MINUTES OF THE
UTAH TAX REVIEW COMMISSION
Thursday, October 9, 2008 – 9:00 a.m. – Room C445 State Capitol

Members Present:
Mr. M. Keith Prescott, Chair
Mr. David Crapo, Vice Chair
Mr. Larry Barusch
Mr. Mark K. Buchi
Rep. John Dougall
Ms. Janis A. Dubno
Sen. Brent Goodfellow
Rep. Wayne Harper
Sen. Lyle W. Hillyard
Ms. Kathleen Howell
Comm. Bruce Johnson

Members Absent:
Dr. Gary Cornia

Staff Present:
Mr. Phillip V. Dean, Policy Analyst
Mr. Leif G. Elder, Policy Analyst
Mr. Bryant R. Howe, Assistant Director
Ms. Angela D. Oakes, Associate General Counsel
Ms. Rebecca L. Rockwell, Associate General Counsel
Ms. Phalin L. Flowers, Legislative Secretary

Note: A list of others present, a copy of related materials, and an audio recording of the meeting can be found at www.le.utah.gov.

1. TRC Business

Chair Dougall called the meeting to order at 9:02 a.m.

MOTION: Mr. Buchi moved to approve the minutes of the June 12 and September 11, 2008 meetings. The motion passed unanimously with Sen. Hillyard, Mr. Jones, Sen. Niederhauser, and Mr. Prescott absent for the vote.

2. Progress Report - Tax Issues Working Group

Ms. Rockwell listed the members of the Tax Issues Working Group. She said that besides Chair Keith Prescott and TRC members Sen. Wayne Niederhauser, Mr. Larry Barusch, and Comm. Bruce Johnson, there are three CPAs on the working group, Mr. Greg Prawitt, Mr. Curtis Trader, and Mr. Boyd Randall, and representatives of the Utah State Tax Commission (Tax Commission), Ms. Lynn Solarczyk, Mr. Kim Ferrell, Mr. Frank Hales, and Ms. Valerie Newson.

Ms. Rockwell said that the working group has focused mainly on the taxation of pass-through entities and taxpayers that receive a share of income, gain, loss, deduction, or credit of those pass-through entities. She noted that the working group would have legislation ready for the TRC to address at its November meeting and explained what would be included in that legislation.

3. Oil and Gas Severance Taxes

Dr. Gabriel Lozada, Department of Economics, University of Utah, and Mr. Michael Hogue, Department of Economics, University of Utah, distributed and discussed "The Effect of Proposed 2009 Tax Changes on Utah's Oil and Gas Industry."

Dr. Lozada explained that he was asked to estimate the effects on production if certain provisions in the state oil and gas severance tax were eliminated. He also explained that his analysis attempts to estimate only the immediate effects. He said that changes in taxes also have secondary effects such as a decrease in employment. Dr. Lozada noted that he did not estimate the macroeconomic effects because they may be offset by actions taken as a result of increasing oil and gas severance tax revenue. For example, the state could either decrease taxes on another sector or increase state spending. He explained that such an extensive analysis was not part of his report. He said that it focuses solely on the oil and gas industry.

Dr. Lozada said that in discussing this industry it is common practice to refer to "production" when in fact a more precise term would be "extraction" as nothing is in fact being "produced," but merely being extracted from the ground. Given this, it is important to remember that "production" is never lost but rather shifted from now to the future.

Sen. Goodfellow asked if the analysis included any review of the effects of depositing oil and gas severance tax revenue into a trust fund to provide an income source after the natural resources are exhausted. Dr. Lozada replied that while this was not part of this analysis, the idea of setting aside some of the profits from the natural resources industry to compensate for the depletion of resources is a good idea because the income that is generated by the "production" of oil and gas is different from income generated from nonextractive sectors. For example, oil and gas deposits can be thought of as part of the natural capital stock of the economy. The income that is generated is in the nature of selling off the economy's natural capital stock. Therefore, not all of the profit should be considered as true income. Some of it should be set aside in a sinking fund so that the total amount of income generated by the resource would be sustainable over the long run. He said he tried to estimate what the effect would be on either the number of wells drilled, the output of wells, or both, if credits and exemptions were removed from Utah's oil and gas industry.

Sen. Goodfellow commented that increased revenue from oil and gas severance taxes should be placed into a trust fund.

Dr. Lozada said that there are two main approaches to studying the oil and gas industry. One approach was used by Dr. Gerking in work that he did for the Wyoming Legislature and in 2002 for the TRC. This approach builds on a mathematical model of exhaustive resource extraction that was written by Harold Hotelling in 1931. In this model, the exhaustibility of the resource is paramount. Unfortunately, these models have not been useful in describing the historical evolution of prices and output in extractive industries. In some sense why extractive industries do not follow the "Hotelling model" has been a puzzle for the last 30 years.

Dr. Lozada said that he employed a short term approach of just using the historical data from Utah to estimate the effects of increases in taxes over the next five or six years.

Dr. Lozada described a graph on page two of his report showing price per barrel of Utah oil in constant 1984 dollars. A similar chart for natural gas is displayed on page three of the report.

Dr. Lozada said that he used historical data to estimate the effect of price on either drilling or production and then translated the short run preferential tax treatment into a price change. For example, there is no severance tax imposed on the first 12 months of production from a "wildcat" well. To estimate the effects of this tax exemption, it was necessary to determine how this translates into a permanent change in price using a net present value formula.

Referring to the bottom of page four of the report, Equation 1, Dr. Lozada explained that the left hand of the model indicates the number of wildcat wells drilled in a year explained by right hand side of the equation which includes a constant term, the number of wells drilled in the prior year, a constant term multiplied by the price of oil in the current year, and an error term.

Equation 2 shows the best estimate of what the relationship is between the variables described above including the number of wells drilled in the previous year and the price of oil. The table between Equation 1 and Equation 2 shows measures of the degree of statistical certainty or uncertainty of Equation 2. Dr. Lozada indicated that there is not a lot of confidence in the numbers but Equation 2 actually looks to be a very good fit.

Dr. Lozada explained that the report also displays models showing the effects of price changes for natural gas wildcat wells, oil development wells, and natural gas development wells. He said that it is difficult to explain the effects of prices on the number of extension wells drilled. There is significant fluctuations in the number of extension wells drilled in Utah and the fluctuations do not appear to be related to price. Dr. Lozada explained that the statistical measure referred to as a *p* value in the tables should be a small number. The smaller the number, the more confidence there is that the model is capturing the pattern. The *p* value of .53 for the coefficient on price is not a small number. Numbers less than .1 are preferred. The .53 value in fact shows that there is the weakest of links between price and the number of extension petroleum wells drilled.

Dr. Lozada commented that where price does not have a strong effect on economic activity, as is the case with oil and natural gas extension wells, then one must also conclude that taxes do not have a strong effect on economic activity because companies are concerned with price net of tax. There are presumably geophysical reasons why companies decide to drill extension wells that are not strongly related to price. Dr. Lozada pointed out that the *p* value for the price coefficient in the natural gas extension well model is .72. The worse that a *p* value can ever be is 1.

Page 10 of the report shows the reduction in the number of wells drilled because of the elimination of the preferential tax treatment. The line "total decline" is a sum of the previous lines. The first number on the total decline line is 1.351. This means that in short run (less than one year), the model predicts that about 1.5 fewer wells in total will be drilled if the tax breaks are removed. The long run decline (three to four years), is estimated to be at 3.6 wells.

Mr. Hogue said that there are about 1,000 new wells drilled each year.

Page 11 displays an analysis of the tiered severance tax rates and the effects of the increase in the severance tax rate in 1992 from four percent to five percent for the value of oil above $13/barrel.

Mr. Barusch asked if it was possible to use the model to assess the effect of a rate change on production. Dr. Lozada said that because the model employs the log of prices and not actual price, there would be a small difference such that an exact extrapolation could not be made for a large increase in the rate. He noted, however, that an estimate of a small increase in rate would be more precise. He said that such an analysis could be performed at the request of the TRC.

Ms. Dubno asked Dr. Lozada to clarify the difference between the short run and long run lost production. Dr. Lozada replied that this is an annual loss of production. He explained that because of inertia in a company's decision making process, production is not precisely timed with change in tax rates and reactions are delayed.

Mr. Crapo asked if the "lost" production is really production deferred to a later period. Dr. Lozada replied that this is correct.

Dr. Lozada reviewed the analysis on stripper wells. He explained that patterns of price and production from stripper wells are not correlated. Just in looking at the raw data, one can assume that attempting to explain stripper well activity by changes in price is not likely to produce a good statistical fit and the model in fact confirms this prediction. Because of this difficulty, Dr. Lozada decided to use a range of numbers to predict stripper well activity. This is called a confidence interval method. A confidence interval of 95% was used. This means that one can be 95% confident that the true decline in the number of stripper wells will fall between the lower and upper number.

Dr. Lozada explained that the top of page 13 exhibits a scatter plot with the horizontal axis being price and the vertical axis being the number of stripper wells. The scatter plot shows no strong correlation between price and the number of stripper wells. Dr. Lozada said that all that can be concluded based on the historical data is that it would be hard to predict what would happen to the number of stripper wells if the preferential tax treatment were eliminated. With regard to natural gas stripper wells, the data indicate a smooth upward trend which appears to render price as an irrelevant factor in stripper well production. Dr. Lozada noted that the p value for price in this model is .6 which is quite high. He also noted that the long run upper confidence interval has the wrong sign. The data does not support the assumption that price affects the number of stripper wells.

The report concluded with an attempt to analyze the effect of the workover and recompletion credits. Dr. Lozada explained that because of difficulties with data, it was not possible to provide a definitive answer on the effects of these credits at this time. However, a more complete analysis will be presented at the next meeting. Dr. Lozada also said that the appendix portion of the report is not complete but that a complete report will be presented at the next meeting.

Mr. Barusch asked Dr. Lozada if the results of this analysis would be different if he had access to net revenue data including the costs of production. Dr. Lozada replied that he does not know the answer to this question without information on a company's production costs. Most empirical work in the field is done using gross revenue data. Dr. Lozada said that when prices increase, the industry finds it profitable to exploit more marginal deposits which then increases the industry's costs. He said that to the extent that whenever prices go up, unit costs go up, and that whenever prices decline, unit costs decline, then the results of this analysis would be similar. The results of the estimations would not be affected if per unit cost and per unit price move together.

Sen. Goodfellow asked if results of the analysis would be different if more current data were available. Dr. Lozada said that while having access to more current data would be optimal, the data series used does include periods of large price fluctuations, so the recent price increases are not historically unprecedented. There is a good chance that the numbers would not change significantly. Once the price of oil reaches $130 per barrel, the effects of the preferential tax treatment are likely to be even less than presented in the analysis.

Ms. Dubno asked for information on cost comparisons between states. She said that she is attempting to develop an equitable severance tax policy given that it is more expensive to drill in Utah compared to neighboring states.

Mr. Barusch suggested that the Utah Petroleum Association be asked to comment on the report at a future meeting. He suggested that the TRC schedule a hearing on severance tax exemptions described in Section 3 of the report. Mr. Crapo said that increased revenues should be placed into the state permanent trust fund.

Mr. Howe distributed and discussed "Estimated Cost of Drilling and Equipping Wells" and a group of charts showing a rotary rig count in selected oil producing states.

Mr. Lee Peacock, Utah Petroleum Association, explained that rotary rigs encompass all drilling rigs in each state.

4. Income Tax Definitions of Business Income

Staff distributed Utah Code Ann. Section 59-7-302.

Comm. Johnson explained that the current definition of business income found in Utah Code Ann. Section 59-7-302 is vague and subject to wide interpretation. He recommended that the TRC study ways of adopting a clear, broad definition of business income. He explained that the current definition comes from the Uniform Division of Income for Tax Purposes Act, which was drafted in 1957. He said that most states have interpreted this definition to include a transactional test (any income arising from transactions in the ordinary course of a trade or business) and a functional test (related to the acquisition, management, and disposition of property that is used in the ordinary course of business). He said that most states argue that only passive investment income should be treated as nonbusiness income. He said that the broad reading by most states is that anything that happens in the ordinary life of a corporation is all included in the definition of business income.

Comm. Johnson said that a more narrow reading of this definition emphasizes that income must be derived from the "regular course of the taxpayer's trade or business." Under this more narrow reading, income that accrues to the business outside of its "regular course" of activity should not be included in the definition of business income. For example, some states argue that income from the liquidation of a subsidiary should be taxed in the same way as was the operating income from that subsidiary. On the other hand, taxpayers argue that this is income from the cessation of the business, not the regular course of business. He said that the Tax Commission has always attempted to apply a principled definition.

Comm. Johnson said the Tax Commission believes that the definition should be clarified but does not have proposed language at this time. Other states have language that could be used as a template. He explained the disadvantage of allowing the federal government to create a definition of business income.

Sen. Hillyard said that he is a member of the National Conference of Commissioners on Uniform State Laws (NCCUSL). He gave a brief overview of the work NCCUSL has done in attempting to clarify the definition of business income. He said that the business community is divided between those who seek a clear and uniform definition of business income under uniform state law and those who want Congress to preempt state action. He suggested that Utah proceed with making changes and not wait for action from other states.

Mr. Buchi suggested that the TRC bring their recommendations to NCCUSL rather than to the Utah Legislature.

Comm. Johnson said that the states should seek to avoid federal preemption and act collectively to adopt a uniform definition. He said that the issue for the state is how to uniformly distribute the tax base among different types of businesses and what should be the tax treatment of businesses without a physical presence in the state. He said that he hopes a broad national consensus will emerge from the work to be undertaken by NCCUSL and that Utah should support such a consensus.

Chair Prescott asked for a synopsis of the leading case law on the issue. Comm. Johnson said that he would work with Mr. Buchi to compile such a synopsis.

MOTION: Sen. Hillyard moved to ask the Tax Commission and Mr. Buchi to return to a future meeting with proposed language to clarify the definition of business income and forward the proposal to the Legislature and/or to NCCUSL. The motion passed unanimously with Mr. Crapo abstaining from the vote.

5. Utah Corporate Income Tax - Deduction for Foreign Operating Company

Comm. Johnson introduced this item. He said that Utah law currently allows a 50 percent deduction for the income of a foreign operating company. He explained that a foreign operating company is a company that is incorporated in the United States but has at least 80 percent of its property and payroll offshore.

Comm. Johnson said that ideally, income that is repatriated by a corporation should be taxed as any other source of income. The fact that a domestic corporation has an operation overseas should not be grounds for preferential tax treatment. All income should be subject to the same factor apportionment. He recommended eliminating the special treatment of foreign operating companies, and if that solution is not possible, to allow statutory provisions to curtail possible abusive situations.

Mr. Crapo asked if the examples described by Comm. Johnson are really abuses or simply good tax planning. Comm. Johnson replied that taxpayers defend their actions as tax planning. He also said that he is uncertain how Utah courts would rule in these cases. He said that there are economic substance principles in the common law and that some transactions are sham transactions with no economic substance. There is a question as to the point at which a taxpayer can meet an economic substance test.

Comm. Johnson said that if it is tax planning, then such tax planning should not be allowed and that the statute should be clarified. The state should not continue to rely on common law arguments regarding economic substance and that Utah ought not to have this blueprint for tax avoidance in its statutes. He said this loophole should be closed.

Mr. Crapo said that such a change may precipitate requests to eliminate the state corporate income tax.

Mr. Howe distributed and discussed "Laws of Utah 1986, Chapter 80," "Senate day 39 Journal," and a packet of letters urging the Utah Legislature to allow the 50 percent deduction for foreign operating companies. He also reviewed minutes of the October 29, 1992 meeting of the Corporate Tax Task Force (task force) where this issue was discussed. He said that at this meeting, the task force adopted a motion that a foreign operating company's "income be taxed 100 percent with factor relief." He said that based on this motion, the legislation recommended by the task force and TRC, as introduced in the 1993 General Session, did not include the deduction for foreign operating company income. The deduction was, however, incorporated by amendment as the bill was considered.

Sen. Hillyard, who was the sponsor of the legislation, said that while he does not specifically remember the amendment, he is sure that it was supported by the task force. It may have been a matter of not sacrificing the entire bill over this single point.

Mr. Buchi emphasized that the task force recommended factor relief in lieu of the deduction. Comm. Johnson said that if you include the income from the foreign source in unitary income you also need to recognize the fact that there is property, payroll, and sales overseas that is generating this income. These overseas factors would then be included in the denominator of the apportionment formula, but not in the Utah numerator. The corporation then has a larger pool of income but Utah may impose its tax only on a proportionately smaller portion of the apportioned income. This is the same approach that would be used with any other U.S. property. Mr. Buchi wondered if additional factor relief, in addition to the usual property, payroll, and sales factors, was intended by the task force in 1992. Comm. Johnson said that the offshore factors could be included in the apportionment formula but that any decisions made today should be based on what the TRC considers to be good tax policy.

MOTION: Mr. Crapo moved that the TRC proceed with a review of this issue and ask the Tax Commission to return with proposals regarding the deduction for foreign operating companies. The motion passed unanimously with Sen. Hillyard absent for the vote.

MOTION: Ms. Dubno moved: to direct staff to compile a packet of all information concerning oil and gas severance taxes to be made available to the TRC prior to the next meeting; and to hold a public hearing for the public to comment on the possibility of repealing exemptions and credits on oil and gas severance taxes. The motion passed unanimously.

Mr. Barusch asked if the TRC will discuss oil and gas severance tax rates. Sen. Hillyard noted that when he voted for the tiered rate structure that he was unaware that the higher rate is a marginal rate. He supported a review of the rate structure.

6. Other Items / Adjourn

Mr. Howe distributed and discussed a letter from the Governor's Office regarding study requests for the TRC.

Ms. Juliette Tennert, Chief Economist, Governor's Office of Planning and Budget, discussed the four issues the governor would like the TRC to study.

MOTION: Mr. Crapo moved to adjourn the meeting. The motion passed unanimously.

Chair Dougall adjourned the meeting at 11:54 a.m.