively possible to do this, this would seem to be the logical approach to taxation. Now, the problem as will be pointed out by many other people who will be testifying in here is that there are

problems of administration. There clearly are, and they are real. There are various problems of how one allocates expenses to Alaska, how does one look at and evaluate inter-affiliate sales, and things of this sort, corporate overhead and how much is allocated to Alaska, and so on. So that there are very real administrative problems to this approach, even though it is a more straight forward approach. It requires, on the part of tax administrator's rules, regulations, rather extensive ones, and obviously involves audit capabilities. One has to audit. There is a lot more auditing under this approach, and so on. And a lot, I think, has been said in the reports by the Department of Revenue and by Professors Zeifman and Ainsworth about these administrative problems. What we would urge the legislature to do though is really to try to weigh these very carefully. This is the major drawback, the administrative problems in this more direct more logical approach, weigh very carefully just: what are the magnitude of these problems? How difficult are they to handle? How many people will be involved? How much money would have to be spent and so forth. How difficult is it really? And what seems to me the attempt you have to get some judgement as is to weigh whether the difficulties in administrating this thing are really worth the effort. It is a difficult thing, really, to assess, and I think that in assessing these kinds of things, one can't necessarily

look for parallels elsewhere or general problems of separate accounting or direct accounting in other states. I don't think you can put too much weight simply on the fact that companies sometimes favor separate accounting. I think when you're looking at the difficulties here, you've really got to look at the circumstances of the oil producing operations in Alaska and try to get some handle on this by looking at that, not by looking at parallels elsewhere. Try to assess _____ ask questions on how to assess, how difficult it would be for the oil producing industry in Alaska. That's what we're talking about.

I won't really spend much time on the net proceeds. It was an attempt last year, really, an indirect attempt at direct accounting by a separate oil and gas production tax. It based, although differing in some respects from separate accounting and from the separate accounting bill, it's basically the same approach as direct accounting. So I think if one is going the route of attempting directly to estimate or tax income in Alaska, one would worry about the differences between the net proceeds and the separate accounting tax, but more important, I think, are the two basic approaches to income taxation in Alaska, and what you're going to have to do is weigh very carefully the pros, cons, advantages and disadvantages of these two basic approaches to a problem inherent in the present corporate income tax

regime in Alaska as it applies to oil and gas production.

Chairman Poland, I had planned at this time to go on with some comments on severance tax. I don't know whether you would want to break for questions on corporate income taxation or go on.

CHAIRMAN POLAND - Do any members of the committee have any questions that they would like to ask Mr. Kilgore at this time?

SENATOR HUBER - Madam Chairman, I thought that Dick might want to make some comments on the data base which you gather by a net proceeds tax approach that you may not find available in the other ones. That's been a major consideration by Levy Company and Associates, helping to develop that particular item.

RICHARD KILGORE - Okay, this is one of the obvious. Looking at this and direct accounting, this is one of the aspects to it. And the net proceeds things, you are doing it on kind of a property by property basis. You are not aggregating everything as you might under certain separate accounting approaches, and having access to that kind of information

would be of use to the State, because it does give the State some feel for profitability of individual properties, ranges of profitabilities, what are cost value relationships in various fields, and so on. And that is of value obviously in designing or further modifying the tax regime in Alaska.

CHAIRMAN POLAND - Any questions? Very well, Mr. Kilgore. We will go on to the severance tax at this time then.

RICHARD KILGORE - I believe our firm is on record as saying that this really is an appropriate time to review your severance tax. We have major new production coming on in Prudhoe Bay, and this production which is obviously quite different in character from that you have now in Cook Inlet. The second reason is that our office has been concerned for some time about the way the present tax works for Cook Inlet production receiving old oil prices. We've been concerned about this, and we think that the legislature should appropriately review this at this time. And I'll come back to that.

Now you have two bills - two severance taxation bills before you, but before I turn to the bills themselves, I would like to review with you certain principals we feel you should keep in mind in reviewing severance

tax legislation. First of all, we've said this before, but I will say it again, severance tax is something that one, a tax which the State cannot really expect to continue to raise endlessly without running into serious problems because of the nature of the tax itself. The tax is a tax on gross value or it's affixed per barrel tax of some sort for unit tax. It does not directly take into account the cost of production, nor net profitability of production. Cost relationships between prices or values and cost can vary considerably amongst producing fields and areas, and where costs are very high, severance taxes, being gross taxes can seriously impinge on profitability and at the extreme they can even result in shutting down production. So, there really are limits on how far the State should think in terms of pushing up severance taxes because of the nature of the tax. We have always felt that as a rule of thought that Alaska severance tax should probably not go above the highest rate in other major producing states, and the highest rate in other producing states per comparable kinds of production, and I think this is probably still a reasonable rule, to keep a severance tax within bounds. Second, given the potential problems with a gross tax such as a severance tax, we have always urged some protection for lower productivity on higher cost wells. This kind of advice goes back to our first written report for the legislature back in January of 1970

where we urged a step schedule which the State later adopted, and your current law does have a step schedule, and does provide some protection for lower productivity wells. So that the two principals basically are not pushing severance tax, try to provide some protection for lower productivity, higher cost wells. Now, you have two bills before you at this time that in principal seems to follow these guidelines. One submitted by the Governor, and the other by the subcommittee on leasing and taxes. While each raises overall severance taxes, neither bill goes above an effective rate higher than Louisiana's 12 1/2 percent on oil. Basically, they are in line with our first guideline, and both of the bills attempt to deal with the problem of higher cost wells, but we feel with different degrees of effectiveness.

The tax subcommittee's bill is basically an extension of the current law. It adds higher well productivity brackets than you presently have, and for the higher well productivity brackets, puts in higher rates of taxation, and at the same time, that bill lowers the rate at the lower end of the brackets. That is lower productivity wells would pay lower taxes under this subcommittee's bill, and this is in line with our second principal.

Now the Governor's bill developed out of the recommendations of the Department of Revenue, introduces a new and rather novel approach. An economic limit factor which attempts to deal with the economic impact of severance tax on high cost wells, and what it does instead of having a step schedule, in a sense it has a continuous schedule, so that the nearer a well is to very low levels or to its economic limit, the less tax it pays. The further it is from that limit the higher it pays. And in principal, this is a very sound thing. But we have reservations about how this particular bill would work in practice. And it appears to us, that despite the intent of the bill, it could work in the direction, and probably would work in the direction of considerably higher taxes, for example, on various Cook Inlet wells in the low well productivity ranges. So despite its adherence to what we feel is a good principal, the way the bill was drafted, and the way it appears to work on our own calculation, it does not seem to achieve its aim. And I think this is something we can take up in more detail when we come to that, and we certainly would illustrate how this appears to work to us. So despite a good principal, it would appear to not meet that principal, and I would feel that is a problem with that particular bill. Despite a good attempt, it doesn't seem to work.

Now, the other thing of concern to us is that both of these severance tax bills which we have before us retain an escalating sense _____ feature in them. That is, as the percent of wellhead value is lower than a certain cents per barrel, it's the cents per barrel tax which has effect, whichever is higher a percentage of value or a cents per barrel. Now, this tends to work in a direction of putting a very high effective severance tax rate on Cook Inlet wells that are getting the old oil price. That is that price which is being held at low levels by the federal government. They pay a cents per barrel tax because that is higher than the percentage of value, and that cents per barrel tax works out to a very high percentage of the value of production, so this present tax and both of the taxes being proposed as alternatives have this feature. High effective rates of taxation on Cook Inlet wells have old oil prices. Not only that, but since they have escalation features in them, the present legislation and the two bills being proposed have escalating features, this gets worse over time. That is the cents per barrel tax goes up, and this feature of high effective rates of taxation for these wells continues. Incidentally, if you make your calculations, you will find out that the Cook Inlet wells producing and getting old oil prices and low productivity wells will pay a higher effective rate of taxation than will Prudhoe Bay wells, than very productive Prudhoe Bay wells under cents per barrel. And this feature would

get worse with escalation. We think the legislature should seriously consider, if not eliminating this feature, that is if not eliminating the cents per barrel, and you may not because this would result in some loss of tax revenues for the State. If you don't feel you can do that, you might want to consider at least putting a halt to further escalation in the cents per barrel tax, that this feature of the taxation, I don't think is really what was intended in the beginning just doesn't continue to get worse over time.

Now, I would like to conclude by saying a little bit about the total tax package in Alaska because I think you will be hearing a lot about this from many people, and while you obviously are going to be evaluating the merits of different approaches to corporate income taxes, the different approaches to severance taxes, you will also have to be concerned with the impact of the total package of oil and gas taxation in Alaska. Severance tax, corporate income tax, property taxes, and so on, the whole range.

Industry witnesses, I'm sure, are going to talk at some length about this, and it is obviously of special importance. The total tax package and how it effects the oil and gas industry is important along with sensible approaches to each part. You obviously do not want to

destroy the oil and gas industry in your state. Here it seems to us, there ought to be two basic considerations when you're looking at the sum of all taxes in the state. Obviously you don't want the sum of all taxes in the State on oil and gas to be really an extreme burden on profitability or the prospects for profitability on successful ventures here. You don't want to do violence to the economics of ongoing oil and gas producing operations. But this is a difficult thing to measure. What may be a larger tax burden in Alaska, while in one state versus another, really can't be considered simply in the absolute. That is how much cents per barrel in total is being paid, and what really matters, obviously, is how the total sum of all the taxes paid by the industry relate to their profitability. What may be greater total taxes in one state, in a more profitable environment may be less of a burden than lower seller taxes in other states. So it has to be considered against the background of what appears to be profitability, and the second principal, another obvious one, I guess, is that you obviously don't want a total tax system which put together really discourages ongoing exploration in your State and the development of your resources.

Now those are two very, very broad principals, and there really are no easy answers as to exactly how the sum total of the package of taxes in the State can be set against

these two, which we think are very important criteria. It is a difficult assessment really to make, and reasonable men can obviously differ in their assessments as to the effect of a total tax package.

In our role as consultants to the legislature, we will do our best to assist and advise you in what is, we think, a difficult task of assessing oil and gas tax legislation.

CHAIRMAN POLAND - Thank you Mr. Kilgore. I don't really think that we have time for questions right now. We will be going into session right away. The Senate has a very light calendar this morning, and what I had hoped to do was for us to come back at 11:00 AM and continue with any questions that we might have or discussions with Mr. Kilgore. This afternoon we will hear from Professor Zeifman and Professor Ainsworth at 1:30 PM. Senator Huber.

SENATOR HUBER - Yes. I'd like to ask that Mr. Kilgore look into a couple items before he comes back. I think most of us here have heard Dick or Milton at least 10 or 15 times criticize the cents per barrel floor that we have in our severance tax, and of course, what I'm looking for is something to replace it, so that we can listen to this, we know that _____ cause in certain cases some unfairness,

but we need something to replace it in case the percentage of wellhead value is eroded by either federal action or other economic factors to where we have the old "bugaboo" negative wellhead value or something that is approaching that, so we would need something to replace that as a floor if we're going to work on that particular area. I wanted, maybe, Dick to look into that and give us some recommendations in that area because it must appear to him like we completely ignore him when he talks on that subject.

RICHARD KILGORE - We have given some thought to this. What we are talking about is a floor which protects you in case the general price level goes down, but also one which does not impose this particular problem on old oil production in Cook Inlet. We have given some thought to this.

(Chairman Poland adjourned the meeting at 9:55 AM)

TESTIMONY OF MR. RICHARD KILGORE
OF WALTER J. LEVY CONSULTANTS CORP.
FOR THE JOINT SENATE AND HOUSE
RESOURCES COMMITTEE MEETING ON
OIL AND GAS TAXATION - MARCH 22, 1977 (AM)

RICHARD KILGORE - I appreciate the opportunity of coming back so fast, and what I'd like to do is fire my remarks, really, to the corporate income tax issue and amplify on the very brief remarks I made yesterday morning, and also comment on what appeared to be some differences with other testimony yesterday. What I propose to do is review again in more detail, really, the pros and cons of the two basic approaches to income tax which are before you. I want to make it clear at the outset, though, that it is not our role here to advocate one approach or another. Basically, we see our role as giving you an appreciation of how we see the pros and cons, and advantages and disadvantages of these two approaches, what they seek to accomplish, how well they seem to accomplish the goals that they are intended for, and leaving it to you to make the final judgement. So I don't want my remarks to be construed as advocacy of either separate accounting or apportionment to modified apportionment approaches, and so on. I think, and I'd also really like to get down to basics on some of this, and I think maybe we lost some of the basics in some of the testimonies yesterday. I think it is important to appreciate at the outset that our concern here, my concern, your concern, is not really with how apportionment or separate accounting work in general in other

states for other industries and so on, what we are concerned with here is not with these approaches as general approaches to income taxation, but what we're talking about is their applicability to the oil and gas industry in Alaska. This is what we're talking about, and I think we have to keep this in mind. Not how well it works for other states, but why other people use it, and so on. If you will remember our original concern with the approach that you now have, the three factor approach that you now have with your income tax system didn't have anything to do with general worth, its general ability, and its general applicability. It had to do with how this thing specifically worked toward the oil and gas industry in Alaska, and this is how this whole question of reviewing your income tax came up, and it appeared to us, and we have testified many times, that the approach didn't seem to work very well for oil and gas operations in Alaska, that is in a portion, a very much smaller amount of income to Alaska than would appear to be earned by the oil and gas industry on producing operations and pipeline operations in Alaska. Now, if the oil and gas industry in Alaska were small scale, and I guess this really wouldn't matter, you probably wouldn't be very much concerned with it, and you probably also could view it as if it doesn't work for the oil industry, it probably works well for other industries, maybe for other industries it apportions more than you might expect, and so on if they wash out. But, as

you all know, the oil and gas industry will be by far the biggest income producing industry in Alaska as far as we all can see, so it obviously is of very considerable importance to you. It is important to you, I think, that you have a tax structure which gets you something like your 9.4% of what appears to be the profits generated by oil and gas operations in the State of Alaska, so we have to keep in mind, we're really talking about these two approaches very specifically in the context of oil and gas in Alaska, not as general approaches. Now, I noted the other day that Professor Zeifman argued against separate accounting at one point, and one of his arguments, I think repeated a number of times, was that a good reason for not adopting separate accounting was that no state has adopted it as a general approach to income taxation. This was an argument against separate accounting. Now, basically, I don't find that a very persuasive argument. First of all, we're not talking about other states, we're talking about Alaska, and we're not talking about general applicability to all industries, we're talking here about oil and gas, and I don't think anybody has suggested that the State of Alaska should adopt separate accounting as a general approach to income taxation in the State, and certainly the two bills before you, Senate Bill 105 on separate accounting, and Senate Bill 202 on net proceeds, both of these are clearly

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intended to apply only to the oil and gas industry in Alaska, so I don't find this a very persuasive argument against separate accounting, and I think we have to keep this in mind. Conversely, just because a number of states use this three factor apportionment formula, I don't think it's a particularly persuasive reason for applying it in Alaska if it isn't appropriate to your oil and gas producing industry.

Now, I'd really like to get down to basics here. Starting off by considering what do we really mean by income in oil and gas operations in Alaska. Is it really so scrambled up by other activities of multi-national, multi-state enterprises that it just can't be unscrambled? Are we really talking about some kind of affliction which can never be put together and that we really just shouldn't bother with it? What is this income in Alaska that we're attempting to identify? Well, let's look first at what the industry does in Alaska. It comes to Alaska, it explores Alaska, hopefully finds oil or gas. It develops those resources, transports them to a point of export in the State, be it Valdez, Cook Inlet, or whatever - at least a bulk of the oil or gas does that, and then it moves into consumption in other states. Now it is true that a lot of this kind of activity and what goes on in this whole process does take place within the integrated scheme of operations of major oil companies. In fact, in many cases the final sale of the oil produced in your state

may not be a sale between third parties until it actually gets to the gasoline pump in California, for example, that may be the first point at which the sale is made, and the rest is within integrated operations. But what does this imply about income earned in Alaska? Is there a concept of income earned in Alaska, if this is the process by which a lot of your oil really moves. Well, I would put it to you that your oil when it leaves the State of Alaska does have a value. It will have a value, and it will have a value that's highly visible. We don't know what the FEA is going to do on the pricing of Prudhoe Bay oil, for example. But it may very well be that they will establish a value at Valdez for example. It may be that they will set a wellhead value. If they set a wellhead value, we can add on a pipeline charge, and we can have a value of oil as it leaves Alaska. So, basically, it's this value of oil leaving Alaska that is identifiable which is really the final revenues from producing oil and gas in this State. These are the revenues which you can identify as being earned by oil and gas producing operations in Alaska. Obviously when you are talking about a net income, you're talking about deducting various kinds of costs. Exploration development costs, pipeline costs, operating costs, amortization of capital costs and the like. The large number of these costs are incurred in the State and can be identified as incurred in the State.

Some of them are obviously some of the costs incurred to produce your oil. To get out of the State are the costs which are incurred elsewhere. Corporate overheads, obviously, a certain amount of corporate overhead time has to do with planning for the oil producing operations in Alaska. Some of the services which are provided to the operations in Alaska come from outside the State, and these are just some of the areas where accounting problems arise, but still these are within reason, identifiable also. So the income we're really talking about identifying in taxing is the value of the oil leaving the State of Alaska and an appropriate allowance for the various costs involved. Now the question for you, with your consideration of income tax, is which of these approaches really identifies income as we seem to see it and say that it is earned by the oil and gas industry by virtue of their operations up here. Which one is going to identify a portion of income which you apply your 9.4% tax. You'll get an appropriate tax on that income. Now, as I discussed yesterday, there are basically two approaches, and those are the approaches which are before you. One is apportionment, and this is where the approach is to look at the total income available, total income earned by a company, and try to work some fraction which gets applied to that total income, gets you income in Alaska. The other

approach is basically separate accounting which goes back to those revenues and cost categories that I discussed just a little while ago, and attempts directly to identify them and come up with income in Alaska, and the question is which of these seems to identify and work best that has come closest to identifying what would appear to be the true income on operations in Alaska, but not only that, taking into account also cost difficulties of tax administration, and that cannot be ignored. An approach which gives you the perfect answer and which is extremely costly or impossible to do in practice, obviously is not the kind of tax that you want.

Now, I'll start with apportionment. You have an apportionment formula in place in your tax laws today. You have Senate Bill 236, which is a modified version of an apportionment formula, but still an apportionment formula nonetheless, and the approach is to start, as I said, with total income of the company before taxes, under your present law, taxable income. This proposal suggests shifting it to book income, but nonetheless starting with the total income earned by an enterprise. The next step in apportionment, whether it be the one you have now or a new one, is to develop a fraction to apply to this total income in a corporation which hopefully when applied, brings back to Alaska an

appropriate amount of income. Now, you do that by taking factors that appear to be indicative of income generating activities, such things as properties, payrolls, sales and the like. These are things which indicate income producing activities are taking place, and what you do is you take ratios of these in the State to the total. Now, the question is does this really work? Does it correctly assign income to Alaska, or maybe _____ when does it work? When would this give you the kind of answer that you would hope to throw up? Well, it would work if roughly the same income is generated per unit of these income identifying factors in Alaska, as in Alaska and outside Alaska. These are the circumstances under which it appears to work. That is, just let's take one factor for a moment. Let's take property, if income is proportional to property in Alaska as it is elsewhere. That says in effect, if rates are returned the same in Alaska as they are elsewhere. If that's the case, and then you take the ratio of property in Alaska to the total, then you will allocate, and apply that to the total income of corporation, you will correctly bring into Alaska the amount of income that's earned there. That's if the ratio of income, in this case the property is the same inside Alaska as it is outside Alaska. And the same would go for the other factors. If you're looking at payrolls, if income to payrolls are the same in Alaska and outside, then this would be the correct factor for

allocating income in Alaska. Now, it's obvious, I guess, to anybody looking at any of these factors, it's unlikely that they will be identical in Alaska and outside Alaska. Rates of return aren't the same. You need fewer people and payrolls under some circumstances to generate income in Alaska and elsewhere, and so on. So that the apportionment approach basically says factors are not perfectly going to be the same in Alaska and outside, and therefore work perfectly, so what do we do? We take a number of these factors. Three in this case and we average them, and hope that that will give us an overall fraction which will appropriately apportion income into Alaska when applied against the total income of a corporation operating here. It averages somewhat obviously better than any single one of these factors taken by itself. Now, the question is how well it really works even when you average these factors, and how much better will it work if you move from the factors that you have now, to an extraction factor. Professor Zeifman was asked in testimony yesterday, how well his approach would work in Prudhoe Bay and Alyeska. Now, his answer was that his approach would be more effective because it takes into account the whole picture. All the profitability of the corporation was the answer. In a more general vein he also said that in reviewing the disadvantages of separate accounting, in my review of the

disadvantages of separate accounting, I didn't mention the most important disadvantage of separate accounting, that is again that it didn't look at the whole pie, it didn't look at the total income of the corporation. So he was saying first of all that his approach would seem to work better for Prudhoe Bay and Alyeska because it looks at the total income of the corporation. And he also said this is one of the disadvantages to separate accounting. Now, it seems to us that looking at the whole pie, that is the whole income of the corporation, all of the income it generates everywhere, it in itself has no value, unless the apportionment you come up with that you apply to this whole pie, the fraction that you apply to it, really works to get the appropriate amount of income in Alaska. What we're saying is that simply looking at the whole pie, looking at the total _____ of the corporation in and of itself is no virtue. Its only virtue only works if the apportionment formula of the fraction you apply to it is appropriate and brings it in, and I think that's very important to appreciate, simply looking to the whole income of the corporation doesn't say that this is an appropriate approach of getting a lot of income as it were.

Now, you remember our analysis all along, with the present system you have looked at these factors and tried to come up with how appropriate they really were. We pointed out

that if you looked at the payroll factor, it was relatively _____ . You have relatively few people on payrolls in the kind of functions that you will have in Alaska in the oil and gas industry. Very few payrolls for production for pipeline and so forth relative to the income generating, so we were critical of this particular fact. In sales, it's been pointed out are often zero in Alaska. Sales are made outside Alaska. Property, that to us appeared to be a better factor. That is, you have very heavy investment here in Alaska to generate the kind of income that you are going to generate, but our analysis said that property being a better factor couldn't make up for these other ones. Now, Senate Bill 236, this new approach, substitutes extraction for sale, and this is clearly an improvement. Oil production is a good measure of generation of income, and therefore it is a better factor. But the question remains, does even this modified apportionment formula do the job? Not just get more revenues, which it clearly will, and the other part of the approach is moving to book net income also will get more revenue, and it's not simply a question of does it get more revenue, does it really get the income apportioned to Alaska that is appropriate? This still remains the question. And this is what I said yesterday, the biggest drawback to the whole apportionment approach and even a modified apportionment approach as proposed

here, is that it is unclear how close you will come to true profitability through this approach. It's a very elusive and very uncertain thing, and it appears to us there's by no means a guarantee that this will happen, and this we see as the most serious drawback to this approach, and there are really two aspects to the question of whether appropriate income is apportioned to Alaska under this approach. One has to do with how much in total is apportioned to the State of Alaska. If you take each of the individual companies, apply this approach, apportion income to Alaska, sum it up, how close does that come to the overall profitability of the industry operating in Alaska, the profitability as I laid it out before. And the second question is, how does it work for individual companies. That is, we apportion use this approach for each individual company operating here. How close does the apportionment formula come to apportioning appropriate income to Alaska for individual companies. Does it work well for some companies, not well for other companies, and so on? If this is the case, that works unevenly amongst the companies, then you have a question of equity of taxation. So these are the two aspects that are important, and this is an uncertain thing and difficult to really try to come to grips with. How well would this thing do the job? Now, I stated yesterday that our office had done some illustrative analysis to try to get some handle on this question. We had been somewhat reluctant to put this

formally on the record and discuss with you a little bit about the results, what I saw as the major results that came out of this thing yesterday, but we were somewhat reluctant to lay out because there are a lot of caveats involved in what we did, and when you put this thing into the public record, it's often used without regard to the caveats which are very important, and we hate to see those get lost. I have been asked if we would put this formally into the record, and I'm going to do so now, and I would then like to discuss it with you including all the caveats and get those on the records. I would like to distribute this to you at this time and discuss it. I would like to spend some time on this. I hate to burden you too much, as I say, I want to make it clear in your own minds exactly what we have here and what we don't have. Now what we have done, we have labeled very carefully a hypothetical illustration. Because it is a hypothetical illustration, I would underscore that. It is a hypothetical illustration of this modified apportionment formula applied to book income which is the feature of this new legislation, and we've done it for three major Prudhoe Bay producers. Now, I would call your attention to the note first of all because this is important. The note says the calculations shown on the table above are not intended to represent projections of income that actually would be of portion to Alaska in 1978 for the three companies

if this new approach were taken. It is not that. Rather their calculations are meant to provide a rough illustration of how this approach might work for three Prudhoe Bay producers that vary in size and scope of overall operations, and even though these are identified as SOHIO, ARCO, and EXXON, and we use some of their data, it really is not meant so much that it is these companies, it is companies of these characteristics, and these are quite diverse companies as you know. EXXON is a huge international company. SOHIO has been basically limited to domestic activities with very little production so far, and ARCO being somewhere in between, so they are not meant to be really the companies. We have used their data just to illustrate what will happen with companies of different size. Now, what we've done in this illustration is on the first line to take from the 1975 annual reports of these companies, these are the latest available to us, the pre-tax net book income of these companies outside Alaska. We've just taken a pre-tax net book income, and since basically in these companies virtually everything is outside Alaska in those years anyway, we take this as the income outside Alaska, and this is data for 1975, and all we've then attempted to do is to graph on to this sort of a Prudhoe Bay operation. Now, we cast around for data to use for Prudhoe Bay, we considered making our own estimates, but we finally settled for some data that had been submitted by SOHIO to the legislature at the request of the legislature, and we reluctantly

used this. It was readily available, reluctant because when SOHIO put this information into the record, they did it with a lot of reservations, and we have the same reservations about it, and anybody looking at these numbers, I think, certainly should take it in the context of all the reservations that SOHIO had about their own data, and we apologize to SOHIO in a way for using it without a complete list of all their reservations.

SENATOR CROFT - Could I ask just one question in that regard? That was the information that was furnished by SOHIO, at the request of the committee was furnished to you?

RICHARD KILGORE - This is SOHIO submission 1.

SENATOR CROFT - To Greg Erickson, analyzing the corporate tax? So it was for that purpose.

RICHARD KILGORE - Yes. It was for that purpose, and they labeled it as hypothetical and so on, which it is, and I want you to understand that that's all that it is, and we appreciate their reservations about it, but we had to have something to give us an idea, something that we could graph upon to present data, and we simply and arbitrarily gave 50% of that to SOHIO and 25% each to the other two companies,

simply because that seems to be roughly their equities in this thing, and if we add that, we end up with a figure for total pre-tax income. This is obviously hypothetical, it has '75 data, it has what someone hypothetically says might go on in Prudhoe Bay in '75 _____ purposes. Then, we attempted to apply the approach of Professor Zeifman to this. Looking at property factors where the numerator were the property factors used in the SOHIO thing. The denominator was property as we found it in the annual reports of the companies. Payroll, we just took an arbitrary 2%. It's arbitrary that makes relatively little difference to the analysis. The extraction factor, we took net production as assumed in the SOHIO hypothetical illustration. We took as a denominator, net production as it appeared in the annual reports of the companies without worrying about whether net production was quite what was meant in this bill, and we averaged the factors for the companies. We then applied it to pre-tax book income which included other activities of companies and this hypothetical illustration for Prudhoe Bay. Divide the average of the three, which is the way this approach would work, and that gave us the income that would be apportioned to Alaska under these circumstances, and that's the second to the last line down there, and then what we did on the final line was

to take this income apportion to Alaska out of the theoretical model, but applying this new approach to this hypothetical model, and looked at what percent that was of the income assumed to have been earned on Prudhoe Bay and Alyeska operations above.

I think that the most striking thing that came out of this was the difference in the way the approach worked for the three companies. Again, three companies of these different characters. In the case of the EXXON type company, the approach came very close to apportioning what is assumed in the beginning was the income there. 650 up on the top. 625 apportion. So it worked very effectively for the EXXON type company in this particular situation. It worked much less effectively in the case of an ARCO type company with these sort of data. It added up to less than half, the income apportion to Alaska, than it was assumed to be earned there in the first place. And of course, in this simple model, EXXON and ARCO are earning the same money in Alaska, but the amount of income apportioned to Alaska under this mechanism are quite strikingly different. In fact in the ARCO type case it's about half. The SOHIO type company comes somewhere in between, and in total the approach allocates about two thirds of the total income from three companies in Alaska. I certainly wouldn't put too much stock in the two thirds, but I think the more striking thing is the differences that

get thrown up amongst the three companies here. Now, these are very _____ calculations, and things could very well change. I might point one thing out to you. What is striking in the case of the EXXON type corporation is that, as I say, it appears to be very effective in this case. And the question is, why? If you go to an addendum on the third page, it basically explains why this works in this particular instance for this type of a company. If you will recall, I said a while ago that if ratios of income to the various kinds of factors you use are the same within and without Alaska, then the approach works in general quite well. To take that a step further, the ratios of income to the various factors such as property or extraction are higher outside Alaska than they are inside Alaska, then the apportionment formula tends to favor Alaska. That is, it brings in more income than it should. If the ratio is higher in Alaska than outside, then these kinds of ratios work to the disadvantage of Alaska. Let me put it this way, if we look at a property factor for example, and within the State of Alaska, one earns whatever 20% on property (on assets) that's the rate of return. If it's 10% on operations outside Alaska, a lower rate of return, and you simply take the total income of the corporation then use the ratios of property to allocate to Alaska, you will not get the income to the State of Alaska that you should.

If the rates of return are higher in Alaska than they are elsewhere, then if you simply had a one factor apportionment formula, simply property, and that says that, say, 15% of the property is in Alaska, and you apply that to the total income, but the problem is that that 15%, what is it going to bring in? It's going to bring in average profitability to Alaska. An average of everything, and if Alaska is higher you're not going to bring in as much income as you should in effect. That is because what you're bringing in is average profitability if you do that. If you simply go with the ratios of property bringing in average profitability into Alaska, when in fact it's higher. And the other way around. If profitability is higher outside Alaska, higher say relative to property, and again you only have a one factor formula, and then you use the proportion of property, you bring in average profitability into Alaska, and in fact it's higher outside, so that you apportion more than you properly should. Now what this is getting to is why does this particular formula for these set of circumstances seem to work for an EXXON type corporation? Well, the answer is basically shown on the addendum. These, what we've done, if you'll look at the top panel, we've got the ratio of income pre-tax net book income to property in this model outside Alaska inside Alaska. Now, if you'll look at EXXON, it has a very much higher ratio of income to property outside Alaska than inside Alaska, Pre-tax income.

And, therefore, application of this formula for the EXXON type corporation is beneficial in the State of Alaska. It pulls in more income than it otherwise would. This very high ratio of 42.4 here, has the effect of favoring Alaska, and that's basically why you get the results that you have here. That's why it works better for the EXXON type than it does for other models that we have. Now, I want to tie back to something that I said the other day. If you look at the question of why does pre-tax net book income to property look so high for EXXON. Is it because it has really such profitable operations outside the United States? This would suggest then that on a pre-tax basis they make 42% return on their property. The answer is that this number, this ratio, is inflated by all those foreign income tax payments that I talked about the other day. EXXON works big international operations. In the year 1975 it payed tremendous amounts of income tax to foreign governments, and that inflated its pre-tax net book income. After tax it would look quite different, but we're talking pre-tax here. This is the way this thing works. So, that has inflated this figure, you get a very high figure. It happens to work to the advantage of the State of Alaska under this model. Now, as I said the other day, this is a particular aspect of this thing, pre-tax net book income including foreign income taxes that may not be the case in the future. These may very well dwindle. Income tax payments

probably will be replaced by purchases of oil, so that this high factor that's built in here with our particular model that happens to throw up a reasonable amount of income for income corporations, may not in the future, may not be this way in the future, but the fact that this EXXON type corporation, international corporation in this particular illustration ends up with an apportionment formula working correctly may not hold in the future. It's uncertain for a lot of reasons, including this particular income tax feature. If we went through this illustration five years from now, the results might be quite different here. In total, and I think amongst companies, I think really there is no way of knowing. Now, again, this is merely illustrative, nothing more. We've taken these three companies because they're quite different companies, they're quite different companies of the type that will be operating in Alaska. Their own income will be quite different obviously, but if you just grafted on the Prudhoe Bay Alyeska thing to this on some rough assumptions as profitability and investments and so on, this is the way it would appear to work, and all I submit is that it does raise questions about this approach and about its ability really to identify income. Clearly, the apportionment by picking another factor that takes up a higher amount of income, but that in the process of merely increasing the income, it creates some inequity, and if what you want to do is simply

increase the take, you ought to increase the rate instead of tinkering with one of the factors to simply produce additional income.

RICHARD KILGORE - Of course, if you increase the rate, you have to increase the rate for other corporations.

SENATOR CROFT - Sure, then what you're saying is that Alaska operations themselves are not paying enough once you've isolated it. Then your solution to that problem is to increase the rate if you think you have to have more, rather than trying to increase one of the factors that go into determining what portion of the income is allocated to the State.

RICHARD KILGORE - Well, this might be one approach. If you're not willing to change the factors, you would be left with changing the tax base which has also been suggested, or you would be left with changing the rate.

SENATOR HUBER - I wish that Dick would discuss the pre-tax net book income on extraction because I want to ask him a question about the sales factor that it replaces. It looks to me like the sales factor that it replaces would be on the same side of the book as how he explained the income

from property up above to where Alaska would get more than its share, because we have less than a reasonable share of the world-wide sales.

RICHARD KILGORE - Well, accept that to the extent that sales are really zero. This may drop out of your thing all together.

SENATOR HUBER - You mean that doesn't work out because we have a multiplying factor, or a dividing factor of zero? I don't like these mathematics that don't work both ways.

REPRESENTATIVE MEEKINS - I'm just trying to figure out how this works. Is it, I might have it backwards, is it the ratio of whatever the factor is to income to the factor if it's higher than outside then.....

RICHARD KILGORE - Then it's to your disadvantage because you're bringing it in at the average.

SENATOR CROFT - In that regard, our best guess as far as Prudhoe Bay is concerned is that with regard to about 75% of the operations at Prudhoe Bay is going to work to our disadvantage. We're talking about 50% SOHIO, and 25% ARCO.

RICHARD KILGORE - Or in total, but as I said, I would not put any precision on these at all. In this particular model, what happens in total, you throw up about two thirds when

the companies combine.

If you'll just look at the illustration itself, you will see that total income apportioned to Alaska, the sum of the three companies is seventeen sixty. When in fact by definition they are earning 2.6, it's about two thirds, but I would not take that as indicative of how much this approach will really do. I think that the more important thing here is how it seems to work for the different companies, and also in a sense says, at least suggests, that for this particular model it also doesn't throw up all of the income as well in total.

REPRESENTATIVE MEEKINS - But you could get a rough estimation of how that's going to work by seeking out different companies and going with their finding what their ratios are in terms of the profitability of their Alaskan activity versus their average, and you could see whether or not you are losing or gaining the respect of that individual company, couldn't you in that respect if you knew clearly that the profits rates in Alaska were much greater than for those factors than their average world-wide, then you wouldn't know exactly how much, but you would know that we're not getting what's appropriate, and we're taking the average instead of the higher rate.

RICHARD KILGORE - It is possible to gather enough information to look around and see how it would work with various companies, but that's not really what I suggest that you do. This is, as I said, intended purely as an illustrative to demonstrate how it works under these particular set of circumstances assumed here, and again I would look very carefully at the notes to this and also to the note which sets out some caveats about this.

Now, this illustrates, I think, some of the potential problems and I think, at least I hope, focuses on the workings of this thing, so you can think about the workings of this approach. This was described, I think, in testimony yesterday, as fictional and I guess it is illustrative based on some real data, but it certainly is not intended to be a projection of what will happen or anything of that sort. It was described as fictional as opposed to some actual data that were used, tax return data that were used to develop this approach, and I would like to make at least a couple comments on some of the inferences that were drawn from those tax return data. For one thing, they were used to illustrate net book income if you'll remember exceeded taxable income for the companies and it certainly demonstrated that, and no one was surprised at that result. Now, the second thing though, is that what turned up in those tax return data is that for

companies for which you had both apportioned income and separate accounting if you'll remember, the former, that is the apportionment is always higher, it was positive, described as always positive, and the latter, separate accounting always zero or negative, and this was taken as evidence that separate accounting doesn't work. Now, I'd like to address myself to that problem. The question is why did you get this result. Why did apportionment give you positive, and in this case which is oil companies operating in the State, 14 of them I believe back in '73, '74, and '75 that you got this kind of result. It was said that Mr. Lipton was wrong when he guessed that perhaps the reason was that you had zero sales and therefore when you went to separate accounting you had zero sales and you started subtracting and so on, but it wasn't indicated what it is that really gives you this kind of result, and I think that it would be of considerable interest to you to find out why you got this kind of result. The explanation really was not given, and when I say it was said that zero sales were not the reason, zero sales in the sense that producers that were producing and selling would declare their sales at zero. That was a hypothesis that we had, apparently that's not it. I can only speculate, I would guess that in the years covered what happened was that there were companies operating in Alaska and spending

money on payrolls, they have some office space, property, exploration, money, geophysical work maybe, bonuses, I think that bonuses were paid and the like, and there must have been such companies that had little or no revenue that were not gaining revenue out of production in Prudhoe Bay, and for these companies they would in fact be running losses. That is they would have no income. Not a question of your producing, but selling outside the State, simply that they don't have any income. Now, if they don't have any income, no revenues incurring these various expenses, they would run losses and separate accounting would certainly show them with losses, but I don't think if this is the explanation, and if it's not I think we'd like to know. If this is the explanation, I think one doesn't go from that to assume that separate accounting always ends up with no income or negative income, clearly if you apply accounting to the producers on Prudhoe Bay, they will not throw up no income. I would also point out the results which said separate accounting negative apportionment positive, why does that happen? Well that happens probably because these companies had payrolls in Alaska. People were here, and they were getting interested in the search here, and so forth, so you threw up some positive income by apportionment. You had some payroll, you had some property and so on. And you throw up positive income, but I think you have to ask the question of whether

this is really what you intend to do if we have companies operating in Alaska at losses because they haven't found any oil, haven't generated any income, do you really want to apportion income to them in Alaska and tax them on it? Should they pay income taxes when in fact they have no income in Alaska?

CHAIRMAN POLAND - Mr. Kilgore, I'm afraid we're going to have to break now. Our schedule this afternoon is 1:30 PM at the Supreme Court Room again, and we only have one individual scheduled to speak this afternoon, and that's the gentleman from British Petroleum, so possibly when he's through, we can resume the rest of this discussion with you. Thank you very much.

AGO 547627

(Answer to question asked by George Silides in Commissioner
Gallagher's testimony)

Tom Williams Madame Chairman with your permission I would like to try to address that question and also try to speak a little bit to what Senator Radar was talking about earlier. For the record my name is Tom Williams I'm the Director of Petroleum and Revenue. We have two changes in the severance tax that we are suggesting. One is the economic limit factor and the other is the increase in cents per barrel floor. Right now we have a federal pricing decision to give oil , to Prudhoe Bay oil new oil treatment for both pricing purposes and for entitlements purposes. Entitlement is a transfer of money back and forth among the refiners to equalize their apposition costs to the national average, that is the objective of the entitlement, and new oil in the lower forty eight comes in the refinery less than imported oil consequently there is a fraction of an entitlement that didn't flow, for the right to run as new oil. Our oil when it gets there, will not be below the cost for import oil it will be right at the cost for import oil. In fact the national policy has been for new oil like high risk North Slope production we got right from our Prudhoe Bay field. National policy is to give that, right now a \$10.95 average price, cause of the realities of market, we tried, if we insisted

or if the producers who own that insisted on getting a market price at the refinery that corresponded to a \$10.95 well-head price, someone is going to have to pay the transportation cost, and if you have say a total \$5.00 transportation cost you would be getting into the market place at \$15.95 the Saudi oil which is competitive with ours is selling for \$13.50 to \$13.75 so somebody would have to, I mean where's the incentive to buy, you'd have to compell people to buy our oil to get \$10.95 price or there would have to be a subsidy. This has not been a thing that we have been requesting the federal government to do. We recognize the fact that this is how the market is, we are far away from it in terms of cost. Consequently the well-head value is not that it's realized by a refinery price that's competitive with the Saudi Arabian oil. Our well-head value is going to be lower than the ceiling. The problem is that they are going to, if they treated this new oil, they are going to try to equalize something that is already equalized and it is going to result in a penalty over \$3.00 a barrel, this equalization. They will equalize all the rest of new oil for the lower forty eight, it won't hurt them too much, it will cause some problems though, because it will over equalize new oil producers in the lower forty eight. But for us it doesn't, it's completely inappropriate because our oil is already coming in at the level corresponding to imports. There is no need to equalize. Consequently if you make them buy at a fractional entitlement at a cost of \$3.00 or \$3.35 that means the refiner is going to pay that much less instead of paying \$13.50 he will pay \$10.50, and that means a Prudhoe Bay producer or the State of Alaska if it takes its royalty in kind and goes out and tries to sell it, when he gets it to the west coast is gonna see only \$10.50 coming to him. \$3.00 goes into the entitlement,

we never see that. So you start from \$10.50 down there in California and then you have that when you get to a \$4.00 welling price. Our contention is that if that happens the game is over. There will be no more exploration. There are no more Prudhoe Bays. It is highly unlikely, there is only one Prudhoe Bay in the United States and there may be a second one down in Mexico, in the Tabascoarea in the farmers fields, but a, there pretty darn few and far between to find a field that large and at \$4.00 well-head value. If that's the prospect, four dollar well-head with

today's cost, even if you found it out of Prudhoe Bay the chances are nil that it would be developed. And so the game is over because we are not likely to find fields twice and three times the size of Prudhoe Bay. So given that the game would be over, we are not doing any more damage by saying that well, instead of \$6.00, \$7.10 is the floor and the point which is our present floor with the cents per barrel, we are simply saying, Why should the people of Alaska follow the resource? At the game, it then becomes a question of priorities and where our allegiance lies, with the people of Alaska or the share holders in the larger corporations? Now there is a balance, but given that \$7.50 is not a reasonable well head price for North Slope oil in the beginning of a cut, and as production continues and through what builds up, if it, the federal began, assuming the federal government doesn't screw things up and destroy the insensitivities, the increase throughfare will lower the pipeline tariff. This will allow the well head value to rise. OPEC countries can be expected to raise their price, that includes Arabia. So if the refinery price for our oil, our refineries will raise the charge for getting our oil from Prudhoe Bay to the refineries will be less. These two things will combine to raise our well head value and by the early 1980's we won't get by talking about the well head value of \$7.50, we will be talking about well head values greater than \$10.00. In fact extrapolating out by the end of this century, we will be seeing well head values of well, your world market values it sounds absurd today, but \$20.00 well values are certainly not inconceivable at that time, and that's \$20.00 in terms of today's dollars, you know, not inflation dollars of the year 2000, that twenty of today's dollars,

thats simply because we have increasing demand, our Latin American neighbors for instance, their energy consumption is growing at a rate ten times ours, their population keeps growing, and world energy demands are far outstripping our own nation's demand and as vast as the OPEC resources are, this is a world wide shortage developing in the next 10-15 years. This shortage is going to cause, ask developers, its going to cause the price to rise in real terms that is to say in addition to the effects of inflation, we will have an additional increase in the real rather than the illusion. Consequently when we turn back, to the point, if the federal government gives us new oil in Tilener's treatment, the question then becomes whether we are willing to sit by and say OK we will take 8% or 10% off for dolars and there it is, its not good, but thats all there is to it. Even though we are paying right now, importing almost 10 mission barrels a day to each, though I don't know what the latest figures are and we are paying our good, loyal allies, Arabs, Iranians, Abu Dhabians, and all those nice people and Indonesians, Nigerians and Algerians, 14-15 somewhere in that range, 14-15 dolars is the average per import acquisition cost.

QUESTION- Tom, I understand what you are saying, I really do, but how, I must have missed somthing, how does that help Cook Inlet today?

- OK, with Cook Inlet, we, Sterling and I have gone to the Federal Energy Administration last summer and in fact, the hearings that they had earlier, in April or May, it was in Anchorage regarding the price of new oil and how to compound the upper and lower tears should move through time, and also about this problem

of oil production that reaches its break-even point with the control oil price. Right now, I mean the federal government is not reluctant to price our oil severly below what its actually worth, in the inlet that oil is beginning from \$5.00 to \$5.15, and for oil of similar quality we are paying, almost, we are probably paying over \$15.00 a barrel to get it from Indonesia to the west coast or Pudget Sound. So we don't see a very friendly attitude on the behalf of the federal government toward Alaska production to begin with. We went there and pointed out that there are some properties in the oil that were at that time dangerously close to reaching this break-even point at \$5.00 a barrel, we said we know you have shis procedure to allow pricing on this basis, to allow the price to go up, so that they continue to have more revenue than expenditures. Then they, thats indeed true, then they said that of course we are not going to give it to the State of Alaska because thats fixed cost, you are going to be stuck there at \$5.00. Well that presents an interesting question about how they rewrite our lease, but they said that they would allow that much pressing relief and return the property to the level of profitability enjoyed in May of 1973 when price controls, that's the reference period they all relate back to, May of '73. But he said, we'll allow to have that same measure of profitability, which to my thinking would include among as profit, you have what's over for tax. So if you raised the severence tax, that's an increase cost, but an oil company can go into the FEA and present the case saying, here are my thoughts, now give me my May 1973 rate of return,

and in fact that should accelerate the movement to a more realistic price to the upper tier which is not still the market price, but at least its, \$10.95 is a good site better than \$5.00. And consequently, if the Federal Energy Administration is doing what they say they are going to do and if they can do it in a timely fashion, there should be no problem for the oil companies because this is simply an expence, severence taxes are recognised as such.

- that had not been explained before, thank you.

QUESTIONS AND ANSWERS IN TESTIMONY
OF COMMISSIONER GALLAGHER, DEPARTMENT
OF REVENUE FOR THE JOINT SENATE-HOUSE
RESOURCES COMMITTEE MEETING ON OIL AND
GAS TAXATION (24 MARCH 1977)

Senator Radar - Madame Chairman, Commissioner, your testimony on the pricing problems, state's position, governor's position; that we do need a maximum well-head or a maximum price to encourage further exploration and development. Aren't your bills which are calculated to persist for barrel and so and so forth as you say to protect the state against federal pricing manipulation or corporate manipulation, let's say take the federal pricing manipulation. Aren't you saying then that under one set of circumstances if the pricing goes bad which means that the companies have no incentive to develop further that we are going to add further burden to that disincentive by a cents per barrel floor so to speak so as to protect the state's revenues?

Commissioner Gallagher - If the federal government is so foolish as to lower the well-head value down to \$4.30, I don't think the state should be any part, have any part of that policy.

Senator Radar - Well but then our policy makes it even more burdensome from the point of view of the further exploration or development of petroleum in the state because we revert to a cents per barrel floor so that the, the very policy that you are adopting here to protect our budget, and I understand why you are doing it, it is because you want to protect our budget, but it, if the course is completely inconsistent with

any state policy which would be to encourage for the petroleum development. If that happened.

Commissioner Gallagher - I don't agree with that Senator. One of the things that we've done to encourage petroleum development and one of the things we talked about in our testimony was about the marginal fields. Prudhoe Bay will be produced at \$4.30.

Senator Radar - Well it would be produced at \$2.00 maybe because it would minimize their losses, but if your talking about the excuse me, go ahead.

Commissioner Gallagher - But Kuparik and Lisburne will not be produced unless they receive substantial return because its an incremental decision. One of the things that we tried to address in our tax policy where these marginal fields they are one and two billion barrel marginal fields. The tax rate under our tax proposals, we would actually lower the taxes on those fields, in fact encourage further production in the state.

Senator Radar - Do you disagree with the a analysis that was presented by a, Mr. Ronaldson SOHIO here as to where are our tax, our total tax burden relates as against Louisiana, California, and Texas?

Commissioner Gallagher - Yes I do, in looking at some of those numbers, I and we haven't run all the numbers ourselves but it seems to me that they've mixed a few apples and oranges and got fruit salad and I can see alot of the numbers they say they are in constant dollars but the only way I can get to some of those

numbers is using current dollar basis.

Senator Radar - Well you agree though that such an analysis is rather important to us don't you?

Commissioner Gallagher - I would, I would, I agree that that analysis is important. We attempted to do that in this tax study but due to only getting two man years into the study, we didn't have time and it takes substantial amount of time to do that sort of study.

Senator Radar - But if that is an important decision, then the fact that we haven't completed that study, if you do take the issue with the a SOHIO approach and perhaps you are correct, I am not saying that you are not but, but you agree that that is important information in this decision making process. A and we disagree with it but we don't have one of our own. Wouldn't that argue that fact alone would argue in waiting until we have that information before we made that decision, wouldn't it?

Commissioner Gallagher - We could provide you with that information so next year, I think it is a real danger to sit around and wait while, let the federal government do things to us.

Senator Radar - Alright then, let me ask you this then. For purposes of balancing our budget this year, we could do that with your ad valorem tax, could we not?

Commissioner Gallagher - I believe, well lets put it this way.

Senator Radar - Go ahead, I was going to say we balanced it the last several years that way, and we could do it this year too, couldn't we?

Commissioner Gallagher - You mean the reserves tax?

Senator Radar - Reserves tax yes.

Commissioner Gallagher - I assume we could, I don't favor extending the reserves tax off into the future though. To me it's a bad policy, its a poor tax and I would like to see it die a natural death.

Senator Radar - But from the point of view of balancing your budget this year you could do it that way, as we have in the last couple of years.

Commissioner Gallagher - Well you could also by raising the cents per barrel to a free market value and also do the same thing.

Senator Radar - Yes, but here's our problem. Neither the state nor the industry knows what incentives or disincentives may occur because of the federal pricing, and yet you are suggesting that we make tax decisions in which we all agree that that federal pricing is very very important if we are at all concerned about the future attractiveness of Alaska as a investment for petroleum industry.

Commissioner Gallagher - Well, one of the things that we have tried to address in our, is our testimony has been directed in all these

hearings toward getting the maximum production out of Alaska. Our tax policy is also directed in that and it addresses these marginal fields.

Senator Radar - Well but, but if the federal government were so foolish as to pursue this policy that you said that we should not have participated in then your floors make it even more difficult as far as the petroleum industry is concerned or as far as the producing marginal wells in Alaska is concerned, isn't it?

Commissioner Gallagher - Well, if they were that foolish, I don't see why we should be a part of that foolish action.

Senator Radar - It seems to me like we are adding on to it and not detracting from their fool hardiness, if they are foolish.

Commissioner Gallagher - If you know, if they did do this there wouldn't be an incentive to developing another Prudhoe Bay, so you know.

Senator Radar - Well but we are adding to whatever, we are adding to the difficulties in the production of whatever fuel might be found by adopting the floors that you are talking about here. Are we not?

Commissioner Gallagher - Not necessarily you may find one down in the Cook Inlet with the free market value should be substantially

above that.

Senator Radar - No.

Commissioner Gallagher - Also the economic limit factor comes into play on these large fields.

Senator Radar - Let me ask you if we're talking about an industry who doesn't know the value that they are going to get from their product and isn't going to know until next year, then how do we develop a stable tax policy at this time, that is dependent upon that? It seems to me as though, and I don't have any answer except that you can balance your budget with the other method. And I also recognize the difficulties of the limits in the future, on that. But at least when we come back here a year from now, when we start talking about the profitability or the non-profitability or the incentives or disincentives, won't we be talking about something that we can relate to the real world at that time, that we can't relate to the real world now?

Commissioner Gallagher - I think our policies to the real world, that's what we are trying to address in fact, if the real world says you should price the energy supply at the alternative market, the alternative market may be \$20.00 a barrel, the alternate energy supplies. The OPEC countries are actually being very nice to the United States and not taken up the alternate energy supply cost. If you want to go to the real world we should maybe put our policies up at \$20.00 a barrel.

Senator Radar - But we can't do that as a state.

Commissioner Gallagher - You could set a cents per barrel that was based on \$20.00 which is the alternate energy cost. That's the real world.

Senator Radar - Well but that option isn't available to us, to tax at that rate, is it?

Commissioner Gallagher - Under a cents per barrel floor, of course, it is. Also, Senator, the FEA may open the pricing decision every ninety days after 1/1/78 or there after. I really doubt that they are going to make a decision on April 15th. I think you will not see a decision until somewhere around June 1. I really expect them to wait and see what the tariffs are, the initial tariffs are before they make some sort of decision.

Senator Radar - That's all. Thank you Madame Chairman.

Senator Colletta - Commissioner do you have one of these in front of you?

Commissioner Gallagher - Yes, I do.

Senator Colletta - O.K., On page 2 and you know just for the purposes of conversation and let's assume that you develop your tax package with the governors' standards, as to what they should include, now I think my question could be simply answered in two steps. First if you do agree that the industry says that they have between fourteen

and 16% worth of return on this project.

Commissioner Gallagher - I don't agree with that, but other than that.

Senator Colletta - O.K. with the assumption then the new tax proposals increase the tax by what percent?

Commissioner Gallagher - About 18% over all five bills.

Senator Colletta - What will their profitability be now that's different between that 14 and 16 percent?

Commissioner Gallagher - I reject number one the 14 to 16 percent that has the risk, under the Mortaida Study they multiplied all the assets by 4 to get the risk factor that may be appropriate to do an exploration work but it may not be important in doing other sort of work, you know the development work. If you want to use the Tanziers 33% or 35%, I don't think that is going to make 1 or 2 percent difference.

Senator Colletta - Commissioner I think I am going to try it another way. But anyway, the governor said it must generate sufficient revenues not only to compensate the state for additional service costs, attending such development but also to provide a reasonable additional dividend to Alaska. Now I would suspect you have computed that dividend in there. Can you tell me what the dividend is?

Commissioner Gallagher - The dividend to Alaskans? Well let me take you through the Prudhoe Bay numbers and maybe, you know I can work it right off the top of my head. We can talk about the dividends to various people. If you had a million two barrels a day there is four hundred and thirty eight million barrels of oil produced each year, three hundred and sixty five times one two, have you got your slide rule with me, times four hundred and thirty eight million times seven dollars and fifty cents per barrel is right on about three billion two. Is that correct, somewhere in there, less one eighth which is our royalty share. So that brings it down to four hundred million, three point two gets down to two billion eight, and let's subtract off the operating costs for the field, about three hundred and fifty million, four hundred million, let's say four hundred million we'll up it fifty million over the estimates, and that makes it down to two four. And let's say the State of Alaska through it's severance taxes takes another four hundred million, that brings it down to two billion and lets say our income taxes in effect takes us down a hundred and eighty, another hundred and eighty million, that leaves a billion eight left to share between the federal government and the oil industry. And so you have, before tax, you have a billion eight on a three billion dollar investment. Lets say they have three billion dollars investment. That's a nice return for oil industry too. One point eight billion dollars pre-tax on three billion dollars is a nice rate of return. Now they might claim that they pay forty eight percent taxes, I, you can look at SOHIO'S last report that was shown in their annual report and they showed they had effective tax rate of under ten percent. One of the things that they

happen to have is about three billion dollars of carry forwards of investment credits that will cancel off, pretty well wipe out at least fifty percent of their tax liability for the next five years. And they all have substantial investment credits so they should have developed substantial investment credits to be carried forward for the next several years, so whatever the effective federal tax rate is, you know, let's say they do pay three hundred million dollars income tax they still get in a billion and a half return on a three billion dollar investment, that's a fifty percent return per year. That's, I would take that, any day.

Senator Colletta - O.K. now, you know, we lost the Chinese and now your gettin to me, I'm understanding the last part of what you said and that's the part that a you know, I still want to come back to, a all of these companies collectively it seems and most of these reports we read, range within a two to teen percent, at least all I've seen, with the exception of one that happened last year, that say that this thing will return to those investors somewhere between this fourteen and sixteen and are you working under the assumption that they have thirty-five to fifty?

Commissioner Gallagher - Well I just, I don't want to go in and talk Chinese because there's a large difference between a, between income you report to your shareholders and discounted in cash flow, because one of the cash flows is, you know discounted

at some high rate of return to lower the number and it isn't fair. But I just demonstrated for accounting purposes it would show a fifty percent at least a fifty percent return. Now a discount in cash flow would be substantially below that because those values are, are reduced through time, for the investment. The major difference between Mortuada's investment and the investment Tanzier, like I pointed out was that one uses a risk multiplier factor that multiplies the assets by four times instead of three billion dollars investment they had, they used a regular return on twelve billion dollars investment and that's how you got a sixteen percent rate on a twelve billion dollar investment and you know, my numbers there kind of match out.

Senator Colletta - O.K. Commissioner I've got one other area that a I need clarified and that's item five the governor's policy statement that it must reduce uncertainty and encourage stable expectations about future resource tax and management policies. If infact these taxes did pass, would these be the last ones, would we be creating a stable future resource?

(GAP)

Commissioner Gallagher - a premarket price. Let's say Cook Inlet was priced at a premarket price. This tax would hit McCarthur River a a higher rate then it would Prudhoe Bay because it's actually more profitable. Now the East Trading Bay Unit which is decidely less profitable, it would tend to treat that fairly. What's comin into a play here is the cents per barrel floor. Yes, our written tax rate on East Trading Bay Unit is probably one third of what the cents per barrel floor should be. Now, that oil if we wanted to go after Cook Inlet it should be maybe priced at fifteen dollars

12

which is the price for Swede a 34% gravity on the west coast, we are only going to 7 1/2 because of Prudhoe Bay, so we are not being inconsistent, we are giving them a break.

Senator Colletta - Thank you Madame Chairman.

Senator Huber - Well, Senator Radar brought it up, I think that it's only fair to ask a ask of Sterling because we do need to get down to the nitty gritty of it. Sterling do you think that the Walter Leavy Associates have the best possible advice for the State of Alaska's interests, or do you think other economic consultants may have something to offer too?

Commissioner Gallagher - I've always appreciated the, I, of Dr. Mead, but you know there are consultants and there are consultants. They give you a good point of view Mead gives you a good point of view. I think there could be a whole series of people in that could give you worth while information.

Senator Huber - In other words you don't think we should base it all on one consultant.

Commissioner Gallagher - That's correct. I think you, you know, we have economists in the Department of Revenue, we should listen to those economists too.

Senator Huber - Obvious on the Walter Leavy Companys advice which we have been receiving quite heavily lately about removing the cents per barrel, do you disagree strongly on that?

Commissioner Gallagher - Absolutely.

Senator Huber - And do you, do the other consultants that you have hired agree with you on this?

Commissioner Gallagher - Of course they are hired by me.

Senator Huber - No some of them weren't hired by you. How about the other ones? How about the other ones on the cents per barrel?

Commissioner Gallagher - I don't know what Mead says. You know, he isn't here before you. I wish Tom Fink was here today, Madame Chairman.

George Silides - Commissioner a, I have a couple of easy ones and then a couple of little more difficult ones, I'll give you the hard ones first if I may. You've touched on them, but I will have to ask them again because I wasn't entirely sure on them and it's a matter of mechanics on the bills. It's been pointed out that the foreign income taxes constitute a large part of the pre-tax book income for international oil companies, and that these taxes are likely to decline sharply in the future as providing the producing governments take over and the companies become contractors and purchasers of crude from governments rather than from concessionaires, and income tax payers. Now, the questions on that is, as you recall this was mentioned a couple of days ago, you touched on it again tonight. Now wouldn't this work to erode Alaska's tax base under the proposed legislation

that is your franchise tax? And wouldn't it work to erode the tax base more if companies would measure foreign operations, let me say that again, and wouldn't it work to erode to tax base more for companies with major foreign operations than for those with only small scale foreign operations?

Commissioner Gallagher - Well Let me say, talk a minute about where the shifting centers are in the world. It's true that I think, I believe, Saudia Arabia gives the companies nine cents for every barrel they raise after they pay for expenses. I think that's what Saudia Arabia gives. And those wells are fifteen thousand or twenty thousand barrel well days with nine cents goes up in a hurry. But alot of profit centers are shifted to other areas of the business. If you will look at the transportation business for integrated companies you might find the profit center is shifted there. Federal government has, may have a oil head put on price ceilings on the well head. They also have it on some refined products but not the whole barrel. Infact the lower end of the barrel is pretty well decontrolled and they receive whatever price they want. You know, all sorts of ends of the business you can transfer your profits to.

George Silides - I'll just take it for what you said Commissioner. Well let me ask you someting - -

Commissioner Gallagher - Infact you know, it's quite obvious to me that the federal government is trying to encourage the shifting of profit centers away from production into refining and sales.

George Silides - But don't think that the fact that the companies are taking their payment as in-kind as it were, does it make any difference in the, to your bill?

Mr. Messenger - I believe I remember the comment that Mr. Kilgore made earlier this week and to the extent that the difference between some of the difference between book income and federal tax would book income before taxes and federal taxable income to the extent that some of that difference represents a foreign taxes. If those foreign taxes reproduce that would reduce that difference between book income and federal taxable income I believe that there would still be a substantial difference between, still, between federal taxable income and it would be still, in our interest to adopt book income because there is still a lot of other erosions from book income in the Internal Revenue Code Book.

George Silides - Well, I understand what you are saying Mr. Messenger but your answer is basically yes, that it does erode some if that happens.

Mr. Messenger - Yes, but it is still better than the federal tax reform.

George Silides - I see, Madame Chairman if I may ask the second question then, another question. Do you have any idea how much income your proposed legislation would apportion to Alaska as against what might be measured by separate accounting as proposed in the Senate Bill 105 for example, once Prudhoe Bay is in operation

that is if we, if income tax law really and truly represented the 9.4 percent tape.

Commissioner Gallagher - I think it should be essentially the same. We pick up some additional features though like the days in port like 50% of the income from the transportation subsidiaries assigned to Alaska and things like that. So I'm it's hard to compare it. Also ours would pick up the OCS.

George Silides - I see. Well in that regard Madame Chairman that brings up another question then. I notice that you mentioned the days in port and of course you were talking about, and you were mentioning also that brings to mind your ad valorem tax or your hardware tax. If you put a tax on the tankers aren't you increasing the cost of transportation, and if you are increasing the cost of transportation doesn't that lower the well-head price?

Commissioner Gallagher - Yea but, you only give up twenty cents on a dollar.

George Silides - What you are telling me is that the differential is what counts? Since we are on the hardware tax, there are some refineries a couple of refineries in at North Kenai and there is one going on up now, being built now in the North Pole, hardly can be termed world scale refineries, especially the one at the North Pole. If you tax those refineries who will be paying that tax in the long run? If we are trying to encourage a refinery say in the North Pole area to, so that the people in the interior can get the same price for oil, fuel oil as they do in Anchorage, aren't you giving with one hand and taking away with another?

Commissioner Gallagher - That's possible. Also they may be export refineries too.

George Silides - The North Pole an export refinery?

Commissioner Gallagher - Not the North Pole ones, obviously not.

George Silides - But the SOCAL one?

Commissioner Gallagher - I know some piloteers for it.

George Silides - The SOCAL one?

Commissioner Gallagher - Yea.

George Silides - Are they export?

George Silides - I'm just curious. And another question on hardware then, I'm presuming that the same answer you gave on the tankers (inaudible) tankers goes for the increase tax on the pipeline.

Commissioner Gallagher - The increase tax, there is no increase tax on the pipeline.

George Silides - Well, under your system there would be a greater take because - -

Commissioner Gallagher - No we're just trying to cure our court case.

George Silides - I see.

Commissioner Gallagher - We already think we have it.

George Silides - One final technical thing again Madame Chairman. Are you aware Commissioner that in addition to the Walter J. Leavy Associates finding a flaw in only part of your severance tax bill, did you know that the Research Division of Legislative Affairs Agency has also found essentially the same flaw?

Commissioner Gallagher - I don't, that is not a flaw. That is the cents per barrel for coming in and playing a part there. It works exactly like it is intended. Those fields that are, where the formula works out to be 50 percent of what the phenomenal rate should be, is in fact 50 percent.

George Silides - Well Commissioner, I'm just calling it to your attention so that you maybe can talk to Mr. Erickson because he feels like the Walter J. Leavy Associates does that the bill is not fulfilling the function that you designed it for and I'm only bringing it to your attention. I'm not in the position, I don't know enough about it to argue about it.