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SUBCOMMITTEE ON TAXATION

AND REVENUE

November 6, 1975

AGO 513294

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Agenda for November 6th

MORNING

9:00	Introduction and opening remarks Chairman John Huber
9:30	Remarks Vice Chairman Steve Cowper
10:00	Discussion with Milton Lipton and Dick Kilgore, W.J. Levy Consultants Corporation, New York
12:00	Break for lunch

AFTERNOON

	Presentations by Committee Staff
1:00	Frank Fleeks Tax Counsel
2:00	Ed Sterner Research Analyst
	Discussion

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A Talk with Dick Kilgore of Levy Associates 7/29/75
in New York

Senator Huber, Senator Colletta, Judy Whitney-Assistant to Representative Bradner.

Levy Associates has said, for many years now, that you people in Alaska should be reviewing very carefully the corporate income tax because we can see, just off the top of our heads a number of problems with the way it is structured now. Whether that will get you an appropriate amount of income from Prudoe Bay we don't know but it should.

We have no lawyers on the staff here, so we can not address ourselves to the legal questions involved. We hope to make a real contribution through our knowledge of the oil industry and how various ways of apportioning, etc. may work for the oil and how much you may get out of it by taking various approaches to the Corporate Income Tax. Perhaps we can have some interchange with legal people who can answer some of the legal questions.

We have been following what is happening in Alaska and notice that the Department of Revenue has taken some steps to try to get more out of the Corporate Income Tax. They have noticed that a lot of corporations are accounting on a real line basis and showing losses on their operations in Alaska and therefore paying no Corporate Income Tax at the present time.

Formula Apportionment Basis. Really what you end up doing is that you get relatively little in the way of Corporate Income Taxes. Interstate Compact, COP ACT, Uniform Division Act, with its 3 formula thing takes

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the percentage of sales, property and payroll [illegible] of the company's operation and then apportions the income to Alaska. Looking at the whole thing, it is unfortunate, but, that method turns out to be a very inappropriate kind of device for apportioning income to Alaska especially with Alaska having oil for leasing operations. Almost every factor really doesn't work.

I do not know how you people have looked at this or what knowledge you have of it, but... Looking at it briefly.

A lot of what I am going to give you is tenative but this is very clear to us, that there are so many problems in using such a formula in this case that it is not appropriate.

PROBLEMS AND THEN AVENUES FOR GETTING AROUND THIS. We have just gotten the materials on what other states are doing and are still thinking it through and seeing what other states are doing in this area and how they have come to grips with this thing. We are really just getting started in this area.

1) Sales factor. When looking at the oil producing operations, you find out that very little crude oil production is sold in Alaska. Most of it results in intregrated operations and therefore there is no sale in Alaska. It actually goes to an affileate refinery down in California or wherever it may be. So you end up with the sales part of this being zero. There are virtually no sales. (Noticed that your own Revenue people assume in their own projections of what you are going to get out the Corporate Income Tax that you are going to get 0% on sales from Prudhoe Bay, also. No sale just a transfer.)

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Senator Huber and Mr. Killgore agreed that Alaska is unique in several ways and almost has to be looked at as a foreign country rather than just another state.

So sales is almost completely knocked out of the formula but you are still dividing by three. Utterly disasterous for Alaska. You need the sales factor.

2) Payroll factor. Almost as bad because what we are talking about is income from oil production and there are really very few people involved. Once we get through with Alyeska there ought to be none. When the real production starts it takes very few people to keep the whole production operation going. The big employment in the oil industry is in what? refinery ? Actually no, it is in marketing, home office, distribution, and this kind of thing. Employment in Alaska in all these areas as compared to elsewhere is going to be very small, meaning there will be a very very small percentage of the employment in Alaska. Yet, the profit in the future will be very big. So you have to have a formula that does not involve people or payroll or you will only get a very small portion of income allocated that way, but the income will really be generate from the oil production. The payroll factor is very very small. .

Department of Revenue says .08% on payrolls..

We have been trying to build up sort of a hypothetical oil company model that will be something on the scale of ARCO to show what they have outside Alaska and what they have inside and so forth.

Colletta would like to see this done with Sohio.

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Huber: Have you looked to see how the particular relationships between the companies and the pipeline itself enhances or further degrades us under the Interstate Compact Act?

Kilgore: No we have not because of the way they operate. They may not be direct employees but rather employees of contractors with the apparent companies. We haven't looked into it but have notes on it and it is a potential problem. They just use contractors and for the other people that are not on the payrolls that is a problem.. I still think that if you looked at all the employees that are not directly on the payrolls you would still come up with only a very small ratio so it really doesnt help very much.

3) Property factor.. Probably the best way of the three but it still is not the solution. If you look at the oil exploration producing operations what you find is a lot of losses all over the place. One drills dry holes endlessly so there are a lot of expenses that are completely unproductive and are not put into the property accounts of the oil companies; they are just written off as losses. So looking at what gets left in those successful producing adventures such as Prudhoe Bay, and even with the very high costs involved you just don't have that much money actually spent. You still get a relatively small fraction because they have tremendous amounts of money invested in mining all over the place. There is an incrediable amount of money spend in marketing. You wouldn't believe the amount of money spent on gasoline station sites alone, and so on.

What you get are three factors, none of which are really good factors for income to Alaska.

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Sales are virtually zero, payrolls you can hardly see, and property which is somewhat better but still by our own figures nowhere near the percentage of income that you would really allocate to Alaska if you did it on oil in place.

Department of Revenue. 12% on the property tax, .08% on payrolls, 0% on sales. Two of which you can not see, dividing by 3 and you end up with 4%. That is 4% of the company's total taxable income allocated to Alaska.

Preliminary numbers. Direct allocation. 1/3 of their net income being on oil production. Looking at where they may be when Prudhoe Bay production comes in, looking at their other operations and then looking at Alaska. The apportionment formula your own people would say 4% but on a generous basis it might come out to be 10%. (33% against 10%).

It is very clear that because of the nature of oil producing operations in Alaska that this formula is really inappropriate. You will end up way below what really is the profitability of oil production.

Huber: Donaldson of Sohio said that they own 52% of the North Slope Reserves and as such are a larger sharer in the pipeline that most.

B.P. remains the prim lease holder. They just sold their production. Very complicated. B.P. gets a certain percentage of production after a certain point.

Huber: In some of the definitions we put out. Any portion of the ABC plan is taxable as an interest. Just wonder if that right to purchase the gas reserves is covered.

I would be inclined to suspect that Sohio would not fit under that.

Huber: The conclusion is that Alaska needs to find a way to tax oil producers in the State of Alaska based upon the profitability of their Alaska operations the same as though they were an Alaska corporation doing the producing, selling, or whatever it is.

What is a fair share? In effect it is around 9% of what really is producing profit in Alaska.

Most obvious and what we have always thought of is, would be some sort of direct allocation scheme. It would appear, if you look at the law, (I don't have the Alaska Statutes but I have asked for it) and I am sure that you have it also - Uniform Division. This would imply that you could ask the administrator to keep reasonable various kinds of things like separate accounting, and other factors that you would need.

Must get at what the producting revenues are. Without worrying about the legalities and whether this could be done. Look at Prudhoe Bay production and what the individual company's production is and price it out that way and call it the revenue being generated from production. The pipeline should be separate accounting and you should deal with that as another tax issue.

Real question of how to handle the allocation of profit. May be a problem for the state. A lot of pretty serious questions on cost allocation.

Losses that companies have sustained in prior periods. How do you handle that? They have been making investments, drilling dry holes,

have intangeble costs on drilling development at least for Federal Income tax purposes. They have been running losses and the question is how do you handle the carriage forward of this things.

Overhead. Things done for production in Alaska are done in Huston, Texas which adds another serious problem of how do you directly allocate those things. The more we think of these things the more we see potential problems.

In other states (and a reason why we try to look at what other states are doing) there seem to be provisions where one allocates costs on bases of revenue or something of that sort. Perhaps you can get around this by some simple formulas which would be reasonably acceptable and would give you a half way decent allocation of costs associated with the Alaska operation which really take place somewhere else and are really appropriate to charge against the Alaska cost.

Huber: Are you familiar with an income type taxation by any other producting countries?

Vertually every country has an income tax but in many countries the income tax and royality tax distiction has a blur. Back in the old days where there was a 50%/50% royality and income tax they were in a position to be rather arbitray about it. They said that the revenue was the posted price. That has changed but that is not our situation as we have the Constitution, Interstate Compact, etc.

Huber: Is there a way that we can get out of the Interstate Compact?

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Yes, it is my undertand that you can get out of it. This is the kind of question that legal people in Alaska should be looking at. Dont rely on us for this kind of thing. Milton asked the Department of Revenue people when he was in Alaska and they said that yes you could get out.

Direct allocation. There are very clearly serious administrative problems. These can not be minimized, but perhaps it can still be done.

On the revenue side it would appear straight forward. One could just say that production times whatever the posted price is in Prudhoe Bay but the legal question you have to ask is, "Does that cause any future problem with any other state?" The companies are going to feel that they are being double taxed on sales. Here and in California there is a potential legal problem.

If you go "value added" and another state does apportionment based on total revenue which does not exclude the cost of coming in there is a potential problem. Maybe not.

The payroll factor would really be appropriate to the state of Texas because the oil companies have substantial payrolls is Huston and Dallas. The apportionment method would be good for them but Texas does not have a corporate income tax.

Cost allocation is not just a simple thing. Many different things have to be considered; however in concept it is the way to go.

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Huber said that he will be sure that Levy Associates gets all the material that his committee works up that would relate to what they are doing.

Colletta: Asked some questions but he was too far from the micophone to pick up the questions, but basically he was concerned that Alaska be able to run Prudhoe gas off the big pipeline that goes to the Cordova area. There will be no way that we will be able to take any of the gas unless the company wants us to. There is a direct distiction. You can enter into any kind of contact that you want to with one exception that there will be no break in the area of regulation by Federal power. Louisana had to run a small line along side the large line to get by those regulations.

Huber: New pipeline committee with W. Bowman, chairman, is to find out all that is effected by the pipeline and that gas must be available to Alaska. There was discussion on how to protect gas for Alaskans and it was decided that this area will not be over looked, by the above mentioned committee nor any other group.

Colletta: If there are too many complications we could in the lease ask them to lay a small line along side the large one (pipe at our expense)

Kilgore agreed to furnish the committee with material on CH4 and CH3OH which he has. (Methol alcohol and methol burned instead of gasoline).

We will be looking at what other countries (non-Arab) are doing along with what other states are doing.

Discussed Witherspoons study.

Direct allocation is a fair way of doing it as long as the practical and legal problems are not so overwhelming. Other alternatives would have to be taken if there are legal problems, so we should not be concentrating all of our efforts in this one area.

If Alaska's law is like these others, I don't know why the Dept of Revenue went along with Sales, payroll and property as the three factors. One or two of them could be substituted for other factors that do relate, fairly. We are trying to think of other factors to modify the plan. Maybe "crude production" should be one of the factors..

Huber: Did you receive any of the materials that Bill Macguire had gotten on the taxes in the Cook Inlet? Do write to him for them.

We are looking at other states and so far it does not look like any other state has gone this direct route but then none of them have the problem at the scale that you do.

Huber: Milton informed me that you were working on a formula to be sure that Alaska received her full share in the Corp Income Tax.

Failing all else Alaska could go the Severance Tax route, but that would only be if other formulas can not be worked out.

Huber: The income tax should be our largest source of income so we will have to find a way to change the law so that it can be beefed up.

I agree that we must find a way of using the Corp Income Tax.

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A Note on
ALASKA'S GROSS PRODUCTION TAX

1. At committee hearings during the week of April 14, 1975, we suggested that the Legislature might now appropriately review the gross production tax on oil and natural gas. Oil and gas prices have risen appreciably since tax rates were last enacted, and are pointed higher. Louisiana, for one, has increased its severance tax on oil to 12 1/2 percent of wellhead value and on gas to 11 1/2 percent or not less than 7 cents per mcf.

Natural Gas

2. SB 295 would increase Alaska's gas production tax from 4 to 10 percent or not less than 5 cents per mcf. The proposed rate would not seem to be out of line, considering that Cook Inlet gas prices are apparently now being negotiated in the range of 33 to 38 cents. Given the comparative fuel value of natural gas, the increased production tax could well be passed on and absorbed in export and Lower-48 markets.

3. It should be noted that a significant proportion of Cook Inlet gas is consumed in Kenai/Anchorage. For these consumers, any increased production tax would mean higher gas prices. The increase to consumers would be proportionately less than the increase to producers at wellhead, however, because of relatively high delivery costs already being borne by Alaskan consumers. The Legislature will have to balance the potential increase in production tax revenues (on the order of $6 million per year) against the higher cost to consumers within Alaska. (See table following for disposition of current natural gas production as between Alaskan and "export" markets.)

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ALASKAN NATURAL GAS DISPOSITION
DECEMBER 11, 1974

(Billion Cubic Feet)

Field	Reserves	Committal		Uncommitted
Kenai	2,400	440	Alaska Pipeline	
		1,038	Collier Chemical	
		400	Socal-Arco	
		228	LNG	
		2,106		294
North Cook Inlet	1,500	532	LNG	968
McArthur River	800	87	Pacific Lighting	713
Beluga River	973	373	Chugach Electric	
		600	Pacific Lighting	
		1,592		1,681
Beaver Creek	400	113	Pacific Lighting	287
Swanson River	300			300
Sterling	200			200
Miscellaneous	395			395
TOTALS	6,968	3,811 (55%)		3,157 (45%)

Source: Division of Oil and Gas, Department of Natural Resources

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ALASKAN SEVERANCE TAX COMPUTATION
MARCH, 1975

(Cents Per Barrel of Taxable Oil)

Gross Production	Cents-per-barrel Tax (Adjusted for WPI)[a]		Percent-of-value Tax ("Old" Oil Price)[b]	
	28°	34°	28°	34°
300 b/d well	27.1	30.3	21.5	23.0
1,000 b/d well	30.9	34.5	24.5	26.2
1,500 b/d well	35.1	39.2	27.8	29.8

a Assume December, 1973 Wholesale Price Index = 146.[illegible] as initial effective WPI. March, 1975 WPI = 230.2. Percentage increase of 57.5 is applied to statutory tax base.

b Statutory rates as follows:

1-300	b/d	5%
301-1,000	b/d	6%
1,001-up	b/d	8%

Crude Oil

4. The current statutory rates for oil gross production tax are set out in the table above. As shown, the cents-per-barrel tax is typically applicable since it exceeds the percent-of-value tax.

5. Revision of the oil production tax might be considered from two standpoints. First, to take account of the wellhead price increases that have occurred recently. Second, to spread further the percent-of-value tax rates that apply to the various average-daily-production brackets, so as both to reduce the tax rate on wells of low productivity and to increase the tax rate on wells of progressively higher productivity.

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6. Typical postings (e.g., 28° API at Cook Inlet Pipeline) have risen from $2.705 per barrel in 1972 to $4.305 as from December, 1973. The State has, of course, benefited from the application of extant statutory rates to higher crude prices. But the increases in crude prices, by increments that substantially exceed past experience, suggest that the gross production tax rates could well be increased. Further, "old" crude prices are likely to move still higher, either through decontrol or through administrative increases in the ceiling; the ceiling price for oil produced under enhanced recovery may be raised apart from other action on "old" oil; and the uncontrolled price for "new" crude is at least twice the current ceiling price on "old" oil.

7. This is not to say that a gross production tax should be looked at as an income tax. But to the extent that historical relationships between wellhead values and production costs have changed significantly, the rate of production taxation could well be reconsidered.

8. At the same time, the tax rates could be further spread so as to mitigate the impact on wells with relatively low average daily production. With Cook Inlet production on the decline, the State should be concerned to optimize total recovery. The Commissioner now has the authority to reduce or suspend royalty payments in hardship cases [AS 38.05.140(d)]; reduction of gross production tax for wells with low producibility would similarly tend to prevent early abandonment. (See table following for the current distribution of wells and of total production by average daily production per well.)

9. By way of illustration, the step-schedule of gross production tax rates might be amended somewhat as follows:

Barrels Daily	Percent of Value: Possible Revised Rates	Percent of Value: Present Rates
0-100	3	5
101-300	6	
301-1,000	8	6
1,001-3,000	10	8
3,000+	12	

The thought here is to reduce the tax rate for lowest productivity wells, raise it somewhat for wells in the middle range, and increase the tax rate progressively for the more productive wells.

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AVERAGE DAILY ALASKAN OIL PRODUCTION
JANUARY, 1975

Barrels Daily	Number of Wells	Total Barrels Per Day (Thousands)
0-100	17	17.8
101-200	15	16.3
201-300	13	14.9
301-500	32	25.3
501-1,000	49	41.9
1,001-2,000	34[a]	38.6
2,001-3,000	15	22.0
3,001+	13	12.9
Total	188	189.8

Note: Number of wells includes only those whose production falls within the indicated production brackets. Total barrels per day is the total output of all wells whose production falls within the indicated production brackets.

a Includes one Prudhoe Bay well.

10. A change such as this would increase gross production tax revenues now by some $1/2 million. The gain in revenue from current production would be less than the increase in percent-of-value tax rates since Cook Inlet operations now are on the cents-per-barrel basis. But under a revised percent-of-value tax rate schedule, Alaska will benefit fully from any subsequent increases in Cook Inlet "old" crude prices, whereas the cents-per-barrel tax schedule would only escalate with the proportion of old-to-new crude prices in the BLS index. The cents-per-barrel alternative could be eliminated, or it could also be revised to set a floor consistent with a revised percent-of-value tax rate schedule.

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11. The major impact of a change such as the above in Alaska's gross production tax on State revenues would come with the beginning of Prudhoe Bay production. As discussed on many previous occasions, the intention, however, ought not to be to tailor the production tax to Prudhoe, but to design the tax so as to be compatible with both current and incoming production, and with the uncertain circumstances of production from fields yet to be discovered. It is the significantly increased value of U.S. crude oil -- as already reflected in "new" crude prices and as probably pending for "old" oil as well -- that warrants reconsideration of Alaska's production tax at this time.

12. We stress that the numbers set out above are only meant to be illustrative and the basis for consideration. We would urge that any proposed change in the step-schedule of production tax rates be reviewed with the Division of Oil and Gas for their evaluation of possible effects on both abandonment in declining fields and development in new fields.

13. There are pros and cons to the question of revision of the gross production tax at this time. U.S. crude prices are very much up in the air; Administration action and/or Congressional enactment may or may not permit further price increases, and the timing of decision is itself uncertain. And as noted, Alaska's immediate revenue gains would not be that large. For these reasons, it may be advisable to defer Legislative action to the next session.

14. On the other hand, the Legislative record (through Committee Hearings) should show that the matter is under review so that bad faith cannot be charged should an ad valorem tax be enacted with carryforward credit against gross production tax and then the gross production tax be subsequently increased.

15. Further, if U.S. crude price increases are allowed and accompanied by some form of excess profits taxation that allows offset for state severance taxes, Alaska ought not to be left too long with the gross production tax question unresolved.

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16. On balance, we do not feel that immediate action is imperative, nor the cost of some delay too great. The more pivotal consideration would be to come up with as good a tax structure as possible.

17. One final observation. Average monthly well production is currently being calculated not by direct metering, but by allocation of lease production among all wells on the lease in proportion to the wells' test rates. By regulation, wells are tested at least every six months. This practice ought to be specified in the statute as an alternative to direct metering where the latter is not practicable.

W. J. Levy Consultants Corp.
May 5, 1975

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October 6, 1975

TO: Senator John Huber, Chairman
Special Committee on Taxation and Revenue

FROM: Franklin D. Fleeks
Committee Counsel

SUBJECT: Alaska Mineral Severance Tax, SB 294.

This memo is a summary of what has happened up to this date on SB 294. It is submitted for your information.

Review of the letters submitted and testimony at the hearing held on May 9, 1975, reveals that mining industry representatives, municipal utility officials, ancillary industry representatives, and interested individuals were unanimously opposed to the tax. The only testimony in favor of the tax was from the Department of Revenue.

The Department of Revenue Position

The Department of Revenue representatives stated that there is a severance tax on all of the state's renewable and non-renewable resources, oil and gas, timber, fishing, etc., except the "hard" mineral industry. The industry, at present, is taxed through a mining license tax, which is a tax on net income. From Commissioner Gallagher's testimony, the hard mineral industry grossed $62,000,000 for the 1974 fiscal year. The sources were as follows:

Sand and Gravel	$42,000,000
Coal	14,000,000
Other	6,000,000
Total	$62,000,000

From the approximately 200 licenses issued only two paid tax. One from the coal industry and one from the platinum industry. The amount collected brought the state $30,000 in revenue. The mining license tax is considered ineffective.

The present law is an additional net income tax. The Department considers it a tax on efficient procedures. Their position is that if a graduated severance tax is imposed it will fall on all producers of hard minerals in the State except those who sever less that $100,000 worth of minerals in a year. SB 294 would serve to tax a non-renewable resource,

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extract revenue from those producers who ship out-of-state or to foreign countries, provide easier administration, and would provide additional revenues from a source that other taxes may not be able to touch. Instead of $30,000 the anticipated revenue is $3,500,000.

SB 294 is considered prospective because of the low level of hard mineral activity in the State. Passage would allow the hard mineral industry to plan rationally its tax cost if further development takes place.

In answer to criticism that the bill was like the British Columbia Royalty tax, the Department of Revenue stated the following. The B.C. bill is a two step royalty linked to international price for the refined mineral and a Canadian wholesale price index. The royalty is in addition to Federal and provincial taxes and cannot be taken as a deduction in computing the taxes. The proposed mineral severance tax would be deductable on Federal and State Income Tax returns, the effect being that the tax would be paid half by the Federal and State governments and half by the taxpayer.

In talking to John Messenger, Assistant Attorney General, it was sensed that it is still the intent of the Department to go forward with the bill. Attempts will be made to make it more palatable.

Mining Industry Position

From testimony and the letters the industry's position is that passage of SB 294 will discourage current and future exploration for minerals. They consider the mineral severance tax a gross receipts tax and as such it is inherently unfair. They also stated that because the proposed tax would add another cost to the already heavy burden of exploring and developing minerals in Alaska, only those prospects having the greatest potential will be exploited. Marginal deposits would be left untouched.

Ancillary Industry Position

Testimony was given by Jim Dotson of the Alaska Air Carriers Association. He represented the view of the air taxi and air charter firms in the State. A large amount of the revenue of his members is derived from providing support to survey teams, geological teams, and others doing the summer exploration work. He had been informed that just because SB 294 had been proposed, two large summer contracts for 1975 had been cancelled. His position was that passage of SB 294 would seriously reduce the air carriers' revenue with a consequent reduction in air service in the State.

Utilities Position

Letters were received from Fairbanks Municipal Utilities System and Golden Valley Electric Corporation, since they are two of the largest consumers of coal for electric generating purposes. Their position is that the proposed tax would be passed on to them and increase their operating costs. This in turn would lead to a rate increase for their customers.

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Native Corporations Position

In our Anchorage staff meeting on September 24, 1975, Representative Anderson gave the Native Corporations' position. He stated that SB 294 would make it more difficult to go to the capital market to obtain funds for exploration and development. He also stated that the proposed bill had caused delays in current negotiations with financial institutions.

It should be noted that the Adminstration, by Governor Hammond's letter of May 8, 1975, states that further hearings would be held " . . in order to jointly develop a rational tax . . "

Listed below are the names of the companies and persons who wrote to the Committee.

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Mineral Severance Tax Project

Digest of Letters

Date	Correspondent
4/25/75	Dr. Johl Morris
4/17/75	Perry, Knox, Kaufman Inc. M.A. Kaufman
4/30/75	Cominco American J.C. MacLean
4/11/75	Rodney A. Blokestad
4/10/75	U.S. Borax J.E. Stephens
4/18/75	Heflinger Mining & Equipment Company Carl F. Heflinger
4/12/75	Eagle Creek Lodge Don Bennett
4/8/75	GVEA R.L. Hufman
4/4/75	Alaska Miners Association - Fairbanks Branch Mark Ringstad
4/11/75	MUS Robert Hanson
5/5/75	John E. Clark
5/6/75	Ketchkian Pulp Company Edward W. Borger, Sr.
5/6/75	Alaska Gold Company W.A. Glovinovich
5/19/75	C.C. Hawley & Association W.E. Shoemaker

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ALASKA
STATE LEGISLATURE

MEMORANDUM

November 3, 1975

TO: Senator John Huber, Chairman
Special Committee on Taxation and Revenue

FROM: Franklin D. Fleeks
Committee Tax Counsel

SUBJECT: Severance Taxes -- Legal Analysis

INTRODUCTION

Review of data available to the staff revealed that everyone is familiar with the concept of severance taxes. However, no one has done a legal analysis of just what severance taxes are for the use of the working legislator. It is the purpose of this memorandum to provide the members of the subcommittee with a concise legal analysis predicated on the use of the severance tax to derive substantial revenues from the state's renewable and nonrenewable resources.

There is confusion in the use of the term severance tax. It should be understood from the outset that gross production tax and severance tax are the same. These taxes come under the general heading of privilege or occupation taxes. These taxes are excise taxes: " . . . taxes imposed

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by public authority for the purpose of raising revenue on the performance of an act, the enjoyment of a privilege, or the engaging in an occupation . . ." 33 C.J.S. 110-111.

The severance tax is not a tax levied directly on persons or property and is clearly distinguishable from ad valorem property taxes and income taxes. The Supreme Court of Montana in ruling on the validity of a license tax imposed on the privilege of engaging in mining, the tax being based on production stated:

> "The state in effect says to producers: Your operations deplete the natural resources of the state, and to the extent that you remove from the earth the natural wealth which nature has provided it, and to that extent impoverish it, you are required to pay a license tax for the use and benefit of the state, for the privilege of extracting such natural wealth. The tax provided is not, therefore, on metals, minerals, or mine products, but rather upon the business of producing metals or precious stones, based on annual production." State ex rel Snidone v. State Board of Equalization, 17 P.2d 68, 72 (1932)

The United States Supreme Court in distinguishing between a property tax and an excise tax imposed upon a product of a working corporate mine stated: ". . . [It] is not a tax upon property as such because of its ownership, but a true excise levied on the results at the business of carrying on mining operations . . . " Stanton v. Baltic Mining Co., 240 U.S. 103, 114 (1916). Because of this

difference, any constitutional requirement relating to imposition of property taxes does not affect the levying of severance taxes. 103 A.L.R. 18, 20.

At present, the State of Alaska levies a gross production tax/severance tax on oil and gas under AS 43.75. The meaning of gross production tax and severance tax as used in the memorandum is as follows:

Gross Production Tax -- A severance tax levied as an occupation tax. The tax is usually imposed at a certain sum per unit of mineral removed. Williams and Meyers, Manual of Oil and Gas Terms, 208.

Severance Tax -- A tax imposed on persons engaged in severing from the soil natural resources, such as timber, oil, natural gas, ore, or the like, based on the quantity or value of the product. 32 A.L.R. 827.

LEGAL ATTACTS ON AND LEGAL DEFENSE OF SEVERANCE TAXES

There is no doubt that the state has the right to levy severance taxes. Much of the litigation is based on the premise that the severance tax is invalid because by imposing a tax on quantity or value of the product, that imposition was arbitrary discrimination which violated both the due process and equal protection clauses of the constitution.

Attempts have been made to convert the severance tax into a property or income tax, in order to bring the severance tax within those taxes constitutional provisions of equality. Also in this vein, allegations have been made that severance was an incidental step in a general manufacturing process and not subject to a privilege or occupation tax.

The courts have generally struck down the arguments advanced above. The United States Supreme Court in ruling on a Louisiana severance tax law based on the taxation of crude oil by its gravity weight laid down the general rules, which are still in effect:

> "The states have a wide discretion in the imposition of taxes. When dealing with their proper domestic concerns, and not trenching upon the perogatives of the national government or violating the guaranties of the Federal Constitution the states have the attribute of sovereign powers in devising their fiscal systems to insure revenue and foster their local interest. The states in the exercise of their taxing power, as with the exertion of other powers, are subject to the requirements of the due process and the equal protection clauses of the 14th Amendment, but that amendment imposes no iron rule of equality, prohibiting the flexibility and variety that are appropriate to schemes of taxation. The state may tax real and personal property in a different manner. It may grant exemptions. The state is not limited to ad valorem taxation. It may impose different specific taxes upon different trades and professions and may vary the rates of excise upon various products. In levying such taxes, the state is not required to resort to close distinctions or to maintain a precise, scientific uniformity with reference

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> to composition, use, or value. To hold otherwise would be to subject the essential taxing power of the state to an intolerable supervision, hostile to the basic principles of our government and wholly beyond the protection which the general clause of the 14th Amendment was intended to assure . . ." Ohio Oil Company v. Conway, 281 U.S. 146, 159, 74 L.Ed. 775, 782 (1930).

If the severance tax is alleged not to be a privilege or occupation tax, the "Tennessee Doctrine" comes into effect. That doctrine states that ". . . a privilege is whatever the legislature declares to be a privilege and taxes as such . . ." Burke v. Memphis, 94 Tenn. 692, 30 S.W. 742.

LIMITATIONS ON LEGISLATIVE POWERS

The wide discretion that the legislature has in imposing taxes are subject to limitations. While the state may classify broadly the subjects of taxation, Ohio Oil Co., supra, in doing so it must proceed on a rational basis. The general rule was stated by the United States Supreme Court in Royster Guano Co. v. Virginia, 253 U.S. 412, 415, 64 L.Ed. 989, 40 S. Ct. 560. The rule is: ". . . The state must proceed upon a rational basis and may not resort to a classification that is palpably arbitrary. The rule often has been stated to be that the classification must rest upon some ground of difference having a fair and substantial object of the legislation . . ." The general rule on

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classification has recently been upheld by the U.S. Supreme Court in a Florida case. The Florida law under attack exempted widows from property tax but not widowers. In upholding the classification Justice Douglas stated for the majority that:

> ". . . We have long held that where taxation is concerned and no specific federal right, apart from equal protection, is imperiled, the states have large leeway in making classifications and drawing lines which in their judgment produce reasonable systems of taxation." Lehnhausen v. Lake Shore Auto Parts Co., 410 U.S. 356, 35 L.Ed. 2d 351, 93 S. Ct.1001. " A state tax law is not arbitrary although it 'discriminates in favor of a certain class . . . if the discrimination is founded upon a reasonable distinction, or difference in state policy,' not in conflict with the Federal Constitution. Allied Stores v. Bowers, 358 U.S. 522, 3 L.Ed. 2d 480, 79 S. Ct. 437. This principle has weathered nearly a century of Supreme Court adjudication, and it applies here as well . . ." Kahn v. Shevin, 416 U.S. 351, 40 L.Ed. 2d 189, 94 S. Ct. 1734 (1974)

Even though classification imposes limitations on the legislature, that limitation will not invalidate a properly drawn law. The state can classify as long as classification is rational, not arbitrary, and all taxpayers occupying the same status or falling into the same class are treated alike.

LEGAL JUSTIFICATION FOR INCREASED RATE OF SEVERANCE TAX

If a high rate of severance tax is imposed by the legislature, the opponents to the levy are sure to attack it on the basis that the tax is unreasonable, arbitrary,

prohibitory and confiscatory. This line of attack on "excessive taxation" through due process has uniformly met the response: ". . . where a statute is in every other respect a valid exercise of the taxing power, the judiciary has no power to declare the statute unconstitutional, even though the tax completely destroys a legitimate and useful business . . ." Morganti, 14th Amendment, Due Process, The Taxing Power, Case Note, 52 Journal of Urban Law, 620 (1974).

The U. S. Supreme Court, beginning with McCulloch v. Maryland, 17 U.S. (4 Wheat) 316, 428 (1819) and continuing up to the present in City of Pittsburgh v. Alco Parking Corp. et al., 417 U.S. 369, 41 L.Ed. 2d 132, 94 S. Ct. 2291 (1974) have held to this view. In an 1869 case involving a federal statute increasing a tax upon circulating notes of state banks the Supreme Court said:

> ". . . The judicial cannot prescribe to the legislative departments of the government limitations upon the exercise of its acknowledged powers. The power to tax may be exercised oppressively upon persons, but the responsibility of the legislature is not to the courts, but to the people by whom its members are elected. So if a particular tax bears heavily upon a corporation, or a class of corporations, it cannot for that reason only, be pronounced contrary to the Constitution. . . "
> Veazie Bank v. Fenno, 75 U.S. (8 Wall) 533.

The Alaskan legislature imposed a license tax upon the manufacture of fish oil and fertilizer. The grounds used to

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attack the tax was that it would destroy the plaintiff's business, taking the plaintiff's property without just compensation. The U. S. Supreme Court upheld the tax:

> " . . . Even if the tax should destroy a business, it would not be made invalid or require compensation upon that ground alone. Those who enter upon a business take that risk . . . We know of no objection to exacting a discouraging rate as the alternative to giving up a business, when the legislature has the full power of taxation . . ." Alaska Fish Salting and Products Co. v. Smith, 255 U.S. 44, 65 L.Ed. 489, 41 S. Ct. 219 (1921).

The most current case dealing with this question is City of Pittsburg v. Alco Parking Corp. et al., supra. Here the city passed an ordinance placing a 20 percent gross receipts tax on private commercial operators of parking facilities. The tax was responsible for nine out of fourteen private commercial operators not being able to conduct business at a profit. In a unanimous decision validating the ordinance, the U. S. Supreme Court held:

> " . . . The claim that a particular tax is so unreasonably high and unduly burdensome as to deny due process is both familiar and recurring, but the Court has consistently refused either to undertake the task of passing on the 'reasonableness' of a tax that otherwise is within the power of Congress or of state legislative authorities, or to hold that a tax is unconstitutional because it renders a business unprofitable . . ."

Article IX, Section 1, of the Alaska Constitution, gives to the State the power of taxation. It is, without doubt, within the power of this legislature to impose a new severance tax. The rate of the severance tax, whether high or low, is within the discretion of the legislative body.

CONCLUSION

It is within the power of the legislature to levy a gross production/severance tax. The subject of the severance tax can be a broad classification. The severance tax cannot be based on an arbitrary classification and the classification must proceed on a rational basis. The courts of the several states and the U. S. Supreme Court have consistently upheld high rates of taxation even though the rate will materially affect legitimate and useful business. A carefully drawn statute with high rates will withstand legal attacks from the affected industry.

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ALASKA
STATE LEGISLATURE

MEMORANDUM

10/9/75

TO: Senator John Huber, Chairman
Committee on Taxation and Revenue

FROM: Franklin Fleeks
Tax Counsel

SUBJECT: Notes on meeting with Michael Tanzer, Economist

Persons present:
Michael Tanzer, Consultant
Hugh Malone, Chairman of House Finance Committee
Steve Cowper, Member of Committee on Taxation and Revenue
and House Finance Committee
James Rhode, House staff
Norman Baily, House staff
Franklin Fleeks, Senate staff

The purpose in attending the meeting was twofold. The first was to hear what the consultant, Michael Tanzer, had to say. The second was to exchange ideas, cement relations and to determine that the course being set by the House and Senate was parallel.

The following items were discussed at the meeting.:

Discussion with House Representatives

In prior talks with the House staff, it was found that there was not much support for the Multistate Compact. Since this staff had heard only the Administration's side, which was favorable to the Compact, the House staff was asked to state their objections. Their main objection to the Compact is that it is not a good tool to tax the oil and gas revenues coming to the State. The allocation formula is not adequate to

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return to the State its fair share of tax revenue. No objections were voiced to the Compact's validity in taxing other multistate business activity. The House staff as well as this staff believes that the Compact's procedures and enforcement can be strengthened. Both staffs have experienced difficulty in securing hard data on which to base their analysis. It was the consensus that the Agencies have the data but the data is not in an easily accessible form. It was agreed that any data received by the two staffs that might be useful to the other would be shared. This has already been implemented.

The political implications of the proposed tax was also discussed. From the House side it is believed that one large stumbling block will be the Native Regional Corporations. In order to persuade the Native Representatives to go along, it must be anticipated that some form of exemption must be written into the statute. (It must be stressed that this exemption is still very much in the discussion stage.) The type of exemption discussed can be constructed to exclude all Alaskan Corporations and include the multistate corporations.

It was the consensus of the staffs, after this discussion, that we are moving on parallel paths and there is no significant difference in our policies or aims.

Discussion with Michael Tanzer

The meeting with Tanzer was basically to orient him to the situation in Alaska, to let him see the developments himself, to see what additional

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information he would need, and to set up a timetable for completion of his work. He stated that his basic approach would be the one set out in his August memo. All assumptions will be weighted to the conservative side to forestall any oil industry argument and, if possible, the data used would come from the oil industry. He will use as his period 20 years; from which he will make three computations.

He was asked to explain his idea of an "excess profits tax". He stated that this was just a label, not a concept. Members of the staffs had constitutional problems with the idea of a state "excess profits tax".

The remaining time was spent dealing with the technical details, i.e. how many computations, what type of format, who would provide what, etc. The timetable agreed on was a final report by December 15, 1975, with an interim report submitted for comment.

Conclusions and Recommendations

Dr. Tanzer is qualified to give an analysis of the oil industry. One of the plus factors is that this analysis will be from a point of view that the legislature has not seen. Even with Tanzer's report going to the House members, I would still recommend that our staff, Ed Sterner in particular, make an in-house analysis. The in-house analysis will provide a comparison to Tanzer's analysis and any other analysis that will be submitted.

Miscellaneous

After meeting with Tanzer, I spent the remainder of the time in Fairbanks looking for data from sources known to me personally. Vic Fischer of

ISGER and his editor Ron Crowe were especially helpful, allowing me full access to their files. Other data, consisting of books, prospectus, statistics, etc. were obtained from my personal sources.

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ALASKA
STATE LEGISLATURE

MEMORANDUM

October 16, 1975

TO: Senator John Huber, Chairman
Committee on Taxation and Revenue

FROM: Franklin D. Fleeks
Committee Tax Counsel

SUBJECT: Value Added Tax

At each of the meeting held, whether formal or informal, the topic of a value-added tax has been discussed. Though all participants had heard of a value-added tax, its concept and operation was not clearly defined. The purpose of this memo is to try to bring clarity to the subject.

History

The value added tax (VAT) is an out growth of multistate turnover taxes used in Europe. The multistate turnover tax was first introduced in Germany during World War I.[1] France adopted the value added tax in 1954. With the formation of the European Common Market (EEC) and its emphasis on harmonizing the various nations taxes, the vehicle chosen was the value-added tax. At present, all of the member states of the EEC have enacted value-added taxes.[2] In the United States, only the state of Michigan had a modified VAT. The modified VAT was repealed when Michigan revamped its law in 1967.[3]

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Discussion

Just what is a value-added tax? The simple definitions is that it is a tax on 'value added' by the taxpayer. The most accurate definition found is that VAT is a net turnover tax with prior tax deduction.[4] What must be emphasized is that VAT is a sales tax collected in multistages. "...It is a method of collecting a sales tax that insures that the tax is shifted to the consumer..."[5] As another writer states "...The value-added tax is neutral as to businesses because it does not apply to businesses; rather it is a retail sales tax on the consumers of goods and services and not a tax on the producers or sellers of goods and services..."[6]

The way the tax works is as follows. A producer or seller of goods or services multiplies his total sales by the applicable rate. From this amount, by the tax credit system, the producer or seller subtracts the amount of tax he paid on his purchases and pays the net amount to the government.7

Application of the Tax to Alaska

The question to be asked is: Can a value-added tax increase significantly the revenues from multistate corporations and oil and gas?

Even though the tax has only been used in one state, Michigan, there is nothing in the Federal or State laws that would bar a VAT. Under Article IX, Section 1, of the Alaska Constitution, the State can enact a VAT law.

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An Alaskan VAT tax would have one fatal flaw if applied to raise tax revenue from the multistate corporations and oil and gas. That fatal flaw is that the VAT is a sales tax. Under current Supreme Court decisions, Alaska cannot apply a sales tax on goods produced her and sold out of the state. The United States Supreme Court has stated:

> "...The vice of the statue as applied to receipts from interstate sales is that the tax includes in its measure, without apportionment, receipts derived from activities in interstate commerce; and that the exaction is of such a character that if lawful it may in substance be laid to the fullest extent by States in which the goods are sold as well as those in which they are manufactured. Interstate commerce would thus be subjected to the risk of a double tax burden to which intrastate commerce is not exposed, and which the commerce clause forbids..."[8]

In a 1972 New Mexico case where the state levied on proceeds from contracts entered into outside the state with out of state clients, the U.S. Supreme Court in a unanimous decision stated: "...But a tax levied on the gross receipts from sales of tangiable personal property in another state is an impermissible burden on commerce..."[9]

Conclusion

The purpose for which a value-added tax would be enacted is to raise significent tax revenues from multistate corporations and oil and gas.

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Because the VAT is a sales tax and under current U.S. Supreme Court decisions the rate cannot be applied to total sales outside Alaska, the VAT would not generate significent additional tax revenues. It is my conclusion that enactment of a VAT tax would serve no useful purpose for the State of Alaska.

Sources

1. Norr and Hornhammer, The Value-Added Tax in Sweden, 70 Columbia Law Review 381 (1970)
2. Gordon T. Butler, The Value-Added Tax; A New $40 Billion Tax For the United States, 50 Texas Law Review 267 (1972)
3. Michigan Complied Laws Annotated, Chapter 206, Income Tax Act of 1967
4. Butler, supra
5. Butler, supra
6. Stanley Surrey, Value-added Tax: The Case Against, 48 Harvard Business Review 77-94, Nov.-Dec. 1970
7. Norr, supra; Butler, supra
8. J.D. Adams Mfg. Co. vs Storen, 304 US 307, 82 L.Ed 1365, 58 S.Ct 913.
9. Evco vs Franklin Jones, 459 US 91, 34 L.Ed 2d 325, 93 S.Ct 349 (1972).

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E. Sloane 10/23/75

A Brief Review of the Multistate Tax Compact

A) What The Compact Does (And Does Not Do)
B) The Economic And Financial Effects Of The Compact
C) The Allocation Formula
    1) The Property Factor
    2) The Payroll Factor
    3) The Sales Factor
    4) The Adjustment Provision
D) Preliminary Results from Compact Membership
E) Alternatives to the Compact
F) Conclusion

A) What the Compact Does

Basically, the Compact provides a means which has not been available in the past to enforce a state's corporate income tax laws. By providing for a general uniformity between the tax laws and regulations of the member states, corporations (and other multistate taxpayers) can be forced to provide the same income reports to all of the states. This makes it possible for states to pool their auditing resources and more carefully check the accuracy and consistency of multistate taxpayer reports. This basic uniformity also helps avoid disputes based on charges of double taxation, charges which could develope if every state's tax laws were significantly different. If disputes as to the proper allocation of incomes do arise, a method of arbitration is provided by the Compact. What the Compact does not do is depart any significant way from past policy in the treatment of multistate corporations. Thus the Compact is basically an agreement between states to ensure the effective and fair taxation of multistate businesses.

B) The Economic And Financial Effects Of The Compact

The Compact has two significant characteristics which a state by itself does not have. First, the enforcement capabilities of the Compact provide a tool by which states can approach a greater equity in the treatment of interstate and intrastate businesses. Without the Compact

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it is possible for some multistate corporations to shift their net incomes to non- or low-tax states, something that one-state businesses can not do. Second, the basically uniform allocation of a corporation's income between states combined with the arbitration mechanism reduces the possibility of significant double taxation to its practical minimum. This eliminates the claim that multistate taxpayers should have special (lower) tax treatment due to the double taxation possiblity, and allows the state to tax at whatever rate it deems reasonable.

C) The Allocation Formula

The advantages of enforceability and equity are bought at the price of basic uniformity in the allocation formulas and regulations of the member states. Although the details of the formula may be shaped by each state, the basic formula which all member states must use is given in Article IV, Sec. 9 of the Compact. The following is a discussion of the three factor formula of property, payroll, and sales, as it relates to Alaska.

1) The Property Factor: This factor, according to the Multistate Tax Compact, Article IV,10 includes, "... the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period." The Alaska Administrative Code, 15AAC10.120(a) states that the property factor numerator "...shall include the average value of the taxpayer's real and tangible personal property in this state during the tax period used, is available for use, or is capable of being used for the production of business income." For most businesses the above definitions are adequate, however, they do not clearly include mineral reserves in the property factor of extractive industries. Although they imply that reserves may be included, it is suggested that

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the phrasing adopted by the Multistate Tax Commission, Feb. 13, 1973, be included in the updated revenue code (to be proposed by the Dept of Revenue in the near future) as follows: "Property held as reserves or standby facilities or property held as a reserve source of material shall be included in the factor. For example, a plant temporarily idle or raw material reserves not currently being processed are includable in the factor" (Commission Reg. IV. 10.(b),).

This would remove any doubt concerning the inclusion of oil, gas, and mineral reserves in the property factor of extractive industries. With the clear inclusion of mineral reserves in the property factor of multistate taxpayers, the property factor should fairly reflect the property interests of a business in this state. (Note: The Alaska Code might also specifically state by what method mineral reserves will be valued, e.g. the same method as for ad valorem tax purposes. This might help avoid debate as to what valuation of reserves should be used.)

2) The Payroll Factor: Fortunately for Alaska, this factor is based upon the "total compensation paid" to the taxpayer's employees rather than the number of employees paid by the taxpayer. Thus, the higher salaries paid in Alaska will be reflected in a higher portion of the payroll factor being allocated to Alaska than if a simple head count were used. This is economically justified by the fact that government services are also made more expensive than in other states. No significant changes to the payroll factor appear to be needed.

3) The Sales Factor: According to the Multistate Compact, both sales which occur in the state and sales which are predominantly due to "income

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producing activity" in the state are allocated to the state (Article IV. 15 and IV.17.((a)(b).). The Administrative Code, 15AAC 10.280., defines an "income producing activity" as "the act or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit." The major exclusion from this allocation rule is "income producing activity" performed by an independent contractor. Such activity is not included in the sales factor because the contractor pays the income tax on that activity. For most business activities in the state this is a fair and reasonable method for the allocation of gross sales. The complex contractual arrangements between the several large pertroleum corporations active in the state (and their vertical integration) make the allocation of their sales and "income producing activities" more difficult to determine. It is clear that the Multistate Tax Compact is referring to just the type of activity which extractive industries are pursuing in Alaska when it refers to "income producing activities." It is suggested that the Alaska Administrative Code for Revenue contain specific reference to the extractive industries and examples of how sales from their "income producing activity" should be allocated to Alaska.

4) The Adjustment Provision. This provision allows for unique situations which may arise in relation to specific states or businesses. Article IV. 18. of the Compact states:

> If the allocation and apportionment provisions of this Article do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> (a) separate accounting;
>
> (b) the exclusion of any or more of the factors;
>
> (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

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(d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Thus, in special cases (e.g. the sales factor for a vertically integrated industry cannot be made to reflect the industry's actual activity in the state) the adjustments can be made without affecting the Compact or allocation formulas in general. Such adjustments must be made only with very good reason and with great care, because their "reasonableness" may be challenged in the courts or during arbitration. The general uniformity of the Compact, however, is not a straight jacket.

D) Preliminary Results From Compact Membership

Although the Multistate Tax Compact did not go into effect in Alaska until July 1, 1970, and the current Administrative Code relating to the Compact did not go into effect until July, 1972, some tentative obesrvations can be made. In 1970-71, the first year under the Compact, and in 1973-74, the first year in which extensive enforcement of the Compact allocation was implemented, corporate income tax revenues jumped 14.41 and 18.34 percent respectively over previous years. This compares with growth rates of 6.48 and 7.84 percent in fiscal years 1970 and 1971 respectively (Figures from "Revenue Projection Detail", 12/19/74). It is not clear just what portion of the greater increases in fiscal years 1971 and 1974 were merely due to surges in economic growth in Alaska, but it is possible that part of the extra growth in tax collections was due to the Compact and its enforcement. A more concrete example of the Compact's value is seen in the additional corporate income tax billings being sent to five or six major multistate (oil) corporations. These are based on Department of Revenue audits which the provisions of the Compact facilitate. Two of these billings are for well over one million dollars each, totalling approximately three million. The final amounts of the other billings

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have not yet been determined. Note that this compares with the $134,860 originally paid by 3 of the 10 oil producers operating in the state in fiscal year 1973 (April 17, 1975 memo by Kathy Hollier, Research Analyst, Department of Revenue). In addition to these billings, the state has already received over $150,000 and has approximately $2.5 million in pending assessments due from other multistate taxpayers' operations in Alaska. Thus, preliminary evidence indicates that the Compact is assisting the Department of Revenue in obtaining significant increases in corporation net income tax revenues. As Alaska's Administrative Code for the Compact is fine tuned to Alaska's needs, it is probable that the Compact will be even more helpful in the future.

E) Alternatives To The Compact

It is possible that the State could choose to develop its own tax allocation formulas and regulations independent from other states. The object of such an independent approach would be to allocate a greater share of multistate taxpayers' incomes to the state than is possible under the Compact. There are three major problems with this approach. First, if Alaska's corporate income tax varies in major ways from other states, Alaska would have to enforce the tax without the close assistance of other states. If past experience is any guide, the state would likely loose money rather than gain it. Second, if the formula caused the tax burden of multistate tax-payers to be significantly higher that intrastate taxpayers, the long term economic effect would be to discourage new investment in the state. Such a possibility should be considered carefully in view of the state's current employement situation. Third, and perhaps most important, all of the legal battles concerning the legal standing and equity of the new tax approach would have to be fought. These

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battles have largely been fought and won for the basic formula and approach used in the Multistate Tax Compact. Thus, for enforcement, economic equity, and legal reasons, such an independent course would be difficult to pursue.

It might be suggested that the state withdraw from the Compact but maintain the basic tax approach of the Uniform Division of Income for Tax Purposes Act (UDITPA - the basis of the Compact). This would gain the state nothing in the way of really new tax options while weakening its enforcement ties with other states. Such an approach would seem to the worst of both worlds.

Finally, the state could remain within the Multistate Tax Compact, refine the state's implementing code, and make any further adjustments needed through the Compact's adjustment provisions. In those industries, specifically extractive industries, which may impose special burdens on the state and/or on future citizens of the state, severance taxes and/or ad valorem taxes could be used to supplement revenues from the net income tax.

F) Conclusion

The Multistate Tax Compact generally appears to be well suited for the needs of Alaska. Preliminary indications are that the Compact is assisting the Department of Revenue in the enforcement of the state's corporate net income tax. The allocation formula lends itself to a basically equitable treatment of both intrastate and interstate taxpayers while allowing for special or unusual cases. If such revenues are considered too low in certain industries, additional separate taxes should be used.

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TITLE: LEGAL ANALYSIS OF THE MULTISTATE TAX COMPACT

file copy

REQUESTED BY: Senator John Huber, Chairman
Committee on Taxation and Revenue

DATE SUBMITTED: 10/16/75

STATEMENT OF FACTS

The Committee on Taxation and Revenue's staff in it initial review of corporate income taxation has put special emphasis on taxation of multistate corporations, under the present Alaska income tax statutes. Alaska is one of forty five (45) states and the District of Columbia which levies an income or franchise tax based on the net incomes of corporations and other similar organizations. Alaska's tax base is tied to the Federal income tax net income figure.

The State of Alaska is a member of the Multistate Tax Compact. The Compact was drafted in 1966 and became effective in 1967 after seven (7) states had adopted it. Alaska became a member on July 1, 1970. The purposes of the Compact are: 1) To facilitate proper determination of State and local tax liability of multistate taxpayers by equitable apportionment of tax bases and, 2) To avoid duplicative taxation.

On this, the initial review of the corporate income statutes, it has been tentatively decided that more revenue can be raised from the multistate corporations by use of the Compact. The method of accomplishing this would be through strict enforcement of the present allocation formula or through changes to the present allocation formula.

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Questions Presented

1) Is Alaska's participation in the Compact legal under the United State Constitution?

2) Will the use of an allocation formula on income derived in Interstate commerce run afoul of the Commerce Clause and Fourteenth (14th) Amendment Due Process Clause of the Constitution?

3) Can the income from a subsidiary of a multistate corporation be unitized with the parent corporation for purposes of applying the allocation formula?

Brief Answer

Legality of the Compact

Under the correct interpretation of the U.S. Supreme Court, the Compact is legal. The Compact does not increase the political power of the states.

Use of Allocation Formula

The allocation formula set out in 15 AAC 10, Multistate Tax Compact, only levies taxes on that portion of the taxpayers net income arising from its activities within Alaska. The taxes imposed by the allocation formula are not a direct burden on interstate commerce and do not conflict with the Due Process Clause.

Unitizing Income of Subsidiaries and Parent Corporations

When the operation of business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary. The income from a subsidiary of a multistate corporation can be unitized with the parent corporation.

Applicable Statutes

Article I, Section 10, Clause 3 of U.S. Constitution

No state shall, without the consent of Congress ... enter into any agreement or compact with another state ...

Article I, Section 8, Clause 3 of U.S. Constitution

The Congress shall have power . . . to regulate commerce .. among the several states . . .

Fourteenth Amendment of U.S. Constitution - Due Process Clause

No state shall make or enforce any law . . . nor shall any state deprive any person of the life, liberty, or property,, without due process of law.

AS 43.19.010. Article IV

Article too long to reproduce

15 AAC 10 Multistate Tax Compact.

Compact too long to reproduce

Discussion

Legality of the Compact

Even though the words of the Constitution seem to prohibit all compacts entered into without the consent of Congress, current judicial interpretation limits the all or nothing aspect of the Article. The United States Supreme Court in 1893 laid down the rule in Virginia v. Tennessee, 148 US 503 (1893), 37 LE 537, which states: "...Looking at the clause in which the terms "compact" or "agreement" appear, it is evident that the prohibition is directed to the formation of any combination tending to the increase of political power in the states, which may encroach upon or interfere with the just supremacy of the United States..."

The several states have entered into the Compact as a means of insuring that the states power to tax multistate corporations will not be interfered with by Congressional action. Congress has set some restrictions in Pub Law 82-272 (15 USCS 381) and has made studies. Each session has seen the matter come up, but with the exception of Pub Law 86-272 , nothing has been done.

The Compact does not increase the political power of the states. The states have the power to tax. In entering into the Compact they are facing the economic reality that much of the business in the country is carried out by multistate corporations. In order to derive a fair amount of tax from those corporations, the states have entered into the

Compact to ensure equitable apportionment among themselves and avoidance of duplicative taxation.

Consent of Congress can also be implied. Virginia v. Tennessee supra. Since the Compact's inception in 1967, there has been continuing Congressional action on the matter. That action has not resulted in any legislation approving or disproving the Compact, of which Congress is well aware. "..It seems fair to say that Congress impliedly consents to the existence of any compact of which it has knowledge and has not been negated by legislators..." The Compact meets the test of Constitutionality.

Use of Allocation Formula

The use of the allocation formula has been attacked on the following grounds by the multistate corporations: 1) It is a tax on the privilege of engaging in interstate commerce, 2) It is inherently discriminatory and 3) It results in a multiple tax burden. The first raises an issue under the Commerce Clause and the second and third raises issues under the 14th Amendment Due Process Clause of the U.S. Constitution.

Both issues have been extensively litigated and most decisions have been returned in favor of the allocation formula. A tax that is a direct burden upon the operation or act of interstate commmerce is unconstitutional. The mere act of carrying on business in interstate commmerce does not except a corporation from state taxation.

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The U.S. Supreme Court stated in the leading case of Northwest States Portland Cement Co. vs. State of Minnesota, 358 US 450, 3 Led 2d 421, 79 S.Ct. 357: "...We conclude that net income from the interstate operation of a foreign corporation may be subjected to state taxation provided the levy is not discriminatory and is properly apportioned to local activities within the taxing state forming sufficient nexus to support the same..." In the case of General Motors Corp. vs Wasnington, 377 US 436, 440-441 (1964), the U.S. Supreme Court following Northwest stated this controlling test:

> "...A careful analysis of the cases in this field teaches that the validity of the tax rests upon whether the state is exacting a constitutionally fair demand for that aspect of interstate commerce to which it bears a special relation. For our purposes the decisive issue turns on the operating incidence of the tax. In other words, the question is whether the state has executed its power in proper proportion to appellant's consequent enjoyment of the opportunities and protections which the state has afforded ... As was said in Wisconsin vs J.C.Penny, 311 US 435, 444 (1940), 'the simple but controlling question is whether the state has given anything for which it can ask return'...

The U.S. Supreme Court has sustained the above decisions in Colonial Pipeline Co. vs Treigle, -US-, 44 L Ed 2d 1, 95 S.Ct. -.

Since the taxes imposed are only levied on that portion of the taxpayers net income which arises from its activities within the taxing state, they do not conflict with the Due Process Clause. Northwest supra. The use of an allocation formula that is nondiscriminatory, properly apportioned,

and related to local state activity to tax multistate corporations will not run afoul of the Commerce and 14th Amendment Due Process Clauses of the U.S. Constitution.

Unitizing Income of Subsidiaries and Parent Corporations

One of the major problem areas in taxing multistate corporations is where the activities done in the taxing state are carried out by a subsidiary of the parent multistate corporation. This issue has been decided principally in state courts. As noted in the immediate prior discussion, the allocation formula has been upheld.

The general test was stated by the California Supreme Court in Edison California Stores vs McColyes, 30 Cal. 2d 472, 183 P2d 16 (1947). It states "...If the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary ... A more particular statement of the test is that a business is unitary if these circumstances are present: 1) Unity of ownership, 2) Unity of operations as evidenced by central purchasing, advertising, accounting and management division, and 3) Unity of use of its centralized executive force and general system of operations..."

The test was followed in Chase Brass and Copper Co. vs Franchise Tax Board, App. 86 Cal Rptr 350 (1970), dismissed 400 US 961 (1970). Chase was a wholly owned subsidiary of Kennecott Copper Corp. Kennecott did

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no business in California. Applying the above test, the California Supreme Court found the business between Kennecott and Chase Brass unitary. The same rationale was followed by the Oregon Supreme Court in Coca Cola Co. vs Dept of Revenue, 533 P2d 792 (1975).

Following the lead of the various state courts, the income from a subsidiary of a multistate corporation can be unitized with the parent corporation for purposed of applying the allocation formula. The power to impose the tax on a unitary business flows from the authorized method of determining income from the taxpayers activities within the state, and authority to pursue the method is present whenever activities are partially within and partially without state, whether or not integrel parts of the system are seperately incorporated, or the accounting system of the taxpayer does not clearly reflect the income. Edison California Stores, supra.

Conclusion

From a legal point of view the Multistate Tax Compact is valid under the United States Constitution. Use of an allocation formula that is not discriminatory will forestall any attack under the Commerce and Fourteenth Amendment Due Process Clauses. It is also possible to unitize the income from a subsidiary of the multistate corporation with the parent.

There is an area in which the Multistate Tax Compact is inadequate for the State of Alaska. That area is the taxation of oil and gas revenues.

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Only a small amount of tax revenue would be generated if the Compact were used exclusively to get to the multistate oil companies' profits. For taxation of the multistate oil companies another type of tax is needed, _ie_ severance, value added, ad valorem, in addition to the Compact.

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ALASKA
STATE LEGISLATURE

MEMORANDUM

November 4, 1975

TO: Senator John Huber, Chairman
Special Committee on Taxation and Revenue

FROM: Edwin B. Sterner
Committee Research Analyst

SUBJECT: Special Oil (and Gas) Taxation: The Economic Basis for the Taxation of Oil (and Gas) in Excess of Normal Corporation Income Tax Levels

I. Economic Rents -- both High and Low

II. The Oil Industry Rent Position

III. What is an "Extraordinary" Rent

IV. Characteristics of a Tax on "Extraordinary" Rents

V. Some Possible Tax Approaches

ECONOMIC RENTS

In its most simple form, an economic "Rent" is what a person can collect because he has something someone else wants. How much the rent will be depends on how strongly the other person wants it. That Rent could be cut if another seller offers the same thing at a lower price or offers a similar thing, a "substitute," at a lower price. The rent could increase if another buyer comes along who will pay more for the item than the first buyer. In general, three

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factors must be present to ensure high rents. First, consumers of the item insist on having a certain amount of the item; that is, demand is inelastic. Second, supply is fixed or artificially controlled. Third, the supply of substitutes at competitive prices is inadequate. A classic example is land on Manhattan Island. There are many buyers who want that location very much (even now); the supply of land is fixed -- the Island is not growing; and the supply of substitutes, at competitive prices, e.g., land on Long Island, is not so great as to reduce Manhattan rents to typical national levels. On the other hand, raw sewage does not rate a very high rent. Demand is almost nonexistent, the supply is more than adequate given current demand, and superior substitutes (if wanted are easy to come by. Current technologcial developments, however, may soon change this situation.

THE OIL INDUSTRY RENT POSITION

What must be determined is whether oil belongs with Manhattan Island or raw sewage.

It is apparent that producers of oil, OPEC members and otherwise, are now in a position to collect rents much greater than the cost of producing the oil. That fact by itself does not tell us much. What we really need to know is *why* the producers are in such a position. First, demand for energy is quite inelastic. For the economy to function

at any particular level, a certain amount of energy is basically needed (even though some corners may be cut and over the long term more efficient energy use may develop). Second, adequate substitutes for OPEC oil at competitive prices are currently not available and current demand tends to bid substitutes' prices up to levels on par with OPEC prices. Third, the supply of oil by OPEC members is artificially controlled so that changes in demand do not cause changes in price. Thus, as demand for OPEC oil falls due to development of substitutes or more efficient energy use, only the quantity of OPEC oil purchased falls, not the price. In theory, if the OPEC price controls were to be maintained perfectly, OPEC would continue to insist on its official "posted price" for oil even if so many substitutes are developed that demand for OPEC oil at the posted prices falls to zero. As long as OPEC is able to sell their oil at high prices, Alaska oil will also yield high rents. This is the case because consumers in Chicago, for instance, will be willing to bid up the price of Alaska oil until it costs the same as OPEC oil delivered to Chicago.

Oil rents are collected now because the three necessary factors are present. Demand is inelastic, there are no substitutes adequate to meet demand, and supply is limited (but in this case, artificially).

Whether all three factors will be present in the future is not so clear. The surge in OPEC oil prices has definitely touched off an unprecedented search for, and technological development of, non-OPEC sources of energy. Great Britain and much of Scandinavia will probably be more than self sufficient by 1980 or shortly thereafter. Alaska will be producing an additional 1.2 to 2 million barrels a day and the decline in production of currently developed fields in the U. S., which is already slowing, may be stopped or reversed. Uses of coal are now increasing and by the 1980's commercial coal gasification and shale oil production may be on line. In short, the supply of energy substitutes will almost certainly be growing very significanly during the next decade.

The trend for demand of oil and gas energy from OPEC sources is not so clear. Even if alternate supplies of oil should greatly increase, the ability of OPEC to collect extraordinary rents will not have been reduced if demand for oil has also grown by large amounts. If demand is stable or grows slowly, however, the increase in substitutes could place severe pressure on OPEC. The greater use of coal gasification, atomic and other alternate energy sources will likely continue to retard the growth in demand for oil as an energy source. If the demand for oil produced energy does remain steady or grows slowly, the increase in supplies of

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energy from all sources will make it possible for more and more nations or industries to turn to alternate sources when OPEC raises its prices. In short, a rise in OPEC prices will cause a greater drop in consumption of OPEC energy than in the past -- demand will be more "elastic."

Should demand become so elastic that more revenues could be gained by lowering oil prices than by raising them, some OPEC countries might find the temptation to cut prices too great to resist. The resulting decrease in OPEC oil prices would cause the value of Alaska oil to fall as well, since a consumer will not pay more for the substitute, namely Alaska oil, than he does for the original item.

As demand for OPEC, or more specifically, Arab oil falls (the demand curve "shifts") and becomes more "elastic" due to the greater availability of substitutes, pressure upon the artificially controlled supply and prices of OPEC oil will gradually increase. Just how much pressure OPEC can take is open for debate, however, some idea can be gained from the current OPEC situation. In spite of the rapid increases in the price of oil, internal development programs and greater imports have already or soon will absorb most of the "petrodollar" surpluses in all but a few countries, principally Saudi Arabia, Kuwait, Qutar and United Arab Emirates. If these countries are to continue their newly acquired "lifestyles" they cannot significantly

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cut their oil production. This means that if demand for OPEC oil falls, the four surplus countries will be pressured to bear the largest burden of production cuts. There are already indications that they are not entirely willing to shoulder this burden. Realizing that any decrease in quantities demanded at higher prices would be largely absorbed by it, Saudia Arabia refused to agree to the very large price increases proposed by Iran and others and finally settled for an official ten percent increase, which with "technical adjustments" works out to something less than that. Furthermore, Kuwait, Qutar and the UAE are all greatly expanding their production capacities.

Indonesia lost $1.5 billion in 1974 revenues due to reduced demand for its oil and plans to increase 1975 production from 1.2 billion b/d to 2 million b/d (Int'l Petroleum Ency. '75, p. 92). Libya's production has fallen from 3.3 million b/d in 1970 to 1.5 million b/d in 1974 and to less than 1.0 million b/d by the end of 1974. Just to return to 1973 levels of 2.2 million b/d, Libya must increase current production by over a million barrels per day (Int'l Petro. Ency. '75, p. 126). If these and other countries insist on expanding production in the face of only slowly growing demand, the already taxed patience of the few balance of payments surplus countries may be stretched to the breaking point. Small amounts of price cutting have already appeared in the form of adjusted gravity ratings and changes and

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through ninety day delays of payment for oil received, which amounts to a three or more percent reduction in price.

Thus, if demand for OPEC oil continues to remain fairly stable or grow only at a slow rate and increasing availability of substitues causes that demand to be more sensitive to price changes (more elastic), OPEC may find it is impossible to maintain fixed price levels in the face of growing desires by several OPEC members to produce more oil. If demand should resume its rapid growth of the past and the development of substitutes lags, OPEC might not only be able to increase production but also continue to increase prices. Although current world conditions tend to favor a downward pressure on oil prices, the situation next year or five years from now may be quite different. Thus, a tax system that yields fair returns to the state and oil producers only at a particular oil price (e.g., $10, or $12, or $7) should be avoided. As rents due to higher or lower prices expand or contract, so should the tax.

WHAT IS AN "EXTRAORDINARY" RENT

We have all heard from one source or another that oil industry profits are "too high" or that OPEC oil prices are "too high." What is meant by "too high" or "extraordinary?" In some cases high prices and/or profits are actually encouraged. Patents are designed to ensure a controlled supply of a new invention so high rents can be charged if

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demand for it is great. So one may wonder why there is concern because oil producers or companies are collecting higher rents than a few years ago. Intuitively, it appears that this concern stems from a feeling that their "high" profits are basically due to a fortunate circumstance rather than any inventive or entrepreneurial acumen or skill. This is characterized by the use of the term "windfall" profit or gain. However, if a company were only making a three percent return on investment and suddenly circumstances changed so its return tripled to nine percent, such a windfall would not be protested, while a tripling of profits from ten to thirty percent would be. So the notion of a "windfall" is coupled to a notion of what a "fair" return is. Roughly, eight to twelve percent returns after taxes are considered generally acceptable (although desired return rates are rising). The Pipeline Consent Decree of 1941 has limited pipeline income to seven percent of investment. Exxon returns on stockholder equity in 1974 and the first half of 1975 (on an annual basis) were 19.98 and 13.82 percent respectively after taxes (based on figures, pp. 55 and 59, Preliminary Prospectus, Sept. 30, 1975, Exxon Pipeline Co., Exxon Corp.).

It now appears that Britain will be allowing a return on the risky North Sea oil investment of approximately 20 percent after taxes (The Economist, March 1, 1975, p. 70). Current bond yields on AA corporate bonds (the most secure) are around nine percent (BP Pipeline issue of Feb. 1, 1975,

was at 8 5/8 percent). Thus, the riskier the investment, the higher the "fair" after tax return: bonds -- nine percent, typical corporate investment -- eight to twelve, riskier investments such as oil -- somewhat more, and the North Sea -- 20 percent. It should also be said that high profits as a result of high rents often serve a useful purpose. Since high profits could be made in the hand calculator business, large investments have been made, increasing the availability and ranges of quality while reducing the price of calculators. Currently higher profits on the production of oil and gas are now pulling capital investment into that area. Thus combining the notions of what returns are "fair," what returns are "extraordinary," and the realization that extraordinary returns do serve a purpose, a tiered system of taxation might seem appropriate.

Thus, one might levy taxes up to a given return on capital at "normal" income tax levels (e.g., Alaska's nine percent rate). Above that rate of return, a very high tax rate could be levied, while leaving enough rent to draw the extra levels of capital needed for development of the state's oil and gas resources. For example, if one assumes that a fifteen to twenty percent return after federal taxes is "fair," and that effective federal tax rates will range between 35 and 45 percent, then a before federal tax return of roughly 30 percent might be considered the point above which extraordinary rents are being obtained and extraordinarily high tax rates could be applied.

CHARACTERISTICS OF A TAX ON "EXTRAORDINARY" RENTS

Rents are based on inelastic demand, a lack of substitutes, and limited supply. Future development in demand and the availability of substitutes are basically not under OPEC's control. OPEC took advantage of a situation which may be quite different in the future (better or worse). Due to this uncertainty, the tax on oil production income must above all be flexible, and that is the underlying goal of the the following desired tax characteristics (keeping in mind that what is desirable is not always practical).

A. The tax should automatically expand and contract with the price (rent) of the oil produced.

B. Prices which yield only "normal" rates of return should be taxed at the same rate as other corporate income.

C. Taxes on rates of return above "normal" can be quite high, but should leave some of the rent to encourage further capital development.

D. "Extraordinary" tax levels should disappear if "extraordinary" rents disappear, and expand if rents expand, thus avoiding cutting into "normal" profit levels.

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SOME POSSIBLE TAX APPROACHES
COMMENTS AND EVALUATION

The following examples are for one year's production. The figures are simplified for ease of calculation. The more complicated equation and assumptions of a complete model are included at the end for those interested.

The figures in the examples are based on the following simplifying assumptions:

1. The pipeline tariff fee is $2.90/bbl and field operating costs are $0.10/bbl, a total production cost of $3.00/bbl.

2. The North Slope capital investment (does not include pipeline) is $2 billion, straight line depreciated for 20 years ($100 million per year).

3. Gross revenue equals price per bbl times quantity.

4. Quantity equals 1.2 million bbl/day times 365 equals 438 million barrels for the year.

5. Royalties equal 12.5 percent of gross revenue.

6. 100 percent equity in the field owned by corporations (eliminates interest costs but not a very realistic assumption).

7. Tax rates were chosen that would yield roughly $1 to 3 billion per year.

A. A Flat Cents (dollars) per Barrel Tax

This is the easiest form of production tax to levy and administer. It does not, however, come close to meeting the

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desirable characteristics described above. It does not react to price level changes or, as the example shows (line 9), to levels of profitability.

B. Gross Severance Tax, at a Percent of Value (e.g., 35 percent)

This is only slightly more complicated than the flat cents per barrel tax in that the Department of Revenue would be required to determine the price per barrel of Alaska oil. Frequent postings of world prices for crude oil at many ports make this a fairly easy task and is already being done for Alaska's current severance tax. The tax does react somewhat to higher and lower prices. It does not react very well to profitability, allowing profits to range quite widely depending on price and costs of production (from 0.4 percent at $6/bbl to 104 percent at $14/bbl in the example).

C. Adjusted Gross ("Net") Tax at a Percent of "Net" Revenue (e.g., 60 percent)

This tax is perhaps somewhat more difficult to administer than the current production tax. In addition to transportation costs (which are already netted out to get the "wellhead value") and royalty costs, an adjusted gross tax would also substract depreciation, interest payments, and perhaps some approximation of operating costs. "Net" is used in quotes because a true net tax would try to account for every expense involved in producing the oil and gas, a most complicated task. Capital, transportation, and royalty

costs for oil and gas production so overwhelm the current operating costs, that unless the tax is trying to squeeze the last drop of "blood from the turnip," a net tax is not necessary. (Furthermore, a true net tax would allow "indirect" costs to be charged against production of Alaska oil, and careful accounting can make such costs appear huge.) Transportation, royalty, depreciation, and interest payments are all fairly easily determined. An estimation of operating costs based on salaries subject to Alaska income taxes could also be made without much difficulty.

By using the adjusted gross revenues as the base for a tax on oil, the possibility of the tax forcing the producer into a losing position is almost eliminated. Thus a higher rate of tax can be levied to capture a greater part of the "extraordinary" rents. Unfortunately, this higher rate is applied against "normal" profit levels as well, resulting in both very low and very high profit levels. In the example, profits range from 18 percent at $6/bbl to 79 percent at $14/bbl, an improvement over the previous example (0.4-104 percent) but still a very wide range.

D. Adjusted Gross ("Net") Tax at a Percent of "Net" Revenue at Graduated Rates

This tax would be no more difficult to administer than the adjusted gross tax at a flat rate (example C), it just takes more math calculations.

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The graduated rates make it possible to tax the "extraordinary" rents at higher levels than lower rent levels. The graduated rates are also more responsive to price and cost changes, and the higher rates can be structured to fall as rents fall.

Thus, this tax complies fairly well with all the desirable criteria except one. It does not assure that normal rates of return (profits) are only taxed at normal tax levels. Using tax package "D" at the seven dollar price as an example: The tax package as presented allows an after state tax profit of 806 million dollars. Assuming a two billion dollar investment, this allowed a return (before federal taxes) of 40 percent. If the investment costs were actually 4 billion, the return would only be 20 percent, and after federal taxes only 11 to 13 percent.

This package also does not reflect the equity investment which a company has in a field or well. If the field were financed one-half through 10 percent bonds and one-half through retained earnings (stockholder equity), this package would allow a 79 percent return on investment at 7 dollars per barrel rather than the 40 percent shown in the example D (see special example 1).

E. Adjusted Gross ("Net") Tax, graduated rates, first step tied to return on investment

This tax package corrects for the short comings in graduated rate example "D." This package might be slightly

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more difficult to administer than "D" because the equity, total capital cost, and interest payment figures play a more important role in calculating the tax levy. These figures should, however, be carefully checked for any adjusted gross tax, if it is being accurately and fairly (for both the corporation and the State) administered.

In this tax, the higher rates come into effect as soon as the rate of return on a well or field passes a given level (e.g., 30 percent). This protects low profit wells or fields while continuing to tax "extraordinary" rents at high levels. It also limits the benefits of debt financing, by allowing the lower tax rates only for returns on equity (see special examples E. 1 and 2), not against a set rate of return as in D.

CONCLUSION

The high rents which are currently being obtained by oil producers are based on conditions which could change for better or worse. Due to the uncertain future of oil prices, the state should adopt a tax formula which automatically captures a large part of high rents yet reacts to falling prices and profits as well. An adjusted gross (or net) tax, based on the market price of oil, with rates tied to the return on investment, seems to fill the requirements of flexibility while retaining a fairly simple method of administration. By tying the rates to levels of capital investment and the

revenue required to obtain a fair return on that investment, the tax package recognizes the wide variation of capital costs, methods of financing, and levels of production present in the State of Alaska.

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General Taxation and Investment Return Model

Equations:

$$II = \sum_{1}^{20} \frac{II_n}{(1+r)^n} \qquad K_E = \sum_{1}^{20} \frac{k_{e_n}}{(1+r)^n}$$

$$II_n = P_n(Q_n) - (F_n + M_n Q_n) - (t_{f_n} + t_{m_n} Q_n) - D_n - R_n - T_n$$

$$Y_n = P_n(Q_n) - (F_n + M_n Q_n) - (t_{f_n} + t_{m_n} Q_n) - D_n - R_n$$

Definitions:

II = Present Discounted Value of all profits from the investment for 20 years

K_E = PDV of all capital investments for 20 years

r = discount rate

II_n = profit from the investment in year "n"

k_{e_n} = capital investment - equity - made in year "n"

P_n = price per bbl (or MCF) in year "n"

Q_n = Quantity sold in year "n"

F_n = fixed costs of operation in year "n"

M_n = marginal costs of opearation in year "n"

t_{f_n} = fixed transportation costs in year "n"

t_{m_n} = marginal transportation costs in year "n"

D_n = depreciation in year "n"

R_n = interest costs in year "n"

T_n = tax levy in year "n" - see "tax packages" below

Tax Packages:

1. Flat Rate $T_n = XQ_n$ — X = tax rate, e.g. $5/bbl
2. % of Gross Revenues (Gross Severance) $XP_nQ_n = T_n$ — X = % tax rate, e.g. 50%
3. % of Adjusted (Net) Gross $T_n = XY_n$ — X = % tax rate, e.g. 80%

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Tax Packages (cont.):

4. Variable Rate Adjusted (Net) Gross

$$T_n = Q_n X_1\left(\frac{Y_n}{Q_n}\right) + Q_n X_2\left(\frac{Y_n}{Q_n} - 1.00\right) + Q_n X_3\left(\frac{Y_n}{Q_n} - 2.00\right) + \ldots$$
$$Q_n X_m\left(\frac{Y_n}{Q_n} - (m-1)1.00\right)$$

$X_1 \ldots X_m$ = marginal tax rate on each dollar (or part of a dollar) of adj. gross, or net, income

5. Variable Rate Adjusted (net) Gross tax - with 1st rate used as a substitute for net income tax

$$T_n = Q_n X_1\left(\frac{Y_n}{Q_n}\right) + Q_n X_2\left(\frac{Y_n}{Q_n} - \frac{ZK_{e_n}}{Q_n}\right) + Q_n X_3\left(\frac{Y_n}{Q_n} - \frac{ZK_{e_n}}{Q_n} - 1.00\right)$$
$$+ \ldots Q_n X_m\left(\frac{Y_n}{Q_n} - \frac{ZK_{e_n}}{Q_n} - (m-2)1.00\right)$$

$X_1 \ldots X_m$ = marginal tax rate on each increment of adj. gross, or net, income

Z =return on capital to which only the normal income tax rate applies, e.g. 30%

K_{e_n} = total current value of equity capital in year "n"

NOTE CONSTRAINT: no factor may be less than zero

in # 4 : $Q_n X_m\left(\frac{Y_n}{Q_n} - (m-1)1.00\right)$

in # 5 : $Q_n X_m\left(\frac{Y_n}{Q_n} - \frac{ZK_{e_n}}{Q_n} - (m-2)1.00\right)$

6. Time differentials in tax

All of the above tax levies can be modified by a time factor. Examples:

1). $.20(n)T_n = T'_n$ for n=1 to 5

means that in the first year of operation, the tax is only 20% of the levy calculated, 2nd year - 40%, etc., and in the 5th year $T'_n = .20(5)T_n = T_n$.

2). $.5T_n = T'_n$ for n=1 to 5

means that in the first five years, the tax will be only one-half normal.

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Special Examples

	"D" as is	D1	Notes on D1	E as is	E1	Notes on E1	E2	Notes on E2
Price per barrel - in dollars	7	7						
1 Gross revenue for year - in millions	3066	3066		3066	3066		3066	
2 Total production cost - in millions	1314	1314		1314	1314		1314	
3a Depreciation - in millions	100	100		100	100		100	
3b Interest on debt	—	100	(1 Billion debt at 10% interest)	—	100	(1 Billion debt at 10% interest)	—	No debt
4 Royalty payments - in millions	383	383		383	383		383	
5 Total operation costs 2+3(a+b)+4 in millions	1797	1897		1797	1897		1797	
6 Net revenues for year, 1 minus 5	1269	1169		1269	1169		1269	
6a Net revenue per barrel in dollars (on 87.5% of production = 383.25 MMbbls)	3.31	3.05		3.31	3.05		3.31	
6b Net revenue needed per barrel to yield 30% return pre-tax, in dollars (Equity capital/383.25 Million bbl)	1.57	.78	(1 Billion equity capital invest.)	1.57	.78	(1 Billion equity capital invest)	3.13	(4 billion equity capital invest)
7a. Tax per barrel, (on 383.25 Million barrels)								
1) on first part [D = 1st $1 or part, 10%] [E = revenue to 30% return - 9%]	.10	.10		.14	.07	(9% x 78c)	.28	(9% x 3.13)
2) on 2nd part [D = 2nd $1 or part, 25%] [E = 1st $1 or part above 30% - 60%]	.25	.25		.60	.60	(60% x $1)	.11	(60% x $.18)
3) on 3rd part [D = 3rd $1 or part, 60%] [E = 2nd $1 or part above 30% - 85%]	.60	.60		.63	.85	(85% x $1)	—	
4) on 4th part [D = 4th $1 or part, 85%] [E = 3rd $1 or more above 30% - 95%]	.26	.04	(95% of 5¢)	—	.26	(95% x 27¢)	—	
5) on 5th part [D = 5th $1 or more, 90%] —	—	—		—	—		—	
Total tax per barrel - in dollars	1.21	.99		1.37	1.78		.39	
7 Tax levy in millions 7a Total x 383.25 Million	463	379		525	682		149	
8 After tax revenue, 6 minus 7, in millions	806	790	(Revenue reduced by only 16 million)	744	487	(Revenue reduced by 257 million)	1120	
9 Return to investment, #8/Equity capital, in percent	40	79	(1 Billion equity, 790MM profit)	37	49		29	(4 Billion equity, 1,120MM profit)
10 Return to state	846	762		908	1065		532	

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D. Adjusted Gross ("Net") Tax, - at graduated (Variable) rates

Price per barrel - in dollars	4	5	6	7	8	9	10	11	12	13	14
1. Gross revenue for year - in millions	1752	2190	2628	3066	3504	3942	4380	4818	5256	5694	6132
2. Total production cost - in millions	1314	1314	–	–	–	–	–	–	–	–	1314
3. Depreciation - in millions	100	100	–	–	–	–	–	–	–	–	100
4. Royalty payments - in millions	219	274	328	383	438	492	547	602	657	711	766
5. Total operation costs 2+3+4	1633	1688	1742	1797	1852	1906	1961	2016	2071	2125	21[illegible]
6. Net revenues for year, 1 minus 5	119	502	886	1269	1652	2036	2419	2802	3185	3569	3952
6a Net revenue per barrel in dollars (on 87.5% of prod.)	0.31	1.31	2.31	3.31	4.31	5.31	6.31	7.31	8.31	9.31	10.31
7a Tax per barrel, (on 383.25 Million barrels)											
1) on 1st $ or part, 10%	03	10	10	10	10	10	10	10	10	10	10
2) on 2nd $ or part 25% (marginal rate 15%)	–	08	25	25	25	25	25	25	25	25	25
3) on 3rd $ or part 60% (" " 35%)		–	19	60	60	60	60	60	60	60	60
4) on 4th $ or part 85% (" " 25%)			–	26	85	85	85	85	85	85	85
5) on 5th $ or part +, 90% (" " 5%)				–	28	1 18	2 08	2 98	3 88	4 78	5 68
Total tax per barrel - in dollars	03	18	54	1 21	2 08	2 98	3 88	4 78	5 68	6 58	7 48
7 Tax levy in millions 7a Total X 383.25	11.5	69	207	463	797	1142	1487	1831	2177	2522	2867
8 After tax revenue, 6 minus 7	107.5	433	679	806	855	894	932	971	1008	1047	1085
9 Returns to investment (8/2 Billion) in percent	5.4	22	34	40	43	45	47	49	50	52	54
10 Returns to state 4+7	230.5	343	535	846	1235	1634	2034	2433	2834	3233	3633

E. Adjusted Gross ("Net") Tax, graduated rates, 1st step tied to return on investment,

	4	5	6	7	8	9	10	11	12	13	14
1-5 Same as in examples A and D											
6 "Net" revenues for year (1 minus 5)	119	502	886	1269	1652	2036	2419	2802	3185	3569	3952
6a. "Net" as % of investment (6/2 Billion)	5.9	25	44	+ +							197%
6b "Net" revenue per bbl, in dollars (on 87.5% of production)	0.31	1.31	2.31	3.37	4.31	5.31	6.31	7.31	8.31	9.31	10.31
6c Net rev. per bbl needed to yield 30% return pre-tax, dollars	1.57	1.57	1.57	1.57	1.57	1.57	1.57	1.57	1.57	1.57	1.57
7a Tax per barrel (on 383.25 Million barrels)											
1) on rev. needed to yield 30% return - 9%	03	12	14	14	14	14	14	14	14	14	14
2) on 1st $ or part above 30% return - 60%	–	–	44	60	60	60	60	60	60	60	60
3) on 2nd $ or part above 30% return 85%			–	63	85	85	85	85	85	85	85
4) on 3rd $ or part +, above 30% return 95%				–	70	1 65	2 60	3 55	4 50	5 45	6 50
Total tax per barrel - in dollars	.03	.12	.58	1 37	2 29	3 24	4 19	5 14	6 09	7 04	7 99
7 Tax levy in millions 7a Total X 383.25	11.5	46	222	525	878	1247	1606	1970	2334	2698	3062
8 After tax revenue, 6 minus 7 in millions	107.5	456	664	744	774	794	813	832	851	871	890
9 Return to investment #8/2 Billion - in percent	5.4	23	33	37	39	40	41	42	43	44	44.5
10 Returns to state 4+7	230.5	320	550	908	1316	1734	2153	2572	2991	3409	3828