1 *et seq*. In the current fiscal year, Alaska's severance tax
2 on oil is expected to yield revenues of over $1.2 billion.
3
4 30. Since 1973 Alaska has imposed a 20 mill *ad*
5 *valorem* tax on oil and gas exploration, production and pipe-
6 line properties. AS 43.56.010 *et seq*. Alaska does not impose
7 property taxes on any other industry in the State. In the
8 current fiscal year, Alaska's *ad valorem* tax on oil property
9 is expected to yield $170 million.
10
11 31. The Oil Tax Act is the latest discriminatory
12 tax imposed by Alaska on the oil and gas industry. Until
13 the Oil Tax Act was passed, oil and gas corporations, like
14 all other corporations doing business in Alaska, were taxed
15 under the uniform provisions of Chapter 20, Title 43 of the
16 State Laws of Alaska ("the Net Income Tax"). The Oil Tax
17 Act is significantly less favorable to taxpayers than is the
18 Net Income Tax. In particular:
19
20 (a) The Oil Tax Act does not allow taxpayers to
21 apportion all of their business income on the basis of
22 a three-factor formula based on payroll, property, and
23 sales. The Net Income Tax allows taxpayers to use that
24 formula.
25
26 (b) The Oil Tax Act forbids taxpayers from taking
27 deductions for accelerated depreciation and drilling costs.
28 The Net Income Tax, like the federal income tax and vir-
29 tually all state income taxes, allows such deductions.
30

1 (c) The Oil Tax Act sets limits on interest deductions. The Net Income Tax contains no such limitations.

(d) The Oil Tax Act sets limits on certain deductions for overhead and administrative expenses. The Net Income Tax contains no such limitations.

(e) The Oil Tax Act restricts deductions for excise taxes levied on the oil industry -- e.g., the federal Windfall Profits Tax imposed by 26 U.S.C. §§ 4986 et seq. The Net Income Tax allows deductions by business taxpayers of all excise taxes by whomever imposed.

32. The history of Alaska's income taxation of the oil and gas industry, moreover, shows graphically how Alaska has altered its pattern of taxation whenever such alteration would increase Alaska's take. Because there was little or no actual production from Prudhoe Bay until mid-1977, Exxon's Alaska operations produced a sizable loss during this time period. Exxon, however, was engaged in substantial exploration and development work, and had significant property interests and payroll in Alaska. The apportionment formula contained in the Net Income Tax thus apportioned a substantial percentage of Exxon's non-Alaska income to Alaska during this period. Between January 1, 1969 and December 31, 1977, Exxon paid $1,111,643 in corporate income taxes to Alaska; in addition, Alaska claims that Exxon owes another $1,835,401 for that period.

33. Prudhoe Bay production commenced in June 1977. Given the now substantial production from the field, Alaska

concluded that separate allocation of production and pipeline income, rather than apportionment as provided for in the Net Income Tax, would produce greater tax revenues. Alaska accordingly enacted the Oil Tax Act effective January 1, 1978, and reversed its policy on apportioning production and pipeline income. If counterclaimants were still taxed under the Net Income Tax, counterclaimants would have paid a total of approximately $31 million in income taxes for 1978 and 1979. Instead, counterclaimants paid in excess of $132 million -- over $100 million more.

34. As a result of all of these taxes, Exxon paid in excess of $88,900,000 to Alaska for 1978, and for 1979 paid about $173,331,000. Exxon Pipeline paid about $49,378,000 for 1978, and for 1979 paid about $61,658,000. Alaska estimates that by 1982, counterclaimants, together with the other oil companies subject to the Oil Tax Act, will pay total taxes more than twenty times the sum of all the taxes of all the other businesses and individuals in Alaska. Counterclaimants alone will pay several times the total taxes of taxpayers other than oil companies.

35. These taxes contrast markedly with the services provided by Alaska to counterclaimants, their employees, and their property. In 1978, Exxon employed a total of 49 employees in all of Alaska -- 43 assigned to Exxon's Western Division, five to Exxon's exploration operations, and one employee to the Exxon chemicals division. In addition, 33 Exxon Pipeline employees were on loan to the Alyeska Pipeline Service Company.

Exxon's employees and their dependents thus represented approximately a .0005 share of Alaska's population.

36. Benefits conferred by the State on counterclaimants' property in Alaska are no greater than benefits to counterclaimants' employees. To be sure, Alaska provides counterclaimants the generalized benefits of law and organized government. But specific services or benefits are difficult to identify. Counterclaimants' property in Alaska consists almost exclusively of Exxon's leasehold interests on the North Slope, Exxon Pipeline's share of the Trans Alaska Pipeline, and Exxon's share of the docks and loading facilities at Valdez. Almost all of this property is located in remote areas, which do not now and never have received significant attention from agencies of the State. Roads to the Prudhoe Bay and Trans Alaska Pipeline facilities, like public improvements such as airfields, were built by the oil companies and other private parties. Prudhoe Bay and the Trans Alaska Pipeline are all patrolled, guarded, and protected by privately-paid forces, not by state or local government.

37. Exxon's Prudhoe Bay holdings are leased from the State. Exxon pays full compensation to the State for these leases in the form of an arms' length royalty arrangement that currently gives the State one-eighth of every barrel of oil produced. Any taxes imposed by the State are in addition to the State's royalty income, and may not fairly be regarded as compensation for the lease of the State's land. Indeed, to the extent the State may assert that its overreaching taxation of Exxon is intended to compensate the State for Exxon's use

of the Prudhoe Bay leases, the State's taxes are invalid as unconstitutional modifications of the terms of the lease contracts between the State and Exxon.

38. In view of these facts, the tax imposed on counterclaimants by the Oil Tax Act, especially when combined with the other taxes levied by Alaska on the oil business, is not fairly related to the services and protection that counterclaimants receive from the State. The Oil Tax Act therefore constitutes an impermissible abuse of Alaska's taxing power and is unconstitutional under the Commerce Clause, the Equal Protection Clause and the Due Process Clause of the United States Constitution, and under the Due Process Clause and the Equal Protection Clause of the Alaska Constitution.

D.

THE OIL TAX ACT IS UNCONSTITUTIONAL BECAUSE ALASKA'S OIL TAX POLICY IMPOSES AN IMPERMISSIBLE BURDEN ON INTERSTATE COMMERCE IN A RESOURCE OF PROFOUND NATIONAL IMPORTANCE

39. The Commerce Clause arose in significant part from the fear that seaboard states would exploit their natural monopoly by levying taxes whose effect would be to penalize the commerce and impoverish the citizens of the less-favored inland states. Such taxes were common under the Articles of Confederation, which preceded the Constitutional Convention of 1787. A desire to still the interstate resentments fostered by such taxes gave impetus to the formation of the American federal union and to the American common market that has been

1 its inseparable companion. The Commerce Clause retains today
2 its historic role as a shield against selfish attempts by
3 states to take advantage of a natural monopoly or quasi-monopoly
4 position -- whether arising from location or from mineral
5 deposits -- by exploiting consumers and producers who are
6 citizens of other states.
7
8 40. Oil is at least as important to commerce today
9 as seaports were in 18th century America. By far the most
10 important source of energy in the United States, oil is unques-
11 tionably a resource of the most profound national importance.
12 Domestic oil supply is of particular significance, because only
13 domestic oil is a secure energy source in the event of a national
14 emergency, and also because foreign supplies of oil, even
15 in peacetime, may be undependable. According to government
16 figures, Alaska today accounts for 19 per cent of all crude
17 oil produced and consumed in the United States, and within
18 twenty years will account for no less than 34 per cent of
19 such oil. Statistics published by the federal government and
20 the American Petroleum Institute indicate that Alaska contains
21 one-third of proven U.S. oil reserves, and an estimated one-
22 third of undiscovered U.S. oil reserves as well. In short,
23 Alaska enjoys a uniquely favored position as compared to most
24 other states of the Union, and controls a disproportionate
25 share of a resource upon which the commerce, the industry,
26 and the security of the country depend. Given the importance
27 of Alaska's oil resources and the position of natural monopoly
28 that Alaska enjoys, the Commerce Clause prohibits Alaska from
29 exploiting its natural advantage in a manner that is seriously
30 detrimental to the other citizens of the United States.

1 41. As discussed in Paragraphs 28-34 above, Alaska has
2 pursued a course of imposing increasingly higher and increasingly
3 discriminatory severance, property, and income taxes on the oil
4 business, entirely without regard to the limitations of the
5 Commerce Clause. In adopting the strategy of using taxation
6 to exploit the State's natural monopoly power, Alaska was aware
7 that the burden of these taxes would fall not on Alaskans but
8 on oil consumers outside Alaska and on the interstate enter-
9 prises, like counterclaimants, that produce Alaskan oil for
10 shipment to the rest of the United States.
11
12 42. Alaska cannot justify its heavy taxation of the
13 oil industry -- and the commensurate burden on interstate oil
14 producers and on oil consumers outside Alaska -- on the basis of
15 any need for the revenue. The fact is that Alaska is extracting
16 from non-Alaska producers and consumers of oil revenues that
17 are not needed for current services, and which Alaska is not
18 spending for current services.
19
20 43. At the end of fiscal year 1978, prior to the
21 receipt of any tax revenues from the Oil Tax Act, Alaska's
22 general fund had a surplus of approximately $500 million.
23 Alaska estimates that the surplus will have grown to over
24 $3.3 billion by the end of this fiscal year and will continue
25 to grow by billions of dollars each year for the next two
26 decades. (Alaska's permanent fund, which is funded entirely
27 from petroleum revenues, had reached almost $500 million by
28 June 30, 1980, and is also expected to continue to grow rapidly.)
29 Over the next two decades, Alaska's revenues are expected to
30

exceed its expenses by more than $184 billion, or about $450,000 for every resident of Alaska.

44. Common sense and simple economics show that Alaskans will not pay any significant part of the price of accumulating their $184 billion surplus. Since little of the oil produced in Alaska is consumed in-state, Alaska need not fear that any appreciable part of the burden of its taxes will be borne by Alaska's citizens. The money to fund Alaska's bonanza will come from the pockets of other Americans, who will pay more for the gasoline and fuel oil they need, or will have less to invest in the vital work of finding and producing additional petroleum resources. [To make up Alaska's projected $184 billion surplus, a contribution of about $900 will be required from every man, woman, and child in the United States outside Alaska.]

45. The Constitution stands for the proposition that, unlike a sovereign nation, a member of the American union may not use its tax power to enrich itself by beggaring its neighbors. Alaska's oil tax policy, and the Oil Tax Act which is the culmination of that policy, unconstitutionally burdens interstate commerce by taxing Alaska's sister states and their citizens for the benefit of Alaska.

E.

THE OIL TAX ACT IMPERMISSIBLY
DISCRIMINATES AGAINST THE OIL INDUSTRY

46. The Oil Tax Act has the effect of singling out one industry for special treatment. Taxpayers engaged in the production of oil and gas in Alaska are subject to the Oil Tax Act. All other taxpayers engaged in business in Alaska are subject to the Net Income Tax. For the reasons set forth in Paragraph 31(a)-(e) above, the Oil Tax Act is significantly less favorable to business taxpayers than is the Net Income Tax.

47. There is no rational basis for discriminating against oil producers by subjecting them to the discriminatory provisions of the Oil Tax Act while all other businesses in Alaska are subject to the Net Income Tax. The Oil Tax Act is accordingly arbitrary and capricious, denies counterclaimants the equal protection of the laws and due process of law in violation of the Due Process Clause and the Equal Protection Clause of the United States Constitution and the Due Process Clause and the Equal Protection Clause of the Alaska Constitution, and impermissibly burdens interstate commerce in violation of the Commerce Clause of the United States Constitution.

F.

THE OIL TAX ACT IMPAIRS THE OBLIGATION
OF THE CONTRACT ENTERED INTO BY ALASKA
WHEN IT RATIFIED THE MULTISTATE TAX COMPACT

48. In 1970, Alaska adhered to the Multistate Tax Compact (the "Compact") and is still a member thereof. AS 43.19.010, et seq. The Compact is a contract among the States. Alaska cannot violate the Compact without acting so as to impair the obligation of its contract, in violation of the Contract Clauses of the United States and Alaska Constitutions.

49. Nineteen states are parties to the Multistate Tax Compact. The Compact was entered into in order to promote the equitable apportionment of tax bases, avoid duplicative taxation and promote uniformity and compatibility in state tax systems. AS 43.19.010, et seq. Article IV of the Compact achieves these goals by requiring each contracting state to apportion unitary business income among itself and other states on the basis of a three-factor formula utilizing property, payroll and sales. In general, each state is allowed to tax only that percentage of a multistate taxpayer's total unitary business income that the taxpayer's property, payroll and sales in the state bear to the taxpayer's total property, payroll and sales. The Compact anticipates that states will only diverge from the three-factor formula in exceptional cases.

50. The Compact requires that Alaska use the three-factor formula except where the formula does not fairly represent the extent of a taxpayer's business activity in the State.

AS 43.19.010, Article IV. In addition, the Compact provides that if a state finds the three-factor formula inequitable, the state must use an alternative allocation method that is "reasonable" and "effectuates an equitable allocation and apportionment of the taxpayer's income." AS 43.19.010, Article IV, Section 18. The Oil Tax Act, as shown above, violates these standards by taxing 100 per cent of income that other states are entitled to and do tax, thereby exposing counter-claimants' Alaska production and pipeline income to multiple taxation. Finally, under the Compact, a taxpayer is also entitled to demonstrate that the allocation and apportionment scheme used is unfair and to petition for the right to use an alternative method. AS 43.19.010, Article IV, Section 18. The Oil Tax Act denies this opportunity to oil and gas companies. For all of these reasons, the Oil Tax Act is contrary to the Compact and thus impairs Alaska's contractual obligations under the Compact in violation of the Contract Clauses of the United States and Alaska Constitutions.

G.

THE OIL TAX ACT CONFLICTS WITH THE OUTER CONTINENTAL SHELF LANDS ACT

51. Income from all activities "other than the production of oil or gas from a lease or property in the state or the pipeline transportation of oil or gas in the state" is computed for Oil Tax Act purposes by apportioning to Alaska a percentage of the worldwide net income of the consolidated business as determined and certified by an independent certified public accountant for the purposes of an annual report to shareholders.

"Other income" is apportioned to Alaska by use of a modified version of the three-factor formula used under the Multistate Tax Compact. In particular, the apportionment factors are adjusted to take into effect activities of oil and gas corporations on the Outer Continental Shelf adjacent to Alaska. The numerator of the payroll factor is increased by the amount of compensation paid to employees who are employed on the Outer Continental Shelf if such employees are directly supplied from a base of operations in Alaska. AS 43.21.040(d). The numerator of the property factor is increased by the value of properties located on the Outer Continental Shelf if those properties are serviced or supplied from an Alaska base of operations or if the properties rely on Alaska facilities for storage of any oil or gas produced. AS 43.21.040(e).

52. The modifications in the formula used to apportion "other income" under the Oil Tax Act, described in Paragraph 51 above, have the purpose and effect of capturing income for taxation in Alaska on the basis of production facilities and personnel located on the Outer Continental Shelf. The Outer Continental Shelf Lands Act provides that "State taxation laws shall not apply to the Outer Continental Shelf." 43 U.S.C. § 1333(a)(2). The Oil Tax Act violates that provision and purports to tax activities that are exclusively under federal jurisdiction for tax purposes, and is thus invalid under the Supremacy Clause of the United States Constitution.

H.

THE OIL TAX ACT CANNOT BE APPLIED RETRO-
ACTIVELY BECAUSE TWO-THIRDS OF THE ALASKA
SENATE DID NOT APPROVE THE RETROACTIVITY PROVISION

53. The Oil Tax Act was passed by the Alaska Legislature and signed by the Governor in July, 1978. Section 4 of the Oil Tax Act purports to make the tax applicable "to taxable income earned or received after December 31, 1977." Section 5 makes the Oil Tax Act effective "immediately." Although Section 5 was the subject of a separate vote in the Alaska Senate, Section 4 was not. Instead, Section 4 was carried with the rest of the legislation by a vote of 11 to 9. Section 4 thus did not have the concurrence of two-thirds of the membership of the Senate.

54. Under Article II, Section 18 of the Alaska Constitution and AS 01.10.070(a), laws passed by the Legislature become effective ninety days after enactment unless the Legislature provides for another effective date by concurrence of two-thirds of the membership of each House. The effective date of a statute does not mean the date of becoming law; a statute becomes effective when it "becomes applicable." AS 01.10.070(f)(3). Although Section 4 purports to make the Oil Tax Act "applicable" to income earned or received after December 31, 1977, fewer than two-thirds of the membership of the Senate approved this provision. Section 4 of the Oil Tax Act is, therefore, invalid.

COUNT II

(DECLARATORY JUDGMENT)

55. Counterclaimants re-aver, as though set forth in full, the averments contained in Paragraphs 1 through 54 of this Counterclaim.

56. An actual controversy relating to the legal rights and duties of the parties exists with regard to the constitutionality of the Oil Tax Act which is appropriate for declaratory relief in that:

(a) Counterclaimants claim and contend that the Oil Tax Act is unconstitutional under the United States and Alaska Constitutions and invalid for the reasons set forth in Paragraphs 14 through 54 of this Counterclaim, and that said counterclaimants are under no obligation to pay any taxes thereunder.

(b) Defendants on counterclaim claim and contend in all respects to the contrary.

COUNT III

(INJUNCTION)

57. Counterclaimants re-aver, as though set forth in full, the averments contained in Paragraphs 1 through 56 of this Counterclaim.

58. The Oil Tax Act and the regulations thereunder are unconstitutional for the reasons set forth in Paragraphs 14 through 54.

59. Unless this Court permanently enjoins enforcement of the Oil Tax Act and the regulations, counterclaimants will suffer irreparable injury in that they will be forced to make recurring payments thereunder in violation of their rights under the United States and Alaska Constitutions.

60. Unless this Court grants interim injunctive relief against the disbursement or dissipation of taxes paid under protest by counterclaimants pursuant to the Oil Tax Act, counterclaimants will be irreparably injured in that adequate funds may not be available for refund to counterclaimants upon the entry of the final judgment of this Court.

61. Counterclaimants have no adequate remedy at law.

WHEREFORE, counterclaimants respectfully pray as follows:

(1) That interim injunctive relief be given enjoining the Department of Revenue, the Commissioner of Revenue, the Department of Administration and the Commissioner of Administration from disbursing or otherwise dissipating the funds paid under protest by counterclaimants pursuant to the Oil Tax Act and requiring that such funds be maintained so that they are available for a refund as ordered by this Court;

1 (2) That counterclaimants have and recover judgment
2 for refund of payments made under the Oil Tax Act prior to
3 the date of judgment herein, and interest as provided by law;
4
5 (3) That this Court find, declare, and adjudge
6 that the Oil Tax Act and the implementing regulations are
7 invalid, unconstitutional and unenforceable;
8
9 (4) That this Court permanently enjoin and restrain
10 defendants on counterclaim, and each of them, from enforcing
11 all or any of the provisions of the Oil Tax Act and order
12 counterdefendants, and each of them, to take all necessary
13 steps to satisfy the judgment in this case;
14
15 (5) That counterclaimants recover their costs of
16 suit herein incurred, and a reasonable attorneys' fee; and
17
18 (6) That counterclaimants have such other, further
19 and different relief as may be meet and just.
20
21 DATED: October 6, 1980.
22

23 HARTIG, RHODES, NORMAN & MAHONEY
ROBERT J. MAHONEY
24 717 "K" Street
Suite 201
25 Anchorage, Alaska 99501
(907) 274-3576
26
and
27
O'MELVENY & MYERS
28 JOHN F. DAUM
BARTON H. THOMPSON, JR.
29 611 West Sixth Street
Los Angeles, California 90017
30 (213) 620-1120

1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25
26
27
28
29
30

and

D. JOSEPH POTVIN
WILLIAM A. WARREN, JR.
Exxon Company U.S.A.
800 Bell
Houston, Texas 77001
(713) 656-6417

By ______________________
Robert J. Mahoney

Attorneys for Defendants
and Counterclaimants
Exxon Corporation and
Exxon Pipeline Company

THE TAXATION OF THE PETROLEUM INDUSTRY UNDER ALASKA'S CORPORATE INCOME TAX

A Report Prepared for the Alaska Legislature and the Alaska Department of Revenue

By:

Jerome M. Zeifman

and

Kenneth G. Ainsworth

January, 1977

TABLE OF CONTENTS

	PAGE
A. Summary of Legislative Recommendations	4
1. Outline of Proposed Bill	4
2. Some Policy Considerations Concerning the Structure of the Proposed Bill	5
B. Analysis of Alaska's Corporate Income Tax Base Under Present Law	9
1. Present Law	9
2. Federal Policies Currently Reflected in Alaska's Tax Law	10
3. Revenue Losses to Alaska Due to the Use of the Eroded Federal Tax Base	14
4. Alternatives to the Use of Federal Taxable Income as a Measure of the Alaska Corporate Tax Imposed on Petroleum Corporations	16
5. Additional Consideration in Favor of Alaska's Departing from the Use of a Federally Defined Corporate Income Tax Base	19
C. Analysis of Alaska's Present Allocation and Apportionment Method	20
1. Present Law	20
2. Effect of Present Apportionment Method on Oil Companies	23
3. Effects of Alternate Methods	28
4. Effects of Separate Accounting	31
D. Revenue Effects of Proposed Legislation	34
E. Some Administrative Considerations in Favor of the Proposed Legislation	38
F. Comparison of Proposed Legislation with Proposals for a "Net Proceeds" Tax Based on Separate Accounting	39
1. Administrative Difficulties with Separate Accounting	40
2. Inequities Created by Attempts to Provide for Credits Between the Current Income Tax and the Proposed Taxes on Net Proceeds	46
G. Further Recommendations	48
1. On-shore Economic Impacts of Outer-Continental Shelf Operation	48
2. Alaska's Participation in Multistate Tax Commission	50
3. Applicability of Proposed Legislation to Production and Transportation of Gas	50
4. Gross-Valued Severance Taxes	51

Introduction

During the 1975 and 1976 sessions of the Tenth Alaska Legislature concern was expressed by many legislators as to the effectiveness of the present corporate income tax law with respect to the income of multi-jurisdictional corporations which do business in other states as well as in Alaska.

Briefly summarized, the present Alaska law applicable to multi-jurisdictional corporations operates as follows:

> First: A determination is made of the corporation's entire taxable income from all sources. Since the Alaska law incorporates the Federal Internal Revenue code by reference, with certain modifications, the corporation's entire taxable income from all sources is largely the same amount of income that is taxed by the Federal Government.[1/]
>
> Second: To determine the percentage of entire income attributed to Alaska, the State has adopted the Uniform Division of Income for Tax Purposes Act. In addition, Alaska has become a member of the Multistate Tax Compact, an organization currently comprised of 21 states, each of which also has adopted the Uniform Act. Under the Uniform Act, Alaska taxable income is determined by multiplying the taxpayer's entire taxable income by a fraction which is the average of the ratios of Alaska-to-total "property", "payroll" and "sales".[2/]

As is discussed in greater detail in the body of our report, Alaska's use of the Federal corporate tax base has created an anomalous situation in which Alaska currently provides its corporate taxpayers with tax subsidies and tax incentives that are designed to subsidize and encourage production of petroleum in states other than Alaska, as well as in foreign countries.

As is also discussed below, the present apportionment formula operates in such a way as to reduce the amount of taxable income attributable to Alaska by corporations which extract non-renewable petroleum resources from the State. This effect occurs largely because the Uniform Division of Income for Tax Purposes Act contains a "destination-oriented" sales factor, in which sales of Alaskan oil are generally assigned to Alaska only with respect to petroleum products which are ultimately consumed in the State. As a result, the exportation of petroleum from Alaska has the effect of reducing the tax liability of the extractor of the Alaska petroleum.

To provide for a more effective means of taxing the income of multi-jurisdictional petroleum companies, we have formulated legislative recommendations which are summarized below in Section A of our report.

Sections B and C of the report include our analysis of the present tax base and apportionment formula, as well as discussions of alternative recommendations.

As is set forth in Section D, the enactment of the proposed legislation would increase Alaska's annual income tax revenues from the petroleum industry by about 400 per cent of whatever amount can be realized under the present law.

CORRECTION

THIS DOCUMENT
HAS BEEN REPHOTOGRAPHED
TO ASSURE LEGIBILITY

Introduction

During the 1975 and 1976 sessions of the Tenth Alaska Legislature concern was expressed by many legislators as to the effectiveness of the present corporate income tax law with respect to the income of multi-jurisdictional corporations which do business in other states as well as in Alaska.

Briefly summarized, the present Alaska law applicable to multi-jurisdictional corporations operates as follows:

First: A determination is made of the corporation's entire taxable income from all sources. Since the Alaska law incorporates the Federal Internal Revenue code by reference, with certain modifications, the corporation's entire taxable income from all sources is largely the same amount of income that is taxed by the Federal Government.[1/]

Second: To determine the percentage of entire income attributed to Alaska, the State has adopted the Uniform Division of Income for Tax Purposes Act. In addition, Alaska has become a member of the Multistate Tax Compact, an organization currently comprised of 21 states, each of which also has adopted the Uniform Act. Under the Uniform Act, Alaska taxable income is determined by multiplying the taxpayer's entire taxable income by a fraction which is the average of the ratios of Alaska-to-total "property", "payroll" and "sales".[2/]

As a result of the concerns expressed in 1975 and 1976, serious policy questions have arisen with respect to two interrelated aspects of the present corporate tax system. On the one hand, questions arise as the extent to which multi-jurisdictional corporations are currently able to offset their Alaska income by losses and other deductible items relating to activities outside of Alaska. On the other hand, questions also arise as to the effectiveness of the present statutory apportionment method used to determine the percentage of a multi-jurisdictional corporation's entire income attributed to Alaska for tax purposes.

In October, 1976, we were retained as consultants to the Alaska State Legislature and the Alaska State Department of Revenue. Since then, we have undertaken a coordinated legal and economic analysis of the present corporate income tax system as applied to the taxation of income from the production of non-renewable natural resources in general, and petroleum in particular.

We have obtained information and data from the following sources: The Alaska Department of Revenue; the Multistate Tax Commission; the staff of the Joint Committee on Internal Revenue Taxation of the United States Congress; the Congressional Budget Office; the United States Department of Commerce; and the California Franchise Tax Board. Based on our analysis to date, we have made findings concerning both the current Alaska method for determining entire taxable income and the Alaska method for apportioning income. We have concluded that the present method is ineffective and embodies policies which the Alaska Legislature ought appropriately to re-evaluate.

As is discussed in greater detail in the body of our report, Alaska's use of the Federal corporate tax base has created an anomalous situation in which Alaska currently provides its corporate taxpayers with tax subsidies and tax incentives that are designed to subsidize and encourage production of petroleum in states other than Alaska, as well as in foreign countries.

As is also discussed below, the present apportionment formula operates in such a way as to reduce the amount of taxable income attributable to Alaska by corporations which extract non-renewable petroleum resources from the State. This effect occurs largely because the Uniform Division of Income for Tax Purposes Act contains a "destination-oriented" sales factor, in which sales of Alaskan oil are generally assigned to Alaska only with respect to petroleum products which are ultimately consumed in the State. As a result, the exportation of petroleum from Alaska has the effect of reducing the tax liability of the extractor of the Alaska petroleum.

To provide for a more effective means of taxing the income of multi-jurisdictional petroleum companies, we have formulated legislative recommendations which are summarized below in Section A of our report.

Sections B and C of the report include our analysis of the present tax base and apportionment formula, as well as discussions of alternative recommendations.

As is set forth in Section D, the enactment of the proposed legislation would increase Alaska's annual income tax revenues from the petroleum industry by about 400 per cent of whatever amount can be realized under the present law.

Additional considerations relating to our recommendations are set forth in Sections E, F, and G.

A. SUMMARY OF LEGISLATIVE RECOMMENDATIONS

1. Outline of Proposed Bill

A privilege (franchise) tax would be imposed on corporations engaged in the extraction, refining or transportation of petroleum in Alaska.

The tax would be measured by the Corporation's "book income" of Federal taxable income, whichever is higher. "Book income" would be determined without regard to taxes on or measured by income.

Corporations engaged in business both within Alaska and within other states or foreign countries would be required to apportion their income according to a three factor formula based on the ratios of Alaska-to-total: property, payroll and "extraction."

The property and payroll factors of the formula would be similar to the property and payroll factors in the Uniform Division of Income for Tax Proposed Act, which is currently in effect in Alaska.

The "extraction" factor would include in the numerator the total units of petroleum extracted in Alaska.

Affiliated corporations engaged in unitary businesses would be required to file combined reports.

2. Some Policy Considerations Concerning the Structure of the Proposed Bill.

(a) Taxable Event

The privilege (franchise) tax approach to the taxation of corporate net income is conventional among the states and is partially modeled after the so-called "double barrelled" income tax structure of states such as California, Idaho, Minnesota, Oregon, Pennsylvania and Utah.[3/]

Under the Supreme Court's decision in the Colonial Pipelines case,[4/] Alaska can inpose such a privilege tax on corporations which do not intra-state business but are engaged exclusively in interstate commerce.

In effect, the tax can be structured so that no corporation would have a lower tax liability than would be possible under the present direct tax on corporate net income.

The privilege tax feature would tend to strengthen the State's position in court cases involving apportionment disputes. It could have special significance in enabling Alaska to tax income relating to economic activities on the outer continental shelf which might otherwise be exempt from the present direct tax.

(b) Corporations Subject to Tax

The determination of the corporations subject to the privilege tax would involve a simple computation based on gross income. The test might simply be whether more than 50 percent of the corporation's "ordinary gross income" is derived from the extraction, transportation, refining, processing developing or marketing of petroleum or petroleum related products. Such a test wouls substantially limit the imposition of the privilege tax to vertically integrated multi-national corporations. However, it might also be desirable to provide a test which specifically excludes from the scope of the privilege tax any corporation which has a total gross income of less than a specified dollar amount, such as $250 million.5/

(c) Tax Base

"Book income" would be defined as the income included in the taxpayer's report to shareholders without regard to taxes on or measured by net income. Since the corporations included within the scope of the tax are generally publically held, their annual reports to shareholders are currently required to be certified by independent Certified Public Accountants and are used for Federal regulatory purposes.

In the case of an affiliated group of corporations, the Commissioner should have the authority to prescribe whether the report between common parent corporation to its shareholders rather than the report of subsidiaries to the parent

will be taken into account for determination of the tax base.

It should be noted that the use of federal taxable income, if higher, as an alternative base would probably occur only in very unusual cases involving the operation of Federal recapture provisions.

(d) A Possible Alternative to The Use of "Book Income"

Although the use of "book income" allows for both easy enforcement and the simple removal of tax subsidies from the tax base, it may be desirable to provide for an item-by-item upward adjustment of federal taxable income. This would restore only specific "erosions" from the Federal tax base.

If an item-by-item approach is taken, it might also be desirable to continue to allow tax subsidies and tax incentives, but only with respect to purely Alaskan activities.

(e) Apportionment Formula

The use of an origin-oriented "extraction factor" based on Alaska to total energy units extracted would tend to maximize the effectiveness of Alaska's apportionment in the simplest and most efficient way.

(f) Combining of the Income of Affiliates

It is essential to the fundamental purposes of the proposed tax that separate accounting methods of reporting not be permitted in the case of any affiliated corporations engaged in unitary enterprises. It is also essential that multi-national corporations be required to apportion their income on a world-wide combined basis in the manner currently being advanced in Alaska and other states.

(g) Administrative Considerations

The proposed legislation would afford Alaska the advantages of continuing to participate in the joint audit program of the Multistate Tax Commission as well as the advantages of dealing effectively with problems which may be peculiar to Alaska.

B. ANALYSIS OF ALASKA'S CORPORATE INCOME TAX BASE UNDER PRESENT LAW

The following analysis relates to Alaska's present method of determining a corporation's entire income from all sources. It should be clearly understood that in the case of a corporation doing business both within and without Alaska, the corporation's entire income will be subsequently subjected to apportionment, so that only a percentage will ultimately be attributed to Alaska for tax purposes. The present Alaska method of apportionment is analyzed in Section C of this report. Thus, this section of the report is limited to a discussion of Alaska's system for determining entire income from all sources.

1. Present Law

Under AS 43.20.021, the responsibility for determining Alaska's total corporate income tax base has largely been delegated by the State Legislature to the United States Congress. This is because provisions of the Federal Government's Internal Revenue code are incorporated by reference for purposes of Alaska's corporate income tax. In effect, the corporate taxpayer first determines the Federal taxable income and is then required simply to make a limited number of adjustments. These are as follows: Income taxes paid to Alaska and to other states and foreign countries are not allowed as a deduction; the foreign tax credit is not allowed; the exemptions relating to Domestic

International Sales Corporations provide under Section 991 of the Internal Revenue code are not allowed by Alaska; and the job development investment credit provided under Section 50 of the Internal Revenue code is limited for Alaska tax purposes to the first $500,000 of qualified investment put into use for each taxable year.

Since Federal taxable income is used as a starting point for the computation of the Alaska tax base, any changes in the exemptions from tax or credits against tax made by the United States Congress would be reflected immediately in changes in Alaska revenues were it not for the recent adoption by the Alaska Legislature of CH 124, SLA 1976 which postpones the effective date of such changes for two years.

2. Federal Policies Currently Reflected in Alaska's Tax Law

On a Federal level there is now wide-spread agreement that the Internal Revenue code and the Federal tax system have not been structured simply as a means for raising Federal revenues. Instead, by creating special tax provisions, the United States Congress has seen fit to encourage or subsidize some types of economic activities and to discourage or frustrate others.

As has been pointed out in the recent "Report to the Senate and House Committee on the Budget" of the United

States Congress,[6/] the encouragement or subsidy, as the case may be, takes the form of a reduced income tax liability. The amount of the reduction from the "normal" tax owed has come in recent years to be called a "tax expenditure". In theory, at least, the Government could have collected the full tax and used some part of it in some other way -- by a Federally administered grant or loan program, for example -- to encourage the same activity or help the same industry.

Thus, for example, Congress has sought to encourage the development of oil and gas by allowing write-offs through the expensing of exploration and development costs. The provision will mean an estimated annual revenue loss to the Federal Government of 1.8 billion dollars by 1981. That same money could be spent by Congress in other ways to stimulate activity in the oil and gas industries. Instead, Congress has decided to "expend" it in the form of tax reductions.

The concept of tax expenditures has been incorporated in the Congressional Budget Act of 1974, which requires the listing of present and proposed tax expenditures and a calculation of their revenue loss implications. In particular, Section 202(f)(1) requires the Director of the Congressional Budget Office to report annually on the "levels of tax expenditures under existing law."

The projected tax expenditures in the most recent report

of the Director of the Congressional Budget Office is relevant in assessing the extent to which Alaska, in following Federal definitions of taxable income is, in turn, providing tax incentives and tax subsidies to corporations subject to Alaska tax.

To assist in making such an assessment, we have prepared the following Table of some of the specific tax expenditure estimates made by the Congressional Budget Office. We have selected those items which are particularly helpful both because of their applicability to corporations generally, and to oil companies in particular.

TABLE I

SELECTED FEDERAL TAX EXPENDITURE ESTIMATES FOR CORPORATIONS

(Millions of dollars, fiscal years)

Function	1977	1978	1979	1980	1981
Expensing of exploration and development costs	840	1,045	1,285	1,540	1,850
Expensing of research and development expenditures	695	725	755	785	815
Capital gains: (Other than farming & timber)	900	1,015	1,090	1,170	1,260
Asset Depreciation Range (ADR)	1,630	1,825	2,000	2,095	2,135
Deferral of income of controlled foreign corporations	365	365	365	365	365
Deductibility of charitable contributions (social services)	352	402	446	489	536

In considering the above data, it is important to note that the tax incentives and tax subsidies granted to corporations by Congress are not limited in a geographical sense to activities that relate to particular States. For example, the provisions of the Internal Revenue code which allow petroleum companies to expense, rather than capitalize, intangible drilling costs have the effect of encouraging the corporation to engage in drilling activities in any state or foreign country in which it may choose to operate. Thus, if the corporation is doing business both within and without Alaska, the tax expenditures made by Congress can be used for non-Alaskan drilling.

In other words, since Alaska has simply adopted the relevant provisions of the Internal Revenue code, Alaska, in effect, offers the same type of tax incentives to develop non-Alaskan wells as Alaskan wells.

Obviously, the same type of effects are produced under the present law with respect to each of the tax expenditures listed in the above table. To give some specific examples: Alaska currently offers preferred tax treatment with respect to gains from the sale of capital assets located outside of Alaska; a corporation engaged in the development of mines outside of Alaska is currently allowed to reduce its Alaska tax by expensing rather than capitalizing the non-Alaskan mine development costs; contributions to non-profit charitable

organizations which do not operate in Alaska can be used to reduce Alaska income tax liability.

In considering the effects on Alaska income tax liability of the above items, it is also important to point out that Alaska follows Federal policies with respect to net-operating loss carryovers. As a result, corporations which do not incur "normal" losses in an economic sense but simply have "tax losses" due to a super-abundance of deductions emanating from tax incentives and tax subsidies, are able to carry over such losses from one tax year to another. Thus, the coupling of the tax incentive and tax subsidy provisions of the Internal Revenue Code with the carryover provisions, allows the corporation with non-Alaskan "losses" the opportunity to use the non-Alaskan "loss" to reduce Alaska tax liability to the maximum extent possible over a five year period.

3. Revenue Losses to Alaska Due to the Use of the Eroded Federal Tax Base

A meaningful perspective can be obtained concerning the effects of federal tax subsidies and federal tax incentives on Alaska revenues by a comparison that we have made concerning the difference between the federal taxable income reported by a selected sample of thirteen petroleum corporations and the so-called "book income" of the same corporations.

The following table (II) compares book values (before income taxes) with Federal taxable income as reported on the income tax form. The estimates of the differences between book value and Federal taxable income for ten of the thirteen sample corporations for which data was available, show that book values exceed taxable income values by 1.6 to 3.0 billions of dollars per year. This variation is not unexpected because not all of the returns in the sample have been fully audited, but more important for state tax policy, Federal taxable income reflects the changing national policies with respect to goals such as lowering the rate of unemployment, encouraging nationwide conservation of resources and nationwide investment in energy supply.

The differences between book income and Federal taxable income indicate that coordinating State taxable income with book income rather than Federal taxable income would have generated about 5 million dollars of additional Alaska taxable income in 1975.

See table on following page.

TABLE II

DIFFERENCE BETWEEN BOOK INCOME AND TAXABLE INCOME FOR A SAMPLE OF OIL COMPANIES OPERATING IN ALASKA

Company	Difference 1973 (thousands $'s)	Difference 1974 (thousands $'s)	Difference 1975 (thousands $'s)
A	NA	221,219	38,825
B	177,629	208,882	129,451
C	NA	NA	17,009
D	39,814	34,204	NA
E	166,769	242,587	150,231
F	193,072	368,175	110,248
G	NA	NA	464,781
H	335,080	448,695	608,333
I	84,495	93,351	NA
J	(61)	(333)	72
K	NA	46,338	(120,374)
L	261,888	280,454	NA
M	278,634	784,519	193,439
Total	1,834,298 (4 cases Not available)	3,056,434 (2 cases Not available)	1,592,015 (3 cases Not available)

4. Alternatives to the Use of Federal Taxable Income as a Measure of the Alaska Corporate Tax Imposed on Petroleum Corporations

Should the Alaska legislature wish to discontinue the present reliance on the "eroded" Federal tax base, several alternative approaches might be considered. The simplest method, and most efficient in terms of enforcement and compliance, would be to use the corporation's own book income as a measure of the tax, since book income is based on "normal" accounting methods which do not reflect the "erosions" created by special tax subsidies and tax incentives.

Admittedly, the use of book figures will allow corporations some flexibility in determining their total tax base.

Nevertheless, that flexibility will be limited in the same manner that the corporation is limited in the preparation of its report to its own shareholders, creditors and Federal and State regulatory agencies with respect to its annual earnings and profits.

At the same time, the Alaska legislature could require the use of either book income or Federal taxable income, whichever is higher. In addition, the State could prescribe its own specific requirements for the determination of book figures.

Although we have recommended the use of book income as a means of determining the entire net income of petroleum companies for Alaska tax purposes, there are other approaches which are both feasible and reasonable. These other approaches would involve item by item adjustments, working either downward from book income or upward from Federal taxable income. Such adjustments themselves could take two forms. Alaska could choose simply to allow a specific tax incentive, regardless of whether the activities related to the incentive are conducted within or outside Alaska. On the other hand, Alaska could allow the tax incentive only if the incentive relates to Alaska activities. Precedents for the latter approach currently exist in a number of states which allow special deductions only for anti-pollution equipment used in the State, as well as the practice in New York of allowing double depreciation

deductions only with respect to property located in New York, and a Wisconsin law which requires tax savings from percentage depletion to be used only for prospecting in Wisconsin.

Another approach might be to limit each item by item adjustment for specific tax subsidies and incentives to an overall dollar amount. Precedent for this approach already exists in Alaska with respect to the investment tax credit which is limited to $500,000.

If the legislature were to choose an item by item approach, we recommend that specific consideration be given to making adjustments which would include such items as the following:

1. The capitalization rather than the expensing of intangible drilling costs.

2. The elimination of accelerated depreciation including ADR. This could be done simply by limiting depreciation deductions to book depreciation.

3. The elimination of the distinction between capital gains and ordinary income (as now done by California and other states).

4. The capitalization rather than the expensing of such items as mine development costs, which are currently given preferred tax treatment under the Internal Revenue code.

5. The elimination of the deferral of tax on dividends from foreign subsidiaries (to be coordinated with combined report approach).

6. The disallowance of deductions for contributions to non-Alaskan charities.

7. The elimination of loss carryovers (as is currently done by California and a number of other states).

8. The disallowance of deductions for foreign expropriation losses.

5. Additional Consideration in Favor of Alaska's Departing from the Use of a Federally Defined Corporate Income Tax Base

During the recent presidential campaign, candidates from both of the major political parties expressed strong support for revisions of the present federal corporate income tax system which would integrate the corporate tax closely with the tax currently imposed on individuals. Under such an integrated system, individual shareholders rather than the corporation

itself, would tend to be taxable on corporate earnings.

Although it is, of course, impossible to predict what form, if any, federal legislation is likely to take with respect to the integration of corporate and individual income taxes, it is significant that the staff of the Joint Committee on Internal Revenue Taxation of the United States Congress is currently engaged in the development of Federal proposals. As a result, it is likely that Congress will soon legislate in this area. Under these circumstances, it also seems likely that in future years Federal definitions of taxable corporate income will become even more inadequate as a vehicle on which Alaska's corporate income tax can be "piggy-backed".

C. ANALYSIS OF ALASKA'S PRESENT ALLOCATION AND APPORTIONMENT METHOD

Following is an analysis of Alaska's current method for determining the percentage of a corporate taxpayer's entire income that is attributed to the State for tax purposes. The data described and analyzed herein is based entirely on the actual tax returns and financial reports of actual corporations.

1. Present Law

Under the Uniform Division of Income for Tax Purposes

Act, which has been adopted by Alaska, the amount of a multi-jurisdictional corporation's entire taxable income that is currently attributed to Alaska is determined in the following way. The entire income is divided into two classes: "business" income and "non-business" income.[7/] Non-business income (which is generally "passive income" received from investments) is ordinarily attributed to Alaska only if the corporation's "commercial domicile" (corporate headquarters) is located in Alaska. The corporation's "business" income is apportioned to Alaska on the basis of a three-factor formula comprised of the ratios of Alaska-to-total: Property, payroll and sales.[8/]

For purposes of the formula, property included in the property factor is valued at its original cost. Wages are included in the numerator of the payroll factor if they are paid to employees who are covered by Alaska's unemployment insurance compensation laws. Sales are generally included in the numerator of the sales factor only to the extent that the products sold by the corporation are ultimately destined for consumption in Alaska. Special "throwback" provisions exist for assigning to Alaska sales made to the United States Government as well as sales made to customers in jurisdictions in which the corporation is not taxable.[9/]

Like Oregon, California, Minnesota and a number of other states, Alaska currently requires affiliated corporations engaged in unitary businesses to file "combined reports".

Under the combined report approach, the entire income of the whole unitary corporate family from world-wide sources is combined and is then apportioned to Alaska on the basis of a combined apportionment formula. On a multi-corporate level, this method is thus the antithesis of so-called "separate accounting" or "direct accounting".[10/]

Under Section 18 of the Uniform Act, if the application of the prescribed formula does "not fairly represent the extent of the taxpayer's business activity in (Alaska)" the Alaska Department of Revenue may require the formula to be modified or the employment of any other method "to effectuate equitable allocation and apportionment of the taxpayer's income".

The Administrator is also authorized to allow the taxpayer to use "separate accounting". However, the authority for the use of separate accounting is generally interpreted (by the Alaska Department of Revenue, by the Tax Administrators of most of the other states[11/] and by the U.S. Supreme Court)[12/] to be limited to cases in which the taxpayer is engaged in "non-unitary" businesses.

Finally, it is also significant to note that under Section 1 of the Uniform Act and Article IV of the Multistate Tax Compact, financial organizations and public utilities, including transportation companies, are expressly excluded from the application of the uniform apportionment rules.

2. Effect of Present Apportionment Method on Oil Companies

The following table (III) presents apportionment ratios for each of the thirteen largest petroleum companies doing business in Alaska. Two ratios are presented for the factors of each company. The ratios in the columns labeled "P.O." (Parent Only) generally reflect current practice, but exceptions as reported by the auditors are indicated. The ratios in the columns labeled "W.W." reflect current reporting practice in some cases, constructed ratios based upon the audits of actual tax reports in other cases, and constructed ratios based partially upon published data as well as data from tax reports or audits.

There are few new generalizations which can be drawn from this display of ratios and two generalizations sometimes made are at least partially refuted. For example, it is found that the property factor is not always the largest of the three factors such as cases H, I, J, M, and C demonstrate. The sales factor is not always the smallest, for example see cases H, J, L, A, C, D and F.

An additional observation is that the worldwide ratios for each company in the sample are quite generally smaller than the same ratio when it is calculated for a parent only or other less than world-wide combination. Possible exceptions are I, A and B, but in two of these cases, namely I and B, the compared ratios are for different years. The smaller ratios do not mean

that a smaller taxable income will be apportioned to Alaska because these ratios will usually be applied to a larger world-wide apportionable income. Table IV elaborates on this matter and compares apportioned income on a world-wide basis with apportioned income on less than world-wide basis.

TABLE III

APPORTIONMENT FACTORS FROM A SAMPLE OF TAX RETURNS OF OIL COMPANIES OPERATING IN ALASKA IN RECENT YEARS
(Ratios are calculated from 1975 data except as noted)

Company	Property		Payroll		Sales	
	P.O.	W.W.	P.O.	W.W.	P.O.	W.W.
A	*.00539	.01117	.00275	.00222	.00483	.00451
B	.00457	.00916[1]	.00300	.00340[1]	.00223	.00080
C	.01758	.01214	.00240	.00167(E)	.01272	.00001
D	.03672	.03462	.00065	.00030	.00925	.00808
E	*.06077	.05641	.03524	.02801	.01474	.01204
F	.06117	.04555	.04044	.03106	.04721	.02703
G	.01655(E) .01479[1]	.00888	.00392	.00188	.00070	.00035
H	.00293	.00177	.00069	.00034	.00359	.00135
I	*.01142[1]	.02747	.03200[1]	.03382	.00107[1]	.00104
J	*.74726	.00336[1]	.06058	.02537[1]	.26374	.00023[1]
K	N.A.	.03024[1]	N.A.	.00664[1]	N.A.	.00134[1]
L	.08578[1] (incl. one sub.)	.02494[1] .02023	.02575 (incl. one sub.)	.01235[1] .01281	.05336 (incl. one sub.)	.00627[1] .00980
M	*.00684	.00189[1]	.00533	.00214[1]	.00058	.00018[1]

FOOTNOTES:
E - Estimate based on tax reports and calculated by author.
P.O. - Parent corporation only except as noted.
W.W. - World-wide combined report.
N.A. - Not available.
1 - Based on 1974 data.
* - United States Consolidated report.

In compiling the next table (IV), apportionment ratios have been applied to the apportionable income of each sample company. The ratios used to compile this table were the result of summing the property, payroll and sales ratios for each company and then dividing by three. This was done twice for each taxpayer i.e. once for the parent corporation and one or more of its subsidiaries which is the usual basis for filing the income tax report, and then again on a "world-wide" basis. The world-wide reports were constructed using tax reports and publicly recorded corporate financial data. Two companies in the sample did file their income tax reports on the world-wide basis in 1975 and these companies have been eliminated from the table.

A comparison of the results for the two basis for assigning taxable income to Alaska shows that the world-wide basis of reporting would assign the larger tax base to Alaska. In further comparison, the world-wide reporting basis produced positive estimates of taxable Alaska income for each sample corporation, but when the less than world-wide reports are examined, four companies in the sample reported negative taxable Alaska income totalling more than thirty-seven million dollars in 1975. It should be noticed that although this negative income assigned to the state from some companies does not currently offset the positive taxable income of other companies, under present arrangements the current year negative income can offset positive incomes in future years for those companies currently reporting the negative incomes.

In conclusion, the world-wide basis for reporting would have added an estimated six million dollars to the current year Alaskan tax base and if all current year negative incomes offset positive incomes, in future years, the world-wide basis for reporting income would result in an additional thirty-seven million dollar tax base increment for Alaska.

TABLE IV

COMPARISONS OF APPORTIONED INCOME FOR A SAMPLE OF OIL COMPANIES OPERATING IN ALASKA IN RECENT YEARS
(Data for 1975 except as noted)

COMPANY		APPORTIONED INCOME TO ALASKA ($'s)
A	P.O.	266,553
	Sub-1	(23,721,269)
	Sum	(23,454,716)
	W.W.	2,405,587
	W.W.	11,740,204
B	P.O.	943,209
	W.W.	2,316,031
C	P.O.	N.A.
	W.W.	14,112,151
D	P.O.	(375,032)
	Sub-1	(13,525,636)
	W.W.	155,153
E	P.O.	N.A.
	W.W.	2,419,211
F	P.O.	16,742,538
	Sub-1	(65,894)
	Sub-2	45,069
	Sum	16,721,713
	W.W.	2,705,775

G	P.O.	4,584,363
	Sub-1	(209,073)
	Sum	4,374,385
	W.W.	13,694,535
H	*P.O.	3,027,848
	W.W.	5,760,441
I	P.O.	2,494,124
	Sub-1	(Negative)
	Sum	2,494,124
	W.W.	445,184
J	P.O.	2,870,420
	Sub	N.A.
	W.W.	2,872,837
K	P.O.	1,580,332
	W.W.	2,451,381
L	P.O.	11,661,485
	W.W.	15,861,009
M	P.O.	9,469,155
	W.W.	10,892,032

FOOTNOTES

P.O. - Parent corporation only except as noted.
W.W. - World-wide combined report.
N.A. - Not available.
1 - Based on 1974 data.
2 - This is an alternative estimate which probably incorporates a substantial redefinition of Alaska tax base. It is not used in the summary explanation of the tabulated information.

3. Effects of Alternate Methods

The next table (V) compares the results of using a two-factor formula (property and payroll), rather than the presently prescribed three-factor formula, to apportion income to Alaska for the purpose of taxing it. The two-factor formula assigned about 25 million dollars of additional taxable income to Alaska when it was applied to worldwide apportionable income. This incremental income was derived from twelve of the thirteen sample companies and the thirteenth company assigned slightly less income to Alaska by the two-factor formula than by the currently used three-factor formula. The origin-oriented two-factor formula will add slightly more than 25 million dollars to the State tax base.

TABLE V

APPORTIONMENT RATIOS BASED ON PROPERTY AND PAYROLL AND THEIR EFFECTS ON INCOME APPORTIONED TO ALASKA
(Data for 1975 -- World-wide except as noted)

COMPANY	APPORTIONMENT RATIOS 2 Factor	APPORTIONMENT RATIOS 3 Factor	APPORTIONED INCOME ($'s) 2 Factor	APPORTIONED INCOME ($'s) 3 Factor	ADDITIONAL APPORTIONED INCOME ($'s) (2 F minus 3 F)
A	.031	.021	20,813,427	14,112,151	6,701,276
B	.002[1]	.001[1]	19,710,349	13,694,535	6,015,814
C	.005	.003	4,557,061	2,405,587	2,151,474
D	.018[1]	.013[1]	3,447,469	2,419,211	1,028,258
E	.017[1]	.014[1]	3,130,587	2,705,775	424,812
F	.001	.001	2,124,707	2,316,031	(191,324)
G	.014[1]	.010[1]	230,960	155,153	75,807

H	.007	.006	6,459,992	5,760,441	699,551
I	.006[1]	.004[1]	628,510	445,184	183,325
J	.007	.005	4,303,023	2,872,837	1,430,185
K	.017	.014	2,980,579	2,451,381	529,198
L	.042	.032	20,824,050	15,861,009	4,963,041
M	.038	.035	12,066,075	10,892,032	1,174,043
TOTAL					25,185,460

FOOTNOTE
1 - 1974 data

The following table (VI) indicates that the origin oriented extraction factor is appreciably larger than the sales destination factor which is currently used. Since the origin-oriented factor is only one of three factors in the apportionment formula, the effect of the factor is shown by table VII after it is combined with the property and payroll.

TABLE VI

SALES (DESTINATION) FACTOR COMPARED WITH THE EXTRACTION (ORIGIN) FACTOR

Company	Sales Factor	Extraction Factor*
A	.000(35)	.013
B	.001	.003
C	.001	.041
D	.000(23)	.005
E	.001	.045
F	.006	.037
G	.000(18)	.003

H	.027	.068
I	.012	.056
J	.008	.052
K	.000(01)	.018
L	.001	.014
M	.005	.017

* Extraction factor based on estimates of Crude Oil Extraction for the late 1970's and early 1980's.

As the next table (VII) indicates, three factor origin formula adds a total of more than 50 million dollars to the Alaska tax base -- an amount about equal to the total tax base of the sample companies for 1975.

TABLE VII

APPORTIONMENT RATIOS BASED ON THREE FACTOR FORMULAS
i.e. PROPERTY, PAYROLL AND SALES, AND
PROPERTY, PAYROLL AND EXTRACTION
(Worldwide Ratios for 1975)

Company	3 Factors Sales Destination	3 Factors Origin*	Tax Base Differences (Origin - Destination) $'s
A	.003	.008	4,370,713
B	.002	.002	1,711,849
C	.021	.034	8,979,919
D	.010	.011	21,705
E	.013	.027	2,628,601
F	.014	.025	2,031,795
G	.001	.002	5,869,087
H	.006	.010	3,888,539
I	.004	.009	455,548

J	.005	.011	3,982,088
K	.014	.030	2,669,889
L	.032	.056	11,769,255
M	.035	.048	4,229,968
		TOTAL	52,608,956

* The origin factor is based on estimates of crude oil production for the late 1970's and early 1980's.

4. Effects of Separate Accounting

The next table (VIII) presents Alaska's recent experience with separate accounting as used by seven of the thirteen companies in the sample. In 1975 several of these companies began to apportion income to Alaska and in one instance, income assigned to Alaska was both apportioned, as well as assigned by the separate accounting method.

To summarize the material presented, it should be noticed that in no case when separate accounting was used, was any positive taxable income assigned to Alaska. In two cases the income assigned to Alaska by the apportionment method was negative, and in four cases the income assigned in this way was positive. Apportioned income was not available for the remaining case. Further generalization cannot be made except to notice that in the one case when income was both apportioned to Alaska and separately accounted for to Alaska in the same year, the apportioned amount was $2,494,124 and the separately accounted amount was a negative $12,758,645.

The total of incomes definitely assigned to Alaska by separate accounting for 1973 was about negative 8.5 million dollars, for 1974 the sum so assigned was over negative 35 million dollars and for 1975 the incomes assigned to Alaska by separate accounting added to over negative 36 million dollars. The 1975 amount is probably smaller than would have been the case had all of the 1975 apportioning taxpayers or the auditors made a determination of the Alaska taxable income by the separate accounting methods used in prior years.

The negative incomes assigned to Alaska in 1975 by the apportionment method were almost 14 million dollars and the positive incomes so assigned for 1975 amounted to more than 8 million dollars. The negative incomes cannot reduce the positive incomes of other current year taxpayers. Thus, there was an appreciable increase in Alaska taxable income for 1975 as these taxpayers were shifting to the apportionment method for reporting Alaska taxable income. The 1975 negative incomes would as usual be available to reduce Alaska taxable incomes in future years for the companies reporting those negative incomes in 1975.

See table on following page.

TABLE VIII

COMPANIES WHICH USED SEPARATE ACCOUNTING IN 1973, 1974, AND 1975, THE TAXABLE INCOME ASSIGNED TO ALASKA BY THAT METHOD AND ALTERNATIVE METHODS WHENEVER POSSIBLE

		1973 TXBLE. INC.	1974 TXBL. INC.		1975 TXBL. INC.	
		Sep. Acctg.	Sep. Acctg.	Apport.	Sep. Acctg.	Apport.
A	P.O.	(4,688,123)	(15,997,275)		N.A.	2,870,420
	Sub_1	0	0		N.A.	N.A.
D	Sub_1	N.A.	N.A.		N.A.	N.A.
E	Sub_1	N.A.	(2,294,094)	(6,060,885)	(23,721,209)	N.A.
H	P.O.	0[1]	0[1]		N.A.	(375,032)
	Sub_1	0[1]	0[1]		N.A.	(13,525,636)
I	P.O.	0[2]	0[2]		0[2]	N.A.
J	P.O.	(1,829,201)	(2,784,713)		N.A.	3,027,848
K	P.O.	(1,979,609)	(16,248,961)		(12,748,645)	2,494,124
	Sub_1	(165)	(165)		(170)	N.A.

FOOTNOTES
P.O. - Parent corporation only.
1 - Not greater than zero for these cases.
2 - Known to be a negative amount.

D. REVENUE EFFECTS OF PROPOSED LEGISLATION

Four steps have been taken to estimate the revenue impact of our recommended revisions of the Alaska corporate income tax.

The first step in the analysis considered the revenue effects of shifting from a less than world-wide basis for identifying total apportionable income to the world-wide basis for identifying total apportionable income. Table IV presented this data and concluded that Alaska would realize a six million increase in its tax base for 1975 or an estimated increase in revenue of $564,000. This estimate does not in any way recognize that the taxable income as apportioned to Alaska on a less than world-wide basis assigns negative income of $37,000,000 to Alaska which could in part or in its totality offset future years' taxable income. If this occurred, a future revenue loss of about 3.5 million dollars could occur. It is our understanding that the Department of Revenue is already moving toward the world-wide basis for apportioning income which will not only increase current year taxable income but it will substantially reduce the threat which any current year negative incomes pose to revenues in future years.

The second stage of the analysis focuses on several alternative ways of assigning world-wide income to Alaska. As previously noted in Table VIII, in recent years separate accounting has never assigned positive taxable income to Alaska. The negative incomes so assigned could as usual reduce future taxable income. Disregarding

these carryover possibilities, the separate accounting methods for this sub-set of the sample shows a loss of revenue for 1975 of $799,000 when compared with the apportionment methods which were alternatively applied.

Two origin-oriented formulas were used to estimate the revenue effects of such formulas. One formula is a reduced version of the present formula, that is, a two-factor formula combining property and payroll. This formula, when applied to 1975 world-wide income, produces a tax base which is 25 million dollars larger than the tax base assigned by the present destination oriented formula. The increment in revenue would be $2,350,000. The second origin-oriented formula is a three-factor formula which combines property, payroll and the extraction factor defined earlier in this report. This factor was estimated for the early production period of the Prudhoe Bay fields. When the three factor apportionment formula containing this third origin-oriented factor is applied to 1975 world-wide income, an additional 53 million dollars of tax base is assigned to Alaska, yielding an estimated $4,944,866 corporate income tax revenue. It should be noticed that if the extraction factor based only on Cook Inlet crude production would assign a smaller tax base to Alaska to the extent of 7.5 million dollars, it would have led to a revenue loss of $705,000. The production prospects for the next decade or two makes this historical hypothetical calculation interesting by way of the contrast it emphasizes.

At this point, it is worthwhile to note that on the basis of

a sampling of smaller companies operating in other industries that the presently used sales factor was about the equal of the property factor -- thus the smaller, more localized companies have experienced a higher effective tax rate because of the differential effect of the sales factor on such companies as compared with the large multi-jurisdictional enterprises.

Thirdly, the total apportionable income, though conveniently keyed to the Federal tax returns, need not be defined as Federal taxable income. The equally available alternative which is not diminished by "Federal tax expenditures" is the net income on the books of the corporation. Starting with net book income, estimates are made of the differences between a book income base and a federal taxable income base. On a nationwide level, these differences amount to two to three billion dollars annually for the companies in the Alaska sample. Alaska's share of this nation-wide amount would have increased Alaska's tax base by about 57 million dollars and its corporate income tax revenue by $5,375,000.

Finally, it must be noticed that for the fairly near future the apportionment factor based on property will increase due to the rapid increase of property in Alaska and the large amount already under construction but not yet incorporated into the apportionment ratios. This property would increase the numerators and the denominators of the apportionment ratios by the same absolute amounts but the increase in the numerators would outweigh the influence of changes in the denominators. By 1978 about 8.5 billion dollars worth

of property now under construction will be added to the present Alaska property. Making a very conservative estimate of the revenue impact of this change in the property factors for the several large companies, Alaska will still realize a substantial increase in revenue. The Alyeska Pipeline properties have been included in this estimating process. Applying the new property ratios to 1975 income would have increased the State tax base by at least 70 million dollars for an additional $6,500,000 of tax revenue.

The payroll factor in the apportionment formula could be expected to change in future years. The change, however, would be modest as compared with the property factor. Furthermore, the changes in payroll which occur for the entire State would involve construction activity more than active petroleum production. For example, contract construction employment increased three to four times for the 1973 to 1975 period; that is from 8,000 to 28,000 employees. During the same period, employment in extractive activities went from 2,000 to 4,000 employees, while manufacturing employment was very steady. Interpreting this data from the Bureau of Labor statistics, it is concluded that the decline in employment in construction is going to be relatively large and that the decline in employment by the oil industry will be of little or no consequence for the assignment of taxable income to Alaska.

To sum up the revenue impact of suggested changes in the corporate income tax, Alaska could expect about a four-fold increase in tax revenue (1) by keying into book value rather than Federal

taxable income for determining apportionable income, (2) by adopting the three-factor origin-oriented apportionment formula and requiring its application to world-wide unitary income and, (3) by fully incorporating property now under construction into the apportionment process. The revenue impact of these changes are based on 1975 incomes. The growth of corporate income which would normally occur would, of course, increase the revenue productivity of the corporate income tax. The changes in the tax would apply to any increments in tax base as they develop and would have the same effect on the Alaska tax base and revenue as already set forth.

E. SOME ADMINISTRATIVE CONSIDERATIONS IN FAVOR OF THE PROPOSED LEGISLATION

In formulating our recommendations, we gave careful consideration to the enforcement aspects of Alaska's income tax. We recognize that the State is rapidly developing advanced techniques for the administration of its tax programs. In this regard, it is important also to recognize that Alaska can easily be faced with insurmountable enforcement difficulties if it tax laws are not designed to cope with the sophisticated tax avoidance techniques that characterize the tax planning of large multi-national corporations, some of which have an annual net income that is at least five times as great as Alaska's total budget.

One of the significant ways in which the State is currently developing its enforcement capacity vis-a-vis multi-national corporations is through its participation in the joint audit programs of the Multistate Tax Commission. As a result, we have been concerned with the formulation of a proposal which would allow Alaska to continue to participate in that program.

To ascertain the extent to which our recommendations can be implemented without disrupting Alaska's working relationship with the Multistate Tax Commission, we have interviewed the Commission's Executive Director and members of its staff. Based on these interviews, we have concluded that the Commission's audit staff can easily adapt its joint audits to accomodate the extraction factor of the apportionment formula that we are recommending. At the same time, we have been assured by the Commission's audit staff that the use of "book income" would make such audits easier to conduct than under the present tax laws. As a result, we feel confident that our proposals would increase, rather than decrease, the benefit that Alaska is able to receive from its participation in the Multistate Tax Commission.

F. COMPARISON OF PROPOSED LEGISLATION WITH PROPOSALS FOR A "NET PROCEEDS" TAX BASED ON SEPARATE ACCOUNTING

In formulating our recommendations, we have also considered the arguments previously advanced to the Legislature in support

of various forms of "net proceeds" taxes based on separate accounting.[13/] However, since the net proceeds tax involves new concepts which have neither been developed by the Federal Government or by other states (with the possible exception of some features or the Nevada tax), no data based on real experiences with real tax returns is available to assess the true economic impact of the net proceeds tax. Both because of the lack of such economic data, and because of administrative difficulties with similar separate accounting methods, with which we have had experience, we recommend against the adoption of a net proceeds tax.

1. <u>Administrative Difficulties with Separate Accounting</u>

The use of separate accounting is based on the assumption that, although the total income of a corporation may be derived from interstate transactions and from many sources in many states, it is possible to isolate hypothetically those portions of the multi-jurisdictional business which are within a single state. The corporation's activities within the taxing state are regarded as though they were carried on by a separate and distinct in-state entity. Income is recomputed for this hypothetical entity without reference to the capital, receipts or operating expenses of the remainder of the corporation.

The use of separate accounting is widely resisted by State Tax Administrators in the case of unitary businesses. As we

have indicated above, its use has also been rejected by the United States Supreme Court.[14/] Likewise, separate accounting was prohibited under the recommendations unanimously adopted by the Judiciary Committee of the United States House of Representatives, following the comprehensive investigation of State tax systems which were conducted from 1961 through 1966.[15/] Nevertheless separate accounting is often advanced by multi-national corporations as their ideal method for determining income attributable to the taxing State.

The reasons for the rejection of separate accounting by progressive State Tax Administrators becomes apparent from a consideration of some of the administrative and theoretical problems presented by this method.

In case of a multi-national petroleum company, only some of whose affiliates operate in Alaska, the use of separate accounting requires not only that hypothetical prices be established for goods or services between affiliates, but also requires an item-by-item analysis of all inter-affiliate loans, credit arrangements, dividend arrangements, partnership agreements, joint ventures, profit sharing arrangements, etc. In short, the use of separate accounting places at the desposal of the parent corporation the maximum opportunity to determine which of its affiliates in which states will be operated on a profit-making basis for state tax purposes or on a "loss" basis for tax avoidance purposes.

Under the circumstances, it is not surprising that a large lobby group of multi-national corporations known as COST (Committee on State Taxation) has been formed to press both the United State Congress and State Legislatures for legislation permitting them to use separate accounting techniques for State tax purposes. It is also noteworthy that COST is comprised of ninety-two of the one-hundred largest corporations in the United States and is both an advocate of separate accounting forms of taxation as well as an opponent of the joint audit program of the Multistate Tax Commission.[16/]

The use by large, vertically-integrated petroleum companies of separate accounting techinques for tax avoidance purposes in Alaska was demonstrated above by Table VIII. In general, this table shows that during 1973, 1974 and 1975, when seven of the largest oil companies operating in Alaska used separate accounting to determine their Alaska taxable income, in no case was any income assigned to Alaska. Instead, each separate accounting was asserted (by the taxpayer) to have demonstrated that the Alaskan operations were being conducted at a loss.

Although on the surface, the separate accounting techniques called for under the net proceeds tax proposals may appear to be more simple than the use of separate accounting in the present income tax, in reality the problems created

under the net proceeds tax would be even more complicated, and tax avoidance possibilities even greated than under the present income tax.

Under the net proceeds tax proposals not only is the multi-national corporation able to set up its separate accounts for its Alaska operations and its operations in other states, it is also permitted to make its own separate determinations regarding the degrees of profitability of its oil-producing operations as distinct from its oil transportation and refining and marketing operations as well as from all of its other income producing activities. At the same time, after isolating the oil extracting operations for tax purposes, it is able to arrange its own internal finances in such a way as to use costs and expenses relating to its oil-extracting operations on the outer continental shelf off the coast of Alaska to offset and reduce its tax liability for on-shore drillings.

Briefly summarized, the separate accounting features of the net proceeds tax, therefore, compound the separate accounting difficulties of the present income tax since the net proceeds tax proposals, in effect, call for a "a separate accounting--of a separate accounting--of a separate accounting" (in other words, a hypothetical segregation of: Alaska from non-Alaska operations, oil production in Alaska from other operations in Alaska, and of on-shore oil operations from off-shore oil operations). In this regard it is

important to note that such separate accounts would be kept for no purpose other than tax computation. As a result any such accounting can easily be adapted to the purposes of tax avoidance.

In comparing the net proceeds tax with the present income tax, proponents of the net proceeds tax tend to argue that by giving the Department of Revenue the statutory authority to determine oil prices for the purposes of the tax, the disadvantages of separate accounting can easily be obviated. However, this argument ignores the realities of even the most conventional modern tax avoidance techniques in every-day use. These techniques may be illustrated by the following example.

Affiliate A, which is taxable in Alaska, engages in a complex variety of transactions with affiliated support companies. The support companies are not taxable in Alaska and charge large service or sales prices which increase the cost of expenses of A. Such support companies perform engineering and geological studies, sell drilling equipment and supplies, transport such equipment and supplies to the Alaska site, etc. While maintaining a high total income of the combined group, the oil production net proceeds of A is kept low by assigning to A a disproportionate amount of deductions.

In such a case, proponents of separate accounting point out that the Department of Revenue would have the legal authority to recompute all of the transactions among all of the parties and their affiliates. However, for the Department of Revenue to do so would involve an extraordinarily complex series of cost-accounting types of audits of each affiliated service organization. Such audits would be similar to the complex audits used only rarely and as an extraordinary remedy by the Federal Government under Section 482 of the Internal Revenue Code.

On a Federal level, under Section 482, the Secretary of the Treasury has long had the power to re-allocate income and deductions among affiliated compaines when "necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations." However, the difficulties of administering Section 482 has been found so great as to limit severely the usefulness of this power, even as an extraordinary remedy on a Federal level.[17/] Under the circumstances, since the problems posed by separate accounting on a State level are even more complex than on a Federal level, it is our opinion that individual states simply are not capable of developing sufficient audit capacity to rely on such extraordinary types of audits for the general enforcement of their tax programs. This is not only true with states such as Alaska, which has a comparatively small audit staff, but is also true with respect to such states as California, which has the largest and most experienced audit staff in the United States.

2. <u>Inequities Created by Attempts to Provide for Credits Between the Current Income Tax and the Proposed Taxes on Net Proceeds</u>

The difficulties in this area emanate from the fact that the income tax currently in effect in Alaska like the income taxes of all other states, is both apportioned and includes income from all sources and from all types of activities. Thus it includes income from refining, transportation and marketing of oil and petroleum products, as well as income from other activities. In contrast, the proposed net proceeds tax would apply only to the net proceeds from the extraction of petroleum.

Recognizing that if the net proceeds tax is imposed as a separate and distinct tax, oil producing corporations will be subject to double taxation, the proponents of the net proceeds tax generally suggest that the tax be imposed in lieu of the income tax or that one of the two taxes be creditable against the other. However, a careful analysis of such credit arrangements suggests the impossibility of relating the two taxes to each other in a way that will not create significant inequities, especially for local Alaska companies that are unaffiliated with multi-national enterprises.

On the one hand, if the net proceeds tax is imposed "in lieu" of the corporate net income tax, then a petroleum

producing conglomerate would be allowed to earn "tax free" income from a wide variety of business activities other than the extraction of petroleum. For example, a multi-national oil-producting corporation could operate a hotel in Alaska and escape income taxation entirely with respect to its earnings from the hotel operations.

If the net proceeds tax is allowed as a credit against the corporate net income tax, then a large petroleum corporation with a large oil production would be able to use the net proceeds tax as a "shelter" to escape tax on Alaska activities that are not directly related to the extraction of petroleum. For example, the large petroleum corporation could purchase an Alaskan fishing enterprise and use the credit from the net proceeds tax to decrease its liability for the income tax imposed on the combined income from both petroleum production and fishing operations.

If, on the other hand, the income tax is allowed as a credit against the net proceeds tax, a multi-national corporation operating a fishing business or a construction company either in Alaska or outside of Alaska would be able to reduce its liability under the net proceeds tax to the extent that it is able to derive income from fishing or construction either inside or outside of Alaska.

As each of these examples illustrates, the effect of efforts to provide for inter-related credits between the two types of taxes would be to give unfair tax advantages to large conglomerate types of operations that would not be available to smaller corporations that are neither members of affiliated groups nor engaged in a variety of income producing activities.

G. FURTHER RECOMMENDATIONS

1. On-shore Economic Impact of Outer-Continental Shelf Operations

In conducting our analysis of the present system of corporate income taxation in Alaska, we became aware of the inter-relationships between the on-shore activities of petroleum companies and activities of some of the same companies with respect to the outer continental shelf. In view of the fact that the outer continental shelf activities have a profound economic impact on the State and obviously creates substantial need for governmental services provided by the State, it would seem reasonable for the State to structure its taxes in such a way as to relate the tax burdens of companies that operate on the outer continental shelf to the benefit which those companies derive from services provided on-shore by the State of Alaska.

To take into account the economic impact of the outer continental shelf activities on the State, we recommend that both the property factor and the extraction factor in our proposed apportionment formula be defined to reflect property and extraction activities on the outer continental shelf which are primarily serviced from on-shore facilities in Alaska. Such an apportionment device would be similar to the "throw-back" principle already embodied in the present sales factor of the Uniform Division of Income for Tax Purposes Act. Under the Uniform Act, sales of goods shipped into states and foreign countries in which the corporation is not taxable are "thrown back" to the state in which the goods originate. Similarly, property and extraction activities not located in any state in which the corporation is taxable, ought appropriately to be assigned to the Alaska numerator if the property and extraction activity are serviced from on-shore bases of operation in Alaska.

We recognize that the case law may be somewhat unsettled concerning the power of the states to take the on-shore economic impact of outer continental shelf activities into account in the apportionment of State taxes measured by net income. Since we have not conducted a detailed analysis of the case law and have not made any revenue estimates of the outer continental shelf activities, our recommendations concerning the on-shore impact of outer continental shelf activity are still tentative.

2. <u>Alaska's Participation in Multistate Tax Commission</u>

Under AS 43.19.030 provision is made for oversight by appropriate committees of the manner in which the Multistate Tax Commission is functioning with respect to Alaska's tax program. It should be noted that to date these committees have not been constituted.

As indicated above, during the course of our investigation we have conferred with the Executive Director and Audit Staff of the Multistate Tax Commission. Because of the Commission Staff's involvement with the audit of large vertically-integrated corporations on a nationwide and worldwide basis, the staff has been able to provide us with invaluable information, as well as a number of helpful suggestions. In our judgements, substantial benefits can be derived by Alaska from continued participation in the Multistate Tax Compact.

3. <u>Applicability of Proposed Legislation to Production and Transportation of Gas</u>

Although our study has been limited to the income taxation of oil companies, our findings suggest that our recommendation may be equally applicable to the production and transportation of gas in Alaska. As a result, a draft bill that we have prepared covers the taxation of income from both oil and gas.

4. Gross-Valued Severance Taxes

It is important to note that the preceeding analysis has been devoted exclusively to a consideration of "net" types of taxes which are measured by profitability and, therefore, provide for substantial deductions from the taxpayer's gross earnings. Under the decisions of the United States Supreme Court,[18/] such "net" types of taxes are generally required to be imposed in some manner that reasonable apportions the total tax base among each of the States in which the interstate corporation is engaged in interstate commerce.

In contrast, the United States Supreme Court has not required severance types of taxes measured by the "gross" value of resources extracted to be determined in a manner that apportions the tax base among any of the states to which the extracted resources are eventually transported or sold.[19/]

Although we have made no specific recommendations with respect to the form or rates of any severance taxes which are, or might be, imposed by Alaska, it is important to note that the adoption by the State of our proposals in the income tax area would in no way preclude the State from also re-evaluating its present severance tax structure.

Background of Authors

Mr. Zeifman is currently an Associate Professor of Law at Santa Clara University School of Law, Santa Clara, California. He formerly served as General Counsel to the Committee on the Judiciary of the U. S. House of Representatives, as well as Chief Counsel to the Special Subcommittee on State Taxation of Interstate Commerce. He has also served as Chief Counsel to the Subcommittee on Anti-Trust and the Subcommittee on the Outer Continental Shelf.

Mr. Ainsworth is a Professor of Economics and is Chairperson of the Department of Economics at Allegheny College, Meadville, Pennsylvania. He was formerly an Economist on the staff of the Special Subcommittee on State Taxation of Interstate Commerce. He has also served as a consultant in the revisions of the tax systems of New York City, the State of Connecticut and the District of Columbia.

Both of the authors confine their non-teaching professional activities to government service.

Footnotes

1/ AS 43.20.021

2/ AS 43.19.01

3/ See, Report of the Special Subcommittee on State Taxation of Interstate Commerce of the Committee on the judiciary of the U.S. House of Representatives (Hereinafter referred to as the Willis Subcommittee Report), H. Rpt. 1480 (1964), Vol. Vol. 1, p. 143.

4/ Colonial Pipelines vs. Triagle, 95 S. Ct. 1538 (1975)

5/ Similar tests were recommended by the House Judiciary Committee in the "Willis Bill" and the "Rodino Bill," both of which were approved by the U.S. House of Representatives.

6/ Budget Options for Fiscal Year 1977, as Required Annually by P.L. 93-3-344, Congressional Budget Office, March 15, 1976.

7/ See Willis Subcommittee Report, Vol. 1, pp. 276-278.

8/ AS 43.19.010, Article IV 4 to IV 8

9/ AS re.19.010, Article IV 9 to IV 17

10/ Ibid.

11/ AS 43.20.031

12/ See Willis Subcommittee Report, Vol. 1, p. 167

13/ See Walgreen Co. vs. Commissioner of Taxation, 258 Minn. 522, 104 N.W. 2d 714 (1960), appeal dismissed 365 U.S. 767, 81 S. Ct. 912 (1961); Butler Bros. vs. McColgan, 315 U.S. 501, 62 S. Ct. 701.

14/ We have assumed that a "net" proceeds tax would be measured by some concept of profitability and would therefore provide for significant amounts of deductions.

15/ See note 13.

16/ See Willis Subcommittee Report, Vol. 4.

17/ See Willis Subcommittee Report, Vol. 1, p. 165; and H. Rept. 1447, 87 Cong., 2d sess, p. 28 (1962)

18/ See Northwestern States Portland Cement Co. vs. State of Minnesota, 358 U.S. 450, 79 S. Ct. 357 (1959). Se also, Willis Subcommittee Report, Vol. 3, pp. 1037-1039.

19/ See Hope Natural Gas Co. vs. Hall 274 U.S. 284 (1927); Oliver Iron Mining Co. vs. Lord, 262 U.S. 172, (1923); Heisler vs. Thomas Colliery Co., 260 U.S. 245 (1922); American Mfg. Co. vs. St. Louis 250 U.S. 459 (1919). See also, Willis Subcommittee Report, Vol. 3, p. 1041, 1042.

PRESENTATION OF TABLES

* To avoid the identification of individual companies the letter designation used in any particular table do not necessarily correspond with the letter designations used in any other tables.

Alaska State Legislature

House of Representatives

Pouch V
State Capitol
Juneau, Alaska 99811

Official Business

MEMORANDUM

TO: Senator Jalmar Kerttula
Representative Terry Gardiner
Co-Chairman, Joint Gas Pipeline Committee

FROM: Mark Wittow, A.A. MW
C. Kevin McCarthy, A.A. C.K.M.

DATE: May 20, 1981

RE: Sponsor Substitute for HB 200

The above bill is designed to accomplish the objectives set out in the Joint Statement on Oil Taxes issued by the Governor and legislative leadership on March 18, 1981:

> Alaska's existing taxation and leasing policies currently provide significant incentives for petroleum exploration and development in the state. Hence, existing levels of taxation, stabilized since 1978, should remain stable at this time.
>
> . . .
>
> Both the Governor and the legislative leadership are determined that through their mutual efforts, a sound strategy for protecting oil and gas revenue will be found.

The Sponsor Substitute for HB 200 was prepared by the Departments of Law and Revenue, and is based on a draft bill prepared at your request by Commissioner of Revenue Tom Williams, John Messenger of the law firm Preston, Thorgrimson, Ellis & Holman and committee staff members Mark Wittow and Kevin McCarthy. This draft bill was distributed on May 11 to Alaskan oil and gas producers, legislative advisors and other interested parties.

SS HB 200 accomplishes the following:

1. Grants a deduction under AS 43.21 for federal Windfall Profits Tax payments;

2. Enacts a reserves tax on producing oil properties, similar to the Reserves Tax enacted in 1975, as a backstop for revenue collected by AS 43.21 in its current form. The millage is set at 30 mills for the

first year and 25 mills thereafter. Gas reserves and any non-producing oil reserves are not subject to the tax;

3. Exempts lands of ANCSA Regional Corporations from the reserves tax in accordance with federal law, and establishes a deduction for revenues required to be distributed under section 7(i) of ANCSA;

4. Makes the technical amendments to AS 43.21 contained in HB 200 and SB 192, introduced at the request of the Governor. These technical amendments will improve the state's posture in the current litigation over 43.21;

5. Makes no changes to current Alaskan oil and gas production (severance) tax (AS 43.55) rates.

In summary, SS HB 200 would maintain tax collections at the levels currently in effect, under accepted oil price assumptions (0-5% real growths), while providing certainty in the face of pending litigation over AS 43.21.

Alaska State Legislature

House of Representatives

Official Business

Pouch V
State Capitol
Juneau, Alaska 99811

MEMORANDUM

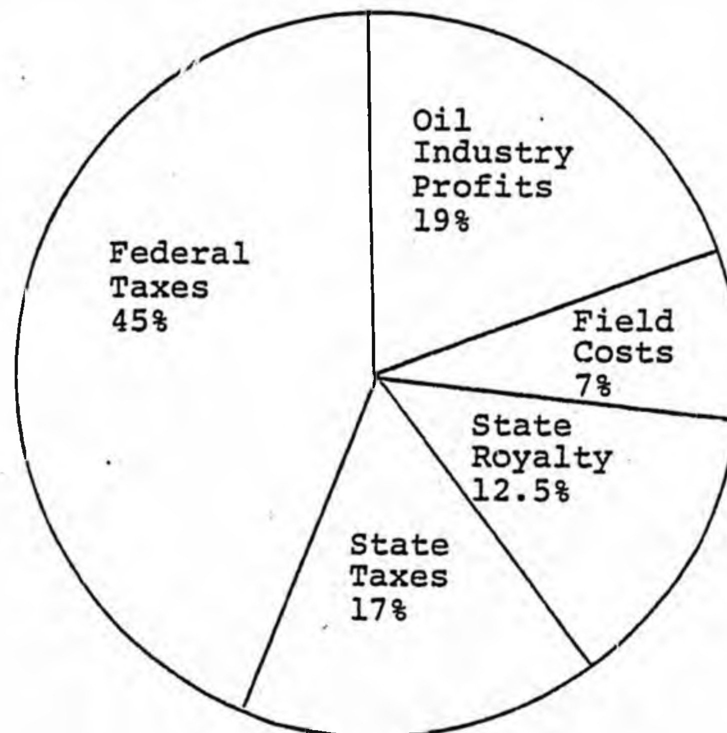
TO: All Legislators

FROM: Rep. Terry Gardiner

DATE: March 3, 1981

RE: Prudhoe Bay Total Oil Revenues and Taxes (FY 82)

Shown below are figures which explain the division of Prudhoe Bay oil revenues. The numbers are from the Division of Legislative Finance estimates for fiscal year 1982, the first full fiscal year that Prudhoe Bay will not operate under price controls. This basic revenue split should remain constant during the years of maximum Prudhoe Bay production under the Federal Windfall Profits Tax (FY 82-91).



Total Revenues: 17.8 Billion

Prudhoe Bay Total Oil Revenues and Taxes (FY 82)

100%	Total Revenues Prudhoe Bay Oil Field (fiscal year 1982)		$17.8 billion
	* * *		
7%	Field Development and Operating Costs (includes facilities, drilling, secondary recovery, etc.)		1.2 billion
45%	Federal Taxes		8.1 billion
17%	State Taxes		3.0 billion
	-severance tax	1.7 billion	
	-corporate income tax	1.2 billion	
	-property tax	.1 billion	
19%	Oil Industry Profits (see additional pipeline income note D page 2)		3.3 billion (see note A)
12.5%	State Royalty (Ownership) Interest		2.2 billion

NOTES

A. Internal rate of return for investors in the Prudhoe Bay field is estimated at least 59%. If a 50/50 debt/equity ratio is assumed, return on equity would rise to roughly 118%. Actual profits may be higher, depending on actual Federal tas payments--figure given assumes 46% effective Federal income tax rate.

B. Figures shown assume a $33.52 wellhead value and production of 1.455 million b/d.

Prudhoe Bay Total Oil Revenues and Taxes (FY 82)

C. Prudhoe Bay Oil ownership interests:

Sohio	46.5%
Arco	17.5%
Exxon	17.5%
State	12.5%

D. Detailed revenue estimates have not been developed for the Trans-Alaska Pipeline System. TAPS is treated as independent profit center by the companies and Federal government, and earns a guaranteed return on investment of approximately 18% independent of field operations for its owners (Sohio/BP, Exxon, and Arco own 90% of the line). Total revenues from TAPS are approximately 3.4 Billion dollars/year, based on a $6.20 tariff and 550 Million barrels/year throughput. Total state taxes on the line (FY 82): approximately $130 Million in income taxes under AS43.21 and $110 Million in property taxes under AS43.56.

Please contact me if you have questions concerning the information.

Alaska State Legislature

House of Representatives

Official Business

JOINT GAS PIPELINE COMMITTEE

Pouch V
State Capitol
Juneau, Alaska 99811

MEMORANDUM

TO: Jt. Gas Pipeline Committee members
House Finance Committee members

FROM: Rep. Terry Gardiner, Co-Chairman
Sen. Jay Kerttula, Co-Chairman
Joint Gas Pipeline Committee

DATE: May 21, 1981

RE: Economic Analysis of Comparative Oil Industry Taxation and Profitability

---

For your information, we have attached is a brief draft memorandum which analyzes the relative attractiveness of Alaska for oil industry investment in a international context. The report's conclusion can be found on Page 17:

> "In comparing the profitability of Alaskan oil with that elsewhere in the world, it is quite clear that it is probably the most profitable investment area in the world. For one thing, the per-barrel profit rate and the DCF profit rate are among the highest in the world. Moreover, other nations intervene in the oil industry much more forcefully through controls on pricing and marketing and limits on management decision-making, and are much less secure sources of oil supply."

DRAFT
May 11, 1981

Update of 1977 Study of "Impact of Increased Taxation On Oil Exploration and Development In Alaska"

1. The purpose of this draft memo is to update our 1977 analysis of the impact of taxation on the profitability of oil exploration and development in Alaska compared to other areas of the world. Table 1 contains estimates of present company profitability in various producing countries around the world, which reveals that company profitability in Alaska, under the present tax system, is still the highest in the world.

2. The OPEC countries, which have large potential oil reserves, are generally not a major target for oil company exploration and development. This is largely because most production there is now controlled by the governments and rates of profit per barrel are significantly lower than elsewhere. (Indonesia is to some degree an exception to this, as will be discussed below.) Additionally, investment in many of these areas is considered extremely risky due to problems of political instability and the possibility of an oil embargo.

TABLE 1

Comparative Profitability of
World Crude Oils (Estimated)

Country	Price*	Capital and Operating Cost	Gross Profits	Company Share of Profits (Rounded)	
				Percentage	Dollars Per Barrel
Saudi Arabia	$30	$1**	$29	1	.25
Venezuela	$30	$2**	$28	1	.25
Nigeria	$37	$1.10	$35.90	2	.80
Indonesia	$31.50	$2**	$29.50	12-15	3.50-4.40
Malaysia	$36	$2**	$34	5-10	1.70-3.40
Egypt	$36	$2**	$34	10	3.40
U.K.	$37	$3-6	$31-34	10-15	3.10-5.10
Norway	$37	$3-6	$31-34	10-15	3.10-5.10
Canada	$33.50***	$2-4	$29.50-$31.50	5-15	1.50-5.40
Alaska (life of field)				33	
Alaska (1-81)	$27	$2	$25	22	5.60

*December 1980 Prices

**Assumed for calculation purposes
(Double that used in 1977 Report)

***Heavy oil; price includes export tax

Sources of Data Are At The End of Report.

Note: Company Shares are based on <u>current</u> tax system take. The actual take over the life of some fields may be less if they went into production during different tax regimes.

3. Another major potential area of exploration and development is the North Sea. Although there is less of a problem of political stability and supply disruptions there, the profit rate is significantly lower than that of Alaska -- the governments' takes range from some 85 to 90% of the profits compared to less than 70% in Alaska. Furthermore, much of the production in that area is controlled by government owned companies.

4. Canada has traditionally been the number two area of exploration and development for the U.S. companies, as rates of profit have been significantly higher than elsewhere in the world. However, recent changes in Canadian policy have both reduced the profit rate and looked toward a significant restriction of activities by foreign oil companies. Exploration has fallen 40% during the past year.

5. The non-OPEC developing countries, such as Egypt and Malaysia, are the other major potential production areas for the companies. However, these countries have tended to model their oil policies on those of OPEC or North Sea countries. For instance, in Malaysia, the government's share of the take can be as high as 95%, while in Egypt it can be up to 90%. While other countries may offer the companies somewhat better terms, these are generally in countries without large proven reserves. (The most important new producing country is Mexico, which has closed its borders to the foreign oil companies

since the 1930s.)

6. All in all, it appears that the most secure and profitable area for the companies for oil exploration and development is the United States, with Alaska having the greatest potential. The company's own belief in this can be shown by their "net profits bidding" under the 1979 Beaufort Sea Lease Sale. Thus, for example, in order to win one tract, Amerada Hess bid to pay the state 93.2% of any future net profits; in addition of course, the company's share of the take would be reduced by royalty and income tax payments. Again, Standard Oil of Ohio bid 79.5% for a tract in the Beaufort Sea where recent drilling activity has already yielded signs of commercial reserves of oil (Oil and Gas Journal, April 27, 1981, p. 120).

7. In the following sections, we present some basic data on the recent tax changes and present policies outside the U.S. which account for the fact that Alaska continues to offer among the most attractive exploration possibilities in the world.

8. The industrialized countries of the North Sea have been securing increasingly greater shares of the profits created by oil price increases. Both Norway and the United Kingdom have instituted windfall profits taxes in various forms which end up giving the governments from 85 to 90% of oil production profits. Because these are industrialized countries whose

political, legal and economic systems more closely resemble those of the United States, their oil policies are of special interest.

9. Norway

Norway is an example of a country whose policy has been increasingly to take a larger share of profits created by oil,while at the same time gradually asserting state control and ownership over oil development through a state-owned oil company (Statoil). Despite these openly declared policies, exploration has increased and the international oil companies have continued to show interest in development. In fact, the only limit to exploration and investment has been the government's own depletion policy.

10. Prior to 1973, Norwegian petroleum taxation policy was quite similar to that of the United States, based on a 12.5% royalty and 52% general corporate income tax (divided between the municipalities and the national government). The first concessions, granted in 1965, did not include state participation. With the discovery of large commercial reserves and the 1973 price increases, Norway made some dramatic changes. Since 1973, Statoil has been given 50-85% equity in all blocks granted without having to contribute to exploration costs. In 1975, a special 25%, nondeductable, tax on net oil and gas income, was added to the corporate income tax, and a royalty of 8-16% (depending on production levels) was established. (Moreover, for purposes of calculation of taxable income, the state basically determined the "market

price" of oil.) From 1975 to 1979, this system gave the government 70% of oil profits. Despite a relatively high take for a developed country at that time, exploration activity continued at the rate desired by the government.

11. Due to the more than doubling of oil prices in 1979 and 1980, the Norwegian government raised the special tax on oil revenues to 35% and reduced deductions for capital expenditures. This raised the government's average take to nearly 85%. Due to the deductions allowed under the special tax for capital expenditures and under the corporate tax for dividends, the actual government take is somewhat lower. However, when one includes state participation in production, this raises the take upwards to 85 to 90% (Storting Report no. 53, "Concerning the activities on the Norwegian Continental Shelf". Norwegian Government Ministry of Petroleum and Energy, 1980.)

12. During the period of time when the new tax system was being proposed, the oil companies claimed that it would reduce the profit rate on investment to such a degree as to jeopardize future exploration and development activity (see _Platt's Oilgram News_, March 17, 1980, p. 3). Two companies, Exxon and France's Elf Aquitaine, warned that they might hold up development of two new fields (_PIW_, March 24, 1980, p. 4). Mobil complained that the tax would reduce the

discounted cash flow from the Statfjord field, thus making it uncertain whether or not additional development would be undertaken (PIW, March 31, 1980, p. 3).

13. Despite these prophecies of doom, exploration activity and production increased following the institution of the tax. Exxon and Elf went ahead and developed their new fields and Mobil continued the development of the Statfjord field with the construction of a third platform (Petroleum Economist, April 1980, and April 1981). Indeed, the Petroleum Economist reported in April 1981,"Last year saw a significant upturn in exploration work in most sectors of the North Sea -- a trend which, will continue through this year to the next" (Petroleum Economist, April 1981, p. 156). Under these fiscal conditions, two North Slope producers, Arco and Exxon, have continued to bid for additional blocks for exploration in Norway, and have actively continued exploration and development activities in their existing concessions.

14. An instructive comparison of the profitability of Norway versus that of Alaska is provided by Mobil's projection of the profitability of the Statfjord field, Norway's second largest field, with production expected to reach 400,000 b/d Mobil has stated that the discounted cash flow rate of return over the life of the field is expected to be 16.9% per year, in real dollars (PIW, March 31, 1980, p. 3).

Assuming a 10% inflation rate, this would amount to a DCF profit rate in current dollars of about 29%. This compares to an estimated current dollar rate of return on Prudhoe Bay of about 60-70%.

15. United Kingdom

British oil policy is quite similar to that of Norway, with an even higher tax take on new fields, but with less emphasis on government participation through the British state oil company (BNOC). The British tax system is somewhat more complicated than that of Norway. It consists of four separate taxes:

1. A royalty equal to 12.5% of gross income from production.
2. A petroleum revenue tax equal to 70% of the net profits. (Net profits are defined as gross income, minus royalty, minus operating costs, minus 135% of capital expenditures, minus an allowance and safeguards designed to protect marginal fields.)
3. A corporate income tax equal to 52% of net profits minus the petroleum revenues tax.
4. In 1981, an additional tax, supplementing the petroleum revenue tax was added, equal to 20% of gross revenues, minus royalties, minus an allowance and safeguards to protect marginal fields. (This tax is deductable for calculation of the petroleum revenue tax and the corporate income tax.)

All in all, these taxes take some 90% of the profits from larger and new fields. The tax take for other fields varies from 60 to 90%, depending on the size of the field and cost of production. (The system is designed to preserve small marginal fields by lowering the tax rate through allowances and safeguards.)

16. There have been three major tax changes since the original tax law was introduced in 1975. In 1979, the petroleum revenue tax was raised from 45% to 60% and the allowances were reduced, which resulted in increasing the government take from 67% to 75%. At that time, oil executives argued that the increase in the petroleum revenue tax would reduce incentives needed to revive exploration and development (see PIW, March 12, 1979, p. 5). This proved to be untrue as exploration and production increased in both 1979 and 1980 (the limit being the area available for exploration as the government only opened up a small area each year for exploration: see Petroleum Economist, June 1980, p. 233).

17 In January 1980, the petroleum revenue tax was again raised, from 60% to 70%, increasing the government's take to over 80%. The UK Offshore Operators Association again claimed that this increase would hurt the stability needed to encourage exploration in UK waters, and again there was a tremendous outcry about the effect of the tax on marginal