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M E M O R A N D U M

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

FROM: Staff MW CAB.

DATE: May 11, 1981

RE: Proposed draft Committee Substitute for HB 200

Attached is a draft bill designed to accomplish the objectives set out in the Joint Statement on Oil Taxes issued by the Governor and legislative leadership on March 18, 1980:

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

This draft bill was prepared at your request by Commissioner of Revenue Tom Williams, John Messenger and Fred Boness of the law firm Preston, Thorgrimson, Ellis & Holman and committee staff members Mark Wittow and Kevin McCarthy. We have discussed the main features of the proposed legislation with Attorney General Wilson Condon and will distribute the draft to Alaskan oil and gas producers, legislative advisors and other interested parties. The fiscal analysis for the draft was prepared by the Department of Revenue.

The draft bill accomplishes the following:

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

2. Enacts a reserves tax on producing oil and gas properties, similar to the Reserves Tax enacted in 1975, as a backstop for revenues collected by AS 43.21 in its current form;

3. Makes the technical amendments to AS 43.21 contained in HB 200 and SB 192, introduced at the request of the Governor. These technical amendments will improve the state's posture in the current litigation over 43.21, but could result in a tax reduction for Alaskan oil and gas producers of up to $142 million in FY 81 and approximately $60 million a year thereafter. (See fiscal note for HB 200, House Journal Supplement #10, 2/20/81).

4. Makes no changes to the current Alaskan oil and gas production (severance) tax (AS 43.55);

5. Exempts oil and gas lands of ANCSA Regional Corporations from the reserves tax in accordance with federal law, and allows all oil and gas income distributed under section 7(i) of ANCSA as a deduction from AS 43.21.

The Findings and Purposes section of the legislation is not yet completed, but will be available for the committee's

consideration by May 18. The detailed fiscal analysis by the Department of Revenue and a legal analysis by Preston, Thorgrimson, Ellis & Holman will be submitted to the committee on that date. Preliminary numbers are being furnished to interested Alaskan oil and gas producers.

We are available at your convenience to discuss the proposed draft in greater detail. The legislative division of legal services is currently preparing a formal draft of the attached draft bill.

Original sponsor: Rules Committee
Request of the
Governor

5/11/81

IN THE HOUSE

BY THE SPECIAL GAS PIPELINE COMMITTEE

DRAFT COMMITTEE SUBSTITUTE FOR HOUSE BILL 200

IN THE LEGISLATURE OF THE STATE OF ALASKA

TWELFTH LEGISLATURE - FIRST SESSION

A BILL

For an Act entitled: "An Act relating to oil and gas taxes, and providing for an effective date."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

* Section 1. AS 43.20.011(e) is amended to read:

(e) There is imposed for each tax [TAXABLE] year upon the entire taxable income of every corporation derived from sources within the state a tax consisting of a normal tax equal to 5.4 percent of taxable income, and a surtax which is equal to 4.0 percent of taxable income, except that the tax on a corporation doing business in the state which derives income from [ENGAGED IN] the production or pipeline transportation of crude oil or natural gas in the state shall be determined and paid in accordance with AS 43.21. For tax years beginning after December 31, 1979, the surtax exemption is $50,000. For controlled corporations described in secs. 1561 - 1563 of the Internal Revenue Code only one surtax exemption may be allowed for the controlled group. Income from sharing in the 70 percent of a regional native corporation's revenue that is required to be divided under sec. 7(i) of the Alaska Native Claims Settlement Act (P.L. 92-203) is taxable income of the recipient under this chapter.

* Sec. 2. AS 43.21.010 is amended to read:

Sec. 43.21.010. APPLICATION. This chapter applies to

every corporation doing business in the state which derives income from the production of oil or gas from a lease or property in the state[,] or from the pipeline transportation of oil or gas in the state. The tax calculated under this chapter is measured by the total taxable income of the corporation <u>during the tax period</u> as <u>determined under</u> [DEFINED IN] AS 43.21.020 - 43.21.040 and is <u>calculated</u> [DETERMINED] at the rates established under AS 43.20.011(e).

* Sec. 3. AS 43.21.020(c) is amended to read:

(c) Net income from oil and gas production shall be determined by the department by deducting from gross income the following:

(1) royalties paid in kind or in value;

(2) taxes imposed under AS 43.55 and AS 43.57 which are actually paid <u>or incurred</u> by the corporation on the production from a lease or property in the state;

(3) taxes imposed under AS 43.56 and AS 29.53 which are actually paid <u>or incurred</u> by the corporation on property used directly in the production of oil or gas from a lease or property in the state, including property used in production, gathering, treatment or preparation of the oil or gas for pipeline transportation, but only if those property tax payments were due and payable only after the date of commercial production from the lease or property with which the property was associated;

(4) the direct costs incurred by or for the corporation in operating the lease or property, including the direct costs of producing, gathering, treating or preparing the oil or gas for pipeline transportation, but not of any

payments received for those activities and not including any indirect costs or overhead expense;

(5) depreciation (using the unit of production method or such other reasonable methods as the department may be regulation establish) on property used directly in the production, gathering, treatment or preparation of the oil or gas for pipeline transportation including amortization of capitalized interest for investments in this property at a rate not to exceed the average cost of borrowed capital to the taxpayer during the year in which it is capitalized;

(6) the amortization of lease acquisition payments and taxes paid or incurred under AS 43.56 and AS 29.53 (including capitalized interest on both) for or on producing properties before the commencement of commercial production from the lease or property for which the property is being used;

(7) interest expense of the corporation, not capitalized during construction, that was paid or incurred in connection with property in Alaska; however, unless (f) of this section applies, the interest expense may [TO THE EXTENT THAT IT DOES] not exceed that portion of the total interest paid by the consolidated business of which the corporation is a part, determined by multiplying the total interest [(REDUCED BY INTERCOMPANY TRANSACTIONS WITHIN THE CONSOLIDATED BUSINESS)] by a fraction, the numerator of which is the value of the corporation's real and tangible personal property used directly in the production of oil or gas from a lease or property in the state and the denomi-

nator of which is the value of all real and tangible personal property of the consolidated business; in this subsection, "total interest paid by the consolidated business" does not include interest expense arising from intercompany obligations within the consolidated business except to the extent that the interest expense reflects a pass-through of interest on a third-party borrowing by the parent or other member of the consolidated business with the purpose, expressed at the time of the third-party borrowing, of financing Alaska business activity of the taxpayer corporation;

(8) expenses incurred by the corporation after December 31, 1977 of unsuccessful exploration of oil or gas in the state including the acquisition costs of abandoned properties, dry hole costs and the costs of geologic and geophysical exploration related to those abandoned properties;

(9) general overhead or administrative expense incurred by the corporation attributable to the production of oil or gas from a lease or property in the state to the extent, except as provided in (f) of this section, that it does not exceed [THE LESSER OF:

(A)] that portion of the total general overhead or administrative expense incurred by the consolidated business of which the corporation is a part, determined by multiplying the total general overhead or administrative expense by a fraction, the numerator of which is the value of the corporation's real and tangible personal property used directly in the production of oil or gas from a lease or property in the state and the denominator of which is

the value of all real and tangible personal property of the consolidated business;

(10) the amount of income from the production of oil and gas from a lease or property that is divided among the 12 regional corporations under sec. 7(i) of the Alaska Native Claims Settlement Act (P.L. 92-203);

(11) the amount by which the total tax paid or incurred by the taxpayer under AS 43.58 for leases or properties in the state exceeds the amount of credit allowed to the taxpayer under AS 43.58.041;

(12) the tax imposed by sec. 4986 of the Internal Revenue Code that is paid or incurred by the taxpayer for oil production from leases or properties in the state[, OR

(B) THE SUM OF $0.12 FOR EACH BARREL OF OIL AND $0.02 FOR EACH THOUSAND CUBIC FEET OF GAS PRODUCED FROM A LEASE OR PROPERTY IN THE STATE].

* Sec. 4. AS 43.21.020 is amended by adding a new subsection to read:

(f) If a corporation demonstrated to the satisfaction of the department that it paid or incurred actual expenses for interest or for general overhead or administration attributable to the production of oil or gas from a lease or property in the state in an amount greater than the amount determined under (c)(7) or (c)(9) of this section, the department may allow the corporation to deduct the greater amount.

* Sec. 5. AS 43.21.040(b) is repealed and re-enacted to read:

(b) The total taxable income of the consolidated business is its entire taxable income less the portion of that

1 taxable income attributable to worldwide production and
2 pipeline transportation of oil and gas. In this section,
3 "taxable income" is taxable income under Subtitle F and
4 chapter 1 of Subtitle A of the Internal Revenue Code of
5 1954, as amended, except that those provisions adopted after
6 December 31, 1975 which change or modify exemptions from tax
7 are not adopted by reference as a part of this section until
8 the second January 1 following the effective date of the
9 federal law. In computing taxable income under this section,
10 the taxpayer is not entitled to deduct any taxes based on or
11 measured by net income.
12 * Sec. 6. AS 43.21.050 is amended by adding a new subsection
13 to read:
14 (d) If the methods of allocation and apportionment
15 provided in this chapter do not fairly represent the extent
16 of a corporation's business activity in the state, the cor-
17 poration may petition for or the department may require, in
18 respect to all or any part of the corporation's business
19 activity, if reasonable, the employment of any method au-
20 thorized under art. IV, sec. 18, of the multistate tax com-
21 pact (AS 43.19.010) to effectuate an equitable allocation
22 and apportionment of the corporation's income. The Commis-
23 sioner shall include in his annual report required in sec.
24 110 of this chapter a report on all relief granted under
25 this subsection, including for each case a statement of the
26 changes in tax liability resulting from the granting of
27 relief, the tax years involved and a description of the
28 method of determining taxable income that was substituted
29 for those provided in this chapter.
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1 * Sec. 7. AS 43.21.070 is amended to read:

2 Sec. 43.21.070. PAYMENT OF TAX. The tax levied under
3 this chapter is payable to the department on or before Sep-
4 tember 30 of each year or in installments, including prepay-
5 ments of estimated tax, at the times and under the condi-
6 tions the department may by regulation require. This tax is
7 payable on the due date set out in this section even though
8 the assessment is under appeal or the validity, enforceabi-
9 lity or application of this chapter or any provision of this
10 chapter is challenged before the department or in the
11 courts.

12 * Sec. 8. AS 43.58 is amended by adding new sections to read:

13 Sec. 43.58.011. FINDINGS AND PURPOSES. [TEXT TO BE
14 PROVIDED].

15 Sec. 43.58.021. AD VALOREM TAX. (a) Beginning
16 July 1, 1981, an annual tax is levied each tax year on the
17 full and true value of taxable property under this chapter.

18 (b) The rate of levy for the tax year beginning
19 July 1, 1981, is 30 mills and is 20 mills for each tax year
20 thereafter, unless a different rate for a tax year is set by
21 law on or before the last day of February in the tax year.

22 Sec. 43.58.031. EXEMPTIONS. The following property
23 that would otherwise be taxable property shall be exempt
24 from taxation under this chapter:

25 (1) an interest of the United States or the state in a
26 property;

27 (2) property exempt from state taxation under the laws
28 of the United States including the exemption of property,
29 whether developed or leased to third-parties, under sec.

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1 21(d) of the Alaska Native Claims Settlement Act (P.L. 92-
2 203, 85 Stat. 688, 43 USC 1601 et. seq.), except that lease-
3 holds and similar interests held in the exempt property by
4 third-parties shall be taxable to the extent of those
5 interests.
6 Sec. 43.58.041. CREDITS. (a) There shall be allowed,
7 as a credit against the tax levied under this chapter for a
8 taxpayer's taxable properties, the amount of oil and gas
9 corporate income tax paid under AS 43.21 by the taxpayer for
10 tax periods under AS 43.21 beginning on or after January 1,
11 1981. The credit shall not exceed the total amount of tax
12 due under this chapter for all of the taxable properties of
13 the taxpayer in the tax year.
14 (b) In addition to the credit allowed under (a) of
15 this section, the amount of oil and gas corporate income tax
16 paid under AS 43.21 by a taxpayer for tax periods under AS
17 43.21 beginning on or before December 31, 1980, shall be
18 allowed as a credit against the tax levied under this chapter
19 for the taxpayer's taxable properties.
20 (c) In applying the credits under (a) and (b) of this
21 section, the credit allowed under (a) of this section shall
22 be applied before applying any credit under (b) of this sec-
23 tion. If the credit allowed under (b) of this section exceeds
24 the amount of tax due under this chapter remaining after the
25 application of the credit under (a) of this section, then
26 the excess credit under (b) of this section may be carried
27 forward and applied in subsequent tax years until it has
28 been exhausted.
29 (d) If a taxpayer's tax liability for a tax period

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under AS 43.21 is redetermined and adjusted after the credit for that tax period has been applied under this section, the taxpayer's tax liability under this chapter shall be redetermined, taking into account the adjustment to the taxpayer's tax liability under AS 43.21.

Sec. 43.58.051. ASSESSMENT. (a) The department shall assess taxable property under this chapter to the owner of it at its full and true value as of July 1 of each tax year.

(b) The full and true value of taxable property under this chapter is the estimated price which the property would bring for its proven reserves in an open market and under the then prevailing market conditions in a sale between a willing seller and a willing buyer both conversant with the property and with prevailing values. In determining this value, the department shall consider all factors which may be known by the department to affect the value of taxable property, including but not limited to the discounted present value of the expected future net income from the proven reserves of the taxable property.

(c) In assessing taxable property under this chapter, the department shall not include the assessed value of property subject to tax under AS 43.56.

(d) If the department discounts the expected future net income from the taxable property to its present value, the department shall presume that the appropriate discount rate is seven percentage points above the rate of inflation implicit in the GNP deflator over the five calendar years immediately preceding the assessment date. A taxpayer may rebut this presumption only by proving to the department

1 by clear and convincing evidence that the use of the pre-
2 sumed discount rate in the valuation of the property would
3 result in constructive fraud. In this subsection, "GNP de-
4 flator" means the deflator for the gross national product
5 published by the United States Department of Commerce.

6 Sec. 43.58.061. ASSESSMENT ROLL. The department shall
7 prepare annually the assessment roll for taxation under this
8 chapter. The roll shall contain:

9 (1) a description of all taxable property;

10 (2) the assessed value of all taxable property; and

11 (3) the names and addresses of persons owning or other-
12 wise holding an interest in taxable property.

13 Sec. 43.58.071. ASSESSMENT NOTICE. On or before
14 October 15 of each tax year, the department shall send to
15 every owner of taxable property named in the assessment roll
16 a notice of assessment showing the assessed value of the
17 property. The notice of assessment is effective on the date
18 of its mailing.

19 Sec. 43.58.081. APPEAL. (a) A person aggrieved by
20 the action of the department in making an assessment may
21 appeal that action and obtain a hearing upon its validity
22 before the department by filing written objections to the
23 assessment not later than 20 days after the effective date
24 of the assessment notice.

25 (b) The procedures for conduct of the hearing and pre-
26 liminary activities to it shall be in accordance with AS
27 43.05.240. At the hearing the appellant bears the burden of
28 proof. In the absence of this proof the assessment is to be
29 upheld by the department. If the department, after hear-

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ing, determines that a correction of the assessment is warranted, the department shall correct the assessment and the assessment roll.

(c) Within 30 days after the decision by the department following the hearing, a person aggrieved by that decision may appeal to the superior court. The superior court shall grant priority on its dockets for the appeals over all civil cases then pending.

Sec. 43.58.091. CERTIFICATION. On or before March 15 of the tax year, the department shall certify the final assessment roll and mail to the owner, operator or other person filing a return and paying tax on the taxable property a statement of the amount of tax due.

Sec. 43.58.101. SUPPLEMENTAL ASSESSMENT ROLLS. The department shall include property omitted from the assessment roll on a supplemental roll, using the procedures set out in this chapter for the original roll.

Sec. 43.58.111. INVESTIGATION. (a) The department may make an investigation of property on which a return has been filed or on property for which no return has been filed. In either case, the department shall make its own valuation of the taxable property, which is prima facie evidence of full and true value.

(b) An employee or agent of the department may enter any premises necessary for the investigation during reasonable hours and may examine property and other appropriate records. The owner of taxable property, upon request, shall furnish to the employee or agent of the department reasonable assistance required for the investigation. If an em-

1 ployee or agent of the department seeking to enter any pre-
2 mises necessary for an investigation under this section or
3 to obtain reasonable assistance required for an investiga-
4 tion under this section is refused such entry or assistance,
5 the superior court may, after reasonable notice to and hear-
6 ing of the owner, order the owner to allow the entry or to
7 furnish the assistance.

8 (c) For the purpose of the investigation, the owner,
9 operator or other person filing a return and paying the tax
10 on the taxable property or his representative may be re-
11 quired to present himself for examination under oath by the
12 department.

13 Sec. 43.58.121. LIMITATIONS ON ASSESSMENT, COLLECTION
14 AND REFUND OF TAXES. The limitations on assessment, collec-
15 tion and refund of taxes under AS 43.05.260, 43.05.270 and
16 43.05.275 shall apply to the tax levied under this chapter
17 except that a redetermination of tax under sec. 41(c) of
18 this chapter shall not be subject to these limitations.

19 Sec. 43.58.131. RETURNS AND PAYMENT OF TAX. (a) A re-
20 turn of taxable property shall be submitted on or before
21 August 1 on the form prescribed by the department based on
22 property values existing on July 1 of each tax year,

23 (1) by a person who is the owner of the property, or
24 who controls that property as agent, or on account of any
25 other person;

26 (2) by a guardian or other person who has charge of
27 taxable property belonging to a minor or other person;

28 (3) by the trustee of a trust estate holding taxable
29 property in trust for the benefit of another person;

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1 (4) by the executor or administrator of a deceased
2 person's estate which includes taxable property;
3 (5) by the receiver of a corporation who has its assets
4 in his hands.
5 (b) The person required to submit the return specified
6 under (a) of this section is primarily liable for payment of
7 the tax levied by this chapter. The persons or estates
8 specified in (a)(2)--(5) of this section in whose behalf the
9 tax levied by this chapter is to be paid are secondarily
10 liable for payment of the tax. With the written approval of
11 the department, an operator or nonoperator of the lease or
12 property may submit returns or make payment of the tax
13 levied under this chapter on behalf of himself and such
14 other persons as the department may approve.
15 (c) The tax levied under this chapter is payable to
16 the department on or before June 30 of each tax year or in
17 installments, including prepayments, at the times and under
18 the conditions the department may by regulation require.
19 This tax is payable on the due date set out in this subsec-
20 tion or at the times required by the department under its
21 regulations even though the assessment is under appeal or
22 the validity, enforceability or application of this chapter
23 or any provision of this chapter is challenged before the
24 department or in the courts.
25 (d) With the prior written approval of the department,
26 a person submitting returns or making payments as required
27 under this chapter for more than one taxable property may
28 regard those properties as a single taxable property for
29 purposes of submitting those reports or making those payments
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1 (e) Any person making payment of the tax levied under
2 this chapter on behalf of one or more other persons owning
3 or otherwise holding an interest in a taxable property may
4 withhold a proportionate share of the payment from any
5 proceeds or other benefits from the taxable property owed to
6 any person on whose behalf the payment is made. Unless
7 otherwise specifically provided by written contract or
8 agreement, the person so withholding a proportionate share
9 of the tax levied under this chapter incurs no liability to
10 those from whom it is withheld by virtue of having made the
11 witholding.
12 (f) By written notice the department may require a
13 person filing a return to submit additional information to
14 the department no later than 30 days after the notice.
15 Sec. 43.58.141. REGULATIONS. The department may adopt
16 regulations in accordance with the Administrative Procedure
17 Act (AS 44.62) as appropriate to administer and enforce this
18 chapter.
19 Sec. 43.58.151. DEFINITIONS. In this chapter:
20 (1) "commercial production" means the production of oil
21 or gas for purposes of sale or other beneficial use, except
22 when the sale or beneficial use is incidental to the testing
23 of an unproven well or unproved completion interval;
24 (2) "department" means the Department of Revenue;
25 (3) "gas" means all hydrocarbon substances not defined
26 as oil in this chapter;
27 (4) "property" means any right, title or interest in or
28 the right to produce or recover oil or gas including:
29 (A) a mineral interest,
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1 (B) a leasehold interest,

2 (C) a working interest, royalty interest, overriding
3 royalty interest, production payment, net profit interest or
4 any other interest in a lease, concession, joint venture or
5 other agreement for oil and gas exploration, development or
6 production,

7 (D) a working interest, royalty interest, overriding
8 royalty interest, production payment, net profit interest or
9 any other interest in an agreement for unitization or
10 pooling under the provision of sec. 614(b)(3) of the Inter-
11 nal Revenue Code of 1954 as defined on the effective date of
12 this paragraph;

13 (5) "oil" means crude petroleum and other hydrocarbons
14 regardless of gravity which, when recovered, are recovered
15 at the wellhead in liquid form, and the liquid hydrocarbons
16 known as distillate or condensate that are recovered by se-
17 paration from gas other than at a gas processing plant;

18 (6) "operator" means the person conducting the explor-
19 ation, development or production operation for a property;

20 (7) "proven reserves" means the volumes of oil and gas
21 in a known deposit which geological and engineering informa-
22 tion indicate to be recoverable in the future under prevail-
23 ing economic conditions and technology;

24 (8) "taxable property" means a property having com-
25 mercial production;

26 (9) "tax year" means a calendar period beginning on
27 July 1 of one calendar year and ending on June 30 of the
28 following calendar year.

29 * Sec. 9. AS 43.58.041 has been included in this Act so that

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persons subject to the tax under AS 43.21 will not bear the cumulative burden of both the tax under AS 43.21 and AS 43.58. The legislature believes that the inclusion of this section granting tax credits does not in any manner change the intent, validity or enforceability of the basic ad valorem tax imposed by this Act. If the inclusion of AS 43.58.041, or any portion of it, results in a judicial decision that the ad valorem tax imposed by this Act is invalid, then AS 43.58.041, or that portion of it which causes the invalidity, shall be void and of no effect whatsoever and the Act shall be read as if that section or that portion of it had never been included.

* Sec. 10. AS 43.21.040(d) and 43.[illegible].040(e) are repealed.

* Sec. 11. AS 43.55.011(d), 43.55.012(a), 43.55.018, 43.58.010, 43.58.020, 43.58.030, 43.58.040, 43.58.050, 43.58.060, 43.58.070, 43.58.080, 43.58.090, 43.58.100, 43.58.110, 43.58.120, 43.58.130, 43.58.140, 43.58.150, 43.58.160, 43.58.170, 43.58.180, 43.58.190, 43.58.200, 43.58.210 are repealed.

* Sec. 12. Sections 1 - 7 and 10 of this Act are retroactive to January 1, 1978, and apply to tax years beginning after December 31, 1977.

* Sec. 13. Sections 8 and 11 of this Act are effective July 1, 1981.

* Sec. 14. Sections 9 and 12 - 14 of this Act are effective immediately in accordance with AS 01.10.070(c).

A SOUND STRATEGY FOR PROTECTING ALASKA'S OIL AND GAS REVENUES:

An Analysis of the Backstop Tax Legislation

prepared for

The Alaska State Legislature
Joint Gas Pipeline Committee

By

PRESTON, THORGRIMSON, ELLIS & HOLMAN

May 27, 1981

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May 27, 1981

The Honorable Terry Gardiner
The Honorable Jalmar M. Kerttula
Co-Chairmen
Joint Gas Pipeline Committee
Alaska State Legislature
Pouch V
Juneau, Alaska 99811

Dear Senator Kerttula and Representative Gardiner:

I am pleased to transmit to you our report to the Joint Gas Pipeline Committee entitled "A Sound Strategy for Protecting Alaska's Oil and Gas Revenues: An Analysis of the Backstop Tax Legislation."

I trust that this report will be useful to the Committee in its consideration of tax legislation now before the Committee. We have appreciated the opportunity to work for the Committee on this subject of vital importance to the State.

Sincerely,

PRESTON, THORGRIMSON,
ELLIS & HOLMAN

By
John R. Messenger

JRM/mmm
Enclosure

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I. INTRODUCTION

In early April our firm and Gregg Erickson & Associates were asked to review and report on the options available to the legislature for implementing the goals established in the "Joint Statement on Oil Taxes" issued on March 18, 1981, by the Governor, the President of the Senate, the Speaker of the House, the Finance Chairmen of the House and Senate and other legislative leaders. The preeminent goal set out in that Joint Statement was a commitment by the Governor and the legislative leadership to find a sound strategy for protecting oil and gas revenues.

Taking this as our charge, we prepared a report to the Joint Gas Pipeline Committee which identified several options available to the legislature. Our report contained a preliminary legal, economic and fiscal analysis of those options, in order to permit an informed choice by the legislature of which options should receive further consideration. Finally, our report contained our recommendation as to which op[illegible]n was most likely to meet the goal of the Joint Statement. In particular, we recommended for further consideration backstop legislation consisting of:

1. a reserves property tax or a combination of a reserves property tax and a severance tax increase; with

2. a credit mechanism which would allow payments made under the oil and gas corporate income tax to be credited against the new tax or taxes.

Although we observed that additional analysis would be required before a final decision could be made, we stated that we were reasonably confident that the option recommended would, after further work, prove to be the one most likely to meet the objective of the Joint Statement and the criteria discussed in our report. We have now completed our additional analysis and we have concluded that the option recommended is indeed the best available strategy for protecting the State's oil and gas revenues.

Since completion of our Report on April 15, 1981, considerable analysis has proceeded on several of the options identified in the Report. There has been extensive discussions of the backstop option with members of the legislature, the Governor, legislative staff, administration officials and other consultants of the legislature and the Department of Revenue. The Department of Revenue has conducted an intensive fiscal and economic analysis of the backstop option. The mutual drafting efforts of the Commissioner of Revenue, committee staff, Legislative Affairs staff, the Attorney General's office and members of our firm have resulted in putting the backstop option in concrete legislative form.

This report will review the analysis which has culminated in the introduction by the Governor of Sponsor Substitute for House Bill No. 200, and explain why we believe that bill meets the goal set forth in the Joint Statement.

II. BACKSTOP CRITERIA

Our April 15 report identified several criteria which should be met by the backstop option in order for it to be a sound strategy for protecting the State's oil and gas revenues. The primary criteria were that the backstop must (1) have sufficient fiscal horsepower to cover the revenues at risk, and (2) be legally secure. In addition, other secondary criteria identified were that the backstop must (1) minimize adverse effects on the current lawsuit, (2) provide administrative convenience, (3) be simple, (4) not over-collect, (5) minimize the likelihood of adverse federal reaction, (6) provide symmetry, (7) have certainty of revenue effect, and (8) minimize spillover effects.

We believe that the backstop option as set out in SSHB 200 meets both the primary and secondary criteria. Our reasons for this conclusion follow:

A. Fiscal Horsepower

After extensive analysis the Department of Revenue has concluded that the imposition of a reserves property tax will generate sufficient revenue to cover fully the revenues currently at risk and those expected to be at risk in the future. The Department has concluded that an annual millage rate of 25 mills will achieve the desired level of revenues. The supporting detail for these conclusions are contained in the fiscal note accompanying SSHB 200 and in the report of Gregg Erickson & Associates to the Department of Revenue.

The reserves property tax estimates made by the department and its consultants were reviewed by the nationally recognized engineering valuation firm of Pritchard & Abbott. In a letter to Commissioner of Revenue, Thomas K. Williams, dated May 20, Pritchard & Abbott concluded after its review of such work that the approach taken was valid, the assumptions used were reasonable, and that the conclusions were consistent with and correctly followed from the approach and assumptions.

B. Legal Security

We have completed our analysis of the potential constitutional challenges that might be raised against the reserves property tax, when it is used as a backstop, and have concluded that the new tax will withstand constitutional challenge and that the reserves property tax as set out in SSHB 200 stands on strong legal footing. The detailed legal analysis of the various constitutional issues is contained in Part IV of this report.

C. Effects On Current Lawsuit

Quite possibly, any change in the State's tax laws could have an effect on the present litigation over A.S. 43.21. A backstop tax could be said to raise questions about the State's confidence in its case and perhaps reduce the urgency of the State's cause. However, the amount of revenue at stake and the disastrous consequences to the State if the State were to lose the litigation require that the State take some action to insure sufficient revenues to

meet its needs even if the State's chances of winning the lawsuit are excellent. Even a small chance of losing is a matter of serious concern because of the financial crisis which would befall the State. These adverse consequences certainly outweigh the intangible effects which tax changes could possibly have on the lawsuit.

D. Administrative Convenience

Although a reserves property tax requires a high degree of technical expertise, it is an easily administered tax. It's administration requires only a minimum number of administrative staff who are supported by retained expertise. As shown in the fiscal note by the Department of Revenue, the new reserves tax can be easily accomodated into the State's existing tax program at minimal cost.

In its 1977 tax study entitled "Alaska's Oil and Gas Tax Structure: A Study with Recommendations for Improvement" the Department of Revenue observed that although the previous reserves property tax proved successful, it contained certain provisions which made its administration more difficult than necessary. One difficulty lay in the fact that the reserves property tax was imposed upon non-producing properties for which there was a lack of economic and engineering information. Another administrative difficulty sprang from the fact that the millage rate was set before the assessment was set. This was felt to put an unwholesome pressure on the assesor to meet budget needs through the assessment valuation.

Both of these difficulties have been removed in SSHB 200. The new reserves property tax is imposed only upon producing properties and the millage rate can be varied after the valuation is determined as it is done in most property taxing jurisdictions.

The previous claims by the oil industry that the imposition of a reserves property tax would result in an administrative nightmare and a huge bureaucracy are not supported either by the experience of other states or by the State's own experience in 1976 and 1977.

E. Simplicity

A property tax on oil and gas reserves is a tried and true tax imposed in other oil and gas producing states. It has also been used successfully in Alaska in the past and, as a property tax, is easily understood.

F. Overcollecting

Once the legislature decides upon the level of revenue that is desired, the reserves property tax can collect the desired revenue without going beyond the legislature's wishes. As shown by the Department of Revenue's fiscal note and the report of Gregg Erickson & Associates to the Department of Revenue, a 25 mill reserves property tax with a credit for income tax payments will yield currently projected revenues.

In addition, SSHB 200 has been structured so that if the reserves property tax at 25 mills will generate more revenue than is desired the legislature can adjust the

millage rate downward to approximate more accurately the desired level of revenue. Of course, each legislature is free to make its own decision as to the level of revenue that is desired.

G. Minimize the Likelihood of Adverse Federal Reaction

Any tax which a state may impose which goes beyond the norm in other states incurs some risk of inviting Congressional restrictions simply because it has gone too far. This risk is probably more significant when the tax is perceived as being passed on to consumers in other states.

Bills have been introduced in Congress in recent years which would place limits on state income taxes and severance taxes. Although none of these bills have become law, a limitation on the way states may tax multistate income or on resource severance tax rates is a real possibility.

The 25 mill property tax contained in SSHB 200 is within the range of property tax rates imposed throughout the nation. The notion of taxing the value of oil and gas reserves is not a novel idea; rather it is a common tax vehicle used in other oil and gas producing states. Unlike income taxes and severance taxes, there are no current Congressional proposals to limit property taxes. Although it cannot be said that the reserves property tax is immune from federal restriction, the likelihood of federal restriction is minimal when compared to other taxes that might be imposed.

H. Symmetry

As reported by the Department of Revenue and its consultants, the reserves property tax collections in SSHB 200 will correspond closely with the oil and gas corporate income tax collections. This will help avoid disturbing previous tax policy judgments by the legislature concerning the tax burden on the oil industry. Although there is not perfect symmetry, the allowance of the income tax credits will help assure that the overall burden on the oil industry will remain relatively stable.

I. Certainty of Revenue Effects

All oil and gas taxes are difficult to estimate with certainty because such taxes are affected by fluctuation in world oil prices and production rates. The Department of Revenue and its consultants Gregg Erickson & Associates, have observed, however, that the reserves property tax is not as sensitive to short term swings in oil prices and production rates as are the severance tax and the oil and gas corporate income tax. Unlike estimates of an apportioned income tax which depend upon judgements about the world wide tax position of individual taxpayers, a reserves tax estimate is more directly keyed to instate activities which are capable of more accurate forecasting.

J. Minimize Spillover Effects

Perhaps the most serious potential adverse spillover effect is the discouragement of future exploration for oil

and gas in Alaska. To mitigate this effect SSHB 200 contains several moderating features. First, the tax is imposed only upon producing oil and gas properties. This will avoid taxing a property before it becomes a viable income producing property. Second, gas reserves are exempt because of the present uncertainty surrounding gas development in the State. As stated by the Governor in his letter of transmittal to SSBH 200, the State should avoid even the possibility that a new tax might effect the economics of currently stalled gas projects. Third, the operation of the credit should prevent the reserves property tax from significantly increasing the overall burden on the oil industry.

III. THE BACKSTOP LEGISLATION

The proposed backstop legislation is contained in Section 8 of SSHB 200. Essentially, it consists of the imposition of a property tax on oil and gas reserves with an allowance of a credit for income tax payments which may be applied against the reserves property tax liability.

A. Tax Imposition (Sec. 48.58.021)

The new tax is an ad valorem tax which begins on July 1, 1981. Unlike other taxes which are imposed on a calendar year basis, this tax would be imposed on a fiscal year basis from July 1 to June 30 of each year commencing with July 1, 1981.

The tax is imposed upon the full and true value of property made taxable under the statute. Property which is taxable includes a broad category of property interests in oil and gas from which there is commercial production. These property interests run the full gamut of potential oil and gas property interests including fee interests, leaseholds, royalty interests, overriding royalty interests, net profit interests and so forth. Thus, to be taxable the property must be a property interest in oil or gas and such property must have commenced commercial production of oil or gas.

These properties are not currently taxed by either the State or municipalities by reason of exemptions contained in both the severance tax statute and the oil and gas hardware tax statute.

The taxable property is taxed at the rate of 25 mills (2.5 percent) each year unless the legislature enacts a different tax rate by the end of February of each taxable year. Section 12 of SSHB 200 sets a 30 mill (3 percent) rate for the first tax year which coincides with the State's 1982 fiscal year.

B. Exemptions (Sec. 43.58.031)

Three catagories of property that would otherwise be taxable under the statute are made exempt. The property interests of the United States or the State are made exempt as provided for in Article IX, Section 4 of the Alaska Constitution. Third party interests in such exempt property, such as leases held by other persons, are not exempt. Thus, federal or state leases to third parties are taxable, but the royalty interest and the retained mineral interest of the federal and state governments are exempt. Similiarly, property required to be exempt under federal law, such as the property interests conveyed under the Alaska Native Claims Settlement Act, are exempt under this bill but only for the length of time required by the Settlement Act. Private interests, such as private leases in exempt Native land, however, are taxable to the extent of such interests. Finally, that portion of the property value attributable to gas reserves is exempt from the tax.

C. Assessment (Sec. 43.58.051)

Taxable property which is not exempt is assessed each year at its full and true value as it existed at the beginning

of the fiscal year. Full and true value is defined, as it is for municipal property tax, as being the estimated price which the property would bring for its proven reserves in an open market and under the then prevailing market conditions in a sale between a willing seller and a willing buyer, both conversant with the property and with prevailing values.

Because property of this nature is seldom traded upon the open market, a valuation method known as the capitalized net income approach is most frequently used. Under this method, the annual net income from the property is projected over the life of the property, using estimates of recoverable reserves of oil and gas in the ground, production rates, prices and expenses. An appropriate discount rate is then chosen and the annual net incomes are discounted to their present value. The sum of these present value net incomes is the market value of the property. A detailed discussion of this method and estimated values for Alaska properties is contained in the report of Gregg Erickson & Associates to the Department of Revenue.

The department in assessing these properties is given the discretion to consider all factors which may affect the value of the property. If the department uses the capitalized net income approach, it has discretion to consider all factors which would affect the value under this approach, such as oil prices, estimated reserves, production rates and expenses. The department's discretion in choosing a discount factor is limited, however, to a standard set by the

legislature. This standard is 10 percentage points above the rate of inflation in the implicit GNP deflator over the five calendar years prior to each assessment date.

D. Tax Calendar

Each tax year begins July 1. That date is the key date for valuation purposes. Although no assessment or other action takes place on July 1, the assessment actions taken later in the tax year are keyed to the valuation of the property as it existed on July 1.

The first date requiring action is August 1. On that date, tax returns must be filed with the Department of Revenue by the owner of the property or the person who controls the property on behalf of the owner. The tax return must include all taxable properties and their value existing on July 1.

After the tax returns have been filed on August 1, but before October 15, the Department of Revenue conducts its own independent valuation work and prepares an assessment roll which contains the identity of all taxable property, its assessed value and the identity of those persons owning the property.

On October 15, the Department of Revenue is required to send an assessment notice to every person owning property which has been included in the assessment roll.

If a taxpayer disagrees with the assessment, he may appeal it by filing written objections with the department within 20

days after the mailing of the assessment notice. A person filing an appeal is entitled to a formal hearing before the department in accordance with the standard hearing procedure applicable to appeals for other taxes. If after a hearing, the department determines that a correction of the assessment is warranted, the department corrects the assessment roll. If the department determines that no correction is warranted, the aggrieved person may appeal the department's action to the Superior Court within 30 days after the department's decision.

On February 1 of the following calendar year, but within the same fiscal year, the Department of Revenue certifies the final assessment roll.

On March 15, after the time for enacting a different tax rate has expired, the department is required to send to every owner of taxable property on the certified assessment roll, a statement of the amount of tax due.

The tax is due at the end of the tax year on June 30, and is payable on that date even if the assessment or the statute is being challenged before the department or the courts. Prepayments or installment payments may be required under regulations of the department.

E. Credits (Sec. 43.58.041)

Persons subject to the tax may credit against their tax liability the amount of tax paid under the Oil and Gas Corporate Income Tax (AS 43.21). The allowable credit is separated into two parts. The first credit consists of

income tax payments made during each taxable year commencing with July 1, 1981 and which income tax payments reflect tax liabilities for tax periods under AS 43.21 after December 31, 1980. The second credit consists of income tax payments made prior to July 1, 1981. Taxpayers who are subject to the new tax but not to AS 43.21 because they are not corporations, are allowed to credit taxes paid under AS 43.20 if they would have been subject to AS 43.21 had they been corporations.

The first credit for current income tax payments is applied in reducing the reserves property tax liability. Any excess credit is not refundable and may not be carried over or carried back to offset reserves tax liability in any other tax year. The second credit for income tax payments made prior to July 1, 1981 may be applied in reducing the reserves tax liability after the first credit has been applied. The second credit, however, may not be taken to the extent that the combined credits will exceed 75 percent of the reserves property tax liability. The excess amount of the second credit, unlike the first credit, may be carried forward to subsequent tax years and applied to reduce that subsequent year's reserves property tax liability.

F. Readjustment of Tax Liability and Credits (Sec. 43.58.041(d); Sec. 43.58.121)

If an income tax liability is adjusted subsequent to the time that it has been credited to reduce the reserves

property tax liability, then the former reserves property tax liability must be readjusted to take into account the readjusted income tax liability and resultant credit. For example, if a person's income tax payments for 1981 are refunded subsequent to the time that those payments have been used to reduce reserves property tax liability, then the reserves property tax must be readjusted to reflect the readjusted income tax payments and the resulting tax liability would then become due. Such readjustments are not subject to the general time limitations on assessment, collection and refund of taxes.

IV. CONSTITUTIONAL PRINCIPLES

The remainder of this report addresses in some detail the constitutional principles underlying the backstop tax legislation. These principles and how the tax conforms to them are extremely important. No additional legal security would be gained if the tax were unconstitutional. We would not recommend legislation which would raise serious constitutional questions. Accordingly, State and federal constitutional principles have provided the necessary guidance and framework for structuring the law.

We have assumed that a taxpayer challenge to the law is likely and that such challenge will raise the maximum number of objections possible. Thus, we expect possible objections based upon equal protection, burden on interstate commerce, lack of a public purpose and violation of due process, among others. We expect a challenge on each of these grounds will be made under both the Alaska Constitution and the United States Constitution, wherever possible. Accordingly, in the discussion which follows we have addressed each of these substantive areas from both a State and federal constitutional law perspective where differences exist.

Generally speaking, the reserves property tax is much less likely to violate constitutional standards, than are taxes which are imposed upon: (1) income derived from interstate commerce, (2) the privilege of conducting inter-

state commerce, or (3) property used in conducting interstate commerce. The reasons for this are more fully discussed below. Reduced vulnerability to constitutional infirmity is extremely important to the State since this tax is a backstop tax. Even if the Oil and Gas Corporate Income Tax should be found unconstitutional, it does not follow that the reserves property tax also will be unconstitutional. In fact, most likely the opposite will be true.

Finally, we point out that the reserves property tax is a traditional tax and its constitutional unassailability well established. However, certain taxpayers have raised the argument that Alaska's entire tax system (not its particular taxes) is unconstitutional because the system in the aggregate results in a confiscation of their property. This is a novel argument. There are no Supreme Court cases which support this argument. In fact, where the argument has been used to challenge single taxes it has received short shrift from the Court. For the taxpayers to prevail on this argument the Supreme Court would have to overrule entire lines of cases and reverse the trend in State tax cases which has allowed the States more and more latitude in fashioning their taxing systems to meet the needs of the local people and economies. Perhaps the taxpayers are making this argument with the hope that this quantum leap by the Supreme Court will come in the case now pending before the Court involving the Montana coal servance tax. That case could be

important to Alaska; it could either add additional support to Alaska's constitutional right to impose this reserves property tax, or it could raise some doubts which do not now exist as to the tax's validity.

A. Commerce Clause

1. Burden on Interstate Commerce

In attacking the Oil and Gas Corporate Income Tax, the taxpayer plaintiffs have asserted that the tax exacts from them more than Alaska's fair share of the profits of the interstate oil and gas industry, and thereby violates the commerce clause of the U.S. Constitution (Article I, § 8). It is likely that similar claims will be raised against the reserves property tax. However, as the following paragraphs explain, the U.S. Supreme Court has consistently upheld similar taxes in the face of such commerce clause challenges.

The United States Constitution, Article I, § 8, states that Congress shall have the power "to regulate commerce with foreign nations, and among the several states, and with the Indian Tribes." The taxpayers may argue, as some have argued in opposing the Oil and Gas Corporate Income Tax, that since almost all Alaskan oil is sold interstate, Alaska's reserves property tax creates an impermissible burden on interstate commerce. However, the U.S. Supreme Court has rejected identical arguments on numerous occasions. A variety of State and local taxes falling on the mining of coal or the producing of oil and gas have been upheld against commerce clause attacks for the simple reason that the taxes were imposed before the resources entered interstate commerce.

An early example of such rulings is the case of Heisler v. Thomas Colliery Co., 260 U.S. 245 (1922). A stockholder of an anthracite coal company challenged Pennsylvania's 1 1/2% tax on the value of all anthracite ready for shipment

or market. Several northeastern states, as amicus curiae, pointed to the fact that 80% of the anthracite was bound for interstate markets and argued that Pennsylvania was seeking to use its monopoly on anthracite production to "compel the inhabitants of other states to pay a tax to Pennsylvania." Id., 260 U.S. at 251-52. In phrases now echoed by the complaints challenging Alaska's Oil and Gas Corporate Income Tax, the consumer states asserted:

> If the tax be upheld, it is inevitable that every State which possesses natural resources essential to other States will impose similar taxes in order to make those whom it cannot directly and constitutionally tax contribute to its exchequer through the channels of commerce. Indeed, several States may combine so as to create absolute monopolies by the enactment of uniform laws exacting taxes similar to this. Such a situation would bring back the commercial conflicts between the States which the commerce clause was enacted to prevent. A result so absolutely repugnant to both the letter and the purpose of the commerce clause ought not to be permitted.

Id., 260 U.S. at 252-53. Compare Paragraphs 70, 72 of the ARCO complaint challenging Alaska's Oil and Gas Corporate Income Tax:

> The keystone of the United States Constitution is the commerce clause, which allowed the Nation to achieve economic unity by limiting the power of any State to exact an exploitative price from other parts of the Nation for use of its resources, markets, or transportation facilities.
>
> . . . .
>
> . . . Alaska has exceeded the bounds of state taxing power by attempting to use the fortuitous presence of a national resource within its borders as a means for exploiting other states and their citizens.

Atlantic Richfield Co. v. Alaska, No. 3AN-79-1903 Civil (3rd Judicial District, filed October 6, 1980). In Heisler the Supreme Court concluded that the plaintiffs' contentions amounted to the assertion that the products of a state are subject to commerce clause regulation even before production or preparation if such products are destined for the interstate market. The Court summarily rejected this contention, saying,

> The reach and consequences of the contention repel its acceptance. If the possibility, or indeed, certainty of exportation of a product or article from a State determines it to be in interstate commerce before the commencement of its movement from the State, it would seem to follow that it is in such commerce from the instant of its growth or production, and in the case of coals, as they lie in the ground. The result would be curious. It would nationalize all industries, it would nationalize and withdraw from state jurisdiction and deliver to federal commerical control the fruits of California and the South, the wheat of the West and its meats, the cotton of the South, the shoes of Massachusetts and the woolen industries of other States, at the very inception of their production or growth, that is, the fruits unpicked, the cotton and wheat ungathered, hides and flesh of cattle yet "on the hoof," wool yet unshorn, and coal yet unmined, because they are in varying percentages destined for and surely to be exported to States other than those of their production.

Heisler, 260 U.S. at 259-60.

The Court held that such articles are not entered into interstate commerce until "they are committed to the common carrier for transportation out of the State to the State of their destination, or have started on their ultimate passage to that State." Id., 260 U.S. at 261. Thus a tax on coal "prepared for shipping" was held not to violate the commerce clause because the coal was not yet in interstate commerce. If a tax on coal prepared for shipping is permissible, then

certainly a tax on oil still in the ground does no violence to the commerce clause because the oil is not yet in interstate commerce.

Less than a year after Heisler, the U.S. Supreme Court reviewed a Minnesota occupation tax on the mining of ore, measured by the value of the ore mined during the preceding year. Oliver Iron Mining Co. v. Lord, 262 U.S. 172 (1923). As in Heisler, plaintiffs argued that since most of the iron ore mined in the State was destined for interstate commerce, the tax burdened that commerce and therefore violated the commerce clause. Again the Supreme Court rejected the argument, citing numerous precedents:

> Plainly the facts do not support the contention. Mining is not interstate commerce, but like manufacturing, is a local business, subject to local regulation and taxation. Its character in this regard is intrinsic, is not affected by the intended use or disposal of the product, is not controlled by contractual engagements, and persists even though the business be conducted in close connection with interstate commerce.
>
> The ore does not enter interstate commerce until after the mining is done, and the tax is imposed only in respect of the mining. No discrimination against interstate commerce is involved. The tax may indirectly and incidentally affect such commerce, just as any taxation of railroad and telegraph lines does, but this is not a forbidden burden or interference.

Id., 262 U.S. at 178-79 (citations omitted). Like the Minnesota ores, Alaskan oil is not in interstate commerce until "after the mining is done," and therefore the reserve property tax does not discriminate against or burden interstate commerce.

In yet a third natural resource tax case, the Supreme Court upheld a West Virginia privilege tax measured by the gross proceeds of the sale of various natural resources produced in the State. Hope Natural Gas Co. v. Hall, 274 U.S. 284 (1927). The Court held that computation of the tax, based on the value of the natural gas at the wellhead (before entering interstate commerce), did not violate the commerce clause. Id. 274 U.S. at 288.

The above trilogy of natural resource tax cases is still controlling precedent today. In 1961, Justice Douglas compared the taking and freezing of fish in Alaska's coastal waters to the extraction of ore in Oliver Iron Mining. Alaska v. Arctic Maid, 366 U.S. 199, 203-4 (1961). He found Oliver to be controlling precedent and upheld Alaska's occupation tax on the taking and freezing of the fish (all bound for interstate commerce) against a commerce clause attack. In Merrion v. Jicarilla Apache Tribe, 617 F.2d 537 (1980), the Tenth Circuit found Oliver Iron Mining and Arctic Maid controlling in upholding the tribe's oil and gas severance tax against a commerce clause challenge. Finally, the Montana Supreme Court has relied on the trilogy of Heisler, Oliver and Hope Gas in sustaining Montana's 30% severance tax on coal. The Montana Court found that the cases on taxation of goods produced in a state all establish a common theme:

> [P]roduction of personal property within a state is a local activity which precedes the entry of the property into interstate commerce, and is therefore subject to state regulation and taxation.

> . . . [W]e have found no United States Supreme Court case, and none has been cited to us, which implicitly or directly overthrows the rule that the several states have the reserved power to tax intrastate manufacturing, extraction, and production of goods.

Commonwealth Edison Co. v. State, 615 P.2d 847, 851 (Sup. Ct. Mont. 1980).

Summary

A tax on property before that property enters interstate commerce does not create a burden within the scope of the commerce clause. The many commerce clause tests evolved by the U.S. Supreme Court in reviewing state taxes all apply to taxes which are imposed, directly or indirectly, upon interstate commerce, such as:

a) taxes on property used in interstate commerce, Fargo v. Hart, 193 U.S. 490 (1904), Johnson Oil Co. v. Oklahoma, 290 U.S. 158 (1933);

b) taxes on the privilege of conducting interstate commerce within a state, Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977), Washington Revenue Dept. v. Stevedoring Ass'n., 435 U.S. 734 (1978); and

c) taxes on net income derived from an interstate business, Mobil Oil Corp. v. Commissioner of Taxes of Vermont, 445 U.S., 425 (1980), Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207 (1980).

In contrast, Arctic Maid and the other cases cited demonstrate clearly that the Court refuses to apply those tests to taxes on locally mined, produced, or manufactured goods which have not yet entered interstate commerce. Taxes on such products do not raise any commerce clause question. This is an important factor in our decision to recommend the

reserves property tax as a backstop tax.

The reserves property tax is imposed upon oil even before severance and hence clearly precedes the commodity's entrance into interstate commerce. It seems clear that the reserves property tax does not violate the commerce clause, unless the Supreme Court were to overturn a long and well established line of cases.

2. Discrimination Against Interstate Commerce

The proposed reserves property tax cannot be said to burden interstate commerce because the property taxed is not yet in commerce. Neither does the tax discriminate against interstate commerce by treating property bound for interstate commerce in a different way than property bound for intrastate commerce. With the exception of specific classes of property for which tax exemptions are required by State and federal law, all oil reserves under producing properties are taxed equally, without regard to the final destination of the oil.

The constitutional rule against laws which discriminate against interstate commerce was well stated in a recent U.S. Supreme Court case, Boston Stock Exchange v. State Tax Commission, 429 U.S. 318 (1977). In that case, the court struck down a New York tax on securities transactions under which out-of-state sales were taxed more heavily than most sales within the State. Justice White stated the rule of the decision as follows:

> No State, consistent with the Commerce Clause, may "impose a tax which discriminates against interstate commerce. . . by providing a direct commercial advantage to local business." °quoting from Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 458 (1959)] See also Halliburton Oil Well Co. v. Reily, 373 U.S. 64 (1963); Nippert v. Richmond, 327 U.S. 416 (1946); I.M. Darnell & Son v. Memphis, 208 U.S. 113 (1908); Guy v. Baltimore, 100 U.S. 434, 443 (1880); Welton v. Missouri, 91 U.S. 275 (1876). The prohibition against discriminatory treatment of interstate commerce follows inexorably from the basic purpose of the Clause. Permitting the individual States to enact laws that favor local enterprises at the expense of out-of-state business "would invite a multiplication of preferential trade areas destructive" of the free trade which the Clause protects. Dean Milk Co. v. Madison, 340 U.S. 349, 356 (1951).

Boston Stock Exchange v. State Tax Commission, 429 U.S. at 329.

Even as this report was being typed, the Supreme Court invoked the same commerce clause discrimination standard to invalidate a Lousiana first-use tax. The Court ruled that the tax and related credits operated to protect local taxpayers from the first-use tax, imposing the tax solely on out-of-state consumers of gas produced on the outer continental shelf. Maryland v. Louisiana, No. 83, Orig. (Sup. Ct. May 26, 1981). Unlike the taxes in Boston Stock Exchange and Maryland v. Louisiana, Alaska's proposed reserves property tax does not discriminate against interstate commerce. Owners of reserves are treated equally, without regard to the final destination of the oil. Unlike the Louisiana

first-use tax, there is no system of exemptions and credits designed to protect intrastate oil producers and users from the effects of the tax.

Some taxpayers may argue that the proposed tax effectively discriminates against interstate commerce simply because most of the oil will eventually be sold interstate. This argument has no merit and was specifically rejected in *Heisler* and *Arctic Maid*, discussed elsewhere. Even if none of the oil were used in Alaska, the tax would be valid so long as it was not designed to favor intrastate commerce.

B. Equal Protection

Among the few constraints on Alaska's broad authority to design whatever tax system it deems appropriate, are the equal protection clauses found in the State Constitution and in the Fourteenth Amendment of the U.S. Constitution, and even these do not greatly confine the State's power to tax certain groups more or less than others. In some states an additional constraint is imposed by a constitutional "uniformity clause" requiring all property be taxed at the same rate. Alaska's constitution, however, contains no such clause, and therefore the only limit on the State's ability to differentiate taxpayers into distinct tax categories is the equal protection clause of the State and federal constitutions.

Provided the classifications contained in the tax statute are related to the purposes of such classifications in the manner required by the U.S. and State Constitutions, Alaska may choose to enact a reserves property tax on producing oil and gas properties. There is no constitutional prohibition against taxing one industry and not another or against taxing one industry at a higher rate than another.

The reserves property tax is a constitutional distribution of the tax burden of the State. The tax falls equally on resident and nonresident taxpayers and the exemptions from the tax meet constitutional standards.

Further, the use of the funds derived from this new tax to meet a variety of the State's pressing needs is consistent with the equal protection standards of both the Federal and State constitutions.

1. Distribution of Tax Burden Under the U.S. Constitution

The State of Alaska is free to apportion its tax burden in any fair and just manner that the legislature may choose. The equal protection clause of the Fourteenth Amendment of the U.S. Constitution requires no strict rule of equality. As the Supreme Court of the United States has stated,

> It is inherent in the exercise of the power to tax that a state be free to select the subjects of taxation and to grant exemptions. Neither due process nor equal protection imposes upon a state any rigid rule of equality of taxation. This Court has repeatedly held that inequalities which result from a singling out of one particular class for taxation or exemption, infringe no constitutional limitation.

Carmichael v. Southern Coal & Coke Co., 301 U.S. 495, 509 (1936) (citations omitted); _quoted with approval in Lenhausen_, 410 U.S. at 363 n.5. The equal protection clause requires only that "the selection [of a class for taxation] is neither capricious nor arbitrary and rests on some reasonable consideration of difference or policy[.]" _Allied Stores of Ohio, Inc. v. Bowers_, 358 U.S. 522, 527 (1959); _cited with approval in Lehnhausen_, 410 U.S. at 359-60. Equal protection under the law is not violated so long as members of a given class are taxed equally. _Charleston Federal Savings & Loan Association v. Alderson_, 324 U.S. 182, 190 (1954).

The State of Alaska may elect to place a reserves property tax on oil while excluding quarries, forests, and other properties. See Lake Superior Consol. Iron Mines v. Lord, 271 U.S. 577, 582 (1926). The findings and purposes in section 43.58.0]] establish that such a classification is not arbitrary and capricious but rests on sound considerations of public policy. Alaska's economy is based on the extraction of the State's abundant natural resources, primarily oil. In an effort to raise money for needed public services and to dampen the uncontrolled oscillations of the State's economy, the legislature may devise a tax system which encourages diversification of the economy, and holds the pace of exploration and development of oil and gas at a desired level. See Magnano Co. v. Hamilton, 292 U.S. 40 (1934); Alaska Fish Co. v. Smith, 255 U.S. 44 (1921). These considerations of policy, articulated in Sec. 43.58.011, are not "hostile and oppressive" (Lehnhausen v. Lake Shore Auto Parts Co., supra) to the oil and gas industry. Rather, they reflect a balanced approach to diversifying the State's economy in preparation for the future when the oil fields will be depleted. Being grounded on sound principles of public policy, the reserves property tax does not violate the equal protection clause of the Fourteenth Amendment.

In a similar instance of natural resource taxation, the Supreme Court upheld a Pennsylvania statute that placed a 1 1/2% tax on the value of anthracite coal mined in the state

but placed no similar tax on bituminous coal. Heisler v. Thomas Colliery Co., 260 U.S. 245 (1922). The anthracite producers clamored that they were denied equal protection under the law. Invoking the "clear and hostile discrimination" test, the Court easily upheld the statute saying,

> Any classification is permissible which has a reasonable relation to some permitted end of governmental action. . . It is enough, for instance, if the classification is reasonably founded in "the purposes and policy of taxation."

Heisler, 260 U.S. at 255 quoting from Watson v. State Comptroller, 254 U.S. 122, 124-25 (1920). In another case the Supreme Court has said:

> Where the public interest is served one business may be left untaxed and another taxed, in order to promote the one, . . . or to restrict or surpress the other[.]

Carmichael v. Southern Coal & Coke Co., 301 U.S. 495, 512 (1937) (citing nine earlier Supreme Court decisions). Like the Pennsylvania anthracite tax, the reserves property tax on producing fields is reasonably founded in the stated purposes and policy of Alaska's taxation system. Just as it was permissible for Pennysylvania to distinguish between anthracite coal and bituminous coal, Alaska may distinguish between oil reserves and other kinds of property, so long as the classification is reasonably related to some permitted end of government action. The government ends served are clearly set forth in the purposes and findings section of the bill. This section makes clear the legislature's objectives

of raising adequate revenues while at the same time encouraging economic diversification, doing so without discouraging oil and gas exploration and development to the maximum extent possible.

Once the legislature has stated the purpose for a given tax classification, the Supreme Court will not override such findings. The Court has said,

> [I]t makes no difference that the facts may be disputed or their effect opposed by argument and opinion of serious strength. It is not within the competency of the courts to arbitrate in such contrariety. Rast v. Van Deman & Lewis Co., 240 U.S. 342, 357 and cases there cited.

Heisler v. Thomas Colliery Co., 260 U.S. 245, 255 (1922).

While the justification for a distinction between producing and nonproducing property is clearly contemplated under the principles discussed above, it is worth pointing out that such a distinction was specifically upheld by the U.S. Supreme Court in Oliver Iron Mining Co. v. Lord, 262 U.S. 172, 180 (1923):

> Equality [under Fourteenth Amendment] does not require that unproductive mining be taxed along with productive mining. Besides, . . ., the tax will be imposed when the ore is mined.

2. Distribution of Tax Burdens Under The Alaska Constitution

The Constitution of the State of Alaska, unlike some other states, has no uniformity of taxation provision which requires that all property in the State be taxed equally. Therefore, the legislature's power to differentiate types of property for tax purposes is guided only by the Fourteenth

Amendment, discussed above, and the similar provision in Article I, § 1 of the Alaska Constitution. With respect to classification for tax purposes, the Alaska Supreme Court has interpreted the equal protection clause of the State Constitution as follows:

> [T]he classification in question [must] "be reasonable, not arbitrary, and must rest upon some ground of difference having a fair and substantial relation to the object of the legislation so that all persons similarly circumstanced shall be treated alike."

State v. Reefer King Co., Inc., 559 P.2d 56, 65 (Alaska 1977) quoting from Isakson v. Rickey, 550 P.2d 359, 362 (Alaska 1]976) See also Williams v. Zobel, 619 P.2d. 422 (Alaska 1980). Although this equal protection standard is different from the federal standard enunciated in Lehnhausen and Carmichael, the basic principles of the federal cases are similar. For example, in Reefer King, supra, the Alaska Supreme Court approved of a tax scheme which imposed a 4% tax on floating processors and only a 1% tax on shorebased processors because the Court deemed the different tax treatment was fairly and substantially related to the State's objective "of encouraging societal contributions of the type made by 'shorebased' processors. . ." Id., 559 P.2d at 66. The contributions made included a contribution to local economies not made by the floating processors. It is an established principle of Alaskan constitutional law that the State may,

> legitimately encourage, through tax incentives or exemptions, industries or types of industries which it considers desirable, and this method of encouragement does not deprive other taxpayers, who do not qualify for the benefit, of their equal protection rights.

Id., 559 P.2d at 66; see also K & L Distributors, Inc. v. Murkowski, 486 P.2d 351, 359 (Alaska 1971). Applying the principle of Reefer King and K & L Distributors, it should be clear that a classification of producing oil properties for tax purposes is a legitimate classification. As the findings state, it is the legislature's judgement that taxes on other industries are undesireable because of the adverse impacts such taxes may have upon those industries and would be counterproductive to efforts to encourage economic diversification but that a reserves property tax is not expected to have any unacceptable adverse consequences on the oil industry in Alaska. In the light of established equal protection standards and the legislature's stated purposes, the reserves property tax does not violate the State Constitution's guarantee of equal protection.

3. Equal Burden Within the Class of Taxpayers

Within a constitutionally permissible class of taxpayers, all such taxpayers must be treated equally or the tax is deemed to violate the equal protection clause of the United States Constitution. Charleston Federal Savings & Loan Association v. Alderson, 324 U.S. 182, 190 (1954). Since the bill does treat all owners of producing oil and

gas properties equally, there is no basis for an equal protection complaint on these grounds.

The reserves property tax falls equally on resident and nonresident taxpayers. The statute makes no distinction whatsoever based on the residency of the taxpayer, and thus is secure from attack under either the privileges and immunities clause of Article IV, § 2 of the United States Constitution; Article IX, § 2 of the Alaska Constitution; or the equal protection clause of the Fourteenth Amendment.

4. Exemptions

The reserves property tax contains tax exemptions for property interests owned by the United States or the State of Alaska, for property exempted from taxation by the laws of the United States, and for natural gas reserves. Each of these exemptions is consistent with the Constitution and laws of the United States and with the Constitution of the State of Alaska.

a. Exemption for Federal Property

Section 4 of the Alaska Statehood Act declares,

> [N]o taxes shall be imposed by said State upon any lands or other properties now owned or hereafter acquired by the United States. . . .

Pub. L. No. 85-508, § 4, 48 USCA § 4, note prec. § 21. Therefore, under the supremacy clause of the U.S. Constitution (Article VI), Alaska may not tax federal property. This prohibition is repeated in Article XII, § 12 of the Alaska Constitution. The exemption of federal property from

taxation is proper under both the federal and State constitutions.

Although property of the United States is exempt, third party interests such as leaseholds in such exempt property is taxable to the extent of those interests. This taxation of leasehold and other third party interests in federal property has consistently been upheld as not violating the United States' constitutional immunity from State taxation under the supremacy clause. United States v. Detroit, 355 U.S. 466 (1958); City of Detroit v. Murray Corp., 355 U.S. 489 (1958); United States v. Township of Muskegon, 355 U.S. 484 (1958); United States v. County of Fresno, 429 U.S. 452 (1977).

b. Exemption for State Property

The Alaska Constitution, Article IX, § 4 states:

> The real and personal property of the State or its political subdivisions shall be exempt from taxation under conditions and exceptions which may be provided by law.

The provision of the bill which exempts property interests owned by the State (Sec. 43.58.031(1)) is in compliance with the Alaska Constitution. Similarly, the taxation of third party interests in property of the State is constitutional. Article IX, § 5 of the Alaska Constitution states:

> "Private leaseholds, contracts, or interests in land or property owned or held by the United States, the State, or its political subdivisions shall be taxable to the extent of the interests."

c. <u>Exemption for Lands Conveyed to Native Corporation Pursuant to the Alaska Native Claims Settlement Act</u>

The bill contains an exemption from the tax for Native Corporations which have an interest in producing oil reserves situated on lands that were conveyed to Alaska Native Corporations pursuant to the Alaska Native Claims Settlement Act (ANCSA). This exemption is required by federal law.

Section 21(d) of ANCSA states:

> (d) Real property interests conveyed, pursuant to this Act, to a Native individual, Native group, or Village or Regional Corporation which are not developed or leased to third parties, shall be exempt from State and local real property taxes for a period of twenty years after the date of enactment of this Act: Provided, That municipal taxes, local real property taxes, or local assessments may be imposed upon leased or developed real property within the jurisdiction of any governmental unit under the laws of the State: Provided further, That easements, rights-of-way, leaseholds, and similar interests in such real property may be taxed in accordance with State or local law. All rents, royalties, profits, and other revenues or proceeds derived from such property interests shall be taxable to the same extent as such revenues or proceeds are taxable when received by a non-Native individual or corporation.

Pub. L. No. 92-203, § 21(d), 43 U.S.C.A. § 1620(d) (Supp. 1981).

The first sentence of this section exempts <u>unleased</u> or <u>undeveloped</u> property from taxation. The implication of that sentence is that leased or developed property may be taxed by State and local governments. However, the first proviso

expressly authorizes local governments to tax developed property. This seems redundant and raises doubts as to whether Congress did intend to grant the taxing authority implied by the first sentence. Section 21(d) is, at best, ambiguous concerning the State's authority to impose a property tax upon leased or developed property owned by Native Corporations.

The legislative history of § 21(d) is of little help in resolving this ambiguity. An earlier version of the Act contained the following language:

> (c) Lands to which a Native village acquires title pursuant to sections 10-12, inclusive, or section 15 hereof, lands to which a regional corporation acquires title pursuant to section 12, and mineral rights to which any Native corporation acquires title pursuant to sections 12 or 15 hereof, shall be exempt from State and local real property taxes: Provided, That municipal taxes or assessments may be imposed upon individually owned real property within its jurisdiction by any Native village incorporated as a governmental unit under the laws of the State of Alaska: And provided further, That easements, rights-of-way, leaseholds and similar interests in such real property may be taxed in accordance with State or local law. All rents, royalities, profits, and other revenues or proceeds derived from such lands and mineral rights shall be taxable to the same extent as such revenues or proceeds are taxable when received by a non-Native individual or corporation.

H.R. 7039 92d Cong. 1st Sess. (March 31, 1971) See also S. 835, 92d Cong. 1st Sess. (Feb 17, 1971) which was identical to H.R. 7039 except that it limited the tax exemption to a period of fifty years.

Analysis of the transition from this version to the final version of § 21(d) does not reveal the drafters' intent. In general, the exemptions were made less broad; more taxation was allowed. But the only new express statement is that municipalities and local governments of all types may tax leased or developed property. Having allowed municipal taxation of leased or developed property by broadening the proviso, perhaps the drafters then changed the first sentence to read "unleased or undeveloped property is exempt" from "municipal taxation", because this seemed more symmetrical or complementary, not realizing that they had made an implicit statement about the _state's_ taxing power as well.

An alternative scenario, equally convincing but not more so, is that the drafters intended to narrow the exemptions so that both states and municipalities could tax leased or developed property. If they set out to do this while also making as few changes in the original text as possible, they could have crossed out a few phrases and added a few phrases, metamorphosing the first version into the final language. Having altered the first sentence to exempt only undeveloped or unleased property, the drafters might have realized that the first proviso was no longer necessary. Still, it is possible they preferred to alter it slightly, making it merely redundant, to removing it entirely, which might have aroused concern among municipal and local governments.

In the end, one is left with two alternatives: either the drafters overlooked the full implications of the change in the first sentence or they chose to retain a proviso which is redundant and creates ambiguity. Neither hypothesis seems more compelling.

Section 21(d) of ANCSA, was recently amended by Congress in the Alaska National Interest Lands Conservation Act, Pub. L. No. 96-487, § 904, 94 Stat. 2371, 2434 (Dec. 2, 1980), and reads as follows:

> (d)(1) Real property interests conveyed, pursuant to this Act, to a Native individual, Native Group, Village or Regional Corporation or corporation established pursuant to section 14(h)(3) which are not developed or leased to third parties or which used solely for the purposes of exploration shall be exempt from State and local real property taxes for a period of twenty years from the vesting of title pursuant to the Alaska National Interest Lands Conservation Act or the date of issuance of an interim conveyance or patent, whichever is earlier, for those interests to such individual, group, or corporation: Provided, That municipal taxes, local real property taxes or local assessments may be imposed upon any portion of such interest within the jurisdiction of any governmental unit under the laws of the State which is leased or developed for purposes other than exploration for so long as such portion is leased or being developed: Provided further, That easements, rights-of-way, leaseholds, and similar interests in such real property may be taxed in accordance with State or local law. All rents, royalties, profits and other revenues or proceeds derived from such property interests shall be taxable to the same extent as such revenues or proceeds are taxable when received by a non-Native individual or corporation.

Though small changes have been made to classify land used only for exploration as tax exempt, the essential ambiguity created by the leading sentence and the first proviso remains.

The proviso explicitly grants municipal and local governments the authority to levy real property taxes on leased and developed Native Land. No such explicit grant of authority is made to the State. In analyzing this ambiguity further, we have resorted to more general principles of statutory construction.

The proper rules of construction can be derived from several recent cases which clarify the standard of review for laws taxing dependent Indians generally and which apply that standard to cases involving ambiguities in ANCSA. In Bryan v. Itasca County, 426 U.S. 373 (1976), the Supreme Court reviewed a challenge to Minnesota's state and county property taxes on the mobile home of a reservation Indian. Minnesota contended that 28 U.S.C. § 1360, which grants to the states civil jurisdiction over Indian reservations, implicitly authorized property taxation (a form of civil law). The Court found that the statute was ambiguous with respect to taxation and invoked the following standard of review:

> Finally, in construing this "admittedly ambiguous" statute, Board of Comm'rs v. Seber, 318 U.S., at 713, we must be guided by that "eminently sound and vital canon," Northern Cheyenne Tribe v. Hollowbreast, 425 U.S. 649, 655 n. 7 (1976), that "statutes passed for the benefit of dependent Indian tribes . . . are to be liberally construed, doubtful expressions being resolved in favor of the Indians." Alaska Pacific Fisheries v. United States, 248 U.S. 78, 89 (1918). See Choate v. Trapp, 224 U.S. 665, 675 (1912); Antoine v. Washington, 240 U.S. 194, 199-200 (1975). This principal of statutory construction has particular force in the face of claims

> that ambiguous statutes abolish by implication Indian tax immunities. McClanahan v. Arizona State Tax Comm'n, 411 U.S., at 174 Squire v. Capoeman, 351 U.S. 1, 6-7 (1956); Carpenter v. Shaw, 280 U.S. 363, 366-367 (1930). "This is so because . . . Indians stand in a special relation to the federal government from which the states are excluded unless the Congress has manifested a clear purpose to terminate [a tax] immunity and allow states to treat Indians as part of the general community." Oklahoma Tax Comm'n v. United States, 319 U. S. 598, 613-614 (1943) (Murphy, J., dissenting).

Bryan, 426 U.S. at 392. The Court held that Minnesota had no authority to tax the reservation Indians.

In a footnote in Bryan, however, the Court said that its analysis might yield a different result for tribal Indians "who have left or never inhabited federally established reservations." Id., 426 U.S. at 376-377, n.2. In Organized Village Of Kake v. Egan, 369 U.S. 60 (1962), the Supreme Court considered whether Alaska's anti-fishtrap laws applied to the non-reservation Thlinget Indians in Alaska. The Court decided the case on the basis of § 4 of the Alaska Statehood Act, saying that Congress had prohibited the State from taxing Indian property, but not from regulating aboriginal fishing rights; therefore, the anti-fishtrap laws were validly applied to the Thlinget Indians. Kake, 369 U.S. at 68. The rule of Kake was summarized in a later case as follows:

> Absent express federal law to the contrary, Indians going beyond reservation boundaries have generally been held subject to nondiscriminatory state law otherwise applicable to all citizens of the State.

Mescalero Apache Tribe v. Jones, 411 U.S. 145, 148-149 (1973). Of course, if *Kake* had involved a state property tax on restricted Native land, there would have been "express federal law to the contrary" since § 4 of the Statehood Act prohibited State taxation of Indian lands. Section 4 only allowed the State of Alaska to tax Native lands that "are held by individual natives in fee without restrictions on alienation".

The United States District Court for Alaska has adopted the *Bryan* standard of review for resolving ambiguities in the interpretation of ANCSA. *Alaska Public Easement Defense Fund v. Andrus*, 435 F. Supp. 664, 670 (D. Ak. 1977). In that case, Natives challenged the Secretary of the Interior's interpretation of the reserved easement provisions of ANCSA. Native plaintiffs argued that the *Bryan* rule should apply and that doubtful expressions should be resolved in their favor. The Secretary of the Interior argued that the *Bryan* rule should not apply to Alaska Natives because they are "not dependent Indians, but rather are well financed, profit making corporations." *Id.*, 435 F. Supp. at 670. Further, the Secretary argued that two rules of statutory construction supported his interpretation: (a) The Secretary's interpretation of a statute delegating authority to him should be accorded great deference, *Udall v. Tallman*, 380 U.S. 1 (1965), and (b) public land grants are to be construed favorably to the government, *United States v. Union Pacific Ry. Co.*, 353 U.S. 112, 116 (1957). After consideration, the

court adopted the Natives' position:

> While it is true that the Alaska Native Corporations are well financed that financing and the corporations themselves are the result of the Act. Prior to the Act, Congress had the power totally to extinguish aboriginal land title without compensation. United States v. Atlantic Richfield Co., 435 F. Supp. 1009, 1029-1030 (D. Alaska 1977); Tee-Hit-Ton Indians v. United States, 348 U.S. 272, 279 & 285, 75 S. Ct. 313, 99 L. Ed. 314 (1955). Thus, although generally the Alaska Natives were not dependent in the sense that they were on reservations, their fate rested in the hands of Congress and they were dependent upon its protection and good faith. In these circumstances the language used, if ambiguous, should be resolved in their favor. Squire v. Capoeman, 351 U.S. 1, 6-7, 76 S.Ct. 611, 100 L. Ed. 883 (1956).
>
> The court's approach, therefore, will be to analyze the statutory language and the legislative intent to determine these issues. If ambiguities remain, they will be resolved in favor of the Natives.

Alaska Public Easement Defense Fund v. Andrus, 435 F. Supp. 664, 670-671 (1977).

The U.S. District Court for Alaska applied the same standard of review to a tax dispute in People of South Naknek v. Bristol Bay Borough, 466 F. Supp. 870 (1979). The Borough had levied real and personal property taxes on restricted lands held in trust for the use and benefit of the Natives. Id., 466 F. Supp. at 872. The Court applied the following rule of construction:

> The focus of the court's inquiry must be whether the power of the Borough to levy the taxes challenged in this has been pre-empted by the relevant federal statutes. In reviewing these statutes the court must follow the general rule that statutes passed for the benefit of

> Indians are to be liberally construed, doubtful expressions being resolved in favor of the Indians. This rule of construction has particular force in determining whether Indians and their property enjoy tax immunity.

Id., 466 F. Supp. at 873 (citations omitted). The Court held that the Native Allotment Act, the Native Townsite Act, and § 4 of the Alaska Statehood Act pre-empted the Borough's authority to tax real property, but that personal property could be taxed.

Applying the principles of law discussed above, it appears that the State's authority to levy a property tax on oil reserves situated on Native Corporation lands remains pre-empted by federal law. Prior to the passage of ANCSA the State's authority to tax Native land was pre-empted by § 4 of the Alaska Statehood Act which states, in pertinent part:

> [N]o taxes shall be imposed by said State upon any lands or other property now owned or hereafter acquired by the United States or which, as hereinabove set forth, may belong to said natives, except to such extent as the Congress has prescribed or may hereafter prescribe, and except when held by individual natives in fee without restrictions on alienation.

Pub. L. No. 85-508, § 4, 48 U.S.C.A. § 4, note prec. § 21.

The section is, of course, silent as to lands held in fee by Native Corporations since these Corporations had not yet been created by ANCSA. Turning to ANCSA to see if the state has been granted authority to tax real property owned by Natives, we arrive at § 21(d). That section expressly

grants to municipal and local governments, the power to tax leased and developed property but is ambiguously silent about the State's authority. The first sentence of § 21(d) and the following proviso raise conflicting inferences; the legislative history is also unclear. Under these circumstances, it seems likely that a federal court following the rule of construction set out in the cases discussed, would resolve the ambiguity in favor of the Natives and hold that the State may not tax leased and developed property.

d. Exemption for Natural Gas

As discussed above, producing oil reserves are a separate and distinct class of property for tax purposes. There is no requirement that other types of natural resources also be taxed. The bill is structured to impose a tax on both producing oil and gas reserves but then grants an exemption for natural gas reserves.

e. Summary of Exemptions

The above discussion shows that the exemptions to the reserves property tax for federal, state, and Native Corporation properties are in response to requirements of the U.S. Constitution and laws and the Constitution of the State of Alaska. Certainly such exemptions have a rational basis and do not offend the equal protection clause of the Fourteenth Amendment of the U.S. Constitution. As stated in Carmichael v. Southern Coal & Coke Co., 301 U.S. 495, 509 (1937):

> This Court has repeatedly held that inequalities which result from a singling out of one particular class for taxation or exemption,

> infringe no constitutional limitation. . . .
>
> Like considerations govern exemptions from the operation of a tax imposed on the members of a class. A legislature is not bound to tax every member of a class or none. It may make distinctions of degree having a rational basis, and when subjected to judicial scrutiny they must be presumed to rest on that basis if there is any conceivable state of facts which would support it.

(citations omitted) Distinctions based on the mandates of State and Federal laws and constitutions must be presumed to be rational and in compliance with the equal protection clause of the U.S. Constitution.

Similarly, such distinctions should also not offend the equal protection clause of the State Constitution since the distinctions simply follow requirements of the U.S. Constitution and laws and the Constitution of the State of Alaska.

The exemption for gas property is not founded upon federal and state mandates but upon legitimate State policies to avoid discouraging gas development in the State. The Governor in his letter of transmittal with SSHB 200 stated, "Because of the somewhat precarious economic situation with respect to natural gas production and transportation, evidenced in part by the difficulties that have attended efforts to obtain financing for a natural gas pipeline from the Prudhoe Bay fields, I am reluctant to impose any possible additional tax burdens on natural gas at this time." Accordingly, the purpose for exempting gas property as stated in SSHB 200 is "to avoid discouraging. . . the development of natural gas production in the State."

As discussed above, the exemption of certain industries to encourage their development does not run afoul of the equal protection clauses of the United States and State Constitutions. State v. Reefer King Co., Inc., 559 P.2d 56 (Alaska 1977); K & L Distributors, Inc. v. Murkowski, 486 P.2d 351 (Alaska 1971); Carmichael v Southern Coal & Coke Co., 301 U.S. 492 (1937).

C. Public Purpose

1. The Backstop Tax

The reserves property tax on producing oil properties will serve numerous valid public purposes of the State of Alaska, which are listed in Sec. 43.58.011 (Findings and Purposes) of the bill. Because the money raised by the tax will be expended for valid public purposes, the tax is immune from challenge under either Article IX, § 6 of the Alaska Constitution or the Fourteenth Amendment of the U.S. Constitution.

a. Review Under the Alaska Constitution

Article IX, § 6 of the Alaska Constitution states:

> No tax shall be levied, or appropriation of public money made, or public property transferred, nor shall the public credit be used, except for a public purpose.

This constitutional requirement has been interpreted by the Supreme Court of Alaska on several occasions. The Court has adopted the following standard for reviewing statutes which allegedly violate § 6:

> In determining the question presented this court adopts for its guidance the general rule, supported by the great weight of authority, that where the legislature has found that a public purpose will be served by the expenditure or transfer of public funds or the use of the public credit, this court will not set aside the finding of the legislature unless it clearly appears that such finding is arbitrary and without any reasonable basis in fact.

DeArmond v. Alaska State Development Corp., 376 P.2d 717, 721 (Alaska 1962).

Applying this standard, the Court approved the expenditure of public money for industrial development loans. In a subsequent case the Court applied the same standard in approving a statute that granted public money to retire the mortgages of those whose homes were destroyed in the 1964 earthquake. Suber v. Alaska State Bond Committee, 414 P.2d 546 (Alaska 1966). Also in 1966, the Court invoked the DeArmond standard verbatim in approving the creation of the Alaska State Mortgage Association, which used public funds to finance private housing. Walker v. Alaska State Mortgage Association, 416 P.2d 245, 251 (Alaska 1966). Finally, in Wright v. City of Palmer, 468 P.2d 326 (Alaska 1970), the Court upheld the city's issuance of general obligation bonds to encourage industrial development. Quoting the Suber opinion, the Court said:

> The basic objective of government is to protect and promote the health, safety and general welfare of the people. When a condition of affairs appears in the state which presents a threat to the accomplishment of that objective, the government has the right, and the obligation, to cope with such threat by whatever measures, within constitutional limits, that are necessary or appropriate.

Wright, 468 P.2d at 331.

As listed in the legislative findings, Sec. 43.58.011(a), the legislature perceives several inadequacies in the level of the public services in this State. To correct these inadequacies in transportation, health care, communications, energy, and justice facilities, to name but a few, the State requires a secure and substantial source of tax revenues.

The State now finds that the Oil and Gas Corporate Income Tax, a significant source of revenue, is being challenged in court, presenting a threat to the accomplishment of the State's various objectives. As stated by the Supreme Court in Wright, "The government has the right, and the obligation, to cope with such threat by whatever measures, within constitutional limits, that are necessary or appropriate." Wright, 468 P.2d at 331.

Assuming that the reserves property tax does not offend the federal constitution (discussed below), the findings and purposes stated in Sec. 43.58.011 are well within the scope of Art. IX, § 6 of the Alaska Constitution, requiring that taxes be levied only for public purposes. The various uses proposed for the tax revenues have been endorsed by the State Supreme Court.

b. Review Under the U.S. Constitution

With the adoption of the Fourteenth Amendment, the U.S. Constitution limited the authority of the states to impose taxes. In Green v. Frazier, 253 U.S. 233, 238 (1920) the Court explained the limitation of the Fourteenth Amendment as follows:

> The due process of law clause contains no specific limitation upon the right of taxation in the states, but it has come to be settled that the authority of the states to tax does not include the right to impose taxes for merely private purposes.

Green, 253 U.S. at 238. In a subsequent case, rejecting a claim that the State of Washington had imposed a tax on the

sale of margaerine within the State purely for the purpose of protecting the State's butter industry, the Supreme Court said of the "public purpose requirement,"

> [T]hat requirement has regard to the use which is to be made of the revenue derived from the tax, and not to any ulterior motive or purpose which may have influenced the legislature in passing the act. And a tax designed to be expended for a public purpose does not cease to be one levied for that purpose because it has the effect of imposing a burden upon one class of business enterprises in such a way as to benefit another class.

Magnano Co. v. Hamilton, 292 U.S. 40, 43 (1934). Thus, the Supreme Court has adopted the principle that the Fourteenth Amendment places a limit on State taxing power similar to that of the "public purpose clause" in Article IX, § 6 of the Alaska Constitution and in testing the validity of State taxes, the court will look to the uses to be made of the taxes collected.

In Carmichael v. Southern Coal & Coke Co., 301 U.S. 495 (1937), the Supreme Court adopted a public purpose standard that foreshadowed the test adopted by the Alaska Supreme Court in DeArmond:

> This Court has long and consistently recognized that the public purposes of a state, for which it may raise funds by taxation, embrace expenditures for its general welfare. The existence of local conditions which, because of their nature and extent, are of concern to the public as a whole, the modes of advancing the public interest by correcting them or avoiding their consequences, are peculiarly within the knowledge of the legislature, and to it, and not to the courts, is committed the duty and responsibility of making choice of the possible

> methods. As with expenditures for the general welfare of the United States, whether the present expenditure serves a public purpose is a practical question addressed to the law-making department, and it would require a plain case of departure from every public purpose which could reasonably be conceived to justify the intervention of a court.

Carmichael, 301 U.S. at 514-15 (emphasis added; citations omitted). So saying, the Court approved an Alabama tax on employers of more than eight persons to be used for unemployment benefits. Thus, the Supreme Court defers to the wisdom of State legislatures in the matter of defining public purposes, and will uphold a taxation scheme if the resultant expenditures are related to any conceivable public purpose.

The Alaskan Government has listed many public purposes which the reserve property tax will serve. These purposes are valid public purposes and the raising of revenues to meet these purposes through a reserves property tax is rational. The tax, therefore, should withstand a challenge under both the public purpose requirement of Article IX, § 6 of the Alaska Constitution and the due process requirements of the Fourteenth Amendment to the U.S. Constitution.

2. Credit for Oil and Gas Corporate Income Taxes

a. Under Alaska's Constitution

Section 43.58.041 of the reserves pr erty tax grants two distinct types of credits against the tax to those who have paid taxes under the Oil and Gas Corporate Income Tax.

It may be argued that these tax credits amount to an unconstitutional gift of public funds. This argument is not valid since the credits serve a public purpose.

As discussed above, Article IX, § 6 of the Alaska Constitution prohibits the appropriation of money or transfer of public property except for a public purpose. Under similar constitutional provisions, the courts of neighboring states have scrutinized statutes which retroactively cancel delinquent taxes or provide a credit against future taxes. In Japan Line, Ltd. v. McCaffree, 558 P.2d 211 (Wash. 1977) plaintiffs challenged the constitutionality of a county tax law which retroactively cancelled a previous tax. They contended that the repeal of a valid tax constituted a gift of public funds, in violation of the Washington Constitution, Article 8, §§ 5 and 7 which state:

> § 5 The credit of the state shall not, in any manner be given or loaned to, or in aid of any individual, association, company or corporation.
>
> § 7 No county. . . shall hereafter give any money, or property, or loan its money, or credit to or in aid of any individual, association, company, or corporation. . .

The Washington Supreme Court rejected plaintiff's contentions because the cancelled tax was replaced by a new and more burdensome tax. Japan Lines, Ltd., 558 P.2d at 214. In San Bernardino County v. Way, 117 P.2d 354 (Cal. 1941), the Court upheld a County resolution cancelling the delinquent property taxes in a road improvement district. The

resolution was challenged by the county surveyor who charged that the resolution violated Article IV, § 31 of the California Constitution:

> Sec. 31. The Legislature shall have no power . . . to make any gift or authorize the making of any gift, of any public money or thing of value to any individual, municipal or other corporation whatever. . . .

The court upheld the resolution, stating that in determining whether any appropriation of public funds is an unconstitutional gift,

> The primary and fundamental subject of inquiry is as to whether the money is to be used for a public or a private purpose. If it is for a public purpose, it is not, generally speaking, to be regarded as a gift.

San Bernardino County, 117 P.2d at 359. Because the county resolution served the public purpose of restoring property to the tax rolls, it was held not to be an unconstitutional gift of public money. See also City of Ojai v. Chaffee, 140 P.2d 116 (Dist. Ct. App. Cal. 1943); Delta Cty. Levee Improvement Dist. No. 2 v. Leonard, 559 S.W.2d 387 (Civ. App. Tex. 1977); Community Television of Southern California v. County of Los Angeles, 45 Cal. App.3d 276 (1975).

These cases must be contrasted with cases such as City of Yakima v. Huza, 407 P.2d 815 (Wash. 1965), in which the Court found unconstitutional an initiative ordinance which would have repealed a recent tax increase and would have allowed taxes already paid under the repealed ordinances to be credited against future taxes. The court found this

repeal-and-credit scheme, unbalanced by any new tax and unsupported by any public purpose, to be in violation of the state constitution. City of Yakima, 407 P.2d at 820.

The determinative factor in each of the cases cited above was whether the cancellation, credit, or refund of a tax owed or already paid served a valid public purpose. If it did, the court permitted the cancellation, credit or refund, notwithstanding that a private benefit was granted to certain taxpayers. If no public purpose could be found, then the refund or credit was found to be an unconstitutional. In evaluating the validity of the tax credit provisions of SSHB 200, we must look to the public purpose served by the credit. In doing this, it is also important to distinguish between the credit allowed for current taxes payable under the Oil and Gas Corporate Income Tax and the credit allowed for taxes already paid under that Act. There can be little doubt that the credit for current taxes is constitutional. The credit is obviously designed to meet the secondary objective stated in the bill, namely to the extent possible and consistent with ensuring adequate revenues in the event the Oil and Gas Corporate Income Tax is declared invalid, the credit avoids increasing the tax burden on the oil and gas industry. This is, of course, a valid public purpose since increasing the burden may discourage desired economic activity.

Credit for Oil and Gas Corporate Income Tax already paid also serves the same public purpose because without

such credit, the State could ensure the desired level of revenues only by collecting more taxes in the short term, or by increasing taxes after (and if) the State should lose the pending lawsuit. Both alternatives, while certainly possible, are less attractive than the allowance of a credit for taxes already paid because those alternatives may discourage development in the future and the credit approach avoids this problem. Nonetheless, the existence of these alternatives may give rise to an argument that the credit for taxes already paid serves no valid public purpose and is therefore unconstitutional. It is for this reason, that SSHB 200 contains two separate credit provisions and a clear severability clause. These indicate the legislature's choice to increase the tax burden (and accept whatever adverse effects occur) rather than risk substantial diminution of revenues in the event the State loses the pending lawsuit (and incur the adverse consequences of such diminution).

b. Under the U.S. Constitution

The credit provisions also are constitutional when judged by the provisions of the U.S. Constitution. At the outset, it should be stated that there is some doubt that the U. S. Constitution contains any provision prohibiting tax refunds. Professor Sekula, in Retroactive Remedial Tax Legislation and the Statute of Limitations--The Silenced Claimant v. I.R.S., 9 Duquesne L.Rev. 1, 27 (1970) hypothe-

sized that a retroactive tax refund could be challenged under the U. S. Constitution, if at all, only on the grounds that it constitutes an unjustifiable classification that discriminates between taxpayers similarly situated, and thus violates the equal protection clause of the Fourteenth Amendment (in the case of State laws). Id. at 44. As discussed in the separate section on equal protection, the Supreme Court will not invalidate a state's choice of objects for taxation, exemption, or credit where the classification bears a rational relation to a valid public purpose. Because the tax credit provisions of the proposed bill are designed to achieve valid public purposes, this federal standard is met.

D. Due Process

1. Excessive Taxes

No doubt it will be asserted that the proposed reserves property tax constitutes a confiscation of a taxpayer's property in violation of the due process clause of the Fourteenth Amendment. A review of the many Supreme Court cases testing property taxes against the due process standard reveals that such an assertion would be without merit. The proposed tax is not arbitrary in its design and we have found no decided cases that invalidate a general property tax statute on the grounds that the rate is too high. Indeed, a recent decision of the Supreme Court confirms that a tax high enough to destroy a business entirely is not constitutionally infirm for that reason.

a. Procedural Due Process

One of the early cases decided under the due process clause of the Fourteenth Amendment was _Davidson v. New Orleans_, 96 U.S. 97 (1877). In that case, the Court set the following standard for reviewing taxes under the due process clause,

> That whenever by the laws of a State, or by State authority, a tax, assessment, servitude, or other burden is imposed upon property for the public use, whether it be for the whole State or of some more limited portion of the community, and those laws provide for a mode of confirming or contesting the charge thus imposed, in the ordinary courts of justice, with such notice to the person, or such proceeding in regard to the property as is appropriate to the nature of the case, the judgement in such proceedings cannot be said to deprive the owner of his property without due process of law, however obnoxious it may be to other objections.

Id., 96 U.S. at 104-5. This formula suggests that due process is basically a procedural requirement. The taxpayer must be allowed some procedural means to appeal his assessment. No substantive standard for measuring the tax is suggested. In Davidson, certain New Orleans landowners protested an assessment against their property for the purpose of draining several swamps within the city. The Court stated,

> Before the assessment could be collected, or become effectual, the statute required that the tableau of assessments should be filed in the proper District Court of the State; that personal service of notice, with reasonable time to object, should be served on all owners who were known and within reach of process, and due advertisement made as to those who were unknown, or could not be found. This was compiled with; and the party complaining here appeared, and had a full and fair hearing in the court of the first instance, and afterwards in the Supreme Court. If this be not due process of law, then the words can have no definite meaning as used in the Constitution.

Id., 96 U.S. at 105-6. This interpretation of "due process" refers only to lawful procedures. Alaska's proposed reserves property tax contains procedures for appealing assessments and, therefore, satisfies the due process requirements of Davidson. See Sec. 43.58.081.

b. Substantive due process: burdens v. benefits

Later Supreme Court decisions have evolved new ways of applying the due process standard. One group of early cases reviewed a series of special assessment taxes. These taxes

were levied to finance local projects and often fell most heavily on properties that were particularly benefited. Heavily burdened property owners complained that their property was being taken for public purposes without just compensation. In these cases, the due process clause of the Fourteenth Amendment was held to limit state governments in the same way that the due process clause of the Fifth Amendment limits the federal government.

The lengthy opinion and dissent in *French v. Barber Asphalt Paving Company*, 181 U.S. 324 (1901), illustrate well the application of the due process clause to special assessments. Barber Asphalt Paving Company had constructed new streets in Kansas City, Missouri, and was suing abutting property owners to enforce the lien of a special assessment tax bill. The majority in *French* upheld the special assessment, which apportioned the cost of new streets to abutting landowners according to a "front footage" rule. The majority found that there had been a legislative determination of the proper apportionment and that this legislative determination could not be reviewed. *Id.*, 181 U.S. at 343-346.

Writing the dissent in *French*, Justice Harlan argued that the assessments violated due process because no opportunity was given the taxpayer to appeal his assessment on the ground that it was significantly in excess of the benefits conferred on his property. However, Justice Harlan

noted that this strict proportionality was only required for special assessments for local improvements:

> Special assessments are a peculiar species of taxation, standing apart from the general burdens imposed for state and municipal purposes, and governed by principles that do not apply generally. The general levy of taxes is understood to exact contributions in return for the general benefits of government, and it promises nothing to the persons taxed beyond what may be anticipated from an administration of the laws for individual protection and the general public good. Special assessments, on the other hand, are made upon the assumption that a portion of the community is to be specially and peculiarly benefited in the enhancement of the value of property peculiarly situated as regards a contemplated expenditure of public funds; and, in addition to the general levy, they demand that special contributions, in consideration of the special benefit, shall be made by the person receiving it. The justice of demanding the special contribution is supposed to be evident in the fact that the persons who are to make it, while they are made to bear the cost of a public work, are at the same time to suffer no pecuniary loss thereby, their property being increased in value by the expenditure to an amount at least equal to the sum they are required to pay. This is the idea that underlies all these levies." Cooley on Taxation, 416, c. 20, § 1; Cooley on Taxation, 2d ed. 606, § 1.

French, 181 U.S. at 362 (emphasis added). The notion that general levies promise "nothing to the persons taxed beyond what may be anticipated from an administration of the laws for individual protection and the general public good" is repeated with force in Carmichael v. Southern Coal & Coke Co., 301 U.S. 495, 522-523 (1937). There, several employers protested the levy of an Alabama tax to provide benefits to unemployed workers. The Court in Carmichael repudiated the

idea that general levies may only burden taxpayers in proportion to the benefit conferred:

> Nothing is more familiar in taxation than the imposition of a tax upon a class or upon individuals who enjoy no direct benefit from its expenditure, and who are not responsible for the condition to be remedied.
>
> A tax is not an assessment of benefits. It is as we have said, a means of distributing the burden of the cost of government. The only benefit to which the taxpayer is constitutionally entitled is that derived from his enjoyment of the privileges of living in an organized society, established and safeguarded by the devotion of taxes to public purposes. See Cincinnati Soap Co. v. United States, supra. Any other view would preclude the levying of taxes except as they are used to compensate for the burden on those who pay them, and would involve the abandonment of the most fundamental principle of government - that it exists primarily to provide for the common good.

Carmichael, 301 U.S. at 521-523 (in footnote 14 the Court lists numerous taxes which confer no direct benefit on the persons taxed). As recited in the statements of legislative findings and purpose, Alaska's proposed reserves property tax serves a variety of public purposes. Being a general levy for the common good, it is unassailable on the ground that it burdens certain taxpayers more than it benefits them. This is not a violation of the due process clause of the Fourteenth Amendment.

c. Substantive due process: taxes that impair a business

On various occasions it has been argued that a state tax which is so oppressive as to destroy a particular busi-

ness is a taking of property without due process. The U.S. Supreme Court has consistently refused to strike down such a tax.

In Alaska Fish Co. v. Smith, 255 U.S. 44 (1921), the territorial legislature of Alaska had imposed a tax on the manufacture of oil and fertilizer from fish with the purpose of preserving herring as a food supply for men and salmon. The Alaska Fish Company complained that the tax effectively prohibited and confiscated it's business without due process. The Court upheld the tax saying,

> If Alaska deems it for its welfare to discourage the destruction of herring for manure and to preserve them for food for man or for salmon, and to that end imposes a greater tax upon that part of the plaintiff's industry than upon similar use of other fish or of the offal of salmon, it hardly can be said to be contravening a Constitution that has known protective tariffs for a hundred years. Rast v. Van Deman & Lewis Co., 240 U.S. 342, 357. Even if the tax should destroy a business it would not be made invalid or require compensation upon that ground alone. Those who enter upon a business take that risk. We know of no objection to exacting a discouraging rate as the alternative to giving up a business, when the legislature has the full power of taxation.

Id., 255 U.S. at 48-49.

In Magnano Co. v. Hamilton, 292 U.S. 40 (1934), appellant, a margarine manufacturer, challenged a statute of the State of Washington which placed an excise tax of fifteen cents per pound on all butter substitutes sold in the state. Magnano Co. claimed that the tax totally erased

its profits in the state, forcing the company to discontinue its business there. Following the principle set forth in Alaska Fish Co. v. Smith, the Court upheld the Washington statute, saying,

> If a contrary conclusion were reached in the present case, it could rest upon nothing more than the single premise that the amount of the tax is so excessive that it will bring about the destruction of appellant's business, a premise which, standing alone, this court heretofore has uniformly rejected as furnishing no juridical ground for striking down a taxing act.

Magnano, 292 U.S at 47.

The principle of Alaska Fish Co. and Magnano was reaffirmed in City of Pittsburgh v. Alco Parking Corp., 417 U.S. 369 (1974). Alco complained that Pittsburgh's 20% tax on the gross receipts of private parking lots was destroying the profitability of those businesses. Nine of the fourteen private lots in the city were rendered unprofitable and the rest made only marginal profits as a result of the tax. Id., 417 U.S. at 372. The Supreme Court of Pennsylvania ruled that the tax was unreasonably high and violated the due process clause of the Fourteenth Amendment. Relying on Alaska Fish Co. and Magnano, the U.S. Supreme Court reversed saying,

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

Id., 417 U.S. at 373.

Therefore, the taxpayers may not complain that the proposed reserves property tax violates the due process clause because it is oppressively high. The above cases demonstrate that the power to tax may well be exercised in such a way as to make a business entirely unprofitable without violating the due process clause. By comparison, the taxpayers cannot demonstrate that the proposed reserves property tax would drive them out of business. The oil industry in Alaska remains profitable despite payment of equivalent taxes under the Oil and Gas Corporate Income Tax. A due process challenge against the reserves property tax would be even less persuasive than the unsuccessful challenges in Alaska Fish Co., Magnano, and City of Pittsburgh.

d. Summary

The reserves property tax does not violate the due process clause of the Fourteenth Amendment on any of the other grounds that historically have been presented to the Supreme Court. The tax is not a special assessment and so is not held to any test of fair ratio between the benefit conferred on a taxpayer and the burden imposed. Carmichael v. Southern Coal & Coke Co., supra.

2. Excessive Assessment

The reserves property tax is to be assessed on the basis of the "full and true value" of the subject property interests. Sec. 43.58.021(a). This full and true value is

defined as the market price of the property's proven reserves, which the Department of Revenue shall determine after considering all factors affecting the value of the property, including the discounted present value of the expected future net income from the reserves. Sec. 43.58. 051(b). If a taxpayer challenges the statutory discount rate, the bill provides that he bear the burden of showing that use of that discount rate would result in constructive fraud. Sec. 43.58.051(d). Each of these provisions is consistent with the United States Constitution and the Alaska Constitution and with the decisions of the respective Supreme Courts.

a. Property assessment and the fourteenth amendment

There have been several cases decided by the U.S. Supreme Court in which the methods or the result of property assessment were challenged. Generally, the challenges are grounded in the Fourteenth Amendment, though it is not always clear whether the due process clause or the equal protection clause of that amendment is the basis of the Court's holding. In either case, the Court's formula for testing the constitutionality of property assessments has remained more or less consistent. As phrased by the Court in Chicago, Burlington & Quincy Ry. Co. v. Babcock, 204 U.S. 585, 596 (1907):

> It is said that this valuation is absurd and due to misunderstanding of the table. But we have nothing to do with complaints of that nature, or with anything less than fraud, or a clear adoption of a fundamentally wrong principle.

So saying, the Court upheld Nebraska's method of assessing railroad property against a challenge founded on the Fourteenth Amendment. Nebraska's assessors had considered, among other things, the capitalization of the railroad's net earnings within the state.

In 1923, the Supreme Court considered a challenge to the assessment of a mine tailings dump. South Utah Mines & Smelters v. Beaver County, 262 U.S. 325 (1923). In that case the court found no constitutional fault with the statutory method of capitalizing the net income of a metalliferous mine to estimate its present value:

> The value of property bears a relation to the income which it affords. If it be property whose production is uniform and of indefinite duration the capitalization of the net income derived from it at the going rate of interest, in the absence of a more certain method, will furnish a reasonable measure of the value.

Id., 262 U.S. at 330. The Court said in dictum, however, that to use such a method on a tailings pile which, unlike an underground ore deposit, has no reserves hidden in the earth would result in "flagrant and palpaple injustice" and would be of doubtful constitutionality. Id., 262 U.S. at 331. Presumably a flagrant and palpaple injustice, is similar to "fraud or the clear adoption of a fundamentally wrong principle", the Fourteenth Amendment test in Chicago, Burlington & Quincy Ry. Co., though that case was not cited. South Utah Mines was decided on other grounds, that is by construing the Nebraska mine assessment statute such that it did not apply to the tailings pile. Id., 262 U.S. at 333.

The Utah legislature could constitutionally require that a fixed multiple of the net income of a mine be used to provide a "reasonable measure" of the property value, when the reserves were uncertain. Alaska proposes to use projected income figures to discount to present value oil reserves that are known to exist. This method too will produce a "reasonable measure" of the value of the reserves and is not "altogether fictitious" or a "flagrant and palpable injustice." South Utah Mines, 262 U.S. at 331.

In a second mineral valuation case, decided by the U.S. Supreme Court in 1931, petitioners claimed that the method of assessing their coal reserves violated the equal protection clause of the Fourteenth Amendment. Cumberland Coal Co. v. Board of Revision, 284 U.S. 23 (1931). The county assessors used a flat rate of $260 per acre of coal land in assessing property values, notwithstanding the well-known fact that coal close to the river was worth much more and other reserves were worth less. The result was that some properties were assessed at 100% of the value of the coal reserves and others were assessed at as little as 25% of their actual value. Id., 284 U.S. at 30. The Court held that this "intentional, systematic undervaluation by state officials of taxable property of the same class" violated the equal protection clause of the Fourteenth Amendment. Id., 284 U.S. at 28 (emphasis added). The reserves property tax proposed by Alaska will be assessed only after consi-

deration of all factors which may be known by the Department to affect the taxable value of the property, thus avoiding the problem of intentional undervaluation which was found unconstitutional in Cumberland Coal Co..

While the Cumberland Court found intentional undervaluation of some (but not all) properties in a class to be a violation of the equal protection clause of the Fourteenth Amendment, the court in Great Northern Ry. v. Weeks, 297 U.S. 135 (1936) held that intentional or fraudulent overassessment violates the due process clause of that same amendment. In Great Northern Ry. Co., the railroad company complained that North Dakota's method of assessment did not reflect the decline in property values that resulted from the Great Depression. The state's witness essentially admitted this, saying, "If all assessments had been reduced to conform to actual market value, the State and its subdivisions would have ceased to function, as the revenue would not even approximate necessary expenses." Id. 297 U.S. at 150.

Expanding on the importance of a finding of intent or fraud as part of the constitutional test, the Court said,

> Courts decline to disturb assessments for taxation unless shown clearly to transgress reasonable limits. Overvaluation is not of itself sufficient to warrant injunction against any part of the taxes based on the challenged assessment; mere error of judgment is not enough; there must be something that in legal effect is the equivalent of inten-

> tion or fraudulent purpose to overvalue the property and so to set at naught fundamental principles that safeguard the taxpayer's rights and property. Rowley v. Chicago & N.W. Ry., 293 U.S. 102, 109-111. The assessment is presumed to have been rightly made on the basis of actual value. Its validity must be tested upon consideration of the facts established by the evidence and of those of which judicial notice may be taken.

Id., 297 U.S. at 139. Because the assessors admittedly intended to overvalue the property, the Court found the evaluation was "grossly excessive" and in violation of the due process clause of the Fourteenth Amendment. Id., 297 U.S. at 152.

Great Northern Ry. Co. apparently is one of a very few cases in which the Supreme Court invoked "substantive due process" under the Fourteenth Amendment. See Southland Mall Inc. v. Garner, 455 F.2d 887, 890 n. 3 (6th Cir. 1972). Subsequent cases testing the constitutionality of assessment procedures rely on the equal protection test of Cumberland Coal Co., continuing to require the taxpayer to show intentional undervaluation of some but not all the taxed property in a single class. See Charleston Federal Savings & Loan Association v. Alderson, 324 U.S. 182 (1945); Southland Mall, Inc. v. Garner, 455 F.2d 887 (6th Cir. 1972) (both citing and applying the equal protection standard of Cumberland Coal Co.).

In summary, the Supreme Court tests the constitutionality of property assessments according to the following formula:

1. The Court will presume that the assessment has been correctly made on the basis of actual value (Great Northern Ry. Co.).

2. The aggrieved taxpayer bears the burden of proving either:

(a) that there has been a systematic undervaluation of other properties in the same class (equal protection problem of Cumberland Coal Co.); or

(b) that his property has been assessed at a value grossly in excess of its actual value (due process problem of Great Northern Ry. Co.), and

3. The taxpayer must prove that the problem in (2)(a) or (2)(b) above is not a mere overvaluation or error in judgment, caused by the choice of one assessment method over another, but rather was the result of intentional or fraudulent undervaluation or overvaluation or the clear adoption of a fundamentally wrong principle. (Chicago, B&Q Ry. Co., Cumberland Coal Co., Great Northern Ry. Co., Charleston A'ssn., Southland Mall, Inc., supra and cases cited therein).

Adopting this constitutional standard, Alaska's reserves property tax contains a presumption that the statutory discount rate is appropriate. 43.58.051(d). The taxpayers may upset this presumption by proving, through "clear and convincing evidence that the use of the statutory discount rate would result in constructive fraud." Id.

b. <u>State court review of assessments in other states</u>

At least three states have applied the U.S. Supreme Court's test or a very similar test in cases challenging the assessments of oil properties. In People v. Coen, 112 N.E.2d 119 (Ill. 1953), a landowner with a one-eighth royalty interest in the underlying oil reserves protested the assessed valuation of that interest. The assessor considered present production, the nature of the oil-bearing formation, and the life expectancy of the field. He did not actually visit the property in question. The Illinois Supreme Court upheld the assessment saying,

> The law presumes that in fixing the value of property the taxing authorities have properly discharged their duties and that the tax is just. One objecting to the valuation has the burden of proving, by clear and convincing evidence, that an excessive valuation was made as the result of some improper, corrupt or illegal motive on the part of the assessing authorities, or that the valuation is so grossly excessive as to create a constructive fraud.

Id., 112 N.E. 2d at 121-22.

In Red Bluff Developers v. County of Tehama, 66 Cal. Rptr. 229 (Ct. App. 1968) plaintiff protested the county's valuation of his reserved rights to oil and gas beneath a residential subdivision, claiming that they had no known market value. It appeared that the county assessor had set a tax which represented his cost of paperwork; making the assessment that there was no known market value for the

mineral estate. The Court of Appeals upheld the assessor, quoting the test set out by the Supreme Court of California:

> It is the rule applicable to assessors and to boards having assessing powers that it is presumed that the assessing officers have properly performed the duties entrusted to them and, consequently, that the assessments are both regularly and correctly made. (Utah Construction Co. v. Richardson, supra, 187 Cal. at p.654.)
>
> . . .
>
> Thus, before taxes can be set aside where they are claimed to be excessive, there must be evidence to show that the assessments were fraudulently or mistakenly made, or that an improper method of valuation was pursued. (Utah Construction Co. v. Richardson, supra, 187 Cal. at p.655; Miller & Lux v. Richardson, 182 Cal. 115, 128.)

Id., 66 Cal. Rptr. at 233.

Finally, in Mobil Pipeline v. Rohmiller, 522 P.2d 923 (Kan. 1974), plaintiff protested the assessed value of his oil pipeline, arguing that the assessor neglected to make certain deductions before capitalizing the operating income of the pipeline. The Court upheld the assessor's finding saying that it would not interfere with the assessor's ruling unless it were shown that the assessor had neglected the instructions of the legislature as to assessment methods or had been arbitrary and capricious, amounting to constructive fraud.

To avoid confusion with regard to the judicial standard of review to be applied, it may help to contrast the problems of a legislative classification which intentionally

taxes certain properties at different rates, with intentionally unequal assessment practices. The former is constitutional, the latter is not. As explained elsewhere in this report, a state legislature may classify taxpayers according to any system which has "a reasonable relation to some permitted end of governmental action. . . ." Heisler v. Thomas Colliery Co., 260 U.S. 245, 255 (1922). The Supreme Court has upheld classifications distinguishing between producers of anthracite coal and bituminous coal, between personal property owned by corporations and individuals, and between mining property and quarries, forests, and other properties (see section on Equal Protection for citations). There is no doubt that Alaska may constitutionally choose to impose a property tax on oil reserves and not on other properties. However, once the subject class is defined by legislation, the state assessors may not intentionally or fraudulently assess some members of the class at a higher percentage of true value than others. This is the teaching of Cumberland Coal Co. and the other cases cited in this section.

Thus, for example, the Pennsylvania legislature could have classified coal reserves adjacent to a river for higher taxation than coal some miles away, for the purpose of encouraging the development of the less accessible coal, or to prevent the water pollution problems caused by coal mining next to rivers. However, so long as the two coal deposits are categorized in the same class, the tax assessors may not

intentionally or fraudulently assess some properties at 100% of true value while assessing others at only 25% of true value.

c. Review of assessments in Alaska

Article IX, § 3 of the Alaska Constitution states:

> Standards for appraisal of all property assessed by the State or its political subdivisions shall be prescribed by law.

Pursuant to this requirement, SSHB 200 prescribes that the subject property shall be assessed at its "full and true value" and lists certain factors to be included and others to be excluded by the assessor in estimating the true value.

As discussed in the Equal Protection section of this report, Alaska's Constitution, unlike certain other states, does not require that all property be taxed at the same rate. Alaska's choice of property tax and assessment methods is constrained only by the Fourteenth Amendment of the U.S. Constitution and the equal protection clause of Article I, § 1 of the Alaska Constitution.

In Twentieth Century Investment Co. v. City of Juneau, 359 P.2d 783 (Alaska 1961), the Supreme Court of Alaska interpreted the Fourteenth Amendment as it applies to tax laws and assessment procedures in Alaska. The Court adopted the language of the U.S. Supreme Court discussed earlier in this section. In response to the taxpayer's claim that his theater building was assessed by a different method than a similar theater nearby, the Court said:

> The equal protection clause [of the Fourteenth Amendment] does not prohibit inequality in taxation which is not shown to be the result of an intentional or systematic undervaluation of some but not all of the taxed property in a single class.

Id. 359 P.2d at 785. The Court held that the theater owner had failed to show that the assessor adopted a different method of assessment with the purpose of either overvaluing plaintiff's theater or undervaluing his competitor's theater. The bare fact that the assessor used different reconstruction cost rates for the two theaters was not proof of intentional discrimination, because plaintiff failed to prove that there was no "conceivable basis that would sustain the different valuations of the two buildings." Id., 359 P.2d at 786.

The plaintiff also alleged that the assessed value of a certain portion of his theater so greatly exceeded the full and true value of that portion as to amount to a confiscation of his property, violating the due process clause of the Fourteenth Amendment. To this contention the Court replied:

> The valuation and assessment of property for taxes does not contravene the due process clause of the Fourteenth Amendment unless it is plainly demonstrated that there is involved, not the exercise of the taxing power, but the exertion of a different and forbidden power, such as the confiscation of property. Such a demonstration is not made simply by showing overvaluation; there must be something which, in legal effect, is equivalent to an intention or fraudulent purpose to place an excessive valuation on property, and thus violate fundamental principles that safeguard the taxpayer's property rights.

Id., 359 P.2d at 787 (citing Great Northern Ry. Co. v. Weeks, supra). The Court held that the assessor was justified in not considering the functional obsolescence or the capitalized income of the theater because these procedures would have been burdensome and expensive, and that this was not arbitrary or fraudulent treatment of the taxpayer. Id., 359 P.2d at 788.

Finally as to the assessor's choice of an assessment method, the Court said,

> The City was not bound by any particular formula, rule or method, either by statute or otherwise. Its choice of one recognized method of valuation over another was simply the exercise of a discretion committed to it by law. Whether or not it exercised a wise judgment is not our concern. This court has nothing to do with complaints of that nature. It will not substitute its judgment for the judgment of those upon whom the law confers the authority and duty to assess and levy taxes. This court is concerned with nothing less than fraud or the clear adoption of a fundamentally wrong principle of valuation. Neither has been shown here.

Id., 359 P.2d 788 (citing Great Northern Ry. Co. and Chicago, B&Q Ry. Co., supra).

In summary, the Alaska Supreme Court has followed the U.S. Supreme Court closely in testing the constitutionality of property tax assessments. Consistent with the Alaska Court's decision in Twentieth Century Investment Co. (repeated and applied in Hoblit v. Greater Anchorage Area Borough, 473 P.2d. 630 (Alaska 1970)), the State may adopt any method of property valuation it chooses, so long as there is no fraud or clear adoption of a fundamentally wrong principle

of valuation.

The reserves property tax specifies a procedure for estimating the full and true value of oil reserves in the State of Alaska. The assessor is to consider several factors, including future net income discounted at a rate of ten percentage points above the inflation rate. In accordance with the Alaska Supreme Court's decisions in Twentieth Century Investment Co. and Hoblit, any taxpayer seeking to overturn the assessor's findings will bear the burden of proving intentional or fraudulent discrimination on the part of the assessor in either overvaluing the taxpayer's property of systematically undervaluing the property of others.

V. CONCLUSION

As a result of our analysis and the work of others, we have concluded that the backstop legislation, as embodied in SSHB 200, is a sound strategy and best available option for protecting Alaska's oil and gas revenues.

PLEASE NOTE: THE FOLLOWING PAGES WERE TREATED AS A UNIT IN THE ORIGINAL DOCUMENT

ALASKA

STATE LEGISLATURE

MEMORANDUM

To: Jt. Gas Pipeline Committee Members

Attached is a report prepared for the Committee which discusses the options available to the State for implementing the goals established in the Joint Statement on Oil Taxes issued by the Governor and the legislative leadership on March 18, 1981. The report, entitled, "Alaska Oil and Gas Income Taxation: A Review of the State's Options," was prepared under the direction of Anchorage attorney John Messenger.

ALASKA OIL AND GAS INCOME TAXATION

A Review of the State's Current Options

prepared for

The Alaska State Legislature
Joint Gas Pipeline Committee

By

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April 15, 1981

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FOREWARD

This study was prepared under a contract with the Legislative Affairs Agency of the Alaska State Legislature. The agreement directed us to

> . . . review and report on the options available for implementing the goals established in the Joint Statement on Oil Taxes issued by the Governor, the President of the Senate, the Speaker of the House, the Finance Chairmen of their respective houses and other legislative leaders on March 18, 1981.

It was specified that our report should include

> legal, economic and fiscal analysis of the various options identified . . . to enable an informed choice of options for further consideration. . . [and our] recommendations as to the identified options.

Although the time allowed to fulfill this assignment was extremely limited (13 days), we have prepared a reasonably comprehensive survey of the State's options. However, the analysis here is not sufficiently detailed to support any final decision on the form of a new oil tax structure, be it temporary or permanent. We do see this document, and the work by others now underway, as useful and perhaps crucial to narrowing the focus of efforts in the immediate future if it is decided to proceed.

The report which follows is the joint product of the three authors. The supporting revenue and economic studies were the responsibility of Mr. Eppenbach and Mr. Erickson. The necessary legal analysis was carried out by Mr. Messenger, who also served as project manager.

We wish to thank the many individuals who, often on very short notice, generously made themselves available to

answer our questions and who provided us with much useful data. Personnel of the Department of Revenue must lead this list--Commissioner Thomas Williams, Deputy Commissioner Joseph Donohue, Director of Petroleum Revenue Robert Johnson, Jerry Heier, Lou Nelson, and especially Charles Logsden. Mark Wittow and Kevin McCarthy of the legislative staff also provided important information, as did Milt Barker of the Legislative Finance Division. The use of data processing facilities at the House Research Agency was crucial to producing this study within the specified time.

I

OVERVIEW

A major part of the revenues expected to accrue from Alaska's oil and gas resources have been put at risk by a lawsuit challenging A.S. 43.21, the State's oil and gas corporate income tax (hereinafter "Ch. 21"). If the litigation is finally resolved in late 1985, the State could--in the worst case--be required to return up to $9 billion to the corporate taxpayers (see Table I).

TABLE I

ESTIMATED CH. 21 (PETROLEUM INCOME TAX)
COLLECTIONS BY FISCAL YEARS
(Millions of Dollars)

Fiscal Year	Annual Collections
1979	233 (actual)
1980	548 (actual)
1981	808
1982	1303
1983	1541
1984	1783
1985	2141
Total for period	8357

In a March 18, 1981 Joint Statement, the legislative leadership and the administration (see Appendix A) announced Alaska's position with respect to this risk: The current share of oil revenues between the producers, the federal government, and the State is fair; it should be preserved in

the future as a model of stability and restraint for other petroleum producing jurisdictions. These goals--and Alaska's established revenue share--will be seriously compromised if the plaintiffs win.

Although legal opinions differ on the State's chances of prevailing in the current lawsuit, no one has suggested that it is free from risk. The large sums involved make even a small victory by the litigants (or a small probability of a big victory) a matter of serious concern.

If the litigation result is a relatively small loss (say $1 billion in 1985), it could be recouped over a few years with increased petroleum taxes. A loss of any larger magnitude would place the State in financial extremis. One option to deal with this problem is to await the outcome of the lawsuit before taking action. There are, however, real economic, legal and political restraints on recouping a substantial portion of lost Ch. 21 revenues under this option.

One way of implementing this option would be to attempt to collect the lost revenues prospectively. The State's oil and gas resources and the oil and gas tax base whether measured by gross production revenues, income streams, or reserves valuation, is depleting. The ability to offset this depletion by raising the tax rates has economic limits. This is especially true if one is attempting to cover lost revenues and also provide for the then current needs. In addition, there are real--albeit poorly defined--political and constitutional limits to the tax rates that would be

required to cover both past lost revenues and future needs. The legal challenge of Montana's 30 percent severance tax (now before the U.S. Supreme Court) and congressional proposals to limit state severance and income taxes are some examples.

Alternatively, in the event of an unfavorable decision, the State could attempt to make up the loss by making tax changes retroactively to 1978. A serious constitutional question would be raised by such a retroactive imposition. States have some latitude in imposing taxes retroactively, but not without limit. Taxes made retroactive to the beginning of a current tax year or applied to recent transactions have been upheld. Similarly, curative statutes which cure invalid tax proceedings or administrative action retroactively have been sanctioned. On the other hand, some other retroactive impositions such as gift and death tax changes have been struck down on the ground that the nature or amount of the tax could not reasonably have been anticipated at the time of the transaction which was later made taxable. Although not entirely clear, tax changes in 1985 of the magnitude needed to cover a loss of Ch. 21 revenues and the period of retroactivity (seven years to 1978) would at least carry a serious legal risk.

Since waiting out the law suit would still leave State revenues at risk, we believe that a decision to do nothing other than litigate the suit will not constitute, in the language of the Joint Statement, "a sound strategy for

protecting oil and gas revenues."

This does not mean that an aggressive effort to win the current litigation is unimportant. Indeed, we consider it an essential part of any plan for protecting the State's revenues. Even if the current oil and gas corporate tax, A.S. 43.21 were repealed this session and replaced by some other tax that raised as much revenue, the result would be to leave in excess of $1 billion already collected by the State at risk.

This billion dollar "overhang" has important implications for the State's efforts to achieve the objectives outlined in the joint statement. Because of the overhang, any new tax designed to replace Ch. 21, or any attempt to create a "saftey net" tax to backstop Ch. 21 (which was enacted in 1978), must either be retroactive to 1978, or otherwise protect more money than the oil and gas corporate tax will collect in future. As we shall show later, this constraint limits the options available to the legislature.

Whether to replace Ch. 21 with a new permanent tax, or to simply protect its revenues with a backstop of some sort is a decision that turns on the degree and range of certainty required with respect to policy, fiscal and legal issues.

On the one hand, to fashion a workable backstop the legislature need mainly be concerned with fiscal effects as they unfold over a limited time span, between now and whenever the litigation is finally resolved, say 1985. Further, the basic criteria that a backstop must satisfy are rela-

tively simple. First, it must have sufficient fiscal horsepower to cover the exposed Ch. 21 revenues. Second, it must be legally (and politically, with respect to the federal government) secure.

Before adopting a permanent substitute for Ch. 21, we expect that the legislature will wish to give it a far more searching examination than would be necessary under the backstop approach. For example, the fiscal effects of a new permanent tax should be examined under a larger set of possible circumstances, and over a longer time frame. Its effects on future exploration and development, for example, would need to be forecast under a similarly wide range of alternative assumptions, as would its effects on differently situated oil and gas producers, and pipeline operators. <u>Most of all, the legal and fiscal security of a replacement must be close to absolute, since a new tax is not the second and reinforcing line of defense that would be created by a backstop; it is a new first line of defense which must stand alone</u>.

In all candor, we doubt that these conditions can be met in the time remaining in this session. Our experience with this type of legislation, going back to 1972, leads us to believe that consensus on the issues raised by a whole new permanent petroleum income tax will require substantial work to achieve. This was certainly the case in 1978, when Ch. 21 was enacted. Numerous concepts for revising the tax were introduced by different legislators and the administra-

tion over the three years preceeding enactment of Ch. 21. Two interim committees approached the task and arrived at very different policy recommendations. After a general consensus had been reached, it took six weeks of very intensive effort to embody the concept in an act that everyone could be reasonably confident would do what was expected of it.

Much of the work done over the 1975-1978 period is and would be relevant to recasting the tax now; but even so, the policy differences are likely to remain. For example, some will claim that two corporations with exactly the same Alaska assets, activities and profits will be taxed differently, and therefore inequitably under any apportionment formula. Others will argue that apportionment is the most appropriate way to tax a unitary business. Similarly, resolving legal questions and revenue projections with reasonable degrees of certainty would surely require much further analysis. Resolving issues of this sort, if they are resolvable, will take time.

II

BACKSTOP CRITERIA

A backstop is much more likely to be achievable within the six weeks or so remaining in this session, but even so, developing a backstop tax will not be a simple task. To serve its purpose a backstop measure must (1) have sufficient fiscal horsepower to cover the revenues at risk, and (2) be legally and politically secure. Some tax bases are probably not large enough to achieve both of these objectives in an absolute sense. As a result, a marginal increment of revenue security would need to be given up to achieve the highest possible legal security (or vice versa). For example, as we note below, any apportionment formula that raises as much revenue as Ch. 21 will almost certainly be challenged and will carry some legal risk.

These matters, and the question of tradeoffs, are addressed below in the context of specific taxes. However, in order to assess these, it is necessary to discuss the other secondary goals which the legislature will probably consider relevant. These are, in no particular order, the following:

Minimize Adverse Effects on the Current Lawsuit. For example, a backstop tax which made use of the three factor apportionment formula which the oil company plaintiffs are arguing for in their suit could be construed as giving them at least moral support in their assertions, and raise questions about the State's own confidence in that part of its

case. The same could be said about any backstop tax, but a specific use of the plaintiffs' favored approach could be especially difficult to explain.

Administrative Convenience. In the context of the large sums we are discussing here the extra costs of administering even the most difficult tax are not very significant. Moreover, the assertions made to previous legislatures by the petroleum industry that the 1975 reserves tax and the 1978 corporate tax proposal would create an "administrative nightmare" and "a huge revenue bureaucracy" have not been validated by actual experience with those taxes.

On the other hand, the fact that some taxes are easier to administer than others is not irrelevant. For example, the very simple reserves tax requires, in the assessment process, substantial technical skill and high levels of administrative integrity. The fact that the Alaska Department of Revenue managed this tax quite well for the two years it was in effect probably does not entirely mitigate the importance of administrative convenience.

Simplicity. By this we mean that the tax should be known and understandable. Taxes which the legislature has already dealt with in the past are to be prefered, other things being equal, to those that are relatively untried or complex in their workings. The severance tax, the reserves tax and the existing apportioned income tax in Ch. 20 all score high in this regard.

Overcollecting. It is important that Alaska not reach

beyond its stated goal of protecting its current share of petroleum revenues. This does not mean that a backstop tax or mechanism need collect or cover collections of exactly the same revenues as will be raised by Ch. 21, which in any event are uncertain. It does mean, however, that the collections should be comparable.

Minimize the Likelihood of Adverse Federal Reaction. Much has been said about the risks of congressional reaction to Alaska's attempts at securing what it considers its fair share of resource revenues. Consuming states have shown increased willingness to use political and judicial tools to limit that share to what they consider fair. The suit against Montana's 30 percent coal severance tax is an example.* Additionally, there have been several congressional proposals which would limit state severance and income taxes.** Although none of these proposals have become law, they can not be dismissed. Action which Alaska might take could have an effect on such proposals.

Symmetry. The taxpayers affected by a backstop, and the tax burdens it currently or prospectively creates should correspond as nearly as possible with Ch. 21, in order that the backstop not disturb the policy judgments already made by the legislature.

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* Commonwealth Edison Co. v. State, 615, P.2d. 847 (Mont. 1980).

** Just some of these proposals include S.1778 96th Cong. 1st Sess. (1979); H.R. 1983 97th Cong. 1st Sess. (1981); S.655 97th Cong. 1st Sess. (1981); H.R. 5076 96th Cong. 1st Sess. (1979); S.1688 96th Cong. 1st Sess. (1979).

Obviously, perfect symmetry in this sense is not possible without knowing each taxpayer's particular tax position. Although it might be desirable from a policy standpoint, achieving that perfect symmetry would carry some additional legal risks. For example, suppose A.S. 43.21 were found invalid, but through the adoption of a backstop mechanism each taxpayer was still required to pay exactly the same amount. An argument could be made that the legislature was simply enforcing an otherwise invalid tax under the guise of a new tax.

Certainty of Revenue Effects. Those of us who have had responsibility for forecasting revenues have an acute sense of how important this criterion is. On one level, certainty of revenue effect means you are much less likely to find yourself mercilessly criticized for missing the mark on your revenue estimate. Beyond that, certainty of revenue effect means that State fiscal planning can be made with more confidence.

No tax can be forecast with complete certainty. Oil and gas taxes are difficult because they are extremely sensitive to world oil prices and to production. Some oil and gas taxes, however, are much more difficult than others. A flat cents-per-barrel tax is easy since there is only one variable to worry about. A corporate income tax using the apportionment formula is more difficult to forecast, since it depends on the entire world wide tax position of each taxpayer which may change from year to year.

Although legislators themselves are not likely to make the actual estimates, they have the same problem. A backstop tax which turns out to have protected less revenue than expected could be difficult to explain to those who, rightly, could care less about the technical problems of forecasting.

Minimize Spillover Effects. Spillovers include all the effects of a tax that were not intended. With respect to the taxes under consideration here, they can range from increased gas rates in Anchorage if a gas severance tax were part of a backstop mechanism, to effects on future exploration and development. Some spillovers may be positive: Some have suggested that earlier construction of the Northwest Gas Pipeline could conceivably result from including a gas reserves tax in a backstop arrangement.

A full analysis of just those spillovers that we consider *likely* would take as much space as this entire study. Fortunately, most of these will probably not be very significant because the backstop tax will be temporary and the backstop mechanism can mitigate spillover effects to some extent. Where spillover effects may have political or especially significant economic reprecussions, they have been identified in the discussion of the individual tax or backstop mechanism that could cause them.

III

TAX TYPES

In our analysis of the backstop approach, we have found it useful, at least initially, to separate the consideration of taxes, per se, from the mechanisms by which they would be made to protect the State's Ch. 21 revenues. For example, enacting a new tax and escrowing Ch. 21 revenues is one mechanism. Allowing Ch. 21 payments to be credited against the new tax is another. Either mechanism could be applied to any of the possible backstop taxes considered here.

A large set of possible taxes was considered in this survey, but all can be adequately described under three basic headings categorized by whether the tax base is (1) the gross revenues from the production stream of oil and gas, (2) the profits derived from that stream, or (3) the value of the property (including reserves) that makes the production possible.

The greater part of our analysis has been devoted to determining with as much certainty as possible the amount of what we have called fiscal horsepower inherent in each of these tax bases, as well as the political and legal constraints on Alaska's ability to achieve that horsepower.

These tradeoffs, horsepower against security, are discussed below in the context of the three specific tax types.

Production or Severance Taxes have several important advantages. They are generally easy to assess, and are a traditional means of raising revenue from the petroleum

industry. Most importantly in this context, a production tax has an inherently large potential for fiscal horsepower, as shown in Table II:

TABLE II

OIL PRODUCTION TAX ESTIMATES
AT CURRENT TAX RATES
(Millions of Dollars)

Fiscal Year	North Slope Production	Cook Inlet	Total
1981	1137	22	1159
1982	1592	36	1628
1983	1956	33	1989
1984	2281	32	2313
1985	2533	25	2558

A change in the nominal rate under the existing severance tax from 12.25 percent to about 22 percent would raise sufficient revenue to cover Ch. 21 revenues.

The current severance tax formula allows for a tax rate modification based roughly on the marginal costs of production (see Table III). If this were eliminated, leaving a flat percentage of value severance tax, the required percentage of value would be between 20 and 18 percent, falling to the lower level in the last year of the backstop period (see Table IV). The fact that the power of a flat rate severance tax (no economic limit factor) grows over the backstop period is an important characteristic that could make it very useful in combination with a property tax on reserves, which shows the opposite tendency.

TABLE III

ANALYSIS OF OIL PRODUCTION TAX RATES

		North Slope		Cook Inlet	
Fiscal Year	Nominal Tax Rate	Estimated Effective Rates	Indicated Economic Limit Factor	Estimated Effective Rates	Indicated Economic Limit Factor
1981	12.25%	11.74%	.96	4.75%	.39
1982	12.25	10.79	.88	4.13	.34
1983	12.25	10.57	.86	3.98	.32
1984	12.25	10.46	.85	3.81	.31
1985	12.25	10.13	.83	2.89	.24

Note: The economic limit factor reduces the tax variably to take account of differing costs. See A.S. 43.55.

TABLE IV

NEEDED INCREASES IN OIL PRODUCTION TAX RATE TO OFFSET CH. 21 REVENUES BY YEARS (Dollar Figures in Millions)

Fiscal Year	Est. Ch.21 Revenues	Total Oil Production Tax Revenues	Required Nominal Rate With E.L.F.	Required Effective Rate
1982	1303	1627	22.05%	19.73%
1983	1541	1989	21.68	19.07
1984	1783	2313	21.68	18.58
1985	2141	2558	22.54	18.10

The principal problems with using the severance tax as a stand alone backstop are the potential political and legal liabilities associated with rates this high, and the potential spillover effects, mainly related to what has been termed the premature shutdown effect. A severance tax of 19 percent (effective rate) combined with a 12.5 percent royalty would mean that any production not earning over 68.5 percent of its cost would be shut down. These difficulties are much less significant at the lower rates possible if the severance tax were used in combination with another tax.

There are several variations on the severance tax which we have also considered. One of these, a state windfall profits tax modeled on the federal tax of the same name, would tax, say, 15 percent of the value of each barrel that exceeds a base price, which escalates with inflation. If the price of oil and the general price level were frozen at today's levels, a state windfall tax of 15 percent would be identical to a flat rate severance of about 6 percent.

The difficulty with a state windfall tax would come if oil prices don't rise as fast as general inflation. The high leverage of the tax would mean a rapid fall in tax revenues. In any event, certainty of effect is clearly a problem with the tax.

A State windfall profits tax might be considered by a court or Congress as simply a severance tax increase, and therefore might carry the same legal and political risks as a high severance tax rate. Additionally, it should be de-

termined whether an argument might be raised that the states are preempted by Congress from enacting a windfall profits tax.

Income Tax. The use of a new income tax to backstop Ch. 21 would probably require a return to some sort of apportionment formula. If that formula were the three factor one contained in A.S. 43.20, which the plaintiffs assert is the only correct one to use, the result is an evident lack of fiscal horsepower. Some have suggested that a roughly accurate rule of thumb is that the traditional three factor formula would raise about one seventh the revenues of Ch. 21.

The collections of any apportioned income tax depend on factors beyond the borders of Alaska, and would vary widely among producers who have very similar holdings in Alaska, depending on the vicissitudes of their business activities outside the State. This is why "rules of thumb" are so frequently used in estimating income tax revenues from apportionment taxes. Clearly, the apportionment taxes are not the best with respect to certainty of effect.

Using a non-traditional apportionment formula such as a one or two factor formula can increase the percentage of Ch. 21 revenue that might be raised, but in no case that we have seen proposed has the level exceeded 50 percent, assuming the same tax rate.

All of these non-traditional apportionment systems would probably be challenged by those who are now litigating

Ch. 21 on many of the same grounds and would carry some legal risk. Although an Iowa one factor formula was recently sustained by the U.S. Supreme Court the court was closely divided.* As a result, the state cannot take complete comfort in a non-traditional apportionment formula.

A property tax on reserves has almost enough fiscal horsepower by itself to cover Ch. 21 revenues. Table V shows the tax rate that would be required to protect current Ch. 21 revenues.

TABLE V

RESERVES TAX RATES REQUIRED
TO RAISE CH. 21 REVENUES

Fiscal Year	Ch. 21 Revenues	Prudhoe Field Valuation Base Case (Billions)	Required Tax Rate
1982	1303	48.6	2.68%
1983	1541	47.5	3.24
1984	1783	45.6	3.91
1985	2141	44.5	4.81

Base Case Assumptions:
1. Discount Rate = 19%
2. Federal Windfall Profits Tax continues in effect until December 31, 1991.
3. Other assumptions consistent with revenue estimates.
4. Prudhoe field only.

We feel confident that the higher tax rates would be legally sustained, but believe it appropriate to avoid going beyond

* Moorman Manufacturing Co. v. Bair, 437 U.S. 267 (1978).

the usual range of property tax rates in the United States.

In addition to a relatively high horsepower, the property tax on reserves has the advantage of being simple in concept. Alaska had such a tax from 1975 to 1977, with both revenue officials and the reserves owners knowledgable about how the tax would work. A property tax on reserves does have some disadvantages. As Table V clearly shows, it tends to loose fiscal horsepower as the years pass, and as the field is depleted. A tax rate that covers current Ch. 21 revenues quite comfortably in FY 1982 would fall far short in subsequent years.

Another problem with a tax on reserves is that its yield is very sensitive to decisions made in the assessment process. For example, an increase in the discount rate from 18 percent to 19 percent will, as shown in Table VI, reduce the valuation and the yield by almost 10 percent.

PRUDHOE BAY
PRELIMINARY FIELD VALUATION RESULTS

Current Severance Tax Rates
Windfall Profits Tax Continues through CY 1993

Appraisal Date	Fiscal Year Payment Date	RESERVE VALUE IN BILLIONS 20% Discount Rate	19% Discount Rate	18% Discount Rate
1/1/81	1982	41.8	45.9	50.7
1/1/82	1983	40.2	44.2	48.9
1/1/83	1984	37.9	41.8	46.2
1/1/84	1985	36.1	39.8	44.2
1/1/94	1995	8.3	9.8	11.7

The discount rate which we have used in our base case calculations is 19 percent, one percentage point higher than Alaska's assessors used in 1975. This is reasonably conservative, and is based in part on conversations with reserves assessment experts in Texas.

IV

BACKSTOP MECHANISMS

A backstop mechanism is the means by which a tax or combination of taxes discussed above will prevent tax revenues from falling below current desired levels in the event that Ch. 21 is declared invalid either in whole or in part.

Arguably, one backstop mechanism is already in place--A.S. 43.20 (The general corporate income tax). The same act which imposed the new corporate income tax (Ch. 110 SLA 1978) on oil and gas production and pipeline transportation corporations also removed the imposition of A.S. 43.20 on those same corporations. If a court struck down Ch. 21 in its entirety, A.S. 43.20 could be revived. Once revived, it could backstop at least some of the revenue loss.

The State's general savings clause--A.S. 01.10.100--does not cover this type of situation. So there is no certainty that A.S. 43.20 would be revived. There is, however, legal support for the proposition that if a repealing act is found invalid, the repealing section also falls and the repealed section is revived. This is especially held true if the invalidated act was a substitution for the repealed act. Using this analogy A.S. 43.20 would be revived as to Ch. 21 taxpayers if the court struck down Ch. 21 in its entirety. Whether the revived A.S. 43.20 could then be retroactively imposed would depend upon whether the retroactive imposition was constitutionally permissable and

whether the assessments would be barred by the State's statute of limitations on assessments. As analyzed under the court tests previously discussed, a defensible argument could be made to support the retroactive imposition and assessment.

A more difficult situation is presented if a court only strikes down a portion of Ch. 21. A.S. 43.20 probably would be revived only if it could be easily incorporated with the remaining portion of Ch. 21 without overlap, and if a court were to find a clear legislative intent for such revival. It is probably unlikely that a court would fashion a new tax by piecing together portions of the two taxes.

In any event, if a court were to invalidate Ch. 21, a revived A.S. 43.20 would only backstop a small portion of the lost revenues.

In connection with the primary criteria already discussed, the backstop mechanism must itself withstand legal challenge, and operate to protect current expected revenues under all possible litigation outcomes. The backstop mechanisms should also satisfy, to the extent possible, the secondary criteria, such as avoiding spillover effects and overcollecting revenues.

We have analyzed a number of possible backstop mechanisms. The following three general approaches which show the most promise are:

1. A new tax or combination of taxes could be imposed and collected concurrently with the oil and gas corporate

income tax. The money collected from such tax or taxes would be available to fund government programs at a level established in the Joint Statement. The proceeds from the oil and gas corporate income tax could then be appropriated to an escrow account until the validity of the oil and gas corporate income tax is finally determined.

2. A new tax or combination of taxes could be triggered into effect by some future event such as a final court determination that Ch. 21 is invalid.

3. A new tax or combination of taxes could be imposed currently with a credit allowance between Ch. 21 and the new tax so that there would be no cumulative collection of both taxes.

Escrow Option. The adoption of a new tax to raise currently expected revenues and the escrowing of Ch. 21 revenues until the validity of A.S. 43.21 is determined is one backstop mechanism. Other variations of this option could be established such as escrowing the new tax rather than A.S. 43.21 revenues. The former approach, however, is probably more defensible since the new tax would have a clearly permissible public purpose--collecting revenues to fund State public programs. Similarly, the State could legitimately escrow tax monies which were under court challenge.*

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* In speaking of escrowing Ch. 21 revenues, we don't mean to imply that the legislature could mandate the escrow of revenues and bind future legislatures. This could be argued as a dedication of revenues prohibited by Art. IX, §7 of the Alaska Constitution. Successive legislatures could, however, appropriate the revenues collected under Ch. 21 to an escrow account.

Depending upon the tax base or bases chosen, this mechanism could fully backstop Ch. 21 revenues at risk. Likewise, the use of this mechanism is legally defensible assuming that the new tax is levied for the legitimate purpose of obtaining revenue to fund State public programs. The State clearly has the authority to impose taxes necessary to fund public programs and is not required to spend funds which it might have to refund as a result of a court challenge.

This option is not without drawbacks under the criteria which have been identified. First, although this mechanism could provide a complete backstop for revenues that might be lost, it also has the potential of collecting revenue beyond currently desired levels. Under this mechanism, if Ch. 21 were invalidated in total, the State would be able to refund Ch. 21 taxes and still be able to fund State programs without overcollecting. On the other hand, if Ch. 21 totally withstands challenge or is invalidated only in part, the State may have exceeded its desired level of revenue collection.

Second, because the State would be collecting both the new tax and Ch. 21 revenues with the potential of collecting beyond the desired revenue level the overall tax burden would be increased. This increased tax burden could create spillover effects such as altering taxpayer decision making and effecting future exploration and development.

Triggering Option. Another mechanism available to

backstop A.S. 43.21 revenues is the enactment of a tax or combination of taxes with an effective date contingent upon some future event. For example, a tax could be enacted which would be imposed retroactively upon a final court decision invaliding Ch. 21. Other variations of this option could be designed all involving a tax which is triggered into existence upon the happening of a future event.

Depending upon the tax base or bases chosen, this mechanism is capable of backstopping the total amount of Ch. 21 revenues which are at risk. With regard to the legality of this option, it should first be observed that it is not uncommon for legislation to be made effective upon the happending of some future event. The retroactive operation of such an option, however, does raise legal questions. As discussed previously, there are limits to the authority of the legislature to impose taxes retroactively. A court could determine that the enactment of the contingent tax was sufficient notice to taxpayers that a tax might be imposed, to be within permissible limits of retroactivity. This result, however, is not free from doubt.

Like the escrow mechanism, this option also has the potential for overcollecting revenues beyond the State's revenue goals. This stems from the practical problem of drawing the triggering mechanism so as to cover all the potential outcomes of the lawsuit. If a court were to strike down Ch. 21 in its entirely, this backstop mechanism could become effective to collect the level of revenues

needed by the State. If, on the other hand, only a portion of Ch. 21 revenues are lost from an adverse decision, a full collection under the new tax might be automatically triggered. Some tailoring of the mechanism might be made which could accomodate various levels of revenue loss but precision to meet every circumstance is probably not possible.

Credit Option. A third mechanism which could be used to backstop Ch. 21 revenues would be the imposition of a new tax or taxes which would be creditable against Ch. 21 or a new tax or taxes to which Ch. 21 tax payments could be credited.

This tax mechanism could be used with any tax base and assuming that tax base had sufficient horsepower is capable of backstopping the total amount of Ch. 21 revenues at risk.

Adopting a new tax which is creditable against other taxes or for which other taxes can be credited is a legally defensible taxing system. First of all, the new tax or taxes could be enacted for the purpose of collecting revenues necessary to fund public programs. Additionally, the legislature could legitimately decide to allow a tax credit for the purpose of avoiding a double taxation effect from the imposition of both an income tax and another tax which might be imposed with respect to the same property or activities. The use of credits to avoid double taxation effects is a commonly accepted taxing practice.

Unlike the overcollection potentials of the other mechanisms, the use of credit system comes the closest to col-

lecting the amount of revenues put at risk while at the same time not overcollecting beyond the revenue goals established by the legislature. For example, if Ch. 21 revenues were allowed as a credit against a new tax, and a subsequent court decision invalidated Ch. 21 in whole or in part, the refund of A.S. 43.21 revenues would be offset by an increase in the new tax by reason of the reduced credit.

Because the credit system minimizes the possibility of overcollecting, the overall tax burden should remain relatively the same. That in turn will serve to minimize spillover effects that might accompany an overall increase in tax burden.

By imposing the new tax immediately with a credit you also avoid the potential retroactivity problems associated with a triggering mechanism.

It is conceivable that taxpayers would cry foul to the use of any backstop mechanism since it would mean tax changes enacted during the pendency of their challenge of Ch. 21. Presumably these taxpayers would claim that the tax changes were made to punish those who challenged Ch. 21. If such were the case, it would certainly raise a serious legal question. However, as we have stated, a backstop can be supported by a clearly permissible public purpose--raising revenue necessary to fund public programs. The legislature having made a policy decision as to the level of needed public programs has authority to enact taxes necessary to raise revenues to support those programs. In making

these decisions the legislature certainly has the right to take into account the certainty of its revenues and the debts that might reduce its revenues. The legislature can adjust its tax structure to ensure sufficient revenues to meet its public programs.

V

CONCLUSIONS AND RECOMMENDATIONS

The contract under which this study was carried out specified that we should identify "options for further consideration." This must, if only by omission, identify those that do not deserve further consideration. We are uncomfortable with this latter implication, since we are unprepared ourselves to rule out the possibility that policy concerns of which we are unaware, or new facts might cause us to change our minds. Nevertheless, we are reasonably confident that the options identified below will, after further work, prove to be those most likely to meet the objectives of the Joint Statement, and the criteria discussed above.

1. The first issue is whether to seek a permanent replacement of Ch. 21 while the litigation challenging it is still pending, or to protect Ch. 21 revenues with a backstop, making revisions to Ch. 21 only in the event the State loses. We believe that the latter course is preferable because we have not identified any option which has the degree of revenue, legal and political security required to be a permanent replacement. As stated earlier, the fiscal and legal security of a replacement must be close to absolute, since a new tax is not the second and reinforcing line of defense that would be created by a backstop; it is a new first line of defense which must stand alone.

As stated sucinctly by the Governor in his budget message:

"Motivation for [this] litigation centers more on fiscal principal than legal principal. . ."

Consequently, any attempt to collect the same level of revenue by other means will have the same result--a lawsuit.

A replacement for Ch. 21 might still be in order if it could be demonstrated that the replacement was more secure than the combination of Ch. 21 with a backstop. This demonstration has not been made. If it were to be made, legislators would need further to decide whether the policy issues opened up by consideration of a replacement (as opposed to a backstop) could be resolved in the time available.

2. The backstop tax that appears to best meet the goals of the Joint Statement is a combination of a new severance tax and a reserves tax or a reserves tax by itself. A 15 percent effective rate severance and a 2.5 percent reserves tax or a four percent reserves tax (as shown in Table VII), would have the necessary fiscal horsepower to cover current as well as past Ch. 21 revenues at risk. It also appears to minimize legal risks, potential congressional reaction, and spillover effects. We recommend that the fiscal and economic analysis of these options be refined, and that the proposals be put in more concrete form.

3. With respect to a backstop mechanism, we recommend that further attention be focused on the credit option. Our preliminary analysis indicates that this option will effectively backstop Ch. 21 revenues with the tax types recommended. It also appears to minimize the legal risk, over-

collection potential, and spillover effects.

If this option is chosen, analysis of variations on the credit mechanism and their effects would be appropriate.

TABLE VII

REVENUE ESTIMATES
FOR RECOMMENDED OPTIONS
(Millions of Dollars)

Fiscal Year	Ch. 21 Revenue	4% Reserves Tax	15% Effective (16.67 Nominal) Plus 25 Mill Reserves Tax
1982	1303	1944	1801
1983	1541	1900	1903
1984	1783	1824	1973
1985	2141	1780	2033
Total	6768	7448	7710

Notes: North Slope reserve property tax estimate[illegible]y.
Cook Inlet valuations would increase these am[illegible]nts.
North Slope valuation assumes 19% discount ra[illegible]nd federal Windfall Profit Tax ending December, [illegible]991.

APPENDIX A

JOINT STATEMENT ON OIL TAXES ISSUED BY THE STATE ADMINISTRATION AND THE LEGISLATIVE LEADERSHIP ON MARCH 18, 1981

Governor Jay Hammond and the leadership of both houses of the Legislature are united in an effort to arrive at the best course of action on pending oil and gas tax issues. Legal challenges by the oil industry have placed as much as one-third of the State's projected tax revenues in jeopardy.

Alaska's existing taxation and leasing policies currently provide significant incentives for petroleum exploration and development in the state. Hence, existing levels of taxation, stabilized since 1978, should remain stable at this time. On the other hand, any significant decreases in State oil and gas revenues appear both unwarranted and unsupported by the majority of Alaskans. The State's current level of taxation -- about one-sixth of the value of Prudhoe Bay production -- provides that both the oil companies and the federal government will receive greater shares of Alaska's wealth than will Alaskans. Accordingly, any greater percentage granted the former at the expense of the latter would be inequitable.

Both the Governor and the legislative leadership are determined that through their mutual efforts, a sound strategy for protecting oil and gas revenues will be found. All agree that any changes which would give large sums of money to the oil industry at the expense of the people of Alaska are unacceptable. The Prudhoe Bay bonanza will not last

forever. We must make use of those revenues now through investments such as hydroelectric power, renewable resource development, and permanent fund contributions which will provide for our future.

APPENDIX B

A NOTE ON RESEVOIR VALUATION METHODOLOGY

Resevoirs are generally appraised the same way as other income earning property; the possible future income from the resevoir is estimated and discounted back to the present at a rate that represents the return expectations of an hypothetical buyer. This was the method the State used to value the Prudhoe Bay field in 1975 and we used the same method in this study.

First, an appraiser needs a solid engineering estimate of the size, hydrocarbon content, and likely annual production rates of the field. For the Sadelrocheit Resevoir, we used the latest Alaska Oil and Gas Conservation Commission forecasts. For the Kuparuk and Lisburne fields, we relied on estimates provided by the Petroleum Revenue Division.

Next, we reviewed estimates of the future costs, both capital and operating, needed to purchase, build, install, and operate all of the equipment in the field. As the valuation method requires, we do not include past costs or financing expenses. Estimates of future costs were developed by H.K. VanPoollen Associates, Inc. in 1979, updated by us and the Legislative Finance Division to reflect recent changes and price increases.

A third major step is to forecast future prices for resevoir products and then net them back to the field. For these estimates, we relied heavily on the sophisticated

PETREV forecasting model operated by the Department of Revenue. In general, these estimates suggest little "real" price increase for oil in the world markets and an average rate of inflation of about 10 percent. Wellhead prices, however, are expected to increase rapidly as the TAPS line lowers its per-barrel tariffs. The current average wellhead price of about $25.00 is expected to rise to about $30.00 next year. For gas, given the uncertainty of its transportation and wellhead value, we assumed a flat $1.00 per MCF real price and sales beginning in fiscal year 1988.

Finally, with these decisions in hand, we scheduled the annual cash flows of the field. Using a computer, we estimated all of the production values, costs and expenses, royalties, excise, property and production taxes, and windfall profits taxes. Since valuations are traditionally based on estimates of before tax income, we did not include a calculation of State or federal income taxes.

The appraisal value is the sum of these annual net cash flows to the producers discounted back to the present at a rate chosen to fairly represent the alternative uses of capital. The choice of the discount rate is critical as the valuation is greatly affected by it. See Table VI for the effect of various discount rates on our preliminary valuations.

We learned from a discussion with personnel of the Texas petroleum appraisal firm of Prichard & Abbott that

they are proposing a State-wide 18% discount rate this year for valuing reservoirs in Texas. They believe this is a fair rate even though short term lending rates have been higher at the beginning of the year.

We believe any discount rate in the range of 18 to 20 percent to be reasonable for Prudhoe Bay and have picked 19 percent for purposes of forecasting property tax revenue. Here are some of the factors we considered:

1. The State, with advice from Prichard & Abbott, used 18 percent to prepare the 1975 property tax valuation of Prudhoe Bay. Although inflation and interest rates have jumped since then, all of the startup risks of the field and pipeline are behind us now. These factors, thus, tend to cancel out.

2. Large fields typically receive lower rates than small fields because of the inherent diversification coming from multiple wells and collection facilities. The fact that once collected, Prudhoe oil must then flow in a single pipeline a great distance to tidewater effectively eliminates this diversification effect.

3. Alaska's North Slope is a generally hostile environment traditionally accorded higher than average rates to compensate for extraordinary risks.

We believe our valuation estimate of $48.6 billion for the Prudhoe Bay field is sufficiently accurate for use in the context of comparing alternatives to Ch. 21. Errors in the range of ± 10 percent may still exist due to the diffi-

culties in getting all data on the same basis. Although the State's Producer Benefits Model (P.B.M.) was once on a calendar year basis, it has been converted along with its data to perform fiscal year studies. To establish a January 1 appraisal date, we elected not to reconstruct back to calendar year reporting as would have been theoretically required.

With respect to the other factors most affecting the field's value, such as oil prices, we used the assumptions contained in the P.B.M.

Of the remaining factors that affect the valuation, the most important is the federal windfall profits tax of 1980. Because of the significance of these tax payments, the available calculation of their likely size, provided by the Department of Revenue, was used and the results of the model adjusted accordingly. The federal windfall profits tax is so significant that even the uncertain termination date of the tax may vary the valuation of the field by $7 billion in the first year.

APPENDIX C

A NOTE ON DATA SOURCES

The time available to undertake this analysis did not permit us to develop independent revenue and cost estimates. In part, we relied on published and unofficial working papers supplied by the Department of Revenue. After reviewing their assumptions and procedures, and working with their data continuously for the 10 days, we believe it the best available for this purpose.

Estimates contained in this study are, to the extent possible, consistent with the Department of Revenue's assumptions and forecasts contained in their report "Petroleum Production Revenue Forecast, Quarterly Report, March, 1981." The concerns expressed in that report about the fallibility of "single point" predictions certainly holds for our work as well. At best, these estimates are only a consistent guide for comparison purposes.

Occasionally, we used unpublished data supplied by the Department, but only on a basis consistent with the same March, 1981 assumptions. This was the case for Table I, the figures for which were derived from work sheets supplied by the Petroleum Revenue Division.

Data for Table II was derived from page 9 of the aforementioned March, 1981 quarterly report.

The biggest difficulty that we found with data was to understand and keep consistent the reporting timetables. To

the extent possible, we have attempted to present estimates on a fiscal year basis, when funds will actually accrue to the Treasury. This wasn't always easy. Ch. 21, for example, is on a calendar year basis but provides for quarterly prepayments three out of four of which are actually received in the following fiscal year. Another example is the production tax which taxes monthly oil and gas production. However, the physical production is accounted for by the companies more than a month later which may fall into a different calendar or fiscal year. As a result, estimating a tax receipt often required calculating "pseudo-variables" which create an artificial event that would have occurred if production, liability and payment were all simultaneous. Table III's estimates of effective production tax rates employ this technique to calculate effective rates using production and tax estimates contained in the March, 1981 report.

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