573 SRES HB 322

HB
322

COMMITTEE REPORT

SENATE

**Finance

5/14/77

5/18/77 Date

Mr. President:

The Committee on RESOURCES has had CSHB 322
establishing an oil and gas corporate franchise tax
under consideration. A majority of the members of the Committee

- ☐ recommends it do pass
- ☐ recommends it do not pass
- ☐ recommends it do pass with attached amendment(s)
- ☒ recommends it be replaced with CS for CSHB 322 and that CS for CSHB 322 do pass Industrial Rec
- ☐ (and) recommends it be referred to the _____ committee
- ☐ reports it back without recommendation
- ☐ AND attaches a report of its intent
- ☐ (other) _____

MEMBERS SIGNING THE MAJORITY REPORT:

[illegible]	Ind Rec	
[illegible]	Ind Rec	
[illegible]	Ind Rec	

MEMBERS NOT CONCURRING IN THE MAJORITY REPORT:

_____ recommends: _____

_____ recommends: _____

_____ recommends: _____

K. Patman
Chairman

AGO 547898

S 60

COMMITTEE REPORT

SENATE

1/20/78

FURTHER: _____

_____

Date: 6/4/78

Mr. President:

The Committee on RESOURCES has had CSHB 322 establishing an oil and gas corporate franchise tax

under consideration and (a majority of the committee) (the committee reports it back as follows)

( ) recommends it do pass ( ) recommends it do not pass

( ) recommends it do pass with attached amendment(s)

( ) recommends it be replaced with CS for _____

and _____ ( ) new title ( ) same title

( ) AND attaches a Letter of Intent ( ) New Fiscal Note

( ) reports it back without recommendation

( ) and recommends it be referred to the _____ Committee

MEMBERS SIGNING DO PASS:

OTHER RECOMMENDATIONS:

_____

Chairman

AGO 547899

S 60 (rev. 6/77)

EFFECTS OF PROPOSED CHANGES IN ALASKA'S CORPORATE INCOME TAX LAW

Summaries of Three Studies Conducted
by Multistate Tax Authorities
for the Alaska Oil & Gas Association

This report summarizes three studies conducted for the Alaska Oil & Gas Association by recognized authorities on taxation of multistate corporations. The studies were commissioned to obtain expert opinion concerning the fairness and effectiveness of the current Alaska corporate income tax law as applied to the oil and gas industry. Limited copies of the complete studies are available from the Alaska Oil & Gas Association, Suite 219, 505 West Northern Lights Blvd., Anchorage, Alaska 99503.

AGO 547987

KUST STUDY

SUMMARY

INCOME TAXATION OF MULTISTATE CORPORATIONS ENGAGED IN OIL AND GAS PRODUCTION AND TRANSPORTATION IN ALASKA

By Leonard E. Kust,
Senior Tax Partner
Cadwalader, Wickersham & Taft
New York, New York

AGO 547989

I. PRINCIPLES OF TAX JURISPRUDENCE

Where the activities of a business extend over two or more states, all of the income from such business cannot reasonably be taxed by each of the states. The whole development of the law regarding state taxation of multistate business income rests on this manifest and undisputed principle. Similarly, international tax jurisprudence and tax treaties are grounded on this basic principle with respect to national taxation of multinational business income.

Under the Constitution and with our federal system, this principle has been implemented by Supreme Court decisions under the commerce and due process clauses and through the voluntary and mutually compatible actions of state legislatures and tax administrators.

The effort has been to avoid multiple taxation of the income of a multistate business through the taxing by each state in which the business has activities of only a portion of the income, determined by some reasonable method of apportionment. The system which has developed has two basic elements: (i) a tax base measured by a company's worldwide income determined by Federal taxable income and (ii) a method of dividing this base through use of an apportionment formula.

The Massachusetts, or three-factor, formula apportions the income of a multistate business to the taxing state on the basis of the average of three fractions: (1) property within the state over total property, (2) payroll within the state over total payroll, and (3) sales within the state over total sales.

It was recognized at the outset that multiple taxation of multistate business income arises not merely from failure to apportion reasonably but from disparity in methods of apportionment as well, even though each method by itself and applied universally might be reasonable. The National Tax Association began advocating uniformity in the method of apportionment as early as 1919. Ultimately, these and other efforts culminated in the Uniform Division of Income for Tax Purposes Act (UDITPA) adopted by the National Commissioners on Uniform State Laws in 1957. UDITPA incorporated the three-factor formula and, most notably, defined the numerator of the sales fraction, with respect to which the greatest divergence from uniformity had developed, as being sales having their destination, that is, delivered to customers, in the state.

The Multistate Tax Compact, inaugurated in 1966 to promote uniformity and thereby avert Federal legislation then under consideration to impose uniformity on the states, incorporates UDITPA.

AGD 547991

Out of a total of 44 states and the District of Columbia which impose a corporate net income tax, 40 provide for the three-factor formula, 25 by adoption of UDITPA or the Multistate Tax Compact and 15 by incorporation in their own tax statutes, four of the latter giving greater weight to the sales factor than to the property and payroll factors. Differences in the economies of the states as to whether primarily industrial, or commercial, or agricultural or extractive have not affected the general acceptance of the three-factor formula as essentially fair and reasonable.

II. ALASKA INCOME TAX--PRESENT STRUCTURE AND APPLICATION TO THE OIL AND GAS PRODUCTION AND TRANSPORTATION INDUSTRIES

Alaska has adopted both UDITPA and the Multistate Tax Compact and determines taxable income by reference to the Federal tax base. No distinction is made between the oil and gas industry and other industries engaged in the production and sale of tangible personal property. Since this is essentially the same treatment which is accorded to the oil and gas industry by all of the states imposing a corporate income tax, Alaska suffers no disadvantage in comparison with other states. Accordingly, there does not appear to be justification for change and departure from uniformity. The burden of proof should rest on those who advocate departure.

III. THE ZEIFMAN-AINSWORTH REPORT

The Zeifman-Ainsworth Report contends that Alaska's tax base has been eroded through Federal tax subsidies and incentives which are unrelated to the definition of net income but which are provided solely to accomplish certain economic and social goals, and that the UDITPA apportionment formula reduces the amount of taxable income attributable to Alaska by corporations which export non-renewable petroleum resources from the state.

Zeifman and Ainsworth's recommendations which have been endorsed by the Department of Revenue and incorporated in H.B. 322 are:

1. Adoption of a tax base measured by the greater of book income or Federal taxable income.
2. Replacement of the destination-oriented sales factor with an "extraction factor" — the ratio of oil and gas energy units produced in Alaska to total oil and gas energy units produced everywhere.

These changes would apply only to corporations with ordinary gross receipts in excess of $250,000,000 more than 50% of which is derived from production, transportation,

AGO 547993

refining, manufacturing, processing, distribution or retail sale of oil or gas or products derived from oil and gas.

The "tax subsidies" cited by Zeifman and Ainsworth are for the most part available to all corporations. It is unfair and perhaps unconstitutional to single out the oil industry.

Furthermore, with respect to the one Federal "tax subsidy" allowed to the oil and gas industries, a current deduction for intangible drilling costs, Alaska does not, as Zeifman and Ainsworth claim, provide an incentive to drill wells outside Alaska. Federal taxable income reflects not only deductions for the cost of wells drilled throughout the world but also the income from such wells. It is not a one-way street. Alaska is no more providing an incentive for drilling outside Alaska than other states are providing an incentive for drilling in Alaska. Denial of this current deduction in Alaska, however, could reduce the incentive to drill wells in Alaska.

Congressman Vanik's computations of "effective taxable income" do not support the view that the adoption of the Federal tax base by Alaska automatically causes Alaska's "effective tax rate" to be less than 9.4%, by something comparable to the difference between the statutory 48% rate and the Vanik "effective U.S. tax rate on

worldwide income." Congressman Vanik's approach of measuring Federal income tax due as a percentage of worldwide income is patently incorrect because the United States, recognizing the principles of international tax jurisprudence, provides a credit against its tax on worldwide income for taxes paid to other countries. Alaska does not provide a credit but imposes its tax rate of 9.4% on a corporation's worldwide income apportioned to Alaska. Obviously after apportionment (or after the foreign tax credit at the Federal level) the amount of Alaskan tax as a percentage of worldwide income will be less than 9.4% (or the Federal tax will be less than 48%).

Book income is an inappropriate tax base. It will greatly increase the administrative and audit costs and burdens of both the oil companies and the Department of Revenue. Furthermore, book income not only reflects taxable income before tax subsidies but also many timing differences unrelated to Congressional tax policies. Use of the higher of Federal taxable income or book income as a tax base would tax income twice to the extent of such timing differences.

The UDITPA apportionment formula provides for fair and equitable division of income of oil and gas corporations between Alaska and the rest of the world and fairly reflects the extent of their activity in Alaska as compared to the rest of the world. The destination sales factor properly

gives recognition to the contribution of the market states to the creation of income. Without the demand and purchasing power of the market states, the value of Alaska's oil and gas would be less and the income tax base of oil and gas companies would be smaller. The extraction factor ignores the contribution of the market state and creates multiple taxation, since nearly every other state uses a destination oriented sales factor.

The extraction factor has been proposed not to make Alaska's apportionment formula "fairer" in terms of reasonable sharing of the income tax base with other states, but to generate more tax revenue. Apportionment formulas are not intended to be vehicles to generate tax revenue but to divide income among the states fairly and uniformly so as to avoid multiple taxation.

IV. SEPARATE ACCOUNTING--S.B. 105

The declared purpose of the "net proceeds" tax is to tax production and pipeline transportation income in Alaska by means of a statutory separate accounting, while retaining formula apportionment (as modified) to apportion all other income.

Conceptually, separate accounting constructs an income or loss statement for the activities of the business in the state as if they constituted an independent business

dealing at arm's-length with the remainder of the business and the outside world. In practice separate accounting is impossible to administer and determine. Separate accounting requires that hypothetical prices be established for goods and services between affiliated companies. Separate accounting must effectively cope with efforts of companies to shift income among divisions, affiliates and states and must devise some reasonable way to attribute overhead expenses to the various business locations and activities of the taxpayer, no doubt by means of an apportionment formula, thereby abandoning to that extent its initial purpose of avoiding the apportionment formula. Furthermore, separate accounting requires maintenance of records needed in the effort to determine geographic income--records which serve no other business function.

S.B. 105 handles the problem of allocating overhead expenses by simply denying a deduction for such costs. Pricing difficulties are "solved" by using as gross income the value of oil and gas produced as determined for purposes of the production tax.

Thus, the proposed net proceeds tax would not by definition apply separate accounting even though it purports to do so.

The proposed net proceeds tax has major infirmities. It purports to be an application of separate accounting but it is not. It represents a sharp deviation

from uniformity and as such would constitute a major disruption of the common consensus underlying the system of state taxation of interstate business income. Separate accounting applied by one state to a whole industry in order to increase its share of the total income over that resulting from the three-factor formula necessarily results in multiple taxation because income which is fully taxed by one state is also apportioned by formula to other states.

V. THE MULTISTATE TAX COMPACT

Alaska's continuing membership in the Multistate Tax Compact and the administrative benefits derived from such membership may not be tenable if either the Zeifman-Ainsworth proposals or S.B. 105 were adopted. The courts may find such proposals to be in conflict with the Compact and as a result may further hold that Alaska has in effect withdrawn from the Compact or that the Compact remains in effect but enactment of the proposals is ineffective to prevent taxpayers from applying the UDITPA formula under the provisions of the Compact.

VI. UNIFORMITY, COMITY AND ENLIGHTENED SELF-INTEREST

Great progress has been made in recent years in adopting uniform allocation methods. Part of the drive for voluntary uniformity has obviously been the desire of both

states and taxpayers to avoid Federal intervention. As long as states strive toward uniformity as a goal of fair taxation, Congress will be hesitant to act. If the drive for uniformity falters through independent action by states asserting their currently perceived self-interest without restraint, Congress will be constrained to exercise its constitutional responsibility to protect interstate commerce by prescribing a Federal standard of uniformity.

Alaska has been in the forefront of the drive for uniformity. By the collective judgment reflected in the development and general acceptance of the three-factor formula, Alaska's net income tax fairly and effectively reaches its proportionate share of the income of multinational oil and gas corporations doing business within the state. The proposed changes would be destructive of community and comity among the states in dealing reasonably with state taxation of multistate business and are parochially designed to increase tax revenues without regard to the general principles of tax jurisprudence for division of interstate business income adhered to by other states.

LEONARD E. KUST

Biographical Information

LEONARD E. KUST is a partner in the New York Law firm of Cadwalader, Wickersham & Taft. He was formerly Vice President and General Tax Counsel of Westinghouse Electric Corporation with which he was associated from 1955 to 1970.

A native of Wisconsin, Mr. Kust is a graduate of the University of Wisconsin and the Harvard Law School. He is a member of the New York and Pennsylvania bars.

He is a past president of the Tax Institute of America, and of the Tax Executives Institute. Mr. Kust has served as Chairman of Governor Scranton's Committee on Tax Administration, Chairman of Task Forces for Governor Shafer's Tax Study and Revision Commission, and was a member of the Advisory Committee of the Commissioner of Internal Revenue. He has served on the Executive Committee of the National Tax Association, as a Director of the Chamber of Commerce of the United States, and as a member of the Taxation Committee. He is a member of the Tax Section of the American Bar Association, a member of the Council of the U.S.A. Branch of the International Fiscal Association, a member of the Advisory Board of the Tax Management, and a member of the Advisory Board of the Tax Foundation.

AGO 548000

Mr. Kust has written on a wide variety of tax issues, including "State Taxation of Income from Interstate Commerce: New Dimensions of an Old Problem," S.W. L.J. 1 (1960); "State Taxation of Interstate Sales," 46 Va. L. Rev. 1290 (1960); "Federal Tax Reform," the Tax Executive, Vol. XIV, April, 1962; "Standards of Conduct for Tax Executives," the Tax Executive, Vol. XIV, July 1962; "A Reappraisal of Taxation of International Business Income," National Tax Association Proceedings, Annual Conference, 1966, p.154; "Alternatives for New Federal Revenues," Tax Review, Tax Foundation, Vol. XXXIV, No. 7, July, 1973.

SUMMARY

POSITION PAPER ON ALASKA OIL AND GAS TAXATION

By John S. Warren
Partner
Loeb and Loeb
Los Angeles, California

AGO 548002

WARREN STUDY

EXECUTIVE SUMMARY OF POSITION PAPER ON ALASKA OIL AND GAS TAXATION

By John S. Warren

Alaska's existing corporation income tax meets all of the generally recognized criteria of a modern and efficient state corporation income tax. It is simple and inexpensive to comply with and enforce, it provides equality among taxpayers, and it contains rules for the allocation of income that provide the best possible assurance against overtaxation or undertaxation of multi-state businesses. The several bills which the Legislature has had under consideration (H.B. 145 and 322, S.B. 105 and 202) are all changes for the worse as far as meeting these criteria is concerned.

If the Alaska tax base for oil companies were to become the greater of book income or federal taxable income (H.B. 322), the Department of Revenue auditors could no longer rely on federal audits. Rather, they would have to verify two sets of figures for each company. Because the financial accounting rules for determination of book income allow some leeway, the Department would have to adopt regulations to prevent manipulation of book income for tax avoidance purposes and to assure equality

among taxpayers. Furthermore, because income or expenses are often reportable in different years under federal income tax rules than they are under financial accounting rules, intricate adjustments would be necessary to avoid including the same item in the tax base for two years.

The changing o' the formula for apportionment of income by substituting an origin sales factor ("extraction factor") for the destination sales factor used by most states (H.B. 322) will force Alaska to withdraw from the Multistate Tax Compact and will deprive the state of the benefits of the joint audit program of the Multistate Tax Commission. More importantly, the use of the extraction factor cannot be justified under the generally accepted principles for apportionment of the income of a unitary business.

Determining Alaska tax liabilities on the basis of separate accounting (H.B. 145, S.B. 105, and H.B. 322 as amended in the Senate) is an even more drastic departure from generally accepted principles of proper state tax policy. It would force Alaska out of the Multistate Tax Compact, would create horrendous audit problems for the Department of Revenue, and might even result in a net revenue loss to the state.

The analytical approaches of the Department of Revenue and the several consultants who have been advising the Legislature leave much to be desired. They have created the impression that Alaska does not get as much tax revenue from the oil companies as it should because the present tax structure does not attribute to Alaska the net income actually earned in Alaska. They then attempt to persuade the state to turn its back on all of the principles of state taxation and multistate business that have been hammered out over the last century - principles that have been widely endorsed by the courts, by tax administrators of other states, and by tax scholars - and to adopt instead one of several new proposals. They have no difficulty in showing that these proposals would increase Alaska's tax collections, but they fail completely to show that they will come any closer to the ideal of taxing the "net income actually earned in Alaska," no more and no less. Alaska would be ill advised to warp its tax structure away from the tried and true principles simply to collect more taxes from one type of business.

JOHN S. WARREN

Biographical information

Education:

Bachelor of Science in Law, University of Minnesota - 1943

Bachelor of Laws, University of California, Hastings College of Law - 1950

Professional:

Loeb and Loeb, Los Angeles, California - 1957 to present (partner 1960 to present)

Government Positions:

Associate Tax Counsel, California Franchise Tax Board - 1951-1957

Consultant, California Department of Finance - 1962

Consultant, California Legislature, Senate Fact Finding Committee on Revenue and Taxation - 1964

Memberships:

State Bar of California

Committee on Taxation (1958-1962)
Committee on Property Sales and Local Taxes (1975-)
Chairman, Subcommittee on Occasional Sales (1976-)

Los Angeles County Bar Association, Tax Section:

Committee on Federal and California Death and Gift Taxes

American Bar Association, Section of Taxation, Committee on State and Local Taxes:

Subcommittee on Non-Federal Solutions to Interstate Tax Problems (1974)
Subcommittee on Important Developments (1975)
Vice Chairman, Subcommittee on Corporation Net Income Taxes (1976)

Articles:

"Sales of Depreciated Properties to Related Entities," 1959 Southern California Tax Institute

"The Unitary Concept in the Allocation of Income," 12 Hastings Law Journal 42 (with Frank M. Keesling"

"Selected Problems in California Corporation Taxes,"
1962 Southern California Tax Institute 939

"Income Taxation of Testamentary Trusts,"
23 Journal of Taxation 278

"California Franchise Tax Allocation of Income of Unitary Business,"
1966 Southern California Tax Institute 529

'California's Uniform Division of Income for Tax Purposes Act,"
15 U.C.L.A. Law Review 156 (with Frank M. Keesling)

"Reform Act Changes in Pension and Profit Sharing Plans,"
1971 Southern California Tax Institute 137

Lecturer:

"Tax Problems of Closely Held Corporations and Their Shareholders"
California Continuing Education of the Bar, 1974

"Advising on California Taxes"
California Continuing Education of the Bar, 1975

"California State and Local Tax Rules Pertaining to the Entertainment Industry"
California CPA Foundation, 1974

Teacher:

Adjunct Professor of Law in State and Local Taxes,
Loyola University, School of Law
commencing January 1977.

BOREN
STUDY

SUMMARY

THE EFFECTS OF HOUSE BILL 322 and SENATE COMMITTEE SUBSTITUTE FOR HOUSE BILL 322 ON UNIFORMITY AND EQUITY

By Gary I. Boren
Professor of Law
Washington University
St. Louis, Missouri

AGO 548010

I.

The removal from Alaska of its oil and gas is compensated for through payments by oil and gas producers of the Oil and Gas Properties Production Tax. That tax has recently been reviewed and amended by the Legislature to ensure that a proper price is being paid for the removal of these resources. Consideration of the treatment of taxpayers under the corporate income tax therefore should be considered independently of concern about proper compensation to the state for the withdrawal of its natural resources.

II.

Alaska, as most states, uses the federal definition of taxable income under the corporate and personal income taxes. Concern has been expressed that erosion of federal taxable income has resulted in an inappropriately small tax base for oil and gas producers under the Alaska corporate income tax. Examination of the items considered as eroding the federal base indicates that oil and gas producers do not receive a disproportionate benefit. To single out oil and gas producers for the withdrawal of all deductions deemed erosions (whether or not peculiar to the oil and gas industry) means that the oil and gas industry in Alaska will bear an excess burden, shifted to them from other taxpayers who continue to be able to receive those deductions.

A study by Congressman Vanik investigating the tax burden of major corporations under the federal income tax has been

AGO 548011

advanced as demonstrating that oil and gas producers are paying a disproportionately low effective rate on their income to Alaska in comparison to the rates paid by local taxpayers. The Vanik study, however, demonstrates primarily that the foreign tax credit has been used to reduce the amount of taxes paid the U.S. Alaska does not permit the foreign tax credit, nor does it grant a deduction for taxes paid on income to any government. The result therefore is that oil and gas producers, and other multinationals, would be paying a higher proportionate effective rate to Alaska than to the federal government. The Vanik study therefore is an argument against the very proposal that it has been used to advance.

Reform of the Corporate Income Tax by the Alaska legislature to be fair must be reform for all taxpayers.

III.

A state may tax only the portion of the income of a corporation to which it has a sufficient connection. The manner of determining how much a state may tax used by almost all states is formulary apportionment. Taxable income for state purposes is determined by multiplying taxable income by a formula of three fractions, called factors. The factors represent the proportions respectively of property, payroll and sales occurring in the taxing state to the total amount of property, payroll and sales occurring everywhere. The three fractions are then divided by

three to obtain an average proportion of activities occurring within the taxing state to activities everywhere. The largest number of states, including Alaska, have adopted a model law called the Uniform Division of Income for Tax Purposes Act to determine the income they may tax.

If states do not apply the same or similar methods for division of income it is possible, even likely, that taxpayers will be subjected to tax on more or less than their total income. Nonuniformity also causes taxpayers difficulties in complying with the laws of numerous states. Federal legislation has been proposed to require a uniform formula by Act of Congress. Progress toward uniformity by the states has been at least one reason why no federal solution has as yet been imposed.

No special uniform apportionment formulas have evolved for oil and gas producers. The normal manner of division of income has been considered appropriate to them. The use of a special formula by one state to increase the income taxable by that State must therefore necessarily result in overtaxation.

IV.

House Bill 322, which has been passed by the House of Representatives would impose a special formula on oil and gas producers in Alaska. The standard sales factor would be eliminated and an extraction factor substituted for it. The sales factor is justified because sales are requisites to income and because a state

may exact a tax for maintaining an orderly market and protecting the sales activities of a taxpayer and the customers who purchase goods from the taxpayer. The states have resisted elimination of the sales factor in a federally proposed formula. Alaska, a market state, benefits usually from the existence of the sales factor. Elimination of sales for oil and gas producers is supported by no plausable justification.

The proposed extraction factor has no comparison in the apportionment formulas of other states applied to oil and gas producers. Had the extraction factor been substituted for sales in the year 1975 the result would have been subjecting $53,000,000 of the income of a limited number of oil and gas producers to double taxation.

The proposed extraction factor has a diminishing connection with activities of taxpayers not involving the processing and sales of petroleum products. Questions of constitutionality are raised for all, and for diversified taxpayers two formulas would seem clearly required. This creates the problems of separate accounting, discussed elsewhere in the paper. The extraction factor would also require maintenance of extensive records not used for business purposes. They would be expensive to maintain and difficult to audit.

House Bill 322 also attempts to include in the numerators of the apportionment formula (which increase the amount of income

taxable by Alaska) items connected to the Outer Continental Shelf. Congress has declared that state tax laws should not apply to the Outer Continental Shelf. California which has considered the action contemplated by House Bill 322 has determined that it is not permissible.

V.

A method of dividing income known as "separate accounting" has from time to time been forwarded for use by Alaska. The doctrine is an attempt to identify income with geographic areas. It is the theoretical opposite of the use of a formula. Formulary apportionment has as its basis the inability to segregate items geographically and the belief that total income of a corporation is to be divided among the states. Taxpayers have attempted to avoid formulary apportionment and to use separate accounting by such pleas as disproportionately high costs in a taxing jurisdiction, or by operating through multiple corporations. It has, however, been demonstrated that higher cost in one state may yet produce additional income for the business, and some of that income therefore is attributable to that state. Nor does the use of multiple corporations mean that application of a formula to total group income is improper: the formula determines how much of the total income is attributable to activities of corporations that are connected with the taxing state. Formulary apportionment permits the taxation of worldwide income, separate accounting does not.

Separate accounting is expensive for the taxpayer and the state and requires the constructing of hypothetical transactions, permitting the possibility of taxpayer avoidance. The main flaw of the doctrine is that it ignores the interdependence of different portions of a unitary business, and the values created by that integration of operations. Separate accounting has been rejected by the overwhelming majority of studies and scholars that considered the question in modern times.

Senate CS for CSHB 322 which would impose a "net proceeds tax" bears some resemblance to separate accounting in its use of hypothetical values and treatment of taxpayers as though they were engaged in two separate businesses. It has attempted to avoid the possibility of taxpayer manipulation but in doing so has arbitrarily eliminated deductions connected to the production of income. In separating oil and gas production and pipeline transportation income in Alaska from worldwide operations and denying the deductions mentioned it increases revenue taxed by Alaska on this portion of a taxpayer operation and apportions the balance of income from worldwide operations by a special formula designed also to maximize Alaska revenue. The result must be double taxation, and for oil and gas production in Alaska approaches the taxation of gross receipts at income tax rates.

VI.

Taxes tailored to increased revenues from producers operating in interstate commerce raise serious constitutional questions. The U.S. Supreme Court has recently stated the necessity to examine such tailored taxes closely. Moreover, specialized tax treatment by individual states reduces uniformity and increases the possibility of federal action. Discrimination against oil and gas producers makes it unlikely that those taxpayers would attempt to expand their Alaska operations. The ultimate question for the legislature, however, is whether the bills would result in a tax structure for Alaska that is fair to the taxpayer and the state. The attempt to increase revenue from the one class of taxpayers under the circumstances investigated in this paper indicates that on this basis also the taxes should not be enacted.

GARY I. BOREN

Biographical Information

Education:

Bachelor of Arts, University of California, Los Angeles - 1957

Bachelor of Laws, University of California, Los Angeles - 1961

Member of the Order of the Coif
Note and Comment Editor, U.C.L.A. Law Review

Professional:

Professor of Law and Director of the Graduate Tax Program, Washington University School of Law, St. Louis, Missouri

Assistant Professor - 1967-1971
Associate Professor - 1971-1975
Professor - 1975-Present

Private practice, Los Angeles, California - 1961-1967

Member State Bar of California

Major Publications:

Equitable Apportionment: Administrative Discretion and Uniformity in the Division of Corporate Income for State Tax Purposes
49 So. Cal. L. Rev. 991 (1976)

Specific Allocation of Corporate Income in California: Some Problems in the Uniform Division of Income for Tax Purposes
30 TAX. L. REV. 607 (1975)

Separate Accounting in California and Uniformity in Apportioning Corporate Income
18 U.C.L.A. L. REV. 478 (1971)

Courses Taught:

*State and Local Taxation
*Federal Income Taxation
*Federal and Estate Gift Taxation
*Seminar in Tax Policy and Current Legislation
Seminar in Advanced Tax Research
Natural Resources

*Courses taught currently

STATE OF ALASKA
THE LEGISLATURE
LEGISLATIVE AFFAIRS AGENCY

POUCH Y · STATE CAPITOL
JUNEAU, ALASKA 99811
907·465·3800

May 6, 1978

M E M O R A N D U M

SUBJECT: Corporate Income Tax Legislation - SCSCSHB 322

TO: The Honorable Kay Poland

FROM: Gregg K. Erickson
Director of Research

Enclosed is a memorandum received from the Alaska Public Utilities Commission responding to a much earlier request of mine concerning the fiscal impact on the Commission of the above cited legislation. They indicate that the total cost of carrying out their responsibilities under the bill in FY 79 would be about $33,000.

Under the draft committee substitute proposed by Senator Croft and the Administration, the fiscal impact on the Commission would presumably be zero, since all the auditing and determination responsibilities would be vested in the Department of Revenue. The Department is preparing a fiscal note on the Croft/Administration bill.

GKE:dh
Enclosure

AGO 547863

02-0018 (Rev. 10/76)

STATE
of ALASKA

MEMORANDUM

TO: Pam Knode
Information Officer
Division of Administrative Services

DATE: April 5, 1978

FILE NO:

TELEPHONE NO:

FROM: Carolyn S. Guess CSG
Commissioner
Alaska Public Utilities Commission

SUBJECT: Comments on SCSCSHB 322

Enclosed please find our comments on SCSCSHB 322. We were requested by Gregg Erickson to examine this committee substitute to see if it would change the fiscal impact on the Commission.

As you can tell from the research that Susan Knowles did, it will not change the fiscal impact on this Commission and, therefore, the original fiscal note should remain.

I understand that John Messenger of Revenue is coordinating comments in regard to the committee substitutes. Will you see that he gets a copy of our comments as well as transmitting, as quickly as possible, our comments to Gregg Erickson, noting please that we are responding to his request of over a month ago.

Thanks a lot.

CSG:lin
Enclosure

AGO 547864

The certification procedure prescribed under SCS CSHB 322, like its predecessor HB 145, involves a significant extension of the Commission's responsibilities.

Section 43.20.068(b) defines taxable income primarily in terms of amounts presented on FPC* report forms and requires the APUC to certify that the calculation was made in accordance with FPC "principles" and regulations. Firms which do not normally prepare FPC report forms in the manner envisioned by the proposed legislation would be required to do so for certification purposes. Section 42.05.502 directs the Commission to review the accounts of the carrier and to certify that net pipeline income submitted under proposed AS 43.20.069** is in accordance with APUC regulations. In addition, the net income so defined was intended to coincide as nearly as possible with the definition of income used in establishing rates. Under both sections the Commission is responsible for identifying deficiencies and, if possible, providing a report of the true and correct income.

Having summarized those components of the proposed legislation which it believes have the greatest probable impact, the Commission offers the following comments. First, there is a potential for two different definitions of taxable income arising under the aforementioned sections of the statutes, one based on FPC report forms and one based on APUC regulations. A similar dichotomy may exist between net income for tax purposes and that for rate-making purposes. The Commission believes that it would be in the public interest for the legislature to make the definition uniform in all sections. Second, the thorough knowledge of FPC principles and regulations discussed in the legislation will involve a greater commitment to monitoring the FPC than is currently required. Third, it is apparent that the legislature's intent is for the APUC to more than simply rubber stamp figures provided by gas pipeline companies. In this light, the certification procedure appears to be akin to issuing an independent audit opinion and will require comparable standards of review and expertise. Additionally, the Commission is constrained to issue a certificate of compliance or deficiency within 45 days from receipt of a request of a pipeline carrier.

Given the Commission's workload, satisfactory performance of the certification responsibility will necessitate hiring a staff person with specialized knowledge of tax accounting. The alternative of developing in-house expertise and diverting limited staff resources to certification would dilute effective performance of existing regulatory responsibilities. Therefore, the fiscal note attached to HB 145 applies to SCSCSHB 322.

* It is presumed that the legislature will modify all references to the FPC to the Federal Energy Regulatory Commission (FERC).

** The Commission believes that this is a drafting error and should be AS 43.20.068. The latter will be assumed in further comments.

Second Session - Ninth Legislature
First Tenth

I. REQUEST
Bill No. HB 145
Title: An Act Relating to the Ak to Net Income Tax
Requested by: Date:
Return Date Requested:
Agency: Commerce Program: Public Inspection

II. FISCAL DETAIL
Budget Request Unit(s) Affected:

A. EXPENDITURES: (Thousands of dollars)

	OBJECT	FY 76	FY 77	FY 78	FY 79	FY 80	FY 81
100	PERSONAL SERVICES		0	15.3	30.6		
200	TRAVEL		0				
300	CONTRACTUAL		0	2.1	2.1		
400	COMMODITIES		0	.2	.2		
500	EQUIPMENT		0	.8			
600	LAND & STRUCTURES						
700	GRANTS, CLAIMS, ETC.						
	TOTAL			18.4	32.9		

B. FUNDING: (Thousands of dollars)

GENERAL FUND			18.4	32.9		
FEDERAL FUNDS						
OTHER						

C. POSITIONS:

PERMANENT/TEMPORARY	/	/	1/	1/	/	/
MAN MONTHS (P./T.)	/	/	5/	12/	/	/

III. ANALYSIS (See Fiscal Note Preparation Instructions, Section III)

Passage of this proposed legislation will require the Alaska Public Utilities Commission to employ at least one additional Financial Analyst III who would be responsible for examining the tax returns for intrastate pipelines.

IV. ATTACHMENTS

Detailed expense estimate

V. DATE: PREPARED BY:

Original: Legislative Finance
cc: Budget and Management
Prime Sponsor (First Legislator Named)

AGO 547866

H/S 50

FISCAL NOTE

Re HB 145

1 Tax Accountant (UFA III, Range 18C)	$24408	
Benefits 25 1/2%	6226	$30634
Contractual:		
Office Space	1890	
Telephone	240	2130
Commodities:		
Stationery and Office Supplies	230	230
Equipment:		
Desk	295	
Chair	135	
Calculator	150	
Dictating Machine (Pocket Secretary)	250	830
		$33824

AGO 547867

STATE OF ALASKA
THE LEGISLATURE
LEGISLATIVE AFFAIRS AGENCY

POUCH Y - STATE CAPITOL
JUNEAU, ALASKA 99811
907-465-3800

MEMORANDUM January 26, 1978

SUBJECT: Membership in the Multistate Tax Compact - (Work Order No. 4448)

TO: Gregg K. Erickson
Director
Division of Research Services

FROM: Randolph Berry
Legislative Counsel

The question presented is whether Alaska will be able to retain its membership in the Multistate Tax Compact should CS HB 322 (Oil and Gas Corporate Franchise Tax) or SCS CSHB 322 (Separate Accounting) or a "4th-factor" approach to multistate oil company taxation be adopted.

The stated purposes of the Multistate Tax Compact, contained in Article I of the compact, are as follows:

1. Facilitate proper determination of state and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes.

2. Promote uniformity or compatibility in significant components of tax systems.

3. Facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration.

4. Avoid duplicative taxation.

The primary mechanism by which the compact is designed to achieve a uniform manner of apportionment and allocation of tax liability of multistate business taxpayers between states is through the use of the three-factor formula based on property payroll and sales set out in the Uniform Division of Income for Tax Purposes Act (UDITPA), which is incorporated as Article IV of the compact.

AGO 547868

However, the ability of a taxpayer to utilize apportionment and allocation under the formula of the UDITPA and the compact is not without provision for exception. Section 18 of Article IV of the compact reads as follows:

> 18. If the allocation and apportionment provisions of this Article do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> (a) separate accounting;
>
> (b) the exclusion of any or more of the factors;
>
> (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
>
> (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income. (Emphasis Supplied)

Thus, where the state tax administrator determines that the allocation and apportionment formula of the compact does not fairly represent a taxpayer's business in Alaska, he may employ a different method of allocating the taxpayer's income, rather than allowing the taxpayer to use the compact formula.

In both CSHB 322 and SCS CSHB 322, there is a stated legislative finding to the effect that the three-factor formula contained in the UDITPA does not fully reflect business activity or corporate income-producing activity in the state of multistate corporations engaged in the extraction, transportation and refining of oil and gas.

Although in this situation the determination that the allocation and apportionment provisions of the compact "do not fairly represent the extent of the taxpayer's business in the state" is being made legislatively, and the legislative process is being used as the "state tax administrator" rather than the case-by-case judgment of the Commissioner of Revenue, this should not logically affect the outcome of the question involved.

If the UDIPTA allocation and apportionment formula is determined to not fairly reflect business activity in the state by multistate oil and gas corporations, then the compact by its own terms provides a list of alternate methods of allocating and apportioning income for such taxpayers which would include the three proposed methods as permissible alternatives.

To date, there have not been any Alaskan cases interpreting or defining the scope and limits of Article IV, section 18 of the compact, so it is necessary to look to other jurisdictions for assistance in interpreting the state's authority under the compact to utilize alternate methods of allocating and apportioning income of multistate businesses.

The majority of cases of note in recent years dealing with the question of separate accounting versus statutory allocation under UDITPA have hinged on the issue of whether the business in question was unitary or non-unitary, with the outcome of this issue being presumed to be determinative of the question of whether separate accounting was permissible or required.

The concept of "unitary business" activity is a judicially developed concept utilized by the courts in determining whether, and the extent to which, a business has income which is subject to formula apportionment under the compact, UDITPA, or other state statutes requiring or allowing apportionment of income from multistate business activity. Whereas the language and application of the UDITPA and UDITPA type three-factor formulas has been comparatively uniform once it is determined that a business has multistate business income subject to formulary apportionment, the definitions and tests of what constitutes a "unitary business" subject to formulary apportionment vary substantially from one jurisdiction to the next, producing what appear to be inconsistent results in the applicability of UDITPA. (An extensive discussion of the concept of "unitary business" is not necessary for purposes of this memorandum, but will be covered in a separate memorandum. For purposes of this memorandum, it is sufficient to say that if a particular multistate business activity is not "unitary," then the UDITPA formula is not applicable and we would not reach the question presented in this memorandum.)

In Superior Oil Company v. Franchise Tax Board, 386 P.2d 33 (Cal. 1963) and the companion case Honolulu Oil Corp. v. Franchise Tax Board, 386 P.2d 40 (Cal. 1963) the California Franchise Tax Board was seeking to impose separate accounting on multistate oil companies, arguing in both cases that the companies were not true "integrated" oil companies, and that the comparatively profitable California operations should not be subject to allocation under the statutory formula. In both cases, the California Supreme Court overruled the Board's contention that the companies' operations were not unitary in nature, and concluded that the companies were authorized to use formulary allocation. However, no contention was argued in either case that even if the companies were determined to be unitary, the allocation formula nonetheless did not fairly reflect business activity in the state.

It should be noted in the Superior case that Superior operated in eight other states, showed losses from its operations in six of the eight states and utilized separate accounting in seven of these states, including the six in which it showed losses. Use of formulary apportionment by Superior allowed it to allocate a portion of these losses to income arising from its operations in California.

In contrast, in Webb Resources, Inc. v. McCoy (401 P.2d 879, Kansas 1965) the Kansas Supreme Court determined that Webb's multistate oil business was not subject to statutory apportionment, but rather its Kansas oil production was subject to separate accounting. But this case, like Superior, was decided on the basis of whether the business activity was unitary in nature.

There is, however, a recent Utah case under the UDITPA involving the same language as section 18, and a business activity roughly analogous to oil production, in which the contention was argued and the decision made on the basis of whether the standard three-factor formula fairly represented the taxpayer's business in the state. (Kennecott Copper Corp. v. State Tax Comm., 493 P.2d 632, 1972) Kennecott Copper Corporation and subsidiary corporations owned and operated mining properties in Utah, with virtually the entire production of the mining properties being sold and delivered to purchasers out of state. Under the UDITPA formula, for the tax years 1967 and 1968, Kennecott had property factors of 42.46 and 35.65 per cent and payroll factors of 42.88 and 33.36 per cent, respectively. But the sales factor for 1967 showed sales in the state of $3.3 million on total sales everywhere of $397 million and resulted in an apportionment fraction of 0.83 percent. The 1968 sales apportionment fraction was 0.568 percent. Yet for purposes of computing its depletion allowance for 1967, Kennecott reported gross receipts for sales from its Utah division of $158 million. The Utah tax commission concluded under the same language as contained in Article IV, section 18 of the compact that the UDITPA allocation and apportionment formula did not fairly represent the extent of Kennecott's business activity in Utah, and made its own determination and allocation of income attributable to business activity in the state. In Kennecott Copper Corp. v. State Tax Commission, 493 P.2d 632 (1972) the Utah Supreme Court upheld the tax commission, stating that the commission was authorized under the UDITPA to depart from the formula and adopt another method to make its own allocation if the apportionment provisions of the Uniform Act do not fairly represent the taxpayer's business activity in the state.

Additionally, of note is the case of Texas Co. v. Cooper (07 So 2d 687, La. 1959) which squarely presented the question of whether the statutory three-factor formula fairly allocated to Louisiana income from oil

produced in the state but sold out of state. Although not decided under UDITPA, the formula used by Louisiana contained the same factors, and the issues were the same as would have arisen under UDITPA. The Louisiana statutes place the burden of showing "manifest unfairness" of the statutory three-factor formula on the party seeking to use separate accounting, and in this case the court, after extensive discussion, held that the tax commissioner had met the burden of showing that the sales-oriented three-factor formula did not fairly reflect the extent of income attributable to oil production in Louisiana.

In view of the above discussion, the answer to the question at hand of whether the adoption by Alaska of either CSHB 322 or SCS CSHB 322 or a "4th-factor" approach would jeopardize Alaska's membership in the Multistate Tax Compact appears to be "no". If, as stated in the legislative findings incorporated in each bill, the UDITPA three-factor formula does not fairly reflect the extent of business activity conducted in the state by multistate oil corporations, which is the foundation upon which both of the above bills are predicated, then the adoption of either bill or of a "4th-factor" approach would be entirely consistent of the compact, and could not be viewed as a breach by the state of its agreements under the compact.

RB:jpd

TAX BURDEN COMPARISON

I. Taking the Arthur Anderson Approach, but using a sensitivity analysis to determine the extent to which the relative tax burden ranking is influenced by various assumptions employed such as market price and transportation charges.

II. Expand the scope of the Arthur Anderson approach to include all fields and activities in the state such as Cook Inlet and gas along with potential development of marginal fields such as Kuparik and Lisburne.

III. Develop figures from each state showing gross oil and gas production, wellhead values, total tax payments. Then compute tax payments as a percentage of total wellhead value and as a percentage of per barrel production. Also, if data is available take tax payments as a percentage of net profit per barrel in each state.

Reference: John Messenger

AGO 547873

STATE OF ALASKA
THE LEGISLATURE
LEGISLATIVE AFFAIRS AGENCY

POUCH Y - STATE CAPITOL
JUNEAU, ALASKA 99811
907 465-3800

MEMORANDUM

April 1, 1978

SUBJECT: SCS CSHB 322 and the Multistate Compact

TO: The Honorable Kay Poland

FROM: Gregg K. Erickson
Director of Research

Several weeks ago, Mr. John Warren testified before your committee and suggested that adoption of the Senate committee substitute for HB 322 would jeopardize Alaska's membership in the Multistate Tax Compact. As you requested at that time, an analysis of these assertions has been prepared and is enclosed herewith (memorandum of March 31 from Mr. Berry to me). A January 26 memorandum on the same subject is also enclosed. An even earlier memorandum is available in our files.

All these memoranda indicate fairly clearly that adoption of either the proposed or existing Senate committee substitutes for HB 322 would not jeopardize the state's membership in the multistate compact. The last paragraph of each memorandum contains a fairly concise summary of its findings.

Please let us know if you wish to have these memoranda circulated to other members, or if you believe additional work is needed in this area.

GKE:jm
Attachments

AGO 547874

STATE OF ALASKA
THE LEGISLATURE

POUCH Y - STATE CAPITOL
JUNEAU, ALASKA 99811
907-465-3800

LEGISLATIVE AFFAIRS AGENCY

M E M O R A N D U M

March 31, 1978

SUBJECT: Membership in the Multistate Tax Compact (Work Order No. 4448 - Part II)

TO: Gregg K. Erickson
Director
Division of Research Services

FROM: Randolph Berry RSB
Legislative Counsel

The question continues to be raised as to the effect on Alaska's membership in the multistate compact of the enactment by Alaska of a statute mandating specific accounting and allocation of income methods for corporations engaged in the production of oil and gas in the state.

As this question has been raised and discussed by various legislative and industry consultants with inconsistent or conflicting answers, it is felt that it would be worthwhile to continue and elaborate on my memorandum on that subject, dated April 28, 1976, to Gregg Erickson, with an attempt to clarify the current state of the law and the practice of allocation of income from oil production in other oil producing states.

There are presently nineteen states which have adopted or joined the Multistate Tax Compact (referred to hereinafter simply as the "compact").1/ Of the twelve major oil producing states, 2/ six in addition to Alaska have joined the compact 3/ and five have not.4/ Of these same twelve oil producing states, ten have income taxes on corporate income; 5/ and of these ten, six are members of the compact. 6/ Of the six oil producing states, in only three has there been litigation on the issue of allocation of income from extractive industry under the compact or UDITPA formula versus separate accounting or other modification of the statutory formula. The litigation in two of these states 7/ involved section 18 of Article IV (the "relief provision"), in the third, the litigation turned on the issue of whether or not the business was unitary in nature, 8/ and the "relief provision" was not raised by either side.

Of the four significant oil producing states which do not belong to the compact but do impose an income tax on corporations with statutory allocation formulas, 9/ one now has a statute which specifically provides that "the income from oil production shall be allocated according to the location of the producing property." 10/ In a second, the court has upheld the requirement of separate accounting for oil production on the ground that the statutory three-factor formula is manifestly unfair to the state. 11/ In the other two, no cases involving departure from the statutory formula was found. Thus it can be seen that there is currently a wide disparity of allocation provision and practice even in the twelve states with the most significant oil production.

In considering whether separate accounting is permitted to be used or may be imposed by a compact state on a business taxpayer involved in business activity in more than one state, it should be borne in mind that the determination may occur in two stages; and either stage may result in a decision that separate accounting is permissible (or conversely that the party requesting separate accounting has not made the necessary showing).

The first stage turns on the question of whether the business activity in the particular state is separate in nature from the taxpayer's business activity in other states, or whether it is part of a "unitary" business. The definition of what is a "unitary" business varies from state to state, which has lead to inconsistencies between member states in the application of the mulitstate compact. However, for a rough working definition, one might say that a unitary business is one in which the business activities of the taxpayer in several states are so interrelated that each part is dependent on the parts occurring in other states.

If the business activity is unitary, then the compact provisions would be applicable to that business activity, and allocation would occur under the three-factor formula, unless relieved under the second stage of the determination. If, on the other hand, the taxpayer's business activity in the particular state is essentially separate and distinct from his activity in other states, then separate accounting would be appropriate, and the compact formula would not be applicable.

If the business activity falls within the definition of "unitary" as in effect in the particular state, separate accounting may still be permissible for, or required of, that business taxpayer if it is determined, under the "relief provision," that the three-factor compact formula "does not fairly represent the extent of the taxpayer's business activity" in the state.

Whereas the first stage determination of whether a multi-state business activity is "unitary" might be viewed as a decision at the front door of whether the taxpayer enters into the compact's coverage, the determination made at the second stage (under the "relief" provision) is one of whether a taxpayer, already determined to be covered by the compact, leaves its coverage out the side door.

Of the cases discussed in the memo of January 26, 1978, the two California cases - Superior Oil Co. v. Franchise Tax Board, 386 P.2d 33 (Col. 1963) and Honolulu Oil Corp. v. Franchise Tax Board, 386 P.2d 40 (1963), and the Kansas case Webb Resources, Inc. v. McCoy, 401 P.2d 879 (1965), [decided prior to Kansas' entry into the compact], all involved the threshold question of whether or not the business activity involved was unitary in nature, and the question of fairness of the statutory formula was not raised. In both the Utah case Kennecott Copper Corp. v. State Tax Commission, 493 P.2d 632 (1972) and the Louisiana case - Texas Co. v. Cooper, 107 So 2d 687 (1959) [although Louisiana is not a member of the compact, its statutory formula parallels that of the compact] the question was decided on the basis of whether the statutory formula fairly represented the taxpayer's business activity in the state, and in both instances it was determined that it did not.

Since the decision of the Webb case in Kansas, which upheld separate accounting of oil production in the state, Kansas has joined the compact (1967), and the question of separate accounting has again been litigated in Amoco Production Co. v. Armold, 518 P.2d 453 (1974), this time on the question of whether the compact's three-factor formula fairly represented Amoco's oil production business in Kansas. Although John S. Warren, in a position paper, relies on the Amoco case for the proposition that oil companies are not excludable from the compact (p. 4), the case did not in fact contain any such holding. The court did say that although the legislature had chosen to specifically exclude certain businesses from

the Uniform Division of Income for Tax Purposes Act, it had not chosen to exempt oil companies. However, the holding of the case was based on the fact that the tax administrator had misinterpreted the Act; and the case was remanded for further proceeding by the tax administrator on the question of whether the UDITPA formula fairly represented the extent of the taxpayer's business activity in Kansas. The court, (contrary to the impression given by Mr. Warren), recognized that if the tax administrator found that the formula did not fairly represent the extent of Amoco's business activity in Kansas, then departure from the formula was appropriate; and the use of separate accounting was one of the authorized alternatives.

From the above discussion, it should be evident that there is no clear authority for the statement that Alaska's enactment of HB 322 in any of its versions would jeopardize Alaska's membership in the Multistate Tax Compact. Absolute uniformity is not required by the compact; its own provisions recognize the need for some flexibility on the part of state tax administration. The court in the Kennecott case recognized that the compact formula might be inappropriate to certain industries unless modified, and the Kansas court in Amoco impliedly recognized the legislature's authority to exclude specific businesses or industries as is proposed in HB 322.

RB:jpd

FOOTNOTES

1/ Alaska, Arkansas, California, Colorado, Hawaii, Idaho, Kansas, Michigan, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah, and Washington.

2/ Alaska, California, Colorado, Florida, Kansas, Louisiana, Mississippi, New Mexico, Oklahoma, Texas, Utah and Wyoming.

3/ California, Colorado, Kansas, New Mexico, Texas and Utah.

4/ Florida, Louisiana, Mississippi, Oklahoma and Wyoming.

5/ Alaska, California, Colorado, Florida, Kansas, Louisiana, Mississippi, New Mexico, Oklahoma and Utah.

6/ Alaska, California, Colorado, Kansas, New Mexico and Utah.

7/ Kennicott Copper Corp. v. State Tax Commission, 493 P.2d 632 (Utah 1972); Amoco Production Co v. Armold, 518 P.2d 453 (Kansas 1974).

8/ Superior Oil Co. v. Franchise Tax Board, 386 P.2d 33 (Calif. 1963) and the companion case Honolulu Oil Corp. v. Franchise Tax Board, 386 P.2d 40 (Calif. 1963), decided under UDITPA prior to California's entry into the Multistate Tax Compact.

9/ Florida, Louisiana, Mississippi and Oklahoma.

10/ Oklahoma.

11/ Louisiana - Texas Co. v. Cooper, 107 so 2d 687 (1959).

January 26, 1978

MEMORANDUM

SUBJECT: Impact of Proposed Changes in Corporate Income Tax Treatment of Oil and Gas Operations on Alaska Membership in the Multistate Tax Compact (H. O. 4448)

TO: The Honorable John Rader

FROM: Gregg K. Erickson
Director
Division of Research Services

The attached memorandum responds to your questions proposed in the above Work Order. The brief answer to your question is that neither the "franchise tax", "direct accounting", or "4th-factor" approaches are likely to be construed as a breach of the multistate tax compact.

In accordance with your instructions we are forwarding a copy of this memorandum to the Department of Revenue for comment.

GKE:ftc
Attachment

b
cc: Attached memoranda to John Messenger,
Deputy Commissioner of Revenue

04-D3LH

STATE OF ALASKA

JAY S. HAMMOND, GOVERNOR

DEPARTMENT OF REVENUE

OFFICE OF THE COMMISSIONER / POUCH S – JUNEAU 99811

May 8, 1978

The Honorable Kay Poland
Chairman
Senate Resources Committee
Alaska State Legislature
Juneau, AK 99801

Dear Senator Poland:

In his testimony on April 28, 1978, Milton Lipton noted three points of a technical nature which he felt should be addressed by the committee. I have talked to Gregg Erickson about these three items and believe that there is either an explanation of the specific language in the draft or a suggestion of specific language to the draft, to clear up the points raised by Mr. Lipton. I will discuss each point in order that it was mentioned.

1. Page 3, line 3

On this point, Mr. Lipton raised the concern that a tariff properly on file with a regulatory agency might be ultimately overturned by that agency or the courts with appropriate refunds ordered. In this situation, he felt that we should assure ourselves that the income tax for any prior periods would be recomputed based upon the new tariff. That was our intent and we believe that the matter can be clarified with the addition of the following additional language at line 6 on page 3 of the proposed committee substitute:

<u>If a tariff properly on file with a regulatory agency is subsequently amended, changed, or overturned retroactively, the reasonable costs of transportation shall be recomputed for that period using the newly determined tariff</u>.

2. Page 3, line 8, (c)(1)

On this point, Mr. Lipton felt that this deduction for royalty paid was too narrow since it included only royalties paid to the state or the United States. We agree. Our intent was to insure that a company would

only be taxed upon its interest in the oil and gas. Accordingly we would propose the following amendment at line 8 on page 8 of the proposed committee substitute:

(1) royalties paid in kind or in value. [TO THE STATE OR THE UNITED STATES.]

3. Page 3, line 13, (c)(4)

On this technical point, Mr. Lipton raised the concern that this particular deduction for operating expenses should fit with the definition of gross value so as to assure that there is not a double deduction of these particular expenses of producing, gathering, preparing the oil or gas for pipeline transportation. We have rechecked the interrelationship of the definition of gross value and this deduction and believe that they do fit together without overlap to assure no double deduction.

We have tied our definition of gross value to the definition of "gross value at the point of production" in the production tax statute. That definition contained in AS 43.55.140(12) provides essentially that the value at the point of production is the value at the point where the oil or gas is metered or measured in a condition of pipeline quality. This means that the oil or gas is valued without deduction for the costs of production including the costs of gathering, conditioning and treating prior to pipeline transportation. For example, for Prudhoe Bay oil production the oil is valued under this definition at the point where it is metered into the Trans Alaska Pipeline (Pump Sation No. 1) and no deductions upstream from that point are allowed. In (c)(4) the companies are then allowed to take their direct upstream operating costs as deductions from the gross value in arriving at net income. Since gross value is determined without deducting these operating expenses under the definition in the production tax statute, there is no double deduction of these items. Therefore we believe the definition of gross value and deduction for operating expenses fit together.

Also, I might note in response to a question from you regarding the proposed Sec. 43.21.050 ASSESSMENT OF INCOME AND TAX, Mr. Lipton did not specify any objection but noted that this was, as far as he knew, a standard provision in other taxes. I agree, but I would like to emphasize the importance of this provision in the separate accounting approach. This provision would help to assure that the tax

avoidance problems which we have pointed out in last year's CS HB 322 are eliminated, since the department itself would be directly assessing the income and tax. This would be similar to the way the property tax is now administered and in our view is essential to administer a separate accounting approach to income taxation.

Mr. Lipton also raised certain policy considerations for the committee on the proposed committee substitute for HB 322. Those items included (1) the use of "book income" instead of "federal taxable income" as a definition of net income from activities other than oil and gas production and pipeline transportation, and (2) the use of the OCS apportionment factors for apportioning income from activities other than oil and gas production and pipeline transportation. As you know, these are items which were contained in our original franchise tax approach, and we believe that they would enhance a new corporate income tax for the oil and gas industry.

Sincerely,

John R. Messenger
Deputy Commissioner

cc: Gregg Erickson

TO: ALASKA OIL AND GAS ASSOCIATION

FROM: JOHN S. WARREN

DATE: APRIL 24, 1978

RE: INCOMPATIBILITY OF PENDING TAX LEGISLATION WITH MULTISTATE TAX COMPACT

In my "Position Pager on Alaska Oil and Gas Taxation," I stated that enactment of the pending legislation on income taxation of oil companies might very well be a breach of the Multistate Tax Compact which would require Alaska to give up its membership in the Compact and the benefits inuring therefrom, such as participation in the joint audit program. I made this statement with respect to both HB 322 and SB 105 (which has become SCS CSHB 322). Crawford Thomas also spoke on this point in his testimony before the Senate Resources Committee on February 24, 1978.

The Legislative Affairs Agency disputes my contention and has advised the Senate Committee that adoption of the proposed legislation would not jeopardize the states membership in the Compact. You have asked for my further comments. There is no present authority squarely on the question of how far a party State may depart from the apportionment prescribed in the Compact without forfeiting its membership; therefore no one

can say dogmatically that enactment of SCS CSHB 322 will or will not forfeit Alaska's membership. Any opinion of what the outcome would be must necessarily be somewhat speculative, but I still believe that an examination of the relevant authorities that do exist will show that jeopardy would surely be created and the end result would probably be termination of Alaska's membership.

The Relevant Provisions of the Compact and MTC Regulations

Article I. "The purposes of this compact are to ... (2) Promote uniformity or compatibility in significant components of tax systems."

Article II. "As used in this compact: ... 4. 'Income tax' means a tax imposed on or measured by net income including any tax imposed on or measured by an amount arrived at by deducting expenses from gross income, one or more forms of which expenses are not specifically and directly related to particular transactions."

Article III. "1. Any taxpayer subject to an income tax whose income is subject to apportionment and allocation for tax purposes pursuant to the laws of a party State or pursuant to the laws of subdivisions in two or more party States may elect to apportion and allocate his income in the manner provided by the laws of such State or by the

laws of such States and subdivisions without reference to this compact, or may elect to apportion and allocate in accordance with Article IV."

Article IV. (the UDITPA provisions) "... 2. Any taxpayer having income from business activity which is taxable both within and without this State, other than activity as a financial organization or public utility or the rendering of purely personal services by an individual, shall allocate and apportion his net income as provided in this Article. ..."

"18. If the allocation and apportionment provisions of this Article do not fairly represent the extent of the taxpayer's business activity in this State, the taxpayer may petition for or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

"(a) separate accounting;

"(b) the exclusion of any one or more of the factors;

"(c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this State; or

"(d) the employment of any other method to effectuate an equitable allocation and apportionment

of the taxpayer's income."

Regulation IV-18. "Article IV, Sec. 18 permits a departure from the allocation and apportionment provisions of Article IV only in limited and specific cases where unusual fact situations (which ordinarily will be unique and non-recurring) produce incongruous results under the apportionment provisions contained in Article IV."

It is clear that the tax to be imposed on oil companies by SCS CSHB 322 would be an "income tax." Therefore, the oil companies must be allowed the option to continue using the standard formula method. There is nothing in the compact that excludes oil companies from the standard treatment; only financial corporations and public utilities are excluded. It follows, therefore, that Alaska's only hope of defending its proposed special treatment of oil companies is to show that it is authorized by § 18 of Article IV.

It would seem impossible to bring Alaska's proposed action within the restrictive language of Regulation IV-18. The situation with respect to the oil companies is neither unusual, unique, or nonrecurring. Moreover, the determination under § 18 is supposed to be made by the tax administrator, not by the state legislature.

AGO 547887

How Would the Multistate Tax Commission React to the Issue?

If Alaska enacts SCS CSHB 322, the Multistate Tax Commission will be faced with a difficult problem. On the one hand, they want very much to maintain and increase the membership in the Compact. On the other hand, they are sure to realize that the Compact's only hope of success is for all party States to remain true to the principle of uniformity. This is why they have committed themselves to a very strict construction of § 18 in their own regulations. Surely they will know that any laxity in enforcing this strict construction would be a serious setback to their efforts to convice the business community, state governments, and particularly the U.S. Congress that the Compact is the best answer to the uniformity problem.

A recent incident involving Florida may be illuminating. After that state had joined the Compact, its legislature passed a law providing for double weighting of the sales factor (a maneuver which increased Florida's tax-take as primarily a market state and which also gave it a selling point in attracting business to establish factories in the state). Reliable sources have told me that there were considerable expressions of displeasure over this at Multistate Tax

Commission meetings. A confrontation was avoided, however, when Florida voluntarily withdrew from the Compact. Alaska can be expected to incur this same kind of pressure to resign if it enacts SCS CSHB 322.

The recent approval of the Compact by the U.S. Supreme Court in the U.S. Steel case has brightened the future of the Compact. The party States look upon it as their best chance to convince Congress that the states can achieve and maintain uniformity on their own and that federal internention is neither necessary or desirable. They are not likely to risk spoiling this opportunity by allowing the legislature of one Party State to take a whole class of taxpayers completely out of the ambit of the Compact. Such lack of self-restraint by one Party State, if left unchallenged by the other Party States, could destroy the credibility of the Compact. It would stand as evidence that any Party State can depart from the standard apportionment formula whenever it thinks it is not getting enough revenue from a particular industry. As such, it would provide wonderful ammunition for the advocates of federal intervention.

Of course, Alaska could try to persuade the other party States to amend the Compact to make the proposed

Alaska method the standard method for taxing oil companies. The chances of Alaska being successful, however, are nil. The market states would never agree to it. They would never consent to the downgrading of the place of marketing as compared to the place of production. They would insist that tax revenue from the oil industry be shared between production states and market states in the same way that it is for all other businesses.

In summary, Alaska is sure to become a pariah among party States to the Compact if SCS CSHB 322 is enacted into law. If Alaska is unwilling to share the tax revenue of the oil industry with other states in the conventional way, it has no future in the Compact.

How Would the Courts React to the Issue?

As improbable as it may be, let us assume that the Multistate Tax Commission takes no action to expel Alaska from the Compact. Any oil company would then be able to force the issue into court by a declaratory relief action, by refusing to submit to a joint audit in which Alaska is participating, or by contesting an Alaska deficiency assessment based on denial of the UDITPA option. This raises the question of how the courts will interpret § 18.

The following cases have been cited by the Legislative Affairs Agency or by me, or both, as having a possible bearing on the question:

Texas Co. v. Cooper, (La. 1959) 107 So. 2d 676.

Superior Oil Co. v. Franchise Tax Board, (Cal. 1963) 386 P. 2d 33.

Honolulu Oil Corp. v. Franchise Tax Board, (Cal. 1963) 386 P. 2d 40.

Webb Resources, Inc. v. McCoy, (Kan. 1965) 401 P. 2d 879.

Kennecott Copper Corp. v. State Tax Commission, (Utah 1972) 493 P. 2d 632.

Donald M. Drake Co. v. Dept. of Revenue, (Ore. 1972) 500 P 2d 1041.

Amoco Production Co. v. Armhold, (Kan. 1974) 518 P.2d 453.

None of these cases involves the Compact. The last three are interpretations of § 18 of UDITPA. The first four involve the question of separate accounting versus formula apportionment for oil companies prior to UDITPA.

The Texas and Webb cases held that the oil companies in question were not engaged in a unitary business and therefore separate accounting was favored over formula apportionment. The Superior and Honolulu cases held that the oil companies in question were unitary businesses, and therefore separate accounting was rejected and formula

apportionment was required.

In the Alaska situation, no one can dispute that the oil companies under consideration are unitary businesses. The Department of Revenue has so treated them in the past, and under the pending bill they would still be treated as unitary businesses, with formula apportionment being applied to all of their income except their Alaska production income. Therefore, Alaska's proposed use of separate accounting could not be defended on the ground that the oil companies are not unitary businesses, and the Texas and Webb cases would be of no help to Alaska.

If it is found to be a fact that an oil company is a unitary business, then the Superior and Honolulu cases are the persuasive authority. They were decided under a statute giving much broader discretion than does UDITPA, and still they held that separate accounting could not be used for oil companies that were found to be unitary businesses.

The more helpful cases, of course, are those decided under UDITPA. The first of these was Kennecott. That corporation was one of the largest taxpayers in Utah, but the Tax Commission felt it was not collecting enough revenue from Kennecott because the sales factor in

the apportionment formula was working to the state's disadvantage, i.e., almost all of the copper was sold outside the state. (Note the parallel to the Zeifman and Ainsworth complaint against the formula as applied to oil companies in Alaska). So the Tax Commission invoked § 18 and required Kennecott to use separate accounting. The court upheld the Tax Commission. The decision, however, would be a very weak reed for Alaska to lean upon. In the first place, it was a 3-to-2 decision, with Chief Justice Callister writing a scathing dissent. It is quite possible that other courts will find the dissent more persuasive than the majority opinion. Secondly, it has been criticized by commentators. See, e.g., Peters, "State Income Tax Problems of Interstate Business," 33 N.Y.U. Tax Inst. 899, 952. Finally, the courts of two other states have indicated their disdain for it. In Chase Brass & Copper Co. v. Franchise Tax Board, (Cal. 1977) 138 Cal. Rptr. 901, it was ruled that Chase and its parent, the very same Kennecott, were engaged in a unitary business and that formula apportionment was proper. In Amoco, infra, the Director of Taxation relied heavily on Kennecott to support his claim to broad authority under § 18, but he still lost his case.

The next court to interpret § 18 was the Oregon court in Drake. There the tax administrator sought to compel a construction contractor to use separate accounting, citing § 18 as authority. The court held that, in keeping with the purpose of UDITPA, the use of any method other than apportionment should be exceptional, and the party - the taxpayer or the tax administrator - who seeks to invoke § 18 has the burden of proof.

Amoco is another case where both the majority opinion and the dissenting opinions should be read. The majority opinion is favorable to my position, and the dissents are even more favorable. The Director of Taxation thought he could continue to require oil companies to use separate accounting after Kansas adopted UDITPA, just as he had been doing before, and as had been upheld by the court in Webb. The court rebuffed him, saying that separate accounting and formula apportionment were no longer two methods of equal stature and that UDITPA made formula apportionment the preferred method, even for oil companies, since they were not among those businesses expressly excluded from the act.

The Director also contended that his action was authorized by § 18. The majority opinion endorsed

Drake as a correct interpretation of UDITPA and found Kennecott to be unpersuasive because of the 3-to-2 split in the Utah court. But the majority thought the Director should have another chance to meet his burden of proof because he had applied the wrong test. His evidence consisted solely of a wide discrepancy in the percentage of the taxpayer's income attributed to Kansas by separate accounting and the percentage arrived at by formula apportionment. The majority pointed out that the test is not whether the standard method clearly reflects net income but whether it fairly represents the extent of the taxpayer's business activities in the state. They remanded the case so that the Director could make a new finding under § 18 using the business activities test.

The two dissenters felt that the Director had failed to meet his burden of proof and so the litigation should end with a judgment for the taxpayer. Chief Justice Falzer wrote: "Tax liability is to be computed on the basis of business activity, and a comparison between formula allocation and separate accounting to ascertain the higher tax, is not within the scheme of the Uniform Act" (518 P 2d 469).

Both the majority and the dissenters agreed

that a showing that separate accounting will allocate more income to the state is not sufficient to support the imposition of separate accounting under § 18. They disagreed only as to whether the administrator should be given another bite at the apple.

There is a clear lesson to be learned by Alaska from the Amoco case. The only evidence that the proponents of SCS CSHB 322 have offered to show that a variance under § 18 is justified is evidence that separate accounting will allocate more income of oil companies to the state than does formula apportionment. In the views of both the majority and the dissenters in Amoco, this evidence is incompentent to meet the burden of proof under § 18.

It is to be noted that in all four of these cases interpreting § 18 of UDITPA were cases where the tax administrator determined that a variance should be made. The incipient Alaska case will present the question of the propriety of the legislature making the determination. Again, Alaska will not be within the express language of § 18. The court is quite likely to find significance in the fact that the language of § 18 contemplates action by the tax administrator rather than

the state legislature, for this would indicate an intention that the section is to be used only sparingly and in very specific cases. It is one thing for the tax administrator, upon review of the facts of a particular case, to find that the standard method does not fairly represent the extent of the taxpayer's business activity in the state and to devise another method that works better in that particular case. It is quite another thing for a state legislature to pre-empt the question and declare that a whole class of taxpayers shall receive non-standard treatment. The framers of UDITPA and the Compact intended the former as a limited continuation of traditional administrative discretion in this field, but they certainly did not intend to include the latter within the meaning of § 18. Such action by a state legislature would probably be viewed by the courts as nothing but an attempt to unilaterally amend the Compact itself.

Conclusion

If SCS CSHB 322 is enacted, Alaska will come under considerable pressure from other party States to quit the Compact. If the issue is not forced at that level, Alaska will have to defend itself in court and will have great difficulty in meeting the burden of proving that its action is compatible with the Compact.

SOHIOBPA A AHG

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TELEX PD CLEVELAND , OHIO APRIL 24, 1978 960599

BP ALASKA
ANCHORAGE ALASKA
ATTN JOHN SAINT

FOR IMMEDIATE RELEASE

CLEVELAND, OHIO, APRIL 24--THE STANDARD OIL CO. (OHIO) REPORTED TODAY THAT NET EARNINGS PER SHARE FOR THE FIRST QUARTER OF 1978 WERE $.75, UP 56 PER CENT, ON A GREATER NUMBER OF SHARES OUTSTANDING, FROM $.48 CENTS FOR THE SAME PERIOD OF 1977. PER SHARE COMPUTATIONS WERE BASED ON 46 MILLION AVERAGE SHARES OUTSTANDING FOR THE FIRST PERIOD THIS YEAR, AND 38.6 MILLION SHARES FOR THE FIRST QUARTER OF 1977.

THE INCREASE IN SHARES REFLECTS ADDITIONAL COMMON SHARE EQUIVALENTS EARNED BY THE SPECIAL STOCK OWNED BY THE BRITISH PETROLEUM COMPANY LIMITED AS SOHIO'S ALASKAN CRUDE OIL PRODUCTION INCREASED.

"NET INCOME ROSE TO $36.3 MILLION FOR THE FIRST QUARTER OF 1978 COMPARED TO $18.7 MILLION IN 1977. THIS INCREASE WAS DUE TO ALASKAN CRUDE OIL OPERATIONS THAT OFFSET SUBSTANTIALLY INCREASED INTEREST EXPENSE, LOSSES FROM THE LENGTHY NATIONWIDE COAL STRIKE, AND LOWER INCOME FROM ROYALTIES," SOHIO CHAIRMAN ALTON W. WHITEHOUSE REPORTED.

RETURN ON ALL-TIME RECORD SALES FOR ANY QUARTER OF $1.03 BILLION WAS UP TO 3.5 CENTS ON EACH SALES DOLLAR FROM 2.3 CENTS FOR THE FIRST QUARTER LAST YEAR DESPITE THE FACT THERE WAS A LOSS FROM THE COAL BUSINESS.

THE COMPANY'S RETURN ON TOTAL CAPITAL EMPLOYED IN THE BUSINESS FOR THE TWELVE MONTHS ENDED MARCH 31, 1978, ROSE TO 5.6 PER CENT FROM 3.2 PER CENT FOR THE TWELVE MONTHS ENDED MARCH 31, 1977.

"SOHIO'S SHARE OF NET CRUDE OIL PRODUCTION FROM THE PRUDHOE BAY FIELD AVERAGE 382,600 BARRELS PER DAY DURING THE FIRST QUARTER OF 1978, WITH NO OIL PRODUCTION FROM THIS SOURCE IN THE FIRST QUARTER OF 1977," WHITEHOUSE SAID. IN EARLY APRIL, NET SUSTAINED PRODUCTION PASSED 400,000 BARRELS PER DAY, WHICH RAISES BP'S STOCK INTEREST TO 45.5 PER CENT.

REPAIRS TO PUMP STATION EIGHT, WHICH WAS DAMAGED BY FIRE DURING STARTUP OPERATIONS OF THE TRANS-ALASKA PIPELINE, WERE COMPLETED EARLY IN MARCH AND AN OPERATING LEVEL OF MORE THAN 1.1 MILLION BARRELS PER DAY IS EXPECTED TO BE SUSTAINED DURING THE SECOND QUARTER THIS YEAR. FOR THE FIRST HALF OF APRIL, OPERATIONS AVERAGED ABOUT 1,130,000 BARRELS PER DAY. AT THIS RATE, SOHIO'S NET SHARE OF PRUDHOE BAY PRODUCTION WAS ABOUT 525,000 BARRELS PER DAY.

INCOME FROM OPERATIONS BEFORE INTEREST AND INCOME TAXES WAS $164.7 MILLION, UP FROM $43.8 MILLION IN 1977. PETROLEUM OPERATIONS IMPROVED TO $173.2 MILLION FROM $25.2 MILLION IN 1977, ALTHOUGH THE IMPROVEMENT WAS RESTRAINED BY LOWER THAN EXPECTED REFINERY RUNS DUE TO SEVERAL MECHANICAL PROBLEMS DURING THE QUARTER. COAL OPERATIONS LOST $10.7 MILLION, COMPARED TO AN $8.7 MILLION INCOME IN 1977. CHEMICALS AND PLASTICS DECLINED TO $2.1 MILLION FROM $3.1 MILLION. ROYALTIES WERE DOWN $7.7 MILLION IN THE FIRST QUARTER OF 1978, WHEN A FIXED SUM LICENSE WAS SOLD TO A TURKISH FIRM.

FIRST QUARTER SALES AND OPERATING REVENUE REACHED $1.03 BILLION, UP 25 PER CENT OVER $823.5 MILLION FOR THE SAME PERIOD LAST YEAR, DUE PRIMARILY TO ALASKAN CRUDE OIL SALES.

COSTS AND EXPENSES, OTHER THAN INTEREST AND INCOME TAXES, ROSE 11 PER CENT TO $865 MILLION FROM $761.9 MILLION IN THE FIRST QUARTER OF 1977. THERE WAS A SUBSTANTIAL INCREASE IN DEPRECIATION AND DEPLETION BECAUSE OF ALASKAN OIL OPERATIONS.

"NET INTEREST EXPENSE INCREASED TO $114.9 MILLION FROM $17 MILLION IN THE FIRST QUARTER OF 1977, REFLECTING THE DISCONTINUANCE OF CAPITALIZING OR DEFERRING INTEREST DURING CONSTRUCTION, TESTING, AND FILLING OF THE TRANS- ALASKA PIPELINE. INCOME TAX EXPENSE INCREASED DUE TO HIGHER PRE-TAX INCOME.," WHITEHOUSE CONCLUDED.

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SOHIOBPA A ANG

SOHIO 2 CLV

EXXON COMPANY, U.S.A.
POUCH 6601 • ANCHORAGE, ALASKA 99502

PRODUCTION DEPARTMENT
ALASKA OPERATIONS

March 22, 1978

Mr. W. Monte Taylor

The alleged Croft-Hammond Compromise substitute bill adopts Croft's separate accounting approach for the determination of corporate income tax liability for oil and gas production and pipeline transportation income. The compromise bill adopts Hammond's apportionment of book income approach for the determination of income other than oil and gas production and pipeline transportation income.

Croft's Senate CS 322, currently in the Senate Resources Committee, and the compromise proposal would adopt variations of wellhead value to directly determine gross income from Alaska oil and gas production with the compromise bill allowing the Department of Revenue flexibility to determine that value by regulation. Definitions of gross income from Alaska production and specific deductions therefrom to arrive at taxable net income are compared below. The major difference between the two bills in allowable deductions is the allowance of some overhead and administration expense by the compromise bill.

Income from oil and gas pipeline transportation would be the same as reported to certain regulatory agencies under both the compromise and Croft's Senate CS 322.

With respect to income from activities other than oil and gas production and pipeline transportation, the compromise proposal differs from Croft's bill, but is similar to Hammond's bill that passed the House, in that it adopts certified consolidated net income as apportionable income. Croft's bill would use a two-factor property and payroll formula whereas the compromise proposal would use a three-factor property, payroll and sales formula requiring the inclusion of Alaska OCS property and payroll in the formula.

Determination of Gross Oil and Gas Production Income:

Croft's Senate CS 322:	Croft-Hammond Compromise:
Gross value as established for purposes of production tax.	Gross income at the Point of Production. Dept. of Revenue by regulation may

Croft's Senate CS 322:	Croft-Hammond Compromise:
	use (1) actual prices or values received, (2) posted price, same field or (3) prevailing prices or values, same field.

Deductions from Gross Income to Determine Net Taxable Income:

Croft's Senate CS 322:	Croft-Hammond Compromise:
Royalties actually paid	Royalties actually paid
Severance tax actually paid	Severance and conservation tax actually paid
Property taxes actually paid on property directly associated with production after date of initial production	Property taxes actually paid on property used directly in production after date of commercial production
Direct costs incurred by corporation in operating field	Direct costs incurred by or for corporation in operating lease or property
Depreciation on investments associated with production including depreciation on capitalized interest and amortization of lease payments and property taxes paid before initial production	Depreciation on property used directly in production including amortization of capitalized interest, lease payments and property taxes paid before commercial production
Interest expense not capitalized according to the percentage that property associated with production in Alaska bears to corporate fixed assets everywhere	Interest expense not capitalized according to the percentage that property used directly in production in Alaska bears to real and tangible personal property everywhere
Expenses after 12/31/76 of unsuccessful exploration efforts in Alaska	Expenses after 12/31/77 of unsuccessful exploration efforts in Alaska
	General overhead and administration expenses according to

Croft's Senate CS 322:	Croft-Hammond Compromise:
	the percentage that property used directly in production in Alaska bears to tangible personal and real property everywhere or .12 cents/bbl or .02 cents for each MCF gas

Determination of Income from Oil and Gas Pipeline Transportation:

Croft's Senate CS 322:	Croft-Hammond Compromise:
Oil - "Net balance transferred from income" reported to ICC. Certified by Alaska P/L Comm.	Oil - "Net balance transferred from income", determined by Dept. of Revenue, reported to Fed. Energy Regulatory Comm.
Gas - "Balance transferred from income" reported to FPC. Certified by Alaska Public Utilities Commission	Gas - "Balance transferred from income", determined by Dept. of Revenue, reported to Fed. Energy Regulatory Comm.

Determination of Income from Activities Other Than Oil and Gas Production and Pipeline Transportation:

Croft's Senate CS 322:	Croft-Hammond Compromise:
Subtract oil and gas production and P/L transportation income from combined corporate income and apportions balance using two-factor payroll and property formula	Subtract oil and gas production and P/L transportation income from consolidated net income certified by CPA for purposes of reporting to stockholders (book income) and apportion by three-factor property, payroll and sales formula, including property and payroll from Alaska OCS in factors

James R. Howell

JRH:djb

xc: W. M. Barstow
H. W. Beathard
N. C. Fitch
S. J. Kettelkamp
R. J. Walker

AGO 547904

STATE OF ALASKA
THE LEGISLATURE

LEGISLATIVE AFFAIRS AGENCY

POUCH Y · STATE CAPITOL
JUNEAU, ALASKA 99811
907-465-3800

April 4, 1978

MEMORANDUM

SUBJECT: Milton Lipton's Comments on Draft No. 5 of Proposed CS of CS for HB 322

TO: The Honorable Kay Poland

FROM: Gregg K. Erickson
Director of Research

Briefly, Milton Lipton's comments to me over the telephone were as follows:

1. He suggested that the definition of gross income was too broad. Mr. Messenger and I have not discussed specific language by which it might be narrowed, but I believe such language could be developed in a matter that satisfies the administration.

2. He suggests that we should not necessarily assume that transportation costs set by a tarrif on file with the pipeline commission are necessarily resonable (page 3, line 3-5). He suggests language to take care of the situation where a filed tarrif may be later found to be unreasonable by a court. I am sure that the administration would have no problem with this change.

3. On page 3, line 8, Lipton suggests that we make it clear that royalties paid to individuals or corporations are also deductable As the bill stands now these are taken account of in the determination of gross value, but there should be no problem (no change in the effect of the bill) by putting this deduction here.

4. Milton questions the usefulness of the concept of book income in the allocation of "other income" (page 6, line 25).

5. On page 7, line 18, he questions the "semmetry" of the attempt to use payroll and property located on the Alaska OCS in the allocation formula for "other income".

I am not sure that the administration would accept these last two changes, although their revenue impact seems almost negligable to us.

AGO 547905

LEONARD E. KUST is a partner in the New York law firm of Cadwalader, Wickersham & Taft. He was formerly Vice President and General Tax Counsel of Westinghouse Electric Corporation with which he was associated from 1955 to 1970.

A native of Wisconsin, Mr. Kust is a graduate of the University of Wisconsin and the Harvard Law School. He is a member of the New York and Pennsylvania bars.

He is a past president of the Tax Institute of America, and of the Tax Executives Institute. Mr. Kust has served as Chairman of Governor Scranton's Committee on Tax Administration, Chairman of Task Forces for Governor Shafer's Tax Study and Revision Commission, and was a member of the Advisory Committee of the Commissioner of Internal Revenue. He has served on the Executive Committee of the National Tax Association, as a Director of the Chamber of Commerce of the United States, and as a member of the Taxation Committee. He is a member of the Tax Section of the American Bar Association, a member of the Council of the U.S.A. Branch of the International Fiscal Association, a member of the Advisory Board of Tax Management, and a member of the Advisory Board of the Tax Foundation.

Mr. Kust has written on a wide variety of tax issues, including "State Taxation of Income from Interstate Commerce: New Dimensions of an Old Problem", S.W. L.J. 1 (1960); "State Taxation of Interstate Sales", 46 Va. L. Rev. 1290 (1960); "Federal Tax Reform", the Tax Executive, Vol XIV, April, 1962; "Standards of Conduct for Tax Executives", the Tax Executive, Vol. XIV, July 1962; "A Reappraisal of Taxation of International Business Income", National Tax Association Proceedings, Annual Conference, 1966, p.154; "Alternatives for New Federal Revenues", Tax Review, Tax Foundation, Vol. XXXIV, No. 7, July, 1973.

GARY I. BOREN

Biographical Information

Education:

Bachelor of Arts, University of California, Los Angeles - 1957

Bachelor of Laws, University of California, Los Angeles - 1961

Member of the Order of the Coif
Note and Comment Editor, U.C.L.A. Law Review

Professional:

Professor of Law and Director of the Graduate Tax Program, Washington University School of Law, St. Louis, Missouri

Assistant Professor - 1967-1971
Associate Professor - 1971-1975
Professor - 1975-Present

Private practice, Los Angeles, California - 1961-1967

Member State Bar of California

Major Publications:

Equitable Apportionment: Administrative Discretion and Uniformity in the Division of Corporate Income for State Tax Purposes
49 So. Cal. L. Rev. 991 (1976)

Specific Allocation of Corporate Income in California: Some Problems in the Uniform Division of Income for Tax Purposes
30 TAX. L. REV. 607 (1975)

Separate Accounting in California and Uniformity in Apportioning Corporate Income
18 U.C.L.A. L. REV. 478 (1971)

Courses Taught:

*State and Local Taxation
*Federal Income Taxation
*Federal and Estate Gift Taxation
*Seminar in Tax Policy and Current Legislation
Seminar in Advanced Tax Research
Natural Resources

*Courses taught currently

JOHN S. WARREN

Biographical information

Education:

Bachelor of Science in Law, University of Minnesota - 1943

Bachelor of Laws, University of California, Hastings College of Law - 1950

Professional:

Loeb and Loeb, Los Angeles, California - 1957 to present (partner 1960 to present)

Government positions:

Associate Tax Counsel, California Franchise Tax Board - 1951-1957

Consultant, California Department of Finance - 1962

Consultant, California Legislature, Senate Fact Finding Committee on Revenue and Taxation - 1964

Memberships:

State Bar of California

Committee on Taxation (1958-1962)
Committee on Property Sales and Local Taxes (1975-)
Chairman, Subcommittee on Occasional Sales (1976-)

Los Angeles County Bar Association, Tax Section:

Committee on Federal and California Death and Gift Taxes

American Bar Association, Section of Taxation, Committee on State and Local Taxes:

Subcommittee on Non-Federal Solutions to Interstate Tax Problems (1974)
Subcommittee on Important Developments (1975)
Vice Chairman, Subcommittee on Corporation Net Income Taxes (1976)

Articles:

"Sales of Depreciated Properties to Related Entities," 1959 Southern California Tax Institute

"The Unitary Concept in the Allocation of Income," 12 Hastings Law Journal 42 (with Frank M. Keesling)

"Selected Problems in California Corporation Taxes," 1962 Southern California Tax Institute 939

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"Income Taxation of Testamentary Trusts,"
23 Journal of Taxation 278

"California Franchise Tax Allocation of Income of Unitary Business,"
1966 Southern California Tax Institute 529

"California's Uniform Division of Income for Tax Purposes Act,"
15 U.C.L.A. Law Review 156 (with Frank M. Keesling)

"Reform Act Changes in Pension and Profit Sharing Plans,"
1971 Southern California Tax Institute 137

Lecturer:

"Tax Problems of Closely Held Corporations and Their Shareholders"
California Continuing Education of the Bar, 1974

"Advising on California Taxes"
California Continuing Education of the Bar, 1975

"California State and Local Tax Rules Pertaining to the Entertainment Industry"
California CPA Foundation, 1974

Teacher:

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Alaska State Legislature

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Senate

KODIAK-ALEUTIAN
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WHILE IN JUNEAU
POUCH V
JUNEAU, ALASKA 99811

February 17, 1978

Don Dickey, President
Alaska State Chamber of Commerce
310 Seward Street
Juneau, Alaska 99801

Dear Don:

Thank you for your letter regarding SCS/CS HB 322. It will be inserted in the Resources Committee hearing record as you have requested.

Additional hearing dates for SCS/CS HB 322 have been scheduled for Wednesay, February 22 and Friday, February 24. If you are interested in providing additional testimony, please contact Sharon Stoops at 465-3717 as soon as possible.

Sincerely,

Kay Poland

Kay Poland
State Senator
Kodiak-Aleutian District

KP:ts

AGO 547911