

ALASKA LEGISLATURE SPECIAL COMMITTEE/SUBJECT FILES 8672

3000 SCOMM 134: HOUSE SPECIAL COMMITTEE ON WAYS & MEANS 2003-04



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SCOMM 134: HOUSE SPECIAL COMMITTEE ON WAYS AND MEANS, 2003-04

MEMBERS:

REPRESENTATIVE MIKE HAWKER, CHAIR
REPRESENTATIVE BRUCE WEYHRAUCH, VICE-CHAIR
REPRESENTATIVE VIC KOHRING
REPRESENTATIVE DAN OGG
REPRESENTATIVE RALPH SAMUELS
REPRESENTATIVE PEGGY WILSON
REPRESENTATIVE NORMAN ROKEBERG
REPRESENTATIVE CARL MOSES

Established by HR 6, 2003.

Contents: 16 files. 79 tapes are also available of meetings held
4/8/03 - 4/21/04.

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134:1

Alaska Corporate Income Tax Primer

Who Pays the Alaska Corporate Net Income Tax

A Corporation that is doing business in Alaska

"Corporation" Includes

- An entity organized as a corporation that is not an S-Corporation, generally referred to as a C-corporation
- A corporation electing S-corporation status
- A Limited Liability Company (LLC) that elects C-corporate status for tax purposes

Exemptions

- S-corporations generally do not pay tax at the corporate level, their income or loss is passed through to the individual shareholders where it is taxed. This income is not subject to tax under Alaska law.

Doing Business in Alaska - Nexus

- Direct business activity of a corporation
- Indirect business activity:
 - By a partnership in which a corporation has an interest
 - By an LLC wholly owned by a corporation (single member LLC)
 - By an LLC electing partnership status (in which a corporation is a member)

Federal & Alaska Taxation of Business Entities and Owners

	C-Corporation	S-Corporation	Partnership	LLC (Mult. Members)	LLC (Single Member)	Sole Proprietor
Federal Income Tax Status	Taxed directly at corporate rates.	Generally not taxed at corporate level. Income assigned to shareholders who pay tax in corporate income.	Not taxed at entity level. Income assigned to partners who pay tax on partnership income.	Elective, either C-corporation status or pass through status as a partnership or S-corporation.	Ignored for tax purposes, all income and activity attributed to owner.	Individual proprietor is taxed directly
Entities' Alaska Tax Status	Same as Federal	Same as Federal	Same as Federal	Same as Federal	Same as Federal	Same as federal
Subject to AK CIT?	Yes	No (rare exceptions apply)	No	Maybe	Maybe	No
Owners subject to AK CIT due to entities income or activity	No	No, all are individuals	Corporate partners - Yes Individual partners - No	Corporate members - Yes Individual members - No	Corporate owner - Yes Individual owner - No	No
Federal Taxation of Distribution	Dividends subject to tax, corporate shareholders can exclude all or part of dividend income	Distributions are tax free to the extent of previously taxed earnings	Distributions are tax free to the extent of partners basis	Controlled by tax status.	Ignored	Ignored
Alaska Taxation of Distributions from Income	Dividends received by corporate taxpayers are subject to tax, corporate shareholders can exclude all or part of dividend income	N/A	Distributions are tax free to the extent of partners basis	Controlled by tax status.	Ignored	N/A
Federal Taxation of Compensation to Owners/Employees	Corporate deduction / Individual is taxed on income. Double taxation avoided.	Deduction against pass through income / Individual is taxed on income. Double taxation avoided.	Deduction against pass through income / Individual is taxed on income. Double taxation avoided.	LLC deduction / Individual is taxed on income.	N/A	N/A
Alaska Taxation of Compensation to Owners/Employees	Corporate deduction / Individual is not taxed. Income in the form of compensation is not taxed.	Corporate deduction / Individual is not taxed. Income in the form of compensation is not taxed.	Partnership deduction / Individual is not taxed. Income in the form of compensation is not taxed.	LLC deduction / Individual is not taxed. Income in the form of compensation is not taxed.	N/A	N/A

**Alaska Department of Revenue
Tax Division**

Non-Petroleum Corporation Income Tax Liabilities by Sector¹

Business Activity	Preliminary		FY 2002		FY 2001		FY 2000		FY 1999		FY 1998	
	%	Tax Liability	%	Tax Liability	%	Tax Liability	%	Tax Liability	%	Tax Liability	%	Tax Liability
Airlines	0%	426,889	1%	2,145,349	1%	1,829,425	1%	2,705,322	0%	1,157,714	1%	1,735,467
Construction	1%	1,413,593	1%	1,935,919	1%	1,357,780	1%	1,673,615	1%	1,638,376	1%	2,050,289
Finance	3%	8,326,531	3%	8,994,254	3%	3,690,786	5%	10,636,659	3%	10,161,632	3%	9,170,326
Fish ²	1%	1,743,738	1%	2,077,476	2%	3,039,414	1%	1,966,142	0%	1,359,905	1%	1,483,496
Manufacturing ³	0%	1,166,218	1%	1,727,297	1%	1,755,109	1%	1,782,218	1%	3,081,797	1%	3,784,507
Mining ⁴	0%	31,030	0%	18,665	0%	285,815	0%	75,900	0%	398,435	0%	246,792
Oil and Gas ⁵	84%	216,146,150	87%	290,496,501	71%	102,873,464	74%	159,031,727	83%	243,494,814	82%	240,554,444
Real Estate	0%	1,213,492	0%	539,347	1%	1,525,122	1%	1,427,584	1%	1,745,832	0%	1,330,113
Retail	4%	9,449,539	2%	6,319,374	3%	4,601,219	3%	6,067,087	2%	5,040,997	2%	5,241,579
Services ⁶	4%	9,420,749	2%	8,186,279	5%	8,704,506	4%	9,481,634	4%	11,118,228	3%	7,657,407
Transportation ⁷	1%	2,768,424	1%	3,548,633	2%	2,828,536	1%	3,120,394	1%	3,669,637	1%	3,157,115
Utility & Comm.	0%	708,840	1%	2,782,964	5%	7,373,389	4%	9,172,989	2%	6,241,187	3%	9,178,023
Wholesale	2%	5,061,710	2%	5,823,224	3%	4,359,367	3%	5,670,993	2%	4,571,731	2%	4,999,215
Other Sectors ⁸	0%	515,607	0%	540,349	0%	568,676	1%	1,164,398	0%	1,310,741	1%	2,841,659
Total⁹	100%	\$258,392,510	100%	\$335,135,630	100%	\$144,792,609	100%	\$213,976,662	100%	\$294,991,025	100%	\$293,430,432

¹ Reporting a tax liability on an original corporate income tax return. Liabilities may differ from amounts remitted by the taxpayer during the fiscal year due to timing differences resulting from estimated tax payments, credits and final payment of taxes. Based upon information provided on tax returns as interpreted by DOR. Prior years have been updated for consistency purposes.

² Includes fish processors that are usually classified under manufacturing.

³ Fish processing, and wood products manufacturing included under fisheries and forestry sectors.

⁴ Does not include oil and gas extraction.

⁵ Only includes liabilities from companies that filed as oil and gas corporations.

⁶ Includes oil and gas services.

⁷ Airline transportation is included in its own sector above.

⁸ Forestry and insurance sectors combined for confidentiality reasons.

⁹ In FY 1999, total general corporation income tax liabilities were updated and, consequently, do not match the liabilities shown in our annual reports.

Alaska Corporate Income Tax Primer

Wholly Alaska Business

A corporation doing business in Alaska, but not in any other state is taxed on its federal taxable income subject to state modifications.

Alaska Taxable Income		Tax Rate		Alaska Tax
\$ 500.00	X	1%	=	\$ 5.00

Multi-state Business

A corporation doing business in Alaska and in one or more other states must apportion its total income to Alaska

Apportionment of Income

Total Income		Apportionment Factor		Alaska Taxable Income		Tax Rate		Alaska Tax
\$ 1,000.00	X	50%	=	\$ 500.00	X	1%	=	\$ 5.00

Apportionable Income

Generally, the combined federal taxable income of the taxpayer, affiliated corporations, and their share of the income of pass through entities owned by the group.

Factors

Oil & Gas Corporations - Modified Apportionment

	Alaska	Everywhere	Factor
Sales	20,000	100,000	20%
Property	50,000	100,000	50%
Extraction	400,000	500,000	80%
Apportionment Factor = Average			<u>50%</u>

Other Corporations - Standard Three Factor

	Alaska	Everywhere	Factor
Sales	75,000 /	100,000	75%
Property	50,000 /	100,000	50%
Payroll	125,000 /	500,000	25%
Apportionment Factor = Average			<u>50%</u>

STATE APPORTIONMENT OF CORPORATE INCOME

(Formulas for tax year 2004 -- as of January 1, 2004)

ALABAMA *	3 Factor	NEBRASKA	Sales
ALASKA *	3 Factor	NEVADA	No State Income Tax
ARIZONA *	Double wtd. sales	NEW HAMPSHIRE	Double wtd. Sales
ARKANSAS *	Double wtd. sales	NEW JERSEY (1)	Double wtd. Sales
CALIFORNIA *	Double wtd. sales	NEW MEXICO *	Double wtd. sales
COLORADO *	3 Factor/Sales & Property	NEW YORK	Double wtd. sales
CONNECTICUT	Double wtd. sales/Sales	NORTH CAROLINA *	Double wtd. sales
DELAWARE	3 Factor	NORTH DAKOTA *	3 Factor
FLORIDA	Double wtd. sales	OHIO *	60% Sales, 20% Property & Payroll
GEORGIA	Double wtd. sales	OKLAHOMA	3 Factor
HAWAII *	3 Factor	OREGON *	80% Sales, 10% Property & Payroll
IDAHO *	Double wtd. sales	PENNSYLVANIA *	Triple wtd. sales
ILLINOIS *	Sales	RHODE ISLAND (2)	40% Sales, 30% Property & Payroll
INDIANA	Double wtd. sales	SOUTH CAROLINA	Double wtd. sales/Sales
IOWA	Sales	SOUTH DAKOTA	No State Income Tax
KANSAS *	3 Factor	TENNESSEE *	Double wtd. sales
KENTUCKY *	Double wtd. sales	TEXAS	Sales
LOUISIANA	Double wtd. sales	UTAH *	3 Factor
MAINE *	Double wtd. sales	VERMONT	3 Factor
MARYLAND	Double wtd. sales	VIRGINIA	Double wtd. sales
MASSACHUSETTS	Double wtd. sales/Sales	WASHINGTON	No State Income Tax
MICHIGAN	90% Sales, 5% Property & Payroll	WEST VIRGINIA *	Double wtd. sales
MINNESOTA	75% Sales, 12.5% Property, and 12.5% Payroll	WISCONSIN *	Double wtd. sales
MISSISSIPPI	Accounting/3 Factor	WYOMING	No State Income Tax
MISSOURI *	3 Factor/sales	DIST. OF COLUMBI	3 Factor
MONTANA *	3 Factor		

Source: Compiled by FTA from various sources.

Note: The formulas listed are for general manufacturing businesses. Some industries have special formula different than those reported.

* State has adopted substantial portions of the UDITPA.

(1) A 3-factor formula is used for corporations not subject to the corporation business franchise tax.

(2) For tax years beginning after 2004, apportionment formula will be double weighted sales.

Oil & Gas CIT Factor Analysis
Impact of Factors Based on Average Revenue for FY98-FY03

Based on 2002 Returns

Average Factors	Current Law	Double Weight Extraction	Eliminate Sales Factor	Single Factor Extraction	Single Factor Property	Single Factor Sales
Extraction	16.3%	32.6%	16.3%	16.3%	0.0%	0.0%
Property	5.3%	5.3%	5.3%	0.0%	5.3%	0.0%
Sales	0.2%	0.2%	0.0%	0.0%	0.0%	0.2%
Average Factor*	7.3%	9.5%	10.8%	16.3%	5.3%	0.2%
Projected Revenue**	\$ 209	\$ 229	\$ 290	\$ 329	\$ 251	\$ 7
Change - Revenue \$		\$ 20	\$ 81	\$ 120	\$ 42	\$ (202)
Change - Percent		9.8%	38.6%	57.5%	20.3%	-96.7%

* Average factors are not weighted by apportionable income, the change in the average factor does not generate a corresponding change in revenues.

** Revenue based on adjusting factors of individual returns filed by the industry.

Summary of Estimated Revenue Impacts of Tax Changes Based on FY98-FY03 Receipts

Action	Total \$ millions	O&G	Other
Change corporate rate by 1% of taxable income	27.0	21.0	6.0
Eliminate federal credits	10.0	9.6	0.4
Allow enhanced oil recovery (EOR) credit for Alaska projects	(6.2)	(6.2)	
Tax net capital gain at ordinary rates	2.0	1.6	0.4
Restrict NOL usage to carryforwards (short term benefit)	2.0		2.0
Tax S-Corporations under AK CIT	29.4		29.4
Tax Partnerships under AK CIT	16.6		16.6
Tax Proprietorships under AK CIT	29.6		29.6
Tax Cruise Ship income under AK CIT*	6.8		6.8

* Very rough estimate from extrapolated data. Approximates head tax of \$8.50 per passenger.

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RANGE OF STATE CORPORATE INCOME TAX RATES

(For tax year 2004 -- as of January 1, 2004)

State	Tax Rates	Tax Brackets	# of Brackets	Bank Tax Rates	Federal Tax Deductible
ALABAMA	6.5	---Flat Rate---	1	6.5	*
ALASKA	1.0 - 9.4	10,000 90,000	10	1.0 - 9.4	
ARIZONA	6.968 (b)	---Flat Rate---	1	6.968	
ARKANSAS	1.0 - 6.5	3,000 100,000	6	1.0 - 6.5	
CALIFORNIA	8.84 (c)	---Flat Rate---	1	10.84 (c)	
COLORADO	4.63	---Flat Rate---	1	4.63	
CONNECTICUT	7.5 (d)	---Flat Rate---	1	7.5 (d)	
DELAWARE	8.7	---Flat Rate---	1	8.7-1.7 (e)	
FLORIDA	5.5 (f)	---Flat Rate---	1	5.5 (f)	
GEORGIA	6.0	---Flat Rate---	1	6.0	
HAWAII	4.4 - 6.4 (g)	25,000 100,000	3	7.92 (g)	
IDAHO	7.6 (h)	---Flat Rate---	1	7.6 (h)	
ILLINOIS	7.3 (i)	---Flat Rate---	1	7.3 (i)	
INDIANA	8.5	---Flat Rate---	1	8.5	
IOWA	6.0 - 12.0	25,000 250,000	4	5.0	* (k)
KANSAS	4.0 (l)	---Flat Rate---	1	2.25 (l)	
KENTUCKY	4.0 - 8.25	25,000 250,000	5	--- (a)	*
LOUISIANA	4.0 - 8.0	25,000 200,000	5	--- (a)	
MAINE	3.5 - 8.93 (m)	25,000 250,000	4	1.0	
MARYLAND	7.0	---Flat Rate---	1	7.0	
MASSACHUSETTS	9.5 (n)	---Flat Rate---	1	10.5 (n)	
MINNESOTA	9.8 (o)	---Flat Rate---	1	9.8 (o)	
MISSISSIPPI	3.0 - 5.0	5,000 10,000	3	3.0 - 5.0	
MISSOURI	6.25	---Flat Rate---	1	7.0	* (k)
MONTANA	6.75 (p)	---Flat Rate---	1	6.75 (p)	
NEBRASKA	5.58 - 7.81	50,000	2	--- (a)	
NEW HAMPSHIRE	8.5 (q)	---Flat Rate---	1	8.5 (q)	
NEW JERSEY	9.0 (r)	---Flat Rate---	1	9 (r)	
NEW MEXICO	4.8 - 7.6	500,000 1 million	3	4.8 - 7.6	
NEW YORK	7.5 (s)	---Flat Rate---	1	7.5 (s)	
NORTH CAROLINA	6.9 (t)	---Flat Rate---	1	6.9 (t)	
NORTH DAKOTA	3.0 - 10.5	3,000 50,000	6	7 (b)	*
OHIO	5.1 - 8.5 (u)	50,000	2	--- (u)	
OKLAHOMA	6.0	---Flat Rate---	1	6.0	
OREGON	6.6 (b)	---Flat Rate---	1	6.6 (b)	
PENNSYLVANIA	9.99	---Flat Rate---	1	--- (a)	
RHODE ISLAND	9.0 (b)	---Flat Rate---	1	9.0 (v)	
SOUTH CAROLINA	5.0	---Flat Rate---	1	4.5 (w)	
SOUTH DAKOTA	---			6.0-0.25% (b)	
TENNESSEE	6.5	---Flat Rate---	1	6.5	
UTAH	5.0 (b)	---Flat Rate---		5.0 (b)	
VERMONT	7.0 - 9.75 (b)	10,000 250,000	4	7.0 - 9.75 (b)	
VIRGINIA	6.0	---Flat Rate---	1	6.0 (x)	
WEST VIRGINIA	9.0	---Flat Rate---	1	9.0	
WISCONSIN	7.9	---Flat Rate---	1	7.9	
DIST. OF COLUMBIA	9.975 (y)	---Flat Rate---		9.975 (y)	

Source: Compiled by FTA from various sources

Note: Michigan imposes a single business tax (sometimes described as a business activities tax or value added tax) of 1.9% on the sum of federal taxable income of the business, compensation paid to employees, dividends, interest, royalties paid and other items.

Similarly, Texas imposes a franchise tax of 4.5% of earned surplus. Nevada, Washington, and Wyoming do not have state corporate income taxes.

- (a) Rates listed include the corporate tax rate applied to financial institutions or excise taxes based on income. Some states have other taxes based upon the value of deposits or shares.
- (b) Minimum tax is \$50 in Arizona, \$50 in North Dakota (banks), \$10 in Oregon, \$250 in Rhode Island, \$500 per location in South Dakota (banks), \$100 in Utah, \$250 in Vermont.
- (c) Minimum tax is \$800. The tax rate on S-Corporations is 1.5% (3.5% for banks).
- (d) Or 3.1 mills per dollar of capital stock and surplus (maximum tax \$1 million) or \$250.
- (e) The marginal rate decreases over 4 brackets ranging from \$20 to \$650 million in taxable income. Building and loan associations are taxed at a flat 8.7%.
- (f) Or 3.3% Alternative Minimum Tax. An exemption of \$5,000 is allowed.
- (g) Capital gains are taxed at 4%. There is also an alternative tax of 0.5% of gross annual sales.
- (h) Minimum tax is \$20. An additional tax of \$10 is imposed on each return.
- (i) Includes a 2.5% personal property replacement tax.
- (k) Fifty percent of the federal income tax is deductible.
- (l) Plus a surtax of 3.35% (2.125% for banks) taxable income in excess of \$50,000 (\$25,000).
- (m) Or a 27% tax on Federal Alternative Minimum Taxable Income.
- (n) Rate includes a 14% surtax, as does the following: an additional tax of \$7.00 per \$1,000 on taxable tangible property (or net worth allocable to state, for intangible property corporations); minimum tax of \$456.
- (o) Plus a 5.8% tax on any Alternative Minimum Taxable Income over the base tax.
- (p) A 7% tax on taxpayers using water's edge combination. Minimum tax is \$50.
- (q) Plus a 0.50 percent tax on the enterprise base (total compensation, interest and dividends paid). Business profits tax imposed on both corporations and unincorporated associations.
- (r) The rate reported in the table is the corporation business franchise tax rate. The minimum tax is \$500. An Alternative Minimum Assessment based on Gross Receipts applies if greater than corporate franchise tax. Corporations not subject to the franchise tax are subject to a 7.25% income tax. Banking and financial corporations are subject to the franchise tax. Corporations with net income under \$100,000 are taxed at 6.5%. The tax on S corporations is being phased out through 2007. The tax rate on a New Jersey S corporation that has entire net income not subject to federal corporate income tax in excess of \$100,000 will remain at 1.33% for privilege periods ending on or before June 30, 2006. The rate will be 0.67% for privilege periods ending on or after July 1, 2006, but on or before June 30, 2007; and there will be no tax imposed for privilege periods ending on or after July 1, 2007. The tax on S corporation with entire net income not subject to federal corporate income tax of \$100,00 or less is eliminated for privilege periods ending on or after July 1, 2007.
- (s) Or 1.78 (0.1 for banks) mills per dollar of capital (up to \$350,000; or 2.5% of the minimum taxable income; or a minimum of \$1,500 to \$100 depending on payroll size (\$250 for banks); if any of these is greater than the tax computed on net income. An addition tax of 0.9 mills per dollar of subsidiary capital is imposed on corporations. Small corporations with income under \$290,000 pay a 7.5% tax on all income.
- (t) Financial institutions are also subject to a tax equal to \$30 per one million in assets.
- (u) Or 4.0 mills times the value of the taxpayer's issued and outstanding share of stock with a maximum payment of \$150,000. An additional litter tax is imposed equal to 0.11% on the first \$50,000 of taxable income, 0.22% on income over \$50,000; or 0.14 mills on net worth.
- (v) For banks, the alternative tax is \$2.50 per \$10,000 of capital stock (\$100 minimum).
- (w) Savings and Loans are taxed at a 6% rate.
- (x) State and national banks subject to the state's franchise tax on net capital is exempt from the income tax.
- (y) Minimum tax is \$100. Includes surtax.

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Potential Corporate Income Tax
on S-Corporations

Where positive taxable income is:	# Returns	Projected Taxable Income	Projected Revenue	Revenue from Top 100	Top 25
< 10,000	629	2,806,257	28,063		
< 20,000	454	6,722,386	89,048		
< 30,000	374	9,287,565	166,427		
< 40,000	255	8,942,698	204,708		
< 50,000	211	9,005,408	239,270		
< 60,000	166	9,150,806	300,048		
< 70,000	135	8,047,575	279,830		
< 80,000	97	6,786,970	271,358		
< 90,000	113	9,022,430	405,219		
Over 90,000	907	329,455,434	27,377,091	14,227,352	7,248,734
Totals	3,341	399,227,529	29,361,061	14,227,352	7,248,734
				48%	25%

Notes:

Revenue based on all entity types that elect treatment as an S Corporation under Internal Revenue Code and Treas Reg 301.7701-1 to -3. 76 entities above are LLC under state law electing S-corp. Projected revenue from LLC = \$469,000.

Revenue is stated after apportionment. Factor estimated by applying weighted factor of domestic C corporations for that group, under the assumption that domestic S-corporation would have similar amount of outside business.

Revenue includes all returns with income greater than zero filed within reporting period. Although some returns are for prior years, we have included the revenue under the assumption that the State would not have received the revenue for a late return until filed. Amount does not include net operating losses. 1,880 S corporations had losses. NOL's will cause fluctuation in revenue for any given year. Data is not presently available to estimate the impact of losses carried forward.

Revenue estimate based on returns with an Alaskan address. 939 additional entities file with an address outside Alaska, for which we do not have readily available data. However, we expect \$1 - 3 million additional revenue from outside corporations.

Compare Top 25 & 100 S-Corp to C-Corp: Top 25 C-Corp = 93% of corporate revenue. Top 100 C corp = 97% corporate revenue. [Table 5, Tax Division Annual Report FY 02.]. Thus S-Corp income base much broader than C-Corp.

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Potential Tax on S-Corporations
by industrial classification

Industry Group	# of Returns in Top Tier	Projected Taxable Income	Top Tier Potential Revenue
Construction	172	56,149,207	4,600,865
Retail Trade	133	50,037,437	4,176,839
Professional, Scientific & Technical	106	36,026,905	2,966,769
Transportation & Warehousing	59	28,479,712	2,443,453
Health Care & Social Services	101	30,170,737	2,436,089
Finance & Insurance	42	27,353,215	2,404,882
Wholesale Trade	44	20,579,257	1,760,210
Manufacturing	19	16,867,118	1,510,269
Real Estate, Rental & Leasing	43	16,957,625	1,423,737
Other Services	43	1,378,919	1,125,896
Accommodation & Food Services	51	13,348,054	1,052,757
Agriculture, Forestry, Fishing	58	9,803,330	691,833
Administrative & Support	16	7,975,581	686,345
Arts, Entertainment, Recreation	13	4,245,632	347,609
Information	*	505,561	43,563
Utilities	*	1,664,427	152,496
Management of companies	*	-	-
Mining, Oil & Gas	*	-	-
Educational Services	*	-	-
Top Tier Revenue by Industry	907		27,627,554

Estimated apportionment factor

99.0934%

Estimated apportioned revenue, top tier

27,377,091

Note:

* Not shown if number of corporations in the top tier is less than 10.

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Potential Corporate Income Tax
on Sole Proprietors

Where positive taxable income is:	# Returns	Projected Taxable Income	Projected Revenue
< 10,000	22,716	71,319,681	713,197
< 20,000	5,255	75,295,551	980,411
< 30,000	2,622	64,133,153	1,137,395
< 40,000	1,458	50,533,340	1,146,534
< 50,000	982	43,928,947	1,214,447
< 60,000	684	37,436,650	1,220,199
< 70,000	500	32,326,125	1,212,829
< 80,000	379	28,452,869	1,215,030
< 90,000	275	23,275,791	1,104,821
Over 90,000	1,511	272,952,610	19,673,985
Totals	36,382	699,654,717	29,618,847

Notes:

Revenue based on all returns with an AK address that filed Form 1040 Sch C for tax year 2001.

Sch C is not necessarily the sole source of income for all returns. Best information available suggests that of the number listed above, 10,993 returns (representing \$311,277,856 pre-tax income) have no reported salaries or wages.

Revenue includes all returns with income greater than zero filed within reporting period. Although some returns are for prior years, we have included the revenue under the assumption that the State would not have received the revenue for a late return until filed. Amount does not include net operating losses. 1,584 Sch C businesses had losses. NOL's will cause fluctuation in revenue for any given year. Data is not presently available to estimate the impact of losses carried forward.

DRAFT

Potential Corporate Income Tax
on Partnerships

Where positive taxable income is:	# Returns	Projected Taxable Income	Projected Revenue
< 10,000	449	1,744,821	17,448
< 20,000	162	2,378,504	31,370
< 30,000	111	2,721,589	48,348
< 40,000	89	3,073,766	69,551
< 50,000	60	2,711,050	75,553
< 60,000	44	2,387,045	77,223
< 70,000	36	2,327,821	87,347
< 80,000	22	1,663,132	71,451
< 90,000	23	1,945,677	92,311
Over 90,000	345	235,236,362	20,746,018
Remove C-corp partners	<u>(16)</u>	<u>(50,938,140)</u>	<u>(4,724,825)</u>
Totals	1,325	<u><u>205,251,627</u></u>	<u><u>16,591,794</u></u>

Notes:

Revenue includes all returns filed from AK with income greater than zero filed within reporting period. Although some returns are for prior years, we have included the revenue under the assumption that the State would not have received the revenue for a late return until filed. Amount does not include net operating losses. 1,295 partnerships had losses. NOL's will cause fluctuation in revenue for any given year. Data is not presently available to estimate the impact of losses carried forward.

Some partnerships have C-corp partners. Under existing corporate tax law, partnership income flows to the corporate partner and is subject to the corporate income tax. A review of the top 100 partnerships resulted in an adjustment to remove income that would have been taxed at the corporate level. Data limitations prevents a more definitive adjustment to all income levels.

Commissioner Briefing
Corporate Income Tax Outline
February 2003

Limitations on the State's Power to Tax

"Nexus" is the legal shorthand that refers to the connection that a potential taxpayer has with a state that justifies and enables that state to impose tax. A corporation must have sufficient "nexus" with the state, by virtue of its business activities within the state, in order for a state to impose taxes.

Public Law 86-272 is a federal law that restricts the power of the states to impose income tax. If a business limits its activities in the state to the solicitation of orders for sales of tangible personal property, the business is immune from that state's income tax.

How States Determine Taxable Income for Corporations

Background

Under the Commerce and Due Process Clauses of the Constitution, states can only tax income that is earned within the taxing state. For a corporation that has no affiliated corporations and does business only in one state, the state can tax all of the corporation's income. If the corporation does business (i.e. has nexus) in more than one state, or is a member of group of corporations that collectively does business in more than one state, then the taxing state must determine, in some acceptable manner, the amount of income earned or otherwise attributable to the taxing state. There are two basic methods to assign income to the taxing state - separate accounting and formulary apportionment.

Separate Accounting

This method computes the amount of corporate income attributable to the state based solely upon income realized and expenses incurred within the taxing state. In the early 20th century, this was the favored method by states. However, as multistate corporations became more complex and vertically integrated, states adopted formulas to measure and apportion income. No state currently uses separate accounting as the preferred method of assigning income except in certain circumstances.

States moved to apportionment primarily because separate accounting produced results that were imprecise and arbitrary. Furthermore, separate accounting was extraordinarily difficult to administer for vertically integrated businesses due to the innumerable intercompany transactions between business segments. Under separate accounting, taxpayers have an incentive to overstate expenses and understate income within the taxing jurisdiction. Administrators were faced with complex and litigious audits geared toward scrutinizing intercompany transactions under an arm's length standard. Today, the administration of a broad based corporate income tax on a separate accounting basis would be nearly impossible in terms of the resources required to effectively monitor intercompany transactions.

Formulary Apportionment

In response to the difficulties of administering separate accounting, the states began to devise formulas whereby a portion of the *total* net income of a corporate business could be attributed to the taxing jurisdiction based upon the factors of profitability – that is the business inputs that gave rise to the income.

Early apportionment formulas used only one factor – property. States soon realized this produced distorted results by giving too much weight to manufacturing activity and not enough to the selling activity. Several states expanded the formula to include payroll and sales. The “*three factor formula*” was eventually incorporated into the Uniform Division of Income for Tax Purposes Act (“UDITPA”).

19 states have adopted UDITPA as the exclusive or optional method of apportionment, 24 states have adopted UDITPA with some changes or have adopted a similar method.

Alaska adopted UDITPA in 1970 and it appears in AS 43.19.

AS 43.20.065 makes the apportionment provisions of AS 43.19 mandatory for all multistate businesses in Alaska.

The Apportionment Formula

The standard UDITPA formula is the average of the property, payroll and sales factor and is expressed as:

$$\frac{\text{Property in State} + \text{Payroll in State} + \text{Sales in State}}{\text{Property Everywhere} + \text{Payroll Everywhere} + \text{Sales Everywhere}} \div 3$$

The above formula weights the factors equally. Some states double weight the sales factor and some states use a single sales factor.

The Income Base – “Business Income” of a “Unitary Business”

Before the apportionment formula can be applied, there are two overriding constraints to apportionment.

First, case law has determined that the formula can only be applied to a unitary business. A unitary business, as the name implies, functions as single economic unit. If the business activity within the state is separate and distinct from the rest of the business, then formulary apportionment is inappropriate.

Second, the nature of the income to be apportioned must be considered. Not all income of the unitary business should be apportioned – only “*business income*”. Under the rules of apportionment, business income is the income that bears a reasonably close relationship to the central business of the unitary group. “*Non-business income*” is

that income that is only remotely connected to the central business. Non-business income is not apportioned, but rather is allocated to the state where the property or business activity is located.

Business income is sometimes referred to as "*apportionable income*" as it is the income to which apportionment factors are applied. Non-business income is often called "*allocable income*".

AS 43.19 adopts the current UDITPA definition of business income at Article IV, 1(a):

"Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property is constitute integral parts of the taxpayer's trade or business operations."

The Combined Report

When determining the extent of unitary business, states disregard the separate legal existence of separately incorporated affiliates. When a group of corporations conduct a single unitary business, states combine the incomes of the separate corporations (eliminating the intercompany transactions within the group) to arrive at the unitary business income subject to apportionment. The apportionment factors are computed in a similar fashion. This process is referred to as "*combination*" and the return filed under this method referred to as the "*combined report*" or "*combined return*".

AS 43.20.065 mandates the use of combined reporting and apportionment.

Separate Reporting

A few states do not require or allow a combined report. These states honor the separate corporate boundaries (and the underlying "separate accounting" used to determine the separate corporation's income). These states still apportion the income of the separate corporation when the corporation does business in more than one state. This method is usually referred to as "*separate reporting*" and taxpayers file "*separate company reports*".

Tests for Unity

Formulary apportionment is tied to the concept of unity because the inputs to the formula come from only the branches or affiliated corporations that make up the unitary group. That is to say, the income and factors of non-unitary corporations or businesses simply are not part of the formula. Therefore, it is critically important that the extent of the unitary business be defined and with this question there has been considerable litigation that has produced several definitions that should, in theory, produce the same results.

Many courts recite the tests contained in *Butler Bros.* an early California case. There, the court set forth the "*three unities test*":

1. Unity of ownership (i.e. the enterprise is linked by common ownership, usually the parent company owning a controlling interest in the common stock such that the parent controls the operations of the subsidiary).
2. Unity of operation, as evidenced by central purchasing, advertising, accounting, and management divisions.
3. Unity of use, evidenced by a centralized executive force and general system of operation.

More recently, courts have expressed the unity criteria as functional integration, centralization of management and economies of scale. Regardless of how the tests are expressed, the concept is that there are flows of value within the business segments, the unitary business operates as a single economic unit, and the parts of the enterprise are inextricably linked and dependent upon each other.

The classic example of a unitary business is the fully integrated oil and gas company that explores for oil and gas, produces and refines it, and ultimately sells fuels and other petroleum products to consumers. Each of those activities is dependent upon the other, and each contributes to overall operations of the company.

Alaska's Tax Base – Federal Taxable Income with Modifications

Regardless of whether the income in question is business or non-business income, the states must set out the rules to measure the income. Most states conform to the Internal Revenue Code ("IRC" or "the Code") to some degree.¹ Alaska links itself very closely to the federal statutes by the adoption of most of the Internal Revenue Code.²

A major departure from the IRC is that Alaska, like most states, does not allow a deduction for taxes based on or measured by net income. Alaska also does not allow a foreign tax credit.

Worldwide Apportionment

During the 1970's, states applied the apportionment factors to the total worldwide income of the business. Worldwide apportionment was controversial because:

1. Applying property and payroll factors on a worldwide basis can distort the amount of income apportioned to the state in light of vastly different wage rates and property costs in developing countries.
2. It is difficult to convert foreign books and records to a format acceptable to the states.
3. States had difficulty accessing foreign books and records for audit.

Companies domiciled in the UK and Japan were particularly vocal in their criticism of worldwide apportionment. These countries made it clear that states that did not employ

¹ California is a notable exception. California has written its own "Internal Revenue Code".

² See AS 43.20.021.

worldwide apportionment would be favored sites for investment. Also, the U.S. State Department under President Reagan strongly criticized worldwide apportionment.

We should note that the U.S. and its trading partners generally follow separate accounting and treaties when determining taxable income at the national level. For example, the IRC taxes the entire income of a U.S. corporation and addresses potential double taxation by allowing a foreign tax credit. No country has adopted a formulary apportionment method.

Water's Edge Apportionment (AS 43.20.073)

California is the recognized leader in developing multistate apportionment legislation and case law and California has long been aggressive in asserting worldwide apportionment. However, in response to the economic and political pressure, California enacted "*water's edge*" legislation whereby taxpayers may elect to combine only those corporations that do business in the U.S. Other states followed with similar rules. Alaska was one of the final holdouts, enacting water's edge legislation in 1991. Alaska's water's edge combination is not available to oil and gas taxpayers.

History of Oil and Gas Corporate Income Tax

Before 1978, no special rules existed for oil and gas corporations – they filed using worldwide apportionment using the standard three factors of property, payroll and sales.

Based upon the belief that the standard factors did not fairly or fully represent the income producing activities and income of oil and gas producers in Alaska, the legislature enacted AS 43.21. This required oil and gas producers and pipeline companies to compute their Alaska taxable income on a separate accounting basis, which greatly increased their tax liabilities. The hallmarks of this statute were:

- Since virtually no oil was actually sold in Alaska, oil produced was considered to be gross income, measured by the value of the oil at the point of production.
- Direct operating costs were deductible.
- General Overhead and Administrative expenses were allocated.

The Alaska oil and gas industry promptly sued the state arguing that AS 43.21 was unconstitutional. Faced with protracted litigation and the potential for huge corporate tax refunds, the legislature looked for alternatives to AS 43.21 and settled upon modifications to standard apportionment effective in 1982.³ Those provisions are in AS 43.20.072.

Special Apportionment – Oil and Gas Producers and Pipelines (AS 43.20.072)

The highlights of AS 43.20.072 are:

- .072 applies to corporations that produce oil or gas in Alaska or own regulated pipelines in Alaska.
- The apportionable income base is worldwide income with adjustments:

³ The Alaska Supreme Court ultimately upheld AS 43.21 with a decision issued in 1985.

Cost depletion is mandatory (percentage depletion disallowed).
Intangible drilling costs capitalized (IRC allows partial write-off).
Slower depreciation methods required (Accelerated Cost Recovery not allowed).

- Standard three factor apportionment modified to: Property, Extraction, and Sales (extraction factor replaces payroll factor).
- "Extraction factor" is oil and gas produced in Alaska divided by oil and gas produced worldwide.
- The sales factor includes intercompany tariffs (normally intercompany transactions are eliminated in combination).

Some Important Alaska Court Cases

1. Unity – Earth Resources

The Alaska Supreme Court found that seemingly diverse business enterprises were nonetheless a unitary business. Earth Resources Company (ERC), the parent company, was domiciled in Texas. ERC's subsidiaries owned and operated a refinery in Tennessee, marketed gasoline, transported crude oil, and conducted mining operations. In Alaska, ERC formed Earth Resources Company of Alaska (ERCA) with the intent that ERCA would build and operate a refinery. ERCA had some minority shareholders. At a time when the Alaska refinery had not been built and was not producing revenue, ERC sought to find some source of income. ERCA, with the help of ERC, purchased a local paving company, which was very profitable and contributed most of ERCA's income during the tax years involved.

The Court found that the companies exhibited sufficient functional integration, centralization of management and economies of scale to support a finding of unity.

2. Business Income and Adoption of the Internal Revenue Code – OSG Bulkships

This case addressed the situation where combination and apportionment rules collide with the sourcing of income provisions of the IRC. The Court set forth the general principle that Alaska's adoption of the IRC and its sourcing rules, take a back seat to the worldwide combination and apportionment provisions (then worldwide) under AS 43.20.065.

Overseas Shipholding Group (OSG) through its subsidiaries owned and operated a fleet of U.S. and Foreign flagged vessels used in variety of shipping operations worldwide. OSG had organized such that a U.S. corporations owned and operated the domestic vessels and a foreign organized corporation owned and operated the foreign flagged vessels. The U.S. parent corporation through its subsidiaries owned and chartered vessels that entered Alaska waters to transport ANS crude oil.

Under IRC section 883, foreign flagged vessels are exempt from U.S. income tax if the country of registry provides a similar exemption for U.S. vessels. Consequently, OSG did not include the corporations that owned the foreign vessels in its Alaska combined return.

The Court recognized the fundamental difference between the federal source-based tax system and the UDITPA apportionment method. The Court noted that Alaska statutes adopt the IRC unless modified or excepted to by a specific provision in Alaska law. The court viewed IRC section 883 as an income-sourcing rule that was excepted to in the adoption of combination and apportionment at AS 43.20.065, and ruled that the foreign corporations should be included in the combined group.

It is interesting to note that within months of this decision, the Alaska legislature, under heavy lobbying pressure from the cruise ship industry, amended AS 43.20.021(a) to adopt IRC 883. Since most of the vessels in the Alaska cruiseship industry are foreign flagged, currently the industry is effectively exempt from Alaska income tax.

With respect to business income, the Court found that OSG's investment companies generated investment income, not operational income and therefore the income was non-business income and should not have been included in apportionable income.

3. Foreign Income Tax – *Gulf Oil Corporation* (1988)

Gulf Oil Corporation, like many oil companies today, find themselves paying arguably exorbitant income taxes to OPEC countries and other oil producing countries. Audit included these taxes in apportionable income relying on AS 43.20.031(c).

Gulf argued that Alaska should follow the federal rules concerning foreign taxes. Federally, a taxpayer can elect to either deduct the payments in their entirety⁴, or a taxpayer can elect to take the tax as a credit. If the taxpayer elects to take a federal credit, the taxpayer must follow the rules of IRC section 901 that restrict the amount of the payment that is creditable. Understandably, the U.S. treasury does not want to subsidize a foreign government's tax take with unlimited foreign tax credits; therefore the 901 regulations start with the presumption that the levy is not an income tax and place the burden on the taxpayer to prove that the levy is an income tax. The 901 regulations provide for a safe harbor calculation that essentially allows a credit equal to what would have been paid to the U.S. federal government rather than the actual tax payment to the foreign government. Gulf

⁴ Virtually any payment to the foreign country save for a bribe, is deductible federally as a business expense, so the characterization of a payment as a royalty, production payment, or income tax is irrelevant.

argued that the Alaska tax addback should be the amount available for U.S. credit, not the total amount of income tax paid to the foreign government.

The Court rejected Gulf's logic, first noting AS 43.20.036 (no foreign tax credit) is an Alaska exception to the adoption of the federal 901 regulations – they simply don't apply. The Court also rejected the notion that Alaska should adopt a federal rule that explicitly is intended to make a levy difficult to characterize as an income tax. The adoption of such a rule would foster tax avoidance.

Alaska Department of Revenue - Income and Excise Audit Division
Overview of Alaska Corporation Net Income Tax - AS 43.20
January 14, 2003
By Mark Graber, Audit Manager

Taxpayers

Alaska taxes the net income of all corporations doing business in the state. There are two exceptions. Insurance companies pay an insurance premium tax instead of income tax. Corporations recognized under Subchapter S of the Internal Revenue Code are generally exempt.

Apportionment Determines Alaska Taxable Income

Corporations doing business both within and outside Alaska apportion a part of their total business income to Alaska by a formula. The formula uses an average of certain ratios ("apportionment factors") that reflect income-producing activity in Alaska as compared to activity everywhere. Taxpayers multiply total business income by the apportionment factor to determine Alaska taxable income. Corporations doing business solely in Alaska pay tax on all their income.

Apportionment Formulas - Oil and Gas Extraction v. Payroll

The standard apportionment formula uses property, payroll, and sales. Oil and gas corporations use an extraction factor (oil and gas produced in Alaska vs. everywhere) instead of the payroll factor. Alaska considers the extraction factor a better measure of business activity in Alaska for oil and gas companies, and the extraction factor increases the tax as compared to using the payroll factor.

Business Income - Water's Edge and Worldwide Apportionment

Before 1991, Alaska required all corporations to apportion a part of their worldwide income to Alaska. In 1991, Alaska enacted "water's edge" legislation. Under the water's edge method, taxpayers apportion only U.S. income. This generally lowers the tax. The water's edge rules apply to all corporations except oil and gas producers and pipelines; they continue to apportion a part of worldwide income to Alaska.

Business Income - Special Rules for Oil and Gas.

Alaska uses the Internal Revenue Code with some modifications to determine business income. One major modification is that corporations cannot deduct net income taxes paid. Other rules accelerate tax payments and apply only to oil and gas companies. These rules deal with intangible drilling costs, depletion, and depreciation methods.

Tax Rates

The same graduated tax rate schedule applies to all corporations. The highest rate is 9.4% and applies to taxable income over \$90,000.

Corporation Tax Collections - 80% from Oil and Gas

Table 2 of the FY 02 Income and Excise Audit Division Annual Report shows total tax collections from oil and gas companies as compared to all other corporations. During FY

00 through FY 02, the Division collected \$848.4 million in corporate income taxes. Oil and gas corporations paid over \$679 million - over 80% of the total.

Corporation Tax Collections - the other 20%

Most of Alaska's small businesses pay no corporation tax because they are able to elect Subchapter S status under the Internal Revenue Code. Alaska law exempts S-corporations, but unlike the federal system, does not impose personal income tax on the flow through of corporate profits to shareholders. A main requirement for Subchapter S status is a limited number of shareholders. Publicly traded companies cannot elect Subchapter S status. In FY 02, approximately 14,900 non-oil and gas corporations filed tax returns. 5,800 S-Corporations filed in FY 02 - over one-third have the total non-oil and gas filings.

Most of the non-oil and gas corporate tax revenue comes from large, publicly traded, multistate and multinational corporations. These corporations include the national retail stores, communications providers, seafood processors, airlines, and construction companies.

CORPORATION INCOME TAX
AS 43.20

Description

Alaska levies the corporate net income tax on net income of corporations that have nexus and derive income from sources within Alaska. Corporations compute their tax liability based on federal taxable income with Alaska adjustments.

Alaska uses an apportionment method to determine the portion of income that is taxable in the state. Corporations other than oil and gas apportion their income to Alaska by using a three-factor formula based on sales, property and payroll. Taxpayers determine Alaska taxable income by applying the apportionment factor to the corporation's modified federal taxable income.

Multistate oil and gas corporations apportion income on a worldwide apportionment method. Other multistate corporations apportion income to Alaska under a "water's edge" apportionment method. A corporation engaged in business solely in Alaska computes its tax liability on 100% of its taxable income.

Rate

Corporation tax rates increase from 1% to 9.4% in \$10,000 increments of Alaska taxable income. The maximum rate of 9.4% applies to income over \$90,000.

Returns

Corporations file returns annually. Tax payments are due two and a half months from the close of the fiscal year. Taxpayers must remit tax payments over \$150,000 by wire transfer or electronic funds transfer (EFT). The payment due date may not be extended.

Tax returns are due three and a half months after the close of the fiscal year. Corporations may extend their filing due date by six months.

Example: The filing due date for calendar year corporations is April 15. Corporations may extend their filing due date to October 15. In any case, payment is due March 15.

Corporations make quarterly estimated tax payments based on past activity and the current year's accrued tax liability. Taxpayers must remit estimated

payments over \$100,000 by wire transfer or electronic funds transfer (EFT).

Exemptions

S-corporations and LLCs are generally exempt from corporation income tax and are treated as partnerships for Alaska tax purposes. Electric and telephone cooperatives, which are required to pay cooperative taxes under AS 10.25, are also exempt.

Credits

Education - Taxpayers who make contributions for educational purposes to accredited Alaska universities or colleges may take a tax credit for 50% of the first \$100,000 and 100% of the next \$100,000 of contributions. The maximum credit is \$150,000 per tax year.

Minerals Exploration Incentive - Taxpayers may take a credit for 100% of eligible costs of exploration activities related to determining existence, location, extent, or quality of a locatable mineral or coal deposit. An approved minerals exploration incentive credit may not exceed \$20 million and must be applied within 15 tax years after the taking of the credit is approved. Application of the credit is limited to 50% of the lesser of the taxpayer's mining license tax liability or 50% of the taxpayer's total corporation net income tax liability.

Oil and Gas Exploration Incentive - Taxpayers may take a credit for up to 50% on state land (or 25% on non state lands) of eligible oil and gas exploration costs. An approved oil and gas exploration incentive credit may not exceed \$5 million per project and is limited to \$30 million per taxpayer. Taxpayers may apply the credit against 100% of corporation net income taxes due.

Alaska Veterans' Memorial Endowment. This bill provides credits of up to 50 percent for contributions of not more than \$100,000 and 75 percent of the next \$100,000 in contributions made to the Veterans' Memorial Endowment Fund. Taxpayers may not use a contribution claimed as a credit for more than one tax type. Also, when combined with credits for contributions to qualifying educational institutions, credits may not exceed \$150,000. These credits cannot exceed 50 percent of a taxpayer's tax liability.

CORPORATION INCOME TAX

2003 - *Gas Exploration and Development Tax Credit* allows a corporate income credit for 10 percent of qualifying expenditures incurred in exploration and development of natural gas reserves in Alaska, except for the North Slope.

Disposition of Revenue

The Division deposits revenue derived from corporation net income taxes into the General Fund except as noted below.

For oil and gas corporations only, the Division deposits into the Constitutional Budget Reserve fund those revenues received as a result of a tax assessment issued by the Division.

History

The corporation net income tax dates back to 1949 when the territorial legislature enacted the "Alaska Net Income Tax Act". The Act imposed a flat tax of 10% of the corporation's federal income tax liability.

1957 - Tax rate was increased to 18%.

1975 - Original income tax act repealed and an income tax act based on taxable income rather than federal tax liability was enacted. The tax was equal to 5.4% of taxable income with a surtax of 4% based on federal surtax exemptions. For 1975, the federal surtax exemption was \$50,000.

1978 - Oil and gas corporations required to calculate taxable income based on a "separate accounting" method requiring the corporations to account for Alaska activity only in determining taxable income (AS 43.21).

1981 - Separate accounting (AS 43.21) was repealed and the modern corporation tax rate structure was adopted (1% - 9.4%). With repeal of AS 43.21, all corporations file returns using worldwide combined reporting and use the same tax rate structure.

1984 - The legislature adopted the special industrial incentive investment tax credit.

1987 - Alaska education credit was authorized.

1991 - Alaska's legislature enacted a bill requiring corporations, except for oil and gas corporations, to calculate taxable income based on the "water's edge" combined reporting method. Oil and gas corporations continue to use the worldwide combined reporting method. Also, the legislature increased the Alaska education credit maximum from \$100,000 to \$150,000.

1994 - Alaska's legislature authorized the Oil and Gas Exploration Incentive Credit. The legislature limited the credit to \$30 million and provided that taxpayers may apply the credit to 100% of corporation taxes due.

1995 - Alaska's legislature authorized the minerals exploration incentive credit. The legislature limited the credit to \$20 million and taxpayers may apply it against 50% of corporation taxes due over a 15-year period.

1995 - Alaska's legislature enacted a bill exempting foreign cruise ship and airline companies from tax.

2002 - Alaska Veterans' Memorial Endowment provides credits of up to 50 percent for contributions of not more than \$100,000 and 75 percent of the next \$100,000 in contributions made to the Veterans' Memorial Endowment Fund. The tax credit provisions will sunset on July 1, 2003.

2002 - The Oil and Gas Exploration Incentive Credit extends the exploration incentive tax credit to June 30, 2007.

2003 - Legislation authorized the Gas Exploration and Development Tax Credit.

FY 2003 Statistics on following page.

CORPORATION INCOME TAX

FY 2003 Statistics**Tax Collections – Oil and Gas Corporations**

General Fund	\$151,088,300
CBRF	17,221,507
Total	168,309,807

Number of Returns	62
Number of Taxpayers	28

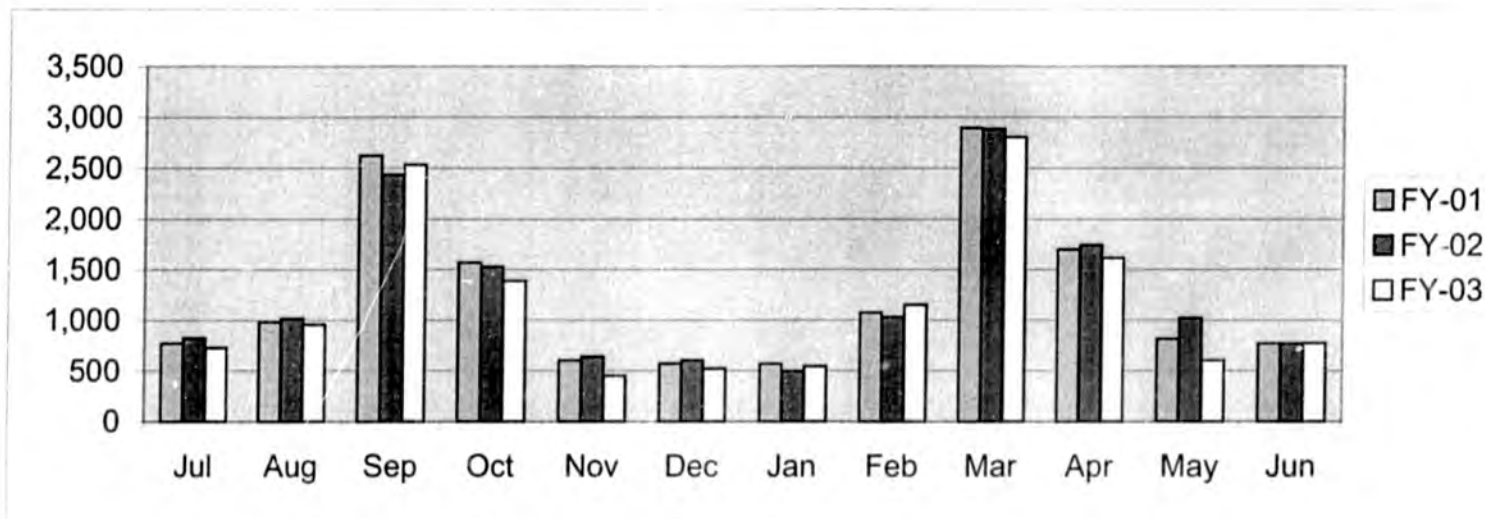
Program Cost	\$624,274
Staffing (<i>full-time equivalent</i>)	7.7

Tax Collections – Other Corporations

General Fund	\$47,712,454
Number of Returns	14,015
Number of Taxpayers	11,618

Program Cost	\$1,108,317
Staffing (<i>full-time equivalent</i>)	18.8

Chart 3
Corporations Filing Activity
For Fiscal Years 2001, 2002 and 2003
Number of Returns Filed by Month



Fiscal Year	FY 2003	FY 2002	FY 2001
Total Returns Filed	14,077	14,997	14,940

Detail of FY 2002 Filing Activity

Entity Type	Original	Amended	NOL*	Incomplete	Total
Subchapter C	6,089	655	377	449	7,570
Subchapter S	5,815	37	3	0	5,855
Exempt	138	7	7	0	152
Homeowners Assoc.	437	1	0	0	438
Oil & Gas	23	39	0	0	62
Total	12,502	739	387	449	14,077

*Net operating loss carryback

Table 5
Corporation Tax Liabilities Statistics

Tax liabilities reported on original returns filed in FY03

<u>Tax Liability Reported</u>	<u>Oil and Gas Corporations</u>			<u>Other than Oil and Gas Corporations</u>			<u>All Corporations</u>		
	<u># Filers</u>	<u>Amount</u>	<u>% Total</u>	<u># Filers</u>	<u>Amount</u>	<u>% Total</u>	<u># Filers</u>	<u>Amount</u>	<u>% Total</u>
Above \$1 million	6	\$212,799,442	98.45%	7	\$15,860,374	37.54%	13	\$228,659,816	88.49%
\$500,000 - \$1 million	4	2,626,401	1.22%	9	6,167,428	14.60%	13	\$8,793,829	3.40%
\$100,000 - \$499,999	3	647,462	0.30%	46	11,207,643	26.53%	49	\$11,855,105	4.59%
\$50,000 - \$99,999	1	70,863	0.03%	46	3,216,772	7.61%	47	\$3,287,635	1.27%
\$10,000 - \$49,999	0	0	0.00%	171	4,094,816	9.69%	171	\$4,094,816	1.58%
\$1,000 - \$9,999	1	1,725	0.00%	417	1,445,887	3.42%	418	\$1,447,612	0.56%
\$100 - \$999	1	219	0.00%	560	226,925	0.54%	561	\$227,144	0.09%
\$1 - \$99	1	38	0.00%	904	26,515	0.06%	905	\$26,553	0.01%
Zero Tax	6	0	0.00%	10,319	0	0.00%	10,325	\$0	0.00%
Total	23	\$216,146,150	100.00%	12,479	\$42,246,360	100.00%	12,502	\$258,392,510	100.00%

Note: Amounts reflect tax liabilities reported on the taxpayer original returns. Liabilities may differ from amounts remitted by the taxpayer during the fiscal year due to timing differences resulting from estimated tax payments, credits and final payment of taxes reported.

Alaska's Petroleum Revenues — An Overview

The Elements of Alaska's Petroleum-Revenue System.

Oil and Gas Production Tax (also called "severance tax") (AS 43.55):

The tax is levied as a percentage of the netback (or wellhead value) in the field, with the exact percentage depending on the "economic limit factor" (ELF) for each field. The netback equals the market price minus transportation costs (tanker, pipeline). In times of very low prices, "floor" rates of 80¢ a barrel and 6.4¢ per Mcf (1,000 cubic feet) become applicable, and these are also adjusted by the ELF.

There are also two conservation surcharges on taxable oil. One is 3¢ a barrel and is always in effect, and the other is 2¢ and operates only when there is less than \$50 million in the Oil and Hazardous Substance Release Prevention and Response Fund. The ELF does not apply to either surcharge.

During FY 2003, \$588 million in production tax was paid to the state of Alaska, and another \$11 million in surcharges.

Royalty (arises from individual oil and gas lease contracts):

The "landowner's share," royalty is not a true tax but a contractual obligation, like rent, that is paid to the landowner for the use of the land. In this case the landowner is the state instead of a private person. If the state elects to take its royalty in value, the royalty payment is based on a netback similar to the severance tax. When the state takes its royalty in kind, it sells the physical oil or gas to a purchaser who receives it at the same point where it is deliverable to the state — namely, the meter into the pipeline.

During FY 2003, \$1,278.7 million in oil and gas royalties was paid to the state of Alaska, of which \$403.8 million was deposited into the Permanent Fund.

Oil and Gas Property Tax (AS 43.56):

The annual state property tax is 20 mills per dollar (2%) of the assessed value on oil and gas production property and pipelines. Refineries, LNG plants and gas utility pipelines are excluded. This tax is shared with municipalities where the taxable property is located. Each municipality levies its own property tax at the same rate as for other taxable property, and the local tax payment is credited against the tax owed to the state.

During FY 2003, \$268.9 million in oil and gas property tax was paid, of which \$48.7 million was paid to the state and \$220.4 million to municipalities — North Slope Borough, \$194.2 million; Valdez, \$13.2 million; Kenai Peninsula Borough, \$7.7 million; Fairbanks North Star Borough, \$4.4 million; and Anchorage, \$2.8 million. The Matanuska-Susitna Borough and the cities of Whittier and Cordova also received small shares.

Oil and Gas Corporate Income Tax (AS 43.20):

All taxpayers under this tax, not just oil companies, determine their taxable Alaskan income using apportionment, in which an Alaskan "slice" is cut from the whole "pie" of a business's income and taxed by the state. For everyone except oil companies, the pie is their income earned in the United States and the width of their Alaskan slice is based on their in-state percentages of U.S. property, sales and payroll. For oil companies, the pie is their worldwide income and the width of their Alaskan slice is based on their in-state percentages of worldwide property, sales and production. The same rates of tax apply to oil companies' taxable Alaskan income as to all other corporations' taxable Alaskan income.

During FY 2003, oil companies paid \$151.1 million in corporate income tax to the state of Alaska. Non-petroleum companies paid \$47.7 million.

How the Pieces Fit Together.

Alaska's system of petroleum revenues is like a three-legged stool. Each of the legs is a particular kind of tax that responds differently to changing economic circumstances.

Severance tax and royalty are linked to market prices.

One leg is the state severance tax and royalty, which are linked directly to market prices because both are based on a netback (or wellhead price) equal to the market price minus the cost of getting the production to market. These revenues respond quickly to price and market changes. They increase directly when prices climb or production increases, and fall when prices fall or production declines.

Property tax is less sensitive to market changes.

A second leg is the state property tax on oil and gas production and pipeline property. Like all property taxes, this tax is based on the long-term value of the taxable property, which is much less sensitive to volatile short-term fluctuations in energy prices than production tax and royalty.

Income tax hedges against regional market conditions affecting Alaska, by looking at worldwide business performance.

This third and final leg considers the worldwide income of an oil company's entire business, not just Alaska, and then carves out an Alaskan "slice" of this worldwide income "pie." This worldwide approach allows Alaska to include in the measure of the tax due a portion of a corporation's profits, for example, from a new discovery in the North Sea or South America, as well as to include part of the profits from "downstream" refining and marketing Outside. Even when prices are low and the Alaskan part of the business may only be breaking even, part of the profits being earned elsewhere are attributed to the Alaskan business to calculate the tax.

These three legs aren't equal, of course. The state gets most of its petroleum revenue from the severance tax and royalties. But the petroleum corporate income tax generates significant tax revenues, as does the property tax, and these both tend to have a softening effect when there is volatility in crude oil markets and big swings in severance tax and royalty collections.

A Two-Page History of Alaska's Oil and Gas Taxes.

Alaska enacted its first oil and gas tax — the production tax with a 1% rate — back in Territorial days in 1955 just as federal lands on the Kenai Peninsula were being opened up to oil and gas leasing for the first time. Drilling on those leases led to the discovery of oil at Swanson River in 1957, which proved pivotal in persuading Congress to pass the Alaska Statehood Act the next year. Tidelands and submerged lands in Cook Inlet that Alaska received at Statehood were soon leased, and in late 1965 the first offshore oil field in the Inlet came into production, with three more in 1967. The Fairbanks flood in August 1967 led to the passage of a 3% "Disaster Severance Tax" by a Special Session of the Legislature that fall — the first change in Alaska's petroleum taxes since 1955.

The discovery at Prudhoe Bay was announced in 1968, and on September 10, 1969 additional state lands there and nearby were leased for \$900 million in bonuses. The magnitude of these events transformed Alaska, and it began a decade of tinkering with its petroleum taxes trying to tailor them to this supergiant field. Historically, the most important of these tinkering were:

Oil and Gas Property Tax (current AS 43.56)

The state property tax was enacted in 1973 as part of a package of legislation passed in a Special Session to end litigation threatening to delay the start of construction of the trans-Alaska pipeline. The provisions for municipalities to tax the same property were a compromise to win their support since they had successfully blocked legislation for a state property tax without municipal-sharing in 1972.

Oil and Gas Reserves Tax (former AS 43.58)

In 1975 Alaska faced a fiscal emergency because of the delays in starting construction of the trans-Alaska pipeline, and as a result state revenues from Prudhoe Bay had not yet materialized to replace the \$900 million from 1969, which was nearly all spent. To fill the gap, the state enacted a temporary two-year tax on oil and gas reserves. This tax succeeded through the cooperation of the North Slope companies paying it, and they cooperated because they could apply their full reserves tax payments as credits against their future production taxes. The tax was collected in 1976 and 1977 and then ceased to operate by its own terms, and it was eventually repealed in 1986 well after all the credits against production taxes had been taken.

Separate Accounting Income Tax (former AS 43.21)

In 1978 the state removed oil companies from the slice-of-the-pie apportionment system that applied to all other taxpayers, and put them under a separate-accounting system to determine the amount of income from their Alaskan businesses. Due to a combination of extremely high oil prices (\$40 a barrel) and extremely low operating costs at the start of Prudhoe Bay's productive life, the amount of taxable income — and hence the amount of tax — was considerably higher under separate accounting than it was under apportionment. There was already litigation over separate accounting in Wisconsin and Vermont, and soon suit was filed over Alaska's tax. In 1980 the Wisconsin and Vermont cases were decided by the U.S. Supreme Court, which ruled both times against separate accounting — going so far as to say in one decision that separate accounting is "theoretically incommensurable" with apportionment, which the Court upheld in both cases.

Because taxpayers had wanted separate accounting in those cases, state officials at the time believed the two decisions did not mean Alaska's separate-accounting law was invalid. But they felt the state should not take the risk of keeping separate accounting on the books during the litigation and letting its exposure grow by a billion dollars a year. So in 1981 separate accounting was repealed and replaced with the current version of slice-of-the-pie apportionment, which limited the state's exposure to the \$2 billion already collected. The state supreme court upheld the separate-accounting law in 1985, and the U.S. Supreme Court declined to hear an appeal from that decision.

The ELF (Economic Limit Factor)

The ELF is a formula in the production tax that adjusts the tax rate for each field. As originally enacted in 1977, the ELF reduced the tax rate by looking at the percentage of the value of the production that is needed to cover the costs of producing that oil and gas. The more marginal a field is, the higher this percentage becomes and the smaller the ELF gets. The ELF becomes zero, and there is no tax, precisely when the cost percentage reaches 100 percent and the field is breaking even. The effect of the original ELF was to lower tax rates for Cook Inlet oil fields, which were already in decline and beginning to become marginal, while allowing the tax rate for Prudhoe Bay to be increased from about 7.9% to 12 percent.

In 1981 as part of the legislation repealing separate accounting, the ELF was suspended for Prudhoe Bay until it reached its tenth anniversary of production. At the same time the base rate for oil was increased from 12.25% to 15 percent for fields in production for more than five years. The purpose of suspending the ELF and raising the base rate was to offset most of the reduction the state's income tax revenue resulting from the switch from separate accounting back to apportionment. In June 1987 Prudhoe Bay reached its tenth anniversary and its production tax rate went from 15% to about 12.45%, which was still higher than the 11-11½% it had been in 1981 just before the enactment of the suspension.

In 1989 the oil ELF formula was changed to include a new factor, field size. The more a field produces, the bigger its ELF and the higher its tax rate. By the same token, small fields have low tax rates or no tax at all. The purpose of the change was to raise taxes for the state's two largest fields, Prudhoe and Kuparuk, while lowering taxes and to encourage development of smaller fields on the Slope, as well as fields with very thick oil like West Sak.

The present ELF is succeeding on both counts. Since 1989 the state has collected over \$2 billion in extra production tax from Prudhoe and Kuparuk because of the new ELF. At the same time, current and planned developments of small nearby fields (so-called satellite fields) will help offset the continuing production decline of those two giant fields, allowing overall North Slope production to remain basically flat over the 2001-2010 decade. The ELF's incentive for developing small fields contributes significantly to the economics of these satellites.

STATE OF ALASKA

DEPARTMENT OF REVENUE

OFFICE OF THE COMMISSIONER

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March 18, 2004

The Honorable Mike Hawker,
Chair, House Ways and Means Committee
Alaska House of Representatives
Alaska State Legislature
Juneau, Alaska

Dear Representative Hawker:

Dan Dickinson, Director of the Tax Division, asked me to deliver the attached information to you. The information he compiled is the result of testimony before the House Ways and Means Committee on February 25, February 27, and March 3, 2004, and requests of Mr. Dickinson to provide additional information.

Please contact me at 465-2302 if you have further questions, or if you need additional information.

Very truly yours,



Landa B. Baily
Special Assistant to
Commissioner Corbus

Attachment

Memo

To: Landa Baily
From: Dan E. Dickinson, Director
Date: 3/15/04
Re: House Ways and Means

Chuck Harlamert, Mike Williams and I testified before the House Ways and Means committee on February 25, 27th and March 3 2004. The committee requested and we supplied certain items. This package covers all the outstanding items:

From February 25

A matrix, like that presented in the Sources book, that shows not when the CBRF will be exhausted but when it will hit a balance of 1 billion dollars.

A breakout of elements in our forecast, like that presented for historical data in the Sources book, showing detail.

There was also a request for analysis of the effect of a head tax or sales tax that affected cruise ship passengers on our obligations to respect international commerce. We have no particular single document that presents such an analysis. We have worked closely with the DOL on this and suggest that they be asked to testify on this legal point if the committee wishes to pursue it.

Finally we were asked about material we had put together on alternative taxes in general and corporate taxes specifically, so I have pulled together the various "think pieces" from our sources book and a briefing paper that was put together last year for the new commissioner.

From March 3

We obtained the following statistics from DCED concerning the number of LLCs in Alaska:
There are 6,031 LLCs organized under Alaska law and 871 organized in other states but registered to do business in Alaska for a total of 6,902.

We were asked to investigate whether any other state had special taxes on freight that would be the equivalent of head taxes on the cruise industry. We could find none.

FALL2003 Revenue Source Book
General Fund Unrestricted Revenue

= OIL REVENUE

Pr Sub	Fall2003 Forecast projections =====>											
Category 2	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
UNRESTRICTED REVENUES												
Taxes												
Property	48.5	45.6	42.4	40.2	37.7	37.5	37.0	36.3	35.5	34.7	34.0	33.3
Sales/Use												
Alcoholic Beverage	15.7	15.7	15.7	15.7	15.7	15.7	15.7	15.7	15.7	15.7	15.7	15.7
Tobacco Products	16.3	16.7	16.8	16.8	16.8	16.8	16.8	16.8	16.8	16.8	16.8	16.8
Insurance Premium	42.6	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7	44.7
Electric and Telephone Cooperative	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Motor Fuel Tax	39.0	39.0	39.0	39.0	39.0	39.0	39.0	39.0	39.0	39.0	39.0	39.0
Vehicle Rental Tax	1.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0	6.0
Tire Fee	2.4	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Total Sale/Use	117.2	125.6	125.7	125.7	125.7	125.7	125.7	125.7	125.7	125.7	125.7	125.7
Income Tax												
Corporate General	49.0	53.7	53.7	53.7	53.7	53.7	53.7	53.7	53.7	53.7	53.7	53.7
Corporate Petroleum	220.0	195.0	179.0	172.0	164.0	157.0	150.0	143.0	135.0	128.0	121.0	113.0
Total Income	269.0	248.7	232.7	225.7	217.7	210.7	203.7	196.7	188.7	181.7	174.7	166.7
Severance												
Oil and Gas Production Inc. Exploration Credit	554.2	417.8	321.0	294.1	321.4	317.3	276.5	249.0	222.5	212.2	193.1	181.7
Oil and Gas Conservation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Oil and Gas Haz Release	9.4	9.3	9.2	9.1	9.2	9.1	9.1	9.0	9.0	8.8	8.5	8.0
Total Severance Tax	563.6	427.1	330.2	303.2	330.6	326.4	285.6	258.0	231.4	221.1	201.5	189.7
Other Resource Taxes												
Fisheries Business	8.3	10.3	10.3	10.3	10.3	10.3	11.8	11.8	11.8	11.8	11.8	11.8
Fishery Resource Landing	2.0	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6	2.6
Mining	0.7	1.3	1.3	1.3	1.3	1.3	1.3	1.5	1.7	1.7	1.7	1.7
Total Resources Tax	11.0	14.2	14.2	14.2	14.2	14.2	15.7	15.9	16.1	16.1	16.1	16.1
Other Taxes												
Estate	1.4	0.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Charitable Gaming	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Total Other Tax	3.9	3.2	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Total Taxes	1,013.2	864.4	747.7	711.5	728.5	717.0	670.2	635.1	599.9	581.8	554.5	534.0

FALL2003 Revenue Source Book
General Fund Unrestricted Revenue

= OIL REVENUE

Pr Sul Sub	Fall2003 Forecast projections =====>											
C&C Category 2	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Licences and Permits Unrestricted												
Motor Vehicle	43.5	45.9	46.4	46.8	47.3	47.8	48.2	48.7	49.2	49.7	50.2	50.7
Other	<u>2.0</u>	<u>2.0</u>	<u>2.0</u>	<u>2.0</u>	<u>2.0</u>	<u>2.0</u>	<u>2.0</u>	<u>2.0</u>	<u>2.0</u>	<u>2.0</u>	<u>2.0</u>	<u>2.0</u>
Total Licences & Permits	45.5	47.9	48.4	48.8	49.3	49.8	50.2	50.7	51.2	51.7	52.2	52.7
Charges for Services												
Marine Highways	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	<u>18.4</u>	<u>18.4</u>	<u>18.4</u>	<u>18.4</u>	<u>18.4</u>	<u>18.4</u>	<u>18.4</u>	<u>18.4</u>	<u>18.4</u>	<u>18.4</u>	<u>18.4</u>	<u>18.4</u>
Total Charges for Services	18.4	18.4	18.4	18.4	18.4	18.4	18.4	18.4	18.4	18.4	18.4	18.4
Fines and Forfeitures	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0	7.0
Rents and Resources												
Mineral Bonuses and Rents	12.1	16.1	28.0	16.8	12.4	14.0	14.0	14.0	14.0	14.0	14.0	14.0
NET Oil and Gas Royalties + interest paid	886.5	737.6	609.7	599.2	593.2	584.1	553.5	531.9	506.1	479.3	422.5	400.1
Timber Sales	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
NET Coal Rent and Royalties	0.8	0.8	0.8	0.8	0.8	0.9	0.9	0.9	0.9	0.9	0.9	0.9
Other Resource Revenue	<u>6.0</u>	<u>6.2</u>	<u>6.2</u>	<u>6.4</u>	<u>6.6</u>	<u>7.1</u>	<u>7.1</u>	<u>7.3</u>	<u>7.5</u>	<u>7.5</u>	<u>7.5</u>	<u>7.5</u>
Total Rents and Royalties	905.6	760.9	644.9	623.4	613.2	606.3	575.7	554.3	528.7	501.9	445.1	422.7
Investment & Interest Revenue	11.7	11.7	11.7	11.7	11.7	11.7	11.7	11.7	11.7	11.7	11.7	11.7
Other Miscellaneous	21.5	14.0	14.0	14.0	14.0	14.0	14.0	14.0	14.0	14.0	14.0	14.0
Total General Fund Unrestricted Revenue****	2,022.9	1,724.3	1,492.1	1,434.9	1,442.0	1,424.2	1,347.2	1,291.3	1,230.9	1,186.5	1,102.8	1,060.5
Total General Fund Unrestricted Revenue	2,022.9	1,724.3	1,492.1	1,434.9	1,442.0	1,424.2	1,347.2	1,291.3	1,230.9	1,186.5	1,102.8	1,060.5
Total Oil Revenue	1,730.7	1,421.4	1,189.3	1,131.5	1,137.9	1,119.0	1,040.1	983.3	922.0	877.1	792.9	750.1
Total Non-Oil Revenue	292.2	302.9	302.8	303.4	304.1	305.2	307.1	308.0	308.9	309.4	309.9	310.4

Commissioner Briefing
Corporate Income Tax Outline
February 2003

Limitations on the State's Power to Tax

"Nexus" is the legal shorthand that refers to the connection that a potential taxpayer has with a state that justifies and enables that state to impose tax. A corporation must have sufficient "nexus" with the state, by virtue of its business activities within the state, in order for a state to impose taxes.

Public Law 86-272 is a federal law that restricts the power of the states to impose income tax. If a business limits its activities in the state to the solicitation of orders for sales of tangible personal property, the business is immune from that state's income tax.

How States Determine Taxable Income for Corporations

Background

Under the Commerce and Due Process Clauses of the Constitution, states can only tax income that is earned within the taxing state. For a corporation that has no affiliated corporations and does business only in one state, the state can tax all of the corporation's income. If the corporation does business (i.e. has nexus) in more than one state, or is a member of group of corporations that collectively does business in more than one state, then the taxing state must determine, in some acceptable manner, the amount of income earned or otherwise attributable to the taxing state. There are two basic methods to assign income to the taxing state - separate accounting and formulary apportionment.

Separate Accounting

This method computes the amount of corporate income attributable to the state based solely upon income realized and expenses incurred within the taxing state. In the early 20th century, this was the favored method by states. However, as multistate corporations became more complex and vertically integrated, states adopted formulas to measure and apportion income. No state currently uses separate accounting as the preferred method of assigning income except in certain circumstances.

States moved to apportionment primarily because separate accounting produced results that were imprecise and arbitrary. Furthermore, separate accounting was extraordinarily difficult to administer for vertically integrated businesses due to the innumerable intercompany transactions between business segments. Under separate accounting, taxpayers have an incentive to overstate expenses and understate income within the taxing jurisdiction. Administrators were faced with complex and litigious audits geared toward scrutinizing intercompany transactions under an arm's length standard. Today, the administration of a broad based corporate income tax on a separate accounting basis would be nearly impossible in terms of the resources required to effectively monitor intercompany transactions.

Formulary Apportionment

In response to the difficulties of administering separate accounting, the states began to devise formulas whereby a portion of the *total* net income of a corporate business could be attributed to the taxing jurisdiction based upon the factors of profitability – that is the business inputs that gave rise to the income.

Early apportionment formulas used only one factor – property. States soon realized this produced distorted results by giving too much weight to manufacturing activity and not enough to the selling activity. Several states expanded the formula to include payroll and sales. The “*three factor formula*” was eventually incorporated into the Uniform Division of Income for Tax Purposes Act (“UDITPA”).

19 states have adopted UDITPA as the exclusive or optional method of apportionment, 24 states have adopted UDITPA with some changes or have adopted a similar method.

Alaska adopted UDITPA in 1970 and it appears in AS 43.19.

AS 43.20.065 makes the apportionment provisions of AS 43.19 mandatory for all multistate businesses in Alaska.

The Apportionment Formula

The standard UDITPA formula is the average of the property, payroll and sales factor and is expressed as:

$$\frac{\text{Property in State}}{\text{Property Everywhere}} + \frac{\text{Payroll in State}}{\text{Payroll Everywhere}} + \frac{\text{Sales in State}}{\text{Sales Everywhere}}$$

3

The above formula weights the factors equally. Some states double weight the sales factor and some states use a single sales factor.

The Income Base – “Business Income” of a “Unitary Business”

Before the apportionment formula can be applied, there are two overriding constraints to apportionment.

First, case law has determined that the formula can only be applied to a unitary business. A unitary business, as the name implies, functions as single economic unit. If the business activity within the state is separate and distinct from the rest of the business, then formulary apportionment is inappropriate.

Second, the nature of the income to be apportioned must be considered. Not all income of the unitary business should be apportioned – only “*business income*”. Under the rules of apportionment, business income is the income that bears a reasonably close relationship to the central business of the unitary group. “*Non-business income*” is

that income that is only remotely connected to the central business. Non-business income is not apportioned, but rather is allocated to the state where the property or business activity is located.

Business income is sometimes referred to as "*apportionable income*" as it is the income to which apportionment factors are applied. Non-business income is often called "*allocable income*".

AS 43.19 adopts the current UDITPA definition of business income at Article IV, 1(a):

"Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property is constitute integral parts of the taxpayer's trade or business operations."

The Combined Report

When determining the extent of unitary business, states disregard the separate legal existence of separately incorporated affiliates. When a group of corporations conduct a single unitary business, states combine the incomes of the separate corporations (eliminating the intercompany transactions within the group) to arrive at the unitary business income subject to apportionment. The apportionment factors are computed in a similar fashion. This process is referred to as "*combination*" and the return filed under this method referred to as the "*combined report*" or "*combined return*".

AS 43.20.065 mandates the use of combined reporting and apportionment.

Separate Reporting

A few states do not require or allow a combined report. These states honor the separate corporate boundaries (and the underlying "separate accounting" used to determine the separate corporation's income). These states still apportion the income of the separate corporation when the corporation does business in more than one state. This method is usually referred to as "*separate reporting*" and taxpayers file "*separate company reports*".

Tests for Unity

Formulary apportionment is tied to the concept of unity because the inputs to the formula come from only the branches or affiliated corporations that make up the unitary group. That is to say, the income and factors of non-unitary corporations or businesses simply are not part of the formula. Therefore, it is critically important that the extent of the unitary business be defined and with this question there has been considerable litigation that has produced several definitions that should, in theory, produce the same results.

Many courts recite the tests contained in *Butler Bros.* an early California case. There, the court set forth the "*three unities test*":

1. Unity of ownership (i.e. the enterprise is linked by common ownership, usually the parent company owning a controlling interest in the common stock such that the parent controls the operations of the subsidiary).
2. Unity of operation, as evidenced by central purchasing, advertising, accounting, and management divisions.
3. Unity of use, evidenced by a centralized executive force and general system of operation.

More recently, courts have expressed the unity criteria as functional integration, centralization of management and economies of scale. Regardless of how the tests are expressed, the concept is that there are flows of value within the business segments, the unitary business operates as a single economic unit, and the parts of the enterprise are inextricably linked and dependent upon each other.

The classic example of a unitary business is the fully integrated oil and gas company that explores for oil and gas, produces and refines it, and ultimately sells fuels and other petroleum products to consumers. Each of those activities is dependent upon the other, and each contributes to overall operations of the company.

Alaska's Tax Base – Federal Taxable Income with Modifications

Regardless of whether the income in question is business or non-business income, the states must set out the rules to measure the income. Most states conform to the Internal Revenue Code ("IRC" or "the Code") to some degree.¹ Alaska links itself very closely to the federal statutes by the adoption of most of the Internal Revenue Code.²

A major departure from the IRC is that Alaska, like most states, does not allow a deduction for taxes based on or measured by net income. Alaska also does not allow a foreign tax credit.

Worldwide Apportionment

During the 1970's, states applied the apportionment factors to the total worldwide income of the business. Worldwide apportionment was controversial because:

1. Applying property and payroll factors on a worldwide basis can distort the amount of income apportioned to the state in light of vastly different wage rates and property costs in developing countries.
2. It is difficult to convert foreign books and records to a format acceptable to the states.
3. States had difficulty accessing foreign books and records for audit.

Companies domiciled in the UK and Japan were particularly vocal in their criticism of worldwide apportionment. These countries made it clear that states that did not employ

¹ California is a notable exception. California has written its own "Internal Revenue Code".

² See AS 43.20.021.

worldwide apportionment would be favored sites for investment. Also, the U.S. State Department under President Reagan strongly criticized worldwide apportionment.

We should note that the U.S. and its trading partners generally follow separate accounting and treaties when determining taxable income at the national level. For example, the IRC taxes the entire income of a U.S. corporation and addresses potential double taxation by allowing a foreign tax credit. No country has adopted a formulary apportionment method.

Water's Edge Apportionment (AS 43.20.073)

California is the recognized leader in developing multistate apportionment legislation and case law and California has long been aggressive in asserting worldwide apportionment. However, in response to the economic and political pressure, California enacted "*water's edge*" legislation whereby taxpayers may elect to combine only those corporations that do business in the U.S. Other states followed with similar rules. Alaska was one of the final holdouts, enacting water's edge legislation in 1991. Alaska's water's edge combination is not available to oil and gas taxpayers.

History of Oil and Gas Corporate Income Tax

Before 1978, no special rules existed for oil and gas corporations – they filed using worldwide apportionment using the standard three factors of property, payroll and sales.

Based upon the belief that the standard factors did not fairly or fully represent the income producing activities and income of oil and gas producers in Alaska, the legislature enacted AS 43.21. This required oil and gas producers and pipeline companies to compute their Alaska taxable income on a separate accounting basis, which greatly increased their tax liabilities. The hallmarks of this statute were:

- Since virtually no oil was actually sold in Alaska, oil produced was considered to be gross income, measured by the value of the oil at the point of production.
- Direct operating costs were deductible.
- General Overhead and Administrative expenses were allocated.

The Alaska oil and gas industry promptly sued the state arguing that AS 43.21 was unconstitutional. Faced with protracted litigation and the potential for huge corporate tax refunds, the legislature looked for alternatives to AS 43.21 and settled upon modifications to standard apportionment effective in 1982.³ Those provisions are in AS 43.20.072.

Special Apportionment – Oil and Gas Producers and Pipelines (AS 43.20.072)

The highlights of AS 43.20.072 are:

- .072 applies to corporations that produce oil or gas in Alaska or own regulated pipelines in Alaska.
- The apportionable income base is worldwide income with adjustments:

³ The Alaska Supreme Court ultimately upheld AS 43.21 with a decision issued in 1985.

Cost depletion is mandatory (percentage depletion disallowed).
Intangible drilling costs capitalized (IRC allows partial write-off).
Slower depreciation methods required (Accelerated Cost Recovery not allowed).

- Standard three factor apportionment modified to: Property, Extraction, and Sales (extraction factor replaces payroll factor).
- "Extraction factor" is oil and gas produced in Alaska divided by oil and gas produced worldwide.
- The sales factor includes intercompany tariffs (normally intercompany transactions are eliminated in combination).

Some Important Alaska Court Cases

1. Unity – Earth Resources

The Alaska Supreme Court found that seemingly diverse business enterprises were nonetheless a unitary business. Earth Resources Company (ERC), the parent company, was domiciled in Texas. ERC's subsidiaries owned and operated a refinery in Tennessee, marketed gasoline, transported crude oil, and conducted mining operations. In Alaska, ERC formed Earth Resources Company of Alaska (ERCA) with the intent that ERCA would build and operate a refinery. ERCA had some minority shareholders. At a time when the Alaska refinery had not been built and was not producing revenue, ERC sought to find some source of income. ERCA, with the help of ERC, purchased a local paving company, which was very profitable and contributed most of ERCA's income during the tax years involved.

The Court found that the companies exhibited sufficient functional integration, centralization of management and economies of scale to support a finding of unity.

2. Business Income and Adoption of the Internal Revenue Code – OSG Bulkships

This case addressed the situation where combination and apportionment rules collide with the sourcing of income provisions of the IRC. The Court set forth the general principle that Alaska's adoption of the IRC and its sourcing rules, take a back seat to the worldwide combination and apportionment provisions (then worldwide) under AS 43.20.065.

Overseas Shipholding Group (OSG) through its subsidiaries owned and operated a fleet of U.S. and Foreign flagged vessels used in variety of shipping operations worldwide. OSG had organized such that a U.S. corporations owned and operated the domestic vessels and a foreign organized corporation owned and operated the foreign flagged vessels. The U.S. parent corporation through its subsidiaries owned and chartered vessels that entered Alaska waters to transport ANS crude oil.

Under IRC section 883, foreign flagged vessels are exempt from U.S. income tax if the country of registry provides a similar exemption for U.S. vessels. Consequently, OSG did not include the corporations that owned the foreign vessels in its Alaska combined return.

The Court recognized the fundamental difference between the federal source-based tax system and the UDITPA apportionment method. The Court noted that Alaska statutes adopt the IRC unless modified or excepted to by a specific provision in Alaska law. The court viewed IRC section 883 as an income-sourcing rule that was excepted to in the adoption of combination and apportionment at AS 43.20.065, and ruled that the foreign corporations should be included in the combined group.

It is interesting to note that within months of this decision, the Alaska legislature, under heavy lobbying pressure from the cruise ship industry, amended AS 43.20.021(a) to adopt IRC 883. Since most of the vessels in the Alaska cruiseship industry are foreign flagged, currently the industry is effectively exempt from Alaska income tax.

With respect to business income, the Court found that OSG's investment companies generated investment income, not operational income and therefore the income was non-business income and should not have been included in apportionable income.

3. Foreign Income Tax – *Gulf Oil Corporation* (1988)

Gulf Oil Corporation, like many oil companies today, find themselves paying arguably exorbitant income taxes to OPEC countries and other oil producing countries. Audi included these taxes in apportionable income relying on AS 43.20.031(c).

Gulf argued that Alaska should follow the federal rules concerning foreign taxes. Federally, a taxpayer can elect to either deduct the payments in their entirety⁴, or a taxpayer can elect to take the tax as a credit. If the taxpayer elects to take a federal credit, the taxpayer must follow the rules of IRC section 901 that restrict the amount of the payment that is creditable. Understandably, the U.S. treasury does not want to subsidize a foreign government's tax take with unlimited foreign tax credits; therefore the 901 regulations start with the presumption that the levy is not an income tax and place the burden on the taxpayer to prove that the levy is an income tax. The 901 regulations provide for a safe harbor calculation that essentially allows a credit equal to what would have been paid to the U.S. federal government rather than the actual tax payment to the foreign government. Gulf

⁴ Virtually any payment to the foreign country save for a bribe, is deductible federally as a business expense, so the characterization of a payment as a royalty, production payment, or income tax is irrelevant.

argued that the Alaska tax addback should be the amount available for U.S. credit, not the total amount of income tax paid to the foreign government.

The Court rejected Gulf's logic, first noting AS 43.20.036 (no foreign tax credit) is an Alaska exception to the adoption of the federal 901 regulations – they simply don't apply. The Court also rejected the notion that Alaska should adopt a federal rule that explicitly is intended to make a levy difficult to characterize as an income tax. The adoption of such a rule would foster tax avoidance.

SPRING 2000 REVENUE SOURCES BOOK

Alaska Department of Revenue
Tax Division

April 7, 2000



Tony Knowles, Governor
Wilson L. Condon, Commissioner
Dan E. Dickinson, Director
Charles Logsdon, Chief Petroleum Economist

F. Constitutional Budget Reserve

Minimum Necessary CBRF Borrowing Authorization

What is the minimum authorization for annual borrowing from the CBRF needed for state government to function? The answer is the anticipated difference between Unrestricted General Purpose Revenue and the General Fund budget *plus \$300 million*. This \$300 million needed for cash flow is repaid at the end of each year.

Why must the authorization be \$300 million more than the anticipated deficit? Because of the following:

1. Since 1990, the General Fund has "borrowed" \$3.9 billion from the CBRF.
2. The Alaska Constitution requires that whenever the General Fund owes money to the CBRF at the end of a fiscal year, any balance in the General Fund – up to the amount of the outstanding debt – must be transferred to the CBRF.
3. Since the General Fund's debt to the CBRF is so large (\$3.9 billion), the entire balance in the General Fund is automatically transferred to the CBRF at the end of each fiscal year, making the General Fund balance \$0 on July 1.
4. Given the payroll, invoices, school funding and other payables that the state owes at any point in time, financial management professionals unanimously agree that the state must always have a balance of at least \$100 million in the General Fund.
5. The first month of the fiscal year has the highest level of General Fund expenditure of any month because, in addition to meeting the state's normal monthly operating expense, including the foundation payment to school districts, the state must pay a disproportionately large amount of General Fund money to the university, for debt service, for summer construction projects and to municipal governments.
6. Although General Fund expenses are high early in the fiscal year, revenue receipts are delayed, so the General Fund must borrow \$300 million in July – both to restore the \$100 million balance after the end-of-the-fiscal-year payback to the CBRF on June 30 and to meet immediate needs – regardless of whether oil prices are high or low.
7. If oil prices were high enough during the year to balance the budget – \$29 per barrel for FY 2001 – the revenue cash flow still would not catch up with the expenditure cash flow until June 30, the very last day of fiscal year, and the day the General Fund happens to receive its largest amount of cash revenue.
8. The story starts all over again at midnight that night when the General Fund balance must be reduced to zero again to repay the CBRF.

The \$300 million is the state's working capital. It is needed to bridge the differences in the day-to-day timing of funds flowing in and out of the General Fund, just like working capital is needed by a company to bridge the differences in the day to day timing of money outflows and inflows.

REVENUE SOURCES

Forecast and Historical Data

SPRING 2002



Alaska Department of Revenue Tax Division

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Could Higher Oil Prices Fill the Fiscal Gap?

The short answer is no, not unless you believe in the improbable. Still, that doesn't stop Alaskans from hoping.

A quick study of the numbers, however, shows it certainly is extremely unlikely. Alaska North Slope crude oil would have to fetch higher prices for a longer period than at any time in the pipeline's 25-year history. And not just a little higher for a short time, but a lot higher for a long time.

▪ How much is the fiscal gap at high, or low, oil prices?

At \$30 oil, Alaska would still face a half-billion-dollar-a-year fiscal gap over the next 10 years.

At \$10 oil, the gap would range between \$1 billion and \$1.7 billion a year.

Figure 9.
Annual Fiscal Gap at \$30/ Barrel Oil

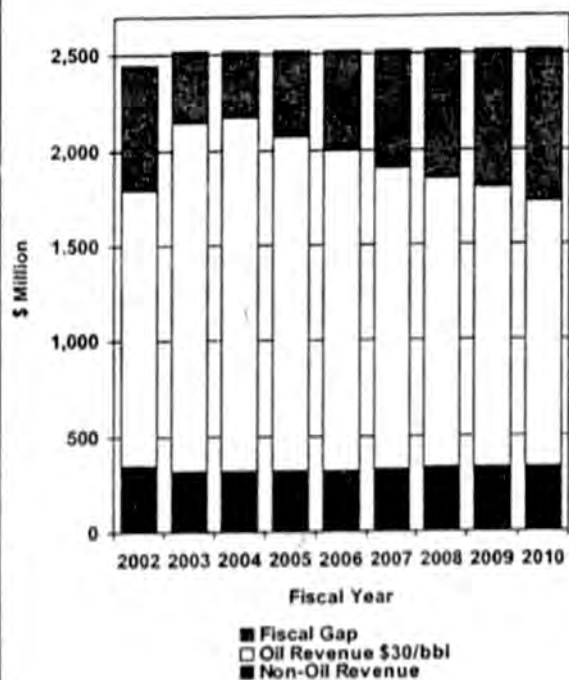
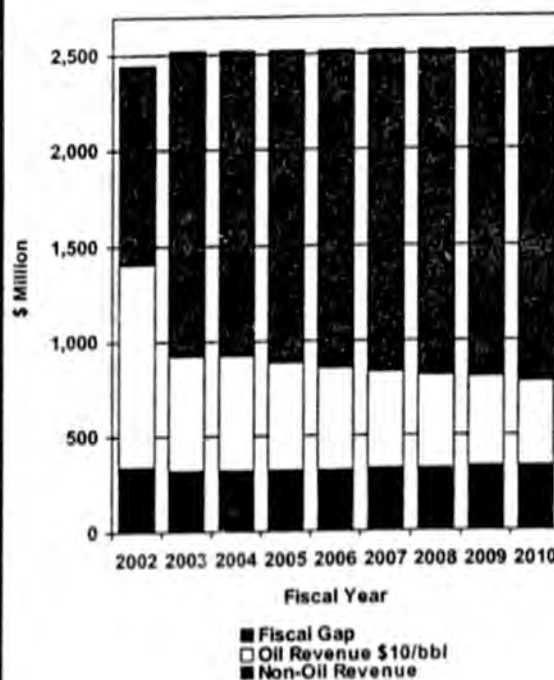


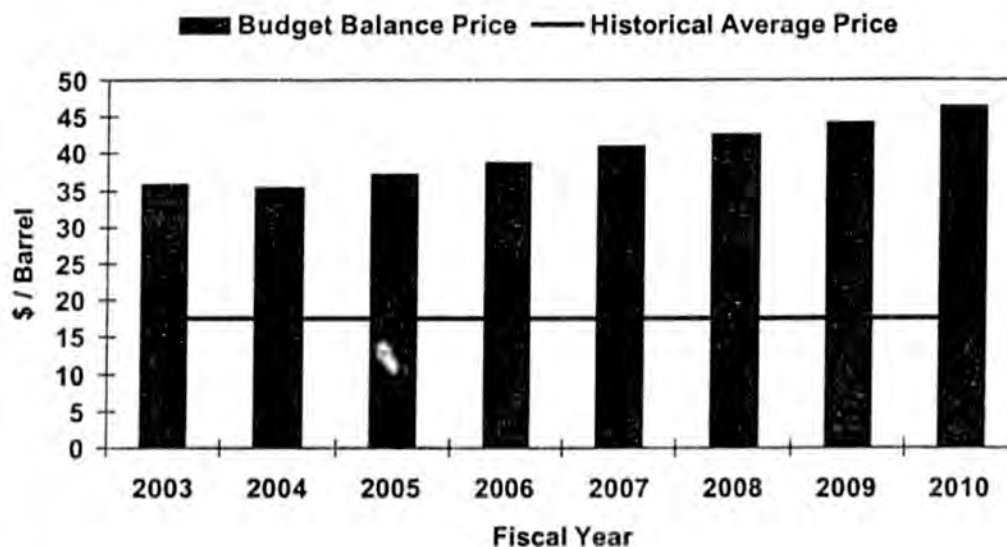
Figure 10.
Annual Fiscal Gap at \$10/ Barrel Oil



- How high would oil prices have to climb to balance the state budget through the end of the decade?

Although we believe North Slope oil production will average slightly above 1 million barrels per day through 2010, the state's declining production tax rate requires a higher price every year just to maintain the same revenues. North Slope oil would have to average \$36 a barrel in Fiscal 2003 to balance the budget. The price would have to average \$40 a barrel over the next eight years to cover the state budget, but that's just the average. The number gets further out of reach each year. In Fiscal 2010, the price would need to be over \$46 a barrel.

Figure 11. Oil Price Necessary to Balance the Budget



- If we want to continue using the Budget Reserve Fund to fill the gap, how high would oil prices have to climb to keep the fund alive until the end of the decade?

To reach 2010 with something, anything, in the Budget Reserve Fund would require oil averaging over \$33 a barrel for the next eight years — 80% higher the Department of Revenue forecast, 25% higher than U.S. Department of Energy estimates, and 30% higher than this month's high prices driven by the threat of war in the Mideast.

Keep in mind that prices would have to hold fairly steady around the \$35 average — the state could not afford a couple of bad years along the way if we wanted to maintain the Budget Reserve Fund and pay our bills. For example, if North Slope oil dipped below \$15 for a year or more, as has happened three times since 1989, the Budget Reserve Fund would take such a deep hit that it might hit empty even if prices rebounded the next year.

- How likely is it that oil prices will climb high enough to balance the budget in some years, or at least extend the life of the Budget Reserve Fund?

Prices could rise above projections in the short term — maybe even enough to balance the budget for a short time. But it would take a major, sustained global shortage of oil to create the consistent, high oil prices for the long term that could save the Budget Reserve Fund, and such a shortage is extremely unlikely.

Oil is a market-traded commodity, with the forces of supply and demand determining the price. When supply exceeds the demand, which was the world situation earlier this year, prices fall. As oil gets cheaper, demand recovers, which, over time, leads to higher prices as demand builds to match supply. But when demand gets too high, squeezing the supply, prices rise and demand falls back down. Prices eventually come down, too. Oil prices don't just move up and down, they always move up and down. High oil prices also push users to rely more on substitute fuels and conservation, serving as a natural relief valve to cut demand when prices climb too far. Because of how the market works, it is highly unlikely that oil prices could ever stay high enough long enough to solve Alaska's budget problem.

Here are some numbers to consider:

- Since a transparent market price for ANS West Coast deliveries emerged in the mid-1980s, Alaska North Slope crude oil delivered to California and Washington refineries has never averaged more than \$28 a barrel in a year. As if that was not sobering enough, the price has averaged below \$20 a barrel for all but three years since 1988.
- The West Coast ANS price has averaged above \$30 a barrel in only six months of the past 175 months, and has never reached the \$35 a barrel that Alaska would need for the entire year to balance the Fiscal 2003 budget.
- Any discussion of the potential for high oil prices would not be complete without looking at the low side of oil prices. Alaska North Slope crude averaged \$9.39 a barrel in December 1998, its lowest monthly price ever.
- And while North Slope oil has exceeded \$30 a barrel on the West Coast six out of the past 179 months, it has fallen below \$15 a barrel in 39 of those months.
- If OPEC nations wage a price war with non-OPEC producers, and if oil drops to \$10 a barrel as it did in late 1998, and if the price stays on the bottom for two years, the Budget Reserve Fund would be empty by November 2003.

Higher — or Lower — Oil Production

Oil production could exceed our forecast, which includes only barrels from fields that are producing or have been discovered. For those that have been discovered, we included production only from those fields we expect to start pumping by 2010.

It is possible, however, that some of the discovered fields could start producing sooner than expected, meaning more production and more revenue to the state. We also expect new oil discoveries on the North Slope, but we do not believe these new fields will begin producing before 2010.

However, these undiscovered fields might also begin producing sooner. We have estimated in this section how much additional production we believe could possibly come from the accelerated development of known reserves and new discoveries.

On the other side of the fiscal coin, it is possible that some of the forecast production from as yet undeveloped fields could be postponed past the expected start-up dates in this forecast. Also, the production rate for developed fields may decline at a faster rate than we project. For every upside there is a downside.

Possible Higher Oil Production

We forecast that "new oil," oil that has been discovered but is not yet flowing through TAPS, will constitute a substantial 10.8% of North Slope production by Fiscal 2005 and 28.2% by Fiscal 2010. Clearly, Alaska is depending on a fair amount of this new oil just to meet our revenue forecast.

But what about undiscovered oil? Oil companies continue to lease new lands and drill exploratory wells in search of reserves, and it is future production from these areas that is harder to predict.

To come up with a credible estimate of potential undiscovered oil that might be produced before 2010, we relied on geological work done by the U.S. Geological Survey and the federal Bureau of Land Management. We then derived an estimate of the North Slope's undiscovered, economically recoverable barrels that could possibly come into production before 2011. We provide in Table 10 our estimate of the potential additional production from these undiscovered reserves over the next decade. These barrels would come from three areas: the National Petroleum Reserve-Alaska (NPRA), the Foothills and the area east of Prudhoe Bay and the Central North Slope. We do not include any production from the Arctic National Wildlife Refuge in this table because even if Congress this year gives the go-ahead for drilling in ANWR, we would not expect to see any production until after 2010.

Table 10. Additional Potential Barrels from Undiscovered Fields
million barrels per day

<u>Fiscal Year</u>	<u>NPRA</u>	<u>Foothills and East of Prudhoe Bay</u>	<u>Central North Slope Satellites</u>	<u>Total</u>
2006	-	-	0.014	0.014
2007	0.040	-	0.028	0.068
2008	0.037	0.034	0.045	0.117
2009	0.035	0.060	0.065	0.159
2010	0.039	0.083	0.082	0.203

If all of the additional undiscovered production were to come online as estimated in Table 10 — 203,000 barrels per day by Fiscal 2010 — the state would receive an estimated \$173 million in additional oil and gas tax and royalty payments in Fiscal 2010. That's a little more than 10% of what would be needed to close the budget gap that year. The revenue to the state is held down by the Economic Limit Factor and the lower production tax rate charged on oil flow for the first five years of production from new fields.

This undiscovered new oil could come from:

National Petroleum Reserve-Alaska.

Phillips announced in May of 2001 that it had discovered three separate hydrocarbon accumulations in the NPR-A. Phillips is continuing to do delineation drilling to determine if these discoveries are commercial. The Department of Revenue has developed a risked estimate that these accumulations will yield 325 million barrels of oil, with production starting at 30,000 barrels per day in 2007. However, the NPR-A might yield more oil. First, the area encompassed by the discovered accumulations is comparable to the area overlying the Alpine reservoir, with potential reserves in Alpine's 429 million barrel neighborhood. Second, Phillips and Anadarko continue to explore in other areas of the NPR-A. Phillips drilled the Mitre and Hunter wells four and 12 miles, respectively, away from last year's discovery. Phillips also plans to drill the Puviak well next year much farther to the west. Anadarko drilled two Altamira wells to the south of the NPR-A discovery. In total Phillips and Anadarko have permitted 34 well locations in the first few years of exploration. Finally, the BLM plans additional lease sales in 2002 and 2004.

Back in 1998, the BLM projected the drilling of 21 exploration wells in the NPR-A leading to the discovery of 600 million barrels of recoverable oil.⁽¹⁾ If the NPR-A yielded 600 million barrels rather than our projected 325 million barrels, these larger reserves would add an additional 35,000 to 40,000 barrels of daily production to our estimated NPR-A production between 2007 and 2010.

Foothills and East of Prudhoe Bay.

The USGS estimates that there are 500 million barrels of technically recoverable reserves in the Central Foothills.⁽²⁾ We estimate that 300 million barrels of these reserves could be economically recoverable, equating to 83,000 barrels per day by Fiscal 2010.

Central North Slope Satellites and the Beaufort Sea.

The USGS in 1995 estimated perhaps 4.3 billion barrels of technically recoverable, undiscovered oil in the central and eastern coastal regions of the North Slope. The USGS believed this oil would mainly be in the turbidite and Barrow Arch Beaufortian geological plays.⁽³⁾ The USGS also stated that less than half of this technically recoverable oil would be economically recoverable.⁽⁴⁾ Of the estimated 3.6 billion barrels of technically recoverable oil remaining net of post-1995 discoveries, 1.5 billion barrels could be economically recoverable.

(1) See Table IV.A.1.b-7 of the BLM's "Northeast National Petroleum Reserve-Alaska (NPR-A) Integrated Activity Plan/Environmental Impact Statement (IAP/EIS) August 1998.

(2) See USGS Open-File Report 95-751, "Economics and undiscovered oil and gas accumulations in the 1995 National Assessment of U.S. Oil and Gas Resources: Alaska", by Emil Attanasi and Ken Bird at Table 3, Page 37.

(3) USGS[95] Table 3, Page 37.

(4) Of the Eastern Coastal region's 1,632 million barrels of technically recoverable reserves, 39% (638 million barrels) should be economically recoverable. Of the Central Coastal region's 2,002 million barrels of remaining technically recoverable reserves, 45.75% (916 million barrels) should be economically recoverable. The economic recovery factors reflect mid-points between the \$18 and \$30 cases of USGS[95] Table 3.

Possible Lower Oil Production

The North Slope, like other mature provinces, depends upon production from new fields to offset declines in older fields. In our predictions of oil flow from discovered fields, which already are included in our revenue forecast, we include barrels from anticipated developments in the second half of this decade from Nanuq (2006), Point Thomson (2008), Sourdough (2008), Liberty (2008), Yukon Gold (2009) and Sandpiper (2010).

This table shows our projections for oil production from these fields, totaling 124,000 barrels per day by Fiscal 2010. These fields represent over 40% of the "new oil" included in our revenue forecast for Fiscal 2010. These field developments could be deferred or cancelled. If they are, the state could lose \$65 million in FY 2010 — almost 10% of its projected petroleum revenue.

Table 11. Anticipated Production from New Fields This Decade
Thousand Barrels per Day

<u>Fiscal Year</u>	<u>Point Thomson</u>	<u>Sourdough</u>	<u>Yukon Gold</u>	<u>Liberty</u>	<u>Sandpiper</u>	<u>Total</u>
2004	-	-	-	-	-	-
2005	-	-	-	-	-	-
2006	-	-	-	-	-	-
2007	-	-	-	-	-	-
2008	20	10	-	35	-	65
2009	30	15	10	55	-	110
2010	30	15	15	52	12	124

The state faces a more serious loss if the production rate for its developed fields decline at a faster rate than we project. Prudhoe Bay has been in decline since 1988. We forecast that Prudhoe Bay will decline at a slower rate than it did during most of the 1990s, with production falling by an average 5.3% per year between 2001 and 2011. However, the steeper decline rate of 1992 to 1999 could return in 2002 if development drilling is less than we have projected. If the 1992-to-1999 decline rate continues throughout this decade, Prudhoe Bay production would run about 124,000 barrels per day under our forecast for Fiscal 2010. Such a steep production drop could reduce state revenues by an estimated \$191 million in 2010.

Alaska Natural Gas Project

It's been more than 18 months since higher natural gas prices across the Lower 48 states reawakened interest in a pipeline to bring natural gas from Alaska's North Slope to Mid-America and California — and hundreds of millions of dollars a year in new revenue to the state treasury. Unfortunately, the same market volatility that pushed prices to record levels in the winter of 2000-2001 also worry producers, pipeline owners and investors, the very sources of the billions of dollars that will be needed to build the gasline.

Over the past 25 years, proposals to move North Slope gas to market — that is, to "commercialize" the stranded resource — have varied between a pipeline to the Lower 48 or one to tidewater, most likely Valdez or Cook Inlet, where the gas would be liquefied and shipped in tankers to Asian markets. High gas prices in the Lower 48 a year ago, coupled with the faltering Japanese economy and abundant gas reserves economically closer to Asia in Indonesia and Australia (without the need for an expensive 800-mile pipeline across the arctic to tidewater), have rekindled interest in the Mid-America pipeline option. Estimates for total project cost, including a gas conditioning plant on the North Slope, 1,800 miles of pipe to the northern end of the North America grid in Alberta, and expansion of existing Lower 48 connections, range from \$15 billion to \$20 billion.

Proponents have studied the cost of a gasline in varying sizes, moving anywhere from 2 billion cubic feet of gas per day to 4.5 bcf/d. Logically, the larger the project, the lower the unit costs of transporting gas to market, which generally is good news for potential developers and investors. However, the larger the project and the higher the cost, the greater the investment risk. That is the dilemma for moving Alaska gas to market.

Another dilemma is the larger the volume of gas moved to market, the more likely the gas could temporarily oversupply the market and drive down prices. That would mean lower prices not only for gas coming from Alaska, but for all of the gas sold in the Lower 48 states. The cost to producers of lower prices also works against the large Alaska project.

If the risks can be lessened, there is no doubt a gas project would be good for Alaska. For example, a 4.5 bcf/day gasline would generate more than \$400 million a year in new state revenue for Alaska if gas prices are at \$3 per million Btu in Chicago. But the producers and others will not make their investment decision based on how much the project could earn for the state treasury. Rather, it will be based on the cost of risk and the rate of return for the \$20 billion investment. A joint study team comprised of the three major North Slope gas oil and gas producers recently concluded the project is not economic based on their cost estimates and market projections. The Department of Revenue also believes the project would yield a sub-market rate of return under existing market projections. Higher prices, obviously, would improve the economics, but many gas price forecasters do not expect prices to hold much above \$3 per million Btu on a consistent basis over the next decade.

The producers, gas pipeline companies and the State of Alaska are working with the state's congressional delegation to reduce the costs and risks associated with the project. There is no question that a gasline would help make up for falling oil production and revenues to the state treasury. And there also is no question that the possibility of a natural gas project deserves a significant amount of state effort to promote and encourage the project.

Broad-Based Taxes

The single largest source of new, non-oil and gas revenue to the state under discussion — other than Permanent Fund earnings — would be a personal income tax or a statewide sales tax. But just how much new revenue would a broad-based tax produce, and what do other states collect, and how do sales and income taxes compare?

Personal Income Tax

What Do Other States Charge?

Of the 50 states, 43 have a personal income tax. Joining Alaska on the list without a tax are Florida, Nevada, South Dakota, Texas, Washington and Wyoming. Of the 43 with a tax, New Hampshire and Tennessee collect taxes on dividends and interest income only.

Most states use federal adjusted gross income as a starting point to calculate the state income tax, and most also use federal provisions in calculating allowable itemized deductions. In addition:

- 29 states exempt Social Security benefits from taxation.
- 8 states exempt unemployment benefits from taxation.
- 37 states exempt interest earned on their own state and municipal bonds.
- 5 states exempt military pay from taxation.
- 33 states allow a standard deduction for taxpayers (12 use the federal amount).

Most states use a series of brackets to tax different incomes at different rates. Montana has the most tax brackets — 10 — ranging from 2% to 11% of adjusted gross income, with some deductions allowed. Some states have a flat tax — Colorado, Michigan, Massachusetts, Illinois, Indiana and Pennsylvania — ranging from 2.8% of federal taxable income in Pennsylvania to 5.6% of adjusted gross income in Massachusetts.

What are the Options for an Income Tax?

There are three options for the tax base for calculating a personal income tax:

- **Adjusted gross income.** Because the tax base would be the highest of the three options, the tax rate would be the lowest. Adjusted gross income is Line 33 on the federal personal income tax Form 1040, which is an individual's gross income from all sources minus: IRA contributions, student loan interest, Medical Savings Account contributions, moving expenses, one-half of the self-employment tax paid by self-employed individuals, the self-employed health insurance deduction and alimony.
- **Federal taxable income.** This is Line 39 on Form 1040, which is adjusted gross income minus either the standard deduction or all of the itemized deductions allowed under federal law, plus the per-person exemptions allowed under the federal tax code. This requires the state to accept whatever tax deductions are allowed under federal law, although the state also could include its own deductions, credits or other conditions.

- **Federal tax liability.** This is what an individual pays the IRS. Because the tax base would be the lowest of the three options, the actual tax rate would be higher than if the rate were applied to gross income or taxable income. For example, a 2.75% tax on gross income, a 3.8% tax on taxable income, or a 20% tax on federal tax liability would all raise the same amount for the state — about \$350 million a year. Another feature of using federal tax liability as the base is that the state tax would be progressive, even with a flat tax rate, meaning the tax rate would increase as an individual's income increased. This also requires the state to accept whatever deductions and credits are allowed under federal law. Federal tax liability is Line 40 on Form 1040 (before several credits under the IRS code), or Line 52 (after Education Tax Credits and Elderly and Disabled Care Credits and others), or Line 52 plus the Earned Income Credit and Additional Child Tax Credit.

How Much Do Alaskans Earn?

IRS data tapes show Alaskans filed 327,510 personal income tax returns for 1999, representing 442,199 taxpayers (114,689 were joint returns). Those returns show:

- Federal adjusted income reported by Alaskans in 1999 totaled \$13.2 billion.
- Almost 90% of the tax returns with more than \$100,000 in adjusted gross income were joint returns.
- About 7% of returns with less than \$20,000 in gross income were joint returns.
- Of the 442,199 taxpayers, 63% reported gross income of under \$50,000 and almost 80% reported gross income below \$75,000 a year.
- The 10% of taxpayers reporting more than \$100,000 a year in gross income represent 33% of total income reported by all Alaskans.
- The 20% earning more than \$75,000 represent 50% of total income for Alaskans.

How Much Would the State Raise from an Income Tax?

Several proposals are under discussion in the legislature, but three have garnered most of the attention. The Legislative Fiscal Policy Caucus proposed a 4% flat tax on federal taxable income, which would raise an estimated \$360 million a year. The governor proposed a 20% tax on federal tax liability, which would raise about \$350 million per year. Representative Bill Hudson proposed a 2.25% tax on adjusted gross income, raising an estimated \$285 million per year.

These are approximate numbers for tax rates and how much revenue would be raised. The table assumes a flat tax, for the sake of simplicity in showing potential revenues.

Income Tax Rates and Revenue Projections (1999 IRS Data)			
\$ Million Revenue	% Adjusted Gross Income	% Federal Taxable Income	% Net Federal Tax Liability
\$250	2.00	2.77	13.86
\$300	2.38	3.29	16.47
\$350	2.75	3.82	19.08
\$400	3.13	4.34	21.70

In addition to deciding on the tax base (gross income, taxable income or federal tax liability), the rate schedule (flat tax vs. a variable tax), and exemptions and deductions, the state also would have to consider expectations for audits and enforcement. The stronger the enforcement, the more effective the program, especially with out-of-state residents.

How Much Did Alaskan Raise from its Old Income Tax?

Alaska abolished its personal income tax in 1980. The tax raised \$210.4 million in Fiscal 1977, its highest collections ever. The tax was assessed as a percentage of federal taxable income, ranging from 3.5% for income up to \$8,000 per year to a high of 14.5% on income in excess of \$300,000. In the middle, taxpayers paid 10% of their federal taxable income over \$52,000.

If the pre-1980 tax rates were in effect today, Alaskans would pay about \$750 million in state personal income taxes. If the tax brackets were adjusted for inflation, that number would be \$660 million.

How Much Would Non-Residents Pay, and How Much Would Alaskans Save on Federal Taxes?

An income tax certainly would collect money from non-residents working in Alaska, but there is no way to know exactly how much it would collect. The IRS reports income earned by taxpayers with an Alaska mailing address; it does not report income earned by non-residents working in Alaska. There are no exact numbers for non-resident wages in Alaska, but estimates range from 3% to 10% and the Department of Revenue believes the true number is probably in the middle. At 6% or 7%, an income tax that raised \$350 million would collect perhaps \$21 million to \$22 million a year from non-residents. It is important to remember that most of the non-resident workers who come to Alaska are here for low-paying summer tourism and seafood processing jobs and would not pay much in personal income taxes.

A state personal income tax would be deductible from federal income taxes for Alaskans who itemize. IRS statistics indicate about 25% of Alaska taxpayers itemize their deductions, though most higher-income Alaskans itemize on their federal returns. And since it would be the higher-income Alaskans who would provide most of the state's new income tax revenues, a substantial portion of that tax would be deducted from Alaskans' tax payments to the federal government.

The easiest way to "export" a tax — that is, to shift its cost — is through its deduction against federal tax liability. There is no deduction for state or municipal sales taxes; only income taxes are deductible. A deduction means part of the tax revenue remains in the state instead of going to the federal treasury.

We estimate that Alaskans would recover about 15% of the cost of a state income tax by deducting it from their federal tax bills. For example, if a state income tax generated \$350 million a year, almost \$53 million would come from the deductibility of the state income tax against federal income taxes. Therefore \$275 million of a \$350 million income tax would come from pockets of Alaskans, assuming \$22 million came from non-residents and \$53 million in lower federal taxes.

How Much Would it Cost to Administer an Income Tax?

The department estimates it could cost \$6 million in one-time expenses to set up an income tax, including computers, software, printing forms and booklets, launching a public education campaign, and establishing offices. Ongoing expenses for an income tax would be an estimated \$6 million to \$7 million per year. Assuming \$350 million or so per year in tax revenues, that would be within 2% of collections. The cost of collection is similar in other states.

Statewide Sales Tax

What Do Other States Charge?

The only states in the nation without a statewide sales tax are Alaska, Delaware, Montana, New Hampshire and Oregon. The others collect taxes that range from a low of 2.9% in Colorado to 7% in Mississippi and Rhode Island.

- In most states, the cities, counties, transit districts and other taxing authorities add their tax onto the state tax rate, with the states handling collection and enforcement, then disbursing the funds to the municipal agencies.
- State and city sales taxes are collected and administered separately in only a very few locations nationwide. Businesses prefer to deal with a single set of rules and a single taxing authority (reducing compliance costs to businesses).

Because of the cumulative effect of adding local sales taxes to the state tax, many states set a maximum overall rate.

- The highest sales tax rate in the nation is in Oklahoma, where the state reports a combined rate of 9.78% as the highest in the state. Louisiana comes in second, with some jurisdictions charging a combined 9.5% rate.

Most states — 27 of 45 — exempt all or some food purchases from sales taxes, with three additional states charging a lower tax rate on foods.

- All states exempt prescription medicines from sales tax.
- Fewer than 10 states exempt non-prescription medicines from sales tax.

Most states — 27 of 45 — allow businesses to retain a portion of their collections as reimbursement for the expense of collecting the tax for the state. The other 18 states do not allow businesses to retain a percentage of the collections.

- For those states that do allow a "discount" to businesses on their sales tax returns, the rate ranges from 0.5% of the amount collected to as much as 5% for businesses with small tax collections.
- One-third of the states set a maximum on the amount of money a business is allowed to retain.

Of those states with a general statewide sales tax, the tax provides an average 32.3% of overall state general fund revenues.

How Many Alaska Cities and Boroughs Already Have a Sales Tax?

About one-third of Alaskans live in a community — a city or a borough — with a municipal sales tax. The rates for those 200,000-plus Alaskans range from:

- A low of 1% in Tenakee and White Mountain.
- To a high of 7% in Wrangell and 6% in Petersburg, Cordova, Kodiak and Kotzebue.

The 97 cities and boroughs with a sales tax collected about \$125 million in Fiscal Year 2001, for an average of more than \$600 per capita.

Each municipality has its own list of tax exemptions, limits and rules, such as a cap on the maximum amount of a single purchase subject to a sales tax (to ease the burden on purchasers of big-ticket items such as cars). There is no uniformity across the state. In this aspect, merchants likely would appreciate a state-governed sales tax program, with one set of rules statewide.

The Alaska Municipal League has gone on record opposing a statewide sales tax. The league's members see the sales tax as historically the domain of municipalities in Alaska and do not want to lose control over the tax revenue or administration. Alaska communities with an existing sales tax also fear the economic damage that could be inflicted upon their cities and boroughs if the state were to impose a statewide sales tax on top of municipal taxes.

- For example, Wrangell and Petersburg, at 7% and 6%, respectively, believe merchants in their communities would lose a significant amount of business to out-of-state suppliers if residents were charged an 8%, 9% or 10% combined state/municipal tax.

Most municipalities allow for some form of exemption for senior citizens, though the process varies from city to city.

- For example, Juneau issues tax-exempt cards to seniors and then requires businesses to keep a log of all tax-exempt purchases. Wrangell uses a different approach. It issues seniors a \$250-a-year sales tax rebate, rather than requiring businesses to keep a log and enforce the exemption.

Assuming the state controlled collection of the tax, the most efficient method for distributing the local tax back to cities and boroughs would be for the state to determine the local share of the tax revenue and then send payments to the cities and boroughs.

How Much Would the State Raise from a Sales Tax?

The Department of Revenue estimates the state would collect approximately:

- \$100 million a year for every 1% in a statewide sales tax on retail goods and services sold in Alaska, assuming no exemptions.
- \$70 million a year if foods and medical goods and services were exempted.

Additional exemptions would reduce the tax burden on some residents and, consequently, reduce revenues to the state. Exemptions also could complicate administration of the tax. And, if the state exempted any goods or services already subject to municipal sales taxes, and then imposed its exemptions on municipalities, some cities and boroughs could see a drop in their tax revenues.

Is a Seasonal Sales Tax a Good Idea?

This is hard to judge, but it appears from Juneau's sales tax records that sales are not as heavily weighted to the summer season as many people might expect. Permanent Fund dividends and the Christmas shopping season appear to help keep the volume of sales from leaning too heavily toward a summer surge.

Based solely on Juneau's records, it appears a six-month seasonal tax might not generate much more than 50% to 55% of the year's taxable revenues. And it could be less if local residents shifted their purchases to the no-tax season.

A seasonal sales tax, while intended to grab more tax revenues from summer visitors, could actually harm local businesses, particularly big-ticket merchants that depend on local sales. For example, would a heavy seasonal sales tax deter residents from making purchases locally during the summer season? Would it hurt car dealers, appliance and furniture stores and electronic shops? Would the sales return each fall?

What is the Nationwide Streamlined Sales and Use Tax Agreement?

Businesses nationwide and other states are working hard to win nationwide adoption of a Streamlined Sales and Use Tax Agreement.

"It is the purpose of this agreement to simplify and modernize sales and use tax administration in the member states in order to substantially reduce the burden of tax compliance."

One of the major reasons for the push is to address the issue of lost state and municipal sales tax revenues to mail order and Internet commerce. The growth of mail order and Internet sales is costing states and municipalities billions of dollars a year in lost sales tax revenues. The retail industry has made it clear that it wants to see a set of uniform sales tax rules nationwide as a condition of working with the states to collect sales taxes on interstate commerce. Alaska would not be in compliance with the nationwide effort if it adopted a state sales tax without ordering the same exemptions and rules for municipal sales taxes statewide.

The agreement, which has been adopted by about 20 states, requires:

"States to administer any and all sales and use taxes levied by local jurisdictions within the state so that sellers collecting and remitting these taxes will not have to register or file returns with, remit funds to, or be subject to independent audits from local taxing jurisdictions."

Who Would Pay the Tax?

A sales tax is generally considered to be regressive, meaning that lower-income people, who spend a greater proportion of their income on local goods and services, would pay a larger share of their income in sales taxes when compared to higher-income people. Exemptions for food, medical care and other necessities would reduce but not eliminate this imbalance.

It's hard to say how much of the sales tax would be paid by visitors from out of state, although the Department of Revenue believes it would be in the range of 10% of total tax revenues for a tax in place for the entire year. Visitors spend heavily on gifts, food, lodging and tours, although federal law prohibits a state sales tax on air transportation.

What Other Issues Should be Considered?

In addition to questions of local control, joining the nationwide streamlined sales tax campaign, and the risk of economic damage to communities that already have a heavy sales tax burden, other issues for the state to consider include:

- Taxable vs. non-taxable sales.
Food (prepared vs. unprepared), medicines (prescription vs. non-prescription), medical care (licensed care only or all care), sales by nonprofit organizations, and sales at vending machines are among the obvious issues.
- Senior citizen tax exemption.
No exemption, or exempt all purchases by seniors, or issue an annual rebate check? If purchases are exempt, should such tax-exempt purchases be limited?
- An exemption for purchases and/or sales by nonprofit organizations.
- Expectation for audits and enforcement.
A stronger enforcement and audit program would add to the costs but likely would produce higher revenues to the state.

One other major issue for the state to consider is whether it wants a "use tax" as part of its sales tax. Most states collect a use tax under the same set of statutes as their sales tax. The sales/use tax helps cover sales by nationwide retailers with a nexus (presence) in individual states. For example, if Alaska had a state sales and use tax and if an Alaskan placed a phone order with Eddie Bauer's catalog department, Eddie Bauer would have to collect a sales and use tax on the purchase because it has a store (a presence) in Alaska.

How Much Would it Cost the State to Administer a Sales Tax?

The Department of Revenue estimates it would cost approximately \$3 million to \$5 million a year to administer a statewide sales tax program, depending on the complexity of the tax, the number of exemptions, and the attention to enforcement and audits. The cost of sales tax programs nationwide average about 1% to 2% of collections. At \$3 million to \$5 million a year, Alaska would be within that range with a reasonable sales tax that raised \$200 million to \$250 million per year.

In addition to annual costs, there would be a first-year expense of approximately \$2 million to set up the tax program, including programming, offices, public and taxpayer educational programs, publications and tax forms, and a web-based filing system.

Sales Tax vs. Income Tax vs. Budget Cuts vs. Dividends?

Supporters of a graduated-rate income tax say it is progressive, in that it assigns a higher rate to higher-income households, consistent with both ability to pay and the benefits received from public spending. Opponents, however, argue that this penalty for success is unfair and that higher-income households do not receive proportionately higher levels of public services.

A flat income tax is not progressive, unless it is assessed on federal tax liability, in which case it picks up the progressivity (the graduated rates) of federal deductions and tax tables.

Supporters of a sales tax say it is fair in that it taxes everyone at the same rate, but opponents of a sales tax say it is regressive because low-income households spend a greater proportion of their income on essential items than higher-income households.

Opponents of reducing the dividend argue it would be regressive, in that all would suffer the same economic loss - regardless of their income. Low-income Alaskans have come to depend on the dividend for a significant portion of their annual household income. Supporters, however, argue everyone should help pay for public services, and that reducing the dividend is one way to ensure all Alaskans contribute to the solution.

Which is Least Painful to the Economy?

There are no recent studies on precisely what would be least harmful to the state's economy, where harm is defined as loss of jobs, household income and economic activity. Is the answer state budget cuts, new taxes, or reducing the dividend? Thoughtful consideration produces some generally accepted assumptions:

- More of the Permanent Fund dividend leaves the state faster than state operating expenses for public services or wages earned by Alaskans, and therefore reduced dividends would be less harmful to the overall economy. Because Alaskans save or invest a greater proportion of their dividends than their wages, and because Alaskans spend a greater proportion of their dividends than their wages on travel and big-ticket purchases manufactured out of state, we believe that reducing dividends would have a smaller overall economic effect on the Alaska economy than a personal income tax or sales tax.
- If, for example, the state wanted to raise \$350 million a year, either from a personal income tax or a sales tax, we believe a sales tax would raise more money from out-of-state residents but the income tax, overall, would be less costly to the Alaska economy. A \$350 million sales tax might collect about \$35 million from out-of-state residents (visitors and workers). A \$350 million income tax would collect perhaps \$22 million from out-of-state workers, while also reducing Alaskans' federal income tax payments by an estimated \$53 million. The net cost to Alaskans of a sales tax would be \$315 million vs. \$275 million for the income tax.

- Although a sales tax would raise more money overall from visitors, an income tax would collect more revenue from non-residents working in Alaska. A non-resident with \$60,000 a year in taxable Alaska wages would pay \$1,800 if the state imposed a flat 3% income tax. That same non-resident worker would have to spend \$60,000 a year — more than his or her entire paycheck — for the state to collect that same \$1,800 a year in sales taxes at a 3% rate. The same math would apply if the non-resident were a seasonal worker earning \$10,000 for the summer. The state generally would collect a greater share of that worker's income through an income tax than a sales tax.

A recent report in State Tax Notes addresses the issue of taxes vs. budget cuts. It was prepared by Peter Orszag, senior fellow in tax and fiscal policy at the Brookings Institution, and Joseph Stiglitz, Columbia University economics professor and winner of the 2001 Nobel Prize in economics.

The report suggests tax increases may be less harmful to the economy than spending reductions because some of the tax increase would result in reduced saving rather than reduced consumption. And since much of an individual's savings do not move around the state's economy (the multiplier effect) the same as wages or purchases, a reduction in savings would be less harmful than government budget cuts.

For example, if individual taxes increase by \$1, consumption may fall by 90 cents and savings may fall by 10 cents. Some types of government spending reductions, however, would reduce demand in the economy on a dollar-for-dollar basis, and therefore would be more harmful to the economy than a tax increase.

The report continued:

"For states interested in the impact only on their own economy rather than the national economy, the arguments made above are even stronger. In particular, the government spending that would be reduced if direct spending programs are cut is often concentrated among local businesses. ... By contrast, the spending by individuals and businesses that would be affected by tax increases often is less concentrated among local producers — since part of the decline in purchases that would occur if taxes were raised would be a decline in the purchase of goods produced out of state.

"In addition, higher-income families appear to consume relatively more goods and services produced in other regions of the country than lower-income families do. ... A tax increase concentrated on higher-income families thus is likely to have a smaller adverse impact on the state economy than other budget-balancing alternatives."

What Other Effects Might Occur from a Broad-Based Tax?

Economists classify a tax as "efficient" when it has little or no effect on economic behavior. For example, taxes are inefficient when they influence consumer buying, investment or labor market decisions or companies' production decisions. Likewise, taxes are more efficient than government spending cuts if they do less damage to the state's economy.

The size of the tax rate may also influence economic behavior. A personal income tax certainly could influence a person's economic decisions by lowering take-home pay, thereby affecting spending and working decisions. The amount of a sales tax also can make a difference in spending decisions. For example, a person who normally buys goods locally may continue to do so at a low sales tax rate. However, a high tax rate may cause the person to purchase the same product on the Internet or by mail order. The Alaska economy would suffer because the expenditure is made out-of-state and the money would not circulate in the local economy.

New Money vs. Old Money?

Finally, any discussion of closing the state's fiscal gap should include a look at "new money" vs. "old (or recycled) money." The more new money can be brought into the state's economy to close the gap, the less damage to Alaska's economic health. Another way of characterizing this is saying if we can export our tax burden, it does less harm to our economy.

Examples of new money are:

- Surplus earnings of the Permanent Fund. This is money not currently circulating through the Alaska economy because it is mostly invested in stocks and bonds outside of the state.
- State tax and royalty revenues from new oil and gas discoveries.
- Taxes generated by new or expanded economic activity.
- Taxes paid by non-residents.
- Federal tax savings from deducting a state personal income tax.
- Cruise ship passenger taxes.

Examples of old, or recycled money include:

- Increased excise taxes, such as alcohol and motor fuel taxes. However, some of the higher taxes would be paid by non-resident workers and tourists.
- Sales taxes.
- Personal income tax.
- Reduced Permanent Fund dividends (the loss to Alaska's economy would be reduced by the amount of dividend money that would have flowed out of state in savings or purchases).

It's also worth considering in these discussions the reality of what has been called the "Alaska Disconnect." That is the disconnect between non-petroleum economic development and the state revenues needed to pay for the increased public services demanded by a growing population. Without a broad-based tax, non-petroleum economic development costs more in public services than it produces in revenues to the state. More jobs means more workers and more families and more children in school, and more public expenses with no additional revenues to pay for those services.

For the past 25 years, Alaska has chosen to take its return on the development of non-petroleum industries in the form of private-sector jobs and private profits rather than state revenues to pay for needed public services. This is not sustainable for much longer.

Specific Taxes

Alcohol Taxes

Alaska's alcohol taxes are assessed and collected at the manufacturing and wholesale level, as are alcohol excise taxes in other states. All of Alaska's alcohol tax revenue is deposited into the general fund. Tax collections in Fiscal Year 2001 totaled \$12 million.

How Do Alaska's Tax Rates Compare to Other States?

Alaska's alcohol excise taxes date back to 1933, and the rates have not changed since 1983. The tax, which is assessed per gallon at the wholesale level, averages about 4 cents per drink when translated to commonly sized servings.

- Alaska's tax rates are:

Beer, \$0.35 a gallon	Wine, \$0.85 a gallon	Liquor, \$5.60 a gallon
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- The national median rate is:

Beer, \$0.19 a gallon	Wine, \$0.60 a gallon	Liquor, \$3.30 a gallon
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- The highest tax rates in the nation are:

Beer	Wine	Liquor
Hawaii, \$0.92 a gallon	Florida, \$2.25 a gallon	Florida, \$6.50 a gallon

The rates shown above, however, reflect only the general excise tax charged in other states. Most states also collect a general sales tax, a specific alcohol sales tax, or an additional excise tax on alcoholic beverages.

Combining all of the state taxes on alcohol, the national median total state tax per \$4.00 drink in a bar is:

- Beer, 30 cents Wine, 32 cents Liquor, 37 cents
- This is 7 to 10 times the four cents per drink excise tax rate in Alaska.

How Much Would the State Raise from Higher Alcohol Taxes?

Proponents of higher alcohol tax rates for Alaska talk in terms of a nickel-a-drink or a dime-a-drink increase, which are easier to understand than the wholesale rates on a per-gallon basis. These tax amounts are based on 12 ounces of beer, four ounces of wine and a one-ounce shot of liquor.

For each nickel-a-drink increase in the tax, the state would gain about \$15 million a year in new revenue. It's impossible to know how a tax increase would show up at the retail level. Would any of the tax be absorbed by wholesalers, suppliers or retailers, or would the entire cost fall on the consumer? And would businesses use the tax increase as an occasion to raise prices in excess of the higher tax bill?

What Other Issues Should be Considered?

Several issues would need to be addressed in considering a tax increase:

- Should the state impose a "floor tax" on inventory as of the effective date of the tax increase? Such a tax would deter stockpiling of alcoholic beverages at the old, lower tax rate, and could prevent businesses from overcharging customers the higher tax rate on old inventory purchased under the lower tax rates.
- Would the state impose its alcohol tax on out-of-state purchases brought into Alaska? This would mostly involve mail order and Internet orders by individuals.
- Would the state increase its tax enforcement efforts? Alcohol tax collection and audit work consumes the equivalent of just nine-tenths of a position at the Tax Division. A higher tax might justify a stronger enforcement/audit program.

What are the Costs of Alcohol Abuse, and Would a Tax Increase Help?

Alcohol abuse cost the Alaska economy an estimated \$453 million in 1999 in criminal justice and protective services, health care and public assistance, traffic accidents and lost productivity, according to a November 2001 report by McDowell Group for the Governor's Advisory Board on Alcoholism and Drug Abuse. Health care costs alone totaled \$48 million. Adult and child protective services attributed to alcohol and other drug abuse in Alaska cost an estimated \$44 million in 1999.

Research indicates that higher taxes would decrease consumption and, hopefully, abuse, but there is no agreement on the exact relation between price and consumption.

"Research shows that as with other consumer goods, purchases of alcoholic beverages decline when their prices rise," according to a January 2001 report by the National Institute on Alcohol Abuse and Alcoholism. Other studies and reports suggest the same trends, including a 1998 survey of high school seniors that indicated "increasing alcohol prices will decrease consumption in this group, especially among females."

The Center for Science in the Public Interest put numbers to the theories when it reported: "Studies indicate that a 10% rise in beer prices would cause a 3% to 4% drop in sales, with a slightly bigger drop for a similar price increase for wine and liquor." The Center adds: "Younger people are generally more price sensitive, so higher prices should help delay and reduce drinking within this group. A study by the National Bureau of Economic Research concluded "that even a modest tax increase of 30 cents for a bottle of liquor and 10 cents for a six-pack of beer would decrease drinking among young people as much as raising the drinking age by one year."

Motor Fuel Taxes

How Much is the Tax in Alaska?

The state excise tax on motor fuel in Alaska is 8 cents per gallon, one-third of the national median rate for combined excise and state sales taxes. The 8-cent rate dates back to 1961. The state receives approximately \$26 million a year from the tax.

How Much is the Tax in Other States?

The median tax on motor fuel in the other 49 states is 24 cents per gallon. That includes motor fuel excise taxes and fees, and sales taxes. The most expensive excise tax states are Rhode Island, 29 cents; Wisconsin, 27.3 cents; Montana, 27 cents; Pennsylvania, 26.6 cents; and Idaho, 26 cents. Georgia's excise tax, at 7.5 cents, is below Alaska, but Georgia adds on a 3% state sales tax at the pump.

The federal tax rate on a gallon of motor fuel is 18.4 cents.

How Much Would the State Raise from Higher Motor Fuel Taxes?

Each 1 cent increase in the state tax would generate an additional \$3 million per year for Alaska.

Cruise Ship Passenger Fee

How Much Do Other Cities and Countries Charge?

The Department of Revenue is not aware of any state tax on cruise ship passengers, but municipal fees exist at most U.S. ports including Seattle, San Francisco, Miami and Port Everglades. The fees generally are in the range of \$6 to \$7 per passenger, although San Francisco charges \$9.50 per passenger. Many charge the fee twice per visit — once per passenger getting on the ship and again as passengers get off the vessel. Taxes, or fees, also are collected at most ports worldwide, including Vancouver, B.C., and Caribbean ports.

The tax usually is levied by the port authority or other government agency in charge of port operations, and often is explained as partially covering the cost of general public services provided to the cruise industry and specifically to embarking and disembarking passengers. This is in addition to providing dock and utility services to the vessel, which are covered under specific port charges.

Do Any Alaska Cities Charge a Passenger Fee?

The only significant port of call in Alaska with a municipal passenger fee is Juneau, which enacted its \$5 per passenger fee in 2000 after voters approved the new tax in an initiative on the 1999 general election ballot. Juneau received more than \$3 million in tax revenues in calendar 2001.

Sitka and Ketchikan have discussed similar fees but have not adopted any such fee.

Who Would Pay the Fee?

The cruise lines pass on passenger taxes, port fees and other such charges to their passengers through a charge listed separately from the advertised price for the cruise, much like airlines show taxes as a separate line at the bottom of each ticket. Consequently, the tax burden of an Alaska passenger fee would be paid by cruise passengers, unless the competitive nature of the business requires some cruise lines to absorb a portion of the fee.

It is possible that the added cost of the new fee might dissuade some travelers from spending as much money as they might otherwise spend on shore excursions, although, for example, a \$30 Alaska fee would add just 2% or 3% to the total cost of an average cruise ticket.

How Much Would the State Raise with a Passenger Fee?

Almost 670,000 cruise ship passengers traveled to Alaska in 2001. A state passenger tax could raise an estimated:

- \$25 per passenger, \$16.75 million a year
- \$30 per passenger, \$20 million a year
- \$50 per passenger, \$33.5 million a year

What About the Municipalities?

One issue that would need to be resolved for a per-capita tax would be tax revenue sharing with municipalities. Although Juneau is the only large port of call with a passenger tax, Ketchikan and Sitka have discussed such a tax in recent years. The issue would be the same as for a statewide sales tax: Would the state take over imposition and collection of cruise ship passenger fees and then return a portion to communities, or would the state collect its own tax and allow municipalities to impose their own fees, too? It is possible the cruise lines would prefer to deal with just one taxing authority, rather than watching as the state and multiple communities adopt different tax rates and rules.

Why Don't Most Cruise Companies Pay Corporate Taxes on Cruise Operations?

The Alaska Supreme Court in 1998 gave the state a victory in its ruling that Alaska could collect corporate income taxes on the apportioned profits of foreign-flagged vessels operating in state waters. This case had nothing to do with passenger taxes; it was limited strictly to the issues of corporate income taxes.

After the state won the case, and the right to tax foreign-flagged cruise ships and other foreign-flagged vessels, the legislature adopted a measure exempting such business activity from state corporate taxes.

The Department of Revenue was unable to provide a strong estimate of possible new revenues to the state from the tax victory in court, mostly because we have never seen a corporate tax return from a cruise line. However, we estimated in 1998 that the state could receive up to \$10 million a year in corporate tax revenues if allowed to assess the tax. Because of the legislation exempting foreign-flagged vessels from corporate income taxes in Alaska, the smaller, domestic operators have to pay the tax while their large colleagues in the trade are excused.

Permanent Fund Earnings

How Much Money is Available from the Permanent Fund?

The Department of Revenue and the Alaska Permanent Fund Corporation believe the amount of "surplus" realized earnings available from the Permanent Fund over the next decade will average about \$250 million per year under the existing statutory framework for calculating earnings and Permanent Fund dividends. However, the actual amount available in any one year will vary enormously — ranging from \$0 to more than \$500 million, depending on the performance of the financial markets and the mechanics of how the surplus is determined.

Relying on the surplus under existing statute to help pay for public services could be risky. For example, if the surplus for Fiscal 2001 were determined on the basis of current-year realized earnings only, there would have been no surplus available. The Department of Revenue projects the same will be true for Fiscal Year 2002.

What is Percent of Market Value, and is it a Better System?

The Department of Revenue strongly recommends calculating the amount available for distribution each year from the Permanent Fund using a moving average over a five-year period. More specifically, the department recommends the legislature adopt the Percent of Market Value (POMV) approach, rather than realized earnings, to determine the amount of funds available for distribution. Using such a moving average would reduce the wild swings in the amount that would be available each year vs. using only a single-year's earnings to determine the amount available for distribution.

Such a moving average would not be new to the Alaskans. We currently determine the dividend using a moving average based on the fund's realized earnings over five years.

Under the Percent of Market Value calculation as endorsed by the Permanent Fund Board of Trustees, 5% of the Permanent Fund's total market value, as averaged over the past five years, would be available for distribution each year. Assuming the fund's long-term earnings target is about 8%, the payout limit at 5% would ensure that sufficient earnings remain in the Permanent Fund to protect it from inflation.

At a 5% payout, the Permanent Fund, in the median case, would generate more than \$1.3 billion a year, on average, between Fiscal 2003 and Fiscal 2008, according to the Permanent Fund Corporation. The earnings — and the dividends — would continue building over time. A \$1.3 billion payout split 50-50 between dividends and public services could, for example, fund a \$1,050 dividend (assuming 600,000 eligible Alaskans) and still leave \$650 million for the General Fund to help pay for public services. Other possibilities include:

- 60% to Dividends / 40% to Public Services, equals a \$1,300 dividend and \$520 million for public services.
- 55% to Dividends / 45% to Public Services, equals an \$1,190 dividend and \$585 million for public services.

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FALL 2002

REVENUE SOURCES BOOK

Forecast & Historical Data



Tax Division

Tony Knowles, Governor
Wilson L. Condon, Commissioner
Dan E. Dickinson, Director
Charles Logsdon, Chief Petroleum Economist

II. OIL AND GAS PRODUCTION OPPORTUNITIES

Oil Production as an Economic Opportunity

Introduction

Promoting resource development was one of the major themes of Alaska's just-concluded election, which prompts several questions. What are the major opportunities for additional oil development over the next decade? What is needed to exploit these opportunities? And if these opportunities are successful, how will they affect Alaska's public finances? Finally, what can state government do to help or, if it makes a mistake, hinder that development?

Oil development in Alaska may someday occur outside the Cook Inlet and North Slope areas, but that is unlikely over the next 15 years. Though small when compared to the North Slope, the health of the Cook Inlet oil patch will continue to be important, especially for the livelihood of Kenai Peninsula residents. However, new oil development opportunities in Cook Inlet are unlikely to significantly contribute to Alaska's treasury. To find that kind of money, we must look north.

North Slope oil production commenced in 1977 and reached a peak rate of just over 2 million barrels per day in 1988. North Slope production then declined for 13 consecutive years to just over 990,000 barrels per day in Fiscal Year 2001. (See Figure 10, Page 37, and Appendix D.) In Fiscal 2002, it increased a small 1.4% to 1,003,343 barrels per day. We now believe that was a one-year exception, and we forecast a steady, modest decline in North Slope production to 955,000 barrels per day between Fiscal 2003 and 2007. On average, over this five-year period, this new forecast reflects a reduction of about 80,000 barrels per day from our spring estimate.

Much of this reduction comes in our lower forecast of heavy-oil production from the West Sak formation in the Kuparuk Unit and the Schrader Bluff formation in the Milne Point Unit. We had anticipated the producers would invest substantially more money to boost production in both fields.

Beginning in Fiscal 2008, new fields coming online should elevate total production back over the million-barrels-a-day level, and we project North Slope production to exceed 1 million barrels a day from Fiscal 2008 through 2012. Production could start down again after Fiscal 2013 unless producers have significant exploration success, which will require the commitment of substantial money to the exploration and development of new fields.

Is there a significant possibility for increases in North Slope oil production over what we have forecast? That's the positive question, but what about the negative? And what are the chances that production levels may fall short of our forecast? The answer to these questions depends in large part on the amount of money exploration and production companies spend to develop oil resources that have already been discovered on the North Slope and to discover additional oil. Those spending decisions depend — in great part — on world oil prices and government regulatory and fiscal policies. The key in all this is that producers need to spend money so that the state can make money from its oil resources.

There is no question that state government policy decisions will affect the level of investment in North Slope oil exploration and development. And state government decision-makers will have to decide what policies are most likely to maximize the public benefit from North Slope production. However, those decision-makers will not all agree upon what constitutes maximum public benefit. Some would no doubt seek to maximize public revenue, while others would favor an increase in the level of private economic activity — including jobs — in place of some potential public revenue.

Finally, state government's take could be set so high that exploration and production companies invest elsewhere than in Alaska. If this happened, an increased government take in the short run could actually reduce Alaska's total take from oil over the long term. On the other hand, a policy of encouraging development by diminishing the government share could also reduce total take. The balance, sought by the host government in every oil province of the world, is to take a healthy share of the profits derived from oil while remaining competitive in the world marketplace for oil and gas investment dollars.

Assumptions and Rules-of-Thumb

Some of the exploration and producing companies with interests on the North Slope announce their capital expenditure plans each year. What do those plans indicate about the likely amount of future production? To answer this question precisely we would need to be privy to internal company information and analysis not available to us. However, equipped with a few rules-of-thumb, an armchair analyst can make a rough translation of the producers' announced capital plans into likely future production.

Here are the assumptions and rules-of-thumb that we use: ⁽¹⁾

- **Prospectivity of the North Slope.** The producers we have talked with tell us the North Slope is still a "world class" geological basin to explore for oil.
- **Finding Costs.** We assume that on average it costs \$1 to find a barrel of oil on the slope. ⁽²⁾ This is a weighted average of our estimate of the cost for finding new fields (just over \$1 per barrel) and for finding new satellite accumulations near already discovered fields (\$0.60 per barrel). Some North Slope producers have a policy to pursue only satellites. Some pursue both new fields and satellites.
- **Reserve Replacement.** Companies trying to maintain a constant level of worldwide production also try to maintain a constant reserve base. Consequently, if a company or group of companies want to maintain the production rate from a particular area (e.g. the North Slope), we would expect them to invest enough in exploration to maintain a relatively constant reserve base in that same area. Therefore, over time, a constant North Slope production level would require exploration expenditures of \$1 for each barrel of newly found oil reserves to replace each barrel of production. Companies can also add to their reserves by spending on new technology to turn uneconomic oil into economically recoverable reserves, such as heavy oil.

(1) These rules-of-thumb come from our discussions with the North Slope producers and our review of available literature.

(2) According to Cambridge Energy Research Associates' (CERA's) "White Paper Outlook for Alaska" (November 1999) ("White Paper") at page 12, "The best performers' North Slope exploration costs are currently about \$1.00 per barrel..." BP has recently stated it costs them \$2.50 per barrel to find oil in Alaska, but they stated that as one reason why they are discontinuing their frontier exploration activity on the slope. Steve Marshall, President, BP Exploration Alaska, Inc. Speech to Fairbanks Chamber of Commerce, March 22, 2002.

(3) Exxon puts the cost of developing Point Thomson's 400 million barrels of reserves at \$1.2 billion. BP puts the cost of developing 55 million barrels of Schrader Bluff heavy oil at \$150 million. MIX, the enhanced oil recovery project at Prudhoe Bay, cost \$160 million for 50 million barrels. There are other rules-of-thumb that some use to derive future production rates from current capital spending: (1) for greenfield development, \$15 million to \$20 million for every 1,000 barrels per day of peak-rate production; and (2) for infill drilling, \$5 million to \$7 million for 1,000 barrels per day. These rules-of-thumb are consistent with the \$3 per barrel estimate we use in this analysis.

- **Development Costs.** Once found, we assume it costs an average of \$3 per barrel to drill and build the facilities to produce North Slope oil. Cambridge Energy Research Associates (CERA), in its 1999 White Paper on Alaska's development prospects, stated that it costs \$2.50 per barrel to develop North Slope oil. However, a survey of recent announcements regarding field developments indicate that the companies' target is close to \$3 per barrel. ⁽³⁾
- **Affordable Development.** A significant amount of the oil that has been found on the slope cannot be developed for \$3 per barrel, but as technological advances are made more of this found oil can be developed economically at \$3 per barrel. In the short term, a producer could maintain its current production level by spending just enough to develop found oil. Eventually, however, technological advances will run up against geologic constraints, and the company's \$3 per barrel oil will decline unless new fields are discovered. This newly discovered oil will cost the companies' \$4 per barrel - \$1 to find the barrel and \$3 to develop it.
- **Minimum Capital Expense.** There is a great deal of discovered oil on the slope that has been developed but not yet produced. Even after building the facilities needed to produce that oil, the companies still must spend additional capital over the years to keep those facilities operable and safe. This spending is often called LTO, or "License to Operate" capital, and is in addition to routine operating and maintenance expenses on the slope. An example of LTO capital would be installation of pollution control equipment to meet new government standards. Based on discussions with the North Slope operators, we estimate the annual LTO expense at about 2% of existing and planned total capital expense for the facility. Consequently, we used a North Slope LTO expense of \$300 million per year for this analysis. This is a fixed cost, and it is the minimum amount of capital spending needed to recover the reserves already developed and slated for recovery. Companies view LTO as "non-rate" expenditures, or expenditures that are not made to increase proven reserves. Our LTO estimate may include more than some companies would characterize as LTO for accounting purposes.

In thinking about the cost of finding and developing new oil fields, it is important to remember that future oil prices are uncertain. What that means is even when oil prices are high, producers still make their capital expenditure decisions based on average or low prices — they do not go out and spend more money on high-cost projects just because today's prices may be high. The fact is they are reluctant to gamble investment dollars on high oil prices in the future. As a result, these rules-of-thumb, adopted in a low-oil price environment, seem to apply even in times of higher oil prices.

Department of Revenue Production Projections for Discovered Fields

The table on the next page reflects the following: (1) the Department of Revenue estimates of the amounts of original oil in place for all of the fields discovered on the North Slope; (2) the amounts of production from each of these fields through the end of June 2002; (3) our estimates of the amounts of additional oil recovery from each of these fields over the balance of their productive lives; and (4) our estimates of the total amounts of production from each of these fields.

Table 1 . Projected ANS Production from Discovered Producing Fields
Million Barrels

	Original Oil In Place	Production Through FY 2002	Currently Projected Additional Production	Total Estimated Production
Prudhoe Bay (Oil and NGLs)	23,700	10,670	3,400	14,070
Prudhoe Bay satellites (Midnight Sun, Aurora, etc.)	1,400	17	500	517
Lisburne	1,800	140	40	180
Point McIntyre	900	350	170	520
Greater Point McIntyre Area (Niakuk, etc.)	300	110	50	160
Kuparuk	6,000	1,820	1,140	2,960
Kuparuk satellites excl. heavy oil (Tabasco, Tarn, etc.)	400	40	140	180
West Sak ⁽¹⁾	12,000	6	370	376
Milne Point- Kuparuk and Sag River ⁽²⁾	1,000	150	220	370
Milne Point- Schrader Bluff ⁽¹⁾	1,600	20	310	330
Duck Island Unit (Endicott, Eider, Sag Delta)	1,200	430	170	600
Badami	160	4	2	6
Alpine	1,100	30	460	490
Northstar	300	10	200	210
Subtotal	51,860	13,797	7,172	20,969
Discovered non-producing fields				
Alpine Satellites (Nanuq, Fiord, etc.)	395	0	180	180
Liberty	300	0	150	150
Point Thomson and Others (Sourdough, Yukon Gold)	1,400	0	560	560
Sandpiper	150	0	60	60
NPR-A (Rendezvous/Spark)	800	0	400	400
Ugnu ⁽¹⁾	7,000	0	0	0
OCS Offshore (Kuvlum, Hammerhead) ⁽³⁾	1,000	0	0	0
Subtotal	11,045	0	1,350	1,350
Total	62,905	13,797	8,522	22,319

(1) These are heavy oil deposits.

(2) Kuparuk refers to the formation in the Milne Point Unit, not the Kuparuk River Unit.

(3) These fields' barrels were not economic to produce in the mid-1990s. For offshore stand-alone developments the minimum economic field size is 1 billion barrels, and each of these fields is smaller than this. However, these fields may become economic to produce if either technological advances allow for lower development costs or the fields can produce as satellites to larger fields.