



Memorandum

TO: Joseph Balash
FROM: Marvin A. Kirsner
DATE: March 2, 2006
RE: Alaska Oil and Gas Profits Tax - Follow-Up Analysis

You asked for a follow-up analysis on two different components of the draft petroleum profits tax.

Exemption for Small Producers:

There is an annual exemption for smaller producers found in Section. 43.55.160(i) and (j) that is designed to exempt producers who produce less than \$73 million annually in petroleum. You indicated that there is some concern that this exemption might be manipulated to the benefit of larger companies for who this exemption was not intended. I noted this in my preliminary analysis, dated February 27.

Section 43.55.160(j) takes a major step in preventing abuse of this exemption by not making it automatic. In order to be eligible for this exemption, a producer must apply for the exemption with the Department of Revenue. The language attempts to prevent a large oil company from setting up several smaller subsidiaries to take advantage of this exemption by requiring an applicant for this exemption to demonstrate that it is a "distinct producer entity" so that that ownership of the applicant would not be reasonably attributed to a single producer entity.

Although the intent of this limitation is to prevent large energy companies from benefiting from this exemption, there are opportunities for abuse. The statute, as drafted, would clearly prevent a company that is 100% owned by a larger company from utilizing this exemption. However, where there is room for abuse is where more than one large company form a joint venture, partnership or corporation together. For example, if Company 1, Company 2 and Company 3 form an LLC, then the LLC might technically be eligible for this exemption, since the ownership of the LLC can not be "attributed to a single producer entity." In such a case, if the Department denied the exemption to the LLC, the LLC might attempt to litigate this, arguing that the net value of the oil and gas is not attributed to a single producer entity, but rather to (in this example) three separate producer entities.

A workable solution to this problem is to adopt a rule similar to Alaska Administrative Code Rule 20.320(b), dealing with the Alaska corporation income tax. This rule provides that a corporation that owns an interest in a partnership that does business in the state must report its share of the

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partnership income on its Alaska corporation income tax return. A similar "look through" provision could be adopted for purposes of this small producer exemption. For example, if the applicant for the exemption is an LLC owned by three large energy companies, the LLC would not be eligible for the exemption, because the Department would be authorized to look through the LLC to its owners.

The statute could allow a partial exemption for joint ventures between large energy companies and a smaller exploration company. For example, say that Large Energy Company and Small Exploration Company form an LLC to explore, develop and produce oil. Assume that Small Exploration Company produces only \$10 Million per year in its Alaska operations, while Large Energy Company produces several hundreds of millions per year. Large Energy Company and Small Exploration Company each own 50% of the LLC. Assume the LLC will produce \$50 million of oil per year. Using a look through provision, the Department could grant an exemption to the Small Exploration Company's share of the oil (one half of the \$50 million), while taxing Large Energy Company's share of \$ 25 million. This would encourage joint ventures between small and large companies while maintaining the integrity and spirit of the \$ 73 million per year ceiling for small producers.

The legislature might also consider a phase out of the \$73 million per year ceiling. For example, for each dollar over \$73 million in oil produced, the exemption amount would be reduced by a dollar. Otherwise, a company would just cease production operations if it comes close to the \$73 million ceiling.

Limitation on Value of Oil per Royalty Agreements:

Section 43.55.150 authorizes the Department of Revenue to adopt regulations that would allow a producer to limit the value of oil based on a royalty settlement agreement with the state. You asked whether this made sense to allow oil companies to limit the value (and therefore tax liability) prospectively as the result of such an agreement. To really answer this, we need to understand the mechanics of such an agreement. If the oil company is bound under the agreement to pay an escalating royalty based on the value of the oil, then it might be fair to limit the value on which the tax is calculated. However, such a provision could result in very complex budgeting issues, since the reduction in income from such agreements would have to be considered in estimating revenues. Again, we would need to investigate the purpose and practical effect of such an agreement before being able to say more. However, since the Department would have the authority to adopt such regulations, it can be presumed that it would not adopt any regulation to allow such a limitation on value of oil that would be economically detrimental to the public finances if it were too one sided in favor of the oil companies.

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Supreme Court Case on Ohio Tax Credit:

The U.S. Supreme Court heard oral arguments in Cuno v DaimlerChrysler yesterday. This is the case that could jeopardize many economic development tax incentives all around the country, including the proposed tax credit for energy companies making investments in Alaska oil and gas infrastructure. Articles in today's tax press indicate that there were many questions from the Justices on standing. As mentioned in our preliminary analysis, there is a fair chance that the Supreme Court might just rule that the plaintiffs did not have standing to bring this action. If this is the case, then the process will likely start over in state court. The problem is that this would result in uncertainty over whether the Alaska tax credit is viable, which in turn could result in reluctance on the side of the large energy companies to expend funds to build the much needed gas pipeline.

Once again, the certain fix for this problem (in the event the Supreme Court does not squarely rule that state economic development tax credits are valid) would be for Congress to pass legislation authorizing economic development tax incentives. Alternatively, the legislature might consider restructuring the tax credit to a direct cash grant program to the energy companies to subsidize construction of the gas pipeline, since the Sixth Circuit case of Cuno v DaimlerChrysler indicated that a direct cash subsidy from a state as an economic development incentive would not violate the commerce clause of the United States constitution.

If you have any questions, please contact me at 561-955-7630 or email me at KirsnerM@gtlaw.com.