SJR

13

MEMORANDUM

DATE: April 1, 2001

TO: Robert D. Storer
Executive Director

FROM: Jim Kelly
Director of Communications

SUBJECT: **Hypothetical look backwards at the effects of SJR 13**

The Alaska Permanent Fund Corporation (APFC) has prepared the attached spreadsheet, "Hypothetical look backwards at the effects of SJR 13" to answer several questions.

Q. If SJR 13 had been in effect in the past, how much money would have been available under the 5 percent limit? *<u>Answer:</u> In 2000, for example, $1,207,460,000 would have been available.*

Q. What percentage of that would have been taken up by the dividend? *<u>Answer:</u> In 2000, for example, $1,173,000,000 would have been taken up by the dividend.*

Q. How much residual income after dividends would have been available for other uses? *<u>Answer:</u> In 2000, for example, $35,000,000 would have been available for other uses.*

What else does the spreadsheet show?

1. The larger the market value of the Fund, the larger the amount of income available for distribution, for whatever purpose, under the payout limit of 5 percent of the Fund's five-year average market value.

2. Dividends take a larger percentage of the distribution in those years when the financial markets produce above-average returns, and a smaller percentage in those years when returns are average or below-average.

3. There have been, and there could be again, years in which the entire 5 percent available would be taken up by the dividend under the current formula.

4. On average, the ratio between dividends under the current formula and the residual available will approximate 75-80 percent to dividends, 20-25 percent to residual. Over the long term, that is a reasonable expectation for the current dividend formula under a 5 percent of market value (POMV) payout mechanism.

5. The spreadsheet overstates the amount of income available for distribution because it does not show the effect of actually paying out the residual income available under the 5 percent limit; that is why it is labeled hypothetical. Intuitively, if the Fund had paid out more money in the earlier years, there would be less income earned in the future years and less available for distribution. The APFC believes that the amount of residual income available will likely be in the range of $175-$300 million per year.

How to read the spreadsheet

The **first** column in the spreadsheet, shows the year-end Permanent Fund market values (pre-distribution of income.) These numbers come from the bottom line of the balance sheet in the APFC's annual financial statements.

The **second** column takes the five-year average of the first column.

The **third** column shows actual and projected dividends which have been computed according to the current dividend formula (which excludes unrealized gains/losses.)

The **fourth** column expresses the third column as a percentage of the second column.

The **fifth** column shows the amount of Fund income available for appropriation under SJR 13. It is 5 percent of column two.

The **sixth** column simply indicates that the fifth column equals 5 percent of the second column.

The **seventh** column shows the amount of Fund income available as a residual of subtracting the dividend distribution (the third column) from the total available under SJR 13 (the fifth column)

The **eighth** column shows the seventh column as a percentage of the second column.

Alaska Permanent Fund Corporation
Hypothetical Look Backwards at the Effects of SJR 13

	1	2	3	4	5	6	7	8	
FY	Year-End Permanent Fund Market Value (Pre-Distribution of Income)	5-Year Average Market Value	Dividend Distribution (Based on Current Law)	Dividend Distribution as a % of 5-Year Average Market Value	Income Available Under 5% Limit (Per SJR 13)	SJR 13 Income Available as a % of 5-Year Average Market Value	Residual Income Available Under the 5% Limit	Residual Income Available as a % of 5-Year Average Market Value	FY
83	4,580								83
84	5,218								84
85	6,969								85
86	8,783								86
87	9,317	6,973.43	391	5.61%	348.67	5.00%	(42)	-0.61%	87
88	9,898	8,037.11	424	5.28%	401.86	5.00%	(22)	-0.28%	88
89	11,019	9,197.44	460	5.00%	459.87	5.00%	(0)	0.00%	89
90	11,962	10,195.96	487	4.78%	509.80	5.00%	23	0.22%	90
91	12,923	11,023.86	489	4.44%	551.19	5.00%	62	0.56%	91
92	14,228	12,006.15	488	4.06%	600.31	5.00%	112	0.94%	92
93	15,975	13,221.52	532	4.02%	661.08	5.00%	129	0.98%	93
94	15,764	14,170.41	556	3.92%	708.52	5.00%	153	1.08%	94
95	17,126	15,203.20	565	3.72%	760.16	5.00%	195	1.28%	95
96	19,037	16,426.00	643	3.91%	821.30	5.00%	178	1.09%	96
97	22,138	18,007.87	747	4.15%	900.39	5.00%	153	0.85%	97
98	25,015	19,815.98	893	4.51%	990.80	5.00%	98	0.49%	98
99	26,446	21,952.46	1,045	4.76%	1,097.62	5.00%	53	0.24%	99
00	28,110	24,149.29	1,173	4.86%	1,207.46	5.00%	35	0.14%	00
01	27,427	25,827.20	1,164	4.51%	1,291.36	5.00%	128	0.49%	01
02	28,655	27,130.72	1,158	4.27%	1,356.54	5.00%	199	0.73%	02
03	29,979	28,123.48	1,103	3.92%	1,406.17	5.00%	303	1.08%	03
04	31,441	29,122.50	1,065	3.66%	1,456.12	5.00%	391	1.34%	04
05	33,039	30,108.28	1,071	3.56%	1,505.41	5.00%	434	1.44%	05
06	34,733	31,569.62	1,148	3.64%	1,578.48	5.00%	431	1.36%	06
07	36,475	33,133.60	1,205	3.64%	1,656.68	5.00%	451	1.36%	07
08	38,287	34,795.07	1,266	3.64%	1,739.75	5.00%	473	1.36%	08
09	40,168	36,540.37	1,331	3.64%	1,827.02	5.00%	496	1.36%	09
10	42,122	38,356.97	1,398	3.64%	1,917.85	5.00%	520	1.36%	10
11	44,149	40,240.09	1,467	3.65%	2,012.00	5.00%	545	1.35%	11

• That the state remains years away from needing to tap additional sources of state revenue.

Copies of the spreadsheet containing the full *ALASKA BUDGET REPORT* analysis are available to subscriber-clients.

ALASKA PERMANENT FUND

Earnings reserve to hit $1.9 billion, as fund eyes first annual loss

A September 30 management report published by the Alaska Permanent Fund Corporation projects that balance available for appropriation in the fund's earnings reserve at the end of FY 99 will be $1.9 billion, up by $521 million from its $1.3 billion balance at the end of FY 98.

At during the last legislative session APFC projections put the FY 98 ending earnings reserve balance at $575 million, but realized gains on sales of securities, mostly stock, pumped up FY 98 earnings and added to the reserve. Sen. Robin Taylor complained then that past APFC projections had underestimated earnings.

"They are always giving us that story," fumed Taylor [see **PF earnings reserve appropriation would cut dividends**, *ALASKA BUDGET REPORT*, April 8, 1998].

During the first three months of the year, the fund lost $860 million,, and APFC's September management report projects that the fund will lose $364 million in FY 99. Income from interest, dividends, and appreciation in the fund's portfolio of bonds was more than offset by a $1.4 billion loss on its holdings of stocks. The report projects that the overall FY 99 rate return on fund assets will be a -0.5 percent. The real rate of return, accounting for inflation would be -2.3 percent.

The projections are calculated every month in accordance with a standard formula. Corporation officials said that the vigorous performance of the U.S. stock market during October will likely result in the projected loss turning into a small gain when the October management report is published in mid-November.

Until this July the fund reported its income without included unrealized gains and losses on stock and bond investments, but rules issued by the Government Accounting Standards Board now require paper profits and losses to be included; APFC reports this value as "GASB income."

Since the fund began operations in 1977, it has never shown an annual loss. Historical fund income, whether as originally reported or as restated under the GASB rule.

The calculation of permanent fund income available for appropriation—called "statutory net income"—and the share of that income going to the dividend program—continues to be governed by the old rules. The September 30 management report projects FY 99 statutory net income at $1.8 billion, down from $2.6 billion in FY 98.

Despite the projected decline in income, the dividend appropriation will increase, under the influence of an averaging formula that ties it to income over the previous five years. APFC estimates that next year's dividend appropriation will be $969 million, up by 9 percent from last year.

Notwithstanding the reduced income available for appropriation, and the increased claim for the dividend, low inflation means that the earnings reserve will again show substantial growth.

Lawyers say feds unlikely to tax permanent fund

Is the Alaska permanent fund vulnerable to being hit with federal taxes? Not according to a secret analysis of the issue presented by Department of Law government affairs attorney Jim Baldwin to a closed-door session of the of the Alaska Permanent Fund Corporation's board of trustees in April.

"My own view, based on what we heard, is that we are in better shape now than we were ten years ago, when they last looked at the issue," said trustee chair Eric Wohlforth. Most of the improvement in the fund's legal claim to tax-exempt status is the result of court rulings in the last decade that have tended to rebuff efforts by tax collection agencies to narrow the interpretation of tax exemptions traditionally allowed to government enterprises, he said. Wohlforth is a private attorney who specializes in acting as bond counsel for governments, government authorities and public corporations.

Attorney General Bruce Botelho said a 1988 legal analysis of the issue was done by Morrison & Forrester, a national law firm that was assisting the state then on several high-profile cases to collect disputed oil revenue.

According to Wohlforth, Morrison and Forrester said that a challenge to the fund's tax exemption could be based on the APFC's status as an entity separate from the rest of state government, and an argument made that the functions of the APFC are essentially non-governmental. The firm recommended several steps the state could take to more firmly integrate the fund with the functions of state government.

"We couldn't do most of those things," Wohlforth said.

In a separate interview, APFC Executive Director Byron Mallott confirmed that the case for tax exempt status wasn't strengthened by any organizational or programmatic changes to the fund. "It was largely external, based on evolution of the law."

Mallott said several factors caused the state's lawyers to suggest another look at the issue, including a constitutional amendment proposal in February 1997 by Sens. Lyda Green, Loren Leman, and Rick Halford that would have required a vote of the people before spending undistributed income from the earnings reserve of the permanent fund for anything except the dividend and inflation-proofing.

Botelho said in an interview that he also wanted the state to be prepared in the event that the interest of federal tax officials was stimulated by a May 1996 newspaper column by Juneau economist David Reaume, and November 1997 newspaper reports of remarks by former APFC Executive Director Dave Rose at a conference on the future of the fund sponsored by APFC. Reaume and Rose both suggested that the fund might be considered fair game for the federal government unless the state was willing to take some of the fund income to support state government.

"[T]he only thing the Permanent Fund Corp. has ever done is to generate income for the private citizens of Alaska through the permanent fund dividend program," wrote Reaume. "More important, many Alaskans have come to believe that this is all it should ever do. If that position is ratified by continued failure to use part of Permanent Fund profits to finance state government, then the IRS well may constructively define the Permanent Fund Corp. to be a private corporation.

"[W]e may not have the option of the Permanent Fund not funding government for much longer. If failure to use Permanent Fund profits to finance a reasonable portion of state government operations leads to the federal government's capturing 35 percent of those profits, then the actual choice will be either to fund state government or to fund the federal government. Under these circumstances, I know where my vote will fall."

Rose said in an interview that his concerns were based on the increasing size of the dividend. "As it gets bigger, it's bound to attract more and more attention."

The executive session to hear Baldwin's briefing on the Department of Law's analysis lasted 28 minutes, according to APFC board minutes.

"I don't think we have a problem, at least not now," commented Peter Bushre, the fund's chief financial officer, who coordinated with the Department of Law on the recent review.

SJR 13 Projections

Submitted to Senate State Affairs Committee 2/21/02

Assumptions

- Legislative passage and public approval of SJR 13
- Distribution of full 5% of total Fund market value
- Dividend: statutory formula
- Inflation-proofing: statutory formula
- Current APFC asset allocation
- Oil revenue: DOR Fall 2001 forecast
- Actual Fund data through December 2001
- 2002 Callan Associates Inc. capital market assumptions

Range of **total 5% payout** (in millions)

	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08
Top quartile	$1,343	$1,397	$1,439	$1,496	$1,571	$1,668
Median	$1,313	$1,330	$1,323	$1,368	$1,420	$1,464
Bottom quartile	$1,260	$1,007	$984	$1,031	$1,033	$1,020

Range of **dividend distribution** (in millions)

	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08
Top quartile	$930	$945	$953	$1,086	$1,270	$1,341
Median	$853	$779	$732	$807	$929	$1,039
Bottom quartile	$778	$620	$509	$551	$570	$602

Range of **residual income** (in millions)

	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08
Top quartile	$432	$497	$545	$519	$452	$417
Median	$391	$418	$438	$390	$318	$272
Bottom quartile	$331	$255	$265	$203	$111	$23

Alaska Permanent Fund Corporation
P.O. Box 25500 Juneau, Alaska 99802-5500
(907) 465-2047

May 10, 2001

Honorable Norman Rokeberg
Chairman, House Judiciary
State Capitol, Room 118
Juneau, Alaska 99801-1182

Re: HJR 15 -- Constitutional amendment for inflation-proofing the Alaska Permanent Fund

Dear Representative Rokeberg:

This is to provide some information and make a request regarding HJR 15, the Board's proposed constitutional amendment for inflation-proofing the Alaska Permanent Fund.

Late in the session, we had a hearing on SJR 13 (the companion bill to HJR 15) in the Senate State Affairs Committee. At that hearing we were presented with a copy of a February 12, 2001 memo prepared by Tamara Cook, the director of Legal Services, raising certain legal issues. Subsequently, we asked Ron Lorensen, outside counsel for the Alaska Permanent Fund Corporation (APFC), to review and comment on Ms. Cook's memo discussing the above-referenced bill. A copy of Ms. Cook's memo and Mr. Lorensen's memo, dated May 9, 2001, are enclosed for your information.

The APFC Board of Trustees held one of its regular meetings here in Juneau on April 30 - May 1. During the Board's work session on May 1, the Board, staff and Mr. Lorensen spent over an hour discussing several of Ms. Cook's comments and concerns. After those discussions, the clear consensus on the Board continues to be strong support for maintaining the existing distinction between principal and income contained in the Constitution and for continuing the Constitution's present protection of principal from appropriation by the Legislature.

In this regard, the Board considered alternative approaches both to the operation of the amendment and to the language of the amendment. At the conclusion of those discussions, the members of the Board reaffirmed their view that the proposed amendment as presently drafted provides the best approach to implementing the Board's policy goals for protecting the Fund for the benefit of both present and future Alaskans.

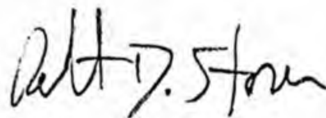
While it is likely that interpretational issues will arise, the Board believes it is important to keep the proposed amendment as short and uncomplicated as possible. The Trustees further believe that they can, in the course of presenting written and oral testimony which helps create the legislative record, make it quite clear that the proposal is definitely intended to continue to keep the principal inviolate.

Now that the first session of this legislature has drawn to a close, the Board asked that I express its hope that your committee and the remaining committees of referral in both houses will continue to move ahead with deliberations on the proposed amendment over the interim and into the second session. In particular, we urge that further hearings on the bills be scheduled so that, if they continue to receive favorable support from the committees, they can be taken up by each house relatively early in that session.

By approving the amendment early next year and avoiding pulling it into the last-minute flurry of negotiations and compromises over funding mechanisms and sources that can arise in the closing days of a legislative session, the Legislature would likely be seen by the public as making a strong statement of its support for providing additional protection to the Fund. Also, the earlier the amendment is passed by the Legislature, the sooner the public discussion and debate over the merits of the proposal can begin in advance of the 2002 general election.

Thank you for your continued interest in the Permanent Fund and attention to this issue.

Sincerely,



Robert D. Storer
Executive Director

Enclosures

c: Board of Trustees

LAW OFFICES OF
SIMPSON, TILLINGHAST, SORENSEN & LONGENBAUGH, P.C.

ONE SEALASKA PLAZA, SUITE 300 · JUNEAU, ALASKA 99801
TELEPHONE: 907-586-1400 · FAX: 907-586-3065

To: Jim Kelly, APFC

From: Ronald W. Lorensen, STS&L

Date: May 9, 2001

Re: SJR 13/HJR 15--Constitutional amendment for inflation-proofing the Alaska Permanent Fund
Our File No.: 846.14

You have asked for my comments on the February 12, 2001 memo from Tamara Brandt Cook, director of the Legislature's Division of Legal and Research Services, to Senator Gene Therriault discussing the Board of Trustee's proposed constitutional amendment for inflation-proofing the fund. I address her concerns in the order they are discussed in that memo:

1. Title of bill. I think Ms. Cook's observation that the title of the proposed resolution does not reflect its contents is probably the result of an insufficient understanding of the use of percent of market value (POMV) payout rules. On its face, the POMV rule expressed by the resolution appears to be intended simply as a limit on the Legislature's ability to appropriate Fund income (which is not expressed by the title). However, as the Board and those of us who have been studying endowment models and the use of POMV payout rules have come to understand, the real purpose of such a rule is to assure the long-term viability of a fund by allowing, over the long term, only the real portion of the income earned by that fund to be spent. With a POMV spending rule, a fund retains that portion of its income attributable to inflation, with the expectation that the fund will grow (again, over the long term) at the same rate as inflation--thereby "inflation-proofing" the fund.

2. Distinction between principal and income. Ms. Cook does not explain why she believes that retaining the distinction between principal and income of the Fund makes little sense. In any event, it is my understanding that continuing this distinction and assuring that Fund principal remains "inviolate" is an important policy goal for the Board in proposing this constitutional amendment (see my further discussion of this point at Paragraph 3, below). I think Ms. Cook is correct that, by retaining the distinction, the constitution's current requirement that Fund principal be used only for those income-producing investments specifically authorized by law would not apply directly to the Fund's income.

E. BUDD SIMPSON · JON K. TILLINGHAST · STEPHEN F. SORENSEN · LESLIE LONGENBAUGH
L. MERRILL LOWDEN · RONALD W. LORENSEN (OF COUNSEL)

However, the Legislature has already addressed that issue in AS 37.13.145(a) by requiring that money in the earnings reserve account be invested in investments authorized for the investment of Fund principal under AS 37.13.120 ("the legal list").

3. Continued protection of Fund principal. It appears from Ms. Cook's discussion in the third paragraph of her memo that she does not interpret the proposed constitutional amendment to continue to protect Fund principal from appropriation and expenditure by the Legislature (i.e., if the earnings reserve account in a particular year was smaller than the permissible payout for that year, the difference could be satisfied out of principal). As indicated above, that interpretation runs counter to the Board's policy goal of keeping Fund principal "inviolate."

In our (the Board's and staff's) efforts to keep the proposed amendment as short and uncomplicated as possible, we have recognized that this interpretational issue may arise. However, because (i) the amendment retains the distinction between principal and income and (ii) does not in any way alter the existing constitutional language that provides the basis for treating Fund principal as "inviolate",[1]/ I believe that the better interpretation of the amendment is that principal must continue to be inviolate and that the Legislature cannot "dip into" principal in order to make a payout otherwise permitted under new subsection (b). As we have discussed with the Board, one way to strengthen the analytical basis for this latter interpretation is for the Board and staff to create a written and testimonial record that makes it clear that the intended effect and interpretation of the amendment is to continue the special protection that Fund principal currently enjoys. This has, in fact, been done consistently since the Board first formally proposed the amendment at its December, 2000 meeting in Anchorage.

4. Effective date of the amendment. Under Section 1, Article XIII of our constitution, a proposed amendment to the constitution must be presented to the voters at the next general election after it is passed by the Legislature. Under that same provision, if the amendment is approved by the voters, it takes effect 30 days after the election results are certified by the lieutenant governor, unless a different date is provided for in the amendment. The amendment as presently proposed does not specify an effective date. Given the timing of the next general

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[1]/ The first sentence of the provision creating the Alaska Permanent Fund (Section 15, Article IX) provides the basis for keeping Fund principal "inviolate." It reads as follows:

> At least twenty-five per cent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses received by the State shall be placed in a permanent fund, *the principal of which shall be used only* for those income-producing investments specifically designated by law as eligible for permanent fund investments. (emphasis added)

The proposed amendment does not change this language.

election (November 5, 2002)--and assuming there is no unusual, protracted election contest as recently occurred in the 2000 Presidential election in Florida--the amendment, if approved by the voters, would almost certainly take effect before the beginning of the 23rd Alaska Legislature on January 21, 2003 (the third Tuesday in January following a gubernatorial election--AS 24.05.090).

In her memorandum, Ms. Cook suggests that having the amendment take effect in the middle of a fiscal year would be awkward, as it would allow the Legislature to appropriate any amount of the Fund's income in the earnings reserve account during the first part of the 2003 fiscal year, while restricting the amount available to the Legislature during the latter part of that fiscal year, after the amendment takes effect. Why or how this situation might be awkward is not readily apparent to me, however, considering that, unless the 22nd Alaska Legislature convenes itself in special section after its regular adjournment in May, 2002 for the express purpose of appropriating money from the Permanent Fund, its first opportunity in FY 2003 to appropriate funds from the Fund will not arise until after the amendment takes effect.

In any event, the timing of the effective date of the proposed amendment raises a policy question for the Legislature, rather than a legal one. In terms of policy considerations, one could actually argue that providing for a July 1, 2003 effective date as suggested by Ms. Cook could actually undermine the chances for passage of the amendment. This is because the delayed effective date might be seen by those who are exceptionally distrustful of the Legislature and the political process as providing an after-the-fact opportunity for the Legislature to "raid" the Fund before the amendment, although passed by the voters, actually goes into effect.

5. Status of earnings reserve account when amendment takes effect. At the end of her memo, Ms. Cook indicates uncertainty about the status of the earnings reserve account when the amendment takes effect and then states her assumption that the entire balance of that account would be available for appropriation under the constitutional provision as it read before the amendment. I do not believe this assumption is correct--once the amendment takes effect, for any fiscal year, the POMV payout rule expressed in new subsection (b) will operate to limit the Legislature's ability to appropriate from the earning reserve account to the amount calculated under that rule. Subsection (b) expressly applies to "appropriations from the permanent fund," and, under existing AS 37.13.145(a), the earnings reserve account is already a part of the Fund.[2]/ Unless the Legislature changes current law before the amendment takes effect, that account will continue to be a part of the Fund on the effective date of the amendment and, thus, subject to the limitation of subsection (b) on appropriations from the Fund.

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[2]/ AS 37.13.145(a) provides in pertinent part: "The earnings reserve account is established as a separate account in the fund. Income from the fund shall be deposited by the corporation into the account as soon as it is received

If you have any questions about these comments or would like to discuss them further, please do not hesitate to contact me.

cc: Jim Baldwin, Assistant Attorney General, Department of Law

LEGAL SERVICES

DIVISION OF LEGAL AND RESEARCH SERVICES
LEGISLATIVE AFFAIRS AGENCY
STATE OF ALASKA

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Juneau, Alaska 99801-1182
Deliveries to: 129 6th St., Rm. 329

JK

M E M O R A N D U M

February 12, 2001

SUBJECT: Alaska Permanent Fund (Work Order No. 22-LS0534\C)

TO: Senator Gene Therriault, Chair
Legislative Budget and Audit Committee
Attn: Heather Brakes

FROM: Tamara Brandt Cook
Director

TBC

You ask for my observations on this draft resolution proposing an amendment to the state constitution dealing with the permanent fund. The title does not reflect the contents of the resolution and, because a joint resolution is supposed to be treated like a bill under the Uniform Rules, normally the title is drafted to reflect the contents. However, because Art. II, sec. 13 only applies to bills, the title defect in this situation is only a procedural and not a constitutional problem. Likewise, a new subsection is normally added as a new bill section and the material is not underlined. The way subsection (b) has been added does not conform to the Legislative Drafting Manual, but will not be fatal to the validity of the resolution if it is adopted by the legislature and approved by the voters.

Substantively, I observe that it makes little sense to retain the distinction between principal and income in subsection (a), since appropriations allowed under subsection (b) are based on averaged market value of the fund and no longer on income generated by the fund. Furthermore, by retaining the distinction between principal and interest, the provision that addresses permanent fund investments applies only to investments of principal. There is no constitutional requirement that interest retained in the fund also "be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments." This seems a bit puzzling, but the legislature can address the investment of interest by law, so the approach probably does not create any great problem.

Subsection (b) is not as clear as might be desirable, but I think it can be applied. However, from my conversation with Mr. Jim Kelly, I gather that it is expected that only income of the fund will be available for appropriation. If this is the intended result, it has not been achieved. That is to say, if fund income is low for a period of years, it will be mathematically possible for an appropriation to be made based on the average of the market values formula that includes some fund principal. Perhaps, this possibility is so remote as not to be a serious problem.

I think it will be awkward for the constitutional amendment to spring into effect in the middle of a fiscal year and suggest that a July 1, 2003 effective date be added. Otherwise, for part of the year the legislature will be able to appropriate fund income, while at the end of the same year it will have access to an amount based on market value of the fund. Also, I am not sure about the status of the balance in the earnings reserve account on the day the amendment takes effect. I assume the entire balance on that day is available for appropriation under the constitutional language as it read prior to the amendment.

TBC:lmb
01-044.lmb

22-LS0534\S.1
Cook
3/20/02

AMENDMENT

OFFERED IN THE SENATE

TO: CSSJR 13(STA), Draft Version "S"

1 Page 2, line 12, following "**Transition**":
2 Insert "**; Suspension or Repeal of Subsection.** (a)"
3
4 Page 2, following line 16:
5 Insert a new subsection to read:
6 "(b) Notwithstanding Section 1 of Article XIII, the legislature may, by
7 resolution concurred in by at least two-thirds of the members of each house, suspend
8 for a definite duration or repeal Section 15(c) of Article IX. A resolution may be
9 adopted under this subsection only after the commissioner of revenue provides written
10 notice to the legislature that Section 15(c) of Article IX has or will adversely affect the
11 federal tax status of the permanent fund."

LEGAL SERVICES

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MEMORANDUM February 12, 2001

SUBJECT: Alaska Permanent Fund (Work Order No. 22-LS0534\C)

TO: Senator Gene Therriault, Chair
Legislative Budget and Audit Committee
Attn: Heather Brakes

FROM: Tamara Brandt Cook TBC
Director

You ask for my observations on this draft resolution proposing an amendment to the state constitution dealing with the permanent fund. The title does not reflect the contents of the resolution and, because a joint resolution is supposed to be treated like a bill under the Uniform Rules, normally the title is drafted to reflect the contents. However, because Art. II, sec. 13 only applies to bills, the title defect in this situation is only a procedural and not a constitutional problem. Likewise, a new subsection is normally added as a new bill section and the material is not underlined. The way subsection (b) has been added does not conform to the Legislative Drafting Manual, but will not be fatal to the validity of the resolution if it is adopted by the legislature and approved by the voters.

Substantively, I observe that it makes little sense to retain the distinction between principal and income in subsection (a), since appropriations allowed under subsection (b) are based on averaged market value of the fund and no longer on income generated by the fund. Furthermore, by retaining the distinction between principal and interest, the provision that addresses permanent fund investments applies only to investments of principal. There is no constitutional requirement that interest retained in the fund also "be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments." This seems a bit puzzling, but the legislature can address the investment of interest by law, so the approach probably does not create any great problem.

Subsection (b) is not as clear as might be desirable, but I think it can be applied. However, from my conversation with Mr. Jim Kelly, I gather that it is expected that only income of the fund will be available for appropriation. If this is the intended result, it has not been achieved. That is to say, if fund income is low for a period of years, it will be mathematically possible for an appropriation to be made based on the average of the market values formula that includes some fund principal. Perhaps, this possibility is so remote as not to be a serious problem.

I think it will be awkward for the constitutional amendment to spring into effect in the middle of a fiscal year and suggest that a July 1, 2003 effective date be added. Otherwise, for part of the year the legislature will be able to appropriate fund income, while at the end of the same year it will have access to an amount based on market value of the fund. Also, I am not sure about the status of the balance in the earnings reserve account on the day the amendment takes effect. I assume the entire balance on that day is available for appropriation under the constitutional language as it read prior to the amendment.

TBC:lmb
01-044.lmb

APFC ANALYSIS OF SJR 13/HJR 15

May 5, 2001

The proposal

The Board of Trustees of the Alaska Permanent Fund Corporation (APFC) unanimously recommends that the legislature approve Senate Joint Resolution 13 or House Joint Resolution 15 which would place before the voters a constitutional amendment to permanently inflation-proof the Fund.

SJR 13/HJR 15 (hereinafter referred to as SJR 13) accomplishes inflation-proofing by limiting the annual payout of Fund income to no more than 5 percent of the Fund's five-year average market value. This methodology protects the purchasing power of the entire Fund and provides the maximum amount of sustainable income to benefit current and future generations.

The benefits

1. Provides constitutional protection against inflation for the total Permanent Fund, thereby more effectively safeguarding the Fund and increasing the amount protected.

2. Maximizes the total amount of Fund income which can be paid out in the future, at least as compared to higher payout rates, and does so in a way that balances the Fund's benefits fairly between the current generation and future generations.

General Election November 5, 2002

Section 15. Alaska Permanent Fund. (a) At least twenty-five per cent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses received by the State shall be placed in a permanent fund, the principal of which shall be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments. All income from the permanent fund shall be deposited in the permanent [GENERAL] fund [UNLESS OTHERWISE PROVIDED BY LAW].

(b) For any fiscal year, appropriations from the permanent fund shall be limited to five percent of the average of the year-end market values of the permanent fund for the last five fiscal years, including the fiscal year just ended. No other appropriations from the permanent fund may be made.

Yes [/] No [ ]

Alaska Permanent Fund Corporation

3. Increases the likelihood that both the Fund's principal and its income will continue to grow in perpetuity in both nominal and real, inflation-adjusted dollars.

4. Makes available, beginning in 2003, $175-$300 million per year, depending on the Fund's market value, for purposes other than inflation-proofing and dividends. This amount will grow over time as the Fund grows.

5. Uses the percent of market value (POMV) payout methodology which smoothes volatility, treats realized and unrealized income equally as investment return, and is consistent with generally accepted accounting principles and modern endowment practice.

6. Lets lawmakers know in advance, within a relatively narrow range, how much Fund income will be available for appropriation each year.

The analysis

Principal and inflation-proofing. Under SJR 13, both the Fund's principal and the earnings reserve account would be inflation-proofed by constitutional mandate. In addition, there would be two constitutional limits on Permanent Fund spending: (1) principal would continue to be unavailable for appropriation; and (2) appropriations from the earnings reserve account in the future would be limited to no more than 5 percent of the Fund's average market value for the past five years. This would provide full inflation-proofing averaged over long periods of time. Accordingly, statutory inflation-proofing transfers to principal would no longer be necessary.

Earnings reserve. All income not appropriated under the 5 percent payout limit would be retained in the earnings reserve account to offset inflation over the long term and to provide a cushion for future payouts in periods of extended down markets. In 2003, the Fund's five-year average market value is projected at $28 billion, which would limit the maximum payout that year to no more than $1.4 billion.

5 percent payout. The 5 percent limit is chosen for three reasons: (1) 5 percent is on the high end of sustainable payout rate that still maintains the Fund's real value; (2) 5 percent allows greater distributions over time than a higher payout; and (3) 5 percent is what the majority of endowments pay out; e.g., 85 percent of all public endowment funds pay out 5 percent or less, and the median payout of endowments, according to a 1999 Greenwich Associates study, is 4.9 percent.

Five-year averaging. Under SJR 13, the annual payout may not exceed 5 percent of the Fund's market value averaged over the prior five years, including the fiscal year just ended. This methodology is chosen to dampen volatility and is consistent with the existing statutory five-year averaging provision for computation of the annual dividend.

20-year perspective. Under SJR 13, *if the full 5 percent of the Fund's five-year average marker value were paid out,* the Fund would earn $57 billion of total investment return over the next 20 years, of which $28 billion would be earmarked for dividends and $20 billion to inflation-proofing, leaving $9 billion in residual income available for appropriation. The ending market value of the Fund in 2020 would be $51 billion.

Dividends. This proposal does not affect the existing dividend program. It should be noted, however, that any future public policy decision to use an additional portion of Fund income for any purpose will affect the dividend, as will market volatility, but under SJR 13, these impacts would either be equal or diminished compared to the status quo.

Residual income available for appropriation. Except in the case of extraordinarily good financial markets, the 5 percent limit set by SJR 13 is above what is required to pay dividends per current law, leaving a residual amount available for appropriation. If the entire 5 percent were paid out, the residual amount is expected to range from $175-$300 million per year in a median case, growing over time as the Fund grows. Because of the mechanics of the existing statutory dividend formula, however, if the dividend in any year is extraordinarily high, the amount of the residual could be reduced to zero.

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If you are under tax examination, your request for an IRS private letter ruling shoul submitted under section 4.02 of Revenue Procedure 97-1 (including the applicable the IRS tax examining or IRS appeals officer. The IRS tax examining officer or IRS officer must then forward the request for an IRS private letter ruling to the IRS Nat

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> IRS
> Attn: CC: DOM: CORP: T
> P.O. Box 7604
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50%

665.0 661.5 684 710 732

Range of total 5% payout

	FY03	FY04	FY05	FY06	FY07	FY08
Top Quartile	1,343.0	1,397.0	1,439.0	1,496.0	1,571.0	1,668.0
Median	1,313.0	1,330.0	1,323.0	1,368.0	1,420.0	1,464.0
Bottom Quartile	1,260.0	1,007.0	984.0	1,031.0	1,033.0	1,020.0

Range of dividend distribution (under current law)

	FY03	FY04	FY05	FY06	FY07	FY08
Top Quartile	930.0	945.0	953.0	1,086.0	1,270.0	1,341.0
Median	853.0 65%	779.0 58%	732.0 55%	807.0 59%	929.0 65%	1,039.0 70%
Bottom Quartile	778.0	620.0	509.0	551.0	570.0	602.0

Range of residual income

	FY03	FY04	FY05	FY06	FY07	FY08
Top Quartile	432.0	497.0	545.0	519.0	452.0	417.0
Median	391.0 [illegible]	418.0	438.0	390.0	318.0	272.0
Bottom Quartile	331.0	255.0	265.0	203.0	111.0	23.0

Range of dividend distribution (under POMV version at 20%)

	FY03	FY04	FY05	FY06	FY07	FY08
Top Quartile	268.6	279.4	287.8	299.2	314.2	333.6
Median	262.6	266.0	264.6	273.6	284.0	292.8
Bottom Quartile	252.0	201.4	196.8	206.2	206.6	204.0

Range of Residual Income

	FY03	FY04	FY05	FY06	FY07	FY08
Top Quartile	1,074.4	1,117.6	1,151.2	1,196.8	1,256.8	1,334.4
Median	1,050.4	1,064.0	1,058.4	1,094.4	1,136.0	1,171.2
Bottom Quartile	1,008.0	805.6	787.2	824.8	826.4	816.0

Range of dividend distribution (under POMV version at 80%)

	FY03	FY04	FY05	FY06	FY07	FY08
Top Quartile	1,074.4	1,117.6	1,151.2	1,196.8	1,256.8	1,334.4
Median	1,050.4	1,064.0	1,058.4	1,094.4	1,136.0	1,171.2
Bottom Quartile	1,008.0	805.6	787.2	824.8	826.4	816.0

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Bottom Quartile	252.0	201.4	196.8	206.2	206.6	204.0

#300 Sales Tax
30 Alcohol Tax
420 Residual Income
750

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Mail Stop 3101

State Capitol
Juneau, Alaska 99801-1182
Deliveries to: 129 6th St., Rm. 329

MEMORANDUM February 12, 2001

SUBJECT: Alaska Permanent Fund (Work Order No. 22-LS0534\C)

TO: Senator Gene Therriault, Chair
Legislative Budget and Audit Committee
Attn: Heather Brakes

FROM: Tamara Brandt Cook
Director
TBC

You ask for my observations on this draft resolution proposing an amendment to the state constitution dealing with the permanent fund. The title does not reflect the contents of the resolution and, because a joint resolution is supposed to be treated like a bill under the Uniform Rules, normally the title is drafted to reflect the contents. However, because Art. II, sec. 13 only applies to bills, the title defect in this situation is only a procedural and not a constitutional problem. Likewise, a new subsection is normally added as a new bill section and the material is not underlined. The way subsection (b) has been added does not conform to the Legislative Drafting Manual, but will not be fatal to the validity of the resolution if it is adopted by the legislature and approved by the voters.

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Legislative Counsel's Review

I think it will be awkward for the constitutional amendment to spring into effect in the middle of a fiscal year and suggest that a July 1, 2003 effective date be added. Otherwise, for part of the year the legislature will be able to appropriate fund income, while at the end of the same year it will have access to an amount based on market value of the fund. Also, I am not sure about the status of the balance in the earnings reserve account on the day the amendment takes effect. I assume the entire balance on that day is available for appropriation under the constitutional language as it read prior to the amendment.

TBC:lmb
01-044.lmb

Senator Gene Therriault, Chairman
Senate State Affairs Committee
Capitol Building, Room 121
Juneau, Alaska 99801

February 21, 2002

Chairman and Members of Senate State Affairs,

My name is Jay Hogan, my wife and I live at 10741 Horizon Drive in Juneau Alaska and I am here today representing no one other than myself. For the record let me stipulate that at an earlier time, it would never have occurred to me to appear before any committee of the Alaska Legislature in opposition to a measure introduced by the Legislative Budget and Audit Committee!

In January 1970, Governor Keith Miller requested introduction of three measures to establish a "resources permar nt fund". In a transmittal letter, Governor Miller stated, the "objective is to assure maximum long-term growth [of the fund] while providing an annually increasing source of income to the general fund." The two bills in the package passed the Senate but failed to move in the House. The third, a Constitutional amendment, made five percent of permanent fund market value annually available for "appropriation for general purposes"; this resolution failed to pass the Senate.

In March 1975, prompted by public concern over the disappearance of the $900 million North Slope lease bonus, 36 Members of the House co-sponsored HB 324 establishing the "Alaska mineral lease bonus permanent fund". Fund principal was to be "invested in perpetuity"; fund income could be, "appropriated to provide funding for operating or capital expenditures for loan or grant programs" eligible for funding under the law. The Legislature passed this statutory permanent fund only to have it vetoed by Governor Jay Hammond as an "unconstitutional dedication of evenue".

In January of 1976, Governor Hammond submitted a sponsor substitute for HJR 39, his 1975 end-of-Session "fix" for the dedicated revenue problem. The substitute was a Constitutional amendment establishing the Alaska Permanent Fund. In his transmittal letter Governor Hammond emphasized, "The income of the fund would be deposited into the general fund without any permanent fund restrictions." The Resolution as introduced read; "All income from the permanent fund shall be deposited in the general fund." House Finance added, "unless otherwise provided by law" completing the sentence as it stands today, unchanged from 1976.

Mike Bradner, Speaker of the House in 1975-76, wrote in the March 1988 Juneau Report:

"The constitutional action creating the fund was also "not about" a lot of things. It was not about dividends, investment policy, unreserved income, and in fact, did not even attempt to tell Alaskans "when" and under "what" circumstances the proceeds of the fund might one day accrue to future Alaskans.

Discussion over the Permanent Fund often takes on a biblical connotation. But amidst all this rhetoric, the simple foundation of the Fund is embraced in the two

previously stated commandments – *to preserve a portion of current oil income, and to preserve it as a future "trust"*.

All the rest of the development of the Alaska Permanent Fund is essentially left to statutory construction. Future Legislatures through general law, as opposed to constitutional law, were left to fill in the details of the Fund. These details included creation of the Alaska Permanent Fund Corporation, the rules of "inflation-proofing" (injecting some Fund earnings into the principal to account for inflation), creation of the dividend program, investment policy, and so on. These details were to be created, and to be changed as need be, by future generations of lawmakers.

What the lawmakers of 1976, in creating the Fund, were trying to avoid was "playing god". They did not want to try to foretell the future – to dictate future policy. As much as possible, commensurate with the basic task of creating the fund, the architects of the Fund did not want to tie the hands of future generations of lawmakers."

On average, SJR 13 would reduce by one third the amount of Permanent Fund income annually available for appropriation by the Alaska Legislature. Currently the Legislature appropriates that "third" as shown in the following appropriation from Chapter 60, SLA 2001:

"Sec. 8. ALASKA PERMANENT FUND CORPORATION. (a) . . .

(b) After money is transferred to the dividend fund under (a) of this section, the amount calculated under AS 37.13.145 to offset the effect of inflation on the principal of the Alaska permanent fund is appropriated from the earnings reserve account (AS 37.13.145) to the principal of the Alaska permanent fund.

The 2001 Permanent Fund Corporation Annual Report gives credit to the long running success of this method of appropriation for inflation proofing. On close inspection, the caption for the inflation graphic on page 17 reads, "Inflation has eroded the purchasing power of $1.00 in 1982 to 48 cents in 2001 . . .— but inflation-proofing has maintained the Fund's real value".

Unlike most other state permanent funds, the Alaska Permanent Fund has been inflation proofed for the past 20 Years. Largely "under reported" throughout the 26-year history of the Alaska Permanent Fund is the part played by the Alaska Legislature in increasing Fund principal. Relegated to the "Notes to Financial Statements" on page 38 of the Permanent Fund Corporation's Annual Report 2001, the principal balance of the Fund at June 30, 2001, was listed by source:

Dedicated State revenues	$7,070,741,000
Appropriations from the State	6,885,906,000
Inflation-proofing	6,929,350,000
Settlement earnings	161,582,000
Total Principal	$21,047,579,000

The Constitutional provision dedicating 25% of certain mineral revenues to the Permanent Fund produced a $7.1 billion Fund principal as of June 30, 2001. <u>But, with the numerous special Legislative appropriations and 12 years of Legislative appropriations</u>

for inflation proofing, the Legislature has nearly tripled Fund principal over that funded by the Constitutional dedication of revenue.

The Permanent Fund Corporation Board of Trustees proposal contained in SJR 13 and HJR 15 would repeal existing Legislative authority to appropriate Permanent Fund income established 25 years ago. With the State's Constitutional Budget Reserve Fund approaching "empty" and increased national/state concern with internal security matters, does this Legislature really want to repeal the existing authority to use all Permanent Fund earnings for what ever purpose this, or any future Legislature, determines to be the best public use at the time?

If the existing flexibility to appropriate earnings is to be changed, I would suggest that discussion and resolution of the part Permanent Fund earnings/payout are to play in the annual State budget should run concurrently with deliberation of the Trustees' proposed amendment to imbed inflation proofing of the Permanent Fund in the Constitution. If the 2002 Legislative Session is not the time for deliberation and resolution of the statutory use of all Permanent Fund earnings/payout, consideration of the Trustee's amendment should be postponed to a time when all Permanent Fund earnings/payout can be allocated by statute. The existing statutory system of annual appropriations for, "the amount calculated under AS 37.13.145 to offset the effect of inflation on the principal of the Alaska permanent fund" has done the job well, and can continue to do so.

Thank you very much for providing this opportunity to appear before the Senate State Affairs Committee.

Jay Hogan
PO Box 21073
Juneau, Alaska 99802

THE ALASKA PERMANENT FUND – PERMANENT FOR WHAT PURPOSE?

During the 1976 Legislative Session, four Alaska daily newspapers editorialized on the proposed fund, some more than once.

Anchorage Daily News – Place a check on state spending . . . offer loans to businessmen, builders and fishermen . . . "Most importantly, the permanent fund addresses that day when the oil runs out."

Fairbanks Daily News-Miner – "What could be more exciting than the prospect of true economic stability for Alaska?" . . . much like a savings account . . . the interest derived would be used to sustain certain state programs that would benefit all Alaskans. . fund a viable agricultural industry . . . loans to Alaskans to build their own homes . . . boat loans to revitalize a depleted fishing industry . . . and avoid careless state spending.

Southeast Alaska Empire – "What happens if, when Prudhoe runs dry, there isn't another massive oil strike on state land?". . . if there is no contingency fund, state government will lead Alaska back to the boom and bust economy we've been in since 1867.

Anchorage Times – There are reasons aplenty to set aside some oil income rather than "spend them in an orgy of pork barrel raids on the treasury". . . "However, sealing up a share of the revenue in a bank account . . . has drawbacks". . . others suggest reducing state debt, reducing or eliminating the state income tax, or revenue sharing to reduce or eliminate local property taxes.

The Alaska State Chamber of Commerce prepared the 1976 Official Election Pamphlet statement in favor of the Permanent Fund proposition. It read in part:

"Just as a wise and prudent family sets aside money in a savings account for the future, so should Alaska's state government set aside a rainy day fund to benefit this and future generations of Alaskans. . . .

Today, as the result of anticipated oil and gas revenues, Alaska stands on the brink of unprecedented prosperity. No one, but no one, argues that these non-renewable resources will last but for a few decades. Similarly, no one should fail to recognize that in those years ahead the cost of state government will continue to spiral upwards. Now is the time to ask ourselves the question: 'when the oil and gas is depleted, where will the funds to feed our giant government come from?' The answer is: the 'Permanent Fund'."

October 22, 1976, an Anchorage Daily News article summed up diverse opinion:

"Nobody knows exactly how the fund will be used; that decision will be made by legislative action in the future. Although the fund is protected against certain kinds of usage, its precise organization and management have been left flexible by designers. . . .

There have been many proposals for possible fund uses. They range from paying direct dividends to Alaskans to using the money to underwrite such vast projects as hydroelectric dams. But, whatever use it is put to, the permanent fund money would have to be a money-maker. Politicians could spend the interest, but never the principle."

Two days later, in a lengthy article the Anchorage Times detailed diversity:

"Those promoting the permanent fund, including Gov. Jay Hammond, see it as a way of providing development capital to diversify the state's economy, strengthen

renewable resources – such as fisheries, timber and tourism – and make possible large projects such as dams, which couldn't otherwise be financed.

They also view it as a savings account, to keep some of the state's income from oil and gas out of the general fund so it can't be spent. They point to the $900 million the state received from the 1969 Prudhoe Bay lease sale, which now is nearly all spent.

Others see the fund as a source of loans for community development, such as home mortgages, small business loans; for power development, ports, utilities, roads, or health, education or social needs, such as day care centers.

Malone [Rep. Hugh Malone, D-Kenai] said the fund could go for all three of those uses. The legislature would decide what per cent of the fund would go to each use. .

Other options include reinvesting the earnings in the permanent fund, pledging the earnings as security for state and local bonds, additional revenue sharing, letting earnings flow into the general fund, lower state income taxes, or return dividends as tax credits."

Thus informed, Alaskans went to the polls and voted almost 2 to 1 for the constitutional amendment establishing the Alaska Permanent Fund.

THE UNIVERSITY OF TEXAS SYSTEM

AVAILABLE UNIVERSITY FUND

Report to the Legislature and Governor
Pursuant to Rider No. 4 to Available University Fund Appropriations
S. B. 1, 77th Legislature, Regular Session, Page III-71

December 2001

B. AVAILABLE UNIVERSITY FUND

1. RATIONALE FOR DISTRIBUTION FROM PERMANENT UNIVERSITY FUND

The Texas Constitution, as amended in November 1999 by adoption of Proposition 17, defines the Available University Fund (AUF) as consisting of distributions from the total return on all investment assets of the Permanent University Fund (PUF). The U. T. System Board of Regents adopted a policy at its November 11, 1999, meeting designed to provide the AUF with a stable and predictable stream of distributions over time, as well as to maintain the purchasing power of both the PUF assets and AUF distributions.

The amendment contained in Proposition 17 limits the discretion of the U. T. System Board of Regents to determine the amount of PUF distributions in any given year by stipulating that annual distributions cannot exceed 7% of the average market value of PUF investments. Also, distributions cannot increase year to year if the purchasing power of PUF investments has not been preserved over rolling 10-year periods. The only exception would be to pay annual debt service on PUF bonds.

The Board of Directors of the University of Texas Investment Management Company (UTIMCO) recommended, and the U. T. System Board of Regents approved, total distributions of $338,433,636 and $317,081,112 from the PUF to the AUF for the fiscal years ending August 31, 2002 and 2001, respectively. The fiscal year 2002 distribution is equal to 4.5% of the average market value of PUF assets for the trailing 12 fiscal quarters ended February 28, 2001, as illustrated in Appendix A. The distribution rate of 4.5% satisfies the limitations in the Constitution. On August 9, 2001, the U. T. System Board of Regents set the distribution rate for fiscal year 2003 and beyond at 4.75%.

The PUF distribution for fiscal year 2002 represents a 6.7% increase over the distribution for the fiscal year 2001. Money credited to the AUF is administered by the State Comptroller and, along with other funds of the State, is invested in accordance with State law.

Table 1

THE UNIVERSITY OF TEXAS SYSTEM
AVAILABLE UNIVERSITY FUND
FY 2000 - FY 2004

	Actual FY 2000	Actual FY 2001
Income and PUF Distributions		
Divisible with Texas A&M University		
Investment Income and Distributions	$ 297,562,712	$ 317,081,112
Surface & Other Income	6,173,996	9,265,625
Expenses of Revenue Bearing Properties	(2,719,540)	--
Net Divisible Income and Distributions	301,017,168	326,346,737
Less: A&M Share (1/3)	(100,339,056)	(108,782,245)
U. T. Share (2/3)	200,678,112	217,564,492
AUF Interest Income	10,034,605	12,381,690
Income and Distributions Available to U. T.	210,712,717	229,946,182
Transfers/Expenditures		
Debt Service on PUF Bonds	(132,470,830)	(60,743,924)
U. T. System Administration:		
Administration	(19,759,754)	(24,841,384)
Information Technology & Distance Education	(2,742,142)	(4,348,003)
U. T. Austin:		
Excellence	(88,727,618)	(102,500,000)
System-Wide Technology & Telecommunications	(1,060,000)	(1,060,000)
Building Revenue Bond Reimbursement	(3,385,007)	(3,391,581)
National Center for Educational Accountability	--	--
Sandia National Laboratories Project	--	--
Total Transfers	(248,145,351)	(196,884,892)
Net Surplus/(Deficit)	$ (37,432,634)	$ 33,061,290

Note: FY 2002 Budget and FY 2003-4 Projections are subject to change due to market conditions and unforeseen emergencies or opportunities.

Source: U. T. System Administration Financial Statements, Annual Operating Budget, and projections from the U. T. System Office of Finance.

PERMANENT UNIVERSITY FUND

Beneficiaries of the Fund

The Permanent University Fund (PUF) is a public endowment contributing to the support of institutions of The University of Texas System (UT System) and the Texas A&M University System (A&M System). The Constitution of 1876 established the PUF through the appropriation of land grants previously given to The University of Texas plus one million acres. Additional land grants to the PUF were completed in 1883 with the contribution of another one million acres. Today the PUF contains 2.1 million acres located in 24 counties primarily in West Texas.

Responsibility and Management of the Fund

The State Constitution vests fiduciary responsibility for the PUF with the Board of Regents of The University of Texas System. The Board has entered into a contract with a nonprofit corporation, The University of Texas Investment Management Company (UTIMCO), for UTIMCO to invest funds under the control and management of the Board. UTIMCO may not engage in any business other than investing funds designated by the Board under the contract. Specific investment decisions are handled by the investment staff as well as unaffiliated investment managers who are employed from time to time.

Investment Objectives

The primary investment objective shall be to preserve the purchasing power of PUF assets and annual distributions by earning an average annual total return after inflation of 5.5% over rolling ten-year periods of longer. The PUF's success in meeting its objectives depends upon its ability to generate high returns in periods of low inflation that will offset lower returns generated in years when the capital markets underperform the rate of inflation.

The secondary fund objective is to generate a fund return in excess of the Policy Portfolio benchmark over rolling five-year periods or longer. The Policy Portfolio benchmark will be established by UTIMCO and will be comprised of a blend of asset class indices weighted to reflect Fund asset allocation policy targets.

Market Value and Book Value of the PUF

On December 31, 2001, the market value and book value of the PUF was $7.2 billion and $7.4 billion, respectively, exclusive of land acreage.

PERMANENT UNIVERSITY FUND

Comparison Summary of Investment in Securities, at Value
August 31, 2001 and 2000
(in thousands)

	2001	2000
Equity Securities		
Domestic Common Stock	$ 1,516,996	$ 1,639,643
Index Funds	1,380 116	1,802,004
Commingled Investments	1,169,366	1,164,205
Limited Partnerships	1,020,811	1,123,614
Foreign Common Stock	227,378	316,210
Other	4,373	10,993
Total Equity Securities	5,319,040	6,056,669
Debt Securities		
U.S. Government Obligations (Direct and Guaranteed)	390,017	529,467
U.S. Government Agencies (Non-Guaranteed)	529,902	326,067
Foreign Government and Provincial Obligations (U.S. Dollar Denominated)	5,397	6,709
Foreign Government and Provincial Obligations (Non-U.S. Dollar Denominated)	109,296	67,141
Municipal and County Bonds	27,844	26,376
Corporate Bonds	504,326	529,309
Foreign Corporate Bonds	20,248	23,202
Commingled Investment	23,281	-
Commercial Paper	5,000	2,601
Other	7,771	7,771
Total Debt Securities	1,623,082	1,518,643
Preferred Stock		
Domestic Preferred Stock	13,120	12,325
Foreign Preferred Stock	1,305	4,060
Total Preferred Stock	14,425	16,385
Convertible Securities	3,709	-
Cash and Cash Equivalents		
Money Markets and Cash Held at State Treasury	887,575	1,039,885
Total Investment in Securities	$ 7,847,831	$ 8,631,582

The accompanying notes are an integral part of these financial statements.

Note 1 Organization

(A) The Permanent University Fund (PUF) is a state endowment contributing to the support of eligible institutions of The University of Texas System (U.T. System) and the Texas A&M University System (TAMU System). The PUF was established in the Texas Constitution of 1876 through the appropriation of land grants previously given to the University of Texas plus one million acres. Additional land grants to the PUF were completed in 1883 with the contribution of another one million acres. Today, the PUF contains over 2.1 million acres of land located in 24 counties primarily in West Texas (PUF Lands).

PUF Lands produce two streams of income: mineral and surface. Mineral income is contributed to the PUF and surface income is distributed to the Available University Fund (AUF). The investments of the PUF are managed by The University of Texas Investment Management Company (UTIMCO). The PUF Lands are managed by U.T. System administration.

(B) Amendments to the Texas Constitution were approved by voters in a statewide election held on November 2, 1999. The amendments were effective November 29, 1999, and allow for a) distributions to the Available University Fund (AUF) from the "total return" on PUF investments, including income return as well as capital gains (realized and unrealized) and (b) the payment of PUF expenses from PUF assets. Before the effective date of the amendments, the constitutional provisions governing the PUF prohibited the expenditure of corpus, and consequently, gains and losses on sales of securities remained in the PUF. Conversely, the Texas Constitution mandated that all dividend and interest income be distributed to the AUF on an accrual basis. The amendments directed the Board of Regents of U.T. System to establish a distribution policy that provides stable, inflation adjusted annual distributions to the AUF and preserves the real value of the PUF investments over the long term. Accordingly, distributions to the AUF in any given fiscal year are now subject to the following: (1) A minimum amount equal to the amount needed to pay debt service on PUF bonds; (2) No increase from the preceding year (except as necessary to pay debt service on PUF bonds) unless the purchasing power of PUF investments for any rolling 10-year period has been preserved; (3) A maximum amount equal to seven percent of the average net fair market value of PUF assets in any fiscal year, except as necessary to pay debt service on PUF bonds. The PUF distribution to the AUF for the year ending August 31, 2002, in the amount of $338,433,636 was paid September 4, 2001.

(C) The accompanying financial statements report the investment in securities of the PUF, including the assets, liabilities and investment income. Beginning November 29, 1999, expenses related to the PUF's investments and PUF Lands are also included in accordance with the constitutional amendments. The PUF Lands are not included in this report.

These financial statements follow the form and content of investment company financial statements and related disclosures in accordance with accounting principles generally accepted in the United States of America. The principles followed will differ from the principles applied in governmental and fund accounting. The Schedule of Changes in Cost of Investments and Investment Income has been prepared for the purpose of complying with the reporting requirement of Section 66.05 of the Texas Education Code.

The annual combined financial statements of U.T. System are prepared in accordance with Texas Comptroller of Public Accounts' Annual Financial Reporting Requirements and include information related to the PUF. The accompanying financial statements may differ in presentation from

Wyoming has just begun to inflation proof State Permanent Funds. During the 2000 legislative session, the Wyoming State Treasurer, " was instrumental in getting legislative changes passed that authorized 'returning' a portion of income to the corpus of the permanent land funds to compensate for inflation. The amount to be returned is based on the beginning balance of each permanent land fund account multiplied by a portion of that year's inflation rate (this year that portion was 5 percent of the inflation rate). The first such transfer was made at the end of FY00 and totaled $1,390,322." By statute, the inflation rate "multiplier" is increased 5% per year to reach "100% of the inflation rate" over a 20-year period. [Wyoming State Government Annual Report 2000, page 3.20]

Phone conversations with Treasurer's Office staff indicate that the recently enacted inflation protection statute is currently under review and that a new spending policy proposal will be placed before the Legislature during the 2002 session. The new plan would replace incremental increases in inflation proofing with the adoption of an "annual spending policy" authorizing "an amount equal to eight percent (8%) of the previous five (5) year average market value of the trust fund, [the permanent Wyoming mineral trust fund and the common school account within the permanent land fund] calculated from the first day of the fiscal year". The 8% of fund value payout would be decreased by .375% per year until fiscal year 2010 when it would reach and remain at "5% percent of the previous five (5) year average market value of [the trust fund or the school account]".

With either system, Wyoming will use a multi-year transition to reach the goal of full inflation proofing. The transition will give the State time to phase inflation proofing into the budget and time to hopefully increase the annual income from the mineral trust fund and the common school account. Stable annual income from both funds is necessary to maintain the current level of annual operating and capital programs.

Keeping Pace With Inflation

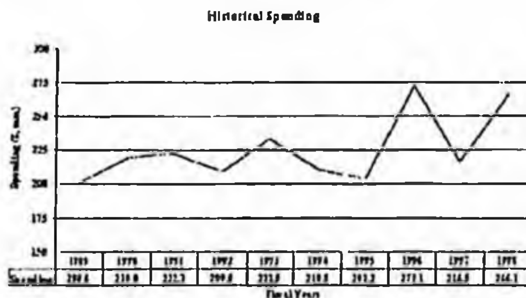
The State of Wyoming is considering changes to the investment programs implemented for the Permanent Funds that should enhance the spending and stability of spending made available from the funds and allow the Fund's assets to keep better pace with Inflation.

The State Loan and Investment Board oversees the Investment of the Permanent Funds. They follow an Investment Policy to guide the selection of managers and use of other service providers, set and monitor investment performance expectations, and to set asset mix policies. Every quarter the Board receives an Investment Performance Report from the State's Investment Consultant (RVK) to ensure the State's Investments are structured and performing per the requirements of the Investment Policy. A Select Committee on Capital and Investments regularly meets to become familiar with the State's Investments to review and consider any necessary legislation.

In past years, spending generated by investment earnings (income) on the Permanent Funds varied year to year directly with investment income. In addition, the State's Permanent Fund Investments were comprised primarily of bonds and cash investments which generally do not produce enough return in excess of spending to grow the assets to keep up with inflation.

The following exhibit illustrates the volatility in spending.

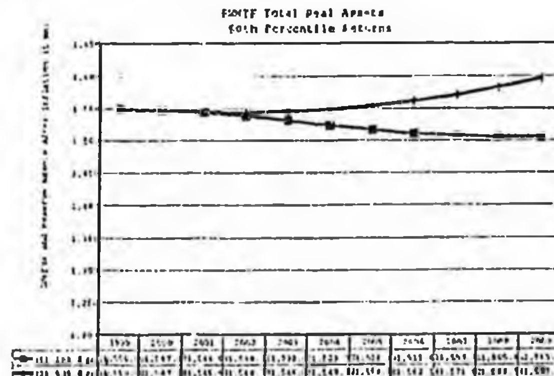
Historical Spending



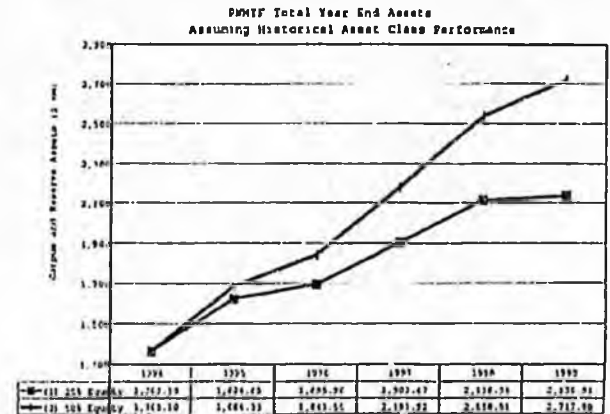
By constitutional definition funds available for spending consist of interest, income, dividend income and realized capital gains. Funds available for spending in the past have varied quite dramatically over time and have been expended instead of being used to help protect the Permanent Funds from the ravages of inflation.

In 1996 the State Land and Investment Board approved participation in stock investments for the Permanent Funds for purposes of enhancing return. The basis for doing so was grounded in the fundamental belief that stocks would outperform bonds over a long period of time. R.V. Kuhns & Associates completed an analysis for the State's Loan and Investment Board that illustrated the impact of adding stocks to the then current fixed Income investments. It was assumed that stocks would offer a 9-10% return while bonds would only offer 6-6.50%. It was decided that up to 25% of the portfolio would be placed in stocks and because of the stock market's volatility, the 25% position would be achieved gradually over approximately a two-year period.

Even with up to 25% of the assets invested in equities, RVK advised that the real value of assets would never increase with the current spending policy. The next graph illustrates the expected growth in the Permanent Fund assets after accounting for Inflation. The exhibit shows changes in assets given the current equity maximums of 25% and 50% equity. All of the scenarios assume maintaining spending at current levels plus an additional $20 million. The graph demonstrates that if the projected spending is maintained, the value of the assets will fall in real terms except if approximately 50% of the assets are placed in equities. For simplicity, the Permanent Mineral Trust Fund is represented. Similar results can also be found for the Common School Fund.



If the State had implemented these changes 5 years ago, Permanent Fund Assets would currently be much larger.



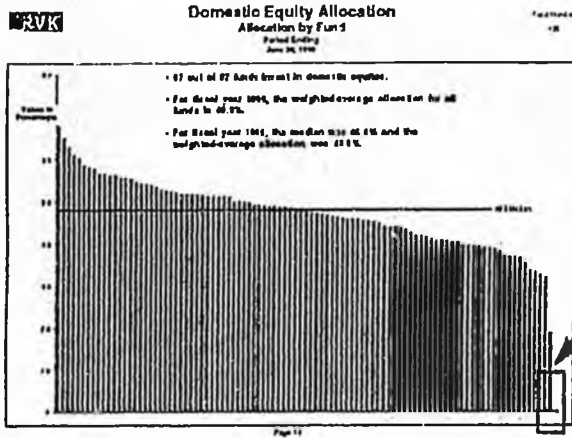
The current investment environment has produced challenges in supporting spending at current levels due to the general decrease in interest rates that has occurred in the last decade. In addition, dividend income has decreased for the average stock levels of 1.0% and 1.5%.

Facing the challenges of maintaining/increasing spending and the desire to Inflation proof the Permanent Fund assets; the State is considering making a change to increase the 25% equity to approximately 50%. Because the stock market has been historically volatile, R.V. Kuhns and Associates pointed out that in some years it may be possible that the amount planned for spending may not be earned by the portfolio.

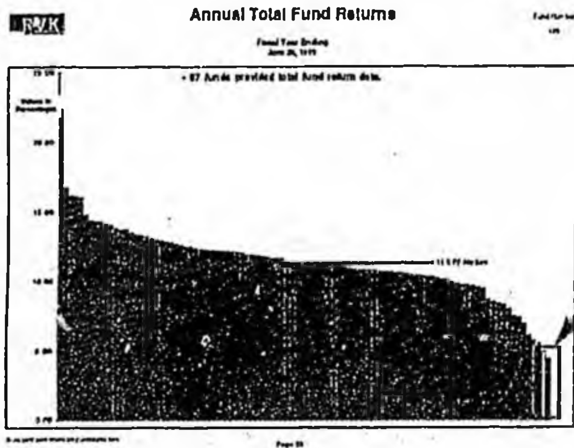
In light of this and the Constitutional requirement to disallow invasion of the corpus or spend unrealized losses, a reserve account will be established for each Permanent Fund. These reserve accounts will be used to "bank" actual returns in excess of spending policy for purposes of supplementing more lean years when investment income is insufficient to meet spending targets.

If the reserve accounts reach a size nearing a large proportion of a year's spending target, any excess above that level will revert to the principal base.

The proposed new equity level of 50% for the Permanent Funds closely resemble the mix of investments of other long-term oriented portfolios. An example within the state is the Wyoming State Retirement Fund, which has a current stock exposure of approximately 57%. In the following exhibit the State's current investment program is listed as one of the equity markets of a universe of large public funds. The State's equity allocation is represented in yellow (highlighted in blue).



The next exhibit demonstrates that having a greater equity exposure benefited the universe funds' investment returns last year. The State's annual return is represented in yellow, 2nd bar from the right indicated by the blue arrow.



In another universe comparison, the Permanent Funds current equity participation is also very small compared to a national collection of endowments and foundations. As of June 30, 1999, the average fund had an equity allocation of 63% compared to less than 10% for the State.

House Bill 21 has been drafted to allow Permanent Fund assets to grow. It is expected that the change in the investment program will enable the goals of increased spending to help address the projected shortfall in the next biennium.

With these goals in mind, it is highly recommended that the spending policy House Bill 21 be passed to assist The State of Wyoming meet its current and future fiscal needs.

THE STATE OF WYOMING

Permanent Fund Spending Policy

ANNUAL REPORT
of the Treasurer

of the
State of Wyoming

For the Period
July 1, 2000 through June 30, 2001

Cynthia M. Lummis, State Treasurer
Sharon Garland, Deputy State Treasurer
Glenn Shaffer, Chief Investment Officer

INCOME EARNINGS RECOGNIZED ON INVESTMENTS
During Fiscal Year 2001

		REGULAR INVESTMENT INCOME	CASH POOL INTEREST 07/01 - 06/30	TOTAL INVESTMENT INCOME RECEIVED
Water Development		$6,954,082.27	$325,460.14	$7,279,542.41
Worker's Compensation		17,099,416.66	5,006,026.68	$22,105,443.34
Tobacco Settlement Trust Fund		1,606,993.77	160,751.51	$1,767,745.28
Miners' Hospital Permanent Land Fund		0.00	1,313,113.78	$1,313,113.78
Public Buildings @ Cap Permanent Land Fund	*	0.00	31,399.23	$31,399.23
Fish Hatchery Permanent Land Fund		0.00	12,144.00	$12,144.00
Common School Permanent Land Fund		53,661,578.00	5,906,992.19	$59,568,570.19
Common School II		0.00	289,101.40	$289,101.40
D.D. & B. Permanent Land Fund	*	0.00	38,409.01	$38,409.01
Carey Act Permanent Land Fund	*	0.00	13,621.29	$13,621.29
Omnibus Permanent Land Fund	*	0.00	222,099.17	$222,099.17
State Hospital Permanent Land Fund	*	0.00	61,201.60	$61,201.60
State Training School Permanent Land Fund	*	0.00	14,111.42	$14,111.42
Penitentiary Permanent Land Fund	*	0.00	86,156.96	$86,156.96
Agriculture College Permanent Land Fund		0.00	312,604.29	$312,604.29
University Permanent Land Fund		0.00	785,987.70	$785,987.70
Permanent Mineral Trust Fund		91,480,232.74	9,965,840.49	$101,446,073.23
Other Funds		0.00	71,212,415.65	$71,212,415.65
		$170,802,303.44	$95,757,436.51	$266,559,739.95

Total Income - Treasurer's Investments	$266,559,739.95

Note: Realized yield for all state investments is 6.20% for FY01. This is an approximation based on income recognized versus end-of-month investments at current amortized cost, and includes investment managers but excludes WYO-STAR.

* All or a portion of the investment income from these funds ultimately goes to the General Fund and is included in the $30,046,858.48 General Fund Income.

INVESTMENT ACCOUNT BALANCES
As Of June 30, 2001

FUND/ACCOUNT NAME	CASH & RECEIVABLES	INVESTMENTS	NET DISC/PERM PURCHASED	ACCOUNT BALANCE (Corpus)
Miner's Hospital	$22,991,625.14			$22,991,625.14
Public Buildings At Capitol	75,405.45			75,405.45
Fish Hatchery	218,235.96			218,235.96
Common School	165,166,812.69 *	$760,379,527.04 ***		925,546,339.73
Common School II	5,000,000.00			5,000,000.00
D.D. & B. Asylum	671,097.20			671,097.20
Carey Act	335,130.33			335,130.33
Omnibus	1,506,753.39			1,506,753.39
State Hospital	986,726.80			986,726.80
State Training School	301,044.60			301,044.60
Penitentiary	658,754.46			658,754.46
Agricultural College	5,489,106.54			5,489,106.54
University	13,671,032.56			13,671,032.56
Subtotal-Permanent Land Fund	**217,071,725.12**	**760,379,527.04**		**977,451,252.16**
Mineral Trust Fund	282,423,892.59	1,557,268,027.92 ***	($26,195.73)	1,839,665,724.78
Tobacco Settlement Fund	973,071.85	33,995,548.79		34,968,620.64
Subtotal-All Permanent Funds	**500,468,689.56**	**2,351,643.103.75**	**(26,195.73)**	**2,852,085,597.58**
Worker's Compensation	71,107,981.29	284,262,140.15 ***		355,370,121.44
Water Development	90,599,797.02 **	65,587,938.54 ***		156,187,735.56
TOTAL	**$662,176,467.87**	**$2,701,493,182.44**	**($26,195.73)**	**$3,363,643,454.58**

* Does not include debt service deposit ($57,984,859.00).
** Includes loans receivable.
*** All or a portion of these funds are now invested by Investment Managers, rather than directly invested by the State Treasurer.

"Cash and Receivables" is actually included with, and part of, the State Agency Pool investments. This investment Pool represents the cash balance of all funds and accounts for which specific investments have not been made. The State Agency Pool investments are not summarized in this report.

PERMANENT WYOMING MINERAL TRUST FUND: CORPUS

	JUNE 30, 2000 CORPUS BALANCE	REVENUE	JUNE 30, 2001 CORPUS BALANCE
Beginning Balance	$1,629,332,131.71		
Severance Tax			
Coal		$16,499,375.51	
Stripper Oil		2,995,108.83	
Oil		16,833,866.22	
Gas		71,344,950.01	
Condensate-Gas		1,485,710.03	
Tertiary-Oil		1,173,694.43	
Wildcat-Oil		888.04	
From General Fund per 2001 Ch 139 Sec300(h)		100,000,000.00	
TOTAL REVENUE ADDED TO CORPUS		$210,333,593.07	
			$1,839,665,724.78

REAL PER CAPITA APPROPRIATIONS, FISCAL 1979-2000

Fiscal Year	July 1 Alaska Population	June Anchorage CPI-U	General Fund Operating Appropriations: Operating *(millions)*	General Fund Operating Appropriations: Per Capita Operating	General Fund Operating Appropriations: Real Per Capita Operating *(FY 1999 $)*	General Fund Total Appropriations: Total *(millions)*	General Fund Total Appropriations: Per Capita Total	General Fund Total Appropriations: Real Per Capita Total *(FY 1999 $)*	Permanent Fund Program Appropriations: PFD Program Cost *(millions)*	Permanent Fund Program Appropriations: Real Per Capita Total Plus PFD *(FY 1999 $)*
1979	413,700	73.9	803	1,942	3,844	1,083	2,617	5,179		5,179
1980	419,800	81.7	924	2,200	3,939	1,160	2,764	4,948		4,948
1981	434,300	89.0	1,314	3,024	4,970	2,587	5,957	9,789		9,789
1982	464,300	95.6	1,661	3,576	5,472	3,445	7,420	11,353		11,353
1983	499,100	97.8	1,829	3,664	5,479	2,848	5,706	8,533	219	9,189
1984	524,000	102.7	1,868	3,565	5,076	3,087	5,891	8,390	175	8,865
1985	543,900	104.7	2,005	3,686	5,149	3,662	6,733	9,405	217	9,963
1986	550,700	108.3	1,998	3,628	4,900	2,832	5,142	6,944	303	7,687
1987	541,300	108.3	1,715	3,169	4,280	2,398	4,430	5,982	391	6,958
1988	535,000	108.4	1,789	3,344	4,512	2,255	4,216	5,688	424	6,757
1989	538,900	110.9	1,975	3,664	4,832	2,379	4,414	5,821	460	6,947
1990	553,171	116.9	2,009	3,632	4,544	2,441	4,413	5,522	482	6,612
1991	569,063	123.3	2,167	3,809	4,518	2,555	4,490	5,326	491	6,349
1992	586,684	127.3	2,195	3,742	4,299	2,772	4,724	5,428	488	6,383
1993	596,808	131.5	2,197	3,682	4,095	2,705	4,532	5,041	525	6,019
1994	600,765	134.3	2,248	3,742	4,075	3,201	5,328	5,803	558	6,814
1995	601,646	138.2	2,242	3,726	3,943	2,470	4,106	4,345	565	5,339
1996	604,966	141.8	2,192	3,623	3,737	2,419	3,999	4,125	643	5,221
1997	609,311	144.1	2,206	3,621	3,675	2,432	3,991	4,051	749	5,299
1998	621,400	146.3	2,169	3,491	3,491	2,355	3,790	3,790	893	5,227
1999	633,729	148.9	2,172	3,427	3,367	2,324	3,667	3,602	999	5,151
2000	646,302	151.6	2,200	3,404	3,285	2,304	3,565	3,440	1,078	5,049

Population estimates from Department of Labor as of July 1 (beginning of each fiscal year).
Population for FY 99 and FY 2000 estimnated by OMB.
Inflation assumptions for FY 99 and FY 2000 taken from DOR Revenue Sources book (reference case).
FY 2000 spending based on Governor's proposed budget and March Permanent Fund projections.
Total Appropriations do not include special PF appropriations.

OMB/BP

~~5/1/01 16:07~~

Brad Pierce

LAWS OF ALASKA

1980

Source SCS CSHB 509(Rules)

Chapter No. 35

AN ACT

Making a special appropriation to the Alaska permanent fund; and providing for an effective date.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

THE ACT FOLLOWS ON PAGE 1, LINE 9

Approved by the Governor: May 21, 1980
Actual Effective Date: July 1, 1980

AN ACT

Making a special appropriation to the Alaska permanent fund; and providing for an effective date.

* Section 1. The sum of $900,000,000 is appropriated from the general fund to the Alaska permanent fund (art. IX, sec. 15, Constitution of the State of Alaska).

* Sec. 2. Beginning July 1, 1980, the commissioner of revenue shall make monthly deposits to the Alaska permanent fund of the appropriation made by this Act. A monthly deposit to the Alaska permanent fund shall be in an amount determined by the commissioner of revenue to be in excess of the general fund revenues necessary to finance state government operation for the month in which the deposit is made.

* Sec. 3. This Act takes effect July 1, 1980.

LAWS OF ALASKA

1981

Source

FCCSHB 1

Chapter No.

61

AN ACT

Making a special appropriation to the Alaska permanent fund, and making appropriations to the Department of Administration and the Department of Community and Regional Affairs for aid to municipalities and unincorporated communities; and providing for an effective date.

---

* Section 1. The sum of $1,800,000,000 is appropriated from the general fund to the Alaska permanent fund (art. IX, sec. 15, Constitution of the State of Alaska, AS 37.13.010).

* Sec. 2. Beginning July 1, 1981, the commissioner of revenue shall make monthly deposits to the Alaska permanent fund of the appropriation made by sec. 1 of this Act. A monthly deposit to the Alaska permanent fund shall be in an amount determined by the commissioner of revenue to be in excess of the general fund revenues necessary to finance state government operation for the month in which the deposit is made.

* Sec. 3. The sum of $380,000,000 is appropriated from the general fund to the Department of Administration for payment of entitlements to qualified municipalities for the fiscal year ending June 30, 1982, in accordance with legislation authorizing the payments.

* Sec. 4. The sum of $24,987,000 is appropriated from the general fund to the Department of Community and Regional Affairs for payment of entitlements to unincorporated communities in the unorganized borough for the fiscal year ending June 30, 1982, in accordance with legislation authorizing

the payments.

* Sec. 5. The sum of $73,800 is appropriated from the general fund to the Department of Administration for costs of administering the entitlements for which an appropriation is made by sec. 3 of this Act.

* Sec. 6. The sum of $252,800 is appropriated from the general fund to the Department of Community and Regional Affairs for costs of administering the entitlements for which an appropriation is made by sec. 4 of this Act.

* Sec. 7. The appropriation made by sec. 1 of this Act is not a one-year appropriation and it does not lapse under AS 37.25.010.

* Sec. 8. This Act takes effect on the effective date of a version of Senate Bill No. 168 entitled "An Act relating to state assistance for municipalities and unincorporated communities; and providing for an effective date."

Range of total 5% payout

	FY03	FY04	FY05	FY06	FY07	FY08
Top Quartile	1,343.0	1,397.0	1,439.0	1,496.0	1,571.0	1,668.0
Median	1,313.0	1,330.0	1,323.0	1,368.0	1,420.0	1,464.0
Bottom Quartile	1,260.0	1,007.0	984.0	1,031.0	1,033.0	1,020.0

Range of dividend distribution (under current law)

	FY03	FY04	FY05	FY06	FY07	FY08
Top Quartile	930.0	945.0	953.0	1,086.0	1,270.0	1,341.0
Median	853.0	779.0	732.0	807.0	929.0	1,039.0
Bottom Quartile	778.0	620.0	509.0	551.0	570.0	602.0

Range of residual income

	FY03	FY04	FY05	FY06	FY07	FY08
Top Quartile	432.0	497.0	545.0	519.0	452.0	417.0
Median	391.0	418.0	438.0	390.0	318.0	272.0
Bottom Quartile	331.0	255.0	265.0	203.0	111.0	23.0

Range of dividend distribution (under POMV version at 40%)

	FY03	FY04	FY05	FY06	FY07	FY08
Top Quartile	537.2	558.8	575.6	598.4	628.4	667.2
Median	525.2	532.0	529.2	547.2	568.0	585.6
Bottom Quartile	504.0	402.8	393.6	412.4	413.2	408.0

Range of Residual Income

	FY03	FY04	FY05	FY06	FY07	FY08
Top Quartile	805.8	838.2	863.4	897.6	942.6	1,000.8
Median	787.8	798.0	793.8	820.8	852.0	878.4
Bottom Quartile	756.0	604.2	590.4	618.6	619.8	612.0

Range of dividend distribution (under POMV version at 80%)

	FY03	FY04	FY05	FY06	FY07	FY08
Top Quartile	1,074.4	1,117.6	1,151.2	1,196.8	1,256.8	1,334.4
Median	1,050.4	1,064.0	1,058.4	1,094.4	1,136.0	1,171.2
Bottom Quartile	1,008.0	805.6	787.2	824.8	826.4	816.0

Range of Residual Income

	FY03	FY04	FY05	FY06	FY07	FY08
Top Quartile	268.6	279.4	287.8	299.2	314.2	333.6
Median	262.6	266.0	264.6	273.6	284.0	292.8
Bottom Quartile	252.0	201.4	196.8	206.2	206.6	204.0

Range of **total 5% payout** (in millions)

	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08
Top quartile	$1,343	$1,397	$1,439	$1,496	$1,571	$1,668
Median	$1,313	$1,330	$1,323	$1,368	$1,420	$1,464
Bottom quartile	$1,260	$1,007	$984	$1,031	$1,033	$1,020

Range of **dividend distribution** (in millions)

	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08
Top quartile	$930	$945	$953	$1,086	$1,270	$1,341
Median	$853	$779	$732	$807	$929	$1,039
Bottom quartile	$778	$620	$509	$551	$570	$602

Range of **residual income** (in millions)

	FY 03	FY 04	FY 05	FY 06	FY 07	FY 08
Top quartile	$432	$497	$545	$519	$452	$417
Median	$391	$418	$438	$390	$318	$272
Bottom quartile	$331	$255	$265	$203	$111	$23

SJR 13 Projections

Submitted to Senate State Affairs Committee 2/21/02

Assumptions

- Legislative passage and public approval of SJR 13
- Distribution of full 5% of total Fund market value
- Dividend: statutory formula
- Inflation-proofing: statutory formula
- Current APFC asset allocation
- Oil revenue: DOR Fall 2001 forecast
- Actual Fund data through December 2001
- 2002 Callan Associates Inc. capital market assumptions

MEMORANDUM State of Alaska

TO: Bruce M. Botelho
Deputy Commissioner, Taxation
Department of Revenue

DATE: November 8, 1984

FILE NO: 366-605-84

TELEPHONE NO: 465-3600

FROM: Norman C. Gorsuch
Attorney General

SUBJECT: Permanent fund interest income

By: Virginia B. Ragle
Assistant Attorney General
Governmental Affairs-Juneau

You have requested an opinion concerning interest earned on funds in or owed to the permanent fund dividend account. This memorandum confirms oral advice given on September 25, 1984. Your questions and our advice are as follows:

1. How should the Department of Revenue handle interest earned on funds transferred to the dividend fund by the permanent fund? The interest should be deposited in the general fund.

AS 43.23.045 establishes the dividend fund, and provides that "each year the commissioner shall transfer to the dividend fund 50 percent of the income of the Alaska permanent fund earned during the fiscal year ending on June 30 of the current year and available for distribution." AS 43.23.045(b). The commissioner is required to invest money in the fund in the same manner as surplus funds of the state are invested under AS 37.-10.070. AS 43.23.045(a). The commissioner of revenue is required to determine the amount of the dividend each year by:

> (1) determining the amount of income of the Alaska permanent fund transferred to the dividend fund under AS 34.23.045(b) during the current year;
>
> (2) determining the number of individuals eligible to receive a dividend payment for the current year; and
>
> (3) dividing the amount determined in (1) of this section by the amount determined in (2) of this section.

AS 43.23.025. No provision is made for inclusion in the dividend of interest earned on money transferred to the dividend fund. No appropriation of that interest was made in any of the appropriations for dividend payments in 1983 or in 1984. Sec. 32, Ch.

107, SLA 1983, p. 14; ch. 44, SLA 1984; secs. 14, 15, Ch. 122, SLA 1984. The interest is unappropriated state revenue which should be deposited by the Department of Revenue in the state treasury and credited to the general fund. AS 37.10.060.

2. Should interest earned on money transferred to the dividend account in 1982 and before be paid with future dividends, retained in the dividend account, lapse into the general fund, or be provided for in some other way? The interest should be credited to the general fund.

A review of the history of legislation and litigation concerning permanent fund dividends leads to the conclusion that interest earned on money transferred to the dividend account during and before 1982 should be credited to the general fund. In 1980, the legislature enacted AS 43.23, establishing a permanent fund dividend program under which the amount of the dividend was based on accumulated years of residency in the state after January 1, 1959. AS 43.23.050 established the dividend fund into which 50 percent of the available earnings of the permanent fund were to be transferred annually. That section provided that "[m]oney in the dividend fund and any interest earned from investment of money in the dividend fund shall be used to pay permanent fund dividends ...." AS 43.23.050(a)(emphasis added). No dividend distribution ever occurred under the terms of the program as enacted in 1980. The constitutionality of the provisions under which dividends accrued based on years of residency before enactment of the statute was immediately challenged in Zobel v. Williams, 457 U.S. 55 (1982), rev'g 619 P.2d 448 (Alaska 1980), and the distribution of dividends was held in abeyance pending the resolution of the Zobels' appeal to the U.S. Supreme Court from the Alaska Supreme Court's ruling that the provisions were constitutional.

In 1982, the governor introduced legislation that provided several options for future handling of the dividend program, depending on the Court's resolution of the constitutional issue. The Supreme Court's decision indicated that AS 43.23.010 was invalid because determination of the amount of the dividend by accumulated years of residency was unconstitutional, regardless of whether the years were accumulated before or after 1979. This triggered sec. 1 of ch. 102, SLA 1982, which established a dividend program without distinctions based on length of residency in the state, and sec. 22 of ch. 102, SLA 1982, which repealed AS 43.23.010 -- 43.23.100. Sec. 28, Ch. 102, SLA 1982.

Under the new dividend program, the dividend fund was established by AS 43.23.045. The language of that section is

similar to the repealed provisions of AS 43.23.050, but no provision is made for use of interest earned by the fund for payment of dividends. Although early drafts of AS 43.23.045 included the language "interest earned from investment of money in the dividend fund shall be used to pay permanent fund dividends ...," that language was deleted before SB 842 was introduced. As the bill made its way through the legislature, the provision appeared in one committee substitute (CSSB 842(Fin), Apr. 12, 1982), but it was deleted from the final version. The bill file for SB 842 (our file 388-130-82) reveals that, during the drafting stage, questions were raised about the propriety of a statutory provision dedicating interest earned on investment of the fund to payment of dividends. Such a provision could violate the prohibition against dedication of funds contained in article IX, section 7 of the Alaska Constitution. 1/ The repeal of the provisions in AS 43.23.050 that dedicated interest earned by the dividend fund to payment of dividends removed a possible avenue of constitutional attack against a program that had already been held up by litigation on constitutional grounds for over two years.

Once the legislature repealed AS 43.23.050 and replaced it with provisions for a dividend account that did not include the dedication of interest earned on investment of the fund for payment of dividends, any authority to use the accrued interest for that purpose ended. 2/ The interest became general, unappropriated state revenue which should be accounted for in the general fund.

3. How should interest on the amount underpaid to the dividend fund for the 1983 dividend be handled? The interest should remain in the undistributed income account.

The amount available for payment of the 1983 dividend was underestimated. An additional $19,855,000 should have been included with the $179,020,000 that was appropriated by the legislature for deposit in the dividend account for payment of the

---

1/ Application of Alaska Constitution article IX, section 7 to dedications of interest generated by specific funds was addressed later in 1982 in a formal opinion of the attorney general. 1982 Op. Att'y Gen. No. 13 at 14-18 (Nov. 30) (attached).

2/ Our advice does not conflict with the general savings clause of AS 01.10.100, since no vested right was extinguished by the repeal. See Bidwell v. Schelle, 335 P.2d 584 (Alaska 1960); see generally C. Sands, Sutherland Statutory Construction ch. 23 (4th ed. 1973).

1983 dividends. Sec. 32, ch. 107, SLA 1983. In 1984, the legislature dealt with the $19,855,000 by appropriating $11,584,000 for 1983 dividends for late filers with an additional $284,800 for administrative costs (secs. 2 and 3, ch. 44, SLA 1984) and $7,985,700 for inclusion in the 1984 dividend (sec. 15, ch. 122, SLA 1984). Until it was appropriated, the $19,855,000 remained in the permanent fund's undistributed income account earning interest, and it was noted as a contingent liability in the Alaska Permanent Fund Corporation's 1983 annual report and financial statements. That interest income should remain in the undistributed income account in accordance with AS 37.13.145.

We note that this year's appropriation of permanent fund income to the dividend account is stated in general terms as follows:

> The income of the Alaska permanent fund allocated annually to pay permanent fund dividends as provided in AS 43.23.045(b) is appropriated to the dividend fund (AS 43.23.045(a)) for the payment of the 1984 permanent fund dividend and administrative costs.

Sec. 14, ch. 122, SLA 1984. The phrasing of this appropriation in general terms so that the amount is ascertainable by a simple mathematic formula will eliminate the confusion caused by the appropriation of a specific but incorrect amount in 1983.

Neither the statute nor the appropriation makes reference to an exact date upon which the commissioner of revenue must transfer the money from the permanent fund to the dividend account under AS 43.23.045(b). The department may adopt regulations under the general regulatory authority provided by AS 44.-17.030 to effectuate the transfer.

VBR/pjg

Enc.

cc: Peter Bushr , Comptroller
Alaska Permanent Fund Corporation

1982

"A Chairman's Retrospect"

In looking back at my second and last year as Chairman of the Trustees, I am pleased to report that nearly all we hoped for was done, and more than many thought possible.

After more than a year of seminars and work sessions, your Trustees and the Special Liaison Committee of the Legislature, chaired by Senator Arliss Sturgulewski, were able to reach substantial agreement on recommendations for limited changes. Most of these emerged in the Permanent Fund Act of 1982.

By this Act, a majority of the Trustees (four of six) will be appointed from the public and for terms of four years instead of three – to reduce the effects of a change in state administration. Our investment list was modernized so as to be more diverse and to better perform against inflation by adding pooled income property investments, other commercial real estate, common stocks, and deposits of U.S. dollars held off-shore. Most importantly, the Permanent Fund is directed to return to principal that portion of income, after expenses and the payment of dividends, needed to protect the buying power of the Fund's principal and income. This straightforward action to meet inflation gives us a permanent fund in the truest sense. This action has not been fully taken by some famous private investment funds and has been done less often still by public bodies.

With the approval of two budget measures, the Permanent Fund has won the means to have staff and managers of its own choosing. This is necessary because the Trustees are held responsible for all that is done in their name. However, the standard controls over the Fund's activities will continue. The Fund is gaining a needed independence from politics as usual while giving a proper accounting to elected officials.

In this latter regard I very much hope that something like the Special Liaison Committee for the Permanent Fund will always have a place at Trustee meetings. I hope, too, that the present good faith between the two groups will be preserved.

The success of the past year is owed to the many Alaskans who felt a personal involvement in fixing the goals of the Fund and gave their support. A continuing involvement is vital because the proper management and direction of the Fund is an on-going affair. The basic concept of the Fund, like liberty, must ever be vigilantly defended and guarded. It will perform to the best interests of all Alaskans to the extent that those responsible take the necessary time and interest to make it work.

I deeply appreciate the opportunity of having served as a Trustee during this formative period. My personal concern for the Fund will remain down the years.

Elmer Rasmuson
Chairman
Board of Trustees

Statements of changes in principal and earnings reserve

Years ended June 30,	2001	2000
Principal		
Balance, beginning of year	$ 20,014,648,000	19,000,909,000
Dedicated state revenues	339,315,000	310,488,000
State transfer from earnings reserve	—	250,000,000
Inflation-proofing	685,929,000	422,920,000
Settlement earnings	7,687,000	30,331,000
Balance, end of year	**$ 21,047,579,000**	20,014,648,000
Earnings reserve		
Balance, beginning of year	$ 6,501,263,000	6,131,203,000
Appropriation to other state agencies	(3,843,000)	(3,014,000)
State transfer from earnings reserve	—	(250,000,000)
Inflation-proofing	(685,929,000)	(422,920,000)
Settlement earnings	(7,687,000)	(30,331,000)
Dividends	(1,112,601,000)	(1,172,451,000)
Net income (loss)	(923,892,000)	2,248,776,000
Balance, end of year	**$ 3,767,311,000**	6,501,263,000
Total		
Balance, beginning of year	$ 26,515,911,000	25,132,112,000
Dedicated state revenues	339,315,000	310,488,000
Appropriation to other state agencies	(3,843,000)	(3,014,000)
Dividends	(1,112,601,000)	(1,172,451,000)
Net income (loss)	(923,892,000)	2,248,776,000
Balance, end of year	**$ 24,814,890,000**	26,515,911,000
Earnings reserve components		
Unrealized earnings reserve	$ 1,383,576,000	3,528,804,000
Remaining earnings reserve	2,383,735,000	2,972,459,000
Total earnings reserve	**$ 3,767,311,000**	6,501,263,000

The accompanying notes are an integral part of the financial statements

16th Legislature Considered 59 Permanent Fund Bills

During the 16th Legislature, there were a total of 59 bills and resolutions introduced dealing with the Permanent Fund. In the Second Session, six of these bills and one resolution passed both the House of Representatives and the Senate and went to Governor Cowper for his signature.

HB 500 (Chapter 209, SLA 1990): This is the State's fiscal 1991 budget. It included:

$487,000,000 appropriated from the income of the Permanent Fund to the dividend fund for the payment of 1991 dividends and administrative and associated costs.

$429,000,000 appropriated from the fiscal 1990 income of the Permanent Fund to principal to offset the effect of inflation.

$25,000,000 appropriated from the earnings reserve account of the Permanent Fund to principal to offset the effect of inflation. This was the first year in which current-year income — after the payment of dividends — was insufficient to fully offset the effect of inflation.

$267,000,000 of dedicated oil revenues appropriated to the principal of the Permanent Fund.

Note that this year, for the first time, both inflation-proofing and dedicated oil revenues were appropriated in the budget bill; in prior years, they have been appropriated by simple force of statute.

Also appropriated to Permanent Fund principal, as a contingency, is any interest earned during fiscal year 1991 on revenue from the sources set out in AS 37.13.010 while the revenue is held in trust, escrow, or otherwise before receipt of the revenue by the state.

$150,000,000 appropriated from the General Fund to the principal of the Permanent Fund (vetoed by the governor).

$3,500,000 appropriated from the earnings reserve account of the Permanent Fund to the Corporation to pay to the Department of Law 25% of the Department's legal costs relating to the North Slope royalty case (State v. Amerada Hess, et al.) and the Dinkum Sands case (United States v. Alaska).

$14,414,800 appropriated from Corporation receipts to the Alaska Permanent Fund Corporation for its fiscal 1991 expenses.

$3,816,00 from the dividend fund to the Department of Revenue to administer the dividend program.

$12,217,300 from the dividend fund to the Department of Health & Social Services for Permanent Fund dividend hold-harmless costs.

$736,600 from the dividend fund to the Department of Public Safety for restitution for crime victims.

$763,400 from the dividend fund to the Department of Corrections for gate money to incarcerated felons.

The legislature passed five other bills which addressed the Permanent Fund dividend program:

SB 102 (Chapter 1, SLA 1990): This bill removed the $10 Winter Olympics check-off from the Permanent Fund dividend application.

HB 380 (Chapter 68, SLA 1990): This bill allows the parent, guardian, or other authorized representative of a disabled individual to apply for prior year permanent fund dividends not received by the disabled individual because no application was submitted on behalf of the individual.

HB 511 (Chapter 197, SLA 1990): This bill relates to the $1.5 million appropriation from the dividend fund made in 1989 to the Departments of Corrections and Public Safety. It provides that if the felons win their lawsuit challenging the constitutionality of the 1988 law which denied them Permanent Fund dividends, then $1.5 million is appropriated from the General Fund to reimburse the dividend fund. If the felons lose their lawsuit, the $1.5 million currently set aside in the dividend fund pending settlement of the lawsuit will be added to next year's dividends.

HB 563 (Chapter 198, SLA 1990): This bill:

1) amends the dividend statutes to require that the PFD check stubs disclose not only the amount by which each dividend has been reduced due to each

Senator Gene Therriault, Chairman
Senate State Affairs Committee
Capitol Building, Room 121
Juneau, Alaska 99801

February 21, 2002

Chairman and Members of Senate State Affairs,

My name is Jay Hogan, my wife and I live at 10741 Horizon Drive in Juneau Alaska and I am here today representing no one other than myself. For the record let me stipulate that at an earlier time, it would never have occurred to me to appear before any committee of the Alaska Legislature in opposition to a measure introduced by the Legislative Budget and Audit Committee!

In January 1970, Governor Keith Miller requested introduction of three measures to establish a "resources permanent fund". In a transmittal letter, Governor Miller stated, the "objective is to assure maximum long-term growth [of the fund] while providing an annually increasing source of income to the general fund." The two bills in the package passed the Senate but failed to move in the House. The third, a Constitutional amendment, made five percent of permanent fund market value annually available for "appropriation for general purposes"; this resolution failed to pass the Senate.

In March 1975, prompted by public concern over the disappearance of the $900 million North Slope lease bonus, 36 Members of the House co-sponsored HB 324 establishing the "Alaska mineral lease bonus permanent fund". Fund principal was to be "invested in perpetuity"; fund income could be, "appropriated to provide funding for operating or capital expenditures for loan or grant programs" eligible for funding under the law. The Legislature passed this statutory permanent fund only to have it vetoed by Governor Jay Hammond as an "unconstitutional dedication of revenue".

In January of 1976, Governor Hammond submitted a sponsor substitute for HJR 39, his 1975 end-of-Session "fix" for the dedicated revenue problem. The substitute was a Constitutional amendment establishing the Alaska Permanent Fund. In his transmittal letter Governor Hammond emphasized, "The income of the fund would be deposited into the general fund without any permanent fund restrictions." The Resolution as introduced read; "All income from the permanent fund shall be deposited in the general fund." House Finance added, "unless otherwise provided by law" completing the sentence as it stands today, unchanged from 1976.

Mike Bradner, Speaker of the House in 1975-76, wrote in the March 1988 Juneau Report:

"The constitutional action creating the fund was also "not about" a lot of things. It was not about dividends, investment policy, unreserved income, and in fact, did not even attempt to tell Alaskans "when" and under "what" circumstances the proceeds of the fund might one day accrue to future Alaskans.

Discussion over the Permanent Fund often takes on a biblical connotation. But amidst all this rhetoric, the simple foundation of the Fund is embraced in the two

previously stated commandments – *to preserve a portion of current oil income, and to preserve it as a future "trust"*.

All the rest of the development of the Alaska Permanent Fund is essentially left to statutory construction. Future Legislatures through general law, as opposed to constitutional law, were left to fill in the details of the Fund. These details included creation of the Alaska Permanent Fund Corporation, the rules of "inflation-proofing" (injecting some Fund earnings into the principal to account for inflation), creation of the dividend program, investment policy, and so on. These details were to be created, and to be changed as need be, by future generations of lawmakers.

What the lawmakers of 1976, in creating the Fund, were trying to avoid was "playing god". They did not want to try to foretell the future – to dictate future policy. As much as possible, commensurate with the basic task of creating the fund, the architects of the Fund did not want to tie the hands of future generations of lawmakers."

On average, SJR 13 would reduce by one third the amount of Permanent Fund income annually available for appropriation by the Alaska Legislature. Currently the Legislature appropriates that "third" as shown in the following appropriation from Chapter 60, SLA 2001:

"Sec. 8. ALASKA PERMANENT FUND CORPORATION. (a) . . .

(b) After money is transferred to the dividend fund under (a) of this section, the amount calculated under AS 37.13.145 to offset the effect of inflation on the principal of the Alaska permanent fund is appropriated from the earnings reserve account (AS 37.13.145) to the principal of the Alaska permanent fund.

The 2001 Permanent Fund Corporation Annual Report gives credit to the long running success of this method of appropriation for inflation proofing. On close inspection, the caption for the inflation graphic on page 17 reads, "Inflation has eroded the purchasing power of $1.00 in 1982 to 48 cents in 2001 . . .— but inflation-proofing has maintained the Fund's real value".

Unlike most other state permanent funds, the Alaska Permanent Fund has been inflation proofed for the past 20 Years. Largely "under reported" throughout the 26-year history of the Alaska Permanent Fund is the part played by the Alaska Legislature in increasing Fund principal. Relegated to the "Notes to Financial Statements" on page 38 of the Permanent Fund Corporation's Annual Report 2001, the principal balance of the Fund at June 30, 2001, was listed by source:

Dedicated State revenues	$7,070,741,000
Appropriations from the State	6,885,906,000
Inflation-proofing	6,929,350,000
Settlement earnings	161,582,000
Total Principal	$21,047,579,000

The Constitutional provision dedicating 25% of certain mineral revenues to the Permanent Fund produced a $7.1 billion Fund principal as of June 30, 2001. But, with the numerous special Legislative appropriations and 12 years of Legislative appropriations

for inflation proofing, the Legislature has nearly tripled Fund principal over that funded by the Constitutional dedication of revenue.

The Permanent Fund Corporation Board of Trustees proposal contained in SJR 13 and HJR 15 would repeal existing Legislative authority to appropriate Permanent Fund income established 25 years ago. With the State's Constitutional Budget Reserve Fund approaching "empty" and increased national/state concern with internal security matters, does this Legislature really want to repeal the existing authority to use all Permanent Fund earnings for what ever purpose this, or any future Legislature, determines to be the best public use at the time?

If the existing flexibility to appropriate earnings is to be changed, I would suggest that discussion and resolution of the part Permanent Fund earnings/payout are to play in the annual State budget should run concurrently with deliberation of the Trustees' proposed amendment to imbed inflation proofing of the Permanent Fund in the Constitution. If the 2002 Legislative Session is not the time for deliberation and resolution of the statutory use of all Permanent Fund earnings/payout, consideration of the Trustee's amendment should be postponed to a time when all Permanent Fund earnings/payout can be allocated by statute. The existing statutory system of annual appropriations for, "the amount calculated under AS 37.13.145 to offset the effect of inflation on the principal of the Alaska permanent fund" has done the job well, and can continue to do so.

Thank you very much for providing this opportunity to appear before the Senate State Affairs Committee.

Jay Hogan
PO Box 21073
Juneau, Alaska 99802

THE ALASKA PERMANENT FUND – PERMANENT FOR WHAT PURPOSE?

During the 1976 Legislative Session, four Alaska daily newspapers editorialized on the proposed fund, some more than once.

Anchorage Daily News – Place a check on state spending . . . offer loans to businessmen, builders and fishermen . . . "Most importantly, the permanent fund addresses that day when the oil runs out."

Fairbanks Daily News-Miner – "What could be more exciting than the prospect of true economic stability for Alaska?" . . . much like a savings account . . . the interest derived would be used to sustain certain state programs that would benefit all Alaskans. . fund a viable agricultural industry . . . loans to Alaskans to build their own homes . . . boat loans to revitalize a depleted fishing industry . . . and avoid careless state spending.

Southeast Alaska Empire – "What happens if, when Prudhoe runs dry, there isn't another massive oil strike on state land?". . . if there is no contingency fund, state government will lead Alaska back to the boom and bust economy we've been in since 1867.

Anchorage Times – There are reasons aplenty to set aside some oil income rather than "spend them in an orgy of pork barrel raids on the treasury". . . "However, sealing up a share of the revenue in a bank account . . . has drawbacks". . . others suggest reducing state debt, reducing or eliminating the state income tax, or revenue sharing to reduce or eliminate local property taxes.

The Alaska State Chamber of Commerce prepared the 1976 Official Election Pamphlet statement in favor of the Permanent Fund proposition. It read in part:

"Just as a wise and prudent family sets aside money in a savings account for the future, so should Alaska's state government set aside a rainy day fund to benefit this and future generations of Alaskans. . . .

Today, as the result of anticipated oil and gas revenues, Alaska stands on the brink of unprecedented prosperity. No one, but no one, argues that these non-renewable resources will last but for a few decades. Similarly, no one should fail to recognize that in those years ahead the cost of state government will continue to spiral upwards. Now is the time to ask ourselves the question: 'when the oil and gas is depleted, where will the funds to feed our giant government come from?' The answer is: the 'Permanent Fund'."

October 22, 1976, an Anchorage Daily News article summed up diverse opinion:

"Nobody knows exactly how the fund will be used; that decision will be made by legislative action in the future. Although the fund is protected against certain kinds of usage, its precise organization and management have been left flexible by designers. . . .

There have been many proposals for possible fund uses. They range from paying direct dividends to Alaskans to using the money to underwrite such vast projects as hydroelectric dams. But, whatever use it is put to, the permanent fund money would have to be a money-maker. Politicians could spend the interest, but never the principle."

Two days later, in a lengthy article the Anchorage Times detailed diversity:

"Those promoting the permanent fund, including Gov. Jay Hammond, see it as a way of providing development capital to diversify the state's economy, strengthen

renewable resources – such as fisheries, timber and tourism – and make possible large projects such as dams, which couldn't otherwise be financed.

They also view it as a savings account, to keep some of the state's income from oil and gas out of the general fund so it can't be spent. They point to the $900 million the state received from the 1969 Prudhoe Bay lease sale, which now is nearly all spent.

Others see the fund as a source of loans for community development, such as home mortgages, small business loans; for power development, ports, utilities, roads, or health, education or social needs, such as day care centers.

Malone [Rep. Hugh Malone, D-Kenai] said the fund could go for all three of those uses. The legislature would decide what per cent of the fund would go to each use. .

Other options include reinvesting the earnings in the permanent fund, pledging the earnings as security for state and local bonds, additional revenue sharing, letting earnings flow into the general fund, lower state income taxes, or return dividends as tax credits."

Thus informed, Alaskans went to the polls and voted almost 2 to 1 for the constitutional amendment establishing the Alaska Permanent Fund.

LEGAL SERVICES

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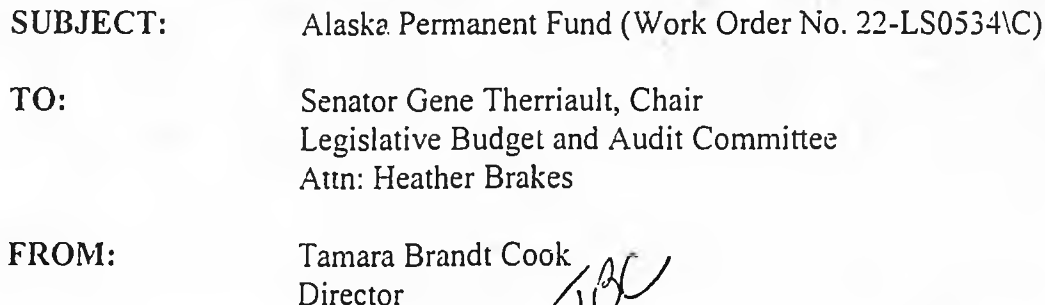
<u>MEMORANDUM</u> February 12, 2001



SUBJECT: Alaska Permanent Fund (Work Order No. 22-LS0534\C)

TO: Senator Gene Therriault, Chair
Legislative Budget and Audit Committee
Attn: Heather Brakes

FROM: Tamara Brandt Cook
Director

You ask for my observations on this draft resolution proposing an amendment to the state constitution dealing with the permanent fund. The title does not reflect the contents of the resolution and, because a joint resolution is supposed to be treated like a bill under the Uniform Rules, normally the title is drafted to reflect the contents. However, because Art. II, sec. 13 only applies to bills, the title defect in this situation is only a procedural and not a constitutional problem. Likewise, a new subsection is normally added as a new bill section and the material is not underlined. The way subsection (b) has been added does not conform to the Legislative Drafting Manual, but will not be fatal to the validity of the resolution if it is adopted by the legislature and approved by the voters.

Substantively, I observe that it makes little sense to retain the distinction between principal and income in subsection (a), since appropriations allowed under subsection (b) are based on averaged market value of the fund and no longer on income generated by the fund. Furthermore, by retaining the distinction between principal and interest, the provision that addresses permanent fund investments applies only to investments of principal. There is no constitutional requirement that interest retained in the fund also "be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments." This seems a bit puzzling, but the legislature can address the investment of interest by law, so the approach probably does not create any great problem.

Subsection (b) is not as clear as might be desirable, but I think it can be applied. However, from my conversation with Mr. Jim Kelly, I gather that it is expected that only income of the fund will be available for appropriation. If this is the intended result, it has not been achieved. That is to say, if fund income is low for a period of years, it will be mathematically possible for an appropriation to be made based on the average of the market values formula that includes some fund principal. Perhaps, this possibility is so remote as not to be a serious problem.

I think it will be awkward for the constitutional amendment to spring into effect in the middle of a fiscal year and suggest that a July 1, 2003 effective date be added. Otherwise, for part of the year the legislature will be able to appropriate fund income, while at the end of the same year it will have access to an amount based on market value of the fund. Also, I am not sure about the status of the balance in the earnings reserve account on the day the amendment takes effect. I assume the entire balance on that day is available for appropriation under the constitutional language as it read prior to the amendment.

TBC:lmb
01-044.lmb

Wyoming has just begun to inflation proof State Permanent Funds. During the 2000 legislative session, the Wyoming State Treasurer, " was instrumental in getting legislative changes passed that authorized 'returning' a portion of income to the corpus of the permanent land funds to compensate for inflation. The amount to be returned is based on the beginning balance of each permanent land fund account multiplied by a portion of that year's inflation rate (this year that portion was 5 percent of the inflation rate). The first such transfer was made at the end of FY00 and totaled $1,390,322." By statute, the inflation rate "multiplier" is increased 5% per year to reach "100% of the inflation rate" over a 20-year period. [Wyoming State Government Annual Report 2000, page 3.20]

Phone conversations with Treasurer's Office staff indicate that the recently enacted inflation protection statute is currently under review and that a new spending policy proposal will be placed before the Legislature during the 2002 session. The new plan would replace incremental increases in inflation proofing with the adoption of an "annual spending policy" authorizing "an amount equal to eight percent (8%) of the previous five (5) year average market value of the trust fund, [the permanent Wyoming mineral trust fund and the common school account within the permanent land fund] calculated from the first day of the fiscal year". The 8% of fund value payout would be decreased by .375% per year until fiscal year 2010 when it would reach and remain at "5% percent of the previous five (5) year average market value of [the trust fund or the school account]".

With either system, Wyoming will use a multi-year transition to reach the goal of full inflation proofing. The transition will give the State time to phase inflation proofing into the budget and time to hopefully increase the annual income from the mineral trust fund and the common school account. Stable annual income from both funds is necessary to maintain the current level of annual operating and capital programs.

Keeping Pace With Inflation

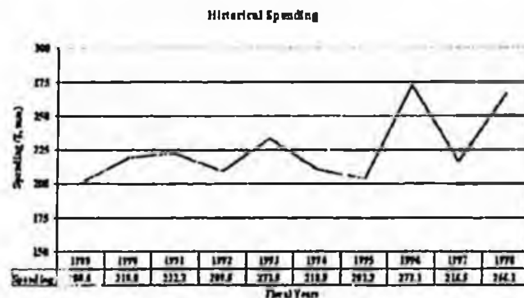
The State of Wyoming is considering changes to the investment programs implemented for the Permanent Funds that should enhance the spending and stability of spending made available from the funds and allow the Fund's assets to keep better pace with Inflation.

The State Loan and Investment Board oversees the investment of the Permanent Funds. They follow an Investment Policy to guide the selection of managers and use of other service providers, set and monitor investment performance expectations, and to set asset mix policies. Every quarter the Board receives an Investment Performance Report from the State's Investment Consultant (RVK) to ensure the State's Investments are structured and performing per the requirements of the Investment Policy. A Select Committee on Capital and Investments regularly meets to become familiar with the State's Investments to review and consider any necessary legislation.

In past years, spending generated by investment earnings (income) on the Permanent Funds varied year to year directly with investment income. In addition, the State's Permanent Fund Investments were comprised primarily of bonds and cash investments which generally do not produce enough return in excess of spending to grow the assets to keep up with inflation.

The following exhibit illustrates the volatility in spending.

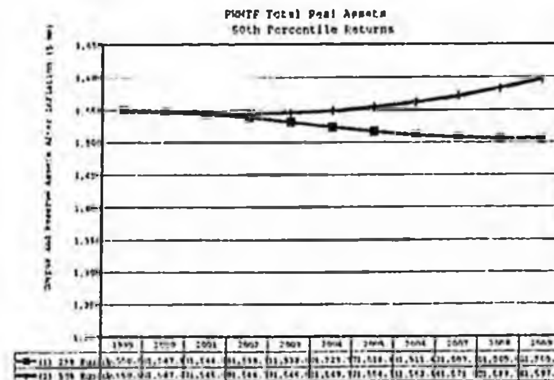
Historical Spending



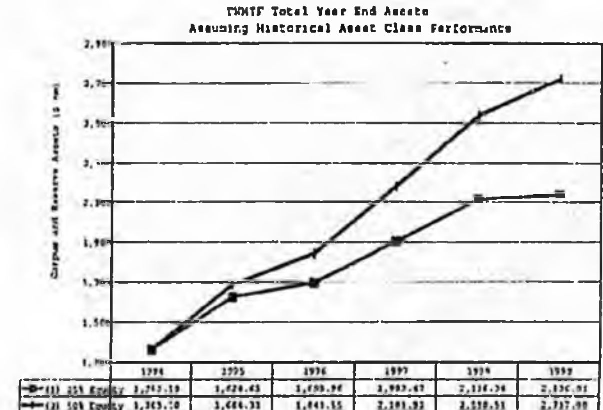
By constitutional definition funds available for spending consist of interest, income, dividend income and realized capital gains. Funds available for spending in the past have varied quite dramatically over time and have been expended instead of being used to help protect the Permanent Funds from the ravages of inflation.

In 1996 the State Land and Investment Board approved participation in stock investments for the Permanent Funds for purposes of enhancing return. The basis for doing so was grounded in the fundamental belief that stocks would outperform bonds over a long period of time. R.V. Kuhns & Associates completed an analysis for the State's Loan and Investment Board that illustrated the impact of adding stocks to the then current fixed Income investments. It was assumed that stocks would offer a 9-10% return while bonds would only offer 6-6.50%. It was decided that up to 25% of the portfolio would be placed in stocks and because of the stock market's volatility, the 25% position would be achieved gradually over approximately a two-year period.

Even with up to 25% of the assets invested in equities, RVK advised that the real value of assets would never increase with the current spending policy. The next graph illustrates the expected growth in the Permanent Fund assets after accounting for inflation. The exhibit shows changes in assets given the current equity maximums of 25% and 50% equity. All of the scenarios assume maintaining spending at current levels plus an additional $20 million. The graph demonstrates that if the projected spending is maintained, the value of the assets will fall in real terms except if approximately 50% of the assets are placed in equities. For simplicity, the Permanent Mineral Trust Fund is represented. Similar results can also be found for the Common School Fund.



If the State had implemented these changes 5 years ago, Permanent Fund Assets would currently be much larger.



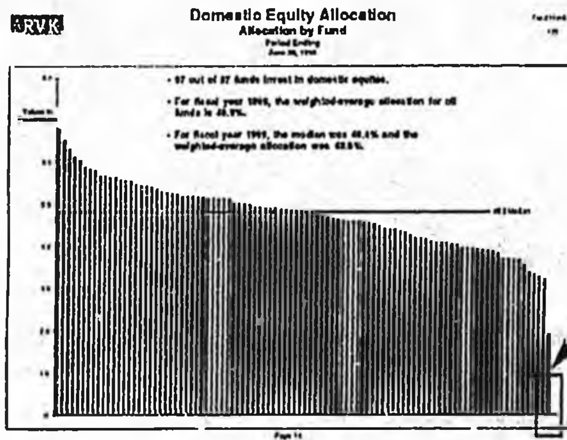
The current investment environment has produced challenges in supporting spending at current levels due to the general decrease in interest rates that has occurred in the last decade. In addition, dividend income has decreased for the average stock levels of 1.0% and 1.5%.

Facing the challenges of maintaining/increasing spending and the desire to Inflation proof the Permanent Fund assets; the State is considering making a change to increase the 25% equity to approximately 50%. Because the stock market has been historically volatile, R.V. Kuhns and Associates pointed out that in some years it may be possible that the amount planned for spending may not be earned by the portfolio.

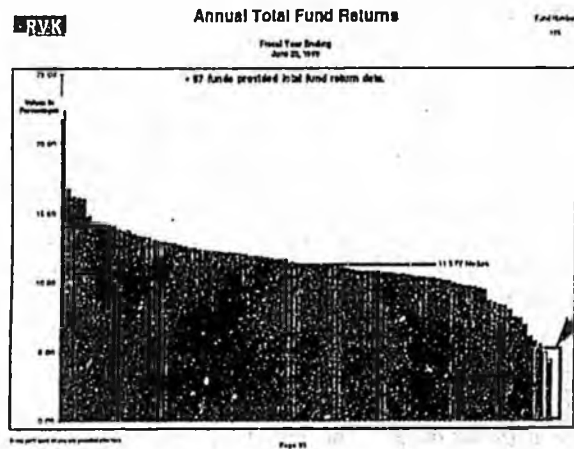
In light of this and the Constitutional requirement to disallow invasion of the corpus or spend unrealized losses, a reserve account will be established for each Permanent Fund. These reserve accounts will be used to "bank" actual returns in excess of spending policy for purposes of supplementing more lean years when investment income is insufficient to meet spending targets.

If the reserve accounts reach a size nearing a large proportion of a year's spending target, any excess above that level will revert to the principal base.

The proposed new equity level of 50% for the Permanent Funds closely resemble the mix of investments of other long-term oriented portfolios. An example within the state is the Wyoming State Retirement Fund, which has a current stock exposure of approximately 57%. In the following exhibit the State's current investment program is listed as one of the equity markets of a universe of large public funds. The State's equity allocation is represented in yellow (highlighted in blue).



The next exhibit demonstrates that having a greater equity exposure benefited the universe funds' investment returns last year. The State's annual return is represented in yellow, 2nd bar from the right indicated by the blue arrow.



In another universe comparison, the Permanent Funds current equity participation is also very small compared to a national collection of endowments and foundations. As of June 30, 1999, the average fund had an equity allocation of 63% compared to less than 10% for the State.

House Bill 21 has been drafted to allow Permanent Fund assets to grow. It is expected that the change in the investment program will enable the goals of increased spending to help address the projected shortfall in the next biennium.

With these goals in mind, it is highly recommended that the spending policy House Bill 21 be passed to assist The State of Wyoming meet its current and future fiscal needs.

THE STATE OF WYOMING

Permanent Fund Spending Policy

ANNUAL REPORT
of the Treasurer

of the
State of Wyoming

For the Period
July 1, 2000 through June 30, 2001

Cynthia M. Lummis, State Treasurer
Sharon Garland, Deputy State Treasurer
Glenn Shaffer, Chief Investment Officer

INCOME EARNINGS RECOGNIZED ON INVESTMENTS
During Fiscal Year 2001

		REGULAR INVESTMENT INCOME	CASH POOL INTEREST 07/01 - 06/30	TOTAL INVESTMENT INCOME RECEIVED
Water Development		$6,954,082.27	$325,460.14	$7,279,542.41
Worker's Compensation		17,099,416.66	5,006,026.68	$22,105,443.34
Tobacco Settlement Trust Fund		1,606,993.77	160,751.51	$1,767,745.28
Miners' Hospital Permanent Land Fund		0.00	1,313,113.78	$1,313,113.78
Public Buildings @ Cap Permanent Land Fund	*	0.00	31,399.23	$31,399.23
Fish Hatchery Permanent Land Fund		0.00	12,144.00	$12,144.00
Common School Permanent Land Fund		53,661,578.00	5,906,992.19	$59,568,570.19
Common School II		0.00	289,101.40	$289,101.40
D.D. & B. Permanent Land Fund	*	0.00	38,409.01	$38,409.01
Carey Act Permanent Land Fund	*	0.00	13,621.29	$13,621.29
Omnibus Permanent Land Fund	*	0.00	222,099.17	$222,099.17
State Hospital Permanent Land Fund	*	0.00	61,201.60	$61,201.60
State Training School Permanent Land Fund	*	0.00	14,111.42	$14,111.42
Penitentiary Permanent Land Fund	*	0.00	86,156.96	$86,156.96
Agriculture College Permanent Land Fund		0.00	312,604.29	$312,604.29
University Permanent Land Fund		0.00	785,987.70	$785,987.70
Permanent Mineral Trust Fund		91,480,232.74	9,965,840.49	$101,446,073.23
Other Funds		0.00	71,212,415.65	$71,212,415.65
		$170,802,303.44	$95,757,436.51	$266,559,739.95
Total Income - Treasurer's Investments			[illegible]66,559,739.95	

Note: Realized yield for all state investments is 6.20% for FY01. This is an approximation based on income recognized versus end-of-month investments at current amortized cost, and includes investment managers but excludes WYO-STAR.

* All or a portion of the investment income from these funds ultimately goes to the General Fund and is included in the $30,046,858.48 General Fund Income.

INVESTMENT ACCOUNT BALANCES
As Of June 30, 2001

FUND/ACCOUNT NAME	CASH & RECEIVABLES	INVESTMENTS	NET DISC/PERM PURCHASED	ACCOUNT BALANCE (Corpus)
Miner's Hospital	$22,991,625.14			$22,991,625.14
Public Buildings At Capitol	75,405.45			75,405.45
Fish Hatchery	218,235.96			218,235.96
Common School	165,166,812.69 *	$760,379,527.04 ***		925,546,339.73
Common School II	5,000,000.00			5,000,000.00
D.D. & B. Asylum	671,097.20			671,097.20
Carey Act	335,130.33			335,130.33
Omnibus	1,506,753.39			1,506,753.39
State Hospital	986,726.80			986,726.80
State Training School	301,044.60			301,044.60
Penitentiary	658,754.46			658,754.46
Agricultural College	5,489,106.54			5,489,106.54
University	13,671,032.56			13,671,032.56
Subtotal-Permanent Land Fund	**217,071,725.12**	**760,379,527.04**		**977,451,252.16**
Mineral Trust Fund	282,423,892.59	1,557,268,027.92 ***	($26,195.73)	1,839,665,724.78
Tobacco Settlement Fund	973,071.85	33,995,548.79		34,968,620.64
Subtotal-All Permanent Funds	**500,468,689.56**	**2,351,643,103.75**	**(26,195.73)**	**2,852,085,597.58**
Worker's Compensation	71,107,981.29	284,262,140.15 ***		355,370,121.44
Water Development	90,599,797.02 **	65,587,938.54 ***		156,187,735.56
TOTAL	**$662,176,467.87**	**$2,701,493,182.44**	**($26,195.73)**	**$3,363,643,454.58**

* Does not include debt service deposit ($57,984,859.00).

** Includes loans receivable.

*** All or a portion of these funds are now invested by Investment Managers, rather than directly invested by the State Treasurer.

"Cash and Receivables" is actually included with, and part of, the State Agency Pool investments. This investment Pool represents the cash balance of all funds and accounts for which specific investments have not been made. The State Agency Pool investments are not summarized in this report.

PERMANENT WYOMING MINERAL TRUST FUND: CORPUS

	JUNE 30, 2000 CORPUS BALANCE	REVENUE	JUNE 30, 2001 CORPUS BALANCE
Beginning Balance	$1,629,332,131.71		
Severance Tax			
Coal		$16,499,375.51	
Stripper Oil		2,995,108.83	
Oil		16,833,866.22	
Gas		71,344,950.01	
Condensate-Gas		1,485,710.03	
Tertiary-Oil		1,173,694.43	
Wildcat-Oil		888.04	
From General Fund per 2001 Ch 139 Sec300(h)		100,000,000.00	
TOTAL REVENUE ADDED TO CORPUS		$210,333,593.07	
			$1,839,665,724.78

THE UNIVERSITY OF TEXAS SYSTEM

AVAILABLE UNIVERSITY FUND

Report to the Legislature and Governor
Pursuant to Rider No. 4 to Available University Fund Appropriations
S. B. 1, 77th Legislature, Regular Session, Page III-71

December 2001

B. AVAILABLE UNIVERSITY FUND

1. RATIONALE FOR DISTRIBUTION FROM PERMANENT UNIVERSITY FUND

The Texas Constitution, as amended in November 1999 by adoption of Proposition 17, defines the Available University Fund (AUF) as consisting of distributions from the total return on all investment assets of the Permanent University Fund (PUF). The U. T. System Board of Regents adopted a policy at its November 11, 1999, meeting designed to provide the AUF with a stable and predictable stream of distributions over time, as well as to maintain the purchasing power of both the PUF assets and AUF distributions.

The amendment contained in Proposition 17 limits the discretion of the U. T. System Board of Regents to determine the amount of PUF distributions in any given year by stipulating that annual distributions cannot exceed 7% of the average market value of PUF investments. Also, distributions cannot increase year to year if the purchasing power of PUF investments has not been preserved over rolling 10-year periods. The only exception would be to pay annual debt service on PUF bonds.

The Board of Directors of the University of Texas Investment Management Company (UTIMCO) recommended, and the U. T. System Board of Regents approved, total distributions of $338,433,636 and $317,081,112 from the PUF to the AUF for the fiscal years ending August 31, 2002 and 2001, respectively. The fiscal year 2002 distribution is equal to 4.5% of the average market value of PUF assets for the trailing 12 fiscal quarters ended February 28, 2001, as illustrated in Appendix A. The distribution rate of 4.5% satisfies the limitations in the Constitution. On August 9, 2001, the U. T. System Board of Regents set the distribution rate for fiscal year 2003 and beyond at 4.75%.

The PUF distribution for fiscal year 2002 represents a 6.7% increase over the distribution for the fiscal year 2001. Money credited to the AUF is administered by the State Comptroller and, along with other funds of the State, is invested in accordance with State law.

Table 1

THE UNIVERSITY OF TEXAS SYSTEM
AVAILABLE UNIVERSITY FUND
FY 2000 – FY 2004

	Actual FY 2000	Actual FY 2001
Income and PUF Distributions		
Divisible with Texas A&M University		
Investment Income and Distributions	$ 297,562,712	$ 317,081,112
Surface & Other Income	6,173,996	9,265,625
Expenses of Revenue Bearing Properties	(2,719,540)	--
Net Divisible Income and Distributions	301,017,168	326,346,737
Less: A&M Share (1/3)	(100,339,056)	(108,782,245)
U. T. Share (2/3)	200,678,112	217,564,492
AUF Interest Income	10,034,605	12,381,690
Income and Distributions Available to U. T.	210,712,717	229,946,182
Transfers/Expenditures		
Debt Service on PUF Bonds	(132,470,830)	(60,743,924)
U. T. System Administration:		
Administration	(19,759,754)	(24,841,384)
Information Technology & Distance Education	(2,742,142)	(4,348,003)
U. T. Austin:		
Excellence	(88,727,618)	(102,500,000)
System-Wide Technology & Telecommunications	(1,060,000)	(1,060,000)
Building Revenue Bond Reimbursement	(3,385,007)	(3,391,581)
National Center for Educational Accountability	--	--
Sandia National Laboratories Project	--	--
Total Transfers	(248,145,351)	(196,884,892)
Net Surplus/(Deficit)	$ (37,432,634)	$ 33,061,290

Note: FY 2002 Budget and FY 2003-4 Projections are subject to change due to market conditions and unforeseen emergencies or opportunities.

Source: U. T. System Administration Financial Statements, Annual Operating Budget, and projections from the U. T. System Office of Finance.

PERMANENT UNIVERSITY FUND

Beneficiaries of the Fund

The Permanent University Fund (PUF) is a public endowment contributing to the support of institutions of The University of Texas System (UT System) and the Texas A&M University System (A&M System). The Constitution of 1876 established the PUF through the appropriation of land grants previously given to The University of Texas plus one million acres. Additional land grants to the PUF were completed in 1883 with the contribution of another one million acres. Today the PUF contains 2.1 million acres located in 24 counties primarily in West Texas.

Responsibility and Management of the Fund

The State Constitution vests fiduciary responsibility for the PUF with the Board of Regents of The University of Texas System. The Board has entered into a contract with a nonprofit corporation, The University of Texas Investment Management Company (UTIMCO), for UTIMCO to invest funds under the control and management of the Board. UTIMCO may not engage in any business other than investing funds designated by the Board under the contract. Specific investment decisions are handled by the investment staff as well as unaffiliated investment managers who are employed from time to time.

Investment Objectives

The primary investment objective shall be to preserve the purchasing power of PUF assets and annual distributions by earning an average annual total return after inflation of 5.5% over rolling ten-year periods of longer. The PUF's success in meeting its objectives depends upon its ability to generate high returns in periods of low inflation that will offset lower returns generated in years when the capital markets underperform the rate of inflation.

The secondary fund objective is to generate a fund return in excess of the Policy Portfolio benchmark over rolling five-year periods or longer. The Policy Portfolio benchmark will be established by UTIMCO and will be comprised of a blend of asset class indices weighted to reflect Fund asset allocation policy targets.

Market Value and Book Value of the PUF

On December 31, 2001, the market value and book value of the PUF was $7.2 billion and $7.4 billion, respectively, exclusive of land acreage.

Comparison Summary of Investment in Securities, at Value
August 31, 2001 and 2000
(in thousands)

	2001	2000
Equity Securities		
Domestic Common Stock	$ 1,516,996	$ 1,639,643
Index Funds	1,380,116	1,802,004
Commingled Investments	1,169,366	1,164,205
Limited Partnerships	1,020,811	1,123,614
Foreign Common Stock	227,378	316,210
Other	4,373	10,993
Total Equity Securities	5,319,040	6,056,669
Debt Securities		
U.S. Government Obligations (Direct and Guaranteed)	390,017	529,467
U.S. Government Agencies (Non-Guaranteed)	529,902	326,067
Foreign Government and Provincial Obligations (U.S. Dollar Denominated)	5,397	6,709
Foreign Government and Provincial Obligations (Non-U.S. Dollar Denominated)	109,296	67,141
Municipal and County Bonds	27,844	26,376
Corporate Bonds	504,326	529,309
Foreign Corporate Bonds	20,248	23,202
Commingled Investment	23,281	-
Commercial Paper	5,000	2,601
Other	7,771	7,771
Total Debt Securities	1,623,082	1,518,643
Preferred Stock		
Domestic Preferred Stock	13,120	12,325
Foreign Preferred Stock	1,305	4,060
Total Preferred Stock	14,425	16,385
Convertible Securities	3,709	-
Cash and Cash Equivalents		
Money Markets and Cash Held at State Treasury	887,575	1,039,885
Total Investment in Securities	$ 7,847,831	$ 8,631,582

The accompanying notes are an integral part of these financial statements.

Note 1 Organization

(A) The Permanent University Fund (PUF) is a state endowment contributing to the support of eligible institutions of The University of Texas System (U.T. System) and the Texas A&M University System (TAMU System). The PUF was established in the Texas Constitution of 1876 through the appropriation of land grants previously given to the University of Texas plus one million acres. Additional land grants to the PUF were completed in 1883 with the contribution of another one million acres. Today, the PUF contains over 2.1 million acres of land located in 24 counties primarily in West Texas (PUF Lands).

PUF Lands produce two streams of income: mineral and surface. Mineral income is contributed to the PUF and surface income is distributed to the Available University Fund (AUF). The investments of the PUF are managed by The University of Texas Investment Management Company (UTIMCO). The PUF Lands are managed by U.T. System administration.

(B) Amendments to the Texas Constitution were approved by voters in a statewide election held on November 2, 1999. The amendments were effective November 29, 1999, and allow for a) distributions to the Available University Fund (AUF) from the "total return" on PUF investments, including income return as well as capital gains (realized and unrealized) and (b) the payment of PUF expenses from PUF assets. Before the effective date of the amendments, the constitutional provisions governing the PUF prohibited the expenditure of corpus, and consequently, gains and losses on sales of securities remained in the PUF. Conversely, the Texas Constitution mandated that all dividend and interest income be distributed to the AUF on an accrual basis. The amendments directed the Board of Regents of U.T. System to establish a distribution policy that provides stable, inflation adjusted annual distributions to the AUF and preserves the real value of the PUF investments over the long term. Accordingly, distributions to the AUF in any given fiscal year are now subject to the following: (1) A minimum amount equal to the amount needed to pay debt service on PUF bonds; (2) No increase from the preceding year (except as necessary to pay debt service on PUF bonds) unless the purchasing power of PUF investments for any rolling 10-year period has been preserved; (3) A maximum amount equal to seven percent of the average net fair market value of PUF assets in any fiscal year, except as necessary to pay debt service on PUF bonds. The PUF distribution to the AUF for the year ending August 31, 2002, in the amount of $338,433,636 was paid September 4, 2001.

(C) The accompanying financial statements report the investment in securities of the PUF, including the assets, liabilities and investment income. Beginning November 29, 1999, expenses related to the PUF's investments and PUF Lands are also included in accordance with the constitutional amendments. The PUF Lands are not included in this report.

These financial statements follow the form and content of investment company financial statements and related disclosures in accordance with accounting principles generally accepted in the United States of America. The principles followed will differ from the principles applied in governmental and fund accounting. The Schedule of Changes in Cost of Investments and Investment Income has been prepared for the purpose of complying with the reporting requirement of Section 66.05 of the Texas Education Code.

The annual combined financial statements of U.T. System are prepared in accordance with Texas Comptroller of Public Accounts' Annual Financial Reporting Requirements and include information related to the PUF. The accompanying financial statements may differ in presentation from

REAL PER CAPITA APPROPRIATIONS, FISCAL 1979-2000

Fiscal Year	July 1 Alaska Population	June Anchorage CPI-U	General Fund Operating Appropriations: Operating (millions)	General Fund Operating Appropriations: Per Capita Operating	General Fund Operating Appropriations: Real Per Capita Operating (FY 1999 $)	General Fund Total Appropriations: Total (millions)	General Fund Total Appropriations: Per Capita Total	General Fund Total Appropriations: Real Per Capita Total (FY 1999 $)	Permanent Fund Program Appropriations: PFD Program Cost (millions)	Permanent Fund Program Appropriations: Real Per Capita Total Plus PFD (FY 1999 $)
1979	413,700	73.9	803	1,942	3,844	1,083	2,617	5,179		5,179
1980	419,800	81.7	924	2,200	3,939	1,160	2,764	4,948		4,948
1981	434,300	89.0	1,314	3,024	4,970	2,587	5,957	9,789		9,789
1982	464,300	95.6	1,661	3,576	5,472	3,445	7,420	11,353		11,353
1983	499,100	97.8	1,829	3,664	5,479	2,848	5,706	8,533	219	9,189
1984	524,000	102.7	1,868	3,565	5,076	3,087	5,891	8,390	175	8,865
1985	543,900	104.7	2,005	3,686	5,149	3,662	6,733	9,405	217	9,963
1986	550,700	108.3	1,998	3,628	4,900	2,832	5,142	6,944	303	7,687
1987	541,300	108.3	1,715	3,169	4,280	2,398	4,430	5,982	391	6,958
1988	535,000	108.4	1,789	3,344	4,512	2,255	4,216	5,688	424	6,757
1989	538,900	110.9	1,975	3,664	4,832	2,379	4,414	5,821	460	6,947
1990	553,171	116.9	2,009	3,632	4,544	2,441	4,413	5,522	482	6,612
1991	569,063	123.3	2,167	3,809	4,518	2,555	4,490	5,326	491	6,349
1992	586,684	127.3	2,195	3,742	4,299	2,772	4,724	5,428	488	6,383
1993	596,808	131.5	2,197	3,682	4,095	2,705	4,532	5,041	525	6,019
1994	600,765	134.3	2,248	3,742	4,075	3,201	5,328	5,803	558	6,814
1995	601,646	138.2	2,242	3,726	3,943	2,470	4,106	4,345	565	5,339
1996	604,966	141.8	2,192	3,623	3,737	2,419	3,999	4,125	643	5,221
1997	609,311	144.1	2,206	3,621	3,675	2,432	3,991	4,051	749	5,299
1998	621,400	146.3	2,169	3,491	3,491	2,355	3,790	3,790	893	5,227
1999	633,729	148.9	2,172	3,427	3,367	2,324	3,667	3,602	999	5,151
2000	646,302	151.6	2,200	3,404	[illegible],285	2,304	3,565	3,440	1,078	5,049

Population estimates from Department of Labor as of July 1 (beginning of each fiscal year).
Population for FY 99 and FY 2000 estimnated by OMB.
Inflation assumptions for FY 99 and FY 2000 taken from DOR Revenue Sources book (reference case).
FY 2000 spending based on Governor's proposed budget and March Permanent Fund projections.
Total Appropriations do not include special PF appropriations.

OMB/BP

~~5/1/01 16:07~~

Brad Pierce

LAWS OF ALASKA

1980

Source SCS CSHB 509(Rules)

Chapter No. 35

AN ACT

Making a special appropriation to the Alaska permanent fund; and providing for an effective date.

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

THE ACT FOLLOWS ON PAGE 1, LINE 9

Approved by the Governor: May 21, 1980
Actual Effective Date: July 1, 1980

AN ACT

Making a special appropriation to the Alaska permanent fund; and providing for an effective date.

* Section 1. The sum of $900,000,000 is appropriated from the general fund to the Alaska permanent fund (art. IX, sec. 15, Constitution of the State of Alaska).

* Sec. 2. Beginning July 1, 1980, the commissioner of revenue shall make monthly deposits to the Alaska permanent fund of the appropriation made by this Act. A monthly deposit to the Alaska permanent fund shall be in an amount determined by the commissioner of revenue to be in excess of the general fund revenues necessary to finance state government operation for the month in which the deposit is made.

* Sec. 3. This Act takes effect July 1, 1980.

LAWS OF ALASKA

1981

Source

FCCSHB 1

Chapter No.

61

AN ACT

Making a special appropriation to the Alaska permanent fund, and making appropriations to the Department of Administration and the Department of Community and Regional Affairs for aid to municipalities and unincorporated communities; and providing for an effective date.

---

* Section 1. The sum of $1,800,000,000 is appropriated from the general fund to the Alaska permanent fund (art. IX, sec. 15, Constitution of the State of Alaska, AS 37.13.010).

* Sec. 2. Beginning July 1, 1981, the commissioner of revenue shall make monthly deposits to the Alaska permanent fund of the appropriation made by sec. 1 of this Act. A monthly deposit to the Alaska permanent fund shall be in an amount determined by the commissioner of revenue to be in excess of the general fund revenues necessary to finance state government operation for the month in which the deposit is made.

* Sec. 3. The sum of $380,000,000 is appropriated from the general fund to the Department of Administration for payment of entitlements to qualified municipalities for the fiscal year ending June 30, 1982, in accordance with legislation authorizing the payments.

* Sec. 4. The sum of $24,987,000 is appropriated from the general fund to the Department of Community and Regional Affairs for payment of entitlements to unincorporated communities in the unorganized borough for the fiscal year ending June 30, 1982, in accordance with legislation authorizing

the payments.

* Sec. 5. The sum of $73,800 is appropriated from the general fund to the Department of Administration for costs of administering the entitlements for which an appropriation is made by sec. 3 of this Act.

* Sec. 6. The sum of $252,800 is appropriated from the general fund to the Department of Community and Regional Affairs for costs of administering the entitlements for which an appropriation is made by sec. 4 of this Act.

* Sec. 7. The appropriation made by sec. 1 of this Act is not a one-year appropriation and it does not lapse under AS 37.25.010.

* Sec. 8. This Act takes effect on the effective date of a version of Senate Bill No. 168 entitled "An Act relating to state assistance for municipalities and unincorporated communities; and providing for an effective date."

Alaska Permanent Fund Corporation
P.O. Box 25500 Juneau, Alaska 99802-5500
(907) 465-2047

MEMORANDUM

DATE: April 11, 2001

TO: Senator Gene Therriault, Chair
Senate State Affairs Committee

FROM: Robert D. Storer, RDS
Executive Director

SUBJECT: **Senate Joint Resolution 15 – Permanent Fund Constitutional Inflation-Proofing Amendment**

This is to request a hearing at your earliest convenience on Senate Joint Resolution 13, "Proposing amendments to the Constitution of the State of Alaska relating to inflation-proofing the permanent fund."

SJR 15 accomplishes inflation-proofing by constitutionally limiting the annual payout of Fund income to no more than 5 percent of the Fund's five-year average market value. This amount comprises all of the Fund's expected "real," i.e., inflation-adjusted, income. For example, the Board's current asset allocation is designed to earn 8.25 percent annually and inflation is expected to average 3.25 percent. By retaining that difference between what is earned and what is paid out, the purchasing power of the Permanent Fund is fully protected against inflation.

The Board is unanimous in its support for this proposal. They believe its benefits are compelling:

1. Provides constitutional protection against inflation for the total Permanent Fund, thereby more effectively safeguarding the Fund and increasing the amount protected.

2. Establishes a limit on annual distributions which helps ensure that the Fund will continue to grow in perpetuity in both nominal and real, inflation-adjusted dollars.

3. Maximizes the total amount of Fund income which can be paid out in the future, at least as compared to higher payout rates, and provides for intergenerational equity by striking a fine balance between short-term and long-term distributions.

4. Beginning in 2003, makes available $175-$300 million per year, depending on the Fund's market value, for purposes other than inflation-proofing and dividends. This amount will grow over time as the Fund grows.

5. Uses the percent of market value (POMV) payout methodology which smoothes volatility, treats realized and unrealized income equally as investment return, and is consistent with generally accepted accounting principles and modern endowment practice.

6. Lets lawmakers know in advance, within a relatively narrow range, how much Fund income will be available for appropriation each year.

In short, the Trustees believe SJR 13 serves the best interests of the Fund and the people of Alaska, and we request an opportunity this session to begin discussing with the members of your Committee the very important issues addressed in this resolution.

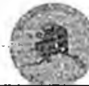
Thank you for your consideration.

Trustees Request Your Support for Constitutional Inflation-Proofing of the Permanent Fund

Clark Gruening, Chair Board of Trustees
Jim Kelly, Director of Communications

Alaska Permanent Fund Corporation

Senate State Affairs Committee
April 26, 2001



Board of Trustees unanimously supports HJR 15/SJR 13

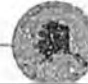
Why is it important and why should Alaskans support it?

"Inflation is like a thief in the night."

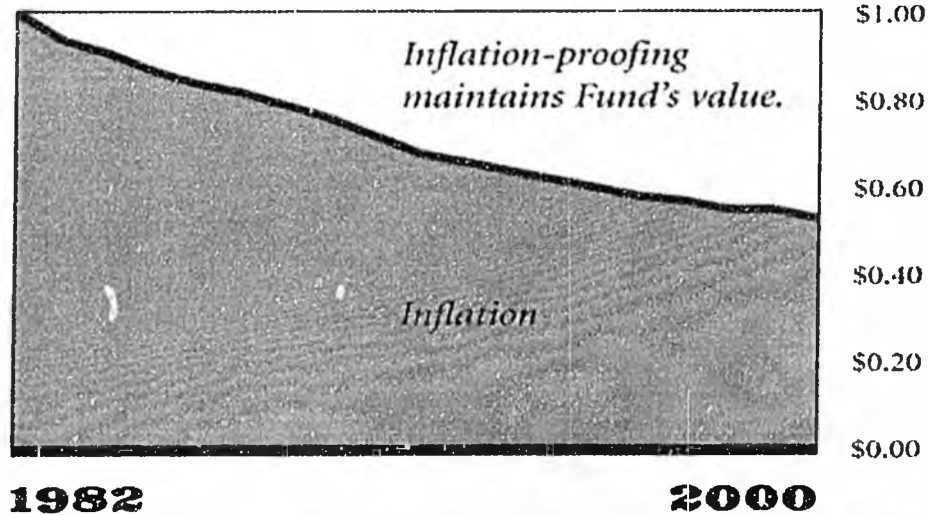
Elmer Rasmuson

First chair, Permanent Fund Board of Trustees

Alaska Permanent Fund Corporation



Inflation erodes value of dollar



Alaska Permanent Fund Corporation

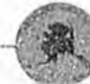
General Election November 5, 2002

Section 15. Alaska Permanent Fund. (a) At least twenty-five per cent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses received by the State shall be placed in a permanent fund, the principal of which shall be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments. All income from the permanent fund shall be deposited in the permanent [GENERAL] fund [UNLESS OTHERWISE PROVIDED BY LAW].

(b) For any fiscal year, appropriations from the permanent fund shall be limited to five percent of the average of the year-end market values of the permanent fund for the last five fiscal years, including the fiscal year just ended. No other appropriations from the permanent fund may be made.

Yes [√] No [ ]

Alaska Permanent Fund Corporation



What is POMV?

Percent Of Market Value			= Total investment return
8.25%	**x**	**$28 billion**	**= $2.3 billion**

Percent Of Market Value			= Retain for inflation-proofing
3.25%	**x**	**$28 billion**	**= $0.9 billion**

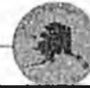
Percent Of Market Value			= Payout of Fund income
5.00%	**x**	**$28 billion**	**= $1.4 billion**

Alaska Permanent Fund Corporation

Benefits of POMV

1. **Preserves** the Fund's purchasing power
2. **Maximizes** distributions over the long-term
3. **Minimizes** fluctuations in annual payouts

Alaska Permanent Fund Corporation



Why limit the payout to 5%?

- 5% real rate of return is at the high end of what is achievable for the Permanent Fund
- 5% is the maximum sustainable payout rate that still maintains the Fund's real value
- 5% allows greater distributions over time than a higher payout
- 5% is what the majority of endowments pay out

Alaska Permanent Fund Corporation

Rolling 5-year real return for 60% stock/40% bond mix (net of 5% payout -- last 75 years)

Rolling Annualized Return (%)

20%
15%
10%
5%
0%
-5%
-10%
-15%

1926 to Present

0.59%

Number of periods with returns < 0%: 126
Number of periods with returns > 3%: 95
Total number of 5-year periods: 281

Rolling 5-Year Return
Average 5-Year Return 1926-

1930 1935 1940 1945 1950 1955 1960 1965 1970 1975 1980 1985 1990 1995 2000

SOURCE: Callan Associates, Inc.

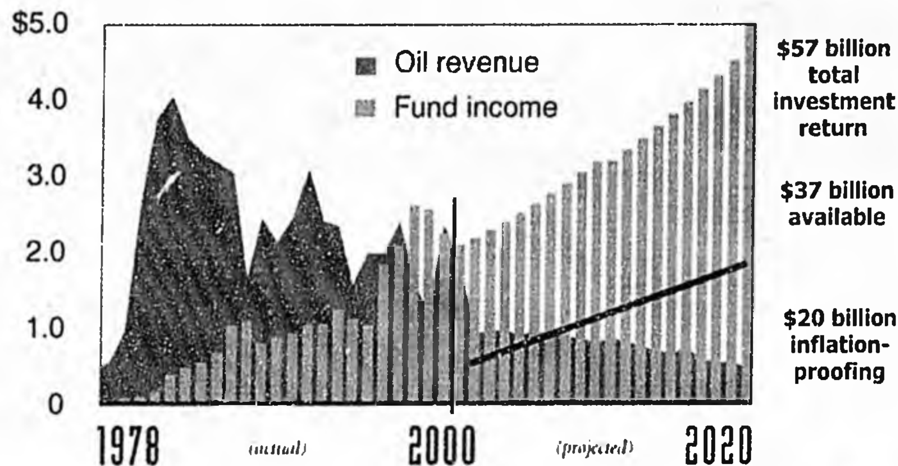
CPI 1926-2000: 3.3%

Alaska Permanent Fund Corporation

Fund statutory net income vs. state oil revenue

(Dollars in billions)

5% POMV



Alaska Permanent Fund Corporation

How is this different from the status quo?

- Constitution vs. statutes
- Total Fund vs. principal only
- Limits withdrawals from the Fund – currently all of the earnings reserve is available for appropriation

Alaska Permanent Fund Corporation

Keep it permanent

5 percent limit protects Alaska Permanent Fund

Anchorage Daily News editorial, April 17, 2001

Public will decide!

Alaska Permanent Fund Corporation

Five myths about how the Permanent Fund works

1. It is possible to be precise about how much total investment return the Fund will produce in the future.
2. The distribution policy which has worked well for the last 20 years will work well for the next 20 years.
3. Any change can be made to the current use of Fund income without affecting the PFD.
4. The Permanent Fund is big enough to be all things for all people.
5. Permanent Fund dividends always go up.

Alaska Permanent Fund Corporation

Alaska Permanent Fund Corporation
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FROM: Robert D. Storer,
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State of Alaska

State Lands on the North Slope

State Patented or Tentatively Approved Lands

Federal Conservation System Unit Boundaries

Roads

Alaska Department of Natural Resources

For illustration purposes only.

North Slope Oil and Gas Activity

Detail Area

NPRA - National Petroleum Reserve - Alaska

ANWR - Arctic National Wildlife Refuge

Noatak National Preserve

Gates of the Arctic National Park & Preserve

Kobuk Valley National Park

Bering Land Bridge National Preserve

Selawik National Wildlife Refuge

Kanuti National Wildlife Refuge

Yukon Flats National Wildlife Refuge

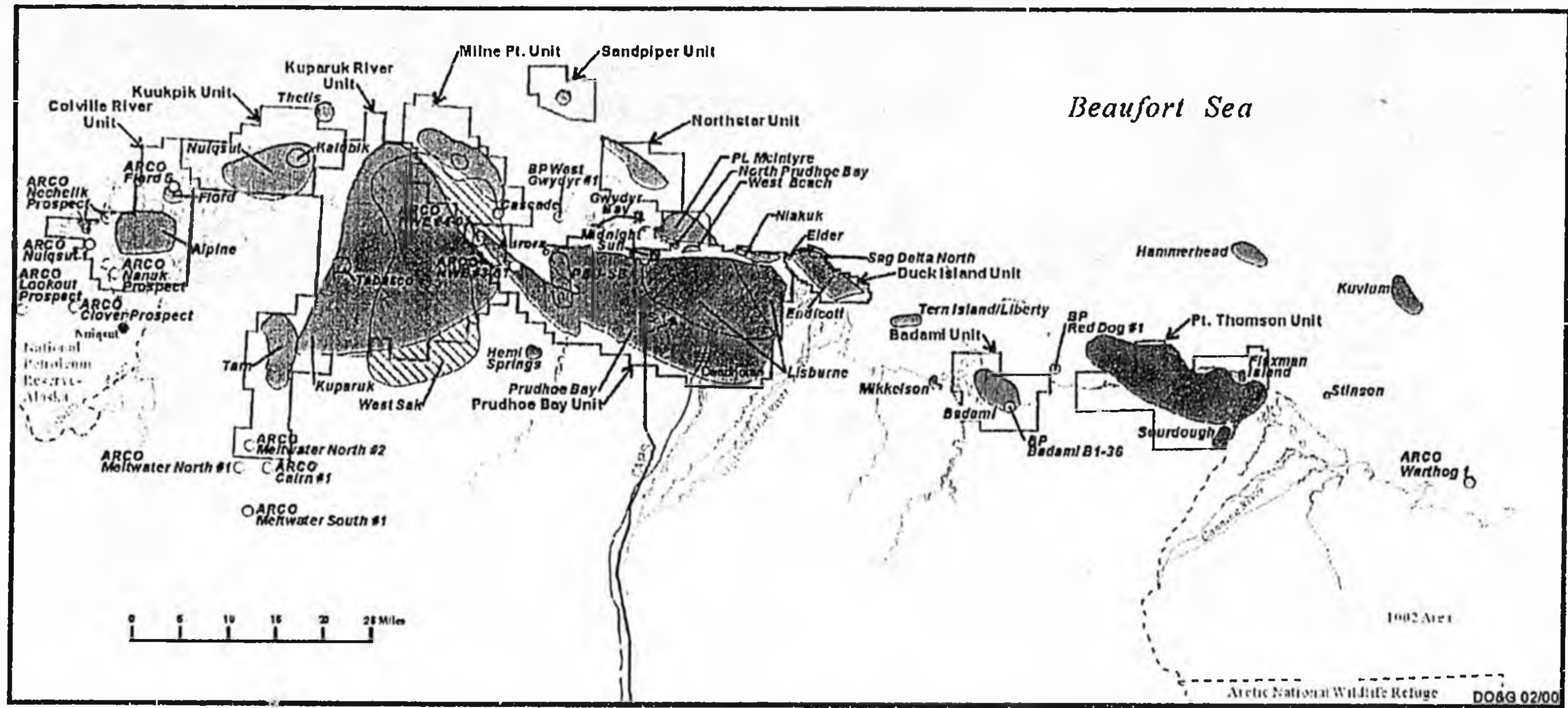
Koyukuk National Wildlife Refuge

Innoko National Wildlife Refuge

Nowitna National Wildlife Refuge

Date Printed: October 24, 2001

Produced by: Alaska Department of Natural Resources, Land Records Information Section



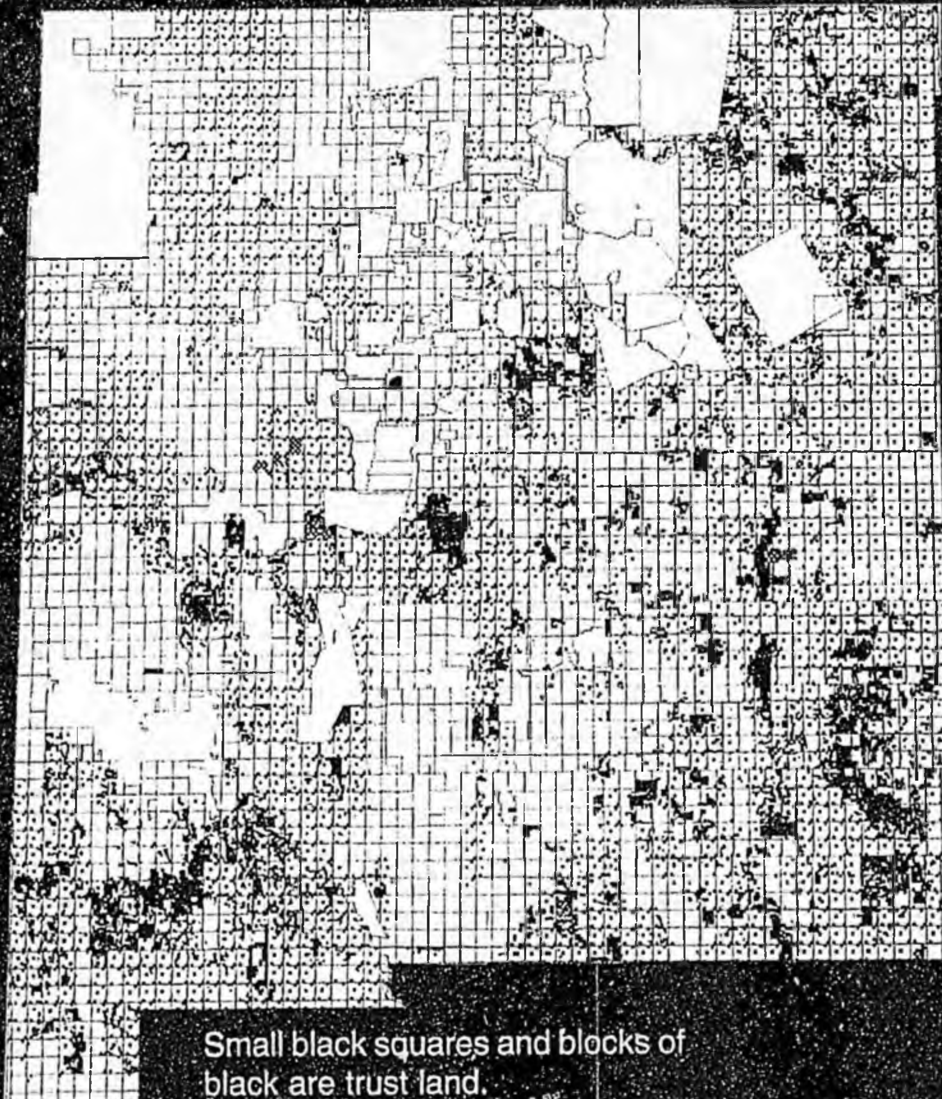
http://www.dog.dnr.state.ak.us/oil

North Slope Oil and Gas Activity
February 2000

Map Legend

- Units
- Oil Field / Accumulation
- Selected Wells
- Proposed / Active Wells

State Trust Land Map



6	5	4	3	2	1
7	8	9	10	11	12
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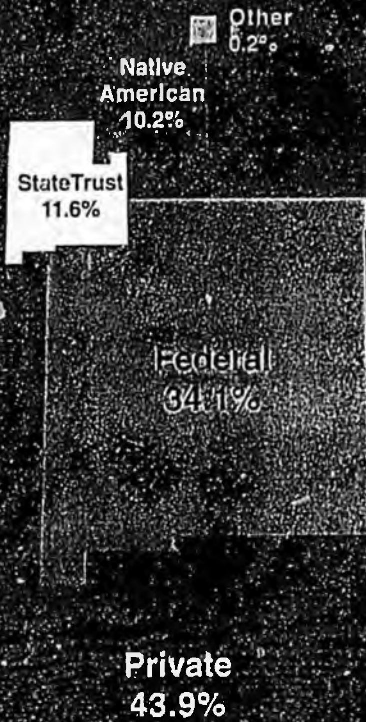
Small black squares and blocks of black are trust land.

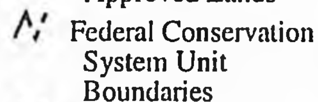
New Mexico Land Ownership

77,666,400 Total Acres



State of Alaska

State Lands on the North Slope



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State of Alaska

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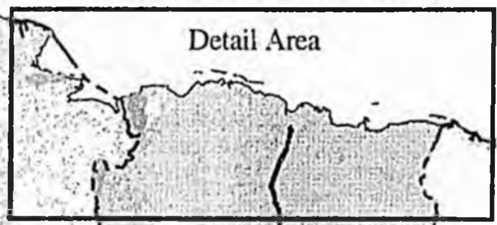

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Beaufort Sea

Colville River Unit · Kuukpik Unit · Kuparuk River Unit · Thetis · Milne Pt. Unit · Sandpiper Unit · Northstar Unit · Nuiqsut · Kalubik · ARCO Fiord 5 · Fiord · ARCO Nechelik Prospect · ARCO Nuiqsut 1 · Alpine · ARCO Nanuk Prospect · ARCO Lookout Prospect · ARCO Clover Prospect · Nuiqsut · National Petroleum Reserve-Alaska · Tarn · Kuparuk · West Sak · Tabasco · Cascade · BP West Gwydyr #1 · Gwydyr Bay · Aurora · Midnight Sun · Hemi Springs · Prudhoe Bay · Prudhoe Bay Unit · Pt. McIntyre · North Prudhoe Bay · West Beach · Niakuk · Eider · Sag Delta North · Duck Island Unit · Endicott · Lisburne · Tern Island/Liberty · Badami Unit · BP Red Dog #1 · Pt. Thomson Unit · Hammerhead · Kuvlum · Flaxman Island · Stinson · Mikkelsen · Badami · BP Badami B1-36 · Sourdough · ARCO Warthog 1 · ARCO Meltwater North #2 · ARCO Meltwater North #1 · ARCO Cairn #1 · ARCO Meltwater South #1 · 1002 Area · Arctic National Wildlife Refuge

0 5 10 15 20 25 Miles

DO&G 02/00

http://www.dog.dnr.state.ak.us/oil

North Slope Oil and Gas Activity
February 2000

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- Oil Field / Accumulation
- Selected Wells
- Proposed / Active Wells

Beaufort Sea

Milne Pt. Unit
Sandpiper Unit
Kuparuk River Unit
Kuukpik Unit
Colville River Unit
Thetis
Northstar Unit
Nuiqsut
Kalubik
ARCO Fiord 5
Fiord
ARCO Nechelik Prospect
Alpine
ARCO Nuiqsut 1
ARCO Nanuk Prospect
ARCO Lookout Prospect
ARCO Clover Prospect
Nuiqsut
National Petroleum Reserve-Alaska
BP West Gwydyr #1
Cascade
Gwydyr Bay
Pt. McIntyre
North Prudhoe Bay
West Beach
Niakuk
Elder
Sag Delta North
Duck Island Unit
Midnight Sun
Aurora
PBU-SB
Tabasco
Tarn
Kuparuk
West Sak
Hemi Springs
Prudhoe Bay
Prudhoe Bay Unit
Lisburne
Endicott
Tern Island/Liberty
Badami Unit
Nikkelson
Badami
BP Badami B1-36
BP Red Dog #1
Pt. Thomson Unit
Hammerhead
Kuvlum
Flaxman Island
Stinson
Sourdough
ARCO Warthog 1
ARCO Meltwater North #2
ARCO Meltwater North #1
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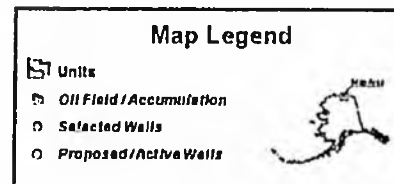

North Slope Oil and Gas Activity
February 2000

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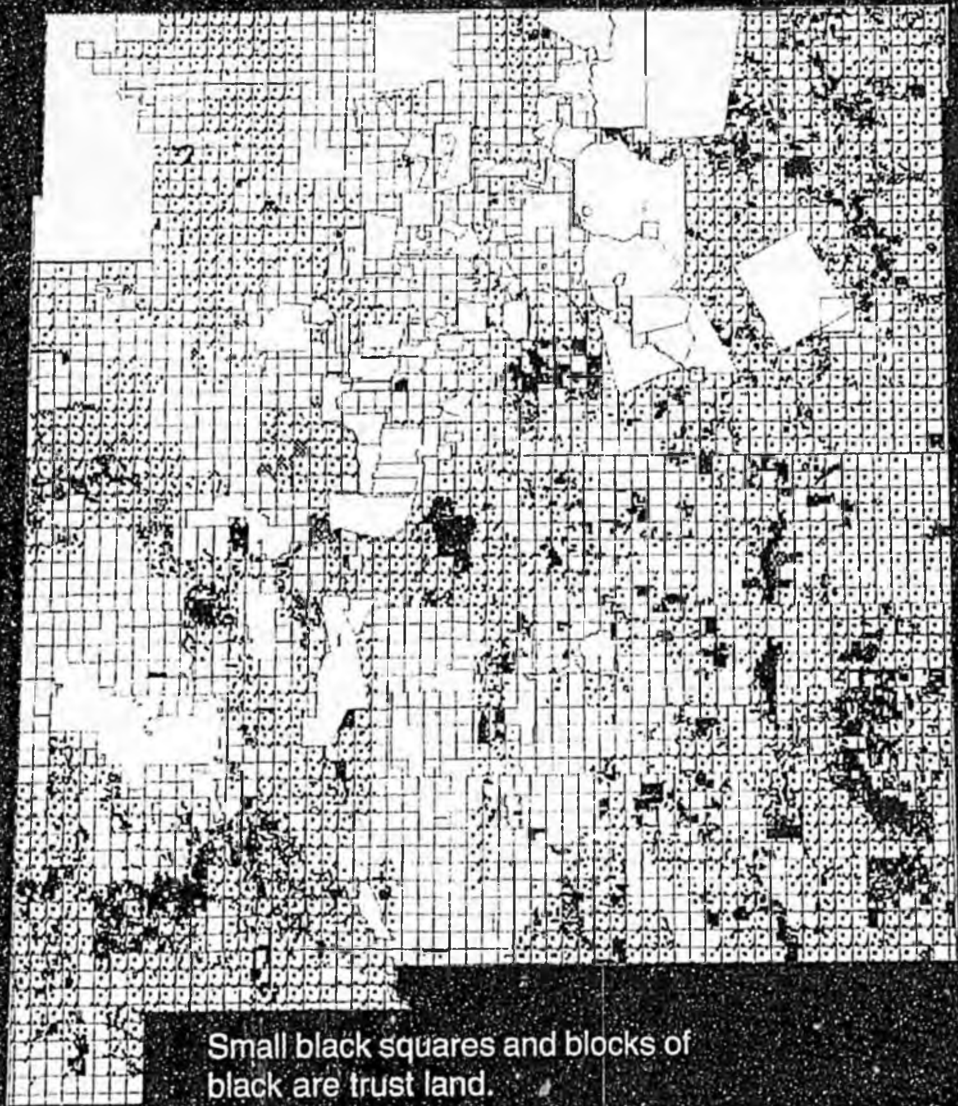
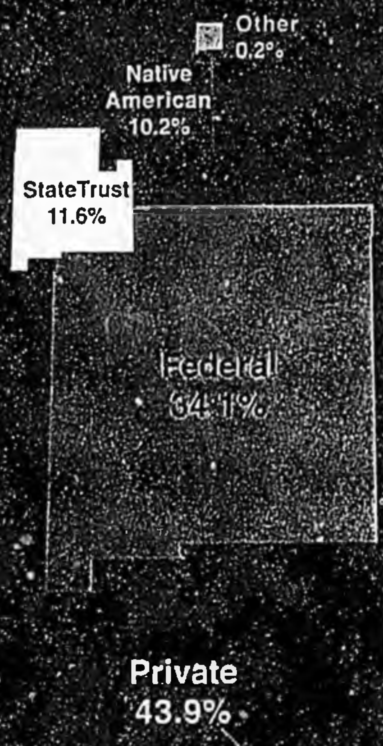


Small black squares and blocks of black are trust land.

New Mexico Land Ownership

77,666,400 Total Acres



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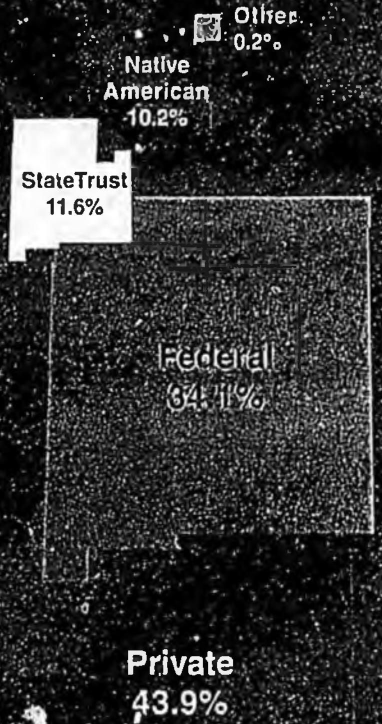

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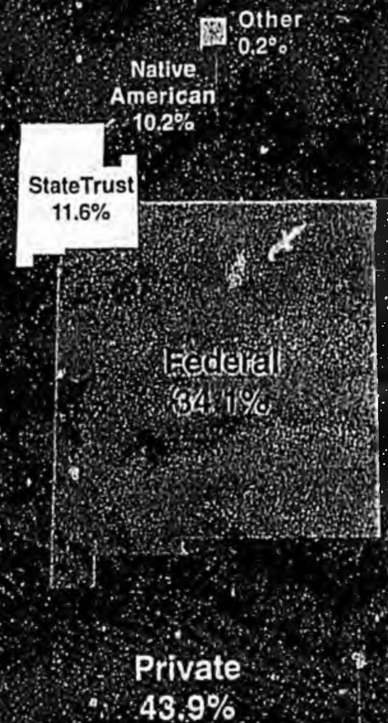

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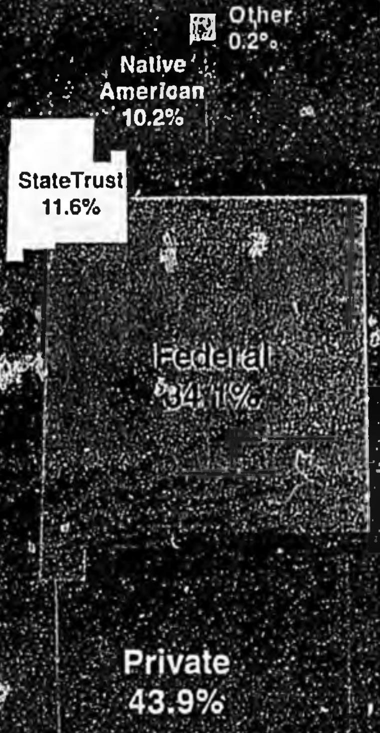

Percent of Market Value—talking points

Analysis of proposals affecting the Permanent Fund boil down to three questions
1. What happens to the Earnings Reserve account?
2. What happens to PFDs?
3. What happens to the fiscal gap?

The answers are not as simple as the questions because the words everyone uses to describe their plans are very slippery and the questions (like the plans) are several layers deep. Back to the questions.

1. What happens to the Earnings Reserve Account (ERA)?

Be concerned about:

- Future flows—does income go anywhere other than the reserve account?
- The Balance—does it remain available to replenish the CBR or for other appropriations?
- Inflation proofing—transfers to principal are off-limit forever. Are we putting in too much? Too little? It shouldn't matter whether inflation proofing is by statute or by constitution as long as the ERA *can* support the transfers and the legislature *does* support transfers.

The key point is that *any* reduction in Permanent Fund balance (including the ERA) reduces future earnings, which reduces future dividends.

2. What happens to PFDs?

Be concerned about:

- The formula vs. money-in-pocket—retaining the current formula is no guarantee that dividends won't change. Back to the key point from #1. The current formula *will* reduce dividends if money is diverted from the sum of Permanent Fund balance and ERA balance.

3. What happens to the fiscal gap?

- Dividends, inflation proofing and surplus earnings in the ERA are "off budget" in that they do not affect the fiscal gap. Under virtually any proposal, dividends and inflation proofing will remain off budget.
- Earnings not used for dividends and inflation proofing can affect the fiscal gap if the surplus earnings are considered general fund revenue.

The "Simple" Proposal by the Permanent Fund

The constitutional amendment appears simple when compared to versions of HB 411 (last year's bill). The appearance of simplicity is primarily because the constitutional amendment simply adopts a percent of market value (POMV) payout without describing what happens to the payout stream.

Although the bill appears simple, here are some points to consider:

1. What happens to the Earnings Reserve Account (ERA)?

- Future flows—Permanent Fund income would be deposited in the Permanent Fund instead of the general fund. This has huge implications.
- The Balance—the ERA is no longer available as budget reserves because the only money that can flow from the Permanent Fund is the 5% annual payout. The ERA cannot be used to reload the CBR or otherwise fill the fiscal gap.
- Inflation proofing—earnings remaining after the payout can be considered inflation proofing. No appropriation is necessary. Expect inflation proofing to be considerably more than under the current system because
  - the entire account will be inflation proofed and
  - any "extra" earnings beyond the payout remain in the Permanent Fund as inflation proofing.

2. What happens to PFDs?

Although the bill is silent, PFDs *will* be affected by the bill. If we retain the current formula for computing dividends, there are two possibilities
- The 5% payout *is less than* the current formula would pay—dividends decline. (This is unlikely—annual dividends take only about 4% of the market value, or 80% of the 5% payout.)
- The 5% payout *exceeds* what the current system pays out as dividends—dividends are not immediately affected, but decline over time because earnings decline as the balance declines due to the higher payout.

If we replace the current formula, dividends would not necessarily decline in the near future. Some money from the 5% payout would be available to prop up dividends.

4. What happens to the fiscal gap?

- The impact on the fiscal gap depends on how much of the payout goes to the general fund and how much to dividends.
- Earnings not used for dividends would reduce the fiscal gap.
- If the entire payout went to dividends, PFDs would increase by about 25%. This would, of course, leave no money to close the fiscal gap.

If inflation is higher than expected, the "up to five percent" clause becomes interesting. There may be some pressure to appropriate less than 5% if it meant less than full inflation proofing. This would leave less payout to reduce the gap.

There are two additional issues raised by the proposed bill

1. Is 5% an appropriate payout rate?
2. What is the impact of basing the payout on a five-year moving average?

A five percent payout is specified because 5% is the projected long-term real rate of return (real return means "after adjusting for inflation"). Just accept the rate as the best estimate. But realize that the rate and the moving average are closely linked.

The 5% rate of return applies to earnings on the *current* balance, while the 5% payout is based on an *average* balance. For a fund that constantly increases because of royalty deposits and inflation proofing, more years in the average translates to a lower average balance. (e.g., the 10-year average balance is $18 billion, the 5-year average is $23 billion and the current balance is $27 billion).

Using a moving average gives a more stable payout, but it makes the effective payout rate lower as well. A 5% payout on a 5-year average balance is equivalent to a 4.3% payout on the current balance. The difference between the 4.3% payout and the 8.25 % rate of return remains in the Permanent Fund, so that inflation proofing is close to 4% rather than the 3.25% required to cover actual inflation.

The result:

the payout is not as aggressive as the Permanent Fund implies,
the fund is "over inflation proofed,"
some money (.3% or $100 million) remains in the general fund to help close the fiscal gap, and
PFDs fall slightly over time because money is transferred from the Permanent Fund to the general fund.

The payout rate and the balance to which it applies are a philosophical debate. A shorter averaging period or a higher effective payout rate would transfer more money to the general fund. Remember that any money transferred to the general fund reduces future dividends.

Board of Trustees

Final

Monthly Management Report - December 31, 2001

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Unaudited market values provided by BoNY. Returns for periods greater than one year are annualized.
Monthly real estate, fund benchmark and total fund returns are calculated internally. All other returns are provided by Callan Associates, Inc.

Section 1: Fixed Income & Equity Performance

	12/31/2001 Market Value	Return as of 12/31/2001 Current Month	Last 3 Months	Fiscal Y-T-D	Calendar Y-T-D	Last 12 Months	Last 3 Years	Return as of 9/30/2001 Last 5 Years
FUND SUMMARY								
Alaska CDs	$ 30.0	0.29%	0.95%	1.97%	4.54%	4.54%	5.07%	5.40%
Domestic Fixed Income	8,537.1	-0.49%	0.26%	4.61%	8.45%	8.45%	5.35%	7.67%
Non-Domestic Fixed Income	624.0	-2.14%	-1.79%	2.88%	0.51%	0.51%	-0.01%	
Domestic Equities	9,338.3	1.90%	12.67%	-5.48%	-10.84%	-10.84%	-0.33%	8.43%
Non-Domestic Equities	4,178.2	1.61%	9.40%	-7.49%	-18.44%	-18.44%	-2.10%	2.22%
Real Estate[1]	2,697.7	1.41%	3.11%	4.82%	11.33%	11.33%	11.92%	11.67%
Total Fund	**$ 25,405.3**	**0.88%**	**6.18%**	**-0.02%**	**-1.65%**	**-1.65%**	**2.52%**	**7.71%**
Total Fund Return Benchmark		*0.43%*	*5.72%*	*-1.31%*	*-3.70%*	*-3.70%*	*2.25%*	*7.78%*

22-LS0568\C
Cook
1/31/02

CS FOR HOUSE JOINT RESOLUTION NO. 15(JUD)

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWENTY-SECOND LEGISLATURE - SECOND SESSION

BY THE HOUSE JUDICIARY COMMITTEE

Offered:
Referred:

Sponsor(s): HOUSE RULES COMMITTEE BY REQUEST OF THE LEGISLATIVE BUDGET AND AUDIT COMMITTEE

A RESOLUTION

1 **Proposing amendments to the Constitution of the State of Alaska requiring income of**
2 **the permanent fund to be deposited into the permanent fund and limiting**
3 **appropriations from the permanent fund to six percent of the year-end market values of**
4 **the fund for the last five fiscal years.**

5 **BE IT RESOLVED BY THE LEGISLATURE OF THE STATE OF ALASKA:**

6 * **Section 1.** Article IX, sec. 15, Constitution of the State of Alaska, is amended to read:
7 **Section 15. Alaska Permanent Fund.** <u>(a)</u> At least twenty-five per cent of all
8 mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing
9 payments and bonuses received by the State shall be placed in a permanent fund, the
10 principal of which shall be used only for those income-producing investments
11 specifically designated by law as eligible for permanent fund investments. All income
12 from the permanent fund shall be deposited in the **<u>permanent</u>** [GENERAL] fund
13 [UNLESS OTHERWISE PROVIDED BY LAW].
14 **<u>(b) For any fiscal year, appropriations from the permanent fund shall be</u>**
15 **<u>limited to six percent of the average of the year-end market values of the</u>**

1 **permanent fund for the last five fiscal years, including the fiscal year just ended.**
2 **No other appropriations from the permanent fund may be made.**
3 * **Sec. 2.** The amendments proposed by this resolution shall be placed before the voters of
4 the state at the next general election in conformity with art. XIII, sec. 1, Constitution of the
5 State of Alaska, and the election laws of the state.

Alaska Permanent Fund Corporation
P.O. Box 25500 Juneau, AK 99802-5500
Telephone (907) 465-2047
Facsimile (907) 586-2057

MEMORANDUM

DATE: November 23, 2001

TO: Jesse Kiehl
Chief of Staff to Senator Kim Elton

FROM: Jim Kelly
Director of Communications

SUBJECT: **APFC forecasts of residual income available assuming an annual 5 percent payout of the Fund's five-year average market value**

You have asked whether the projections regarding residual income presented in the spreadsheet titled "Alaska Permanent Fund Corporation Hypothetical Look Backwards at the Effects of SJR 13," are still valid.

The short answer is that the numbers presented in the spreadsheet were never intended to be valid as projections going forward because, as indicated in the April 1, 2001 memorandum which accompanied that spreadsheet,

> "The spreadsheet overstates the amount of income available for distribution because it <u>does not</u> show the effect of actually paying out the residual income available under the 5 percent limit;"

However, there was one projection in that memorandum which was valid then and remains valid today:

> **"The APFC believes that the amount of residual income available will likely be in the range of $175 - 300 million per year."**

There are three points to keep in mind regarding this projection:

1. Expenditure of that $175 - 300 million would not place inflation-proofing in jeopardy; the Fund would still be able to retain sufficient income over time to provide long-term protection of the total Fund's purchasing power.

2. Any appropriations out of the Fund, in addition to dividends per existing statutes, would cause dividends to decline relative to the status quo.

3. This range of represents the APFC's most informed estimate of likely outcomes over the next ten years - taking volatility of investment returns into consideration.

Why the APFC thinks it is important to take volatility into consideration. In recent years, the APFC has moved away from providing forecasts which focus on individual numbers and instead has preferred to talk in terms of ranges of likely outcomes. This shift recognizes that it is not only impossible to produce reliably accurate single point-in-time numbers for future years, it is misleading to indicate that any of us can assess the impacts of future events such as financial market performance with "laser-guided precision."

With that cautionary note, there are two fundamental principles - one relating to investment policy and one to spending policy - with which one can assess the soundness of any proposed change to the current use of Fund income.

- Time greatly reduces - but does not eliminate - the volatility in annual returns. That is why from an **investment policy** perspective, asset allocation, diversification, disciplined rebalancing and long-term time horizon are all key elements of a successful investment program. In this regard, the important question to ask is, **"Does a particular proposal have a neutral, a positive or an adverse effect on the Board's investment strategy?"**

- From a **spending policy** perspective, the best way to moderate the impact of volatility is averaging. So, for example in the case of the Alaska Permanent Fund, which - with its 53 percent target allocation to equities - has a one-in-four chance of a negative total Fund return in any given year, averaging returns over five years reduces the likelihood of a negative return to one-in-twenty. This moderation of the impact of volatility provides a valuable cushion to ensure stability of distributions. In this

regard, the important question to ask is, **"Does a particular proposal enhance or diminish the Fund's ability to produce a sustainable and stable income stream (after inflation) to benefit current and future generations?"**

I hope this is responsive. If you have any further questions, please let me know.

Alaska Permanent Fund Corporation
P.O. Box 25500 Juneau, AK 99802-5500
Telephone (907) 465-2047
Facsimile (907) 586-2057

MEMORANDUM

DATE: January 7, 2002

TO: Melanie Lesh,
Aide to Representative Bill Hudson

FROM: Jim Kelly
Director of Communications

SUBJECT: *"What would happen if the Permanent Fund's earnings reserve account (ERA) were called upon by the legislature to effectively replace the CBRF as the source for funding the budget gap when the CBRF runs out?"*

The Department of Revenue estimates that the CBRF will be depleted late in calendar 2004 and thus will be unavailable to fund the expected $1.099 billion budget gap in FY 05. Based on the APFC's current projections, the Fund's ERA most likely would be sufficient in FY 05 to fund the budget gap that year and pay dividends per current formula. However, there is a chance that the ERA itself could be depleted by that date in the event of continued negative investment returns between now and then.

The full answer depends on whether the Board-proposed percent of market value (POMV) payout limitation has been placed in the constitution by the time the legislature needs to use the Permanent Fund for the state budget.

If the constitutional amendment has been passed. The APFC's analysis of the constitutional amendment proposed under HJR 15/SJR 13 indicates that the Permanent Fund is likely to be able to produce earnings to support an annual payout of five percent of the five-year average market value of the Fund. That is

estimated at from $1.2 billion to $1.4 billion per year in inflation-adjusted 2001 dollars. That payout would be for all purposes approved by the legislature, including the dividend and the general government budget. If you assume no change in the present dividend statute, which is based on realized income rather than market value, some $175 million to $300 million would be available each year for budget purposes other than the dividend. These estimated ranges are narrow because of the five-year smoothing built in to the payout proposal.

That constitutional amendment would protect the Permanent Fund. If the statutes that specify other limits on spending from the ERA conflicted with the legislature's needs, they could be amended or repealed without posing a risk to the Fund.

If the constitutional amendment has not been passed, however, there would be two very large differences. First, the amount available for the legislature to appropriate each year would vary much more widely. Instead of a range of $1.2 to $1.4 billion, it could be as little as a few hundred million to well over $2 billion. Second, all the existing, specific limits on the ERA would have to be maintained, as would the inflation-proofing statute, in order to protect the Permanent Fund against invasion of principal and against inflation.

To illustrate the first point, consider the following numbers:

First, note the current projected June 30, 2002 balance in the realized ERA, after dividends and inflation-proofing: $1.9 billion.

Second, note the annual swings in statutory net income over the past four years plus 2002 projected:

1998	$2.6 billion
1999	$2.5
2000	$2.2
2001	$1.2
2002	$1.2

Third, note the annual "Net Change" in the realized ERA for the same period:

1998	$1,282 million
1999	$1,201
2000	$382
2001	- $588
2002	- $471

The first number, $1.9 billion, is the beginning size of the cushion in the realized ERA. When that is gone, or nearly gone, the legislature would be completely subject to the wide variability demonstrated by the second set of numbers in terms of appropriations for all purposes. The third set of numbers shows what is left for funding the budget gap after paying dividends and inflation-proofing.

In short, the Fund - even with the POMV limitation - is just not large enough to be all things to all people. Although it gains increased stability with the POMV limitation, the Fund cannot continue to pay dividends per the existing statutory formula, retain sufficient earnings for inflation-proofing and completely fund the fiscal gap. If asked to do too much, instead of a Permanent Fund, you would have a temporary fund.

Here's another perspective on what would happen if the ERA were to be treated as the "new" CBRF and no structural changes were made to the Fund nor any new state revenues established:

First, future Fund earnings would begin to diminish as: (a) the Fund's growth is reversed due to unsustainably large payouts from the ERA, and (b) the Fund earns a lower rate of return as the Trustees shorten the Fund's investment horizon to reflect the increased annual distributions. Then, as the ERA begins to shrink in size, it becomes vulnerable to an extended period of low or negative investment returns, high inflation, and/or low oil prices, and eventually -- and perhaps quite suddenly -- is completely dissipated, leaving no income at all for inflation-proofing, dividends or the budget gap. That is the nightmare scenario.

That is how Alaska's fiscal situation goes from bad to much, much worse.

Board of Trustees

Final

Monthly Management Report - December 31, 2001

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Alaska State Legislature

SENATOR
GENE THERRIAULT
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(907) 488-0857
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Senate

While in session
State Capitol
Juneau, Alaska
99801-1182
(907) 465-4797
Fax: (907) 465-3884

Senate District Q

Date: 4/30/01

Number of Pages including cover: 3

To: Gregg Erickson / ABR

Fax: 586-1987

From: Joe Balash

Re: per your request. call if you have any other questions.

Email: Senator_Gene_Therriault@legis.state.ak.us

Memorandum

To: Sen. Gene T...riault

From: Joe Balash, State Affairs Committee Aide

Date: 1/27/01

Subject: APFC Trustees' proposed constitutional amendment

You have asked for my thoughts on the APFC Board of Trustees' proposed constitutional amendment. In particular, you asked about what other steps would be required to carry out this proposal. I have included a brief description of what the language does, what questions it raises in my mind, and where able to, my answers to those questions.

The proposed language does two things. First, it takes the existing section of the Constitution establishing the permanent fund and changes the disposition of the earnings of the fund. Currently, the constitution reads "all income from the permanent fund shall be deposited in the general fund unless otherwise provided by law." The existing law puts all income in the earnings reserve. Within the earnings reserve are the realized and unrealized earnings. The PFD formula is based upon the realized earnings of the fund. The proposed amendment would change this set-up by depositing all income from the permanent fund in the permanent fund. The significance is that the permanent fund is off-limits from spending; if all income from the fund is going to be deposited back into the fund, there will have to be additional changes made to the constitution if the PFD program is going to be maintained. Which leads to the other 'half' of the proposal.

The second part of the proposal would add another paragraph to Article IX, section 15 to state:

> "(b) For any fiscal year, an appropriation from the permanent fund to the general fund shall be limited to five percent of the average of the year-end market values of the permanent fund for the last five fiscal years, including the fiscal year just ended. No other appropriations from the permanent fund may be made."

This would be quite a change from existing interpretations/opinions on how the permanent fund may be used. This language allows the principal to be spent, but limits that spending to 5% of the five-year rolling average of the fund's market value (about $1.24 billion in FY02). This is a big departure from the way people have been looking at the Permanent Fund for some time now. If such a change is going to be made, the repercussions need to be fully explored with an eye toward the long-range use of the fund. Also, the public's perception of what is being proposed will be critically important since they will be voting on the measure.

The constitutional amendment proposed by the APFC Board of Trustees raises some interesting questions about the future of the Permanent Fund and the state's fiscal policy. They break down into three broad categories: (1) is this really a measure to protect the Permanent Fund from inflation? (2) what are the other pieces that make this work mechanically? and (3) what happens to the PFD program?

Question 1: Is this really a measure to protect the fund from inflation?

The title of the resolution drafted by the APFC Trustees reads, "Proposing amendments to the Constitution of the State of Alaska relating to inflation-proofing the permanent fund." Not to suggest that the Board of Trustees is somehow disingenuous, but the change proposed here, if adopted, will drive additional changes that ultimately can determine Alaska's course of fiscal policy for some time. And the manner in which they suggest the fund be inflation-proofed is not *really* inflation-proofing per se.

The Trustees propose managing the fund on a "percent of market value" (POMV) basis. It is slightly different from what the Legislature proposed in 1999 in that the language is permissive rather than explicit. The All-Alaska Plan would have created a revenue stream that would be paid out every fiscal year. This language appears to allow a revenue stream to be paid out, but does not require one. Instead, it allows the Legislature to make a limited appropriation each year. This does not explicitly inflation-proof the fund. Rather than insuring that a defined pot of money, the principal, be increased according to the CPI so that the pot has the same value at the end of the fiscal year that it had at the beginning of the fiscal year, this approach limits the amount of the fund that can be "spent". Basically, this is supposed to prevent the fund from being "overspent".

While it is certainly true that over the long-term, limiting spending to something less than 5% will protect the integrity of the fund, it does not guarantee that the fund will not lose value in a given year. The first year that total returns do not equal inflation plus the appropriation made to the general fund, observers will point out that the fund lost value. The public needs to understand that there should be a long-term view taken when looking at the fund.

Question 2: What are the other pieces that make this work mechanically?

Overall, the language appears to be aimed at a long-term goal/view for how the fund should be used. However, there are some steps that will have to be taken between what we have now and what is proposed. First, is the earnings reserve going to be rolled into what we now consider the principal? If so, that can be accomplished with two steps—making an appropriation from the earnings reserve to the principal and then repealing the statutes establishing the earnings reserve. There would be some timing issues to work out, though. If for example, the amendment were on the ballot in 2004, the appropriation would have to be made after the appropriations for FY2004's dividends and inflation-proofing and the statutes would probably have to be repealed effective June 30/July 1, 2005. Which raises additional timing questions. Would the same legislature that put the amendment forward pass these additional pieces of law contingent upon the amendment's passage? Or would the task fall to the next legislature? There could be some trickiness here similar to what the legislature encountered in 1999—lay everything out so the public knows what will be happening or hold back a little so as not to make it appear as a done deal (thereby incurring their wrath in that same general election).

If the earnings reserve is not going to be rolled into the rest of the fund, what is to be done with it? This is somewhat important since the reserve accounts for something close to 23% of the entire fund's current value and would affect the availability of funds in the future. Since I don't think that the Trustees intend to keep the earnings reserve separate, I haven't spent a lot time thinking about the potential down-side.

Question 3: What becomes of the PFD?

This question has bedeviled every plan proposed to this point that I am aware of. It is certainly important to the public since it will impact them quite directly. Since the current PFD formula is based on realized earnings, it would become useless under a "percent of market value" (POMV) method. In all likelihood, the PFD pool would be based on a given percentage of the fund's market value. However, this, too, would require statutory changes—which again raises questions of timing similar to those mentioned above. Also, would this appropriation be the full 5% of the rolling average allowed by the Trustees? If not, there would almost certainly be a drop in the value of the PFD checks. Would everything be on the table and contingent upon the adoption of the amendment by the voters?

There is an additional "problem" created by the new language. The section that allows for "spending" up to 5% of the permanent fund in a given fiscal year appears to require that the appropriation only be made to the general fund. If this is the case, and PFDs continue to be paid, then PFD growth will impact the state's bottom line. Is it the Trustees' intent to have PFDs compete with all other GF spending by the Legislature? A lot of effort has been made to differentiate between GF and all other spending, including PFDs. This would most definitely blur that line. In addition, if PFDs are competing with other GF funding one has to consider the possibility that the judiciary may be tempted to infringe on the Legislature's appropriation power. Decisions will be forthcoming in the next 18 months that may give a better idea of whether this is likely or not (GRF/Medicaid for abortions, *Kasayulie*).

General Conclusions

What the Trustees have presented is not all that bad when considering all the implications. Their proposed language impacts the PFD and the general fund in very significant ways. Needless to say, this proposal goes much further than simply inflation-proofing the permanent fund. In the resolution adopted by the Trustees last December, the legislature is urged to reject all other amendments affecting the section of the constitution containing permanent fund. This would appear to mean that they would reject all other proposals—creating a formidable roadblock for competing visions of the fund, thereby framing the debate on any "Long-Term Fiscal Plan".

Subject: SJR13
Date: Thu, 26 Apr 2001 18:14:57 -0800
From: Mary Griswold <mgrt@xyz.net>
To: Jim Kelly <jkelly@alaskapermfund.com>
CC: Joseph Balash <Joe_Balash@legis.state.ak.us>

April 26, 2001

Hi Jim,

I listened to your presentation at the SSTA committee meeting this afternoon. I think you made a good case for SJR13. I signed up to testify, but it turns out that Therriault lost the slip of paper with my name on it. His aide just called me to apologize and let me know that I can testify next week.

I am concerned about one concept as you presented it.

I think it is deceptive or at least confusing to say that the principal will not be eroded with a 5% payout which is further limited to the income in the earnings reserve account. I agree that the acquired principal will not be eroded, but what we really expect to maintain is the inflation-proofed principal, which IS subject to erosion because the inflation-proofing dollars are inseparable from the other dollars in the earnings reserve account.

Earlier in this process, I was concerned that the principal was not truly inflation-proofed if its inflation-proofing dollars were left in the earnings reserve account. I wanted periodic transfers from the earnings reserve to the principal in times of plenty to protect the principal in leaner days. However, because only 5% of the fund's market value may be appropriated each year, the principal is in fact fully inflation-proofed as much as market models permit. I am willing to accept the small risk that the real value of the principal of the permanent fund may be occasionally eroded in a prolonged down market. I stress that it is very important to limit the payout to no more than 5% to make this an acceptable risk.

Regarding Tamara Cook's memo of February 12, 2001, I would remove from the resolution at the end of line 7 to line 8 "the principal of" and add to the end of the sentence at line 9 "and for the purpose provided in (b)," meaning that all funds in the permanent fund shall be used only to make money and to provide for a 5% payout even if this erodes the value of the principal (which is very unlikely).

As I mentioned in an earlier e-mail, I think life would be a lot simpler if we got rid of the earnings reserve in the statutes to complement the constitutional amendment. 80% (adjustable) of the 5% would go to dividends, 20% (adjustable) would go to government. The constitution does not recognize the earnings reserve account. It was created by statute to distribute income under the current system based on earnings, but it is not necessary or even relevant for POMV distribution. It can only confuse people. I offered statutory changes to 37.13.140 and .145 (a-e) to delete it in Bill Hudson's HB35.

I plan to present some of this at next week's committee meeting if they remember me.

Mary

SITE: ~~OFF-NETS~~ HOMER LIO

COMMITTEE: Senate State Affairs

DATE: 4/26/01

SUBJECT OF MEETING: SJR-13

Update#:

THE SEAL OF THE STATE OF ALASKA

PLEASE SIGN IN

PLEASE PRINT:

NAME	ADDRESS (MAILING & ZIP)	REPRESENTING	DO YOU WANT TO TESTIFY? Y or N
MARY GRISWALD			Y SJR 13

Subject: SJR13
Date: Wed, 25 Apr 2001 20:52:29 -0800
From: Mary Griswold <mgrt@xyz.net>
To: Joseph Balash <Joe_Balash@legis.state.ak.us>

April 25, 2001

Dear Senator Therriault,

Thank you for scheduling a hearing on SJR13.

I enthusiastically support imposing a 5-year rolling average 5% market value payout restriction on the Permanent Fund.

The main reason I support this constitutional amendment is that it provides a better money management framework. POMV payout reduces the pressure to manage the permanent fund for return over value. Managing for value is generally considered a better fiscal approach. A 5% payout is generally recognized by large endowments as the highest sustainable payout, beyond which the real value of a fund would diminish over time.

A secondary benefit is that this methodology will provide a reasonable money stream for government if the legislature chooses to use it. Right now the money sitting in the earnings reserve account is available for legislative appropriation for purposes other than dividends, although the legislature has not ever spent it. There will be more pressure in the future for the legislature to use this money. SJR 13 will limit the amount the legislature can use to a predictable and modest amount.

It is important to recognize that our dividends are as much as they are because the legislature made special appropriations from the earnings reserve account to the principal and because it did not spend the earnings available to it. Any use of permanent fund earnings for purposes other than dividends will decrease the value of our checks because whatever is spent will not be available to earn more money. However, our dividends could be cut by much more under the current payout system than under POMV.

5 POMV payout combined with allocating 80% for dividends and 20% for government would preserve the status quo dividend formula with the understanding that the 20% transfer from the fund will reduce the fund's future income producing potential.

I believe it is time to allocate some permanent fund earnings to government and see 5 POMV payout as the best way to do that. But most importantly, I see 5 POMV payout as a better money management tool which will keep the permanent fund permanent for future generations.

Thank you for your consideration.

Mary Griswold
Homer

The private benefit arguably represented by the dividend program continues to fall into a gray area in terms of public purpose. At one end of the spectrum are the approved disaster insurance programs. The IRS found a sufficient governmental purpose to help its citizens protect themselves against natural disasters in the wake of significant disasters with profound economic consequences for the state. The IRS may have been particularly persuaded by the suggestion that, absent such programs, the financial consequences would be borne more directly by the state. At the other end of the spectrum are the prepaid tuition programs, which the IRS characterized as private investment schemes wrapped in the state's cloak of tax exemption. It may be difficult to argue that the dividend program is more like the former than the latter.

It is an open question whether dividend payments to individuals outside the context of a higher education purpose (or some other "approved" governmental purpose) will suffice to satisfy the public purpose criterion.

Morrison & Foerster believe that as long as the income from the Fund clearly accrues to the State and no individual has a vested right in the income or assets of the Fund, the income and assets are those of the state alone, and thus not subject to federal taxation. How the state chooses to appropriate or spend its revenues should have no impact on this determination, except perhaps to further reinforce the argument that the investment activity is an integral part of the State and essential governmental function. And as long as the dividend program is implemented as a matter of legislative grace, M&F believe that it will be difficult for the IRS to argue that, having earned the income (investment being an appropriate public purpose and essential government function), it is not entirely within the discretion of the State to appropriate it as it sees fit, whether through legislative allocation or annual budget appropriations.

To the extent that the Fund, or some portion of it, becomes irreversibly dedicated to the benefit of private beneficiaries, or to the extent that the dividend program becomes an entitlement that is beyond the reach of government, then it becomes more like the prepaid tuition programs and is subject to potential challenge by the IRS as a private, rather than public investment activity.

		Alaska Permanent Fund	Michigan Education Trust	Florida Hurricane Catastrophe Fund	Hawaii Hurricane Relief Fund	California Earthquake Authority
Corporate Status		State Fund; managed by a public corporation	Public Corporation	State Fund	Public Corporation	State Agency
	Ownership of Assets	State	Investors	Reverts to the state upon termination	Reverts to the state upon dissolution	Transferred to the state upon termination
Control and Domination		Investments dictated by law; LB&A Cmte has oversight	Independent of the State; decisions could not be overridden by any agency		Initial plan of operations subject to legislative review	Initial plan of operations approved by the legislature; amendments approved by the insurance commissioner
	Board Make-up	state officials and public members confirmed by the legislature		state officials	state official and public members confirmed by the senate	state officials
	Employees	state employees		Fund employees and contract advisors	Administered by a state agency	Employees subject to state civil servant requirements
Source and Destination						
	Source	State royalties and settlements	Participants	Insrurers/Participants; some nonparticipant funds	Participants + additional state funds (mortgage recording fee)	Equivalent of state premium tax collections; some seed money; sale of fund premiums
	Destination	Currently, a matter of legislative grace	private beneficiaries	revenues earmarked for the fund	insurers and the insured	insurers and the insured
IRS ruling		none requested	rejected	exempt	exempt	exempt

Integral Part Theory

Federal taxation does not reach income earned by a state—or an integral part of a state

- Congress may tax the income of states—but must do so specifically
- Morrison & Foerster (D.C. tax attorneys) contend this is the Fund's strongest argument

What constitutes an integral part of a state? Three essential elements are reviewed:

1. Corporate Status
2. State creation; control and domination; and declaration of state purpose
3. Source and destination of program funds

No single element is determinative in and of itself.

IRS looks very closely whenever a private benefit is created. However, sufficient indicia of state control and public purpose can support integral part status, despite the existence of significant private benefit.

There is *nothing* comparable to the Permanent Fund and its dividend program. The areas where a private benefit has caused the IRS to get concerned involved mechanisms where the individuals who paid into the entity (fund, corporation, agency) were the only recipients of the private benefit. In our situation, the Fund comes only from royalties that the state already owns, plus some additional grants of general fund dollars in the early 1980s. Payments of dividends to private individuals from income of the fund does not seem to be similar to any of the other "investment schemes" that the IRS required some public purpose to justify the private benefits in question.

Subject: **Attached draft**
Date: Mon, 25 Mar 2002 01:34:31 -0900
From: Gregg Erickson <gerickso@alaska.com>
To: Senator_Gene_Therriault@legis.state.ak.us
CC: Joe_Balash@legis.state.ak.us

Dear Senator Therriault:

Do you or Joe have anything to add to this story (draft attached)?

My deadline is late Tuesday. If you'd rather phone, I'm at 586-1290.

Thanks,

Gregg Erickson
--
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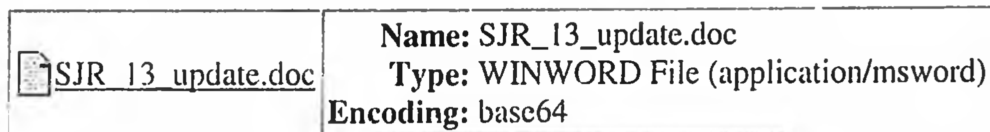

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DRAFT

PERMANENT FUND

Therriault to push adding PFD to trustees' PF amendment

House State Affairs Chair Gene Therriault says he doesn't buy the argument that making the permanent fund dividend program a part of the Alaska Constitution will threaten the fund's tax exempt status, and the North Pole senator says he wants to move forward with an independent legal analysis of a plan to add the dividends provision to a constitutional amendment being pushed by trustees of the Alaska Permanent Fund Corporation.

SJR 13, the trustees' constitutional amendment proposal, would require all permanent fund income to be returned to the fund, and limit annual appropriations from the fund to 5 percent of the fund's market value, a level trustees say will ensure full inflation-proofing. Therriault's plan is to add provisions mandating that a certain percentage of any money withdrawn from the fund be paid as dividends directly to Alaska residents. The Legislature would not be required to pay dividends if no money was taken from the fund.

At a March 21 hearing on SJR 13, Therriault provided members with copies of legal opinions prepared for APFC by the national law firm of Morrison & Foerster [see **Lawyers say feds unlikely to tax permanent fund**, *ALASKA BUDGET REPORT*, November 4, 1998]. He noted that APFC witnesses cited the opinions in February as the basis for their conclusion that the federal government would likely try to tax the fund's earnings if the dividend program were made a part of the state Constitution [see **APFC lawyer warns senators against putting dividend in Constitution**, *ALASKA BUDGET REPORT*, February 27, 2002]. He also

"I read through them and I understand the trustee's concern," said Therriault. "There is a potential tax problem." But Therriault said his reading of the opinions is suggests that there are ways to minimize any legal risk. He asked Joe Balash of his staff to summarize the legal issues.

Balash said Congress has the right to tax the income of states, but must specifically exercise this right, and has so far not done so. Based on this doctrine, courts have generally held that activities and funds that are an "integral part" of a state government are exempt from taxation. The question then becomes: Is the institution being considered for taxation an integral part of a state? Three factors are considered:

- Legal status, whether incorporated as part of a state or separately,
- The degree of state control or domination of the institution, and
- The source and destination of the money or other assets of institution.

No single element is determinative on its own, Balash said, but applying the tests to the permanent fund doesn't suggest vulnerability to federal taxation, even assuming a constitutional requirement that dividends share in any payout.

The Alaska Permanent Fund Corporation is a state-owned corporation with a separate legal existence, but it's officers are all state employees. Moreover, the corporation doesn't own the fund: it remains the property of the state government, a point the APFC has emphasized in its recent annual reports. The "legal status" provides a strong argument for exemption.

On the issue of "control or domination" Balash said there is no question that the fund is under the state's power and command. APFC is not allowed to spend money except as the Legislature appropriates, and the Legislative Budget and Audit Committee has statutory legislative oversight of its activities. State law, Balash noted, defines what kind of investments are permissible and the distribution of the proceeds.

Balash said the Internal Revenue Service has increasingly focused on the last test: where the money comes from, and where it goes. Permanent fund dividend payments could easily be considered a private benefit, a factor that would tend to concern the IRS, but money coming into the fund clearly is not from private sources, indicating that the arrangement would be of less concern to the IRS. "It is only individuals investing their money, then earning a [tax-sheltered] return, and then getting a benefit back that really caused the concern to the IRS."

Balash painted a far different picture than the committee received from APFC officials. Speaking to the committee on February 21, Juneau attorney Ron Lorensen, under contract to assist the fund, said that creating a private interest in the fund, such as making dividends mandatory, would make the entire fund taxable. "It's not worth risking." Even if only "a little" of the fund's earnings were dedicated to dividends, "it all becomes susceptible as soon as the Legislature gives up control over any portion of it."

Citing legal advice from Lorensen and the national law firm of Morrison & Foerster, APFC Executive Director Robert Storer said at the February hearing that the corporation opposes a constitutional amendment guaranteeing the dividend.

Therriault made it clear at the March 21 hearing that he has reached a different conclusion, and that his approach to putting the dividends into the Constitution—as a fixed percentage of any money the Legislature decides to use from the fund—would not mandate an annual dividend as some earlier proposals [see **Ogan PF dividend amendment moves despite tax worry**, *ALASKA BUDGET REPORT*, April 12, 2000, and **Trustees' amendment spawns confusion**, May 2, 2001].

"Under the proposed percent of market value methodology [as proposed by the trustees], if there is to be a draw from the permanent fund, it must be limited to 5 percent. That's permissive—it doesn't dictate that you have to take a draw." Making the dividends a fixed percentage of any draw doesn't force the Legislature to take any money out of the fund. He claimed that the option would always open

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for other uses of any money left in the fund because citizens could always change the Alaska Constitution.

Therriault said he is comfortable now that the state would prevail if the dividend program were linked to the percentage-of-market-value (POMV) limit being pushed by the APFC's trustees, and assuming that the Legislature would have full discretion to set the amount of the draw, up to POMV limit.

"It is almost a slam-dunk in our favor," he said, citing recent IRS rulings on the taxability of disaster funds established by Hawaii, Florida and California. "When you compare with these disaster funds, we've got a lot stronger case."

Therriault said the state already is using some permanent fund earnings for state government functions, and presumably would continue to do so, even if dividends were constitutionally mandated as a share of any money drawn from the fund. He said that also strengthens the state's case.

So what is the next step for SJR 13?

"I wanted to have this discussion to bring you up to speed, give you my interpretation, give you an opportunity to digest it, and see if you come to the same conclusion," Therriault said, indicating that he hopes the committee will take some final action on SJR 13 sometime in the next two weeks."

Therriault noted that the possibility of taking a holiday from inflation-proofing is under discussion in the House. "I'm not sure that the Senate would ever agree to not inflation-proofing, taking a holiday from inflation proofing, or taking a 7 or 8 percent draw from the overall value of the fund."

Sources say Therriault will bring the matter up in the Senate Majority Caucus to be held ASK LOREN WHEN??.

On March 22 in the House, the day after the Senate hearing, Democrat Harry Crawford, joined by Democrat Eric Croft, introduced a constitutional amendment resolution that embodies the Therriault proposal. Sponsor substitute for HJR 14 would establish the POMV scheme as proposed by the APFC trustees, but require that "At least fifty percent of the amount appropriated ... during a fiscal year shall be used during that same fiscal year for a program of dividend payments to state residents established by law."

The Crawford-Croft resolution contains a repealer provision that would wipe out the dividend mandate if the courts give a final judgment that the fund is subject to federal taxes. As originally introduces last year, Crawford's HJR 14 would have restructured the constitutional budget reserve.

ASK CRAWFORD WHERE HE GOT THE IDEA.

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RECEIVED
APR 21 1998
SIMPSON, TILLINGHAST,
SORENSEN & LORENSEN

Re: Alaska Permanent fund Corporation

Dear Jim:

You have requested an update of the Report ("Report ") that we provided to the Alaska Permanent Fund Corporation ("APFC") approximately 10 years ago, regarding the question whether the Fund and APFC are subject to federal taxation. I have reviewed the cases and rulings that have been issued since 1988, as well as the statutory amendments made to Title 37, chapter 13 of the Alaska Statutes, Attorney General opinions, and the recent annual reports. This letter summarizes and discusses the legal developments relating to the central legal arguments addressed in our previous report. We assume for purposes of this letter that the factual description of the Alaska Permanent Fund ("Fund") and the APFC contained in the Report are still applicable, apart from the legislative amendments which substituted references to the fund for references to the APFC, and other changes discussed below at page 32.

I Executive Summary

As before, we believe that there are three primary arguments supporting the position that the income of the Fund and the APFC are not subject to federal taxation.

First, it might be argued that the constitutional doctrine of implied immunity of state instrumentalities from federal taxation applies. As we concluded before, this doctrine has been so narrowly construed that it offers only questionable protection. The few legal developments under this doctrine have only reinforced our previous conclusion.

MORRISON & FOERSTER LLP

Mr. James L. Baldwin
April 7, 1998
Page Two

Second, we relied on a history of IRS rulings, albeit without judicial authority, to argue that income earned by a State or an integral part of a State is not specifically subjected to State taxation. Since 1988, there has been quite a lot of ruling activity related to the integral part doctrine, as well as publication of the first judicial decisions to address it. We believe that these additional authorities strengthen the position that the Fund and the APFC are an integral part of the state and thus not subject to state taxation.

Third, we argued that, in the alternative, the income is excluded under section 115 of the Internal Revenue Code ("Code").[1] Section 115 excludes from gross income any income that is derived from the conduct of an essential governmental function and accrues to a State or political subdivision. At the time of the Report, there were a number of older authorities in this area, but there were no recent authorities. Since 1988, this has been an unusually active area for IRS rulings. Recent case law also has addressed this statute, and the IRS has published one ruling of precedential value. Although we believe that these developments continue to support also the position we took with respect to the Fund and the APFC, they do indicate that the IRS's analysis increasingly turns on the issue of private benefit.

In short, we believe that the legal developments in this area in the last 10 years reinforce the conclusions reached in our earlier Report.[2]

Finally, we note that a number of the recommendations we made to strengthen the Fund and the APFC's position were subsequently adopted. We felt at the time that the practical changes and proposed statutory amendments would substantially reinforce the State's legal position that the Fund and the APFC are integral parts of the State and that income earned on Fund assets is earned directly by the State. We believe that the factual analysis in the subsequent cases and rulings underscore the wisdom of such actions.

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[1] All references to the Internal Revenue Code or the Code are to the Internal Revenue Code of 1986 as amended, 26 U.S.C. §1 *et seq*

[2] We have reason to believe that the IRS is currently considering several additional private rulings under the integral part doctrine and section 115, which may further elaborate on the factors that are essential to exemption under the integral part doctrine or exclusion from income under section 115. We understand that they have been controversial, in that they were previously submitted and rejected and have been resubmitted to the IRS. We do not have enough information at this time to determine if the rulings will add any meaningful discussion or elaboration to the prior rulings.

II. Constitutional Immunity

The 1988 Report concluded that the constitutional doctrine of implied intergovernmental tax immunity had been so narrowly interpreted over the years that it was unlikely to provide a reliable basis for arguing that any income received by a state was immune from federal taxation should Congress choose to impose such taxation. At one time, the constitutional doctrine of intergovernmental tax immunity held that, as a matter of constitutional relationship between the federal government and the states, the federal government may not tax the sovereign states. This doctrine has been so eroded over the years that it is difficult to determine what its remaining scope might be.

During our previous consideration of this issue, the Supreme Court decided *South Carolina v. Baker*, 485 U.S. 505 (1988), which held (among other rulings) that the doctrine of intergovernmental immunity did not bar a nondiscriminatory federal tax on interest earned by holders of state government-issued bonds ("[T]he States have never enjoyed immunity from all federal taxes considered to be 'on' a State."). Although that case did not deal with a federal attempt to tax a state or state instrumentality, but rather a state attempt to dealt with a tax on bondholders, the Court offered a sweeping analysis of the doctrine of intergovernmental tax immunity, a discussion which might be characterized as dicta. Although the Court never addressed the question of the "extent to which, if any, States are currently immune from direct federal taxation," 485 U.S. at 523 n. 14, the decision includes the often-quoted caveats that "at least some state activities have always been subject to direct federal taxation", 485 U.S. at 523 n.14, and "at least some nondiscriminatory federal taxes can be collected directly from the States even though a parallel state tax could not be collected directly from the Federal Government." 485 U.S. at 523.[3]

We concluded that *South Carolina*, read in conjunction with the Court's expansive reading of the commerce clause in *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985), suggested that the Court recognized few restraints on the federal commerce or taxing powers over state activities. Nevertheless, we believed that the Court was likely to conclude that there was a limited set of core powers of sovereignty that would remain immune from the federal taxing power, such as state tax revenues, but that there was less comfort that the Court would not approve a

[3] The Court defined "directly" with respect to a state tax on the federal government as "'when the levy falls on the United States itself, or on an agency or instrumentality so closely connected to the government that the two cannot realistically be viewed as separate entities ...'" and indicated that the same definition applied to a federal tax on a state. 485 U.S. at 523.

nondiscriminatory tax on other state income, such as investment income. Report at 69-76.

The *South Carolina* case, of course, had just been decided at the time of our prior Report, and the impact of the decision and dicta therein had not yet been determined. Since then, there have been approximately half a dozen federal cases regarding the intergovernmental tax immunity doctrine, and none have given us a reason to alter this conclusion.

> Specifically, in a case concerning federal taxation of investment income of the state-created Michigan Educational Trust ("MET"), a federal district court rejected the intergovernmental tax immunity claim on the grounds that the MET was not so closely connected to the state that the two could be realistically be viewed as separate entities. *Michigan v. United States*, 802 F. Supp. 120, 126 (W.D. Mich. 1992). On appeal, the state dropped its intergovernmental immunities claim. The 6th Circuit eventually ruled that the Michigan Educational Trust was indeed an "integral part" of the state, and thus exempt from federal taxation. *Michigan v. United States*, 40 F. 3d 817 (6th Cir. 1994). The Court noted, however, that "it was an appropriate move" for the state to drop its intergovernmental immunities challenge because that doctrine had "been severely eroded with the passage of time, and several years ago the Supreme Court suggested that it is now an open question whether there is 'any' extent 'to which States are currently immune from direct non-discriminatory federal taxation.'" *Michigan v. United States*, 40 F.3d at 823 (quoting *South Carolina v. Baker*, 485 U.S. 505, 518 n.11 (1988)).
>
> The 6th Circuit concluded that "*we are confident that today's Supreme Court would say that Congress is free to impose a non-discriminatory tax on the investment income at issue here if it wants to.*"

40 F.3d at 823 (emphasis added). Since the Court had already concluded that the MET was an integral part of the state, this statement with respect to the intergovernmental immunities doctrine is disturbing, since it indicates that even a generally favorable Court would not conclude that a state's investment income is exempt from federal taxation.

Since then, no other case has addressed the question of the potential permissible constitutional scope of federal taxation of the states.[4]

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[4] Several cases have discussed the doctrine in the context of discriminatory indirect state taxation of persons or entities arguably associated with the federal government. These include: discriminatory state taxation of federal retirees, *see, e.g., Harper v. Virginia*, 509 U.S. 86 (1992); *Davis v. Michigan*, 489 U.S. 803 (1989); nondiscriminatory state taxation of oil and

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III. Federal Taxation Does Not Reach Income Earned by an Integral Part of a State

We previously contended that the strongest argument was that the Fund and the APFC were an "integral part" of the state, and thus wholly outside the federal tax code. That is, the IRS has consistently taken the position that the federal income tax law does not impose income tax on income earned directly by a State or an entity that is an "integral part" of a State absent a specific statutory provision.

This is a separate argument from the constitutional doctrine of intergovernmental immunities, which is premised on the constitutional relationship between the federal government and the states.

In contrast, the "integral part" argument assumes that, if Congress so chose, it might be empowered to tax the states directly, but that careful review of the income tax laws reveals that Congress has not attempted to do so. At its most developed, the "integral part" theory argues that any congressional imposition of tax must be clear and unequivocal. The Internal Revenue Code expressly taxes corporations, but does not expressly tax states or political subdivisions, and there is no evidence that Congress ever intended the code to apply to states. The IRS had developed this theory in several precedential published rulings as well as numerous nonprecedential administrative interpretations and internal memoranda. *See* Report, at 27-39.[5]

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gas production on Indian reservations by non-Indian lessees, *Cotton Petroleum Corp. v. New Mexico*, 490 U.S. 163 (2988) (describing the intergovernmental immunities doctrine as "'thoroughly repudiated' by modern case law"); and whether state use taxes on bankruptcy sale proceeds unduly burden the processes of the federal bankruptcy court, *California v. Sierra Summit, Inc.*, 490 U.S. 844 (1989).

[5] See the Report, at footnotes 26 and 30, for a discussion of the varying forms of IRS interpretations and rulings, and their precedential weight. In this letter, we have included discussion of many Private Letter Rulings (PLR) which are written advice provided to taxpayers who submit written requests for rulings on specific legal issues based upon a specific set of facts. Under section 6110(j)(3), such private letter rulings are directed only at the taxpayer that requested the ruling and may not be used or cited as precedent. Since the IRS has substantially reduced its output of published guidance and no longer produces even general counsel memoranda (discussed at footnote 30 of the report), private rulings are a valuable window into the developing position of the IRS, particularly in areas such as this which are rarely the subject of published guidance and even more rarely litigated. Although nonprecedential, private letter rulings also can provide a basis for seeking a similar interpretation by the IRS with respect to similar fact patterns.

At the time of the Report, there was no judicial authority to support the "integral part" theory. In our Report, we discussed the then-recent IRS private ruling issued to the Michigan Educational Trust ("MET"), which was the nation's first government-sponsored prepaid college tuition plan. In that ruling, the IRS determined that the fund was not an integral part of the state, and thus its income was not exempt from taxation. PLR 8825027. (March 29, 1988). Since our Report, the State of Michigan challenged the IRS in tax refund litigation. The trial and appellate decisions in *Michigan v. United States* are the only judicial decisions ever to consider the integral part theory. 802 F. Supp. 120 (W.D. Mich. 1992), *rev'd*, 40 F.3d 817 (6th Cir. 1994).

Since 1988, the IRS has been invited to rule on the "integral part" theory several times, due in large part to the interest on the part of the states in prepaid college tuition investment programs, disaster insurance funds, and self-insurance programs for local governments. The IRS has issued another precedential Revenue Ruling as well as numerous private rulings. These rulings, however, have further developed the theory in unexpected ways. The IRS has been inexplicably inconsistent in its approach, narrowly applying the theory in some cases (prepaid state tuition plans) yet expansively applying it in others (state disaster insurance programs).

A. Michigan Educational Trust

The Michigan Education Trust case is interesting because of the many structural parallels with APFC in terms of its creation and control by the State. Its facts diverge, however, in terms of the source and destination of the funds. It further highlights the IRS's concern with private benefit, although this typically is raised in the context of section 115 rather than the "integral part" doctrine.

The Michigan Education Trust was established as a public corporation. Its corporate purpose — higher education — was declared by the legislature to be a public purpose and an essential function of state government. It was "allocated by law" to the state treasury department, but acted independently of the department. It had an independent board appointed by the governor and confirmed by the senate; the board included the state treasurer. The board exercised its powers as authorized by the statute, including investing, paying out funds, determining the eligibility of participants, and contracting on behalf of the state. A separate state administrative board was made up of officers of the state, including the governor. The administrative board had to approve the form contracts used.

The state attorney general had advised the trust's board that it was an "agency" of the state. The employees of MET were subject to rules governing state employees, *e.g.*, civil service and state laws governing liability of public officers, and the MET was

subject to laws governing the conduct of state agencies, *e.g.*, open records law, open meetings laws, and FOIA. The attorney general provided legal counsel.

An important factor was the source of funds — the entire assets of the MET consisted of actuarially-determined amounts paid by parents under pre-paid tuition contracts. MET was to invest the funds and guaranteed the college tuition of beneficiaries at some time in the future. The act expressly provided that the funds were to be used solely for the purposes of the trust and could not be used by the state for any other purposes. The assets of MET were not considered state money or state revenues, and were not subject to payment of full faith and credit obligations of the state (although the appellate court later determined that the reason for this may have been to give the trust broader investment powers than it otherwise would have). Another important factor was the destination of funds, which were to be paid out to beneficiaries. Moreover, upon dissolution, the assets would not go to the state but would be distributed pro rata to the investors, although state could claim any actuarially determined excess. The state was not legally obligated to make up any shortfall in funding, although it was authorized to do so.

The MET funds were segregated from state funds, although they could be pooled with state funds for investment purposes. Apparently, state treasury department employees actually handled the investments. The bank trust accounts were in the name of the state treasurer, with the state as agent for the trust. MET made an annual accounting to the state governor and legislature. Annual audits were conducted by the state auditor general. Fund payments were paid out through state warrants. Trust income was exempted from state taxes.

During our work on the 1988 Report, the IRS issued a private letter ruling rejecting the exempt status of the MET. PLR 8825027 (March 29, 1988). The IRS discussed the "integral part" theory only briefly, concluding that MET was not an integral part of the state. The key factors mentioned in the IRS ruling were that it was created as a corporation to operate independently from the state; the trustees' decisions could not be overridden by any state agency; the funds were not derived from the state, were not subject to the claims of the state's creditors, and were not considered state funds; the state could not loan, transfer, or use MET funds for any purpose; and the MET funds could be used only for the tuition payment or refunds to investors.

Michigan then filed returns and sued for a refund of the taxes paid. In the District Court, the parties stipulated the facts and filed cross motions for summary judgement. The District Court denied the refund claim, determining as a matter of law that the MET was subject to federal taxation. *Michigan v. United States*, 802 F. Supp. 120 (W.D. Mich. 1992). Michigan raised, and the court addressed, several possible

bases for exemption —constitutional doctrine of intergovernmental immunities and the 10th Amendment, the integral part of the state doctrine, section 115, and section 501(which expressly exempts charities and certain other similar entities).

The District Court implicitly accepted the "integral part" theory as a matter of law that states are *de facto* exempt from federal internal revenue laws. MET was a corporation, however, and thus was subject to federal taxation unless it was an integral part of the state entitled to the state's immunity. The Court concluded that MET was not an integral part of the state because, although the state put up some seed money, the actual funds came from investors and could not be used by the state to pay state creditors or for any other purposes. Also, MET's obligations were not backed by the full faith and credit of the state.[6] The Court concluded that these facts demonstrated that MET was an entity distinct from the state and not entitled to immunity as an integral part of the state.

Michigan appealed to the 6th Circuit, which reversed, holding that the MET was exempt from federal taxation, as an instrumentality or political subdivision, and as an integral part of the state. *Michigan v. United States*, 40 F. 3d 817 (6th Cir. 1994), *rev'g* 802 F. Supp. 120 (W. D. Mich. 1992). The 6th Circuit initially addressed the question whether Congress had imposed taxation on a government corporation such as MET. The Court observed that the Internal Revenue Code plainly imposes tax on corporations. Literally read, that section would tax all governmental corporations include municipalities organized as bodies corporate, public universities, and federal instrumentalities that are organized in corporate form (citing a list of federally owned corporations that are presumed to be exempt from taxation). The IRS conceded the legal premise that the Code did not impose taxation on a state, a political subdivision, or an "integral part of a state." 40 F.3d at 823.

The Court further cited a long line of Supreme Court authorities requiring Congress to express its intent unequivocally when it intends to alter the usual constitutional balance between the States and the federal government. The Court concluded that Congress knew how to make the kind of "plain statement" necessary to impose a tax on a state instrumentality but had not done so here.

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[6] The Court's opinion regarding the constitutional arguments and section 115 are discussed at pages 3-4 and 25-32, respectively. The court also rejected exemption under section 501 because MET's direct benefits impermissibly inured only to parents who purchased contracts, thus violating the private benefit and private inurement restrictions on section 501 charitable organizations. As we suggested in our prior Report, a similar concern would likely be raised with respect to the Fund, APFC, and the dividend program if exemption were sought under section 501.

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Unfortunately, the 6th Circuit's decision is so over-inclusive in its argument and use of analogous legal tests that it is somewhat muddled, and to some extent confuses, rather than clarifies, the appropriate legal standard under the "integral part" theory. The 6th Circuit seemed to feel that it had to conclude that the MET was not only an instrumentality but also a political subdivision in order to conclude that it was an integral part of the state. The Court determined that the statutory description of the MET as a "public body corporate and politic" rendered it a state instrumentality. 40 F.3d at 818. The Court relied on an Advisory Opinion of the Supreme Court of Michigan that the grant of corporate powers to a state agency rendered it a "quasi-corporation" but that the agency nevertheless "remains an instrumentality of the State." Id. (quoting Advisory Opinion re Constitutionality of PA 1966, 380 Mich. 554, 575, 158 N.W. 2d 416, 425 (1968)).

The Court then reviewed the case law regarding whether an entity is a political subdivision or part of a state for tax purposes, concluding that the standard was whether the entity had been created by state authorities, acting within their constitutional powers, and had been delegated the right to exercise a part of the state's sovereign power for the purposes of carrying out state functions. The treasury regulations defined "political subdivision" as a division of the state which either is a municipal corporation or has been delegated the right to exercise part of the sovereign powers of the state. The Court concluded that the contractual obligations of the MET were no less than those of other entities determined by the courts to be political subdivisions, and that the contracting powers delegated to the MET empowered it to exercise essential governmental functions on behalf of the state. Id. at 825.[7]

Citing prior authorities[8], the Court focused less on the creation and powers of the entity rather than its purposes, finding that the "real criterion" was whether the activities

[7] Not surprisingly, this aspect of the Court's decision has been criticized as confused and inconsistent with the authorities relating to political subdivisions, primarily on the grounds that MET was not granted sovereign powers.

[8] Commissioner v. Shamberg's Estate, 144 F.2d 998 (2d Cir. 1944), *cert. denied*, 323 U.S. 792 (1945) (port authority is political subdivision even though it had no power to impose taxes or pledge the credit of the state and was not subject to debt-limiting provisions of state constitution). Critics question how MET can be a political subdivision without sovereign powers. The political subdivision argument is not likely to be strong outside the 6th Circuit, due primarily to the lack of sovereign powers. The case law is quite old that a political subdivision must have sovereign powers, defined as the power to tax, the power of eminent domain, and the power to regulate (the police power). The case cited, *Shamberg's Estate*, is the leading "political subdivision" case. It dealt with a port authority that had eminent domain and police powers, but not the power to tax -- it was held to be a political subdivision. Other political

of the subdivision were for a public purpose. Responding to the District Court's rather summary dismissal of higher education as a governmental function, the 6th Circuit determined that education was a governmental purpose and public function, particularly given the history of Michigan as a land grant state and the emphasis in the state constitution of education as an essential government function. The Court noted that the act creating the trust included extensive legislative findings that it was an essential function of the state to support education, to encourage attendance to state institutions, and to provide educational assistance to students. The Court found that education was at least as much a state purpose as the bridges and tunnels that were the functions of the entities held to be exempt political subdivisions in the prior case law. The Court thus concluded that MET was a public agency authorized to exercise contracting powers on behalf of the state for a purpose declared by the legislature to be a public purpose.

The Court then added that MET would qualify as a political subdivision since it was a "public body corporate and politic", and thus was "in a broad sense" a municipal corporation. *Id.* at 825-26.[9]

For further support, the Court also borrowed a six-factor test used by the IRS and the courts for determining whether an entity is an agency or instrumentality for purposes of federal law governing governmental benefits plans. Those factors are (1) whether it is used for a governmental purpose and performs a governmental function; (2) whether it performs its function on behalf of a state or political subdivision; (3) whether there are private interests involved or whether the state or political subdivision has the powers and interests of an owner; (4) whether control and supervision is vested in public authorities; (5) whether express statutory authority is required for the instrumentality and whether such authority exists; and (6) the degree of financial autonomy and the source of operating expenses. 40 F.3d at 826-27 (citing *Rose v. Long Island Railroad Pension Plan*, 828 F.2d 910 (2d Cir. 1987), *cert. denied*, 485 U.S. 936 (1988), and Rev. Rul. 57-128, 1957-1 C.B. 311). The Court concluded that MET satisfied the first five factors (the sixth was not presently satisfied but the court

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subdivision cases discussed by the 6th Circuit include *Commissioner v. White's Estate*, 144 F.2d 792 (2d Cir. 1944) (bridge authority was political subdivision with power to issue exempt bonds); *Philadelphia National Bank v. United States*, 666 F.2d 834 (3rd Cir. 1981)(Temple University was not a political subdivision eligible to issue tax-exempt debt); *Rose v. Long Island Railroad Pension Plan*, 828 F.2d 910 (2d Cir. 1987), *cert denied*, 485 U.S. 936 (1988)(metropolitan transit authority (MTA) was political subdivision and pension plan was part of MTA).

[9] The Court did not cite any authority for this conclusion, which not surprisingly, also has been criticized by commentators and the IRS.

speculated that it could not be ruled out for the future), and concluded that, on balance, the presence of five factors led to the conclusion that it was a state instrumentality.[10]

The Court also distinguished United States v. Maryland Savings-Share Insurance Corporation, 308 F.Supp. 761 (D. Md.), *rev'd on other grounds*, 400 U.S. 4 (1970) ("MSSIC"), which was discussed in our Report at pages 85-90. In MSSIC, the Supreme Court upheld the lower court's conclusion that a nonprofit insurance corporation charted to insure savings and loan accounts was not exempt from federal taxation as an instrumentality. The 6th Circuit pointed out that that MSSIC was a private corporation, organized by and for savings and loan members, with a Board largely comprised of elected directors. 40 F.3d at 827-828. In contrast, the MET was a public instrumentality, had a board appointed by the governor, and was delegated authority to contract on behalf of the state.

The court also rejected both of the government's arguments that the trust could not be an integral part of the state because its corporate form made it functionally independent and because the source and earmarking of funds made it fiscally independent. The Court determined that it was "immaterial' that the state chose to use a public corporation rather than to assign the functions to a traditional department. 40 F.3d at 828. The Court cited the example of the U.S. Postal Service as a corporate entity that did not become taxable by virtue of its corporate form. 40 F.3d at 828-29. Similarly, the Court rejected the argument that the source or earmarking of funds was determinative, again citing the example of the U.S. Postal Service, the TVA, and ports authority as examples of governmental instrumentalities that obtain funding from private sources and are earmarked for the performance of public functions that the agencies were created to perform. The Court was also critical of the government's focus

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[10] Critics argue that this six-factor test of "instrumentality" is irrelevant for two reasons. First, it was developed in a different context involving different law, legislative history and intent, and different requirements (ERISA and governmental plans). This argument was made by the IRS in criticizing the MET case in subsequent rulings. *See, e.g.*, PLR 9809013 (Nov. 7, 1997); PLR 9706006(Nov. 8, 1996); PLR 9627016(April 5, 1996); PLR 9622019 (Feb. 28, 1996). The IRS's challenge is a bit disingenuous, however, since it was the IRS itself that issued a series of G.C.M.s and rulings relying on this six-factor test for purpose of section 115. *See, e.g.*. G.C.M. 34704 (Dec. 2, 1972); G.C.M. 34502 (May 2, 1971); PLR 8820030 (Feb. 16, 1988); PLR 8740015 (July 2, 1987); PLR 8650017 (Sept. 10, 1986). Second, critics argue that "instrumentality" is not synonymous with "political subdivision" or "integral part of a state", and that instrumentalities are not even certain of exemption under section 115. *See, e.g*, Letter to Editor from Prof. Ellen P. April, 66 Tax Notes 121 (Jan. 2, 1995) (citing *Maryland Savings-Share Insurance Corp. v. United States*, 400 U.S. 4, 7 n.2 (1970) ("MSSIC") and Rev. Rul. 77-261, 1977-2 C.B. 34).

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on the form, rather than the substance of the entity, analogizing the trust to government student loan programs and state pension funds. *Id.* at 829.

Not surprisingly, the IRS has chosen to reject the 6th Circuit's decision, criticizing it in public appearances and statements, and taking the position that it is not authoritative anywhere outside the 6th Circuit. In rulings since *MET*, the IRS has repeatedly rejected the analysis of the Court as "internally inconsistent", arguing that its "reliance on the [six] factors listed in Rev. Rul. 67-128 ... to reach its conclusion is misplaced." *See, e.g.*, PLR 9809013 (Nov. 7, 1997); PLR 9706006(Nov. 8, 1996); PLR 9627016(April 5, 1996); PLR 9622019 (Feb. 28, 1996). Moreover, the IRS declared that it would no longer entertain state requests for rulings relating to the exemption of state prepaid tuition programs under the "integral part" theory or section 115, thus shutting the door on states that might want to adopt a variation on the Michigan plan that might be more acceptable to the IRS. Rev. Proc. 96-34, 96-1 C.B. 721.

Lacking access to guidance, the states began to lobby for Congressional grant of exemption to such programs. Finally, in 1996, the Small Business Job Protection Act added new section 529 to the Code, which expressly provides tax-exempt status for state tuition programs that meet the requirements of the statute. P.L. 104-188, §1806. Even after this statement of Congressional approval, the IRS continues to refuse to issue rulings under the "integral part" theory or section 115 to states relating to prepaid tuition programs, thus in effect taking the position that only plans organized pursuant to the statute may be exempt. Rev. Proc. 98-3, 1998-1 I.R.B. 100 (Jan. 5, 1998).

B. Disaster Insurance Programs

The IRS has issued a number of widely publicized "integral part" rulings to states in recent years that shed additional light on the IRS's concerns in this area, particularly regarding which characteristics of an entity qualify it as an integral part of the state. In contrast to the MET IRS ruling, the extent to which a proposed state entity's activities appear to be private rather than public in nature (*e.g.*, private funds, investors, beneficiaries) continues to be a significant consideration, yet apparently is not determinative once certain other indicia of state creation and control and financial commitment are satisfied.

The most significant rulings in recent years involve a series of proposed state disaster insurance programs, which typically create some sort of entity or fund which individuals or insurers would pay into or purchase insurance from, which entity would then pay claims or reimburse insurers in the event of a certain natural disaster.

1. Florida Hurricane Catastrophe Fund

In 1995, Florida successfully obtained a private ruling which held that the Hurricane Catastrophe Fund ("CAT Fund"), a trust fund created by state law, would be considered an integral part of the state. PLR 9507037 (Nov. 4, 1994). It is described as a "trust fund under state law", *i.e.*, a separate legal entity, but it does not appear from the ruling or the state statute that it was structured as an actual trust but rather as a state fund. Participating insurers were to pay premiums into the fund, and would be reimbursed for a percentage of losses resulting from certain events. The state also imposed an assessment on a broader class of insurers, including many nonparticipants, with the revenues to be earmarked for the fund.

It appears that the state was not liable if the fund proved to be insufficient, although if that occurred, local governments could issue revenue bonds for the benefit of the fund, and the bonds would be backed by the fund's future revenues. It appears that monies in the fund were not subject to the state's creditors. The ruling does not indicate whether the fund was treated as a state account for accounting purposes, or whether there was any duty to provide financial reports or to be audited by the state. The state legislature also could appropriate funds from the fund for grants to local governments and nonprofits for preparedness programs. All assets of the fund would revert to the state upon termination of the fund. It was governed by the State Board of Administration, a three-member board comprised entirely of state officials. Operations of the fund were conducted by fund employees and contract advisors. It appears that the board was not created for the purposes of governing the fund, but rather was a pre-existing body that had been created under the state constitution to administer certain special purpose tax revenues, and also could be delegated other powers under state law.

The ruling cryptically states that "[t]he method of accounting for moneys related to certain operations does not by itself determine whether the operation is an integral part of the state or an entity separate from the state." Nothing in the ruling discusses the method of accounting for funds. It is known that the fund was very controversial and was initially rejected by the IRS. This comment may be an observation that the fund was actually a state fund, rather than an independent fund, and that that distinction alone did not resolve the issue of integral part. Certainly, past IRS rulings have found that the existence of a separate legal entity or independent entity was a determinative factor in finding that an entity was not an integral part of the state.

The ruling does rely on the state's exercise of its taxing power and "significant contribution" of monies to the fund, the state's power to appropriate monies from the fund for certain specified purposes, and the state's receipt of the assets upon dissolution as significant factors in concluding that the state has a "financial interest" in the fund. Another factor cited by the ruling was that the monies could only be used for purposes

authorized by state law, and no other purposes. The ruling also noted that the state exercised direct control over the fund through the board which consisted of state officials.

Curiously, there was no discussion of the issue which animated the debate over the MET ruling — the significant private benefit. Here the very purpose of the fund, as there, was to pay out virtually all of the income and assets to private parties, but that issue was not even discussed. Apart from the MET ruling, it would appear from a general review of IRS rulings that the private benefit analysis is limited to section 115 and plays little or no part in determining whether an entity is an integral part of a state. That may well be the wrong interpretation of the IRS's position, however. Contemporaneous public statements by Florida state officials during the ruling negotiations indicate that the IRS's chief concern was indeed the MET -type private benefit issue. The Florida CAT Fund was perceived by the IRS not as a state fund but rather as plan to help private insurers. Negotiations with the IRS dragged on for over a year — the IRS apparently demanded that the state have a significant investment of its own funds at risk in the fund before it would rule that it was an integral part of the state.

Subsequently, Florida apparently did not enact the plan in the form it was presented to the IRS, and the IRS threatened to withdraw the exemption ruling unless the state committed "significant" state funds to the fund. Several amendments to the plan were made, including additional annual appropriations from the general revenue fund and another state trust fund for the first two years, a broader base of nonparticipants who would be taxed to fund the program, and additional powers on the part of the state to appropriate monies from the fund. The IRS accepted these changes and issued a favorable supplemental ruling. PLR 9522039 (March 6, 1995).

2. Hawaii Hurricane Relief Fund

In the wake of Hurricane Iniki, Hawaii also developed a state sponsored disaster relief fund, which the IRS held was an integral part of the state. PLR 9627016 (April 5, 1996). Significantly, the fund was established as a public corporation. The fund was placed under the State Department of Commerce and Consumer Affairs for administrative purposes. The board was made up of the commissioner of insurance, *ex officio*, and six members chosen by legislative leadership and the governor. Departmental employees were assigned to the fund, and continued to be considered state and departmental employees.

The fund issued hurricane policies for properties covered by private property insurance, and the private insurance companies served as servicing agents for the fund hurricane policy as well as the property insurance. The fund's policy revenues were

kept in a trust fund outside the state treasury. The fund revenues came principally from annual premiums for the policies. The fund was authorized to levy annual assessments on insurers in the state. The law also created a special mortgage recording fee to be earmarked for the fund. If the fund was insufficient to pay claims, the law also provided for increased assessments on insurers, or additional special assessments, or surcharges on hurricane policy premiums. Additionally, the law authorized creation of a bond fund within the state treasury, and authorized the commerce department to issue state debt obligations which would not be backed by the full faith and credit of the state, as well as other further revenue bonds which would be backed by the full faith and credit of the state under certain limited circumstances. The bond fund would make loans to the trust fund to support its operations. Upon dissolution of the fund, any remaining monies after settlement of any claims, would revert to the state general fund.

The ruling concluded that the state exercised significant control over the fund. All board member would be state officials or nominated by state officials and confirmed by the state senate. The initial plan of operations was subject to legislative review. It would be administered by a state department and was required to report annually to the state insurance commissioner. Employees were considered employees of a state department. The state had made a substantial financial commitment to the fund through assessing the mortgage recording fee, levying an annual assessment on insurers, providing for potential surcharges on premiums, pledging full faith and credit for certain debt obligations, and receiving the assets of the fund upon dissolution. Based on the elements of state control and financial commitment, the IRS concluded that it was an integral part of the state.

3. California Earthquake Authority

The IRS revisited the issue with the California Earthquake Authority ("CEA"), issuing, revoking, and reissuing rulings as the state amended its proposed program to satisfy the IRS. Initially, after about six months of negotiations, the IRS issued a private ruling determining that the CEA was an integral part of the state. PLR 9622019 (Feb. 28, 1996). As described in the ruling, the CEA was established by a statute which created both an agency and the fund to provide earthquake coverage. Private insurers were required to offer coverage in one of two ways — either directly, or by participating in the fund and issuing a fund policy to be administered and serviced by the private insurer. Premium rates for fund policies were subject to approval by the state and subject to public rate-making procedures.

The fund was governed by a board consisting of three voting members, all state officials, and two nonvoting members, both legislators. The board members could designate a state employee to serve in their place. The board also had an advisory panel,

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representing the insurance industry and general public, to be appointed by the board members. Meetings of the board and advisory panel were subject to state open meetings requirements. The fund was administered under the direction of the state insurance commissioner. The initial plan of operations had to be approved by the commissioner and legislature. Subsequent amendments had to be approved by the commissioner. Senior executives would be employed under contract. The fund's employees were subject to state civil service requirements, and subject to state laws governing post-government employment.

The state annually would contribute the equivalent of the state premium tax collections on the fund policies to the fund as part of the fund's capital. The state also contributed the remaining balance in a defunct previous earthquake trust fund. Participating private insurers would pay an initial assessment to the fund based upon market share. The primary source of revenue, however, would be premiums for fund policies sold. The fund would purchase reinsurance. The statue authorized that a certain percentage of investment income could be used for earthquake mitigation programs. If the fund were unable to cover claims, the fund could ask the state treasurer to issue debt obligations to be repaid through a policy surcharge, but the state would have no liability for those obligations. The statute expressly provided that the state would not be responsible for any of the liabilities of the fund. In the event of the fund's termination, all assets would be transferred to the state.

The ruling distinguished *MSSIC* on the grounds that : (1) only three of eleven MSSIC directors were selected by state officials; (2) the state made no financial contribution to MSSIC; and (3) the state had no present interest in the income of MSSIC. The ruling also mentions that MSSIC was a corporation, but does not discuss the significance of that fact. The ruling also mentions that under the MSSIC charter, the full faith and credit of the state was not pledged for MSSIC's obligations. Similarly, the California statute expressly declined to give the state's backing to the obligations or liabilities of the CEA.

The ruling also distinguished *MET* in a discussion, repeated in other rulings, that makes it clear that the IRS does not agree or acquiesce to that decision. The *MET* decision was distinguished as "internally inconsistent" because it found that the MET was both a political subdivision and an integral part of the state. The California ruling further rejected the decision's discussion of the factors listed in Rev. Rul. 57-128 as irrelevant because they apply only to entities that are separate from a state, and are not used to determine if it is a separate entity or an integral part of a state. This seems to misstate the Revenue Ruling, which admittedly is not an "integral part" or section 115 ruling, but in another context does spell out a list of factors to be considered in determining whether a entity is an instrumentality of a state or not.

Other factors cited in the ruling were the significant government interest set forth by the state in providing assistance to its citizens and economy in the event of natural disasters of the magnitude of an earthquake. The state also had argued that this plan represented an exercise of the state's power to regulate an industry, and that the fund was as valid an exercise of state power as the regulatory alternatives.

Two months later, the IRS revoked the ruling letter for further review of the issue. Letter dated April 30, 1996, LEXIS, FEDTAX, TNT, 96 TNT 102-54. It appears that this revocation may have been prompted by the state legislature's consideration of further legislation that threatened to significantly revise the CEA.

The state then conducted an unusual high pressure campaign, seeking assistance from the White House and imposing pressure through its congressional delegation. Legislation was introduced in Congress to grant an express federal tax exemption to the CEA.

Then in June, 1996, the IRS reinstated the ruling granting exemption as an integral part of the state without discussion. PLR 9641010(June 25, 1996) (reinstating PLR 9622019). The ruling noted that the state legislature was considering legislation affecting the fund, and warned that the IRS was not giving any opinion as to the continuing exempt status of the fund if the legislation were to be enacted.[11]

After the California legislature further amended the statutory scheme, the state again sought a reaffirmation of the IRS's ruling. Subsequently, the IRS again issued a ruling to California, concluding that after numerous statutory changes, the CEA was an integral part of the state. PLR 9706006(Nov. 8, 1996).

In general, the legislative amendments did not really address the issues of either state control or financial interest, which apparently were the chief concerns of the IRS. The chief purpose of the amendments appears to have been to forbid the CEA from declaring bankruptcy, to strengthen the capitalization of the fund, and to create additional "tiers" of remedy in the event that the assets of the fund proved inadequate to satisfy claims, including various additional surcharges on participating insurers. The

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[11] Published accounts of the California Earthquake Authority tax negotiations, discussed below, and private discussions with Florida, Hawaii, and California state officials and IRS officials reveal that the IRS was very concerned about the overwhelmingly private benefit characteristics of these funds. The IRS required amendments, if necessary, to strengthen state control, to impose requirements that assets revert to the state upon dissolution (although given the nature of these funds, the possibility of remaining assets is so remote as to be meaningless), and most important, to require a significant state financial commitment.

amendments also seemed to make it harder for participants to avoid sharing the burden of fund obligations by dropping out. The only amendments that seemed relevant enough to warrant mention in the IRS's discussion in the final ruling were: (1) the legislature "provided for" additional surcharges on policies, and probably more important, the state appropriated some monies to assist in the start-up of the fund, and loaned additional monies at a legal rate of interest; and (2) the board members and officers were made subject to the financial disclosure requirements for state officials. Otherwise, the ruling is almost verbatim identical to the earlier ruling (PLR 9622019).

The California ruling is somewhat surprising in that the state assumed no liability for the fund, unlike the Florida hurricane catastrophe fund. The California insurance commissioner publicly stated that lawmakers demanded that the state's general fund be immune from liabilit , and described the structure of the program as one of "building firewalls between the CEA and the General fund."

C. Other Integral Part Rulings

There have been a few other integral part rulings worth noting. Unfortunately, several rulings have made broad and disturbing statements that a corporation created by a state is not an integral part of a state because it is a corporation and is not within a branch of government. For example, in PLR 9549030 (Sept. 11, 1995), the IRS ruled that a corporation created by a county to manage a commercial district was not an integral part of the State or a political subdivision of the State "because it was created as an entity separate and distinct from the district and is not within the Executive or Legislative branches of County". [12]

Similarly, another ruling concerned a state-created public corporation which was organized to establish a university. PLR 8935012 (May 30, 1989). The governing board was appointed and confirmed by the state. It received state appropriations for capital outlays and operational expenses. Apparently the state itself argued that the corporation was an entity separate and apart from the state. The IRS concurred and concluded that it was not an integral part of the state, without further discussion. [13]

Similarly, the IRS has determined that a regional development authority was not an integral part of the state, apparently because it was formed as a separate corporation,

[12] The ruling did conclude that the corporation's income was excluded from taxation under section 115, and thus was required to file a federal corporate tax return.

[13] The ruling did conclude that section 115 applied to exclude the corporation's income from federal taxation.

had its own officers and employees, and was not under the control of any state agency or any one political subdivision. PLR 9009063 (Dec. 8, 1989).[14]

One distinction between these rulings and other favorable rulings is that these involve public corporations, while other favorable rulings involve trusts or other entities of more nebulous legal status It is difficult, however, to determine the significance of corporate status, especially when the IRS does not elaborate on the issue, or when the IRS eventually finds the entity to be exempt under another provision. For example, while the IRS considered corporate status to be a negative factor for MET, it apparently was not the determinative factor in concluding that it was not an integral part of the state.

Certainly, there are other rulings that conclude that a corporation can be an integral part of the state. For example, the Hawaii hurricane fund was organized as a public corporation, yet the IRS did not raise that as an issue. It would appear generally that while corporate status is a significant factor for the IRS, it may be neutralized by sufficient evidence of state control and, in the words of the IRS, "domination." *See, e.g.*, G.C.M. 39601 (Jan. 30, 1987) (lawyer trust fund); G.C.M. 38921 (Nov. 26, 1982) (housing authority).[15] Yet is extremely difficult to predict when separate organizational structure will be determinative or what level of government control renders a separately organized entity an integral part of the state.

Also, if a corporation cannot by definition qualify as an integral part of the state due to its separate legal existence, then the same rational should apply to a trust. Yet there are several rulings that conclude that trusts can be integral parts of a state. *See* Rev. Rul. 87-2, 1987-2 I.R.B. 4 (1987).

In one recent ruling, the IRS held that a trust was an integral part of the state regardless of the fact that was created as a separate and distinct entity apart from the political subdivision. The IRS reviewed a trust set up by a municipality to pay retiree medical benefits. PLR 9809013 (Nov. 7, 1997). Although the municipality asked for a ruling under section 115, the IRS concluded that section 115 did not apply because the

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[14] *See also* PLR 8934052 (May 21, 1989) (arts commission is "corporate and politic," therefore not integral part).

[15] *See also* PLR 8920056 (Feb 22, 1989) (An unincorporated city economic development board was not an integral part because the board could hire its own staff who were not considered city employees. The board was created under state statute and funded by taxes, board members were appointed by the city, the city budgeted expenses, the board submitted financial reports to city, city audited the board).

trust was an integral part of the state. The trust was created by statute to hold and invest amounts contributed by the municipality to fund retiree medical benefits for former public safety officers. The trust was administered by a board, and six of the eight trustees were appointed by program participants (and at the time were active municipal employees although that was not a requirement), and only two were appointed by the municipality. However, the legislative body of the municipality confirmed all appointments. Day-to-day administration was performed by a municipal employee, who was paid by the municipality and participated in the employee benefit system. The municipality provided facilities, equipment, and legal services to the trust. The municipality could amend or terminate the trust at any time, and in the event the trust were terminated, all assets would revert to the municipality. The IRS stated:

> *If an enterprise is deemed to be an integral part of a state or political subdivision of a state, that enterprise will not be treated as a separate entity for federal tax purposes, regardless of the fact that the enterprise was created as a separate entity.*

PLR 9809013.

The IRS determined that it must consider all the facts and circumstances, particularly the state's degree of control over the enterprise and the state's financial commitment to the enterprise. Key factors were that the municipality had made a substantial financial commitment by providing all of the start up money as well as portion of the annual costs. Other important factors included the significant influence exerted by the municipality, its power to amend or terminate the trust at any time, the control over day-to-day operations by a city employee, approval of the board by the city legislative body, and the requirement that the board act only as authorized by the statute. *Id.*

Yet in PLR 9217032 (Jan. 27, 1992), the IRS determined that a mine reclamation trust fund created under state law was not an integral part of the state because it was separately organized as a trust under state law, the trustees had total discretion over the funds, and the trust could accept funds from nongovernmental sources. It is difficult to square this ruling with the later disaster fund rulings, except that it was clearly a separately organized legal entity.

Whether the governing board is appointed by the state or independently elected was a deciding factor in PLR 8944031 (Aug. 7, 1989). That ruling held that a soil and water commission was an integral part of the state, but the soil and water districts were not an integral part because the governing bodies consisted of four independently elected members and only one government appointee.

Yet another group of rulings echo the MET ruling in considering the source and/or destination of the assets and income of the entity. In 1994, the IRS held that a trust fund created by a state court to collect private contributions to pay for judges' portraits was an integral part of the state. PLR 9439008 (June 30, 1994). The funds were from private sources and there was no financial commitment on the part of the government. A key factor in the ruling, however, were that the court created the trust and controlled it through its ability to select and discharge the state employees who controlled the funds and the trust. Moreover, reflecting the IRS's interest (sometimes) in the destination of funds, the ruling was expressly made contingent on trust documents being amended to provide that any funds remaining after the purposes were met would be delivered to the government's general fund. The ruling concluded that the trust was an integral part of the state, since it was created by the court, controlled by the court officers, and upon termination, any remaining funds would go the state general fund.

In another ruling, the IRS considered a "lifeline" fund, created by the state to subsidize the utility rates of the poor, and concluded that it was an integral part of the state. The fund was created by statute, although it is unclear from the ruling what its legal status was. The funds came from a state-ordered surcharge on utility bills, and were invested until paid out to needy individuals. It was administered by a committee appointed by a state commission. No state officials served on the governing committee. The fund's budget was subject to state review, and annual reports were submitted to the legislature. If terminated, assets would be distributed as ordered by a state public utilities commission, but could not revert to private interests. The IRS concluded that the fund was an integral part of the state due to the state's control over the creation, operation, funding, and supervision of the fund. PLR 8931042 (May 8, 1989). The fact that the assets and income were paid out entirely to private individuals did not seem to merit discussion.

Another recent ruling addressed funds created by state officials from the proceeds of litigation judgments or settlements. The state created two funds to hold settlement payments received as a result of litigation by the attorney general. PLR 9733003 ((May 9, 1997). A fund was created in the state treasury to hold litigation judgments or settlements, and was controlled by the treasury department. Distributions from the fund were made pursuant to court order. All income from investment of the fund was deposited in the fund. Fees were paid to the treasurer for investment and administrative services. The fund consisted of two litigation settlements, funds A and B. Settlement A was from state litigation against a trade school. The state court's order required the Attorney General to create a fund, fund A, to receive payments from the defendants for civil penalties, attorneys fees, and restitution to students of the school. In other words, the proceeds in the fund were to be paid as restitution to the individual claimants. The second fund, fund B, consisted of settlement proceeds of antitrust cases

in federal court brought by the state as *parens patriae* for its residents. The plaintiff class members who were to receive the settlement proceeds in fund B were the state and municipalities.

The state argued that the funds were an integral part of the state.[16] In discussing the "integral part" issue, the IRS noted that the state was involved in the administration of the funds, and state employees, acting in their governmental capacities conducted the funds' business. In both cases, a court controlled distributions and the state remained answerable to the court regarding its administration of the funds.

For fund A, the state controlled disbursement because of the jurisdiction of the state court. The state was not responsible for shortfalls in either fund and did not contribute state funds to either fund. The state did not have the authority to access the assets or income of the funds for the benefit of the state. The state's only financial interest was as a potential claimant. Regarding fund A, the IRS determined that the fund benefited private parties and lacked public benefit, and was not an integral part of the state.

Regarding fund B, the IRS determined that the state lacked the requisite level of control since disposition of the assets and income had to be determined by a federal court. The IRS concluded that the Fund was not an integral part of the state, but rather was a form of receivership imposed on the state by the court.

The litigation settlement ruling is instructive in that it focuses on two concerns of the IRS. The focus on creation and control by the state has long been an element of the "integral part" theory. The focus on "private benefit" however, is a recent development. At times, private benefit appears to be the determining factor, as in this ruling and the MET rulings. Yet just as often, programs such as the disaster insurance programs, that unquestionably have an almost exclusive private benefit are held to be "integral parts" of the state. *See also* PLR 8925010 (March 21, 1989) (city development district is integral part of city even though money reverts to private property owners upon dissolution).

Corporate status does not explain the distinction, since the Hawaii hurricane fund, for example, was a corporation. Curiously, this new destination of income analysis is borrowed from the section 115 analysis, discussed below, and the private benefit focus, which we see in both "integral part" and section 115 rulings, appears to be borrowed from section 501 charitable organization law, which forbids any nonincidental

[16] The state also argued that the income of the funds would be excluded from income under section 115. See discussion below at page 25-32.

private benefit. It is unclear why the IRS has adopted this analysis, but it is equally clear that not only is it now a key element under section 115, there is a not insignificant likelihood that the IRS may well import it into an "integral part of the state" determination as well.

D. Summary Regarding Integral Part Theory

Overall, we believe that these developments have helped to further elucidate the courts' and the IRS's rationale under the integral part theory in ways that generally are favorable to the fund and the APFC. The *MET* decision is particularly generous, as are the disaster fund rulings.

Ten years after the Report, the fact that APFC is structured as a corporation continues to give some cause for concern. Commentators have argued that the use of a separate entity, such as a corporation or a trust, must preclude integral part status, and must be analyzed under section 115. This does not seem to be the IRS position, however. Although the rulings of the last 10 years continue to be inconsistent on this point, it appears that, given sufficient indicia of control and financial commitment by the state, a corporation or trust is not automatically precluded from being an integral part of the state.

In this case, the assets and income are not those of the corporation, but rather belong to the State. As a matter of statute, APFC is simply the manager of the Fund assets. This has been reinforced through the 1992 amendment of section 37.13.030 which now plainly clarifies that the assets are managed and invested by APFC, rather than "allocated to" APFC. Similarly, the annual report clearly reports income and assets as those of the Fund, and not the corporation.

Certainly, it would appear that - apart from the corporate structure issue - state creation, control and domination, and declaration of state purpose are essential factors. Similarly, the MET and disaster fund rulings seem to teach that some not significant part of the assets must come from the state, and that it must have some financial risk in the enterprise. The IRS's MET ruling reflects the IRS's evolving but erratic interest in the destination of funds as well although this did not appear to concern the 6th Circuit.

A comparison of MET with the Alaska Permanent Fund and APFC is both instructive and reassuring. The key characteristic of the MET and similar prepaid tuition programs, which gives pause to the IRS and, we suspect to any court, is the source and destination of the program funds at issue. The MET may have had all the appearances of being a part of the state, but it was still wholly a private activity conducted by private investors for the benefit of private beneficiaries. The state

contributed only minimal start-up administrative funds, all of the funds were entirely private funds, the MET's assets were not considered to be state assets, the income was not state income, and upon dissolution, the assets reverted to the investors rather than the state. The IRS-state negotiations over the disaster fund rulings, and subsequent rulings in other areas, discussed below, reveal that the source and destination of the assets and income, as well as private benefit, are becoming significant concerns of the IRS with respect to the integral part doctrine, as well as section 115.

In contrast, the assets and income of the Alaska Permanent Fund are unquestionably those of the state, and not the corporation or any private person. While the legislature has chosen to appropriate certain state funds to the dividend program, the recipients do not have an entitlement to the income of the Fund. If the corporation were dissolved, the assets would remain those of the State, and would not accrue to any individuals. This argument, of course, is premised on the legislature's ultimate control over any allocation, appropriation, or payment to private persons. If at any time, the legislature or government loses that power of appropriation, or private persons are granted an entitlement to the assets or income in the Fund, this argument is considerably weakened.

What plainly bothers the IRS about prepaid tuition programs, although it seemed to be unable to discuss it openly in the MET ruling, is the appropriateness of "lending" the state's tax-exempt status to private investors so they can earn a greater return on their investment than they might otherwise. IRS officials have frequently raised this objection in public discussions of prepaid tuition programs. Apart from tax-exempt bonds, the tax code is full of provisions designed to prevent taxable persons from benefiting from a charitable organization's exemption (*e.g.*, UBIT). The IRS views such programs as opening the door to abuse.

On the other hand, the *MET* decision and disaster fund rulings indicate that private benefit does not, in all cases, undermine the integral part argument. It would appear from both *MET* and the disaster fund rulings that sufficient indicia of state control and public purpose can support integral part status, despite the existence of significant private benefit. Obviously, however, it is an open question whether dividend payments to individuals outside the context of a higher education purpose (or governmental pensions, or health insurance claims, or other "approved" governmental or public purpose) will suffice to satisfy the public purpose criterion.

Unfortunately, since the IRS continues to reject the holding and rationale of the 6th Circuit's *MET* decision, it is clear that it could not be relied on as a basis for obtaining a ruling. Similarly, it likely would provide cold comfort in an administrative proceeding, such as an audit or appeal. We suspect that other courts may well be

skeptical of its reliance on the political subdivision cases in particular, or its apparent finding that "instrumentality" status is sufficient for exemption under the "integral part" theory.

Although it is difficult to reconcile the IRS's continuing hostility to prepaid tuition plans, which the IRS labels as private investment schemes that seek improperly benefit from the state's exemption, with its generous position on disaster insurance programs, a key distinguishing factor is the element of the state's financial commitment to the enterprise. The IRS insisted that the disaster programs include a significant level of state financial commitment as a source of funds, such as through contributions of funds, earmarking of certain tax or fee revenues, or allowing certain debt obligations to be backed by the state's full faith and credit. In the case of the Fund, it is an essential distinction that the assets clearly are those of the State.

IV. Section 115 Exclusion From Income

The previous Report concluded that the Fund might alternatively claim exclusion of income under section 115, although that position was not entirely free from doubt.[17] Section 115 requires: (1) that the income of an instrumentality be derived from an essential governmental function, and (2) that the income accrue to the State. We noted that the few judicial authorities did not clearly support this argument, yet the IRS appeared to be more liberal than the courts in applying section 115 in the ruling context, particularly with respect to finding "accrual" of income by the State. Since 1988, section 115 has been discussed on only one reported case, *Michigan v. United States*, 802 F.Supp. at 120, described above, which was reversed by the appellate court without discussion of section 115. The IRS has issued one precedential ruling and approximately 170 nonprecedential rulings in this area.

A. Michigan Educational Trust

In *Michigan v. United States*, the state made the alternative argument that the MET's income was excluded from gross income under section 115. In the private ruling, the IRS did not discuss the essential governmental function prong of the statutory test, concluding rather that the accrual requirement was not met because the income served private interests that were more than incidental to the public interest. PLR 8825027 (March 29, 1988). The MET provided direct economic benefits only to

[17] Section 115 and "integral part" theory are not merely alternative arguments. The distinction has important consequences — if the income were excludible under section 115, APFC would be required to file tax returns.

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provide participants who were the beneficiaries of a contract. The IRS stated "The basic principle underlying section 115 is that property (including any income thereon) must be devoted to purposes which are considered beneficial to the community in general, rather than particular individuals." PLR 8825027.

The District Court also did not discuss the "essential governmental function" requirement, although its discussion of the "integral part" claim and 501(c) exemption claim certainly suggest that the Court found that element wanting. *Michigan*, 802 F. Supp. at 123-125. Instead, it held that section 115 did not apply because MET did not satisfy the accrual requirement. 802 F. Supp. at 124. The opinion reaffirmed earlier cases which require an actual or bookkeeping transfer of income to the state, or require that the state have a vested right or enforceable claim to the income. *Id.* In contrast, the MET statute expressly provided that the state had no claim to either MET's assets or income. The possibility of excess assets passing to the state upon dissolution was too remote to constitute "accrual". *Id.* at 124.

The 6th Circuit, having ruled that the MET was an integral part of the state, found it unnecessary to reach the section 115 issue. *MET*, 40 F. 3d at 829. In its discussion of the "integral part" theory, the Court effectively made the case that financing higher education was an essential governmental function, distinguishing *Philadelphia National Bank v. United States*, 666 F. 2d 834 (3d Cir. 1981), *cert. denied*, 457 U.S. 1105 (1982) (which suggested that higher education was not an essential governmental function). We suspect that even the 6th Circuit, had it addressed the section 115 claim, also would have found the accrual element wanting. Under *MSSIC*, potential escheat to the state is not accrual, and the lack of a state financial obligation or risk of state funds is fatal. 308 F. Supp. at 765-766.

B. Rev. Rul. 90-74: Pooled Insurance Funds

The IRS has only issued one authoritative ruling under section 115 since 1988, Rev. Rul. 90-74, 1990-2 C.B. 34, although this ruling has prompted many dozens of private rulings under section 115 addressing pooled risk-sharing or self-insurance funds formed by political subdivisions. These follow Rev. Rul. 90-74, which held that the income of an organization formed, operated, and funded by political subdivisions to pool their casualty risks or other risks concerning public liability, workers compensation, or employee health benefits, is excluded from income under section 115. The key test is whether private interests participate in the organization or benefit more than incidentally from the organization. However, the fact that the purpose of the entity is to insure and reimburse payment of claims to individuals has been held to be an incidental private benefit. PLR 9741002 (June 26, 1997); PLR 9740005 (June 26, 1997); PLR 9646026 (Aug. 20, 1996).

Rev. Rul. 90-74 illustrates the typical ruling. The political subdivisions agree to create a pooled self-insurance entity, which could be a corporation. *See, e.g.*, PLR 9646026 (Aug. 20, 1996); PLR 9101005 (Sept. 1, 1990).[18] In some cases, the pooling entity was created or authorized by state statute. This did not appear to be a necessary factor, although it supported the finding of essential government function. Each participating body authorized participation in the entity. The board was elected by the member political subdivisions, and controlled the entity. Typically, the state treasurer managed the fund, although this was not the case in all the rulings. Each member contributed funds from general revenues based on actuarial risk determinations. The entity received investment income. The entity reimbursed members for casualty losses. In the event of dissolution, assets would be distributed to member political subdivisions. The rulings held that the investment of funds was a necessary incident of the power of governmental entities to raise revenue and meet expenses. The rulings also concluded that insuring political subdivisions against risk arising from governmental activities also was a governmental obligation. The rulings determined that risk pooling (rather than purchasing commercial insurance) fulfilled the obligations of the political subdivisions to protect their financial integrity. A universal requirement was that no private interests participated in or benefited from the operation of the entities. The IRS concluded that the entities performed an essential governmental function. Regarding the accrual requirement, the rulings observed that, since income was used to reimburse losses incurred by the participating political subdivisions or to reduce their annual fees, and did not benefit private interests, and since assets would be distributed to members upon dissolution, the income accrued to a political subdivision. Any private benefit to employees (*i.e.*, payment of claims) from insuring against these risks was incidental to the public benefit.

C. Section 115 Rulings

Since 1988, the IRS has issued over 170 private rulings under section 115, triple the number during the previous decade. These rulings generally look to *Maryland Savings Share Insurance Corp. v. United States*, 308 F. Supp. 761 (D. Md.), *rev'd on other grounds*, 400 U.S. 4 (1970) ("*MSSIC*") and Rev. Rul. 77-261, 1977-2 C.B. 45 for guidance.

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[18] Apparently, even if these self-insurance entities are not organized as separate corporations, they are treated as such by the IRS (absent exclusion under section 115) because unincorporated entities primarily involved in insurance activities are taxable as corporations. Rev. Rul. 83-132, 1983-2 C.B. 270.

The key "essential governmental function" factors most often cited in the rulings include state control and domination, the importance of the activity to the state as evidenced by legislation declarations, and the extent of the state's own investment in the enterprise, which indicates whether the state viewed the function as sufficiently essential "to lay its money on the line." The rulings look at the state's investment in the enterprise, whether the state bears the operating costs, and whether the state has committed to meet the liabilities of the enterprise. The key accrual factors seem to be whether income is paid to or credited to the account of the state; whether, upon dissolution, the enterprise's assets will be transferred to the state; and the extent of private benefit.

1. State Investment Funds

In recent years, the IRS has considered investment pools established on behalf of political subdivisions, and has reaffirmed its position in Rev. Rul. 77-261, 1977-2 C.B. 45, that investment of public funds can be an essential governmental function. In PLR 9541030 (Oct. 13, 1995), the IRS ruled that the income of an unincorporated investment pool established by several political subdivisions was exempt from federal taxation under section 115. The purpose was to permit investment of idle funds. The investment objective was maximum current income consistent with the primary objectives of preservation of capital and maintenance of liquidity. The fund members were political subdivisions and their integral parts. A nonprofit corporation was organized solely to govern the fund. The board of the corporation managed and administered the fund; board members were elected by the member political subdivisions. The state treasurer served as president of the corporation and was a board member. The net assets or earnings did not inure to and were not distributed for the benefit of any private persons. Members could withdraw their funds with interest at any time. If the fund dissolved, the net assets would be distributed to the fund member political subdivisions. The IRS relied on Rev. Rul. 77-261, concluding that the fund performed an essential governmental function. The income was used solely to provide benefits to members, which were political subdivisions, and in the event of dissolution, all assets were to be distributed to members. Consequently, the IRS concluded that the income accrued to political subdivisions within the meaning of section 115. However, since the exemption from income was under section 115, the IRS ruled that the fund was required to file a tax return. The ruling did not address the tax status of the nonprofit corporation.

Similarly, in PLR 9435031 (Sept. 2, 1994), the IRS considered a pooled investment fund created for state school districts to invest surplus funds. Because the school districts had the power to tax, it was held that they were political subdivisions. The fund was a public corporation authorized by state statute. It was governed by a board. All but one board member were elected by the participating school districts, and

were school district employees. The board held legal title to cash and other property contributed by the members. The board could enter into contracts for administrative and custodial services. The investment goals were safety, liquidity, and return on investment. The income could not accrue to a private party. Upon dissolution, assets would be distributed to the members.

The IRS concluded that "[t]he investment of positive cash balances by a state or political subdivision thereof in order to receive some yield on the funds until they are needed to meet expenses is a necessary incident of the power of the state or political subdivision to collect taxes and other revenues for use in meeting governmental expenses." Therefore the fund performed an essential government function. Since no part of it accrued to any private party, members could redeem their interest at any time except during emergency situations, and the dissolution clause provided that the assets returned to members. The IRS held that the income accrued to a state or political subdivision. The fund was a wholly-owned instrumentality of the political subdivisions, and its income was excluded under section 115.

This approval of governmental investment activities as essential governmental functions has been criticized by some commentators who favor restricting state exemption from federal taxation. It also potentially creates some tensions with the IRS position on programs like the prepaid tuition programs, where the IRS takes the position that it is not an essential governmental function for the government to lend its own exempt status to the investment activity of individual investors. The IRS faces this difficulty particularly in reviewing programs in which the state indirectly conducts investment activity on behalf of individual beneficiaries.

2. Litigation Settlement Funds

As discussed above, several rulings address funds created by state officials from the proceeds of litigation judgments or settlements. In one case, a state created two funds to hold settlement payments received as a result of litigation by the attorney general. PLR 9733003 ((May 9, 1997). Settlement A was from state litigation against a trade school; the proceeds in fund A were paid as restitution to the individual claimants who were former students of the school. The second fund, fund B, consisted of settlement proceeds of antitrust cases in federal court brought by the state as *parens patriae* for its residents. The plaintiff class members who were to receive the settlement proceeds in fund B were the state and municipalities.

The IRS seemed to conclude without discussion that the funds were an essential governmental function. Applying the accrual test, however, the IRS determined that only the income of fund B was excluded from gross income under section 115, since

that income eventually accrued to the state and municipalities, while private parties received more than an incidental private benefit from fund A.

3. Other Section 115 Rulings

Other rulings under section 115 continue to illustrate that the IRS is, inexplicably, more liberal than the courts in finding both essential governmental function and accrual.

For example, a decedent bequeathed property to a city in trust to be used exclusively to establish and support a library. The IRS recognized libraries as ordinary municipal functions, and concluded that section 115 was met without any analysis of the accrual requirement. PLR 9115016 (Jan. 10, 1991). Although there was no private benefit, there also was not accrual to the city, at least not as it has historically been understood. The city had no control over the library, its assets or income, and under the terms of the bequest, the assets and income could not be used by the city for any other purpose. Thus, the apparent lack of control did not seem to affect the determination of either essential governmental function or accrual.

A mine reclamation fund ruling provides another unusual ruling relating to accrual. PLR 9126027 (March 29, 1991). As part of a mine reclamation program, a state created an insurance program to pay private property owners for land subsidence due to mining. The program was funded by a federal grant. Homeowners paid a fee to participate. Upon termination, the remaining funds reverted to the federal government, not to the state. The ruling determined that such a program was an essential governmental function. It concludes that the accrual requirement was satisfied because all of the income "used to perform the public purpose," which was payments to private landholders. Curiously, there is no discussion of the fact that the entire purpose of the program was a substantial private benefit limited to participants in the program. This would appear to be inconsistent with the IRS's ruling with respect to the Michigan Educational Trust, although it is consistent with the IRS rulings under the "integral part" theory relating to disaster insurance programs.[19]

[19] This ruling also is inconsistent with GCM 39006 (June 28, 1983), which reviewed a similar mine subsidence fund which was established by statute but run by insurers. The IRS ruled that the state had no long-term commitment (other than a start-up loan) and received no financial benefit. The beneficiaries were private landowners. The IRS denied exclusion under section 115. PLR 9126027 does not mention GCM 39006, which suggests that the accrual test requires a direct financial benefit to the state.

D. Summary of Section 115

It is clear from the rulings that the IRS adopts a very broad view that an "essential governmental function" is whatever the state legislative says it is. Most rulings quote Rev. Rul. 77-261, which stated the premise that "it may be assumed that Congress did not desire it any way to restrict a state's participation in enterprises that might be useful in carrying out those projects desirable from the standpoint of the state government which, on a broad consideration of the question, may be the function of the sovereign to conduct." *See, e.g.*, PLR 9669634 (Dec. 1, 1995).

For purposes of the accrual test, the IRS has long looked to the destination of the funds and more particularly, looks for benefits to private individuals, which apparently is fatal under section 115 (although apparently not under the "integral part" theory, under the *MET* decision and disaster fund rulings). Certainly in the MET ruling, the IRS made its decision based on a private benefit analysis without any actual discussion of accrual. This seems to reflect a trend toward emphasizing a concern with benefits to private individuals over the historical understanding of the accrual test (which required that the income must accrue in a technical sense). *See* Rev. Rul. 90-74. To some extent the IRS appears to use the private beneficiary test as a separate requirement from the accrual test, rather than a part of it, *see, e.g.*, PLR 8825027 (MET). On the other hand, there are numerous rulings in which the IRS has granted section 115 exclusion to governmental pension plans, which exclusively pay benefits to individuals. *See, e.g.*, G.C.M. 34704 (Dec. 2, 1971); PLR 8825027 (July 2, 1988). The IRS has not explained how it distinguishes pension plans from prepaid tuition plans in terms of the applicable criteria. One possible explanation is that the rulings also appear to reflect a trend toward examining whether the activity benefits the government financially by relieving it of some present or future financial obligation, which can have the effect of permitting private benefit which is considered "incidental" to the public benefit, resulting in an even more generous application of section 115.

Although there is no authority for this argument, it may be possible to argue under section 115 that any income that does not benefit private parties (*i.e.*, is not transferred to the dividend fund) should be excluded under section 115. We find no rulings addressing whether income can be allocated in this fashion, although the *MET* ruling determined that the payments by the state and investors into the fund were excludible, presumably as some form of "capital" contribution. Section 115 does not purport to characterize all of the income of an entity as taxable or excluded from gross income. Rather it provides that "gross income does not include" income of a certain character. Arguable, income that in fact accrues to the state should be excludible, even if the income that ultimately benefits private persons might not be.

V. Other Developments

We understand that there have been several factual developments which we believe enhance the Fund's position. These include legislative clarification of the Permanent Fund provisions and other statutory provisions, state court decisions, Attorney General opinions, and perhaps subtle changes in the way the APFC presents itself publicly and in publications such as its annual report. There may well be other developments that we have failed to note here that also serve to enhance the Fund's position in asserting these legal arguments.

For example, AS section 37.13.030, which formerly stated that the Fund's assets were "allocated to" the APFC, was amended in 1992 to state that the Fund's assets were to be managed "by" APFC, thus clarifying that the statute creating the APFC effected no change of ownership. *See also* AS 37.13.020, .140, .150, .160, .170, .180, .190 for similar changes in reference from APFC to the Fund. In particular, the statute no longer refers to the "net income of the corporation" but rather to the "net income of the Fund." AS 37.13.140.

We note that there have been, over the years, positive albeit subtle changes in the language used by APFC to describe its functions and role *vis a vis* the Fund and the State. The Annual Report plainly indicates that the assets and income are those of the Fund, and that APFC is a state instrumentality which is the investment manager and not the owner. We understand that APFC's accounting procedures record the assets and earnings as those of the Fund, and the earnings reserve account is reported on a public fund model rather than a corporate model.

The Alaska Supreme Court confirmed that the earnings reserve account is subject to legislative appropriation and cannot be spent absent a legislative appropriation. *Hickel v. Cowper*, 874 P.2d 922, 934-935 (Alaska 1994).

Since 1988, several Attorney General opinions have reinforced earlier opinions with respect to the Fund and APFC's relationship to the State and the applicability of certain state laws. For example, the Attorney General determined that all operating funds of the APFC are public funds subject to the constitutional requirement that they be used only for a public purpose, and could not be expended in a manner inconsistent with the government-approved budget. The opinion further concluded that the APFC was subject to the State's Open Meetings Act and the Ethics Act, both of which apply only to governmental agencies. OAG File No. 663-93-0397 (July 6, 1993). Similarly, the AAG determined that the APFC is subject to state contracting and procurement requirements applicable to state agencies. OAG File No. 663-93-0250 (Jan. 26, 1993).

VI. Conclusion and Recommendations

We continue to recommend that the State take the position that the Fund and APFC are integral parts of the state, and thus not subject to federal taxation, relying on the authorities cited in our prior Report and the _MET_ decision. We recommend that section 115 be presented as an alternative basis for exclusion of income from federal taxation, relying on the authorities cited previously and Rev. Rul. 90-74.

The many rulings issued by the IRS, while not authoritative, are nevertheless instructive. It is clear that many of the factors discussed in rulings relating to legislative purposes, governmental function, and state control are present in the Fund and APFC. *See* Report at 45-64, 104, 122-25. The recent rulings reinforce the importance of these indicia of state creation, control and domination. While we would reiterate our preference that the Fund be managed by an agency rather than a corporation, the statutory amendments and other changes in the APFC's mode of doing business have done much to relieve this concern. The several rulings granting integral part status to corporations also indicate that although this may be an important threshold consideration for the IRS, it does not appear to be determinative given sufficient evidence of state control and financial commitment.

We continue to be concerned about the potential perception of the dividend fund program as an improper private benefit, particularly in light of the wide-ranging discussion about the future of the Fund and the dividend program. While private benefit has always been an element of the accrual test under section 115, it increasingly appears to be an important criterion of independent significance. The rulings suggest that private benefit is simply impermissible under section 115, other than that incidental to the public purpose (*e.g.*, payment of state employee insurance claims under a pooled insurance program). It is unclear to what extent the income of the Fund, although it clearly accrues to the State, might be considered to ultimately benefit private beneficiaries.

The developments of the last ten years also have revealed the surprising extent to which this concern with private benefit seems to be influencing the IRS' interpretation of the "integral part" theory. Since that theory has been developed in only one case, _MET_, which the IRS rejects, the IRS presently is to a great extent in a position to interpret "integral part of a state" as it chooses, constrained only by its own prior (and reversible) rulings. On the other hand, the disaster fund rulings seem clearly to suggest that private benefit is not a bar to an entity being characterized as an integral part of the state. In cases where there is significant private benefit, the IRS appears to be willing to overlook it if there is not only sufficient evidence of public purpose and state control, but also a significant state financial commitment such that the assets of the state are at risk in the enterprise. Although this focus on the state's financial commitment does not

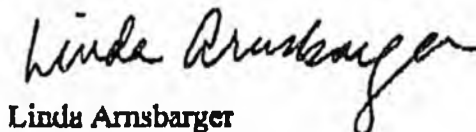
appear to be greatly emphasized in the rulings, it was clearly the guiding principle in the IRS's negotiations with the states regarding those rulings. And certainly that element is satisfied with respect to the Fund.

The private benefit arguably represented by the dividend program continues to fall into a gray area in terms of public purpose. At one end of the spectrum are the approved disaster insurance programs> The IRS found a sufficient governmental purpose to help its citizens protect themselves against natural disasters in the wake of significant disasters with profound economic consequences for the state. The IRS may have been particularly persuaded by the suggestion that, absent such programs, the financial consequences would be borne more directly by the state. At the other end of the spectrum are the prepaid tuition programs, which the IRS characterized as private investment schemes wrapped in the state's cloak of tax exemption. It may be difficult to argue that the dividend program is more like the former than the latter.

We believe that as long as the income from the Fund clearly accrues to the State and no individual has a vested interest in the income or assets of the Fund, the income and assets are those of the State alone, and thus not subject to federal taxation. How the State chooses to appropriate or spend its revenues should have no impact on this determination, except perhaps to further reinforce the argument that the investment activity is an integral part of the State and essential governmental function. And as long as the dividend program is implemented as a matter of legislative grace, we believe that it will be difficult for the IRS to argue that, having earned the income (investment being an appropriate public purpose and essential governmental function), it is not entirely within the discretion of the State to appropriate it as it sees fit, whether through legislative allocation or annual budget appropriations.

Conversely, to the extent that the Fund, or some portion of it, becomes irreversibly dedicated to the benefit of private beneficiaries, or to the extent that the dividend program becomes an entitlement that is beyond the reach of the government, then it becomes more like the prepaid tuition programs and is subject to potential challenge by the IRS as a private, rather than public, investment activity.

Sincerely,



Linda Arnsbarger

Enclosures

dc-111890

Integral Part Theory

Federal taxation does not reach income earned by a state—or an integral part of a state
- Congress may tax the income of states—but must do so specifically
- Morrison & Foerster (D.C. tax attorneys) contend this is the Fund's strongest argument

What constitutes an integral part of a state? Three essential elements are reviewed:
1. Corporate Status
2. State creation; control and domination; and declaration of state purpose
3. Source and destination of program funds

No single element is determinative in and of itself.

IRS looks very closely whenever a private benefit is created. However, sufficient indicia of state control and public purpose can support integral part status, despite the existence of significant private benefit.

There is *nothing* comparable to the Permanent Fund and its dividend program. The areas where a private benefit has caused the IRS to get concerned involved mechanisms where the individuals who paid into the entity (fund, corporation, agency) were the only recipients of the private benefit. In our situation, the Fund comes only from royalties that the state already owns, plus some additional grants of general fund dollars in the early 1980s. Payments of dividends to private individuals from income of the fund does not seem to be similar to any of the other "investment schemes" that the IRS required some public purpose to justify the private benefits in question.

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		Alaska Permanent Fund	Michigan Education Trust	Florida Hurricane Catastrophe Fund	Hawaii Hurricane Relief Fund	California Earthquake Authority
Corporate Status		State Fund; managed by a public corporation	Public Corporation	State Fund	Public Corporation	State Agency
	Ownership of Assets	State	Investors	Reverts to the state upon termination	Reverts to the state upon dissolution	Transferred to the state upon termination
Control and Domination		Investments dictated by law; LB&A Cmte has oversight	Independent of the State; decisions could not be overridden by any agency		Initial plan of operations subject to legislative review	Initial plan of operations approved by the legislature; amendments approved by the insurance commissioner
	Board Make-up	state officials and public members confirmed by the legislature		state officials	state official and public members confirmed by the senate	state officials
	Employees	state employees		Fund employees and contract advisors	Administered by a state agency	Employees subject to state civil servant requirements
Source and Destination						
	Source	State royalties and settlements	Participants	Insrurers/Participants; some nonparticipant funds	Participants + additional state funds (mortgage recording fee)	Equivalent of state premium tax collections; some seed money; sale of fund premiums
	Destination	Currently, a matter of legislative grace	private beneficiaries	revenues earmarked for the fund	insurers and the insured	Insurers and the insured
IRS ruling		none requested	rejected	exempt	exempt	exempt

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