

SCOMM

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

HB  
322

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

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

"March 8, 1977

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

Dear Mr. Speaker:

Under the authority of art. III, sec. 18 of the Alaska Constitution, and in accordance with AS 24.50.060(b) and the Uniform Rules of the Alaska State Legislature, I am transmitting a bill establishing an oil and gas corporate franchise tax.

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

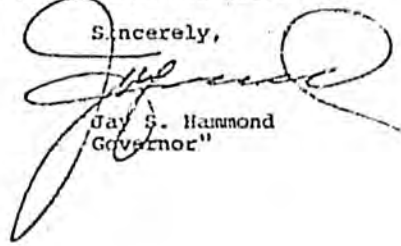
HB  
322

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

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

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

Sincerely,



Jay S. Hammond  
Governor

## STATE OF ALASKA

JAY S. HAMMOND, GOVERNOR

## DEPARTMENT OF REVENUE

OFFICE OF THE COMMISSIONER

POUCH 5 - JUNEAU 99811

April 25, 1977

The Honorable Kay Poland  
Chairman  
Senate Resources Committee  
Alaska State Legislature  
Juneau, AK 99801

*circled suggestions were  
adopted by Sen. Resources*

Dear Senator Poland:

You have asked the Department of Revenue to testify on the proposed CS for SB 105 relating to the Alaska net income tax act. Specifically you have asked the department to respond to ways in which the bill may be changed to improve the administration of the tax. Accordingly I have included the technical changes and administrative changes which we would recommend.

1. page 1, line 25  
delete the reference "AS 43.20.066" and insert the following in its place "AS 43.20.011"
2. page 2, line 2  
after the word "accordance" delete the following phrase "with section 18 of article IV of the Multi-State Compact (AS 43.19.010) and"
3. page 2, line 3  
after the word "secs." delete the phrase "12-14" and insert the following in its place "67-69"
4. page 2, line 8  
after the word "under" delete the phrase "secs. 11(e) and (f) of this chapter" and insert the following in its place "sec. 11(f) of this chapter."
5. page 2, lines 9 and 10  
after the word "chapter" delete the rest of the sentence and insert the following in its place "shall be calculated using gross income and deductions from gross income as defined in this section."
6. page 2, line 1.  
delete the word "revenue" and insert "income" in its place.
7. page 2, line 12  
delete the words "wellhead value" and insert the phrase "value of oil and gas produced" in its place.

*important  
change.* →

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8. page 2, line 15  
delete the word "revenue" and insert the word "income"  
in its place.
9. page 2, line 25  
after the word "the" insert the word "direct"  
(exclude indirect & overhead)
10. page 2, line 28  
after the word "services" insert the phrase "and not  
including indirect costs or overhead"
11. page 3, line 5  
after the word "capitalized" insert the phrase "and  
also including the amortization of"
12. page 3, line 20 *NOT ADOPTED*  
after the word "properties" insert the phrase "after a  
well has been plugged and abandoned."
13. page 3, between lines 25 and 26  
insert the following:  
(e) deductions from gross income under this section shall  
not include expenses previously deducted on a return filed  
under this chapter. (*same as used for severance*).
14. page 6, line 21  
delete the word "consolidated" and insert the word  
"combined" in its place.
15. page 6, line 21  
delete the word "allocation" and insert the word  
"apportionment" in its place.
16. page 7, line 15  
delete the reference "As 43.20.330" and insert "AS 43.20.335"  
in its place.
17. page 8, between lines 3 and 4  
insert the following:  
Sec. 43.20.075 BOOKS AND RECORDS. The department may  
provide by regulation the manner in which books and records  
must be kept and maintained for purposes of determining  
gross income and deductions from gross income under  
secs. 67-69 of this chapter.

Sincerely,

  
John R. Messenger  
Deputy Commissioner

WILLIAMS  
TESTIMONY

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

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

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

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

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

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

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

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

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

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

- that had not been explained before. thank you.

GALLAGHER  
TESTIMONY

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

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

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

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

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

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

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

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

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

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

numbers is using current dollar basis.

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

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

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

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

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

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

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

Commissioner Gallagher - You mean the reserves tax?

Senator Radar - Reserves tax yes.

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

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

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

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

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

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

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

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

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

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

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

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

above that.

Senator Radar - No.

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

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

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

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

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

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

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

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

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

Commissioner Gallagher - Yes, I do.

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

and 16% worth of return on this project.

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

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

Commissioner Gallagher - About 18% over all five bills.

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

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

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

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

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

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

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

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

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

(GAP)

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

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

Senator Colletta - Thank you Madame Chairman.

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

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

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

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

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

Commissioner Gallagher - Absolutely.

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

Commissioner Gallagher - Of course they are hired by me.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

George Silides - The North Pole an export refinery?

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

George Silides - But the SOCAL one?

Commissioner Gallagher - I know some piloteers for it.

George Silides - The SOCAL one?

Commissioner Gallagher - Yea.

George Silides - Are they export?

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

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

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

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

George Silides - I see.

Commissioner Gallagher - We already think we have it.

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

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

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

QUESTIONS AND ANSWERS  
PROFESSORS ZEIFMAN AND AINSWORTH  
March 21, 1977

SENATOR HUBER - I'd like to get into that change in apportionment formula. I believe you said substituting a production factor for sales.

PROFESSOR ZEIFMAN - We called it an extraction factor.

SENATOR HUBER - Alright an extraction factor. Was that in addition to sales or was that separate from sales?

PROFESSOR ZEIFMAN - In our proposal, we recommended the use of an extraction factor instead of the sales factor. So that there would only be property, payroll, and extraction.

SENATOR HUBER - Okay, now you can by defending yourself, why instead of an extraction factor, in answering this question, you'll get what I want, instead of an extraction factor why didn't you, so that Alaska would get the best possible deal, why didn't you put in a factor that said the average number of degree days below zero degrees celceus? Now, I'm serious about that. If you can answer why you did something like that instead of that....

PROFESSOR ZEIFMAN - If I were a resident of Alaska, I think I'd prefer rainy days in Juneau.

SENATOR HUBER - \_\_\_\_\_ but why is it we can't use something like that instead of adding an extraction factor. What stops us?

PROFESSOR ZEIFMAN - Well, I think the nature of the Supreme Court decisions in this area if you'll look at the Northwestern Portland Cement Company case, is that an apportionment factor has to or should in some ways reflect the business activities of the company in the State and be reasonably related to the economic impact that those activities have on the State. If we were using rainy days in Juneau to total rainy days, that would make no sense unless the companies themselves were producing the rain.

SENATOR HUBER - Excuse me Madam Chairman. Do we have to have the concurrence of any of the other members of the multi-state compact in order for the change in factor or can we change it unilaterally for Alaska?

PROFESSOR ZEIFMAN - I think that you can change it unilaterally for Alaska both pursuant to Section 18 of the compact, but also this is a sovereign state and you can enact this whatever laws you wish. There is no penalty provided for in the compact for states that depart in this line. I think that you can change it unilaterally.

SENATOR HUBER - If we went ahead with the extraction factor which would take care of things in oil, wouldn't we then have lost the sales factor that takes care of such things as us getting a fair return from the J. C. Penny Company, and from other outfits that sell in Alaska? In other words, you've got enough of it, I think.

PROFESSOR ZEIFMAN - Yeah. Well, I don't think in fact that that follows. I think you could continue to use the sales factor for other types of industries. As a matter of fact I would draw a distinction between the petroleum industry and other types of industry because of the fact that the petroleum industry is removing from the State a non-renewable resource, and I think that's a perfectly legitimate basis for drawing distinction between the use of an extraction factor and sales factor. I think that the sales factor is far more appropriate to a merchantile type of operation that is not engaged in production and certainly not engaged in the removal or the extraction of non-renewable resources.

SENATOR HUBER - Well, I can see Professor, and I won't pursue this much longer, Madam Chairman. I can see that our extraction factor could very well be New Jersey's sales factor, and they could for instance have an extraction factor maybe on wood products or something else. That would then become a sales

factor here. It's like a doubled ended thing, it could work from both ends.

PROFESSOR ZEIFMAN - Well, My immediate reaction is that I don't think you have to worry about that too much. West Virginia for example has a two factor formula based only on property and payroll, and Florida has a different type of a sales tax there than Alaska does. The fact that other states have departed from the Uniform Act in one form or another or had not adopted the Uniform Act, I don't think is a matter that ought to persuade you one way or another.

SENATOR HUBER - It is obvious, Madam Chairman, that some of us don't understand about the multi-state compact and how some of the factors are brought into it. They might appreciate an answer of just if you wanted to change to the two factor system or substitute extraction factors for sales on petroleum, or sales on other things, who in this State has to act in what manner. What has to be done to bring this about?

PROFESSOR ZEIFMAN - I think it simply requires an act of the State Legislature.

SENATOR HUBER - I can't find any multi-state compact act in our books now. It looks like the thing is done somewhere else, except we're members is all I know. I can't find it in the statutes.

PROFESSOR ZEIFMAN - There is a statute, I don't have the statutes in front of me, but the citation is referred to.

SENATOR HUBER - It makes us a member of the multi-state compact but it doesn't spell these out.

PROFESSOR ZEIFMAN - You have also adopted the formula and also the formula has a provision in it that the Uniform Division of Income for Tax Purposes Act has a section 18 which permits modification.

SENATOR CROFT - I had two particular sets of questions. One, in the Bill itself on the bottom of Page 3, the definition of net income, Section 41.1030 defines net income as the net income determined and certified by an independent certified public accountant for the purpose of a report to shareholders covering its earnings, and the like, and I noticed in today's Wall Street Journal on Page 6 there's a summary of a considerable amount of recent activities with regard to the drawing suspicion that independent auditor's opinions are simply unreliable. In the first place, the commission on auditor's responsibilities of the American Institute of Certified Public Accountants as long as two and one half years ago put out a report critical of auditors opinions, and now there's a Senate subcommittee headed by Lee Metcalf of Montana holding hearings on the role of auditors and financial reporting,

and this article says a highly critical report by the subcommittee staff accused auditors of being too close to their corporate clients and recommended a major expansion of the government's role in setting accounting and auditors standards, and I'm curious why with the increasing suspicions that corporate management can manipulate the auditors reports. You're suggesting that the study should base its tax on something of that nature.

PROFESSOR ZEIFMAN - Well, Senator, I think that any changes in the procedure in this area as our society becomes more and more consumer oriented, if that's the right way to describe it, any changes will reflect a tightening up of the procedures rather than a liberalization of them in terms of tax avoidance, so that the concern of Senator Metcalf, which I would agree is a legitimate one, about the use of the independent \_\_\_\_\_ I think is relevant, but I think that the significant thing is that given all of the flexibility that does exist in the law, the company has an incentive under the present system to face it fully and realistically, to put it in a colloquial way, I think our proposal catches the company between the bark and the tree, or the auditor between the bark and the tree. The accountants have an interest in maximizing earnings and profits in terms of the report to the share holders, and they have an interest in minimizing taxable income for tax accounting purposes. So we're suggesting that the State would do better by adopting a tax base which is measured by an amount where the

company itself has an incentive to maximize the amount rather than minimize it. I cannot see company accountants for purposes of reporting earnings and profits collectively, espousing as your suggesting, espousing an accounting method that's going to decrease their earnings and profits. So, to whatever extent there is flexibility, by and large, the companies own accountants will want to maximize the book income, now if we were talking about this as a 60% tax, we might have a different kind of a situation, but in view of the fact, once again, that the accountants have a desire to maximize earnings and profits, I would think that it would be a desirable thing for the state to simply say, listen what you report to your shareholders, we regard as more a reflection of your real profitability, and then as a way of protection, I don't think this is needed, but as the Administration bill does, if you simply say look, we'll take federal taxable income or book income whichever is the higher, you have plugged the loopholes if that's what you want to call them more effectively than has the federal government, and I would suggest you have plugged the loopholes more effectively than has any other state in the United States.

SENATOR CROFT - Madam Chairman, I don't care to belabor the point, I do understand what you're saying if you're basic assumption is correct that the companies for reporting purposes will maximize their income in terms of book value which may or may not be correct, then what you say may be appropriate,

but the notion that the independent auditor is not subject to manipulation by the corporation, it seems to me that all of the information the past couple years indicates they are, but if you are correct about book value, it seems to me that what you're saying is that our Department of Revenue, if you're correct with regard to your figures about oil corporations in Alaska today, our Department of Revenue has simply not been doing an adequate job of enforcing the existing law, be it you're saying that they can take book value now and have increased the income taxes to be paid to the State of Alaska because they have the authority to do that even under the multi-state compact do they not?

PROFESSOR ZEIFMAN - No. Respectfully, I think you misunderstand the law. The law talks about giving the administrator the power to modify the apportionment formula, but not the unapportioned tax base.

SENATOR CROFT - Let me ask you then, what is the interpretation of 43.19.010, Section 18, which says that the allocation and apportionment provisions of this article do not fairly represent the extent of the taxpayers business activity in this state. The taxpayer may petition for or the tax administrator may require in respect to any or all of the taxpayers business activity if reasonable A. separate accounting. And then they go ahead and list three other factors.

PROFESSOR ZEIFMAN - Senator, I believe that's not relevant to this discussion. That is the means of dividing a pie. The pie is the tax base prior to apportionment. The size of the allocation and apportionment method is a method of determining what percentage of the pie is going to be taxed by Alaska, but the subject of how large is the pie which is going to be subject to the apportionment and allocation is the subject of the undivided tax base. For defining the undivided tax base prior to apportionment, the State has adopted the federal definition of taxable income so that our findings in no way indicate any remission on the part of the Department of Revenue, though the Department of Revenue does not have the power to eliminate the deductions for intangible drilling expenses in defining the tax base, so I think that the talk about the tax base prior to apportionment is a separate subject than the subject of modifying the apportionment formula. I hope that's clear.

SENATOR CROFT - Then I'm curious why you propose, Madam Chairman, that we change the formula if the present formula adequately addresses Alaska's interests. Why is one of your major provisions a change in the formula as well as increasing the size of the pie?

PROFESSOR ZEIFMAN - Well, if I were hungry so to speak, and I was concerned about getting more to eat, I would try to

persuade my mother to both make larger pies and to give me a larger percentage.

SENATOR CROFT - And would you argue the percentage of the existing pie if you had the authority to do it?

PROFESSOR ZEIFMAN - Yes.

SENATOR CROFT - And we have that authority?

PROFESSOR ZEIFMAN - No. Only under extraordinary circumstances is the case I would argue that in terms of both the case law and the statutes that only under those circumstances in which the company is involved in something called a nonunitary type of business and that would not be relevant with respect to the vertically integrated petroleum companies.

SENATOR CROFT - I thought you had said a minute ago that the section of the statute that I read gave the State only the authority to change the allocation as it related to other states and not to increase the size of the pie itself.

PROFESSOR ZEIFMAN - Right.

SENATOR CROFT - Then my question is, how has the State attempted to increase the amount of the multi-state income that's allocated

to the State under its existing statute? You said that that was one of the two things that you would do.

PROFESSOR ZEIFMAN - Well, when you say the State do you mean the Department of Revenue or the legislature?

SENATOR CROFT - No. the Department of Revenue.

PROFESSOR ZEIFMAN - Well, the Department of Revenue, as I understand it, has been trying to administer the present formula in its present statutory form. The legislature in its wisdom has enacted a statutory method including the use of a sales factor and said, so to speak, to the Department of Revenue, this is the general method of doing it, and this is the method that you should use. In very extraordinary cases, we are giving you authority to exercise some discretion. Generally, that kind of administrative discretion that is provided for in the statute has not been construed as far as I understand it by the tax administrator of this State or by the tax administrators of other states as a kind of license to exercise an \_\_\_\_\_ discretion and say look, we don't like the size of the pie that the statutory formula gives us, so therefore I'm going to come up with my own method of doing this. I would be opposed frankly as an interested citizen if you will, to that type of approach to the whole text deals anyway with where the Administrator would take the position of "We didn't get enough money from

your company this year, therefore, we're going to change the rules some. I think that's the worst kind of tax administration.

SENATOR CROFT - One final question. Doesn't your bill allow that though? Doesn't it say that in the event the Commissioner of Revenue decides that the method of reporting that the company uses on book value isn't adequate, that the Commissioner can change the rules of the game and require a different reporting method?

PROFESSOR ZEIFMAN - Now, that's a different kind of a situation, Senator Croft, that's prescribing a normal amount of administrative discretion with respect to prescribing rules which most tax administrators have that would be consistent with the statutory scheme. I would not construe every grant of discretion to be a total departure, I think as you are suggesting, from the prescribed statutory methods.

SENATOR RADER - Is there an easier way or a more clearer way to get the tax that the State should have from the petroleum activities and what we \_\_\_\_\_ do you have any other suggestions? Are there any other avenues that would be easier or more fair?

PROFESSOR ZEIFMAN - Well, easier, yes. I think that, first of all my philosophical point of view, if you wish, the nature of a corporate income tax, a tax measured by profitability

is such that it invariably runs into the kinds of problems we're discussing, allocation and apportionment. I personally feel that the most effective and the easiest way to tax petroleum production is at the wellhead in terms of the severance tax. I think that an effective severance tax is perhaps the most, certainly the easiest if it's valued properly. I want to add, however, though there's a subject that I'm particularly interested in. The income tax does offer you the advantage perhaps, and I don't hold out any guarantee of this, but at least it gives you a crack at outer-continental shelf development through the apportionment device. Under the present law, you are just not going to get, I would say you have no chance of winning a supreme litigation, trying to impose a severance tax with respect to outer-continental shelf activity, so in that regard, that would be the exception. I think an apportioned income tax has a better chance of withstanding constitutional attack with respect to the outer-continental shelf production, but generally in the arsenal of state tax weapons, if that's an appropriate way to put it, I would regard the severance tax as the main battery, and income tax as kind of a secondary battery.

SENATOR RADER - Are there other states using the method that you are suggesting here that we adopt.

PROFESSOR ZEIFMAN - There are no other states as far as I know that have adopted the method of using book income. It's rather interesting. Some years ago, the State of Tennessee had that kind of a provision that taxable income is the income determined by a normal \_\_\_\_\_ two standard accounting procedures. When we were investigating the tax structures of all the states, I was particularly fascinated by that and talked to the tax administrator, and to my surprise, he said "oh well, we don't bother with that, we'll accept whatever income they report for federal tax purposes. That part of it is novel of our proposal in that respect. The idea of an apportionment formula based on production as one of the factors is not novel, it's used in one form or another by different types of states. A few states, I don't have our report with me, but some states have used apportionment factors, special apportionment factors based on cost of production. As I mentioned West Virginia eliminates the sales factor entirely, so that the use of a specially fashioned apportionment factor designed to reflect the peculiar economic situation of the State I think is very conventional.

PROFESSOR AINSWORTH - Senator, if I might add just a comment to Professor Zeifman here that the book value is not used as such by any state that we know of. On the other hand, a number of states do start with taxable income and then tend to restore

toward book value to some degree. I think with the Supreme Court case in mind that Professor Zeifman just mentioned in his earlier testimony and with the general desirability as many states see it of restoring taxable to a degree that this would be a forward looking step and you might find yourself cut off from the restoration thing and you would have to go all the way to its value if you wished to use it.

SENATOR RADER - Of course you have a great volume of law and experience and regulation as to what is \_\_\_\_\_ taxable income. Do we have any such law, body and experience as to what should be book value income, so that when you have this acute, I know that you mentioned that the bad apple is the bad apple, the bad apple accessor or the bad apple tax payer in this direct accounting approach left too much to discretion. Do we have a body of law that can resolve disputes? Part of our problem with our corporate citizens or other citizens is to resolve as easy as possible, put grease on those places where we have pressure and have a difference of interests so that it will work without too much scraping and burning and chewing. What kind of discription do we have of book income that when we get into a dispute with someone as to.....

PROFESSOR ZEIFMAN - Well, I think that we have the experience of the Securities Exchange Commission and the experience of

stockholders in general. I appreciate the observation, and I think Senator, that it's a very profound one. I think that the great body of law however, is a two edge sword. The great body of law has also created an army of lawyers, accountants and tax planners that have given an enormous incentive to diminish the taxable base through various types of devices. I think that the beauty of the book income proposal is that the company as I mentioned to Senator Croft, if the company wants to diminish its income for Alaska tax purposes, it's got to persuade its shareholders that it is not being operated very profitably.

SENATOR RADER - Well, let me ask you this. Let's take EXXON because they're so large and let's assume that only 5% of their operation is in this state. From their point of view to their stockholders, they're going to be interested in a consolidated sheet that shows their whole operations. Do you say it's their incentive to keep them honest and to sell their stock and to keep the FCC, and if they meet all of the FCC requirements, but still won't they have the same incentive and the same opportunity to shift the responsibility of their costs in the book method as they would have in any other method? And if we are only 5%, let the Alaska portion show as being unprofitable and pick it up someplace where they don't go on book method.

PROFESSOR ZEIFMAN - Again, Senator, I think that your observation gets right to the heart of the question, and I agree with your

observation, however, that would occur only if you have a separate accounting system. I think your question illustrates the disadvantages and the dangers of separate accounting.

SENATOR RADER - Can you create a system to do that? I mean you've only had one system and the federal government doesn't care, they're not going to care as to how we do it at least between the states, excuse me, go ahead.

PROFESSOR ZEIFMAN - You see the advantages, rather than talk about individual companies like EXXON, we have not identified the individual companies. In no case, let's assume that the book income, I think you can reasonably assume that the book income is going to be at least twice, at least double the amount of federal taxable income.

SENATOR RADER - This is as defined by them.

PROFESSOR ZEIFMAN - Yes, worldwide.

SENATOR RADER - Without any body of law to define how they define that.

PROFESSOR ZEIFMAN - Other than the regulatory procedures of the FCC.

SENATOR RADER - Which are only calculated to prevent them from overstating their \_\_\_\_\_, not understating them, I assume.

PROFESSOR ZEIFMAN - Well, it cuts both ways, and although we are talking about book income as though it were different from federal taxable income. Let me also point out this, Senator, I think this is a key feature that frankly I think that Mr. Kilgore glossed over. Many of the basic book accounting mechanisms are in fact policed by the Internal Revenue Service. For example, Mr. Kilgore mentioned inventory accounting and talked about the fluctuation of inventory. Well, the Internal Revenue code requires that the company use the same tax accounting technique in terms of evaluation of its inventory, the exact same for federal tax purposes as it does for reporting its book income, and so in a sense the advantages of book income as I see it is you have the feds. in a sense policing a big hunk of the accounting aspects of the company. The company cannot play hanky panky with its inventory accounting, with its gross receipts, with the major blocks of its item. The IRS is policing that, and the internal revenue code requires that it police that, so that in using book income, you're not departing from.....(end of tape) ..... provision that would go like this would say no depreciation deductions would be allowed in excess of the depreciation actually taken of the companies books. In that way small companies would

continue to have the advantages of accelerated depreciation here and there, but the large companies would not be able to use quick write-offs to a very large extent to substantially reduce their taxable income. So, I think that although we have been talking about the difference between book income and federal taxable income as though they were two different things, the major sediments that comprise blocks of income and expenses that comprise book income are in fact audited by the Federal government.

SENATOR RADER - Well, then you're saying we're not making a significant change. It is a significant change, but you're saying that the major portions are already audited so \_\_\_\_\_ right now.

PROFESSOR ZEIFMAN - Right.

SENATOR RADER - And so we're talking about this insignificant change which is going to be tempered by their own statement to their own stockholders in which they have a goal of maximizing profits instead of minimizing, but then I get down to this, and we don't have a body of law. That's really largely management discretion, I assume. The security exchange regulation which I don't know now, that's what I'm asking you, isn't it largely a management discretion then to, you're not breaking the federal tax laws when you report your income differently to your stockholders on different accounting

basis, and as Senator Croft observed independent auditors will I think, generally submit to management discretion if there is no breach to the law, and the most that they would do would be to footnote it with an asterik and say this is within management discretion, and can be done three different ways, This is an acceptable way. How do we eliminate without a body of knowledge and law, and with the same opportunity to shift income for book purposes between one state and another or between one opportunity and another, so long as the bottom line is the same.

PROFESSOR ZEIFMAN - Well, the last part of your sentence, Senator, is the part that I have the most trouble with, and somehow Senator Croft's question indicated for example a misunderstanding. We are combining the notion of use of book income with the idea of the combined report. We are saying to EXXON if you will, look, we don't care. If you want to play games for any purposes. If you want to keep your Alaska subsidiary at a low level of profitability for your books, you go ahead and do it. We are aware of that fact that you might want to do that. The advantages of the apportionment formula and the combination approach, and as a result the \_\_\_\_\_ disadvantages of separate accounting is we are saying look, we are going to look at the whole pie, and we want the book income of the whole pie, and so long as we're dealing with the book income of the whole pie, it makes no difference whether the company in its internal bookkeeping among its affiliates divides it up.

SENATOR RADER - I see what you're saying. I understand that, but now let me ask you one other thing. You say no other states have adopted this. Now, to be the devil's advocate, why not? Is this something of your own creation that hasn't been tried yet?

PROFESSOR ZEIFMAN - Let me make this observation of why not, and I say this I hope that based on 20 years of experience working for the United States Congress, I would say lack of political muscle, in the sense especially with respect to the petroleum industry and because of the United States Congress. The Congress does not have political muscle in part to remove the tax subsidies from the internal revenue code, on the one hand that are related to the petroleum industry. Another part of it is perhaps a question of policy. When Congress decided that it was going to, if ever there was a radical departure from the use of normal accounting procedures, it was percentage deflation. Congress decided it was going to subsidize the petroleum industry, and so it provided for a percentage depletion. In a sense, the use of book income as we conceive it, and in terms of a general policy, we are saying look what we are interested in the earnings and profits with no subsidies. If we are going to subsidize the petroleum industry, we might do it in other ways, but we're talking about a tax base that is based on purely accounting procedures, as distinct from a tax base that's eroded through policies that reflect a desire to reduce the tax.

SENATOR RADER - Let me ask you again, and I think you've answered it, and it's only my own inability to receive your intelligence as fast as you can state it. I'm unaccustomed and haven't got quite the receiver you have transmitter either, but when you get back to it, is there a body of law through the FCC or otherwise to which we could go to if we were in a dispute with any one of our corporate citizens, and say, we think that when we say book value that the questions have been answered to the extent that there's a reasonable body of law that people with the opposite interests of the taxpayer and the tax collector can look at that and their attorneys can look at that and handle that problem without rubbing each other wrong and fighting their way through courts interminably.

PROFESSOR ZEIFMAN - I think Senator, that there's probably as much of a body of law on that subject as there is..... I think it's a less complicated body of law in terms of the federal taxable income, and its lack of complexity, I think, is an advantage. As a lawyer, let me make this observation. This is an everyday kind of dispute. If I'm a minority stockholder for a closely held corporation, and we get involved in litigation as to its profitability, or if there's going to be a dispute among partners for the evaluation of the states. The extent to which the accountants have overstated or understated various items I think is a subject that the courts and most lawyers have had a great deal of experience with. I suppose I'm doing my own profession a disservice, but I'm suggesting that the use of book

income takes the body of law, the normal body of law, and applies that as distinct from the highly specialized priesthood of the internal revenue code.

SENATOR RADER - One more question, if I might. Now, Mr. Kilgore, I think, suggested this morning that he made some actual projections using this extraction factor and it did not appear to him to protect the State as well as he had thought it might. I might have misunderstood him in that, but have you done any such estimates as to how it will actually work.

PROFESSOR ZEIFMAN - Yes, we have on the basis, and I'm glad you mentioned that Senator, because I had a meeting with Mr. Kilgore and Mr. Lipton in New York, and at the outset before I agreed to accept the contract as a consultant to Alaska, I made it clear that I did not want to be a consultant or make any recommendations unless I was able to make the recommendations as I put it on the basis of actual data and not addressing myself to paper solutions to paper problems. I think that the data that Mr. Kilgore has relied on has been data which has been admittedly been fictitious, a sample that was provided to a large extent by Standard Oil of Ohio. Our predictions and our data are based on a study of the actual tax returns.

SENATOR RADER - If my previous question about is there an easier or better way, and you said well, the easiest and the simplest way is at the wellhead. Count the barrels and put a tax on it, and a gross income tax instead of a net income tax so you don't have to worry about all the rest or the other half of that problem. What is the customary way of doing that? Do I understand you to say that the main reason that you're proposing the book income tax is the ability or the possibility to capture the outer-continental shelf production which can not be done with a severance tax.

PROFESSOR ZEIFMAN - No. The use of the book income, you could adopt our proposal in part using the extraction factor and the outer-continental shelf feature without adopting the book income part. Do you follow? That's an apportionment part. The book income is the means of defining the pie.

SENATOR RADER - Now wait a minute, say that to me again, I don't understand it.

PROFESSOR ZEIFMAN - You could continue to use federal taxable income and still have a formula that has an extraction factor in it, and also include in the numerator of the extraction factor as is done in the administration's bill, the amounts related to the outer-continental shelf production. It's not the book income feature of our proposal which relates to the

outer-continental shelf, it's the extraction factor.

SENATOR RADER - I see. Thank you, Madam Chairman.

SENATOR HUBER - I wonder if I could get just a line, a short quicky on the bottom of Senator Rader's before the thought is lost? I was following along very well when you answered Senator Rader about going it alone. This is the reason for going with the compact instead of going it alone. If a corporation or any corporation taking in a profit, is doing so from a state such as Delaware or Washington, that does not have an income tax, and then they have an Alaska subsidiary here, and they don't give a darn about the Alaska subsidiary taking a blood bath every year in the annual report book because their stockholders are in the main corporation and they think the more Alaska takes a blood bath in the Alaska corporations the higher the value of the coupons that I clip. Now, aren't we still leaving that loophole? I think it's a yes or a no.

PROFESSOR ZEIFMAN - Under our proposal, No.

SENATOR HUBER - That loophole is plugged?

PROFESSOR ZEIFMAN - Yes, because of the fact that we're saying to the company, that's the advantage, and you see this is the disadvantage to separate accounting. We're saying to the

company, look, we're saying to the whole group, the whole multi-corporate enterprise. We're saying look, we want to see the whole pie, and then we will apportion a piece of the whole pie to us, and so if the company, for example, and I appreciate your question, Senator because it really illustrates what we're getting at. Suppose you had under the present system to make it simple. Lets say New Hampshire does not have a corporate income tax, and I were going to drill in Alaska, here's what I would do. I would create a New Hampshire parent. I'd get a Delaware corporation, has its principal place of business, its so called domicil with Delaware, have its office in New Hampshire, and have it own an Alaska subsidiary. I would operate the Alaska subsidiary at a low level of profitability and the New Hampshire parent at a high level of profitability. Since New Hampshire has no corporate income tax, I'd be off the hook entirely, and if Alaska insists on separate accounting, Alaska has no remedy. Under our proposal, we're saying look, we are going to take the Delaware corporation. We don't care about all these arrangements, we want to know the size of the pie, the total income, the total profitability of the whole family, then we will make an apportion to Alaska. That is the modern progressive method of corporate income taxation that has been adopted by those other states that have progressive modern forms of taxing corporate income including California, Minnesota, and many other states.

SENATOR HUBER - They can't get out of that by only operating in the states that isn't a member of the inter-state compact?

PROFESSOR ZEIFMAN - That's right. They cannot get out of it. That's the advantage of the combined report approach, and you see, this is exactly what has been going on in Alaska for years. Alaska affiliates of large petroleum companies have been reporting to Alaska that they have a low level of profitability. They have said separate accounting. The tax administrator recently, consistent with the practices of a multi-state tax compact have been saying in so many words, listen, we are not going to buy that. We want to know whether or not, we want to know about the relationship between you and the parent. In a sense this is what I'm getting at with the treaty. The treaty which Great Britian has persuaded the Treasury Department to adopt, and which the Senators from Alaska were opposed as well as I understand the Governor and the tax administrator would say to Alaska, you must only look at the Alaska subsidiary, and if the Alaska subsidiary is operated a low level of profitability, there is no way, according to this treaty, that you can look at the parent if the parent is located in Great Britain, and that's exactly the disadvantage of separate accounting. It's been \_\_\_\_\_, I suppose I'm making a speech, but it's been \_\_\_\_\_ by the proponents of separate accounting some wierd notion, they say we ought to draw a ring around Alaska as though it's kind of a bath tub, and only look at the local subsidiary. Well, I am suggesting to

you that if you really want to know about the profitability of the petroleum companies operations in Alaska, that I would urge you not to simply look at the books of Alaska's subsidiary, but to go for the whole pie.

SENATOR HUBER - Thank you Madam Chairman. It did straighten me out, but I'm going to have to do some more background yet on why, I guess that's the word. There's a piece missing there.

REPRESENTATIVE GRUENING - Professor Zeifman, you mentioned the treaty. Does that treaty in any way prevent us from getting the advantage of the franchise tax?

PROFESSOR ZEIFMAN - It sure would. Of course, the treaty has not yet been approved. Fortunately, it has to be ratified by the United States Senate, and due to the opposition of some Senators it came close to being ratified by the way. I would like to urge this body to adopt a resolution urging the President to withdraw the treaty, and the present Secretary of the Treasury to get the United States out of that treaty. But at any rate the treaty would, as I indicated, prevent you from looking at the whole pie. It also would prevent you from. I'm sorry, the treaty would. The separate accounting proposal would accomplish the same thing as the treaty, and that's what I find is rather extraordinary, the proposal that Alaska would inflict upon itself. The same limitations on its

own taxing power by compelling its own tax administrator to look only at the Alaska subsidiary in its books, destroy the most powerful weapon that it's had, when the petroleum industry is urging especially those parts of it that are related to the United Kingdom is urging the Congress to impress this limitation on Alaska as well.

REPRESENTATIVE GRUENING - Aren't we doing about the same thing though on the franchise tax in terms of apportionment in theory as done under the multi-state compact by saying, okay, we're going to take a different look at what the basis is, but we're still going to use an apportionment theory to attribute the sum of that income back to Alaska.

PROFESSOR ZEIFMAN - Right, exactly.

REPRESENTATIVE GRUENING - But is there a constitutional problem then with through treaty with the federal government telling us that we can't use this as a describing basis. I mean isn't this an interference under the constitution with State rights?

PROFESSOR ZEIFMAN - One of the unfortunate conditions under which you labor is the supremacy clause of the constitution which makes the federal statutes and treaties and treaties are given equal status under the supreme law of the land, so that if for example the United States were to enter into a treaty with France protecting french citizens against

inheritance taxes in Alaska, I think you would be stuck.

REPRESENTATIVE GRUENING - I have one other question. Mr. Kilgore, this morning outlined some disadvantages of the franchise tax, and I think maybe Senator Rader's questions about the body of law might have answered them, but as I recall, you were here this morning listening to his presentation. Three things allows a different treatment on accounting methods, greater write-off flexibility and companies can revise their accounting procedures. Now, maybe Mr. Kilgore ought to elaborate on that, but as I understand the criticism there, it's not so definite, you're relying on the incentive factor to keep them from changing, as I understand his criticism, I may be unfairly stating it.

PROFESSOR ZEIFMAN - I very much appreciate the fact that Senator Rader brought this up in questioning because it frankly compelled me to address myself to it. That is, you know, I want to make it clear that the use of book income is not an either, or, we're not saying we're not going to use the federal tax system because anyone who has filed a corporate income tax report can tell you. You just don't go changing your inventory method in terms of the book income and your accounting method for the purposes of the companies books without the IRS policing them, and so any system, for example, and I was rather amazed by Mr. Kilgore's observation about inventory. There is a very strict requirement, and as a matter

of fact there is probably no subject which is more carefully audited by the Internal Revenue Service. You just can't go playing around for federal tax purposes by using a different inventory method of accounting on your books that you are using for federal tax purposes. The inventory accounting that you use for federal tax purposes is required by law to be the same as you are using for your book income. So that fluctuation, I think, is very unrealistic.

REPRESENTATIVE GRUENING - What is meant by greater write-off flexibility under the franchise. Maybe I should ask \_\_\_\_\_  
I mean that was listed as a disadvantage, greater write-off flexibility.

PROFESSOR ZEIFMAN - I would agree that there would be greater write-off flexibility with the use of book income, and some write-offs would be permissible.

REPRESENTATIVE GRUENING - That are not permissible under .....

PROFESSOR ZEIFMAN - Yes, but again the observation is the company, if it does that, it's going to diminish its earnings and profits for shareowners. I'll give you the example, I think, the most dramatic example of that. The petroleum industry as you know, is able right now to expense intangible drilling costs. Take a current deduction, and use intangible drilling costs to minimize their federal taxable income as a result. Well, many

of the large petroleum companies do not expense their intangible drilling costs because if they did they would diminish their earnings and profits for purpose of distribution to the shareholders, so they capitalize their earnings and profits, in a sense it is true, I would agree with Mr. Kilgore's observation that there may be some ways in which the companies could have a lower book income this year, that they would have some flexibility, but at the same time that flexibility as I put it sort of gets them between the bark and the tree because in order to reduce the Alaska tax base, they would have to tell their stockholders they were earning less money, and that's a different kind of position than they are now in.

REPRESENTATIVE MEEKINS - Is there a provision in the bill that, I think I heard you say, that you take the federal taxable income or the book value, whichever is greater, so in relation to what Senator Rader was asking, you're saying that there's a motivation that's strong enough to keep them from playing around with these possibilities, flexibilities they have, with the motivation being that they have to report to their stockholders the profitabilities because that's what we're looking at. They can't erode our Alaska tax base without going against that other need that they have.

PROFESSOR ZEIFMAN - Yes, they could not go below which is the advantage of the alternative base here. No matter how much flexibility there is.....

REPRESENTATIVE MEEKINS - They'll never go below the taxes, so in that respect we're not any worse off even if they did.

PROFESSOR ZEIFMAN - It is inconceivable to me that the use of book income will cause, the way it's written in this bill, it's inconceivable to me that the use of book income would result in a lower tax base for Alaska with the alternative written into it.

REPRESENTATIVE MEEKINS - You see, that brings up the question, I mean the point of going to book income is that there's not really that much faith in the federal taxable income because of the subsidy as you call it written into it. So I'm wondering wouldn't it also make sense to, couldn't we have the alternative be federal taxable income plus putting back into that some of these allowances that are taken out? Couldn't we do that also and then.....

PROFESSOR ZEIFMAN - Yes, we mentioned that in our report as an alternative. You could take federal taxable income \_\_\_\_\_ add back all capital losses. California has done that. Federal taxable income plus, we will prohibit carryovers. Federal taxable except that intangible drilling expenses are to be deducted.

REPRESENTATIVE MEEKINS - Well the, what I'm getting at is then you would really have them because you could also then say that either, or whichever is higher, book value or that value, but that valu

is even higher, so the difference, if there was any possibility of arranging that as some people are fearing, you'd have even still a higher base for the federal taxable income in which to make or take your percentage.

PROFESSOR ZEIFMAN - I agree that that's an alternative. The advantage of book income is that you're doing it all in one fell swoop and the easiest way that we know how. The item by item thing, frankly again if I can be political, would compel you to have to fight it out on each front. You're going to add back, you're going to have a vote and add back, disallow the carryover, the capital gains item by item. The book income does have the advantage of simplicity, I think.

REPRESENTATIVE MEEKINS - I have one more question on separate accounting. I'm not quite sure. When you do separate accounting, does that mean you just look at the Alaska subsidiaries, the numbers that they have on their books, but you don't consider anything else at all. There's no apportionment whatsoever, there's just totally separate accounting?

PROFESSOR ZEIFMAN - Essentially, yes.

REPRESENTATIVE MEEKINS - Essentially you are using the numbers that the companies give you, in that case, wouldn't that be correct?

PROFESSOR ZEIFMAN - Essentially, yes.

REPRESENTATIVE MEEKINS - Can you put back into that your own extraction factors and things like that?

PROFESSOR ZEIFMAN - No, the extraction only works when you are talking about a pie to a portion.

REPRESENTATIVE MEEKINS - Yes, so if you put in an extraction factor, you're not.....

PROFESSOR ZEIFMAN - Let me give you a simple example of separate accounting that the Supreme Court reputiated. There is a case, Wallgreen Drugs. Now you know everybody's got a drug store, that ought to be simple, it's just like a candy store. Wallgreen Drugs tried to argue that it ought to be able to use separate accounting because it could show through separate accounting that its Minnesota drug stores were being operated at a lower level of profitability than its non-Minnesota drug stores. The Minnesota tax administrator said, "hey listen, we can't unscramble that egg. All we know is that Wallgreen is in the drug retailing business. In effect it's a kind of a view that goes like this, it doesn't have any geographic source. It has an economic source. They said in effect, "look the ice cream manufacturing plant that you've got outside of Minnesota, that contributes to the profitability of the Minnesota store, so we're going to require you now to make an apportionment, add the

whole thing together. How much income did all of your drug stores earn all over the United States, and then we will make an apportionment based on the ratio of Minnesota to total property payroll and sales. The taxpayer argued separate accounting. We ought to be able to use separate accounting, I can keep my own books, I can show you the Minnesota sales of the Minnesota drug store", but the court repudiated that, so on its surface separate accounting is deceptively simple, but with any degree of sophistication at all, especially when you're dealing with multi-national companies, it is no difficult problem at all for a non-United States company for example, or a New York based company to operate its Alaska subsidiary at a low level of profitability, and especially in getting it back, Senator, to your observations about the federal government, here's the rock now. The federal government doesn't care. In other words if you have a New Hampshire company operating at a high level of profitability, and the Alaska subsidiary at a loss, the federal government doesn't care because it's getting the tax from the New Hampshire company, and it's not concerned about the policing of it. The federal audit in the apportionment area is not really going to be helpful. So, I hope that my observations are, I hope that I have been helpful to you, and again, I want to reiterate that no state of the United States, currently and as far as I know in the last 30 or 40 years has adopted separate accounting method of taxation under these

kinds of circumstances as a general method of imposing a tax. The controversy has always been as to whether or not any form of separate accounting was going to be permitted, even in extraordinary circumstances, and generally the court has been said to look with disfavor on the separate accounting notion. I might add, for example, in California, you don't have much Alaska case law. I mean, you have no Alaska case law on this subject, but in California, let me give you an example. This perhaps will confuse you because it goes the other way. The Wildcat Oil Company, drilling a dry hole in one state and operating, if you want, not striking oil. It then goes to drill another hole in another state and still doesn't strike oil, and it goes on through six or seven states that way, and still doesn't strike oil, but most of California, and in California it strikes oil, and all of the oil is sold at the wellhead, right then and there. This is an unusual type of operation. The California tax administrator said in so many words, "this is one of those extraordinary cases in which we might try separate accounting, because after all if we only talk about the California operation, it's a desirable state of affairs. The taxpayers said, "listen I'm a unitary business, I've been operating all around, you've got to treat me as a single entity. The California courts invalidated the use of separate accounting under those circumstances. So, again, I would urge you to examine the notion of separate accounting very carefully because, not because of the disadvantages that Mr. Kilgore points out, about the hypothetical pricing and

the administrative overhead. That's not the disadvantage of separate accounting, the disadvantage of separate accounting is that you don't get to look at the whole pie, and he didn't mention that.

SENATOR RADER - Then, it's like you say, if the piece of the pie was very profitable and the rest of their operation non-profitable, we might want to separate out and have accounting only as California attempted to do. You're saying that our court, if they followed the California court would not permit separate accounting if the Alaska operation was a bonanza and the Texas operation was no longer profitable.

PROFESSOR ZEIFMAN - That's right if they followed the California Supreme Court. And perhaps Professor Ainsworth ought to address himself to this because in the longrun the advantages of the combination approach, as I see it, is in the longrun you're dependent upon the fact that on the overall profitability of the whole multi-corporate family, and I would argue that that provides you with a much more stable type of a tax base. It's almost like a diversified investment. We could, for example, in the Wallgreen Drug case, you could have this kind of a situation which would make good business sense. Wallgreen goes into Minnesota, intentionally operates its drug stores at a low level of profitability, sells its products low and at a cheap price in order to compete in the local market, but it really is as a result the profitability of the whole. The whole company is

enhanced because of the additional sales and the large quantity, so for the State to deny itself, and to take away from the tax administrator, if I could leave you with this thought, whether you buy that proposal or adopt a proposal of that book income, or the extraction factor, perhaps there's a separate question, and maybe these are not alternatives. Whether you adopt the proposal of book income or the extraction factor is perhaps a separate question, but I would urge you to not voluntarily, by your own act, deprive your Department of Revenue and your State of the most effective tax weapon that you have in the corporate income tax area, and that's the ability to look at the whole picture and the whole pie.

SENATOR RADER - Well, I have a little different line of inquiry, if I could? We're in Juneau with the Prudhoe Bay situation where we're in pricing hearings right now, or we start Wednesday. Are you at all familiar with what our problem is there? They have not set a price for Prudhoe Bay as one tier or another tier, new oil or old oil. They haven't said, they might leave it uncontrolled like they suggested for Pet 4, which is not producing doesn't make any difference then. There's some suggestion that's come to our attention that the Federal government in their Prudhoe Bay pricing will take into consideration the tax structure that the corporations operating there and elsewhere in Alaska are facing in so far as it affects their incentive to explore and develop further. It seems to me

like sort of a delima problem. If we were going to increase the tax burden on a petroleum industry, our state administration is going in and asking for the highest possible price, I believe that's there position, the highest possible allowable federal price, it would be new oil or uncontrolled oil, and so it would be with the foreign oil, and their argument is that we need this as an incentive because of the extraordinary cost in Alaska. True we've had a bonanza in Prudhoe Bay, but then that's statistically and otherwise not expected to be counted upon and that we really need a very, very high price here to insure that lesser sands, sands that we know to be less profitable in existance, that you will preclude us from pumping or developing those, or even exploring further unless you give us a high price, and the State if urging the same thing because we are a royalty owner on one side. We've got one hat as an \_\_\_\_\_ and on the other side, we have the hat of the tax collector, and on the side of the \_\_\_\_\_, we want the highest price we can get, and we also want it for our oil company citizens. We're all citizens and we are all \_\_\_\_\_ 7/8 and 1/8 all have the same interests, but when you get to the point of doing the taxes, should the State if we're going to pull taxes, impose it now before they set a price on that oil, or should we wait until after they set a price on that oil. The argument being that if we try to set it before we set a price on the oil, that it destroys our credibility that we need a high price for purposes of encouraging development, and the other argument being that if

we don't assess it now, that it will not be taken in as a cost, and therefore that if we try to assess it later on, we would genuinely create a disincentive that would be so severe to the companies that they couldn't produce under the pricing, and I'm not sure I understand the problem, so I'm certainly sure I can't explain it. Does any of this ring a bell to you?

PROFESSOR AINSWORTH - I think that in a situation like that, I don't know how the State tax or the enactment of a state tax right now would effect the price that the federal authorities might permit you or might not permit you. I would suggest, of course, that any business entity including oil companies would welcome a higher price, and part of the justification in that in the case of oil is always the exploration and coming up with new and better resources, and I think so far as the oil supply situation in general was concerned, that I would leave that pretty much to national policy. Now, as to your own tax, I would say yes, a state tax will indeed reduce in some measure, if you look narrowly at it, the profitability of the oil company. I don't think there's any question about that. On the other hand, what I think taxpayers as well as tax collectors and the State generally would also see is that this tax comes at a time and in a situation where you have no history of taxing oil companies really. I think that this is a whole new thing as far as the State of Alaska goes with substantial oil being produced and generating income and therefore being subject to tax. So that you're coming in more or less at ground zero

as far as major production is concerned and what you ought to be concerned about is not whether you go from say the experiences of '73, '74 where so many separately accounted zero income to your state and so on and so forth, but you ought to look at that and say well now, how will our tax compare with other taxes around about in other states because ultimately it's the differential between your state's tax and other oil producing states tax. If that differential is not substantial after you take account of the very high quality deposit you have here, why then I'd see no great disadvantage to the State going with a 9.4% tax that was effectively applied to oil profit. Every State taxes it in some measure.

SENATOR RADER - Now let's follow that up a little bit. I saw an analysis put together by one of our operators here which had indicated that our total combined tax load if you consider our Ad Valorum taxes, the taxes on the pipeline, the taxes on the whole works, of their properties and their operation that we were 114% above California, or Texas, or something like that. We were 99% of Louisiana. In other words there might be one state in the Union that has imposed a heavier tax load on its petroleum extraction industry than Alaska. Is that, how do you respond to that kind of a statement? And if that is the case should we be talking about imposing any more tax?

PROFESSOR AINSWORTH - Well, I'm not familiar with that particular oil company's own report on its tax problems, but I would suggest

that this is one company, and it apparently comes up after it analyzes its own tax situation for its own information presumably. With this finding, that difference might possibly apply to one company, but not apply to all companies. Certainly a differential of tax as between and among states would however, have to look at what I understand to be the relatively good deposit that you have here, differentially good deposits relative to some other area, and if I were looking at this, I think, strictly from a state point of view, I would certainly take account of that quality differential before I assessed any ninety nine hundred and fourteen study that a particular oil company made.

SENATOR RADER - Let's assume that we determined that our present tax level was all taxes combined, was at the very top, very close to the top in the nation. Do you think as a policy matter, can we go much beyond that or not? What kind of constraints do we have there?

PROFESSOR AINSWORTH - All taxes combined, I think I've seen some of these general statements also, and yet I don't have a detailed picture of them before me, but frequently the general statements I've seen, when they say all taxes combined, the oil companies had sometimes included what they paid the farmer for the oil in North Dakota as a part of the payment to the State.

SENATOR RADER - They broke out the royalty payments as being different than the tax payments.

PROFESSOR AINSWORTH - So you certainly ought to wipe that out first.

SENATOR RADER - I think that's broken out clearly. What they did was they took the operation, they took the wells in operation, and they took the pipeline, the gathering lines of the rest of it and they applied it, and said you can pick this whole thing up and move it to Louisiana and use Louisiana's rates, in some places they're higher than ours, in some places they're lower than ours, and in some places there's no Ad Valorem taxes, \_\_\_\_\_ that we were at 99% Louisiana, and Louisiana was the highest in the nation, and we were 114 - 125% of other states to which they made the comparison. Now let's assume, I don't know if it's right or not either, but let's assume for purposes of discussion that that presentation was fairly made.

PROFESSOR AINSWORTH - If that were fairly made, then I would only caution that the only thing that they can't pick up from the State of Alaska and put it in Louisiana, even hypothetically, is the oil itself in the ground, and that's differentially good in Alaska, so you may have a margin there to work on.

SENATOR RADER - And how would you determine that the historical experience of the petroleum industry in all fields of Alaska as compared with historical experience of the industry in all fields in Texas, or something? How would you determine that?

PROFESSOR AINSWORTH - Well, I think I would make a current comparison of productivity, potential productivities as we look from here ahead.

SENATOR RADER - Well, if you do that, because of our extraordinary Prudhoe Bay situation, then I would assume that you might say we could afford a tax at a much higher rate than 125% of the next highest state in the nation, and still not provide disincentive to the petroleum industry. If you look at only where we are so far rather than statistically trying to estimate the likelihood of a repeat. I don't know how to judge it, I'm completely at sea on it myself, so I'm not asking you a question on which I have any opinion. I just know that the oil companies make the argument that I'm making to you, and that is "look, we're at the very highest right now, we admit that Prudhoe Bay is a heck of a find, but can we afford to continue hoping to hit that one long shot if your taxes are out of line with what is customary in other producing states". How do we analyze that?

PROFESSOR AINSWORTH - I would say the first thing to analyze would be to do your own study of differential taxation. Included in that study, I would certainly look at all of the work that

the companies have done and take full account of what they've done, say for their Texas, their Louisiana, whatever other place, how they came out of it there as getting all the information you can about statements regards taxability, levels of taxation in various states, and come to your own conclusions, then as to how far you could go on a differentially high side would depend largely, I think, on the relative of quality which is perhaps not quite the right word here of your own deposits visa vis others, actual and potential, and I would be concerned that the State of Alaska should, especially with this a non-renewable type resource, take its own long distance welfare into account in deciding whether or not the tax differentially high, and how far you might reasonably go in that direction.

SENATOR RADER - Well, I think in taking a look at our own welfare, we'd like to say that, we certainly would not want this to be the last exploration done by the petroleum industry in this state because of the fact that we have established an unreasonable taxing method based upon a bonanza, instead of based upon what could be expected to be an average productivity profitability for an industry, and I have no idea how to judge that, nor do I think again, I think you're right, you have to look at and compare our own state with other states, and I don't say you rely on any one else's analysis for that, but I'm just saying let's assume that we've made that analysis, and we've found that our taxes were among the highest and we have transportation

costs. If you did get too high, how would you know it?

PROFESSOR AINSWORTH - You would know it by whether or not the companies continued to operate at profitable levels and whether they continue to explore, how far they went. I would think you could consider that as kind of a current evaluation of what they do in the circumstances that they present.

SENATOR RADER - If we were to take something that's current here on how to explore, what would we have to do, ask them ask EXXON, I keep picking on EXXON just because we started in. It's nothing personal or impersonal about it, but they are a corporate citizen. Would we ask them how much of their exploration budget is coming to us as against other states and other areas of the United States to determine whether or not we think that we have already based a tax level which has created disincentive considering the costs of production and the transportation problems when we get through with the rest of it. How would we go about putting our finger on what is a reasonable level? Everybody talks about fair share. You want to tax your fair share? Sure. I want to pay my fair share. Sure. They're miles apart. Nobody knows what that is.

PROFESSOR AINSWORTH - I think you have very little problem there because as is so vividly reported at the federal level and regards the shortages of fuel just this past winter.

Nobody seems to have data that they agree about regards reserves and what was and what wasn't done with that. We seem to get different stories on that. I would think that the best thing and it probably doesn't apply explicitly or exclusively to Alaska, but would be that if one could come up with your own independent testiments of what your resources are, and the potential yields and profitabilities of them.

SENATOR RADER - Well, we could do that to some extent, but finally the proof is what is their ability to spend the money to poke the hole, and there's been some suggestion that the state should start going out and wildcatting. That way they would know alright, but I imagine they would blow a lot of money too.

PROFESSOR AINSWORTH - That might be a kind of a check that the State would want to make.

SENATOR RADER - Can you think of any way we could get a handle on that problem as to whether or not we've become unreasonable in our tax policy, and in effect driving our petroleum industry out of the state, or diminishing to an unreasonable point their incentive to explore further for new finds and new development.

PROFESSOR AINSWORTH - I think the only way to work at that is to do what seems to be a reasonable job of getting your tax in order for the first time on this kind of industry and activity

really. By that I mean bringing it up surely to the level of other states which with the sales destination and so on, I would judge under the separate accounting would not be the case. Get it up to that level then assess the differential quality as best you can. The information is imperfect. The companies and the energy people in the federal government seem to agree on that at least, and you just have to continue to evaluate.

SENATOR RADER - Well is there any argument in anybody's mind that we are taxing among the highest rate on our severance taxes and on our other taxes than any other states? You see that I thought we were nudging the very top for a long, long time and exceeded almost everybody.

PROFESSOR AINSWORTH - Of course, we're buying an awful lot of oil just now from foreign sources which I think would have a total tax and price situation that would make Alaska's quite minutive perhaps.

SENATOR HUBER - In the studies that you've been doing, do you have any doubt but what singling out Prudhoe Bay. It seems to be what we're basically talking about there anyway. Is there any doubt but what it could stand exceptionally high taxation rates in comparison with other places in the country? Have you discovered that it couldn't, that it would have to be held down to an average of what other states are, or could Prudhoe Bay as being a bonanza, something that you don't find

everyday, could it bear a high rate of taxation in relation to other places?

PROFESSOR AINSWORTH - Of course we're out of the area of the income tax.

SENATOR HUBER - No, we're really not out of the area of the income tax. We're talking about a total rate. Madam Chairman, if you'll give me a little latitude here, Senator Rader was tying us down to the approximate maximum of what other states were doing, and we've had other studies and testimonies since the Tanzer report indicating that Prudhoe Bay is capable of supporting from 50-85% total taxation rate, and many other studies that show maybe as much as 50%. We know that countries in the middle east, some of them with about the same production that we have here are sustaining from 10-11 dollars a barrel tax out of a total price of \$14, so that's what I want to get some comments about. I thought it was all going on one side that maybe the oil companies were going to leave before we left this room.

PROFESSOR AINSWORTH - I would not expect that, but more specifically to that point, I think first of all, your suggestion, Senator, that one looks to the other states, but also of course to other places in the world, the petroleum market and its exploration and so on is indeed a worldwide kind of thing, so before concluding as to what could be done by way of taxation

of petroleum companies in Alaska, I would certainly take a very broad look at it. Secondly, it seems to me that we're really not quite at the point of being differentially high in Alaska. We're really sort of starting from the beginning as far as oil operations are concerned, and the ineffectiveness historically, ineffectiveness of the sales destination package historically has set a low base here as a starting point and unless something is done, I think that it would continue perhaps unfortunately low to the disadvantage of the State. Then a final observation I would make is this that in terms of the kind of taxes that are most inconveniently kind, as it were, for all taxpayers, but certainly including corporate taxpayers, it seems to me the net income tax applies only when there is in fact net income, and what we're proposing primarily is a system for determining what that net income is and assigning its fair share to Alaska, and then taxing it. If it comes out zero as it conceivable could, though I think unlikely in the foreseeable future, why then it would go away, unlike a tax, say well the tax that Professor Zeifman mentions as the first string on the bow, if you wish, the severance tax, that does not vary with the profitability of the oil companies, so in a sense an income tax is a more conveniently kind tax which gets less if profitability diminishes. So its differential effect between and among the states would be somewhat moderated as compared with say the severance tax and those other taxes which are not geared to net profitability, so I think you have a way

to go before you come up to for all practical purposes this line if you look nationwide and indeed OPECwide, and also the income tax would be of less concern, I should think, than almost any other tax because it is a net thing. It's only after their profitable that in fact taxes are applied.

SENATOR HUBER - Madam Chairman, would you care to comment upon the different make up of the type of oil companies that we have on the slope in Alaska, mainly comment maybe on there being more of the vertically integrated multi-national in regards to the small independents there in many states like Texas and other places. I know it's an entirely different problem of handling them and dealing with the two different kinds of companies. In fact it's entirely different to be fair with them even. Would you care to comment on that?

PROFESSOR AINSWORTH - I would comment to this extent on that, and then perhaps Professor Zeifman can add something. It seems to me that if you look at the House proposal before you 322, the destination versus the Senate proposal 105, the separate accounting one, that for the company which is entirely and exclusively in Alaska, any one of these three is likely to come to about the same end result, because you are indeed all there. Now, if you look at it however, from the other perspective. If you keep the destination factor or if you use the separate accounting device as a way to determine Alaska taxable income, then you will be providing an opportunity

for the large integrated company to reduce its tax liability differentially low, relative to the small highly local company because the effective rate of 9.4% will indeed be applied to that local company which is 100% Alaska no matter how you look at it. The whole pie is here obviously and simply. The destination factor and the separate accounting factor provides an opportunity for some shipping of income out of Alaska which might by the House 322 be apportioned to Alaska, and in that sense, the small local company will be treated equally. They will pay their 9.4% on income just as the large company will pay 9.4% on its income more reasonably now apportioned to Alaska, so the small company gains not in the sense that its taxes go down all that much, but in the sense the other competitors, larger competitors will be paying at the same effective rate or more nearly so, now there is also a size provision that applies in some measure here and perhaps Professor Zeifman.....

PROFESSOR ZEIFMAN - Our proposal of course applies really for all practical purposes only to multi-national corporations, and I think we've already discussed the tax avoidance possibilities of them with respect to the use of separate accounting. I would sort of like to address myself to both of your observations, and that is that I wouldn't necessarily be persuaded by one way or the other by the fact that whether Alaska has the highest effective rate of taxation of the petroleum industry of any state in the United States of course has some relevance, but

I don't think that that ought to be necessarily the measure. At the same time, you could say that one of the chief industries of Alaska, perhaps more than other states, that the heaviest industry in Alaska is the petroleum industry, and therefore it follows that it would come out that way. I interestingly enough, and this is purely coincidental, most of my experience or ten years of my experience with the Congress, especially with the subcommittee on the outer-continental shelf was working with a chairman from Louisiana who used to be in his earlier days, was the majority leader of the Louisiana assembly, and he used to talk to me in great lengths about the problem of taxation in Louisiana where the State had a similar kind of situation before the oil companies came, and that was the timber industry. It came into Louisiana, stripped the timber bare, and left, and left the state with practically no tax base, and then when the petroleum industry came, I suppose Huey Long who often became criticized for other things began a program to try to develop an effective tax program with respect to the petroleum industry, but as the petroleum industry becomes more and more multi-national, again I want to reiterate that for the State to look at a multi-national petroleum company, only in terms of the profitability as determined by the company, in terms of its own books, in terms of the Alaska subsidiary, I think prevents you from getting the kind of data and the kind of perspective that you would need in order to make this kind of a decision. As I mentioned to you before, if I were working for a multi-national petroleum

company, what I would do would be to try to demonstrate again, and again, and again the low level of profitability of Alaska petroleum developemnt, and the way I would do it would be to establish affiliates, have them operate in Alaska, and control them from parent corporations that exist elsewhere and argue that their profitability was low. So again, I think in order to get the kind of perspective that you're talking about, that both of you are talking about, you have to look at the whole picture of the petroleum companies operations. Also, again I think that we run into this problem all over, in the sense that the New York stock exchange threatened to move out of New York. There are some industries that can't move. The California wine industry is not going to move from California. I don't think the citrus industry is going to move from California, and the petroleum industry is not going to move from Alaska, but you have, I think, an especially important problem here, and that is the non-renewable nature of the resource, and so I think that in addition to asking yourself the question about what happens if, are we going to discourage the petroleum companies to move out. You ought to also ask the question of the extent to which you are extracting revenues from them that are commensurate with the burden and with the long-range economic environmental burden that they are imposing on the State. The more the petroleum industry comes into Alaska, the more it imposes burdens, so I would suggest to you that an important measure of the tax begins where I first started, the preficatory

language of the bill that the measure of the tax to a large extent ought to be related to the economic burden and demand for services that the petroleum industry creates for the State. Admittedly, to translate that into a tax rate is I guess fortunately for us lawyers, that's the kind of thing that economists are dealing with.

SENATOR HUBER - Madam Chairman, it's interesting to note about this language at the beginning of the bill. I think maybe Professor Zeifman mentions that it seems to be important. If I remember right, I don't have to remember back very far. Four years ago our drafting attorneys used to tell me that we couldn't put it in. Three years ago they started putting it in if I jumped up and down hard enough, and now every bill I get has it drafted in, and they all tell me it don't mean anything, it has nothing to do with the legality, so I'm not sure that it does, but there's one observation that you made about the 9.4% tax that Alaska corporation would have to pay doing the same thing, and where the multi-national or vertically individual company gets away from it, and this is where we got started, where we are now is trying to plug up that loophole, that Alaska corporation would have to pay, and the other ones wouldn't have to pay. We look back at history like you mentioned in Louisiana, and we found that our fur traders were here and all they did was left us with a bunch of mad indians, and then they came along and dug the gold up and left us with tailing piles, then the salmon were gone and

all we're left is fighting with the Japanese over whats left of the little piddlin bit of salmon that's left, so now it's oil. It seems like Alaska has had one after another.

PROFESSOR ZEIFMAN - It sort of ends the history of successful people in mankind doesn't it?

SENATOR HUBER - Something on that order, but we end up with in each case Alaska's ending up with the impact, but look at salmon, and those pilings that we pick up all over aren't worth a damned, as Senator Poland will tell you. It's another thing that makes it a paying thing, and somehow or another I suppose we're trying to do the same thing with the petroleum industry which we know is depletable.

CHAIRMAN Poland - Senator Huber, did you have another question? I think that our consultant for the Committee, Mr. Silides might have some.

GEORGE SILIDES - Madam Chairman, both Mr. Erickson and I have several, but I think we'll have to defer, except for one which I think is going to need answering on Rader's plan of \_\_\_\_\_ If we might be able to mail them or telephone them in.

PROFESSOR AINSWORTH - Or if you wish we could remain with you, whichever.

GEORGE SILIDES - I'm concerned about how effectively your approach would be in apportioning income to Alaska from Prudhoe Bay and the Alyeska operations. You know, Alyeska in particular is wholly an inter-state corporation. That was the question. How effective are you or would your scheme be in apportioning income to Alaska from the Prudhoe Bay and the Alyeska operation?

PROFESSOR AINSWORTH - Well, I would argue that it is the more effective way by far in the sense that first of all, I think there's a little bit of a mystery as to how the pipeline company is going to operate totally, but I would argue that, let me put it this way in order to be very specific. Again, I'm not talking about the book income part of it, and I'm talking in part about the extraction factor, but the part again that I want to emphasize, because frankly, respectfully, I feel that Mr. Erickson has totally misunderstood the nature of this problem, but anyway I want to make that clear that the idea of looking at the whole picture of the out of state owners and their profitability of the whole picture of their profitability is important, extremely important because the truth of the matter is that in a true economic sense, the pipeline companies are not operating solely in Alaska. They are part of a worldwide conglomerate type of operation, and although they have set up subsidiaries that operate in Alaska, in a true economic sense, those pipeline companies are truly and part of a unitary kind of business, and it has been suggested

to me for example by Mr. Erickson, that the state ought to draw a ring around Alaska, and therefore make sure that it is effectively taxing all those companies. That ring that Mr. Erickson would draw around Alaska is a ring that would prevent the State from having any effective remedy if the control of the pipeline companies, let's face it, the pipeline companies are not controlled by Alaska. They are not controlled by the legislature. They are controlled by corporations who have their corporate headquarters, and the major portion of their resources outside of Alaska. If they operate those in a manner to minimize their profitability which they easily can do, and the Department of Revenue is straddled with what I call this bow and arrow, obsolete, outmoded, mioptic form of taxation based on separate accounting. I think you are opening the flood base for widespread tax avoidance on the part of pipeline operators.

GEORGE SILIDES - Madam Chairman, Professor, that was not Mr. Erickson's question, but at any rate, one last thing. What is to prevent, now let me ask you this, you have said that no other state has adopted this particular procedure.

PROFESSOR AINSWORTH - Now, let me be very specific about this, and I'm very appreciative to Senator Rader for having brought this up. When I said that no other state has adopted this procedure, I am talking about the use of book income as a taxpayer, not the subject of the so called worldwide combination

or combined report which most of the progressive states have adopted.

GEORGE SILIDES - I understand all that, but now supposing that all the other 49 states have adopted this book income, wouldn't Alaska or Prudhoe Bay with it's high profitability, wouldn't Alaska income be voted by other states as jumping on to a possible venture?

PROFESSOR AINSWORTH - If all of the states adopted the book income approach, all the states would agree on the total size of the worldwide pie that's all. That is not related. If I could rephrase your question, I think what you're getting at is if all states are adopting the kind of apportionment formula that we are talking about.

GEORGE SILIDES - No.

PROFESSOR AINSWORTH - Well, I understand it to be addressed to book income, and I would say that the effect of all states adopting book income as the state taxable income would be to enlarge the corporate tax revenue for every state, a little bit as we suggested it be enlarged in Alaska. It would not shift income from one state to another, but every state would be more effective in raising revenue by that device.

GEORGE SILIDES - From the company?

PROFESSOR AINSWORTH - Yes, but not at the expense of Alaska.

GEORGE SILIDES - That answers my question.

PROFESSOR AINSWORTH - If I may Madam Chairman, in further comment so far as the pipeline property is concerned, in making my estimates of revenue, I have assumed that property would indeed be incorporated into the numerator and the denominators of the appropriate oil company, so in that sense it would also be incorporated into this proposal that we have. We did not exclude that as part of the property factor.

GEORGE SILIDES - Professor we understand that we have a unique situation here, the pipeline companies are actually small.

PROFESSOR AINSWORTH - Also, let me make an additional observation about the pipeline company which is a form of justification for departing from the uniform act. The uniform act itself and the draftsman of the uniform act expressly, intentionally they were cognizant of the fact that transportation companies present special problems, and so they did not include, they excluded transportation companies from the coverage of the uniform act, which is a further justification for the use of an extraction factor with respect to the apportionment of income in Alaska.

CHAIRMAN POLAND - Are there no further questions? Thank you very much Professor Ainsworth and Professor Zeifman, and ladies and gentlemen for your patience. We will resume our joint resources meeting here tomorrow at 1:30 in the afternoon.