TESTIMONY
OF THE ALASKA OIL AND GAS ASSOCIATION
TO THE HOUSE RESOURCES COMMITTEE
REGARDING HB 328

March 16, 2012

Co-Chairmen Feige and Seaton and, and Members of the House Resources Committee:

Good afternoon. For the record, my name is Kara Moriarty and I'm the Executive Director of the Alaska Oil and Gas Association, or AOGA. AOGA is a business trade association whose mission is to foster the long-term viability of the oil and gas industry here, which will benefit all Alaskans. Our member companies account for the majority of oil and gas exploration , production, transportation, refining and marketing activities in Alaska, and they reflect the breadth and scope of our industry across the state. My testimony today regarding House Bill 328 reflects a 100% consensus among the membership.

AOGA opposes HB 328. It would re-impose the separate-accounting income tax (AS 43.21) that Alaska used to have for oil and gas companies from 1978 through 1981. Effective starting with the 1982 tax year, Alaska abandoned separate accounting in favor of the present oil and gas corporate income tax in AS 43.20, and AS 43.20.072 in particular, which uses apportionment.

Because separate accounting and apportionment are terms of art in the context of taxing multistate and international businesses, let me begin by briefly describing what each one is, how it works, and the relative strengths and weaknesses of each.

Separate accounting and apportionment both seek to answer the same question — how much income of a multistate or international business is properly attributable to its in-state assets and activities so it can be taxed by that state?

Separate accounting takes the approach of looking at what the business actually has and does in the state, and then seeks to determine directly the net income as if that in-state portion of the business stood alone, separate from the rest of the business — hence the term "*separate* accounting."

Conceptually, separate accounting seems to tackle head-on the question of how much income is made by the in-state portion of a multi-jurisdictional business. But appearances can be misleading, and in the case of separate accounting, its vulnerability arises from the fact that the in-state portion of such a business does not actually stand alone from the rest of the business. Whether the overall business is conducted within a single corporate entity or through a unitary web of closely and carefully coordinated affiliates, the opportunities are often present for the in-state portion to engage in business transactions with the out-of-state portions that technically are completely legal and proper, but which have the effect of shifting income and expense, gains and losses, into or out of the in-state part of the overall business.

To illustrate how complicated and difficult it can be to unravel such transactions between or among parts of the same overall business, let me tell you about the regulations that have been adopted under the Internal Revenue Code to control artfully created tax opportunities within such a business. Printed out in 11-point Times New Roman font, Treasury Regulation 1.1502-13 runs for over 70 pages, single spaced. This mammoth regulation establishes the *general* principles for unraveling various tax effects otherwise created artificially by transactions between or among affiliated corporations. Following it are Treasury Regulation 1.1502-14, and 1.1502.15, and 1.1502-16, which apply and adapt those general principles to specific kinds of businesses or specific kinds of transactions. These further regulations run in numerical order all the way out to Treasury Regulation 1.1502-*100*. That shows how complicated things can get when you have to start unraveling transactions between corporate affiliates, which separate accounting requires.

Apportionment, by contrast, starts with a "pie" containing the apportionable income for the in-state and Outside business together, and then determines how wide a "slice" is attributable to the income-generating potential of the in-state portion of the business. It is this "slice" that is then taxed by that state. This avoids the need to unravel transactions between parts of the overall business, and it also avoids the analytical difficulties that arise when a unitary business as a whole is greater than the sum of its individual parts.

The key assumption underlying apportionment is that, overall, a dollar invested in state has the same income-generating potential as a dollar invested anywhere else, that a dollar of sales in state has the same potential as a dollar of sales elsewhere, that a worker in state is as productive per dollar of wages and benefits as a worker Outside, that a barrel of oil or its equivalent of gas produced in state represents comparable potential for profitability as one produced someplace else, or a similar assumption about comparable in-state and everywhere potential as measured by a similar business attribute or indicator. For oil and gas producers and pipeline companies and their affiliates that are doing business in Alaska, the width of the Alaskan "slice" of their respective business's "pie" is the average of the percentages of that business's real or tangible property (at cost), its sales, and its oil and gas production that is present within Alaska.

After laying out this key economic assumption underlying and justifying the apportionment methodology, the Alaska Supreme Court continued —

> These ... factors are merely indicative of the business' income producing capabilities. They are not intended to reflect the business' precise sources of income for any particular year. The factors in an apportionment formula represent an attempt to relate the taxpayer's presence within the state to his presence everywhere.[*]

[*] *State, Dep't of Revenue v. Amoco Production Co.*, 676 P.2d 595, 599 (Alaska 1984) (citation and internal quotation marks omitted).

What all of the theory and economics boils down to this: For any given taxpayer, the question of whether its Alaskan income tax will be greater under separate accounting than under apportionment depends on whether the actual profitability of its Alaskan business is greater overall than the actual profitability of the combined in-state and Outside business as measured by the per dollar invested, per dollar sold, and per barrel produced. If the in-state part of the business is materially superior by these standards than the combination, it wants apportionment as the lesser tax; if materially inferior, it prefers separate accounting.

This means that certain oil and gas taxpayers can start out — and quite likely some already have started out — preferring separate accounting from the day they first start business in Alaska because they would pay less tax than with apportionment. Others will start out preferring apportionment. Which side of the line a particular company falls on depends solely on its own facts and circumstances. There is nothing inherent about separate accounting that causes a taxpayer's tax to be greater than that taxpayer's tax with apportionment.

But there is something inherent about a non-renewable resource like oil and gas. No matter how long an oil company may initially start out preferring apportionment over separate accounting as the lesser tax, there eventually will come a day when its oil and gas resources in Alaska will become sufficiently depleted that separate accounting will become the smaller tax for that business. Again, the specific time when this crossover occurs will vary widely from one producer to another because each one has its own unique set of circumstances for its in-state and Outside business. But eventually the crossover date will arrive.

We believe it is premature at this time for Alaska to restructure its income tax and make it suitable for such an advanced stage in the economic life of its oil and gas industry and the businesses participating in that industry. We also believe enacting separate accounting at this time could be ill-advised because, depending on how Alaska structures the rest of its overall tax regime, the enactment of separate accounting might turn out to be a self-fulfilling prophecy in terms of hastening the crossover for more and more members of the industry here. That is particularly likely if separate accounting is enacted as part of an overall tax structure and policy of merely of taking more money from the industry, instead of optimizing the opportunities.

Having 100% of nothing is just as poor as having 0% of everything. Clearly there is a sweet spot between these two extremes where the tradeoff is optimized between the size of one's share and the size of what there is to be shared. Alaska has badly overshot the mark already in terms of the size of its share, and enacting separate accounting merely to increase its share still further would be a mistake. For this reason AOGA opposes HB 328 and urges you not to enact it.

Thank you for this opportunity to testify, and I'm happy to take any questions the Committee may have.