Table F–1. TAX EXPENDITURE ESTIMATES BY FUNCTION—Continued

(In millions of dollars)

Description	Corporations			Individuals		
	1976	1977	1978	1976	1977	1978
Income security—Continued						
Exclusion of railroad retirement system benefits	-----	-----	-----	190	200	205
Exclusion of sick pay	-----	-----	-----	195	50	55
Exclusion of unemployment benefits	-----	-----	-----	3,335	2,745	2,445
Exclusion of workmen's compensation benefits	-----	-----	-----	590	705	810
Exclusion of public assistance benefits	-----	-----	-----	95	100	105
Exclusion of special benefits for disabled coal miners	-----	-----	-----	50	50	50
Net exclusion of pension contributions and earnings:						
Employer plans	-----	-----	-----	7,290	8,715	9,940
Plans for self-employed and others	-----	-----	-----	1,060	1,305	1,535
Exclusion of other employee benefits:						
Premiums on group-term life insurance	-----	-----	-----	765	800	835
Premiums of accident and accidental death insurance	-----	-----	-----	65	70	75
Income of trusts to finance supplementary unemployment benefits	-----	-----	-----	10	10	10
Meals and lodging (other than military)	-----	-----	-----	310	330	350
Employer contributions to prepaid legal expense plans	-----	-----	-----	-----	5	10
Employee stock ownership plans (ESOP) funded through investment tax credits	25	245	255	-----	-----	-----
Exclusion of capital gain on home sales if over 65	-----	-----	-----	40	40	70
Excess of percentage standard deduction over low-income allowance	-----	-----	-----	1,140	1,285	1,410
Additional exemption for the blind	-----	-----	-----	20	20	20
Additional exemption for over 65	-----	-----	-----	1,145	1,220	1,280
Retirement income credit and credit for the elderly	-----	-----	-----	110	495	440
Earned income credit	-----	-----	-----	220	215	205
Veterans benefits and services:						
Exclusion of veterans disability compensation	-----	-----	-----	595	655	690
Exclusion of veterans pensions	-----	-----	-----	30	30	35
Exclusion of GI bill benefits	-----	-----	-----	305	255	200
General government: Credits and deductions for political contributions	-----	-----	-----	35	40	35
Revenue sharing and general purpose fiscal assistance:						
Exclusion of interest on general purpose State and local debt	2,845	3,105	3,470	1,520	1,650	1,850
Credit for corporations in U.S. possessions	240	285	310	-----	-----	-----
Deductibility of nonbusiness State and local taxes (other than on owner-occupied homes and gasoline)	-----	-----	-----	7,255	8,035	8,990
Interest: Deferral of interest on savings bonds	-----	-----	-----	550	565	625
Business investment:						
Exclusion of interest on State and local industrial development bonds	150	195	235	75	90	110
Excess first-year depreciation	40	45	45	140	135	145
Depreciation on buildings in excess of straight line:						
Rental housing	100	100	100	405	405	405
Other	225	210	200	200	180	175
Expensing of research and development expenditures	1,325	1,395	1,450	25	30	30
Expensing of construction period interest and taxes	415	475	500	215	150	140
Capital gains: Corporate (other than farming and timber)	545	555	550	-----	-----	-----
Investment credit	7,655	8,640	9,670	1,810	1,970	2,205

See footnote at end of table.

Table F-1 TAX EXPENDITURE ESTIMATES BY FUNCTION—Continued
(In millions of dollars)

Description	Corporations			Individuals		
	1976	1977	1978	1976	1977	1978
Personal investment:						
Dividend exclusion	-----	-----	-----	430	455	480
Capital gain: Individual (other than farming and timber)	-----	-----	-----	7,320	7,030	7,360
Exclusion of interest on life insurance savings	-----	-----	-----	1,655	1,815	1,995
Deferral of capital gain on home sales	-----	-----	-----	845	890	935
Deductibility of mortgage interest on owner-occupied homes	-----	-----	-----	4,870	5,435	6,050
Deductibility of property taxes on owner-occupied homes	-----	-----	-----	4,030	4,500	4,995
Deductibility of casualty losses	-----	-----	-----	310	345	380
Credit for purchase of new home	-----	-----	-----	650	100	-----
Other tax expenditures:						
Deductibility of charitable contributions (other than education)	350	400	445	4,360	4,930	5,475
Deductibility of interest on consumer credit	-----	-----	-----	2,105	2,310	2,565
Maximum tax on earned income	-----	-----	-----	605	730	855
MEMORANDUM						
Combined effect of provisions disaggregated above:						
Capital gains	865	885	905	7,770	7,560	7,860
Exclusion of interest on State and local de	3,110	3,475	3,925	1,645	1,850	2,090
Deductibility of State and local nonbusine	-----	-----	-----	10,865	12,125	13,480
Deductibility of charitable contributions	540	620	655	4,870	5,440	6,040

[1] All estimates are based on the tax code as of Dec. 31, 1976.

The 1976 Act repealed a special provision for U.S. firms operating in a less developed country (LDC). When a foreign subsidiary of a U.S. corporation operating in a LDC repatriated dividends to its parent corporation, that income could, under prior law, be reported net of foreign income taxes paid. U.S. tax liability was then calculated on that net amount and the foreign tax taken as a credit. For non-LDC corporations, foreign source income must now be "grossed up" by adding back in an amount equal to foreign taxes paid. Under prior law the failure to "gross up" dividends by the amount of the foreign taxes paid to LDCs resulted in a tax expenditure.

The profits of a domestic international sales corporation (DISC) are not taxed to the DISC but instead are taxed to the shareholders when distributed to them. This deferral was available for 50% of the export income of a DISC prior to 1976. The Tax Reform Act of 1976 permits DISC benefits to the extent that current export gross receipts exceed 67% of the DISC's average for a 4-year moving base period (initially 1972-75) which will move forward year-by-year after 1979. DISCs with less than $150,000 of taxable income are exempt from the incremental rule. The Tax Reduction Act of 1975 denied DISC benefits to exporters of energy products and the 1976 Act terminated DISC benefits for 50% of military sales.

The 1976 Act phases out the 14-percentage-point tax rate reduction provided under prior law for domestic corporations qualifying as Western Hemisphere trade corporations.

TITLE 43 U.S.C. § 1333

§ 1333. Laws and regulations governing lands—Constitution and United States laws; laws of adjacent States; publication of projected States lines; restriction on State taxation and jurisdiction

(a) (1) The Constitution and laws and civil and political jurisdiction of the United States are extended to the subsoil and seabed of the outer Continental Shelf and to all artificial islands and fixed structures which may be erected thereon for the purpose of exploring for, developing, removing, and transporting resources therefrom, to the same extent as if the outer Continental Shelf were an area of exclusive Federal jurisdiction located within a State: *Provided, however,* That mineral leases on the outer Continental Shelf shall be maintained or issued only under the provisions of this subchapter.

(2) To the extent that they are applicable and not inconsistent with this subchapter or with other Federal laws and regulations of the Secretary now in effect or hereafter adopted, the civil and criminal laws of each adjacent State as of August 7, 1953 are declared to be the law of the United States for that portion of the subsoil and seabed of the outer Continental Shelf, and artificial islands and fixed structures erected thereon, which would be within the area of the State if its boundaries were extended seaward to the outer margin of the outer Continental Shelf, and the President shall determine and publish in the Federal Register such projected lines extending seaward and defining each such area. All of such applicable laws shall be administered and enforced by the appropriate officers and courts of the United States. State taxation laws shall not apply to the outer Continental Shelf.

(3) The provisions of this section for adoption of State law as the law of the United States shall never be interpreted as a basis for claiming any interest in or jurisdiction on behalf of any State for any purpose over the seabed and subsoil of the outer Continental Shelf, or the property and natural resources thereof or the revenues therefrom.

federal regulation invalid or the regulation itself is changed. Accordingly, until such time, retirement benefits payable to disabled San Francisco policemen and firemen, after such personnel has applied for service retirement under the new Charter provisions, are not excludable from gross income under the exclusion formula contained in Revenue and Taxation Code Section 17131(d).

[¶ 205-026] Legal Ruling No. 366.

Franchise Tax Board, December 11, 1973.

Franchise—Corporation Income—Allocation and Apportionment—Taxation of Income Generated by Offshore Oil Operations.—The activities of a unitary enterprise conducting offshore oil operations under federal jurisdiction by reason of the Outer Continental Shelf Lands Act can only be reflected in the denominators of the three-factor apportionment formula. Under the Act, California lacks jurisdiction to tax the revenues derived from the Outer Continental Shelf since it is under exclusive federal jurisdiction. By including the Continental Shelf factors only in the denominators of the formula, no income is apportioned to California.

However, the operation of a drilling barge within California's jurisdiction must be reflected in the California numerators of the apportionment formula denominator.

See ¶ 12-414.

Facts:

Advice has been requested as to the treatment to be accorded to the income earned by unitary businesses, taxable in California, from oil operations beyond the three mile continental limit. The operations considered are:

1. The actual operations of an offshore oil well, beyond the three mile continental limit, conducted from a fixed drilling platform; and

2. The exploring and drilling operations beyond the three mile continental limit conducted from floating drilling barges.

Questions:

For California franchise tax purposes, what is to be included in the numerator and denominator of the apportionment formula with respect to:

1. Activities conducted from fixed drilling platforms which are under federal jurisdiction by reason of the the Outer Continental Shelf Lands Act?

2. Activities conducted from fixed drilling platforms which are within the jurisdiction of a foreign country?

3. Activities conducted from floating drilling barges?

Decision:

See discussion.

Discussion:

1. In 1953 the United States Congress passed the Outer Continental Shelf Lands Act (67 Stat. 462, 43 U.S.C. §§ 1,331 et seq.) which extended the Constitution and laws of the United States to the Outer Continental Shelf, i.e., that property located beyond the three mile limit of state jurisdiction which was established by the Submerged Lands Act (43 U.S.C. §§ 1,301 et seq.). The outer limit of the continental shelf is not established with precision, but rather is marked only by a steep drop of the continental mass toward the ocean deeps. (1953 U.S. Code Congressional and Administrative News, p. 2,178). In some cases this may occur several hundred miles from shore.

Section 1333(a)(1) of the Outer Continental Shelf Lands Act extends federal jurisdiction to all artificial islands and fixed structures erected on the Outer Continental Shelf:

> ... to the same extent as if the Outer Continental Shelf were an area of exclusive Federal jurisdiction located within a State. ...

It is a matter of settled law that no state has jurisdiction to tax in an area of exclusive federal jurisdiction located within a state. *Surplus Trading Co. v. Cook*, 281 U.S. 647, *Standard Oil Co. v. California*, 291 U.S. 242, *James v. Dravo*, 302 U.S. 134. Since Congress extended federal jurisdiction to the Outer Continental Shelf "to the same extent" as if it were an area of exclusive federal jurisdiction within a state, this body of settled law applies with equal force to the Outer Continental Shelf and effectively prohibits the imposition of any state tax on revenues derived therefrom.

The lack of jurisdiction in a state to tax in areas of exclusive federal jurisdiction applies not only to direct taxes but to indirect taxes as well. In *James v. Dravo*, *supra*, the United States Supreme Court was faced with the question of whether "annual privilege taxes" measured by profits from "business and other activities" could be imposed by West Virginia on a contractor working on government-owned land. The Supreme Court stated that this depended upon, "... whether the United States has acquired exclusive jurisdiction over the respective sites. Wherever the United States has such jurisdiction [the Court added] the state would have no authority to lay the tax."

In the Buck Act, 4 U.S.C.A., §§ 101-110, Congress did provide the states with jurisdiction to levy certain specified taxes within federal enclaves. The

Buck Act cannot be construed, however, to apply to the Outer Continental Shelf. Section 1333 provides:

> . . . State taxation laws shall not apply to the Outer Continental Shelf. . . .
>
> The provisions of this section for adoption of State law as the law of the United States shall never be interpreted as a basis for claiming any interest in or jurisdiction on behalf of any State for any purpose over the seabed and subsoil of the Outer Continental Shelf, or the property and natural resources thereof or the *revenues* therefrom . . . (Emphasis added.)

In view of the well settled law establishing the absence of state jurisdiction to tax in federal enclaves, the provisions of Section 1333(a)(1) extending federal jurisdiction to the Outer Continental Shelf by reference to such enclaves, the provisions of Section 1333 negating any possible application of the Buck Act to the area in question, it is clear that California tax laws cannot reach revenues derived from the Outer Continental Shelf.

Before considering the formula it should be mentioned that the income to be apportioned is the total business income including that derived from the Outer Continental Shelf. When a corporation doing business solely within California commences operations on the Outer Continental Shelf, outside California, it becomes subject to Section 25101 and its business income will be apportioned in a like manner with other unitary businesses as follows.

Property Factor: All real and tangible personal property owned by the taxpayer everywhere must be included in the denominator. But the numerator can include only those properties with sufficient California connections. In this situation, any such contacts appear to be minimal.

Although some suggestions have been made to exclude the property from both the numerator and the denominator, if such is done, there will be an indirect apportionment of additional income to California contrary to federal law.

However, it may be noted that, under the rule set forth in *Montgomery Ward & Co., Inc.* v *Franchise Tax Board*, 6 Cal. App. 3d 149 (1970), that oil in transit to a California location would be considered California property includible in the numerator of the property factor.

Payroll Factor: Regulation 25132 provides that the payroll factor shall include the total amount paid by the taxpayer in the regular course of its trade or business for compensation during the tax period. Subdivision (b) further provides that the denominator of the payroll factor is the total compensation paid everywhere during the taxable year. Accordingly, compensation paid to employees whose services are performed entirely in a state where the taxpayer is exempt from taxation, for example by Public Law 86-272, is included in the denominator of the payroll factor. In other words, there is no throwback of the payroll to the California numerator even though the taxpayer is exempt from taxation in the state in which the services are performed. Where the services are performed partially within California and without California, the tests set forth under Regulations 25132(c) and 25133 apply. Payroll shall be included in the California numerator in accordance with the provisions of Section 25133 and the regulations thereunder.

Sales Factor: In view of the express federal ban against any state taxation of revenues derived from the Outer Continental Shelf, none of the sales, if any, which take place in the Outer Continental Shelf area will be includible in the sales factor numerator. Furthermore, in order that there be no indirect taxation of income from such sales, the sales factor denominator must include these sales. And, of course, if the natural resource is placed on the driller's own ships, no sale has occurred. On the other hand, if the natural resource is piped or brought into California, then the sale can be included in the numerator thereafter (assuming that it is subsequently sold in California).

It should be recognized that there are two fundamental considerations involved in this question. There is first the mandate that; under California law, the income of a unitary business must be apportioned by formula. *Edison California Stores* v. *McColgan*, 30 Cal. 2d 472 (1947). *John Deere Plow Co.* v. *Franchise Tax Board*, 38 Cal. 2d 214 (1951). Secondly, there is the federal prohibition against state taxation of revenue derived from the Outer Continental Shelf.

It is established that while formula apportionment is inherently incapable of attaining exactitude, so long as the formula employed produces a reasonable result its use will be sustained. *El Dorado Oil Works* v. *McColgan*, 34 Cal. 2d 731 (1950). It is submitted that the formula factors set forth above take into account both fundamental considerations. They provide formula apportionment to California of the income reasonably attributable to California sources, and by including the Continental Shelf factors only in the denominator, they do not apportion income to California, thereby giving effect to the federal law.

2 Section 25120(f) of the California Revenue and Taxation Code provides that the definition of "state" includes a foreign country. A basic purpose of the Uniform Division of Income for Tax Purposes Act (UDITPA), which is codified in Sections 25120-25139, is to insure that 100 percent of income, no more or no less, would be subject to tax. See Pierce, The Uniform Division of Income for Tax Purposes Act, 35 Taxes 747.

It therefore seems clear that where another state has jurisdiction to tax and the taxable activity has no connection whatever to California, the factors associated with the activity may not be reflected in

the California numerator. These factors, however, are income producing and must be included in the denominator. *McDonnell Douglas Corporation v. Franchise Tax Board*, 69 Cal. 2d 531 (1968).

3. The Outer Continental Shelf Lands Act extends federal jurisdiction (and prohibits state taxation) "To the subsoil and seabed of the Outer Continental Shelf and to all artificial islands and fixed structures which may be erected thereon. . . ." 443 U.S.C. §§ 1333(1).

It has been established by a number of decisions that a drilling barge or rig is neither an artificial island nor a fixed structure within the contemplation of the Act, but rather is properly classified as a vessel.

Offshore Company v. Robison, 266 Fed. 2d 769 (1959); *Producers Drilling Co. v. Gray*, 301 Fed. 2d 432 (1966); *Marine Drilling Company v. Autin*, 363 Fed. 2d 579 (1966). Although the cited cases arose in the context of wrongful death or injury under the Jones Act (46 U.S.C. § 688), rather than a tax contest, they hold squarely that drilling barges or rigs are vessels and not within the ambit of the Outer Continental Shelf Lands Act. It therefore follows that the Act likewise does not exempt the activities of such barges or rigs from state taxation and California can apply its usual rules to tax the income earned from the operations of the barges.

Under the Submerged Lands Act (43 U.S.C. §§ 1301 *et seq.*) California's jurisdiction to tax extends offshore for three miles. There can therefore be no question that, to the extent that the drilling barges are within the three mile limit their presence and activities must be reflected in the California numerators of the apportionment formula. Similarly, the activities of drilling barges not present within California's jurisdiction will only be reflected in the denominator of the factors of the apportionment formula.

When, during a taxable year, the drilling barge is both within and without California waters, its operations and presence shall be reflected in the California numerator in accordance with the rules set forth in Cal. Adm. Code, tit. 18, Regs. 25128 to 25136, inclusive.

[¶ 205-027] Legal Ruling No. 367.

Franchise Tax Board, December 14, 1973.

Franchise—Corporation Income—Sales Factor of the Apportionment Formula—Advertising Receipts.—Receipts from sales of advertising space in magazines and periodicals are included in the numerator of the sales factor of the apportionment formula in the same ratio as the sales of magazines and periodicals in California bears to total sales.

See ¶ 12-442.

Advice has been requested regarding the inclusion of advertising revenue in the sales factor of the apportionment formula under the Uniform Division of Income for Tax Purposes Act (UDITPA) for publishers of magazines and periodicals.

Receipts from the sales of magazines and periodicals and advertising space in such magazines and periodicals by publishers, gives [give] rise to income from transactions and activity in the regular course of the taxpayer's trade or business constituting "business income" under Section 25120(a), Bank and Corporation Tax Law. Gross receipts from those transactions constitute "sales" as defined in Section 25120(e) which are required to be included in the sales factor (Section 25134) of the apportionment formula under UDITPA.

Tangible property is that which is visible and corporeal, having substance and body. *Roth Drug, Inc. v. Johnson*, 13 Cal. App. 2d 720, 734 (1936). It is evident that a magazine or periodical has substance and body. Consequently, the sale of magazines and periodicals by the publisher to subscribers and newsstands are sales of tangible personal property. (cf. *Time, Inc. v. Hulchin*, 201 N.Y. 2d 374, 377, 31 Ill. 2d 344.) Receipts from such sales are to be included in the sales factor in accordance with Section 25135 governing sales of tangible personal property.

The sale of advertising space in such magazines and periodicals is closely connected with the sale of the publication. The primary purpose of the advertiser is to reach the market provided by the publisher. The publisher in turn guarantees a particular circulation volume, or in other words, a market. Since advertising included in magazines and periodicals is inextricably connected with the sale of those publications, it is concluded that advertising receipts are to be included in the numerator of the sales factor based upon the ratio which sales of magazines and periodicals in this state bears to the total sales of magazines and periodicals everywhere.

[¶ 205-028] Legal Ruling No. 368.

Franchise Tax Board, December 14, 1973.

35° Gravity - $4.85/bbl Controlled Price

Tax Calculation

Under Current Law

(a) % Of Value Method:

300 bbl X $4.85 X 5% =	$72.75
700 bbl X 4.85 X 6% =	203.70
600 bbl X 4.85 X 8% =	232.80
	509.25
Less 1/8 Royalty Portion	63.66
Tax =	$445.59

(b) Cents Per Bbl Method:

300 bbl X $.3519 =	$105.57
700 bbl X .4224 =	295.68
600 bbl X .5632 =	337.92
	739.17
Less 1/8 Royalty Portion	92.40
Tax =	$646.77

Tax Payable (higher of (a) or (b) = $646.77

Tax Calculation Under HB 321

Tax rate = 10% of value or $.75 per bbl plus adjustments for gravity (up 1/2 cent for each degree above 27°) and for Gross National Product Deflator-- (1st Qtr. 1977 = base period).

Cents per bbl = $.75 X .04 = $.79

Percent of value rate and cents per bbl rate multiplied by Economic Limit Factor (ELF):

$$ELF = \frac{100 \text{ bbl}}{1600 \text{ bbl}} = .0625$$

1.000 - .0625 = .9375 = ELF

Cents per bbl adjustment:

$.79 X .9375 = $.7406

% of value adjustment:

10% X .9375 = 9.375%

Tax Calculation

1600 less royalty (200) = 1400 bbls

% of value method:

1400 X $4.85 = $6,790

$6,790 X 9.375% = $636.56 (Tax)

Cents per bbl method:

1400 X $.7406 = $1,036.84

Tax Payable: $1,036.84

Difference in tax between HB 321 and Current Law:

HB 321 =	$1,036.84
Current Law	646.77
	$390.07 = 60.3% increase in tax

Production tax burden as a % of producer's net share of $6,790 (1400 bbls X $4.85):

Under current law = 9.5%
Under HB 321 = 15.3%

Joint Resources Committees

QUESTIONS AND ANSWERS
PROFESSORS ZEIFMAN AND AINSWORTH
March 21, 1977

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

PROFESSOR ZEIFMAN - We called it an extraction factor.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

PROFESSOR ZEIFMAN - Yes.

SENATOR CROFT - And we have that authority?

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

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

PROFESSOR ZEIFMAN - Right.

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

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

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

SENATOR CROFT - No. the Department of Revenue.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

SENATOR RADER - This is as defined by them.

PROFESSOR ZEIFMAN - Yes, worldwide.

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

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

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

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

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

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

PROFESSOR ZEIFMAN - Right.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

PROFESSOR ZEIFMAN - Under our proposal, No.

SENATOR HUBER - That loophole is plugged?

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

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

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

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

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

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

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

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

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

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

PROFESSOR ZEIFMAN - Right, exactly.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

PROFESSOR ZEIFMAN - Essentially, yes.

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

PROFESSOR ZEIFMAN - Essentially, yes.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

GEORGE SILIDES - No.

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

GEORGE SILIDES - From the company?

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

GEORGE SILIDES - That answers my question.

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

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

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

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

STATEMENT

OF

BRISTOL BAY NATIVE CORPORATION

February 9, 1978

Madam Chairman, my name is Donald F. Nielsen, a shareholder and Vice President of Bristol Bay Native Corporation.

We are opposed to S.B. 236 or any other proposal to establish an oil and gas corporate franchise tax. Under the terms of our agreement with a major oil company, if oil or gas is produced on our lands, we will share in the production and would become a producing oil company. The market for our production would be outside of Alaska. The figure in excess of $250,000,000 gross receipts may be of some protection in the immediate future; however, there is no assurance that if such a proposed bill becomes law that this figure could not be adjusted downward to fit any given corporation, nor does it take into account any future price increases.

As an Alaskan corporation, we do not feel we should be required to keep separate accounts and pay any different tax than any other normal Alaska corporation. Also, we feel the proposed franchise tax, if passed, could later be applied to other industires such as mining, all of which tends to discourage major investments and financing of any type of investments in Alaska. The same reasoning applies to any burdensome tax policies that that effect Alaska's investment climate. Thank you.

CITIES SERVICE MINERALS CORPORATION
A SUBSIDIARY OF CITIES SERVICE COMPANY
1016 WEST SIXTH AVENUE
ANCHORAGE, ALASKA 99501

DON STEVENS, PH.D.
DISTRICT GEOLOGIST

(907) 272-9441

March 17, 1977

Mr. Bill Bishop
Bristol Bay Native Corp.
445 East 5th Avenue
Anchorage, AK 99501

Dear Bill:

Mr. Ranspot and I want to thank you and the Bristol Bay Native Corporation staff for the courtesies extended during our meeting last week. We found our review of the Bear Creek Mining Data to be most interesting and, in fact, these data exceeded our expectations. Bear Creek Mining has done an excellent job in its investigation of porphyry type targets.

As I mentioned on the phone, we have had to decline entering into an exploration agreement with Bristol Bay Native Corporation for a number of reasons in spite of the excellent mineral potential indicated by the data reviewed.

Certainly one important reason for being very hesitant to engage in new minerals exploration programs has been the Hammond administration's attitude toward mining taxes. Not only are attempts being made to adversely change the present mining license tax but several comments by the administration have indicated that an additional severance tax bill is going to be introduced in the next session of the legislature. One needs only to look at what has happened to taxes on oil and gas production in the last ten years to believe that the same thing will happen to the mining industry. With the high capital costs and the high infrastructure costs in mine development in Alaska a high tax burden will simply eliminate any chance for development of a mining industry.

The attractiveness of possible mining operations on native corporation land is being outweighed by the ever more burdensome tax policies generated in Juneau.

Sincerely,

Donald L. Stevens

DLS:bh

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