OIL AND GAS TAXATION

SENATE RESOURCES COMMITTEE

HOUSE RESOURCES COMMITTEE

Testimony of Lawrence L. Wilson

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My name is Lawrence L. Wilson, Associate Tax Counsel, Union Oil Company of California. I shall be speaking today on a number of bills which cover income taxation, severance taxation and property taxation. Specifically, these will be SB 105 and its companion bill, HB 145 and HB 322, all of which deal with income taxation along with SB 202 which is the "net proceeds" tax. I will also cover SB 103 and HB 321 and its companion bill HB 144, which deal with severance taxation. Finally, there will be remarks covering HB 323 dealing with property taxation and HB 328 dealing with the Reserves Tax. Where appropriate, my remarks will also comment on testimony that has already preceded my testimony. The first bill I wish to comment on is SB 105. No reference is made to HB 145 since it is an identical bill.

SB 105

SB 105 is a bill which purports to determine income to Alaska through the "separate accounting" method. The preficatory language in Section 1 states that the present method of apportioning income under the three-factor formula embodied in the Multistate Tax Compact does not fairly represent the extent of

the business activities in Alaska for corporations engaged in the production and pipeline transportation of crude oil and natural gas. Section 1 goes on to state that the legislature, therefore, intends that section 18 of Article IV of the Compact, which allows separate accounting, shall be adopted for determining income derived from the production and pipeline transportation of oil and gas.

Richard Kilgore of Walter J. Levy and Associates and Professors Jerome Zeifman and Kenneth Ainsworth have commented on "separate accounting" as a method of determining income with Mr. Kilgore defending it and Messrs. Zeifman and Ainsworth attacking it. Even Mr. Kilgore acknowledged that the administrative problems of determining "value" for a product transferred out of the state and of allocating expenses to Alaska were troublesome. Messrs. Zeifman and Ainsworth painted a picture of corporate maneuvering by astute managers to deliberately operate Alaska affiliates at a low profit through such means as selling property to the affiliate at high prices to get high depreciation and by allocating excessive overhead.

However, none of these witnesses have provided this Joint Committee with the really significant reasons why separate accounting is an unsatisfactory method of determining income within a state. First, even if one could overcome the administrative problems of valuing production and allocating overhead, separate accounting simply cannot adequately and properly determine how much profit of a business is derived from within a

state where the overall business has parts which are dependent upon one another and which are located in more than one state. It was for this very reason that the "unitary business" concept was developed along with apportionment formulas to determine how much of the total income of the total multistate business should be apportioned to a state. This is precisely the procedure which Alaska uses today, as well as most taxing jurisdictions, i.e., the total income of the total business of a multistate company is determined and then apportioned.

The other reason why separate accounting should not be adopted is that it exposes the taxpayer to multiple taxation. Income which would be fully taxed in Alaska would also be apportioned to other states using the apportionment method, which looks to the total income of the taxpayer as a taxable apportionment base. Conversely, Alaska's or any other state's adoption of separate accounting could cause it to lose tax from an overall profitable multistate company -- specifically, where the in-state separate accounting calculations produce an in-state loss for such overall profitable company. As Mr. Bonney of EXXON will demonstrate, LATER, this would have been his company's case had Alaska been on separate accounting during the development years of the North Slope. Instead, Alaska received income tax by using the current apportionment method, apportioning a part of that company's overall profit into Alaska.

Turning to the provisions of SB 105, it is clear that the bill is not even the form of separate accounting which any of the witnesses were debating. Rather, it is a hybrid form of

separate accounting. It seeks to determine income by simple reference to the wellhead value of oil and gas used for severance tax purposes and then allows only seven deductions while totally ignoring any other legitimate deductions which represent business expenses allowable under established principles of income taxation. Five of the seven allowed deductions relate to costs closely associated with production. Another category is for unsuccessful exploration costs incurred in Alaska. The only out-of-state cost allowed is for interest expense "not capitalized and capitalizable", but this expense would be severely limited for most companies through the use of a ratio of the book value of the fixed assets associated with the field to the total book assets held by the corporation and of its affiliates. All interest expense related to a company's operations within the state should be recognized as a current operating expense, without the limitation described in this bill.

It is clear that SB 105 would introduce new concepts of taxing an oil and gas producer which radically depart from concepts found under the existing Alaska corporate income tax structure. The traditional concepts established over decades of experience and which are contained in that corporate income tax structure would in large part not apply, yet the producer would be taxed at the same 9.4% corporate rate of tax.

One of the seven deductions is for "severance taxes actually paid." This provision may appear to be without problems until one analyzes it in connection with the reserves tax.

Unless the statute is amended, the reserves tax will likely result in nearly $240-250 million dollars paid to the state next June 30th. With the $220 million paid on June 30, 1976, the aggregate of nearly $500 million represents, in essence, prepaid severance taxes because the reserves tax may be used as a credit against future severance taxes payable. Hence, the word "actually" in the clause "severance taxes actually paid" takes on significance, and it appears that the authors' intent is to allow as a deduction only that amount of severance tax "actually" paid over after the credit with the result that some $500 million would be denied as a deduction.

Depreciation is allowable but only on facilities closely associated with production, but the amount of depreciation is simply left to the Department of Revenue to handle by regulation. Depreciation is a vastly complex subject under income tax laws and can be handled in many ways to provide fair and equitable results to a taxpayer. The bill provides little or no guidance on a subject of such importance to a taxpayer.

As noted earlier, SB 105 does not fit within the category of the "separate accounting" method of determining income. What it really seeks to do is draw a ring around successful oil and gas operations and allow as expenses only those that are literally tied to the lease, plus expenses for unsuccessful exploration efforts and a severely limited amount of interest expense. The resulting amount is supposed to be net income, but in fact, would represent a level of income much higher than would occur under regular principles of income taxation.

In addition to the tax received by Alaska based on an inordinately high level of income, the authors of SB 105 would, under Section 43.20.014, still seek to reach, through apportionment, the taxpayer's out-of-state income, including its oil and gas and pipeline income as well as all other income. In short, SB 105 would allow Alaska to fully, or, rather, more than fully, tax directly all of the Alaska income from oil and gas and pipeline transportation and would also require the taxpayer to apportion to Alaska all of its other income except the income already taxed by SB 105. And, of course, the final effect to the taxpayer would be that other states where it does business would also apportion income to themselves under their tax laws and included in that apportionment to them would be the Alaska income already fully taxed by Alaska.

A state may constitutionally tax only that income of a taxpayer which is derived from within its borders. That fundamental rule applies irrespective of the method used to determine income. SB 105 seeks to reach all income from oil and gas and pipeline transportation in Alaska and at the same time, through apportionment, seeks to reach the taxpayer's other income including its non-Alaskan oil and gas and pipeline income, thereby raising the constitutional question of the taxation of extraterritorial value in violation of the Fourteenth Amendment of the U. S. Constitution.

With respect to income from pipeline transportation of oil, Sec. 43.20.013 simply provides that where such a pipeline is regulated by the Interstate Commerce Commission (ICC), the

annual taxable income "shall be eight percent of the valuation." There are no guidelines to determining income under any set of rules, and items of income and expense are not even considered. Obviously, this provision is aimed at the Trans Alaska Pipeline and, in effect, says that the tax shall be valuation times 8% to get around $600 million of "annual income" which, when taxed at 9.4%, produces a tax of about $60 million.

Attempting to tax a business in this manner would be similar to a law which says that an individual shall be deemed to have annual income equal to a certain percentage of the assets he owns. For example, suppose such a law says that a person's annual income is deemed to be 50% of his assets and the person owns an apartment house worth $200,000 but has a $150,000 mortgage against it. His annual income would be $100,000 to be taxed irrespective of his costs. It would not matter that the person may, in fact, show very little profit.

A taxing scheme which deems "income" to be a percent of value of assets without regard to actual income and expenses is, in effect, nothing more than a property tax under the guise of an income tax and raises serious legal and constitutional problems.

The authors, however, have attempted to provide a form of "escape hatch" to the foregoing method of taxation by providing in Section 43.20.013(c) that the corperation operating such an ICC-regulated oil pipeline may elect to have taxable income from the pipeline determined under rules and regulations of the

Alaska Pipeline Commission. Thus, the idea seems to be that if the corporation does not like the percent-of-value method of determining annual income (which would deem annual income to be at a very high and ficticious level), then it can be economically forced to submit to the rules and regulations of the Alaska Pipeline Commission whose rules may or may not be parallel with the ICC rules. In fact, section 6 of the bill contains an amendment to Section 42.06.041 by adding new provisions which require the Alaska Pipeline Commission to give the Department of Revenue a certificate that the pipeline corporation so electing has complied with the Commission's rules and regulations. Subsection (c) of Section 041 provides that the Commission shall by regulations establish an accounting procedure to define net income to "coincide as nearly as possible with the net income definition used by the Commission in establishing rates and measuring rate of return."

What is happening under these provisions seems clear enough. The idea seems to be to put such an onerous tax burden on the ICC-regulated pipeline that it would be forced to elect to comply with all applicable regulations and orders of the Alaska Pipeline Commission concerning accounting methods and reports. In short, the Commission would set the rules for income determination notwithstanding that the pipeline company remains subject to the primary jurisdiction of the ICC. Thus, there would be four parties involved in determining income: the taxpayer, the ICC, the Alaska Pipeline Commission, and the Commissioner of Revenue who is interpreting the Alaska Commission's rules.

Use of the tax laws to achieve the apparent goal of regulation by the Alaska Pipeline Commission is an abuse of the taxing power. Further, the scheme raises obvious legal and constitutional questions and with so many parties that would be involved in the income determination process, the stage would be set for endless controversies.

The foregoing discussion relates to ICC-regulated oil pipelines. Where an oil pipeline does not yet have a value established by the ICC or where the oil pipeline is strictly an intrastate oil pipeline, the bill provides that such a corporation having one of these pipelines shall have its income determined under the rules and regulations of the Alaska Pipeline Commission. Here again, as would be the case of an ICC-regulated pipeline corperation which was forced to elect to have income determined by the Commission (discussed above), the income determination is left to another agency under rules and regulations as it chooses. In essence, the whole matter of determining income to tax under an income tax law is left to the vague guidelines of another governmental agency. This, in itself, raises questions whether there has been an unconstitutional delegation of legislative authority. But even if one gets over that hurdle, the fact remains that whatever rules would finally apply, those rules would not accord with general principles of income taxation which ought to apply to pipeline operations just as they apply to any other type of operation.

As to gas pipelines regulated by the Federal Power Commission (FPC), SB 105 provides in Section 43.20.013(d) that

taxable income shall be determined in accordance with reporting procedures established by the FPC. Here again, there is a departure from normal application of income tax principles because a gas pipeline, though regulated, is really no different from any other taxpayer insofar as having income tax principles applied to its operations. The regulation and rate-making process of the FPC fully takes into account a gas pipeline's handling of its operations where that pipeline utilizes the provisions of the Internal Revenue Code to achieve tax savings for the benefit of not only its customers but also its shareholders.

Finally, I would like to say a word about Section 43.20.015 which deals with "Public Reporting." Under that provision the Commissioner of Revenue is to compile and transmit to the legislature each year an annual report which shows the tax paid under SB 105 together with the itemized deductions that have been allowed and how much tax revenue was not collected because of the deductions. Further, the report is to provide a summary of the total amount of oil and gas produced by each taxpayer, the taxable income as calculated under Section 12 and 13 relating to oil and gas income and pipeline transportation in Alaska, and the out-of-state income of the taxpayer apportioned to Alaska.

In short, SB 105 would open up for general scrutiny without safeguards of confidentiality the whole operation of the oil and gas producers and pipeline operators in Alaska. I would hope that we haven't progressed to the point in this country where a

taxpayer's returns have become a matter of public record. I doubt if anyone would consent to having their tax return information bundled up by the tax collector to be laid bare for anyone to review. There are strict rules in all states and at the federal level covering disclosure of tax return information, and there are ways whereby certain limited groups of people having a legitimate interest can obtain that information on a strictly confidential basis with criminal sanctions imposed for violations. But under SB 105, the information could be made available to a large number of people where there are no guidelines whatsoever over disclosure. Such a provision is one that simply should not be tolerated no matter who the taxpayer may be.

HB 322

The next bill I wish to discuss is HB 322. This is the Department of Revenue's bill which adopts the recommendations of Professors Zeifman and Ainsworth. Essentially, this bill has the following features:

1. Impose a franchise tax on oil and gas producers operating in Alaska who have gross receipts of $250 million or more.

2. The income base to be taxed would be the higher of (1) pre-tax book income as reported to stockholders before any reduction by reason of taxes on income, or (2) taxable income under the Internal Revenue Code.

3. Apportion the pre-tax book income under item 2 by means of a three-factor formula where the property and payroll factors are the same as now contained in the Multistate Compact but the sales factor in the Compact would be replaced by an extraction factor. Such extraction factor would be the ratio of oil and gas produced in Alaska (expressed in BTU's) to total production of the taxpayer everywhere.

Thus, there are two main themes to HB 322: tax base changes and apportionment factor changes. Such changes are the same changes discussed and recommended by Professors Zeifman and Ainsworth in their testimony earlier this week.

Professors Zeifman and Ainsworth would reject federal taxable income as a tax base because the Federal Internal Revenue Code contains many deductions, credits and exclusions which they allege have diluted revenue-raising potential through subsidization of of some activities while discouraging others.

In their report, though not mentioned except briefly in their testimony, the professors attempted to demonstrate how the revenue raising potential has been eroded and referred to the concept of "tax expenditures" which, in essence, is simply a listing of those items or categories constituting deductions, credits, or exemptions found in the Internal Revenue Code, together with the estimated effect they have on revenue collected. This listing is required to be published each year under the

Congressional Budget Act of 1974. However, instead of discussing and commenting on the more than 75 general categories of items in the published list as they apply to both individual and corporate taxpayers, the professors chose only to extract in their report but six categories, and only one of the six (expensing of exploration and development costs) applies specially to the petroleum and mining industry.

I have here the complete listing of "tax expenditures" for the Fiscal Year 1978 which also shows those "tax expenditures" for years 1976 and 1977. A copy of this listing is attached. There are two columns for each year, one for corporations and one for individuals. A review of both the number of categories listed as well as dollar amounts will reveal that individual taxpayers indeed have fared very well compared with corporate taxpayers. It will also be noted that there are only two items relating specially to the petroleum industry. One deals with the expensing of exploration and development costs, which, from the testimony of the professors as well as Mr. Kilgore, one would think was the major provision in the Internal Revenue Code but which in reality represents a rather small item compared to other items in the listing. In fact, that item has a revenue loss effect about equal to the loss from the credit allowed for buying new homes. The other category deals with the excess of percentage depletion over cost depletion. But this latter item applies to over 100 different minerals which involve percentage depletion--oil and gas being but one category. In any event, percentage depletion has

negligible application to major oil companies because of the severe restriction of percentage depletion for oil and gas resulting from the 1975 Tax Reform Act. The professors' attempt in their paper to show the petroleum industry as a highly favored industry that receives a major share of tax benefits is simply incorrect.

After leveling a finger at corporate taxpayers generally, the professors then recommended that one special group--namely oil companies--be singled out for tax "reform". However, the professors failed to discuss either in their paper or their testimony the inequity or possible legal problems of proposing a "book income" base for major oil companies which would be far different than would apply to any other class of taxpayers. They did not even mention in their report that no state in the country has a law utilizing "pre-tax book income" as a tax base though questioning by the Committee did bring out this information.

Even if one were to agree with the novel approach suggested by Professors Zeifman and Ainsworth and embodied in HB 322, a true advocate of their theory could not logically propose its use with one set of taxpayers and then ignore its applicability to the vast majority of other taxpayers. If such a radical change in tax approach is to be made, then it should apply to all taxpayers under all income tax laws at the same time, with corresponding adjustments of tax rates for all.

An approach which uses the higher of book income before taxes or taxable income can lead to distorted results. Mr. Bonney of EXXON will demonstrate through a simple example how the use of one versus the other could prevent a full recovery of a capital investment and yet tax phantom or non-existent income. Further distortion may result from the inclusion of earnings of non-controlled companies in pre-tax income, as required by generally accepted accounting principles. While the oil companies may be required to report the earnings of their investments in non-controlled companies, they do not determine if or when the earnings of these entities are distributed. Yet HB No. 322 provides for immediate taxation of this income because it would be included within the pre-tax book income reported to stockholders.

Professor Zeifman emphasized the fact that book income is invariably larger than taxable income, thereby showing that big corporations have tax benefits. However, of what real significance is it that a corporation's management chooses to adopt a conservative book accounting method as long as it is consistent in doing so year after year to avoid distortions? Differences between book and tax income due to different treatment has existed for decades under generally accepted accounting principles. For tax purposes the Internal Revenue Service, as well as a company's own auditors, will require a full reconciliation of the taxable income back to the book income and there are extensive schedules in tax returns which do this every year.

The only point Professor Zeifman is making is that under the Internal Revenue Code corporations are permitted certain deductions, or credits, or exclusions which, if taken advantage of, show a lesser "taxable" income than shown on the books if the management chooses to use a consistent method which treats the item differently. But the same thing can be said for all taxpayers, i.e., all taxpayers receive some form of tax treatment which causes their taxes to be less than if the tax law simply taxed the gross dollars received at a specified rate This can be seen from the "tax expenditures" listing referred to earlier. Pointing the finger at one group of taxpayers as ones who should first go on the chopping block of reform while ignoring others who are not so treated is asking a lot of any legislative body whose duty it is to play fair with its citizens, whether they be corporate citizens or individuals.

Substitution of an "extraction" factor for the "sales" factor

The second main point of HB 322 deals with deleting the sales factor and substituting an extraction factor.

Before plunging into this subject, I believe it would be helpful to give the Committee some background about the traditional three-factor formula utilizing property, payroll and sales, where it came from and why it is used today by most states which tax corporate income. Another reason why this will be helpful is that Professors Zeifman and Ainsworth gave their testimony recommending a change strictly on the basis

that its use will apportion more income and, therefore provide more tax. However, the matter is not quite as simple as the professors have indicated.

When states began taxing corporate income over 50 years ago, there were various formulas used to divide the income. Because there were different formulas, it was not long before disputes arose between states and taxpayers, usually involving the question whether the state was reaching for too much of the taxpayer's income. It is very important to bear in mind all the way through the discussion of this subject that a state can constitutionally tax only that income of the taxpayer which is derived from within the state's borders. Thus, the search has always been to find a formula which gives both the taxpayer and the state fair treatment. But as to the taxpayer who operates in more than one state, the problem has also been to utilize a method of dividing income which does not subject the taxpayer to multiple taxation.

It is not difficult to see how multiple taxation can occur. Suppose X corporation operates in states A, B, and C, each of which has the same standard three-factor formula of property, payroll, and sales and each of which has an 8% income tax rate. In would be rare if X corporation had exactly the same mixture of property, payroll, and sales in each state. However, when each of the three states apply their tax laws and divide the income under their uniform formulas, X's total tax to all three states will be no more than 8% of its total income.

But let's vary the example just slightly and assume that in state A, X corporation has a heavy concentration of property and payroll but not many sales and that state A decides to delete its sales factor and have only a two-factor formula. In such a case state A will apportion to itself a greater amount of X's income but apportionment to States B and C will remain the same. The result will be that an amount greater than X's total income will be apportioned in the aggregate to all three states and X will have been subjected to multiple taxation because State A broke the uniformity.

The foregoing is a simplified example but nevertheless demonstrates how multiple taxation can result. As noted earlier, disputes over income taxation existed for decades and it was not until 1957 when the Commissioners on Uniform Laws in conjunction with the tax section of the American Bar Association and many other interested parties finally wrote a model law known as the "Uniform Division of Income for Tax Purposes Act" (UDITPA) in the hope that states would adopt it and thus put an end to the chaotic condition that existed. The apportionment formula settled upon utilized property, payroll and destination sales. Underlying this three-factor theory of apportionment is the concept that the employment of capital in the form of property, labor as reflected in payrolls and ultimate sales to generate the sustaining revenues for the business are all vital factors to be given equal weight in determining income. Thus, the theory recognizes that in a true economic sense some part of taxable income is earned at every stage of the business process.

To date, about one-half of the states (including Alaska) have adopted UDITPA and all but two states which impose an income tax use the three-factor formula of property payroll and sales.

The UDITPA model law only deals with apportionment of income and does not contain provisions setting forth rules or procedures whereby a state cooperates with other states to administer income taxation on a joint basis. In an effort to promote uniformity of tax rules and cooperation, a number of states formed what is now called the Multistate Tax Compact. However, a state which adopts the Compact also adopts the three-factor division of income formula based on the UDITPA model law. Alaska adopted the Compact in 1970 but followed the UDITPA formula before 1970. Hence, states which have adopted the Compact and states which simply follow the UDITPA rules have compatible laws.

With this brief background let me turn to the proposal to delete the sales factor and impose an extraction factor. The nub of the professors' argument is that the sales factor is low due to destination sales which causes lesser apportionment of income to Alaska and this can be cured by substituting an extraction factor. Thus, the sales factor is dismissed by the professors and the reader of their paper and the audience to their testimony is simply left with a conclusion void of any reasoning except maximizing revenue.

There was a sound reason for the UDITPA and Compact treatment of sales on a destination basis for purposes of the "sales" factor. A destination sale is one which occurs in a state if goods are

delivered in that state or services are performed in that state. Suppose a manufacturer has its plant in Illinois and has a large payroll at that plant. From this plant the manufacturer ships most all of his products to purchasers in other states. If this is the only plant, the property and the payroll factor to Illinois

will be high and if the sales are attributed to the Illinois plant as the origination point of the sale, then Illinois would apportion nearly all the income for taxation in Illinois. As can be seen from this simplified example, the major manufacturing states would receive an unreasonably high proportion of apportioned income to the detriment of non-manufacturing states. Hence, the "destination" sales concept is one which not only affords protection to less populated, non-manufacturing states, such as Alaska, but also gives legitimate recognition to sales activity in consumer states by deeming the sale to "occur" where the purchase takes delivery.

What the professors have proposed as a factor change is no different from what they might propose in any state based upon simple reasoning to get more revenue, the only difference being that in such other states it might be a different factor which provides the key. For example, they might shift their proposal to Illinois or Pennsylvania to point out that its sales factor also is destination-oriented and because most products are shipped out-of-state, the ratio of sales in either of those states will be lower. The professors could then recommend that the "destination" sales factor be changed to an "origin" sales factor or that the sales factor be deleted in favor of one based on manufactured units (e.g., television sets) in the state to total units manufactured everywhere. By such changes, those states could then command most of the apportioned revenue since, being manufacturing states, they already have the bulk of property and payroll and, through the sales factor change, they could prevent

dilution of the total factor to be used by the taxpayer.

But suppose it was some state which did not have heavy manufacturing (i.e., low property and payroll in the state)? Under the professors' reasoning this might call for use of only a sales factor -- i.e., destination sales and not origin sales because only the former would help the state (in contrast to what was said above as being in the "best interests" of Illinois or Pennsylvania). By so limiting the formula to a single factor, the non-manufacturing state maximizes apportionment of income to the state.*

The foregoing are only two examples out of many one could establish to tailor apportionment formulas for various states if the only objective is simply maximizing revenue without concern for inequitable or unconstitutional consequences. However, the problems with the examples are parallel to the same problems that are contained in the professors' proposal for an extraction factor. In each instance there is a break in the uniformity of treatment by a state which inevitably results in the taxpayer being subjected to multiple taxation. The state breaking uniformity will tax a larger part of the income by use of its advan-

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* Recently the Iowa courts struck down as unconstitutional that state's use of a single factor of sales because it was not an adequate measure of the taxpayer's income derived from within Iowa. (Moorman Mfg. Co., Polk Cty. Dist. Ct. No. CE 3-1595 (12-17-76)). Similarly, in General Motors Corporation vs. Dist. of Columbia, 380 U.S. 512 (1965), the United States Supreme Court struck down use of a single sales factor by the District of Columbia.

tageous apportionment factors. Unfortunately, part of that same income will also be apportioned to and taxed by the other states having the uniform apportionment formula.

As noted, the professors have given no reason for use of the extraction factor except that it will raise revenue. Missing is the reasoning why the present factors are not a proper measure of a taxpayer's income within Alaska or, conversely, why use of the extraction factor will give a more accurate measure of that income. Merely saying that oil goes out of the state and does not count as a "sale" in Alaska to its detriment is not good enough because, as shown earlier, any state could analyze its economic position and make the same argument when it observes a resource material or manufactured item being shipped out of the state. If that happened, then clearly the states and taxpayers would be back to the same chaotic situation that existed before the uniform rules of UDITPA and the Multistate Tax Compact were formulated and adopted.

To satisfy constitutional requirements, an apportionment formula must fairly and reasonably measure a taxpayer's net income in the particular state since a state has jurisdiction to tax only that income derived within its borders. The professors and some Alaskan critics of the present three-factor formula have simply looked at the oil production aspects of the business of a multistate oil company operating in Alaska but apparently wish to ignore the other part of the business where that oil has to be transported, refined into products, distributed and sold.

In fact, the bulk of such a company's employees and a large portion of its investment lie in these phases of the business. Moreover, the revenue which pays for the expenses of company operations is generated mainly out of the sales of refined products.

The concept of income taxation is the taxation of the overall profits of an enterprise which may have many parts in many states but all of which contribute to the ultimate profit or loss. In devising a formula to measure income for apportionment, the drafters of the UDITPA model law were not being arbitrary when they settled upon use of property, payroll and "destination-oriented" sales. They were looking for a formula which not only contained elements reflecting as many aspects or segments of the business as possible but also for a formula which could be easily and uniformly administered and which provided equitable treatment to states as well as taxpayers. Using these guidelines, the drafters found that property, payroll and sales provided a balance of factors reaching and reflecting the essential elements of any manufacturing or mercantile business.

There can be no doubt that the author's solution fails to protect the taxpayer from multiple taxation but, rather, actually creates it. While this is reason enough to reject use of the extraction factor, it also is clear that use of this form of factor in place of a sales factor reduces the segments or sectors contained within a business whose operations are reflected in the formula. Sales from all phases of the integrated business are the sustaining element of the business without which the business fails, and such sales reflected in the sales factor

are drawn from the total business. Units of petroleum extracted are important to the business too but represent operations pertaining to only one segment or phase of an integrated petroleum company's total business.

While crude oil extracted may have a value at the point of production, that value exists only because of consumer demand for products produced within other equally important phases of the business consisting of refining, product transportation and marketing distribution. In this regard, oil production in the case of the oil industry is not unique and the same reasoning can be applied for iron ore in connection with steel making, for raw timber in connection with finished wood products, or even for grapes grown for winemaking since in each of these cases the raw product can be viewed as having been "extracted". In all these cases, as well as with the oil industry, the "extracted" material undergoes a complex transformation into products resulting in sales revenues only after having been acted upon by other necessary phases of the business containing most of the taxpayer's employees and containing facilities representing a substantial part of the taxpayer's invested capital, both of which are distinct from the "extraction" phase yet still a part of the overall operation of the enterprise.

By using an extraction factor in place of a sales factor the whole element of sales which sustain the business for its survival are disregarded. Units of oil and gas produced is simply not a proper measuring factor and, as will be pointed

out in an example by Mr. Bonney of EXXON, the substitution of an extraction factor can result in a distorted attribution of "downstream" income from transportation, refining, marketing, etc. to Alaska which can result in the taxpayer having income taxed twice.

From the foregoing it can be seen that substituting an "extraction" factor for the "sales" factor actually distorts rather than improves the measurement of net income of the total enterprise attributable to or derived from within a particular state. What it does is provide a change to "maximize" revenue which is not a goal of formula apportionment when done at the expense of sacrificing the other principles which lie behind the concept of apportionment.

I would like to say a word about the provision in HB 322 which the professors recommend as being a basis for Alaska including OCS property, payroll and extracted oil and gas as its own factors when the OCS property is dependent upon on-shore Alaska operations. The professors were certainly correct in saying that there may be problems. However, they failed to point out that section 1333 of Title 43, which deals in part with state laws applicable to the OCS area, contains rather troublesome language for a state attempting to extend its tax laws to the OCS area. Section 1333(a)(2) contains the following sentence:

> "State taxation laws shall not apply to the Outer Continental Shelf."

At least one state, California, has looked deeply into this matter of whether California, could consider the OCS developed area as providing property, payroll and sales factors for use by California, i.e., the same consideration being recommended by Professor Ainsworth. The California Franchise Tax Board in Legal Ruling No. 366 has held that California cannot claim property, payroll and sales in the OCS area for California's benefit, i.e., California cannot put these factors in the numerator for California. There is attached to my testimony copies of the pertinent federal statute referred to above, along with a copy of Legal Ruling No. 366 of the California Franchise Tax Board.

SB 202

SB 202 is basically the same bill which was considered in the 1976 session as SSSB 620. The main difference between the bills is that under SSSB 620 the net proceeds tax was a credit against regular corporation income tax insofar as that corporation income tax would represent tax on income from oil production taxed under SSSB 620; under SB 202, the taxpayer also remains subject to the Alaska corporation income tax but is deemed to be exempt only to the extent of income earned from production of oil in the state. In short, under SSSB 620 there was an actual credit against the Alaska corporation income tax but the net proceeds tax credit was only applicable against that part of the corporation income tax which was applicable to income from Alaska oil operations. Under SB 202 there is no credit as such but the taxpayer who apportions income to Alaska is simply not

taxed on income deemed to come from Alaska oil production.

As some of the members of this Committee know, I testified on SSSB 620 last year and pointed out what I believed to be the deficiencies in that bill. That testimony is no doubt still available in the Committee files and I do not propose to go into all the details of the bill again. Rather, I shall have some general comments on the bill and point out how this bill impacts on the taxpayer, as well as point out some of the legal problems with its operation.

The "net proceeds tax" contemplated by its proponents has features of an income tax in that it attempts to reach a level of "income" or "profitability" from successful oil and gas production operations with a tax rate applied which is equal to (or higher than) the regular Alaska corporation income tax rate (i.e., 9.4%). Essentially, the tax would be determined by subtracting from the wellhead value of oil and gas production certain limited costs and expenses directly associated with production and multiplying the difference by the corporation income tax rate of 9.4%.

Proponents of the "net proceeds" tax have chosen to label it as an "ad valorem" tax rather than an "income" tax. However, in substance and operation the tax is unquestionably a form of income tax and merely calling it by another name cannot change that fact.

Because the "net proceeds" tax approach is itself a form of separate accounting, taxpayers will be exposed to multiple

taxation under that approach for the same reasons as discussed in connection with SB 105. In fact, the economic effect to a taxpayer would be even more adverse since the goal of the "net proceeds" tax is simply to isolate successful Alaskan oil and gas producing operations, allow a very limited amount of deductions closely and directly associated with production, and tax the resulting "net proceeds" at the corporation income tax rate (9.4%) as though those "net proceeds" constituted net income of the taxpayers.

Proponents of the "net proceeds" tax in the past have admitted that the "net proceeds" to be taxed would represent a tax base which is higher than would occur under regular principles of income taxation applicable to other taxpayers. Hence, the economic effect is that Alaska would place a tax (at the 9.4% corporate income tax rate) on a level of income (but called "net proceeds" instead of "income") which is much higher than would result under regular income tax principles, and that same income (or at least a certain level of that income) would be included in the base subject to apportionment to other states and taxed by them because they use the standard three-factor apportionment formula.

But the adverse effect of the "net proceeds" tax approach would not stop there because under that approach the same taxpayer would still be subject to the regular Alaska corporation income tax. SB 202 would still require the taxpayer to apportion to Alaska under the three-factor formula all of the tax-

payer's income from outside Alaska, including its non-Alaska oil and gas income. Thus, SB 202 would provide Alaska with the best of all worlds: it would receive a tax at the 9.4% corporate income tax rate on Alaska "net proceeds" which would constitute a tax base much higher than under regular income tax principles and, through apportionment, it would also seek to reach all of the taxpayer's income from outside Alaska as well as any non-oil and gas income from within Alaska.

The concept of the "net proceeds" tax which would operate in substance like an income tax raises a legal question whether the method would permit the state to tax a greater amount of net income than reasonably could be attributed to Alaska.

Proponents of the "net proceeds" tax have claimed that a "precedent" exists for such form of tax and have cited the states of Nevada, Utah, Colorado, Idaho, Montana, and New Mexico as examples. However, a review of the statutes in those states reveals that the "net proceeds" tax has nothing whatsoever to do with a scheme to tax income such as that being advanced by the proponents of the "net proceeds" tax. Rather, the "net proceeds" involved in the states referred to are simply convenient and simplified means of arriving at a value on mining or oil properties for purposes of applying property tax rates by local county assessors in order to provide property tax revenue in the local counties. Such a method is essentially a substitution for the rather sophisticated and complex valuation procedure that would otherwise occur each year, such as the complex

valuation of the Prudhoe Bay field for purposes of applying the reserves tax in Alaska.

It is safe to say that no state in the country imposes a "net proceeds" tax of the type the proponents in Alaska have in mind.

I would now like to direct my comments to the Legislative Council's proposed production tax changes incorporated in the identical bills, SB 103 and HB 144.

DESCRIPTION OF THE BILL

As discussed yesterday, the proposal would:

a. Change the point where the taxable value of oil is determined from the "well" to the point where "oil is first metered or measured in a condition of pipeline quality".

b. Realign the stepped tax rates, lowering the tax on the first 1,000 bbls per well per day and substantially raise the tax on all production over the first 1,000 bbls with a high rate of 14% on all production exceeding 3,500 bbls per day.

c. Use lease or property averaging in determining each well's daily production.

d. Tax flared gas at 5 times the normal rate.

e. Advance the monthly tax due date to the 20th day of the month following production.

COMMENTS

1. Adoption of lease or property averaging of daily bbl. per well production is a step in the right direction in properly ascertaining the stepped tax rates applicable to a field. The change, of course, will aid both the taxpayer and the state administratively.

2. The resultant increase in the overall industry tax burden (estimated by the Legislative Affairs Agency to be about $180 million per year by 1980) is completely unwarranted, considering the question of need which others have already addressed and considering the fact that Alaska oil is already being taxed at virtually the highest level in the nation. The limited benefit given to the lower producing fields in Cook Inlet in no way should be considered as justification (or a basis of consistency) for placing such a harsh extra tax burden on high producing wells in the North Slope or any other location. This approach portrays the concept of taxing the taxpayer at a high level, not on the basis of state governmentel need, which we believe to be grossly unfair.

3. Retention of the alternate cents-per-barrel rate floor with its wholesale price index adjustments more than counteracts any true benefit out of reduced rates given low Cook Inlet producing wells through percentage rate reduction. As Levy Associates has maintained, this minimum price-setting device has created an artificially high value on the old Cook Inlet oil for tax purposes, resulting in an effective tax rate well in excess of what we believe was intended by the legislature on such oil. The last time I reviewed the situation--which was about a year ago--the cents-per-barrel feature of the severance tax had caused Union and other companies for which it reports severance tax to pay about

$5 million more than would have been paid under the percent-of-value method. We view this amount as simply an unintended windfall benefit to the State since January 1, 1974, the date the current cents-per-barrel tax took effect.

4. We do not see any justification for imposing a penalty rate (5 times normal rate) for flared gas, considering the fact that such flaring controls are best placed with regulatory agencies, not taxing agencies. If proper regulatory authority exists to flare gas, such as for safety pruposes, there is no justification for adding tax at a confiscatory rate to a product that the producer loses through flaring where that flaring is done for reasons of safety.

5. Moving the point of measurement of production value downstream to the point of metering in a condition of pipeline quality could unjustly place a substantial tax on transportation costs on some fields which for a variety of reasons require movement of oil significant distances before measurement. Since the Alaska Production Tax is an occupation tax on the privilege of severing oil and gas, it would be more appropriate to continue measuring it by its value at the point of severance, i.e., the wellhead, instead of adding on to it incremental values of gathering, transportation and field treatment.

6. Advancing the delinquent date for payment from the first of the month following the month of production to the 20th day of the month following the month of production would place

an undue administrative strain on the reporting groups within the various producing companies. In most cases, the production data to calculate tax liability and prepare returns must be transmitted to offices outside Alaska. Advancing the delinquent date by 10 days will simply make worse an already short time open to comply with the law. By advancing the reporting time 10 days, the State, overall, only gains a total of 10 days for revenue collection which seems inconsequential compared with the added administrative burden on producers.

My next comments pertain to HB 321 and SB 238, identical bills, which contain the Administration's recommended changes to the oil and gas production tax.

Briefly, the bills would replace the present stair-stepped tax rates on oil production per well with a single rate of 10% on value or one alternative minimum cents-per-barrel rate of 75 cents (adjusted for gravity and for changes in the "Gross National Product Deflator").

Also, the 4% rate on gas would increase to 10% with a new alternative minimum tax of 6.4 cents per MCF. The new percentage rate and cents-per-unit rates would be adjusted by an "economic limit factor (ELF) discussed later.

The proposal also makes other changes, including changing the point of measurement from the wellhead to the point of measurement of pipeline quality. The proposal also imposes a double rate of tax on flared gas.

We strongly oppose perpetuation of cents-per-barrel floor prices and expansion of it to gas production, as well as increasing the minimum price to which it relates, that is, $7.50 per barrel. As Milton Lipton has advised, the current floor as escalated by the National Wholesale Crude Price Index has worked in unintended ways on Cook Inlet Crude, creating an artificial taxing value well in excess of the value permitted by the FEA on old oil. Now the Administration not only recommends continuance of the minimum price concept but also proposes to increase the minimum price to $7.50 per barrel.

The Administration supports this course with the argument that the FEA price is artificially low. But the oil companies producing such "old" oil nevertheless suffer the economic realities of federal pricing. Accordingly, we believe it is unfair that in addition to bearing such economic loss in price, the Cook Inlet producer must also bear an increase in production tax because of an arbitrary floor of $7.50 per barrel used as the measure of tax. This, of course, would be equally true on the North Slope if the FEA placed a value below $7.50 on that production. We fail to see any justification for the State to arbitrarily burden the production with such a heavy production tax through an artificially set value because of the possibility that FEA pricing decisions may not be favorable.

As mentioned above, HB 321 introduces the concept of an Economic Limit Factor (ELF) as an adjustment to the percentage rate of tax applied to both oil and gas. According to the Department of Revenue's February 1977 study, the Department believes that the present "stair step" rate schedule does not adequately take into account differences in the economic conditions existing from field to field, e.g., a well producing 1,000 bbl/day at one location may be marginal while such a producing rate at another location may be profitable. In short, the stair-step approach is deemed defective because it does not adequately protect against excessive taxation as a well approaches its economic limit.

To correct this, the Department proposes an ELF, the calculation of which begins by determining a fraction the numerator of

which is the "monthly production rate at the economic limit" and the denominator of which is the production during the month for which the tax is to be paid. Under HB 321, the numerator is by statute deemed to be 100 barrels times the number of well-days. Well-days are by definition the number of days a well is operating. Thus, if there were 10 wells on a lease operating for 28 days each, the numerator would be 100 X 10 X 28 = 28,000 bbls. If the total monthly production on the lease was 280,000 bbls, the ratio would be 10%, or expressed as a decimal, .10. The next step in determining the ELF is to reduce "unity", i.e., 1.00, by the ratio expressed as a decimal. Thus, 1.00 less .10 = .90 = ELF.

The best way to explain how the HB 321 mechanism works is through a simplified example, a copy of which is attached. The example uses Cook Inlet production of 35° oil at a $4.85 per barrel controlled price. Under the bill, one of the adjustments is a half-cent for each degree above 27°, so 4 cents is added to the 75 cents. The GNP Deflator adjustment is ignored. The statutory presumption of 100 barrels is the numerator and 1,600 barrels is the denominator which gives a decimal of .0625, and when subtracted from 1.00 gives an ELF of .9375. Both the cents per barrel of 79 cents and the 10% rate are multiplied by .9375 to find the adjusted cents-per-barrel and percent-of-value rates. Next, the royalty of 200 barrels is subtracted to find 1,400 non-royalty barrels. Finally, the 1,400 barrels are multiplied by the value of $4.85 and then by 9.375% to find the tax under the percent-of-value method, and are multiplied by $.7406 to find the tax under

the cents-per-barrel method. Since the tax of $1,036.84 is the higher (i.e., under the cents-per-barrel), that tax is the one that would be payable.

At the bottom of the example the tax under HB 321 is compared with the tax produced on the same production if it occurred this month (March 1977) under current law. As shown, the increase is about 60%. Also at the bottom of the example it is shown that the effective rate of the production tax under current law would be 9.5% but 15.3% under HB 321. While not shown, if the production rate had been 800 bbls/day instead of 1,600, the increase in tax over the current tax would have been around 75% instead of 60%.

As mentioned earlier and used in the example, the monthly production rate at the economic limit is, by statute, presumed to be 100 barrels times well-days unless the producer in a formal hearing proves by "clear and convincing evidence" that it is otherwise. However, in proving this, HB 321 contains some rather curious and questionable ground rules which do not track with reality. These provisions are found in subsections (b), (c), and (d) of Section 43.55.013. In essence, the "average monthly direct operating cost" (based on at least 4 consecutive months) is divided by the value at the point of production of oil which is produced from the lease, but this "value" is not the value the producer actually gets but, rather, that value which is deemed to be the value of comparable crude at West Coast refineries for imported oil which is then "backed out" to the wellhead.

Translated, the "value" used to divide into the monthly operating costs is, for Cook Inlet, Indonesian Crude laid into Los Angeles at about $14.50 per barrel. When the $14.50 is "backed out" to the wellhead, the value at the wellhead is about $13.50. Thus, it is not the $4.85 real price used to calculate "monthly production rate at the economic limit" but, rather, $13.50.

While that is bad enough, with regard to the "direct operating expenses allowed", the bill only allows four: drilling supplies, fuel, routine maintenance and wages and benefits of employees working on production operations. Specifically excluded are capital expenditures, tangible or intangible drilling expenses, costs of well workovers, costs for repairs or replacements (other than routine maintenance), depreciation or amortization, taxes, insurance, overhead, or monies paid or set aside to cover the cost of terminating operations, i.e., abandonment costs.

Allowing only four listed costs is not realistic because there are cash operating costs not allowed but which are tied to operations versus no operations. Any cash cost which would be affected by a decision to operate or not operate is the realistic approach and more in line with the way it would actually be approached by a producer in a true situation. HB 321 would even deny severance taxes on the production itself and property taxes on the equipment. In short, "economic limit" is that point at which actual revenue and actual costs are equal.

I requested Union Oil's oil and gas division engineers to run some calculations using real data as a test. Doing it in the

normal way, our people used the realistic value of about $4.85/bbl for value and the real operating costs to get an ELF of about .67. But by using $13.50 per barrel as a value and limiting the costs to the four categories the ELF was around .92. We also made a rough comparison of the taxes under HB 321 compared with taxes paid in 1976 and found that the tax on oil production would have been increased by about 50% if HB 321 had been in effect in 1976.

HB 321 also contains an ELF for gas production though it is not totally clear under the bill language how this is computed. In any event, the principle is the same and the same four direct operating costs are used but the value used for gas is the highest price in the field or within 100 miles.

With respect to gas production, the minimum of 6.4 cents per MCF is especially onerous, since gas is customarily sold under long term contracts and those contracts may not permit the seller to receive a value which happens to be the highest price on the lease on "within 100 miles". The 6.4 cents minimum tax is equal to 64 cents gas at a 10% rate, but there are contracts of sale for gas where the price is much less than 64 cents. Hence, the effective rate of tax on gas is much higher. For example, if gas were sold at 42 cents, the tax would nevertheless be the minimum of 6.4 cents (assuming no ELF applied) which would equate to an effective rate of tax of 15.2%.

With respect to the proposed gas rate increase--while admittedly the gas tax rate might warrant some degree of increase, the severity of this proposal is overreaching. We would suggest that any value tax on gas be based on actual sales price at the

sales meter. We would discourage taxation governed by an artificial floor price or by what some other producer may be receiving for his gas in some other field.

For flared gas, the rate is doubled, i.e., 12.8 cents. Even gas used for safety flaring necessary to safe operations would be taxed, which cannot be justified by any standard. We oppose this double tax for the same reasons as stated in the discussion under SB 103.

In summary, while there is merit to the concept of an economic limit factor, the manner in which it is determined under this bill is unrealistic and virtually meaningless. It seems to me a lot more thought has got to go into it before it can be a worthwile mechanism. The way it is set up now--with questionable use of phantom values and restricted costs--an ELF so determined could have other consequences beyond just severance tax because the concept of economic life of a field is one used in valuation for property tax too. If economic lives of oil or gas properties as used for property valuations are to be determined using the methods for the ELF for severance tax purposes, then the stage is further set for endless arguments and disputes over property values as well as in connection with the ELF itself.

I would next like to comment on the Administration Sponsored Bill, HB 323.

This bill proposes several amendments to the so-called "20-Mill Hardware Tax", and certain provisions of Title 29, governing municipal taxing limitations.

Section 1 would add to the statute a highly controversial amendment to regulation 15 AAC 05.840 which was issued by the Department of Revenue in June 1976. This provides that any municipal tax levy, say for bonded debt, which is in excess of the $1,500 per capita limitation is not creditable against the 20-mill tax.

We take direct exception to this provision in that AS 43.010(a) quite clearly provides for a maximum tax of 20 mills on our state-assessed properties. This issue is presently being litigated in a case involving the 1976 tax levy of the North Slope Borough. It would seem appropriate to let the court rule on this important issue rather than to amend the statute at this time.

Heretofore, the state 20-mill tax has applied to exploration, production, and pipeline transportation properties. HB 323 would extend this tax to refineries, liquefaction or processing plants, plants manufacturing oil or gas products and also to tankers and other marine equipment used in the transportation of oil and gas.

We believe it inadvisable to enact any further extension of this special state property tax imposed upon oil and gas producers.

The taxable basis on the marine equipment is specified as replacement cost less depreciation based on useful life multiplied by a fraction of days in Alaska ports over days in port both within and without the state. This proposal raises serious questions in

that it is believed that only the home port, under long standing case law and practice, has taxing jurisdiction over ocean-going vessels.

Aside from the "home port" doctrine, and assuming that Alaska could legally assess these properties, we would suggest a more equitable formula. One possibility would be use of days in Alaska ports versus days in the year.

Due to the controversial nature of this issue, however, we would respectfully urge that this section of the bill be stricken, irrespective of what action is taken on the remainder.

HB 323 additionally would delete the existing provision for using straight line depreciation of historical cost on pipeline assessable values in those instances where the physical life of the pipeline materially exceeds the economic life of reserves committed thereto. As a consequence, pipelines would be assessed with regard to "economic" value based on the economic life of committed reserves.

This issue is being litigated in the Cook Inlet Pipeline Co. case and it would seem appropriate to let the court rule on the issue rather than amending the statute. It is further believed that the existing law and Regulation 15 AAC 05.890 pertaining thereto are sufficiently workable to develop assessments for operating pipelines which will be fair and reasonable, both for the state and the taxpayer.

Section 8 of the bill provides that the municipal taxing limitation of $1,500 per capita shall be adjusted each year in accordance with changes in the Consumer Price Index for Anchorage.

Assuming that the $1,500 per capita levy is reasonable, it would likewise be reasonable to key it to an inflation index.

Section 12 makes the provisions of HB 323 retroactive to January 1, 1977, except for tanker assessments which begin January 1, 1978. This retroactive provision seems peculiarly unreasonable in view of the fact that the 1977 tax returns have been filed and assessment notices have been issued by the Department.

I will now turn to House Bill Number 328, the Administration's proposal on the Oil and Gas Reserves Tax.

The Reserves Tax was enacted for a two year period, 1976 and 1977, for the purpose of meeting anticipated revenue shortfalls for Fiscal Years 1976 and 1977. The statutory tax rate for 1976 was 20 mills (2%) and the 1977 tax rate was set by the 1976 legislature at the same rate -- 20 mills. Reserves Taxes paid in 1976 were $223 Million and in 1977 are expected to total approximately $270 Million.

In Fiscal Year 1976, because of the Reserves Tax revenues and increases in other revenue sources, unrestricted general fund revenues exceeded expenditures by approximately $125 Million, leaving a surplus of $505 Million, of which $338 Million was available for appropriation at 6/30/76. Revenues in FY 1977 are also expected to exceed expenditures, thereby increasing the surplus.

HB No. 328 proposes to reduce the 1977 tax rate from 20 mills to 12 mills, reducing the revenue from this tax from $270 Million to about $170 Million, but subject to the following:

(1) If on October 1, 1977, TAPS thru-put is less than 600,000 bbls/day, an additional 8 mills would be levied, payable November 30. 1977.

(2) If on December 15, 1977, TAPS thru-put is less than 1.2 Million bbls/day, the Reserves Tax would be extended another year.

While the prospect of a reduced tax rate is always welcomed, we question the propriety of the limitations mentioned, which limitations are so specific and restrictive.

Present indications are that the Prudhoe Bay Field will start delivering oil to TAPS reasonably close to schedule at mid-1977. It seems unreasonable that some minor variance from the restrictive provisions of this bill could cause the tax rate to be increased and possibly for the Reserves Tax to be extended another year.

Accordingly, we believe that the Reserves Tax should expire, as scheduled in the existing statute, at the end of 1977. However, we certainly agree that the 1977 tax rate can be reduced to 12 mills, since the 1978 budget can be met with no difficulty and the 1979 budget as well unless there were some serious, prolonged delay in TAPS startup. This reduction would certainly be consistent with the original intent of the reserves tax which was to help the state over a potential period of deficit in the General Fund.

ATTACHMENTS TO TESTIMONY

OF

LAWRENCE L. WILSON

SPECIAL ANALYSES BUDGET OF THE UNITED STATES GOVERNMENT

FISCAL YEAR

1978

repeal of all itemized deductions resulting in tax expenditures. This hypothetical revenue gain would be $21.2 billion in 1978, whereas the simple sum of the tax expenditures for each separate item is $31.3 billion. The estimate for the combined effect of all such deductions was derived from a model of the tax system that accounts for the interaction between tax expenditure provisions and the provisions of the normal structure. In particular the model provides that individuals would take the standard deduction if itemized deductions were repealed. No comparable estimate can reasonably be made for the combined effect of a hypothetical repeal of all exclusion provisions.

A few aggregations of related tax expenditure items are presented and discussed in the next section. These aggregates have been specially estimated so as to account for the interactions referred to above but do not consider the effect of changes in behavior. Where tax expenditures for both individuals and corporations result from the same tax code provision, such as the investment tax credit, the two estimates may appropriately be added together.

Tax Expenditures by Function

Estimates of tax expenditures are grouped together by functional category and presented in table F–1. The estimates are shown separately for individuals and corporations. Wherever possible, particular tax expenditures have been classified according to the functional categories used for budget outlays. Many tax expenditures do not, however, fit into these categories and for this reason three special functional categories have been added: business investment; personal investment; and other tax expenditures.

A brief description of each of the special tax provisions for which a tax expenditure estimate is shown in table F–1 follows.

National defense.—The supplements to salaries of military personnel, including provision of quarters and meals on military bases and quarters allowances for military families, and virtually all salary payments and reenlistment bonuses to military personnel serving in combat zones, are excluded from tax. Disability-related military pensions received by current retirees are largely excluded from taxable income. The Tax Reform Act of 1976 terminated the exclusion of noncombat related disability pensions for those who entered the armed services after September 24, 1975.

International affairs.—Prior to 1976, a U.S. citizen was generally able to exclude up to $20,000 a year of foreign earnings if the taxpayer were a bona fide resident of a foreign country. After 3 years of foreign residence a taxpayer could exclude up to $25,000 a tax year of foreign earnings. The Tax Reform Act of 1976 modified these provisions, limiting the exclusion to $20,000 only for employees of U.S. charitable organizations and reducing it to $15,000 for all others, denying tax credits for foreign taxes paid on excluded income, and taxing income beyond the amount eligible for exclusion at the higher bracket rates which would apply if the excluded income were also subject to tax. The estimates also reflect the tax-exempt status of certain allowances received by Federal employees working abroad.

Table F-1. TAX EXPENDITURE ESTIMATES BY FUNCTION[1]

(In millions of dollars)

Description	Corporations			Individuals		
	1976	1977	1978	1976	1977	1978
National defense:						
Exclusion of benefits and allowances to Armed Forces personnel	-----	-----	-----	1,020	1,095	1,260
Exclusion of military disability pensions	-----	-----	-----	90	105	115
International affairs:						
Exclusion of gross-up on dividends of LDC corporations	40	-----	-----	-----	-----	-----
Exclusion of income earned abroad by U.S. citizens	-----	-----	-----	145	120	135
Deferral of income of domestic international sales corporations (DISC)	1,220	1,030	1,190	-----	-----	-----
Special rate for Western Hemisphere trade corporations	50	35	25	-----	-----	-----
Agriculture:						
Expensing of certain capital outlays	85	80	70	455	370	440
Capital gain treatment of certain income	10	10	15	315	330	350
Natural resources, environment, and energy:						
Exclusion of interest on State and local government pollution control bonds	110	170	220	50	75	100
Exclusion of payments in aid of construction: Water and sewage utilities	-----	15	10	-----	-----	-----
Expensing of exploration and development costs	640	610	600	160	105	150
Excess of percentage over cost depletion	1,010	1,035	1,060	285	275	300
Pollution control: 5-year amortization	10	−80	−130	-----	-----	-----
Capital gain treatment of royalties on coal and iron ore	15	20	20	40	45	50
Capital gain treatment of certain timber income	290	300	325	95	95	100
Commerce and transportation:						
Exemption of credit unions	145	165	185	-----	-----	-----
Exclusion of certain income of cooperatives	410	455	490	−155	−165	−170
Corporate surtax exemption	4,170	4,650	4,250	-----	-----	-----
Deferral of tax on shipping companies	110	90	70	-----	-----	-----
Railroad rolling stock: 5-year amortization	−25	−35	−40	-----	-----	-----
Financial institutions: Excess bad debt reserves	485	560	645	-----	-----	-----
Deductibility of nonbusiness State gasoline taxes	-----	-----	-----	710	795	880
Community and regional development:						
Housing rehabilitation: 5-year amortization	15	10	5	25	20	10
Education, training, employment, and social services:						
Exclusion of scholarships and fellowships	-----	-----	-----	195	250	285
Parental personal exemptions for students, ages 19 and over	-----	-----	-----	720	750	770
Deductibility of contributions to educational institutions	190	215	240	510	540	565
Deductibility of and credit for child and dependent care expenses	-----	-----	-----	790	840	870
Credit for employing AFDC and public assistance recipients	10	15	15	-----	-----	-----
Health:						
Exclusion of employer contributions to medical insurance premiums and medical care	-----	-----	-----	4,760	5,195	5,840
Expensing of removal of architectural barriers to the handicapped	-----	5	10	-----	-----	-----
Deductibility of medical expenses	-----	-----	-----	2,315	2,585	2,870
Income security:						
Exclusion of social security benefits:						
Disability insurance benefits	-----	-----	-----	330	380	430
OASI benefits for aged	-----	-----	-----	2,775	3,175	3,460
Benefits for dependents and survivors	-----	-----	-----	645	730	795

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
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	1,680	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	8,095	8,950
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	425
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	7,685	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	4,900	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	7,500	7,860
Exclusion of interest on State and local debt	3,110	3,475	3,925	1,645	1,850	2,090
Deductibility of State and local nonbusiness taxes	-----	-----	-----	10,865	12,125	13,460
Deductibility of charitable contributions	540	620	635	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 qualified for service retirement under the new Charter provisions, are not excludible from gross income under the sickpay formula contained in Revenue and Taxation Code Section 17139(d).

[¶ 205-026] Legal Ruling No. 366.

Franchise Tax Board, December 14, 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 income 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 506 (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. . . ." (43 U.S.C. §§ 1333).

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*, 361 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. Hulman*, 201 N.E. 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.

MARCH 1977 PRODUCTION
1600 BBL/DAY WELL
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%

AGO 547563

TO: CHAIRMAN, HOUSE RESOURCES COMMITTEE
AND ALL COMMITTEE MEMBERS

FROM: SUB-COMMITTEE ON OIL & GAS

During the week of march 21 - 26 the Joint Senate and House Resources Committees met to hear testimony relating to the various oil and gas taxation bills currently before us. Some of the bills under discussion, have not been refered to this committee.

Of the ones that have been, the Sub-committee on Oil and Gas recommends that H.B. 321, H.B. 322, C.S.H.B. 323, H.B. 328, and S.B. 274 be brought to the full committee's attention for consideration and that they be acted upon and passed out of committee no later than April 7.

Each of these bills have a further referal to House Finance and the Finance Committee has scheduled hearings and work sessions on these bills beginning early next week. Representatives from the oil companies and several nationally recognized economists will be present. We urge all members, who are able, to attend.

RECOMMENDED BILLS

H.B. 321 - SEVERENCE TAX

This tax, in our opinion, rates highest in priorities. It's timeliness is dependant upon the actions undertaken by the Federal Energy Administration in setting a recommended "well head" price by April 15, 1977, and further by actions later taken by the I.C.C. in recommending the transportation cost of North Slope crude. For other features of the bill, we refer the committee's attention to the Governor's transmittal letter for H.B. 321, included with this report.

H.B. 322 - ALASKA NET INCOME TAX OR FRANCHISE TAX

This tax bill, in our opinion, has several advantages over our present income tax collection system. It is easy to administer, is based upon the amount earned within the state, including OCS development, and would provide the State and the industry with a stable taxation policy for years to come. For other features, we refer you to the Governor's transmittal letter for H.B. 322, included in this report.

H.B. 323 - PROPERTIES AD VALOREM TAX

This tax bill, in our opinion, is premature. It would increase the scope of taxable property to include refining, liquefaction, and marine transportation. We believe that it would act as a "disincentive", at this time, for future development within our state, and of all the tax bills before us, meet with the most resistence. Accordingly, we have asked the Department of Revenue to place before this committee, a committee substitute for H.B. 323 which would reduce the bill to a "house-keeping" measure. This has been done and is before the committee for consideration.

H.B. 328 - RESERVE TAX

This tax bill amends the reserves tax bill to allow a credit reduction of tax levied 12 [20] if the oil flow through the Trans-Alaska Pipeline by October 1, 1977 has reached at least 600,000 barrels of oil on a daily average. Otherwise, the bill extends the reserve tax beyond the December 31, 1977 effective date of the original act. We urge its passage.

S.B. 274 - THE TAKING OF OIL AND GAS ROYALITY IN KIND

This bill requires that royality oil and gas be taken "in kind" rather than in money unless deemed otherwise by the commissioner, the Alaska Royality Oil and Gas Development Advisory Board, and the the Legislature. As an encouragement for future development within our state, we urge the passage of this bill.

RLD ?
Are you taking up that bill tomorrow that I suppose Stuart part of?

CONCLUSION:

The Sub-committee bleieves that the passage of these tax proposals, taken in conjunction with the desire to have the Alaskan Permanent Fund replace the eventual and inevitable passage of our nonrenewable resources, will produce a desired benefit for the State of Alaska. We further believe that they <u>will not</u> act as a disincentive for the oil industry and that their passage will ensure Alaska's "fair share" in the wealth of our state. Regarding this aspect, we urge committee members to read the Tanzer Report, "IMPACT OF INCREASED TAXATION ON OIL EXPLORATION AND DEVELOPMENT IN ALASKA", submitted to all members of the Alaskan State Legislature on March 25, 1977.

We have asked that Mr. John Messenger from the Department of Revenue be present to assist committee members in answering their questions and would, as this time, like to highly commend the staff of Senate and House Resources for providing the back-up material needed for the committee's deliberations.

Rep. Merle G. Snider
Rep. Hugh Malone
Rep. William Akers.

HOUSE BILL NO. 321 by the Rules Committee by request of the Governor, entitled: HB 321

"An Act relating to the oil and gas properties production tax; and providing for an effective date."

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

The Governor's transmittal letters appear following the bill to which it pertains: fiscal notes appear in House Supplemant No. 31 to today's journal.

"March 8, 1977

HB 321

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

Dear Mr. Speaker:

Under the authority of art. III, sec. 18 of the Alaska Constitution, and in accordance with AS 24.30.060(b) and the Uniform Rules of the Alaska State Legislature, I am transmitting a bill relating to the oil and gas properties production tax.

As a result of a recent study of Alaska's oil and gas tax structure, the Department of Revenue has recommended several changes in the state's production or "severance" tax. This bill incorporates those specific recommendations.

Currently the state's oil production tax is calculated according to "stair stepped" rates depending upon the level of production for the lease or property. As currently structured the tax may have an adverse impact upon a particular property as it reaches its economic limit. The "stair step" approach may not alleviate this adverse effect since the economic limit may vary substantially from one part of the state to another. This is because it may be more costly to produce and transport the oil in the more remote areas of the state. Accordingly, the bill contains an economic limit mechanism which automatically scales the tax rate down as the production nears its economic limit. This will insure that the tax will not unduly inhibit oil production as it reaches its economic limit.

One of the immediate dangers which face the state's revenue picture is the potential for artificially depressed pricing of the state's North Slope oil. This could result from federal pricing decisions or excessive tariff costs from the wellhead to the refinery. To insulate the state's petroleum revenues from these forces, the bill provides for a mechanism which would raise the cents-per-barrel floor to correspond to a mid-range market value for North Slope oil and tie that floor to an index which will let the floor keep pace with inflation.

One of the Department of Revenue's recommendations -- the oil and gas surtax -- which was designed to offset revenue losses due to depressed pricing of North Slope oil and which was to be imposed only on holders of state-owned leaseholds was deleted on the advice of this department because of the substantial legal problems involved.

The bill places the tax on gas at a parity with the tax on oil. Currently gas is taxed at only 4 percent while oil is taxed from 5 to 8 percent. The bill would tax both oil and gas at 10 percent. In addition, the bill sets a cents-per-Mcf floor for the gas tax similar to the cents-per-barrel floor for oil. This new floor for gas corresponds to the highest market price in the state, and it too is tied to an index to keep pace with inflation.

Sincerely,

[signature]

Jay S. Hammond
Governor"

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

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

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

"March 8, 1977

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

Dear Mr. Speaker:

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

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

HB 322

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

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

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

Sincerely,

Jay S. Hammond
Governor"

AGO 547569

HOUSE BILL NO. 328 by the Rules Committee by request of the Governor, entitled:

HB 328

"An Act amending the oil and gas reserves ad valorem tax; and providing for an effective date."

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

" March 9, 1977

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

Dear Mr. Speaker:

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

Section 1 of this bill proposes that the reserve tax levy be reduced from 20 mills to 12 mills this year with the condition that an additional levy will be made if there is a delay in the start-up of the Trans-Alaska Pipeline.

This amendment is proposed because the state has a budget surplus for FY 1977. This surplus is somewhat illusory, however, since the reserve tax payments may be recouped by oil and gas producers by credits against future severance tax. Accordingly, the adoption of this measure would reduce the surplus for 1977 and also reduce the amount "borrowed" from future revenues.

Section 2 provides for a contingent 1978 assessment at a rate to be determined by that year's legislature.

Sincerely,

Jay S. Hammond
Governor"

AGO 547570

HOUSE BILL NO. 323 by the ...
the Governor, entitled:

"An Act relating to the oil and gas exploration, production, and pipeline and marine transportation property tax; and providing for an effective date."

(introduced, read the first time and referred to the ...ittees on Resources and Finance.

"March 8, 1977

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

Dear Mr. Speaker:

Under the authority of art. III, sec. 18 of the Alaska Constitution, and in accordance with AS 24.30.050(b) and the Uniform Rules of the Alaska State Legislature, I am transmitting a bill relating to the oil and gas exploration, production, and pipeline and marine transportation property tax.

The Department of Revenue has recently completed its study of Alaska's oil and gas tax structure and has made several recommendations. One set of recommendations dealt with the state's 20-mill property tax imposed by AS 43.56. This bill would implement that set of recommendations.

The bill corrects four problem areas in the current property tax: the omission of certain important kinds of oil-and-gas-related properties from the definition of taxable property; present uncertainty about how pipelines should be valued; the static nature of the $1500 per-capita limitation on municipal taxation, and the extent to which municipal property tax payments should be allowed as credits against the state tax. The bill's features are described below:

Section 1 of the bill makes clear that taxes paid to municipalities which exceed the statutory limitations in AS 29.53.045 and 29.53.050 are not creditable against the state tax.

Section 3 of the bill removes the current uncertainty on pipeline valuation by ensuring that pipelines will be valued on the basis of their full and true value with due regard to their economic value. This will eliminate the possibility of pipelines being valued under the depressed valuation method of actual cost depreciated.

Section 4 of the bill defines full and true value of property used in refining or liquefying of gas or oil as replacement cost less depreciation. It also defines the value of taxable marine transportation property.

Section 7 adds new categories of taxable property including oil refineries, gas processing plants and liquefied natural gas facilities. This will mean greater revenues to the state from these important oil and gas properties.

Section 8 and 9 of the bill tie the $1500 per capita municipal limitation to the Anchorage cost-of-living index in order that the limitation would increase over time as inflation raises the cost to municipalities of providing services to its residents.

HB 323 In addition, Sections 2, 4, 5, 6, and 7 are aimed at amending the relevant provisions of AS 43.56 to provide for the taxation of marine transportation property (i.e. tankers) on an apportioned basis determined by the number of days spent on ports loading and unloading gas and unrefined oil divided by the total number of days-spent-in-ports everywhere. Although these provisions raise close and difficult questions of constitutional law regarding the ability of the state and municipalities to impose an ad valorem property tax on such vessels in light of the traditional application of the "home port" doctrine, it is the view of the Department of Law that these vessels have sufficent nexus with the state to bring them within the constitutional parameters of the state's taxing power.

Sincerely,

Jay S. Hammond
Governor"

AGO 547571

TESTIMONY OF MR. RICHARD KILGORE
OF WALTER J. LEVY CONSULTANTS CORP.
FOR THE JOINT SENATE AND HOUSE
RESOURCES COMMITTEE MEETING ON
OIL AND GAS TAXATION - MARCH 21, 1977

CHAIRMAN POLAND - We will bring the meeting of the Senate and House Resources Committee meetings to order. We have with us as our first witness this morning, our consultant from the firm of Walter J. Levy, Mr. Richard Kilgore. We have asked Mr. Kilgore to address us this morning on the net income tax bills and those closely associated thereto. We will break at 10:00 AM, and will resume again this afternoon at 1:30 PM.

For those who are sitting behind me, if you'll raise your hand so that Mr. Farleigh can notify me if you have a question, you will be recognized, and with that I'd like to welcome Mr. Kilgore back to Alaska and let him take over.

RICHARD KILGORE - Thank you Senator Poland. I think it is appropriate since I am the leadoff witness, that I present here this morning what I call an overview of tax legislation.

CHAIRMAN POLAND - Mr. Kilgore, for the record, would you identify yourself.

RICHARD KILGORE - Yes. I'm Richard Kilgore. I'm Director of Research for W. J. Levy, Consultants. I've been with the firm for about fourteen years.

What I'm going to attempt to do here this morning is to provide what we would call an overview. I'm not really going to go into very much detail about the individual pieces of legislation, at least the specific provisions of them, and concentrate more on the approaches, the alternatives, and so on. Most of my remarks will have to do with income taxation, but I also have some remarks on severance taxation if we have enough time; and I'd like to say a little bit in the end about a total tax package - total tax regime in Alaska because the whole thing is obviously more than a sum of these parts if it has to do with the impact of the total program.

I'd like to look at the major areas of taxation and really consider the alternatives presented to you because they are quite diverse, and give you our appreciation, really, of the major pros and cons this time of the major pieces of legislation, of the major approaches and the kinds of pros and cons, advantages and disadvantages which we think you legislators should be looking at and asking questions of witnesses as you go along. We will be available as I say, for specifics later.

As many of you may recall, our firm has been urging upon the legislature, for many years, that it review its corporate income tax, and especially to do this before Prudhoe Bay Production really comes on and you have major questions of taxation there. We have pointed out in the past, and I think it's fairly well known now the problems of apportionment under the present regulation, and I don't really think we have to get into that in detail. We ourselves did our own analysis of how the present system might work for Prudhoe Bay. Taking data submitted by SOHIO, in submission 1 at the request of the legislature, and very roughly what it turned up was that if one applies the present system, that is the three factor apportionment system with sales and property, and payroll, what you turn up in the way of income apportion to Alaska is roughly one quarter of what the producing income and the pipeline income would be. Saying that another way - if the present system were applied to Prudhoe, using as I say, data supplied by SOHIO, what you would get is an effective rate of taxation instead of something like 9.4% an effective rate of taxation, roughly a quarter of that, two to two and a half percent, so there are obviously problems with the present system, and as I say, I won't burden you with too much of that as I think by this time it's fairly well known by everyone.

Now, you at the present time have before you three different bills, basically two different approaches, but three different bills designed basically to deal with this problem of the inappropriateness of the present formula. The first is the bill submitted by the Governor, and this comes out of the work of Professors Zeifman and Ainsworth, and a report done by the Department of Revenue. This is SB 236, and HB 322. We basically feel that this is quite an imaginative and new approach, and involves basically two features: A change in the tax base, and a modification of the apportionment formula. I'll come back to that. Second, we have a bill on separate accounting introduced by the subcommittee on leasing and taxation, and third we have the net proceeds bill introduced again this year which reads to similar, and I guess even identical, to the net proceeds tax of last year. So we have three bills basically, I'm going to say, on two approaches, and lets look at some of the pros and cons of these. I should say at the outset that like many things in the field of taxation, no one approaches his ideal here, there's no magic answer to this that's going to come out, and one approach is not just going to stand out that is uniquely better than any other one. It's just not the case. So there's clearly room for debate, and for your careful look at these approaches. So first lets look at this Governor's bill coming out of the Zeifman and Ainsworth work.

Basically, as you see, there are two features to this legislation. One is a change in the tax base, and the second is a change, as I say, in the apportionment factors themselves. The present system as you probably know, uses federal taxable income. That's its base, and takes a portion of that federal taxable income. This new proposal involves a switch to book net income before income taxes as reported by oil companies to their stockholders. Now, there are certain clearcut advantages or pros for the State in this switch in tax base from taxable income to book net profits. First of all, figures are readily available from annual reports. This concept of income is reported by most companies or at least most of the major companies that will be operating as oil producers in Alaska. Second, as you will hear, I'm sure, from Professor Zeifman and from the Revenue Department, there are fewer so called erosions than in federal taxable income, that is under federal taxable income rules there are various kinds of generous accounting rules allowed to companies which works to reduce the amount of income on which they pay taxes, and you're fairly familiar with this too, I'm sure. Such things as intangible drilling expenses are under federal tax law, can be treated as expense items, not as capital items, and this involves large write-offs. The federal government allows accelerated depreciation and so on, and companies in their book accounting

rarely, if ever, expense intangibles or use accelerated. They use normal kinds of depreciation under normal accounting rules. So very clearly switching in this direction results in a higher tax base than federal taxable income, and this obviously throws up more income to the State of Alaska. But switching from taxable income to debt book income does have problems. It is not without problems. I'll just enumerate a few of these. Later we can talk about these in more detail. Even within acceptable accounting principals there's a certain flexability, obviously, to companies in respect to how they report income, the kind of deduction and so on. Inventory gains and losses are often treated differently by companies, and they have some choice in this. Currency changes, how they are affected by currency changes, gains and losses, they are often treated differently by companies. Incidentally, some of these factors which resulted in different kinds of accounting don't always even show up in company annual reports. If they're not material, they may not even be stated within a company annual report. One would probably have to go beyond that, if one wanted to see the effect of these factors. There is also a certain amount of flexibility in accounting for write-offs. When does one realize a loss, if one has some sort of venture that is going bad, at what point do you write the thing off as a total loss? There is a certain amount of flexibility in this. Companies at times will use what is sometimes

called the "blood bath" approach to accounting. When things really go wrong, and you have a lot of losses, there is a tendency to just write it all off in one year, and take all the bad at one time. Of course, the company doing this, it would effect the tax base that Alaska would be looking to in this approach. But, I don't think any of these while they present problems in switching to book income are probably disabling. Revisions could also be a problem. Companies at times change accounting procedures, and will then revise their book income and various parts of this back through time, and this would cause problems also if one does this, if there's a later revision, do you then change your tax base, and so on. So this presents problems. I think perhaps, a more serious problem in going to pre-tax book income has to do with how one arrives at that. Now, normally pre-tax income, if you went to a company annual report, what you would do was take net income after taxes and add back all income tax payments, and that's apparently what is proposed here in this piece of legislation. That would include all income taxes including income taxes paid to foreign governments. This looks to us like it could really present problems, and it raises questions about what sort of a tax base you are really reaching when you look at pre-tax book net income. If you'll take the annual report of a company like EXXON which is going to be an operator in Prudhoe Bay, is going to be a producer there, also a company that has very large foreign operations and pays very large

foreign income taxes, it is very interesting to see what has happened in the past to those foreign income taxes, and then I would like to talk about what may happen in the future to foreign income taxes and how this might effect the tax base that you'd be using if you should go to net book income under your appropriate income tax.

If you look at the annual report of EXXON or any other oil company operating in the foreign field, what you will find is that over the past few years, and particularly the years '73 and '74, there was a very sharp buildup in foreign income tax payments. That is tax payments to foreign producing governments such as the Saudi-Aribs in Iran, and so on, and the result of this huge increase in foreign income tax payments this bid build up, as you all know, had to do with the increase in OPEC prices. OPEC dictated very substantially higher prices. These higher prices were obviously not intended to benefit the companies, but to benefit the producing governments themselves, and so what the producing governments did was take a large part of this income generated by the very much higher prices and tax it away from the oil companies in the term of income taxes. Some of it they called royalty, some of it they called income tax, but there was a very large income tax component to this, and this resulted in very large increases in foreign income tax payments

by oil companies. And, if Alaska had been on this system which involves using book income, what would have happened over these years is that Alaska would have benefited from a huge increase in pre-tax income from a company such as EXXON, and this would have resulted in large part not after tax profits EXXON earned, but because of its income tax payments to foreign government. So Alaska, over this period, would have benefited from a very short run up in pre-tax income because of income tax payments by oil companies to foreign governments. It would have worked to the benefit of Alaska, had Alaska been on this system. But now, if we look ahead, we find the concession terms are changing in the middle east and elsewhere, and almost all foreign areas. Foreign governments have increasingly taken control of producing operations themselves. When the companies remain, they remain as producers and operators, but they serve in increasingly different roles. They serve as contractors, not as concessionaires, and under this new type of system, payments to the producing governments tend not to be in the form of income tax, they tend to be in terms of purchase of oil, purchase at market prices with the companies being compensated in terms of service fees for their continuing operations in these countries. So what is beginning to happen is these huge payments to foreign producing governments are increasingly not called income tax payments, they are called purchases,

purchases of oil from the Saudi Arabian State Oil Company for example, and already if you look at the annual report of a company like EXXON, you will see that we have a decline already in 1975, and I guess when the 1976 annual report of EXXON is out, you will find another decline in foreign income tax payments, so what had happened in foreign oil markets would have worked to the benefit of Alaska over the past few years, but now would be working in the other direction. That is EXXON may have a relatively constant after tax profit on its foreign producing operations in countries such as Saudi Arabia, but its pre-tax will be going down. Why? Because it won't be making income tax payments to the Saudi's or other foreign governments. It will be purchasing oil and this would effect the pre-tax profit. So you could have a declining base from this kind of thing.

Now, I dwelled at some length on this because it's interesting. What it demonstrates is that when you use this approach, you do have some problems, and you have things happening outside Alaska which effects the tax base that you are going to reach an apportion part of, but it's very much affected by the things that have nothing to do with profitability in Alaska. And this, I think, the foreign income tax things, are a good illustration, and they are an important one,

and that's why I spent some time with this. So under this kind of system you would have things effecting net book income that really have very little to do with Alaska, and this is something of a problem, and one doesn't know for the future how these various kinds of changes would effect it, and what I'm talking in foreign income taxes probably will work to the disadvantage of Alaska. Other things that we may know nothing about could work the other way. So moving to book income as a concept had truly some advantages. You'll have obviously a higher income that you are trying to take a part of, but it's not without problems. We can discuss those more at some later point. The second part of this approach has to do with a change in the apportionment formula. What has been suggested here in the legislation is changing from sales to extraction, and there are some very clear advantages to Alaska in this obviously. The extraction isn't oriented measured and is production measured in Alaska, and is obviously more appropriate than a measure such as sales where a large part of sales of crude oil in Alaska are not made within Alaska, but they are made without Alaska. So this kind of a move will clearly apportion more income to Alaska, and is certainly a step in the direction of higher appropriate income tax receipts for the State of Alaska. Now here again, although this step obviously works in the direction of favoring Alaska and higher income tax payments to the State,

there are technical problems as well that you should be aware of, and especially in foreign areas. Net production of companies is not always so easy to define, and net production as set out in the annual reports of the oil companies may not quite match Alaska's definition. The legislation before you does define net income in certain specified ways. The production figures that you get from the companies may not always match, and there may be problems of meeting your definitions, especially in foreign areas such as Indonesia, for example, where companies work under contracts. The concept of net production is not the same as the simple system where one has the simple royalty that one takes off, and it may be difficult to define what really is net production. What is production of a company? What is purchased oil? So that moving in this direction has some benefits for the State, but it obviously is not without problems.

In general, we feel that this approach, this one and rather novel new approach for the State has certain advantages. I sum these up by saying it will clearly increase Alaskan tax revenues. It works better in a sense, and why it does is quite obvious. Book income is higher than taxable income. Extraction is a better measure than sales, so you throw up more income to Alaska. If you throw up more income it

obviously means you are moving closer, hopefully, to getting something like 9.4% of what will be the producing income in Alaska. And although the administration end of it is not quite so simple as it looks, initially, and for some of the reasons that I've set out here, it obviously has some administrative advantages over other approaches. It is somewhat simpler, and this is certainly an advantage in this approach. Now the real basic disadvantage that we feel to this whole approach is that while it would get higher income apportioned in Alaska, one doesn't really know out of this system, how close one would get to true profitability. That is, how much income in Alaska and how close that is to what seems to be extensively profitability in Alaska. This is very difficult to know, very difficult to know how close it is. In total and company by company, it's difficult to know how the thing will actually work.

We ourselves tried a very simple approach to try to see how close it would come, and what we did, and anyone can do this, if one takes the annual reports to say, the three major companies that will be producing on Prudhoe Bay, ARCO, EXXON, and SOHIO, takes the latest data available for them, and that's the 1975 annual reports of these companies, (the 1976 one is not out), and then simply adds to that data for Prudhoe Bay, profitability, production, and so forth for Prudhoe Bay, and rather than make our own estimates

for that, again we turn to the data submitted by SOHIO, in SOHIO submission 1, so what we attempted to do was simply combine the data for Prudhoe Bay/Alyeska as contained in SOHIO submission 1, with the company's latest annual report data, and then attempted to see how this new approach would work that is using as our tax base pre-tax book inco and then using a property factor, payroll factor and an extraction factor, and this is a very rough approximation obviously, but what happens when one does that, you find out that this apportionment formula does not apportion all the income that is assumed for Prudhoe Bay and Alyeska. It does not apportion it all, and more interesting than that, what you get is if you look at the three companies, just to see how three companies of this type would fare under this system, you get quite different results for the different companies. That is, some companies, at least one of the companies, you would get a fairly high porportion of the income earned in Alaska by this approach. From another company, you would get quite low percentage of it, so that one could, at least this little illustration suggests, that one could have companies with exactly similar operations in Alaska such as for example ARCO and EXXON, and get very different tax liabilities for the two companies, and we think this looks to be a potential disadvantage. You say this is only an illustration and one doesn't know what would be thrown out of this approach, but it does suggest