

SCOMM

12:7

Back/Forth Income Tax Credit

Fr: "Approaches to
Corporate Income Taxation of
Oil Industry Operations in Alaska"
by W.J. Levy Assoc.
Dec. 1974

41. If a Net Proceeds Tax is considered as an alternative whereby the State is able to get a more appropriate approximation of taxable income than via apportionment, some sort of back/forth credit versus corporate income tax would be necessary.

42. One possibility, that Net Proceeds Tax liability may be taken as credit against corporate income tax liability.

Does this raise questions as to the State's commitments under the Multi-state Tax Compact? If not, it could be a relatively simple alternative.

Alternatively, Alaska may consider to exempt from Net Proceeds Tax liability any company that opts for direct and separate reporting for purposes of corporate income tax, and that enters gross proceeds (as defined for Net Proceeds Tax purposes) as the relevant basis for determination of taxable income.

Overlapping Exposures — *Multiple Taxation*

43. In whatever way Alaska may choose to identify and subject to taxation higher taxable income for petroleum operations than is gotten from the apportionment formula, overlapping exposure of corporate income to state taxes would be implied.

Simply put. If Alaska gets less than appropriate taxable income via apportionment formula, other states get more. If Alaska opts for a more reasonable alternative for itself, other states will still use the apportionment formula. And thereby, other states will be taxing as allocated income some part of what Alaska separately had identified as income generated by Alaskan operations.

double taxation

44. If all states were to go completely separate routes, each uniquely chosen to maximize that state's taxable income and income tax revenues, the premise of the Multistate Tax Compact would obviously be undercut.

45. Alaska's concern is to avoid gross inequity in the identification of taxable income subject to its tax regime. But it cannot with impunity ignore the fact that taxable income in Alaska is inextricably intertwined with interstate business, Federal law and Federal policy. The issue is probably not so much in what direction Alaska should go, but how far. And if there is no magic formula, as in most legislative affairs, then reason would have to rule.

46. Further, if a Net Proceeds Tax is considered, there should be simultaneous consideration of the range of extant taxes imposed on the oil industry in Alaska. In particular, the battery of ad valorem taxes -- on reserves and property -- ought to be reviewed with reference both to administration, purpose, and revenue.

Tax Rates

47. Hereto, we have considered a Net Proceeds Tax as one alternative approach to taxation of oil producing income that might otherwise be inadequately allocated as taxable income in Alaska. This assumes that a Net Proceeds Tax rate would be the same as the State's corporate income tax rate -- even though the effective rate of taxation could presumably be higher under a Net Proceeds Tax because it arrives at a higher calculation of taxable income than via the apportionment formula.

48. From a company's standpoint, a Net Proceeds Tax would in principle, and whatever the tax rate, subject the petroleum producing industry to a separate category of taxation compared with that imposed on other corporate enterprise in Alaska.

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EXTRACTION FACTOR PROBS

SOHIO EXAMPLETABLE A

I. <u>Allocation of Taxable Income Under Established Multistate Compact</u>	<u>Property</u>	+	<u>Payroll</u>	+	<u>Business Volume (Sales)</u>	=	<u>Allocation</u>
Alaska	70%		5%		10%		28%
	<hr style="width: 50%; margin: 0 auto;"/>			3			
All Other States Combined	30%		95%		90%		72%
	<hr style="width: 50%; margin: 0 auto;"/>			3			<hr style="width: 50%; margin: 0 auto;"/>
Total Income Taxed							100%
II. <u>Allocation of Taxable In Court Under CSHB 322 in Alaska and Under Multistate Tax Compact in other States</u>	<u>Property</u>	+	<u>Payroll</u>	+	<u>Business Volume (Extraction Factor)</u>	=	<u>Allocation</u>
Alaska	70%		5%		99%		58%
	<hr style="width: 50%; margin: 0 auto;"/>			3			
All Other States Combined	30%		95%		90%		72%
	<hr style="width: 50%; margin: 0 auto;"/>			3			<hr style="width: 50%; margin: 0 auto;"/>
Total Income Taxed							130%*

* This example indicates that 30% of Sohio's income would be double taxed.

SOHIO EXAMPLE

TABLE B

If all of Sohio's business were in Alaska and all of its income were represented by the box below, all of its income would be taxed at 9.4% under present law.

ALASKA

100% of Income	X	9.4%
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Since a substantial part of Sohio's business will be in Alaska and a substantial part of it will be elsewhere, the present law of Alaska taxes the part of it that is attributable to Alaska at 9.4% and the other states tax the part attributable to them at their rates of taxation. Using the allocation from Part I of Table A:

<u>ALASKA</u>		<u>ALL OTHER STATES</u>		
28% of Income	X	72% of Income	X	Other States Tax Rates

Alaska would receive 9.4% of the Company's Alaska income. While this might represent 2.5% to 3.0% of the company's total income, these lower percentages are not very meaningful, except that they reflect the fact that when a company does business in more than one state, each of the states will generally tax the share of the income attributable to that state.

EXAMPLE II

ALASKA H.B. 322
USING HIGHER OF BOOK OR TAXABLE INCOME
TAXES RECOVERY OF CAPITAL

Alaska House Bill No. 322 proposes to base Alaska taxable income on the higher of taxable income as defined in AS 43.20.011(e) (adjusted federal taxable income), or book net income determined without regard to any taxes on, or measured by, net income.

Since the tax is based on the higher of taxable income or book net income before income taxes, it appears that all Alaska oil and gas producers (including native corporations) will effectively be prevented from fully recovering their capital investment for Alaska income tax purposes and will therefore be taxed on phantom income. Consider the attached simplified example which clearly shows that only \$76,000 of a \$100,000 capital expenditure would be recovered through the depreciation deduction allowed by the proposed law. The taxpayer would lose as a tax deduction 24% of the cost of a capital expenditure necessary to produce income and would be taxed on \$24,000 of non-existent income.

EXAMPLE: Company X is in the business of producing oil and gas. It owns machinery which it purchased for \$100,000 on January 1, 19A, for use in its producing operations. Production income is \$50,000 per year and the machinery has an expected useful life of five years. Depreciation and income using tax and book methods are as follows:

Year	Tax			Books		
	Revenue	Depreciation (DDB/SYD)	Taxable Income	Revenue	Depreciation (S/L)	Net Income
19A	\$50,000	\$40,000	\$10,000	\$50,000	\$20,000	\$30,000
19B	50,000	24,000	26,000	50,000	20,000	30,000
19C	50,000	18,000	32,000	50,000	20,000	30,000
19D	50,000	12,000	38,000	50,000	20,000	30,000
19E	50,000	6,000	44,000	50,000	20,000	30,000
Total		<u>\$100,000</u>	<u>\$150,000</u>		<u>\$100,000</u>	<u>\$150,000</u>

Since the Alaska bill requires that the higher of taxable income or book income before taxes be used as the tax base, the Alaska income and related depreciation for each year are as follows:

Year	Tax/Books	Depreciation	Alaska Taxable Income
19A	Books	\$20,000	\$30,000
19B	Books	20,000	30,000
19C	Tax	18,000	32,000
19D	Tax	12,000	38,000
19E	Tax	<u>6,000</u>	<u>44,000</u>
Total		\$76,000	\$174,000
Real Net Income			<u>150,000</u>
Phantom Net Income subject to 9.4% tax			<u>\$ 24,000</u>

EXTRACTION FACTOR PROBLEMS

UNION

EXAMPLE I

~~BRAND~~

Coal Carbon

ALASKA H.B. 322
 USING EXTRACTION FACTOR ATTRIBUTES ONE-THIRD
 OF NON-PRODUCING INCOME TO PRODUCING OPERATION

Alaska House Bill No. 322 proposed to substitute an extraction factor for the sales factor in the Alaska apportionment formula. This substitution can result in an attribution of as much as one-third of all "downstream" income (i.e., income from transportation, refining, marketing, etc.) or non-producing income to Alaska, and can cause this one-third "overlap" of downstream income to be taxed twice. Consider the following simplified example:

Assume that a producer of oil and gas in Alaska with upstream operations wants to expand into California with downstream operations. Sales, payroll, and property would be as shown below. Further assume that all production is in Alaska.

	Alaska	California	Existing Law Apportionment Factors	
			Alaska	California
Sales	\$50,000	\$50,000	50/100 = .5	50/100 = .5
Payroll	\$20,000	\$20,000	20/40 = .5	20/40 = .5
Property	\$30,000	\$30,000	30/60 = .5	30/60 = .5
			1.5 ÷ 3 = .5	1.5 ÷ 3 = .5

Assuming taxable income of \$40,000, each state would have taxable income attributed to it of \$20,000 (\$40,000 x .5 apportionment factor) under the uniform formula and there is no overlapping taxation.

Now assume that an extraction factor is substituted for the sales factor in Alaska, while all other amounts remain the same:

	<u>Data</u>	<u>Apportionment Factors</u>
Extraction	10,000 Units	10/10 = 1.0
Payroll	\$20,000	20/40 = .5
Property	\$30,000	20/60 = <u>.5</u>
		2.0 ÷ 3 = .66667

This will have no effect on the California apportionment factor which remains at .5 since California still abides by the uniform rules. Since total taxable income is still \$40,000, Alaska has attributed income of \$26,667 (\$40,000 x .66667), while California's attributed income remains at \$20,000. Thus, substitution of an extraction factor results in the attribution of one-third of the California downstream income to Alaska, and a \$6,667 "overlap" of income which is taxed twice. In effect, the Alaska producer would be paying one-third more income tax on his California operations than would his competitors in that state. This added burden could even block his expansion plans completely.

Can the Oil and Gas Corporate Franchise Tax Proposal by the Administration of the State of Alaska result in duplicative taxation?

A. Proposed Law

The law would define net income as the higher of (1) taxable income for federal income tax purposes or (2) net income reported to a company's shareholders without regard to any tax on net income.

B. Illustrative Case

Assume a company invests \$2,000 in a project having a life of 5 years. The company elects to write off the \$2,000 for federal income tax purposes using the so called sum-of-the-years-digits (SOYD)*/ method of rapid depreciation. For its financial reporting purposes the company writes off the investment in equal amounts each year of its life.

Results would be as follows using the indicated revenues and expenses:

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>	<u>Total</u>
1. Revenue	\$1,000	\$1,000	\$1,000	\$1,000	\$1,000	\$5,000
2. Expenses	200	200	200	200	200	1,000
3. Net	<u>800</u>	<u>800</u>	<u>800</u>	<u>800</u>	<u>800</u>	<u>4,000</u>
4. Tax Depreciation	666	534	400	266	134	2,000
5. Federal Taxable	<u>134</u>	<u>266</u>	<u>400</u>	<u>534</u>	<u>666</u>	<u>2,000</u>
6. Financial Depreciation	400	400	400	400	400	2,000
7. Financial Income, Before Tax	400	400	400	400	400	2,000
8. Taxable by Alaska	400	400	400	534	666	2,400

C. Results

The amount subject to federal taxes over the life of the project is \$2,000, and the financial net income before tax is also \$2,000. However, the amount subject to Alaskan taxes would be \$2,400, or 20% more than the amount subject to federal taxes. Effectively then the 9.4% tax rate would be 11.28%.

*/ Under the SOYD method a project with a 5 year life would have depreciation equal to the following percents of the total investment for each year, respectively: 33.3%, 26.7%, 20.0%, 13.3% and 6.7%.