

## The Battle Over Payment for Alaska's Tax Credits

by Jonathan E. Iversen



Jonathan E. Iversen

Jon Iversen is an Alaska-based tax attorney with Stoel Rives LLP who provides tax planning and tax structuring advice and represents clients in tax audits and appeals. His practice emphasizes Alaska state and local taxation. Before joining Stoel Rives, Iversen served as director of the Tax

Division of the Alaska Department of Revenue. He also worked as an assistant attorney general representing the Alaska DOR in tax matters and the Alaska Department of Natural Resources in royalty cases and other oil and gas concerns.

In this edition of *Alaska Tax: The Last Frontier*, Iversen discusses the latest efforts to fund Alaska's unpaid oil and gas production tax credits.

As I write this article, Alaska is just past peak tourist season with a month or so of summer remaining. Fireweed is in bloom, fishing charters are out chasing salmon and halibut, mountainsides that were covered in snow just a couple of months ago are green, highways are busy with additional traffic, and downtown Anchorage is bustling with new faces and families in matching rain gear. Tourism is a shot in the arm for the economy — one that is much appreciated by many residents.

Yet when it comes to Alaska's overall revenue picture, the driver is really oil and the real boon for this summer is that Alaska North Slope oil prices seem to have stabilized in the \$70- to \$80-per-barrel range. These price levels are directly linked to Alaska's fiscal health, and the revenue from tourism pales in comparison with revenue from oil, regardless of the number of sunny days we enjoy in a given summer.

The last article discussed the ongoing debate about Alaska's oil and gas production taxes, the importance of rebatable production tax credits in incentivizing investment, and the fact that those incentives became a target when Alaska's revenue dropped because of the drop in oil prices. Unfortunately, the success of the rebatable production tax credit program led to its downfall when oil prices dropped. The bill is due — oil and gas explorers and developers are holding over half a billion dollars in rebatable tax credits and the full tab is expected to ultimately reach close to a billion dollars. Although the Legislature repealed the rebatable credit program, the queue of valid outstanding credits remains to be paid, and lawmakers and policymakers have been searching for a resolution to this predicament.

### Rebatable Production Tax Credits

A brief summary of the nature of Alaska's rebatable oil and gas production tax credits will be useful in understanding the problem Alaska is facing. In general, Alaska's production tax is levied on the net revenue of oil and gas production from leases or properties in the state.<sup>1</sup> Net revenues are calculated based on a destination value of the oil or gas, less (1) the pipeline and marine transportation costs to get from the point of production to the destination market; and (2) operating and capital costs for oil and gas exploration, development, or production upstream of the point of production (called lease expenditures).<sup>2</sup> Net revenues are then multiplied by the tax rate and the result is reduced by credits.<sup>3</sup>

<sup>1</sup> Alaska Stat. 43.55.011(e); and Alaska Stat. 43.55.020(e).

<sup>2</sup> Alaska Stat. 43.55.150; and Alaska Stat. 43.55.160.

<sup>3</sup> This oil and gas production/severance tax based on net revenue is unique in the United States — other states with a severance tax levy the tax on the gross value at the point of production without netting off upstream costs.

**Table 1: Nontransferable Production Tax Credits**

Name	Statute	Description	Sunset Date	Area
\$5/barrel (bbl) credit	Alaska Stat. 43.55.024(i)	\$5/bbl credit applied against tax liability for "new" oil production	The earlier of three consecutive or nonconsecutive years in which average North Slope price per barrel is greater than \$70, or after seven years of production after 2016	North Slope – oil
Sliding scale credit	Alaska Stat. 43.55.024(j)	Credit against tax liability for oil production from "legacy" fields that does not qualify for the \$5/bbl credit for production from "new" fields. Credit ranges from \$0/bbl when gross value is $\geq$ \$150/bbl to \$8/bbl when gross value is $<$ \$80/bbl	No sunset	North Slope – oil
Small producer credit	Alaska Stat. 43.55.024(c)	\$12 million credit for producers of average of not more than 50,000 British thermal units equivalent bbl/day; phases out at 100,000 Btu equivalent bbl/day	The later of 2016 or the ninth year after the year of first commercial production before May 1, 2016	All areas

"New production" means one or more of the following: (1) production from a lease or property that does not contain a lease that was within a unit on January 1, 2003; (2) production from a participating area established after December 31, 2011, that is within a unit formed before 2003, if the participating area does not contain a reservoir that had previously been in a participating area established before December 31, 2011; or (3) production from acreage that was added to an existing participating area on or after January 1, 2014, for the volume produced from the additional acreage. Alaska Stat. 43.55.024(i); and Alaska Stat. 43.55.160(f).

The credits that are available for any given explorer or producer depends on where that company's exploration, development, or production operations are in Alaska. Companies doing work on the North Slope have different credits than companies working in Cook Inlet in Southcentral Alaska. Likewise, companies exploring or producing in "Middle Earth" (areas of the state south of the North Slope and outside Cook Inlet) also have a different suite of credits.

All the Alaska production tax credits can be used to reduce production tax liability, but not all the credits are transferable or rebatable. As shown in Table 1, some credits can be applied only against production tax liability and cannot be transferred or carried forward for use in a later calendar year.

Some other credits are rebatable and can also be transferred to a producer for use against the producer's oil and gas production tax liability. These rebatable and transferable credits are summarized in Table 2.

**Table 2: Rebatable/Transferable Production Tax Credits**

Name	Statute	Description	Sunset Date	Area
Carried-forward annual loss credit	Alaska Stat. 43.55.023(b)	Credit for expenditures that were not deductible in calculating the tax for previous calendar year	Costs must be incurred before 2018	Previously available for all areas
Qualified capital expenditure credit	Alaska Stat. 43.55.023(a)	Credit for qualified capital expenditures	For Cook Inlet, costs must be incurred before 2018; for North Slope, costs must have been incurred before 2014	Continues for Middle Earth only
Well lease expenditure credit	Alaska Stat. 43.55.023(l)	Credit for seismic in a unit and intangible drilling and development costs	For Cook Inlet, costs must be incurred before 2018; never available for North Slope	Continues for Middle Earth only
Alternative credit for exploration	Alaska Stat. 43.55.025(a)(1)-(4)	Credit for exploration wells and for seismic outside a unit	Expenditure must be incurred for work performed before 2022 for Middle Earth wells, before 2018 for Middle Earth seismic, and before July 1, 2016, elsewhere	Continues for Middle Earth only

It is these rebatable/transferable credits that have been the subject of scrutiny over the past few years. The result was the phaseout or repeal of rebatable credits through H.B. 247, which passed in 2016, and through H.B. 111, which passed in 2017. For costs incurred after 2017, the only *transferable* credits that may be earned are for Middle Earth projects, and *rebates from the state* can be obtained only for credits for costs incurred before July 2017. And although the rebate program has been repealed, companies are holding hundreds of millions of dollars in credits for costs incurred before July 2017 that remain unpaid by the state.

### The Tax Credit Queue

The oil and gas production tax credit program was designed to incentivize investment, and the rebate program was specifically geared for exploration and development by explorers, small producers, and new entrants to the state. To qualify for the rebates, companies must have no

production tax liability — or any liability to the state related to their oil and gas operations — and must be small producers, which is defined as production of less than an average of 50,000 Btu equivalent barrels per day.<sup>4</sup> It is these companies that have been hit the hardest by the lack of a truly meaningful appropriation to the oil and gas tax credit fund for the last two years compared with the outstanding balance of credit certificates awaiting purchase; the fiscal 2018 appropriation was \$77 million to pay down a pre-2017 queue of rebatable credits of around \$470 million.<sup>5</sup> By regulation, the pre-2017 queue would be paid first on a pro rata basis.<sup>6</sup> Rebate applications filed after 2016 would be prioritized in the first instance based on the year in which the application was received, and then further prioritized based on

<sup>4</sup> Alaska Stat. 43.55.028(e), (j).

<sup>5</sup> See Alaska Department of Revenue, Tax Division, Revenue Sources Book (fall 2017), p. 81.

<sup>6</sup> 15 Alaska Admin. Code 55.525(a), (h).

the percentage of Alaska residents in the applicant's workforce.<sup>7</sup>

The Alaska Department of Revenue estimates that a balance of around \$821 million in tax credits will be in the purchase queue in fiscal 2019, most of which will have been earned in prior years, although the total could be higher, because that figure assumes that \$125 million would be transferred to producers for use against production tax liability.<sup>8</sup> This outstanding balance has been a source of extreme stress for companies that invested in the state in reliance on the program, many of which used the credits in financing transactions as a source of collateral and repayment to advance exploration and development projects. Low oil prices over the last few years combined with advisory bulletins issued by the DOR have resulted in a supply of credits that eclipses demand in the secondary market. Clearly, something must be done to pay down the queue.

### New Legislation to Pay the Bill

To alleviate the financial stress created by the lack of meaningful appropriations for the purchase of tax credits, Alaska Gov. Bill Walker (I) introduced H.B. 331 in February to establish the Alaska Tax Credit Bond Corp. in the DOR.<sup>9</sup> The corporation would be authorized to issue up to \$1 billion in bonds to finance purchases of the oil and gas tax credits.<sup>10</sup> The purchase amount would be the face amount of the tax credits, discounted each year by 10 percent, although a lower discount rate down to the true cost of interest plus 1.5 percent would be available under specific conditions.<sup>11</sup>

On April 13 Legislative Legal Services issued a memorandum to Rep. Paul Seaton (R), who had asked whether H.B. 331 is constitutional.<sup>12</sup> The memorandum outlined two areas of potential constitutional attack. The first area would be a potential violation of the prohibition against

dedicating future revenues for a specific purpose in Article IX, sections 7 and 13 of the Alaska Constitution — withdrawals from the treasury must be done by annual appropriation.<sup>13</sup> The second area of attack would be that the bonding debt would not be permissible under Article IX, sections 8 and 11 of the Alaska Constitution, which place limits on contracting for state debt, but provide an exception for debt incurred though the issuance of revenue bonds by a public corporation of the state.<sup>14</sup> Legislative Legal Services concluded that it is unlikely H.B. 331 would violate the prohibition against dedicated funds because H.B. 331 provides that debt service on the bonds would be from funds that "may be appropriated" by the Legislature annually.<sup>15</sup> However, the memorandum stated that the issuance of revenue bonds by a public corporation funded through annual appropriation was a more novel concept that carried a "substantial risk" of being found to be unconstitutional.<sup>16</sup>

The Alaska attorney general countered in a letter dated April 27 to the members of the House Finance Committee and its co-chairs, Seaton and Rep. Neal Foster (D), and in a May 2 legal opinion issued to Walker.<sup>17</sup> In these documents, the attorney general argued that H.B. 331 is constitutional because the legislation expressly conditions payment of the bonds on annual appropriations and provides that the bonds are not a general obligation of the state and are not state debt under Article IX, section 8 of the Alaska Constitution.<sup>18</sup> In reaching the conclusion that H.B. 331 is constitutional, the attorney general pointed to the express language of H.B. 331 and the Alaska Constitution, Alaska Supreme Court precedent, the record of Alaska's constitutional convention, and the history in Alaska and other states of issuing subject-to-appropriation debt at state and local levels.<sup>19</sup>

<sup>7</sup> *Id.*

<sup>8</sup> See Alaska Department of Revenue, Spring 2018 Revenue Forecast, at 2 (2018).

<sup>9</sup> The Senate version of the legislation was S.B. 176. This article refers to H.B. 331 because that was the vehicle that ultimately passed.

<sup>10</sup> See Alaska Stat. 37.18.010 et seq.

<sup>11</sup> Alaska Stat. 43.55.028(m).

<sup>12</sup> See Legislative Legal Services memorandum.

<sup>13</sup> *Id.* at 1-3.

<sup>14</sup> *Id.* at 3-7.

<sup>15</sup> *Id.* at 2.

<sup>16</sup> *Id.* at 7.

<sup>17</sup> See letter from Attorney General Jahna Lindemuth; see also Lindemuth's opinion.

<sup>18</sup> See attorney general's opinion at 1, May 2, 2018.

<sup>19</sup> *Id.* at 2-9.

The Legislature passed H.B. 331 on May 11, and the bill was signed into law June 21, but its fate is unclear. Notwithstanding the attorney general's letter and legal opinion, a lawsuit was brought in superior court May 14 challenging the constitutionality of the law.<sup>20</sup> Alaska filed a motion to dismiss the complaint June 25 that has yet to be decided. Because the lawsuit would affect the marketability of the bonds, the DOR has stated that it does not plan to proceed with issuing bonds at this time.

### On the Horizon

The next article will include an update on the constitutional challenge to H.B. 331 as well as more details about the new law. Also, 2018 elections are looming and the legislative session starts in January 2019, with the threat of additional tax changes — no doubt there will be much to discuss. The uncertainty continues for taxpayers in Alaska, as does the financial stress that explorers and small producers have been enduring. ■

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<sup>20</sup> *Ferrer v. State of Alaska*, 1JU-18-00699 Civil.