Alaska Oil and Gas Association

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AOGA Comments
HB 399 – House Finance Committee
April 9, 2018

Co-Chair Foster, Co-Chair Seaton, Members of the Committee:

For the record, my name is Kara Moriarty and I'm the President/CEO of the Alaska Oil and Gas Association, commonly known as "AOGA."

AOGA is a professional trade association for the oil and gas industry and I thank you for the opportunity to discuss the reasons of our opposition to House Bill 399. Although I am here on behalf of a diverse group of companies, my testimony today represents the thoughts and sentiments of each member, which was approved by unanimous consent.

Bill Section 1. Section 1 of HB 399 would amend AS 43.20.021(a), adoption of §§ 1 – 1399 of the Internal Revenue Code ("IRC") by reference, so that tax credits under §§ 21 – 51[1] of the IRC, as amended late last year by Public Law 115-97 (December 22, 2017), would not be available in computing a taxpayer's tax liability under Alaska's income tax (AS 43.20).

Tax credits for individuals. Although individuals are not currently taxable under AS 43.20, it seems unnecessary to repeal the adoption by reference of IRC provisions relating to tax credits that only individuals can take.

Nonrefundable personal tax credits. IRC §§ 21 – 26 constitute Subpart A (titled "Non-refundable personal credits") of Part IV ("Credits Against Tax") of Subchapter A ("Determination of Tax

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[1] The IRC no longer has §§ 16 – 20 nor §§ 54 and 54AA, so the deletion of the existing adoption of these IRC sections by reference under AS 43.20.021(a) would have no current effect.

Liability" under Chapter 1 ("Normal Taxes and Surtaxes") of the Federal Income Tax. Federal tax credits for individuals include:

1. the credit for expenses for household and dependent care services necessary for gainful employment (IRC § 21);
2. the credit for elderly and permanently and totally disabled individual taxpayers (IRC §22);
3. credits for expenses in adopting one or more children (IRC §23);
4. the $1,000 tax credit for each qualifying child "for which the taxpayer is allowed a deduction under section 151" of the IRC (IRC §24);
5. the credit for interest on certain home mortgages (IRC §25);
6. the "Hope Scholarship Credit" and the "Lifetime Learning Credit" (IRC §25A);
7. the credit for qualifying retirement savings contributions of eligible individuals (IRC §25B);
8. the credit for installed nonbusiness energy efficiency improvements and other residential energy property expenditures (IRC §25C);
9. the credit for qualifying expenditures for solar electricity, solar water heating, fuel cell property, and small wind energy property for an individual's residence (IRC §25D);
10. the credit for health insurance costs of eligible individuals (IRC §35); and
11. the credit for first-time homebuyers (IRC §36).

Note: IRC §26 sets limits on the total amount of the preceding tax credits that an individual may take for a given tax year.

Refundable personal tax credits. Some credits are refundable instead of being allowed to carry back a year or carry forward for up to 20 years until they are used up:

12. IRC §31 provides that the amount of federal withholding tax that an employer withholds from a person's salary or wages is a credit against that person's income tax;
13. Similarly, IRC §33 provides that the amount of federal withholding tax "withheld at the source" for a nonresident alien is a credit against that alien's personal income tax under the IRC[2];
14. The "earned income" credit under IRC §32 is available only for "eligible individual[s,]" which can include nonresident aliens[3] if there is an election for them to be treated as United States residents for U.S. income tax purposes for the year when the "income" is "earned[,]"; and
15. The credit for coverage under a qualified health plan (IRC §36B).

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2 IRC §33 further provides that federal withholding tax "withheld at the source" for a foreign corporation is a credit against that corporation's income tax under the IRC. This is different from situations where a federal credit is offered as an incentive for certain activity, or to address situations of individual hardship. In the case of withholding, the foreign corporation has already, in effect, paid the tax; the credit merely allows this payment to be recognized, instead of making the corporation bear the tax for a second time.

3 *See* IRC §§32(c)(1)(D) and 6013(g) and (h).

<u>Tax Credits for Corporations</u>. Currently only corporations are subject to tax under AS 43.20, and there are a fair number of tax credits available to corporate taxpayers under the IRC that are incorporated by reference in AS 43.20.021(a):

1. "foreign tax credit" for "taxes imposed by foreign countries and possessions of the United States" (IRC §§27 and 901[4] (relating to Puerto Rico and "possession tax" credit)
2. Puerto Rico economic activity credit (IRC §30A)
3. "alternative motor vehicle" credit (IRC §30B)
4. "refueling property" credit for alternative-fuel vehicles (IRC §30C)
5. "new qualified plug-in electric drive motor vehicle" credit (IRC §30D)
6. credits under IRC §34 for the "amounts payable to the taxpayer" under IRC §§ 6420, 6421 and 6427 "determined without regard to" IRC §§ 6420(g), 6421(i) and 6427(k) respectively
7. the general business credit, as earned in the current tax year or as carried forward or back to the current tax year, under IRC §38(b) for —
    1) the investment tax credit under IRC §46
    2) the work opportunity credit under IRC §51(a)
    3) the alcohol fuels credit under IRC §40(a)
    4) the research credit under IRC § 41(a)
    5) the low-income housing credit under IRC §42(a)
    6) the enhanced oil recovery credit under IRC §43(a)
    7) the disabled access credit under IRC §44(a) (for small businesses only)
    8) the renewable electricity production credit under IRC §45(a)
    9) the empowerment zone employment credit determined under IRC §1396(a)
    10) the Indian[5] employment credit under IRC §45A(a)
    11) the employer Social Security credit under IRC §45B(a)
    12) the orphan drug credit under IRC §45C(a)
    13) the new markets tax credit under IRC §45D(a)
    14) the small-employer pension plan startup cost credit under IRC §45E(a)
    15) the employer-provided child care credit under IRC §45F(a)
    16) the railroad-track maintenance credit under IRC §45G(a)
    17) the biodiesel fuels credit under IRC §40A(a)
    18) the low-sulfur diesel fuel production credit under IRC §45H(a)
    19) the marginal oil and gas well production credit under IRC §45I(a)
    20) the distilled spirits credit under IRC §5011(a)
    21) the advanced nuclear power facility production credit under IRC §45J(a)
    22) the nonconventional source production credit under IRC §45K(a)
    23) the new energy efficient home credit under IRC §45L(a)
    24) the energy-efficient appliance credit under IRC §45M(a)
    25) the portion of the alternative motor vehicle credit to which IRC §30(b)(g)(1) applies

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[4] HB 399 does not propose to repeal the adoption of IRC §901 by reference in AS 43.20.021(a).

[5] IRC §45A(a)(6) specifically defines "Indian tribe" to include Alaska Native villages and Alaska Native regional and village corporations under the Alaska Native Claims Settlement Act "recognized as eligible for the special programs and services provided by the United States to Indians because of their status as Indians."

26) the portion of the alternative fuel vehicle refueling property credit to which IRC §30C(d)(1) applies
27) the Hurricane Katrina housing credit under IRC §1400P(b)
28) the Hurricane Katrina employee retention credit under IRC §1400R(a)
29) the Hurricane Rita employee retention credit under IRC §1400R(b)
30) the Hurricane Wilma employee retention credit under IRC §1400R(c)
31) the mine rescue team training credit under IRC §45N(a)
32) the agriculture chemical security credit under IRC §45O(a) for eligible agricultural businesses
33) the differential wage payment credit under IRC §45P(a) for employees who are active-duty members of the uniformed services
34) the carbon dioxide sequestration credit under IRC §45Q(a)
35) the portion of the new qualified plug-in electric drive motor vehicle credit to which IRC §30D(c)(1) applies
36) the small employer health insurance credit under IRC §45R(a)

and

37) the paid family and medical leave credit under IRC §45S(a) for an eligible employer,[6]

8. the carryback or carryforward under IRC §39 of unused credits in the current tax year
9. the credit for biodiesel and renewable biodiesel used as fuel under IRC §40A
10. the credit under IRC §45B for the portion of employer Social Security taxes paid with respect to employee cash tips for food and beverages
11. the investment credit under IRC §46 for —
    1) building rehabilitation under IRC §47
    2) the credit for energy property under IRC §48 placed in service during the tax year
    3) credit for a qualifying advanced coal project under IRC §48A
    4) the credit under IRC §48B for gasifying coal, petroleum residue, biomass or other material into a synthesis gas composed primarily of carbon monoxide and hydrogen for direct use or subsequent chemical or physical conversion
    5) the credit under IRC §48C for a "qualifying advanced energy project"
    6) the credit under IRC §48D for a "qualifying therapeutic discovery project[.]"

A number of these federal tax credits seem unlikely ever to be used by a company doing business in Alaska, and so they could stop being adopted by reference for purposes of Alaska's income tax without impacting any taxpayers. Yet except for historically-based credits like those for Hurricanes Katrina, Rita and Wilma which all occurred in 2005, why should Alaska preemptively disallow credits for activities simply because those activities currently don't occur here? Why not leave the door open to credits for bringing new activities to Alaska? — and then if there proves to be a problem adapting a federal credit for Alaskan purposes, it could be specifically dealt with at that time.

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[6] To avoid repetition, the IRC sections for these 37 credits listed above are not repeated when those sections' respective numbers would be reached in numerical order in the primary list of federal tax credits.

Indeed, it seems far more appropriate, and prudent, to consider the merits of these credits individually since a good number of them seem to reflect sound tax policy for Alaska's purposes. For example, why should the credit under IRC §45A for employing Alaska Natives be disallowed? Surely, it's a good thing to for the State to encourage the hiring of Alaska Natives.

Similarly, why should the credit under IRC §45P be disallowed for Alaskan employers who make up the wage difference for employees on active duty in military service? Certainly, we have a lot of people who serve in the National Guard and similar services.

Why should small Alaskan employers providing health insurance for their employees not get a tax credit for those costs under IRC §45R? The majority of businesses in Alaska are "small."

Why should the credit under IRC §45N for costs of training for mine safety be disallowed for Alaskan mines? Or the distilled spirits credit for Alaska's recent and growing crop of small distilleries? Or the renewable electricity production credit under IRC §45(a) or IRC §45K for electricity from wind farms like the one on Fire Island? Repealing these tax credits for state purposes makes no sense unless there is a good reason for repeal.

Coming to our own industry, why should the enhanced oil recovery (EOR) credit under IRC §43(a) be disallowed for our corporate income tax under AS 43.20? Surely getting more oil out of Alaska's aging oil fields is a good thing — it's essential for the future of our industry, and for the State's fiscal future as well.

Moreover, the EOR credit is different from most of the credits from the past few years, and it is different in two important ways. First, the credits arose primarily as credits against the production tax under AS 43.55, while HB 399 deals generically with federal tax credits that Alaska has adopted for purposes of its corporate income tax under AS 43.20. Second, and more fundamentally, oil companies' taxable income is based on their worldwide net income, and part of that net income is apportioned to the Alaskan part of the business based on the percentages of their worldwide production, worldwide sales and worldwide property (at original cost) that are in Alaska. *See* AS 43.20.031(e); AS 43.20.144; 15 AAC 20.300. This means an oil company could be losing money in its Alaska business, but still have sufficient profits elsewhere to have positive net income overall, of which a part would be apportioned to the Alaskan business on the basis of these percentages and taxed.

All this brings us to a second major point: Just last year House Bill 111 created the Alaska State Legislature Oil and Gas Fiscal System Working Group — a bicameral, bipartisan working group to analyze the State's oil and gas fiscal regime. To our knowledge, this Working Group has never met, much less ever discussed how to change the present fiscal regime. Yet the House Finance Committee introduced HB 399 on February 23rd — the 39th day of this Second Regular Session — without having held any hearings on changing tax credits under the state income tax for oil companies and non-oil companies alike. And here we are on April 9th — the 80th day of the Session — publicly discussing specific tax credits for corporate taxpayers for the first time. We think it would be wise for this Legislature to let the Working Group do its work.

Bill Section 2. This would amend AS 43.20.145(c) to conform with the repeal of AS 43.20.145(b)(3) in Bill Section 4.

However, there is a serious constitutional issue with the language of AS 43.20.145 that HB 399 does not address, which is the definition of "affiliated group" in AS 43.20.145(h)(2). The present statute says:

> (2) "affiliated group" means a group of two or more corporations in which 50 percent or more of the voting stock of each member of the group is directly or indirectly owned by one or more corporate or noncorporate common owners, or by one or more of the members of the group.

AS 43.20.145 was originally enacted as AS 43.20.073 in 1991 (*see* § 3, ch 11, SLA 1991) and it derives this "50 percent" standard from the definition of "consolidated business" in AS 43.20.144(h)(2) (enacted by § 3, ch 116, SLA 1981 as AS 43.20.072(g)(2) and relettered as (h)(2) in 1998),[7] which in turn derived from AS 43.21.120(2) in the former separate-accounting income tax for oil companies enacted by § 3, ch 110, SLA 1978 and repealed by § 19, ch 116 SLA 1981.

The constitutional issue arises because the Supreme Court of the United States ("SCOTUS") has rejected a simple ownership test as the constitutional standard for a state to be able apportion to itself and tax part of a multi-jurisdictional business's income from sources outside the taxing state. In *F.W. Woolworth Co. v. Taxation & Revenue Dept.*, 458 U.S. 354 (1982), the parent corporation owned 100% of

[7] AS 43.20.144(h)(2) provides:

> (2) "consolidated business" means a corporation or group of corporations having more than 50 percent common ownership, direct or indirect, or a group of corporations in which there is common control, either direct or indirect, as evidenced by any arrangement, contract, or agreement; the requirements of this chapter apply whether or not the taxpayer is the parent or controlling corporation[.]

the stock in a number of subsidiaries, but did not exercise the potential control to influence the subsidiaries' business activities; applying instead the "unitary business" concept, SCOTUS invalidated the New Mexico's attempt to tax income of the Woolworth subsidiaries that had no business contact with that state. *Id*. At 364-372. In the companion case to *Woolworth — ASARCO Inc. v. Idaho State Tax Comm'n*, 458 U.S. 308 (1982) — SCOTUS also found ASARCO was not a "unitary business" and rejected Idaho's proposed test based on a percentage of dividends paid to the parent on shares in the subsidiaries that are directly or indirectly owned by the parent. *Id.* at 315-330.

This "unitary business" concept relies on three indicia: "functional integration" of the business, "centralization of management" of the overall business, and "economies of scale"[8] — which, combined, effectively results in a "unitary business" as a whole being greater than the sum of its parts.

In 1983 SCOTUS agreed with the result in *ASARCO*, saying:

> Under both the Due Process and the Commerce Clauses of the Constitution, [[9]] a State may not, when imposing an income-based tax, "tax value earned outside its borders." *ASARCO*, *supra*, at 315.

Container Corp. v. Franchise Tax Bd., 463 U.S. 159, 154 (1983). However, in *Container Corp.* the California Franchise Tax Board had applied the "unitary business" concept to apportion part of Container Corp.'s income to its activities within California. The Court wrote:

> The unitary business/formula apportionment method is a very different approach [from "formal geographical or transactional accounting" to trace the actual flow of profits from subsidiary to parent] to the problem of taxing businesses operating in more than one jurisdiction. It rejects geographical or transactional accounting, and instead calculates the local tax base by first defining the scope of the "unitary business" of which the taxed enterprise's activities in the taxing jurisdiction form one part, and then apportioning the total income of that "unitary business" between the taxing jurisdiction and the rest of the world on the basis of a formula taking into account objective measures of the corporation's activities within and without the [taxing] jurisdiction. This Court long ago upheld the constitutionality of the unitary business/formula apportionment method …. [citations omitted] The method has not gained wide acceptance, and is in one of its forms the basis for

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8 *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980) at 428; *quoted* in *Exxon Corp. v. Wisconsin Dep't of Revenue*, 447 U.S. 207 (1980) at 222.

9 Due Process requires the taxing state to have a legal connection ("nexus") with that which it seeks to tax; in the case of income, the income-producing activity – in the absence of a "unitary business" – needs to occur within the taxing state or have a reasonable and close relationship to that state. The Commerce Clause prevents states from creating burdens or obstacles to Interstate and/or Foreign Commerce, whether by taxes they impose and seek to collect or by other actions.

> the Uniform Division of Income for Tax Purposes Act (Uniform Act), which has at last count been substantially adopted by 23 states, [[10]] including California.

463 U.S. at 165.

In *Meadwestvaco Corp. v. Illinois Dept. of Revenue*, 553 U.S. 16 (2008), SCOTUS reaffirmed the "unitary business" concept, declining to address "a new ground for the constitutional apportionment of intangibles based on the taxing State's contacts with the capital asset rather than the taxpayer[.]" Id., slip op. at 13.

So, if HB 399 is going to be amending AS 43.20.145(c)(2), then it should replace the obsolete test in that paragraph based on 50% ownership or more that dates back to 1978 and replace it with the "unitary business" concept that SCOTUS has extensively developed after Alaska adopted ownership-percentage. It would also be prudent to make a similar amendment to AS 43.20.144(h)(2) for oil companies.

Bill Section 3. This would repeal the reference to "royalties" from the existing phrase "[d]ividends and royalties taxable to a corporation" in AS 43.20.145(d). These "royalties" are not royalties in the oil and gas sense — AS 43.20.145 does not apply to oil companies (AS 43.20.144 applies to them). These "royalties" are royalties for using intellectual property or something that has been invented and patented. *See* AS 43.19.010 (Multistate Tax Compact), Article 4 (Division of Income), ¶¶ 4, 5 and 8. Compared to such "royalties" in the oil and gas business, these royalties for intellectual property and inventions are commonplace, and thus Bill Section 3 should probably be deleted from HB 399. But, because this has little if any impact on our members, AOGA does not formally take a position on this, although others may.

Bill Section 4. This Bill Section would repeal eight existing sections and subsections in AS 43.20. If any changes are made to Bill Section 1 on the basis of our comments above about tax credits, then AS 43.20.021(d) — fixing the credit against the Alaska tax at 18% of the amount of the corresponding federal tax credit adopted by reference in AS 43.20.021(a) — should not be repealed since it would continue to have a useful purpose with respect to the federal credits that AS 43.20.021(a), as amended, would allow.

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[10] Alaska was the first state to adopt the Uniform Division of Income for Tax Purposes Act. *See* AS 43.20.050 – 43.20.150 as enacted by § 1, ch 75, SLA 1959. These provisions were essentially the same in substance as those now in Article IV of the Multistate Tax Compact (AS 43.19.010).

It is unnecessary to repeal AS 43.20.036(a) because that subsection bars the use of the federal tax credit for foreign taxes.

If the federal investment tax credit under IRC §46 that comprises part of the general business tax credit under IRC §38(b) is not repealed under Bill Section 1, then the $20 million cap on such credits under AS 43.20.036(b) should not be repealed either.

The repeal of the special credits in AS 43.20.042 seems appropriate as a dead letter, since investments made after December 31, 1994 are ineligible under subsection (g) of that statute, and no such credit may be carried forward to tax years after December 31, 1999 under (f) of the statute.

AS 43.20.144(g) and AS 43.20.145(g) relate solely to situations there is a contract under AS 43.82 (the Alaska Stranded Gas Development Act), which is still in full force and effect. Since HB 399 would not repeal AS 43.82, it should not repeal AS 43.20.144(g) and AS 43.20.145(g) because that would be inconsistent with what AS 43.82 authorizes.

We have no stake in the repeal of AS 43.20.145(b)(3) because that section does not apply to companies producing oil and gas and/or transporting it by pipeline. However, we do not see the purpose in repealing that statute, which simply requires the inclusion of "foreign sales corporation[s]" in a business's "water's edge combined" return. Such "foreign sales corporations" are not themselves "foreign" in the sense of being outside the U.S., for if they were, then the U.S. "water's edge" provisions of AS 43.20.145 would not apply to them.

Bill Sections 5 – 7. Bill Section 7 provides that the changes under Bill Sections 1 – 5 take effect 1 January 2019. We agree that changes under HB 399 should take effect at the start of a tax year instead of part way through.

Bill Section 5 provides a fallback in case HB 399 passes but the effective date in Bill Section 7 fails. This fallback is for the provisions of Bill Sections 1 – 4 to apply to taxpayers who file income tax returns for tax years that begin on or after the date when Bill Sections 1 – 4 take effect without the effective date clause. If HB 399 passes on or before October 2 this year, the Bill would take effect 90 days later (i.e., on or before 31 December 2018), and under Section 5 the applicability of the changes would begin at the start of calendar year 2019, the same as if the effective date clause did pass.

Bill Section 6 requires the Department of Revenue to adopt regulations to implement the Act, but prevents those regulations from coming into effect before the first of 2019.

In summary, AOGA opposes this bill and urge the committee to not adopt it. If changes are going to be made to Alaska’s corporate income tax, we would encourage the Legislature utilize the Working Group as was designed when the group was created.