MINUTES OF THE
UTAH TAX REVIEW COMMISSION
Thursday, November 13, 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
Mr. Bruce Jones
Rep. Rosalind J. McGee
Sen. Wayne L. Niederhauser

Members Absent:
Dr. Gary Cornia
Mr. Dixie Leavitt

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 Prescott called the meeting to order at 9:10 a.m.

MOTION: Sen. Goodfellow moved to approve the minutes of the October 9, 2008 meeting. The motion passed unanimously with Rep. Dougall, Sen. Hillyard, and Mr. Jones absent for the vote.

Mr. Howe noted that with the passage of Constitutional Amendment B, as required under 2007 General Session S.B. 18, $20 million, plus interest, will be deposited into the permanent state trust fund on July 1, 2009.

MOTION: Sen. Hillyard moved that the TRC endorse legislation that would increase the amount of severance taxes to be deposited into the permanent state trust fund by $20 million each year ($15 million from oil and gas severance taxes revenue and $5 million from mining severance tax revenue) until all severance tax revenue is deposited into the permanent state trust fund.

Mr. Barusch asked to divide the motion. He noted that there are present ongoing costs associated with natural resource extraction. Sen. Goodfellow said that overall economic conditions should also be considered when deciding current vs. future spending of these tax revenues.

Mr. Lee Peacock, President, Utah Petroleum Association, spoke in support of the motion.

The motion to increase the amount of severance taxes that are deposited into the permanent state trust fund by $20 million dollars ($15 million oil and gas and $5 million mining) each year passed unanimously with Rep. McGee absent for the vote.

The motion to eventually have all severance tax revenue deposited into the permanent state trust fund passed with Mr. Barusch and Sen. Goodfellow voting in opposition and Rep. McGee absent for the vote.

2. Tax Issues Working Group Report

Ms. Rockwell gave the TRC some background information on pass-through entities. She discussed 2009 General Session draft legislation, "Income Taxation of Pass-Through Entities and Pass-Through Entity Taxpayers," which was distributed prior to the meeting. She explained key provisions of the bill, including noting that the bill repeals state corporate taxation on S corporations at the entity level and expands withholding requirements.

MOTION: Comm. Johnson moved to adopt 2009 General Session draft legislation, "Income Taxation of Pass-Through Entities and Pass-Through Entity Taxpayers," as a TRC bill. The motion passed unanimously with Rep. McGee absent for the vote.

3. Income Tax Definitions of Business Income

Comm. Johnson distributed and discussed "Draft Legislation (BusinessIncome)." He noted that business income and nonbusiness income are taxed differently and that there has been litigation, nationally and in Utah, to define what constitutes business income. He explained that the draft legislation clarifies the definition of business income, as requested by the TRC. He explained that business income and non-business income are subject to different apportionment rules.

Comm. Johnson said that the new definition retains and expands the current definition of "business income" under the state corporate income tax. He said that some disputes have arisen over the treatment of business income from a business liquidation and court ordered awards in civil trials. He said that it is the Utah State Tax Commission's position that virtually everything that a corporation does involves business income, except for certain income from long-term passive investments. He said that these amendments clarify that income from liquidation and from the sale of business assets constitute business income.

Comm. Johnson said that the courts have treated partial liquidations and full liquidations differently. He said that the policy question is to what extent income from the life cycle of a business should be considered to be business income.

Mr. Crapo said that the definition is a good start. He said that the draft language summarizes the current jurisprudence. He suggested that a definition of "operational function" should be included to avoid future litigation.

Comm. Johnson said that he welcomes efforts to further refine the definition.

Mr. Buchi said that the draft language is a major change in policy. He suggested that language from relevant case law be included in the definition. He suggested that the draft language be widely distributed for review and comment by interested organizations. He said that some courts have ruled that income from a liquidation is not considered to be business income.

Chair Prescott requested that Mr. Buchi, Mr. Crapo, and Comm. Johnson continue to meet and discuss the definition of business income and bring back recommendations and solutions to the TRC in January. Mr. Buchi said that he would share information with interested organizations.

4. Oil and Gas Severance Taxes

Dr. Gabriel Lozada, Department of Economics, University of Utah, distributed and discussed "The Effect of Proposed 2009 Tax Changes on Utah's Oil and Gas Industry." He explained that the document is an updated report from his presentation at the previous meeting. He said that he included information obtained from studies in Wyoming and Montana and also information on the relationship between cost of production and prices. He said that it is not a controversial assumption to treat taxes as a decrease in price. However, it is harder to make a similar assumption for other costs.

Dr. Lozada said that the scatterplots in the report show the tightness of fit between present period price and past period price and production, including number of wells drilled. With regard to petroleum and natural gas wildcat wells, the report provides a short-run estimate of the number of wells drilled in relation to price.

Dr. Lozada said that with regard to natural gas development wells, there is little relation between price and drilling. The *p value*, that measures the strength of fit, is quite high for this equation. The same is true for extension wells. He said that overall the change in natural gas wells is less sensitive to price than for oil wells. The amount by which drilling will decrease is quite small if various severance tax exemptions were to be removed.

Dr. Lozada pointed out that pages 22 and 23 show the results on production and drilling if severance tax rates are increased, assuming different price levels.

Dr. Lozada also reviewed the results of his analysis for stripper wells. He said that there is considerable inertia in both oil and natural gas stripper wells. He concluded by saying that the policy implications for this result is that it cannot be shown that increasing the tax rate on stripper gas wells will have a discernable effect on natural gas production from stripper wells.

Mr. Buchi said that the TRC has received prior testimony that major companies that develop new oil and natural gas fields will not operate stripper wells due to the low amount of revenue generated by these wells. He said that smaller companies with lower overhead will then take over stripper wells. He said that the industry has supported the stripper well exemption due to the low operating margin from these wells. Dr. Lozada said that the data indicate that during some periods of time the number of oil stripper wells has increased during periods of declining prices and that wells have not been shut in. Mr. Buchi said that the stripper well industry segment relies on this exemption to be profitable.

Comm. Johnson said that a producer faced with declining oil prices has a choice to either shut in the well or reduce production. If a producer expects prices to eventually increase, the producer is not likely to shut but will likely instead reduce production to a stripper well level.

Dr. Lozada said that an alternative to the current structure of the stripper well exemption would be to define a stripper well not by production but by the total revenue that the well produces. He said that this would account for price changes.

Mr. Lee Peacock, Utah Petroleum Association, said that while Utah's severance tax rate is favorable compared to other western states, the overall tax burden is comparable to other states. He noted that any production on Native American lands results in double taxation. Mr. Peacock said that now is the wrong time to discourage new well drilling and that the industry has had a large positive impact on the state. He said that tax policy must favor investment in Utah as opposed to other states. He said that at one time most stripper wells were higher producing wells but are now at the end of their economic life. He said that if the margin on a stripper well declines due to a higher tax rate, the response of the operator will be to shut in that stripper well sooner than the owner otherwise would have. He said that while prices are important, operating margins are even more important. He said that capital markets are not providing new investment and that most operators must invest in new production using current cash flow. He also said that the new federal administration also introduces new uncertainties for the oil and gas industry. He concluded by encouraging the TRC to not change the state oil and gas severance taxes.

Comm. Johnson asked if some owners would allow productive wells to fall to stripper status rather than shut in the well. Mr. Peacock said that it is his experience, other than for wells at the margin, that producers will not restrict production based on the definition of a stripper well. Comm. Johnson asked if it would not make more sense to adopt the Kansas model where the definition is based on revenue, not production.

Mr. Barusch asked if the industry would support making the various exemptions contingent on price. He asked if the industry is willing to discuss what is a reasonable margin above which the exemptions are phased out. Mr. Peacock said that he could not answer this question without consulting the members of his organization.

Mr. Scott Gutberlet, General Manager, Uintah Basin Division, Questar Gas Corporation, said that he would welcome an opportunity to present information at a future meeting.

Ms. Dubno asked Mr. Gutberlet to respond to a report by the Colorado Legislative Council showing that Utah has an overall lower tax burden on the oil and gas industry compared to other oil and gas producing states. Mr. Gutberlet replied that while the information on tax comparisons is roughly accurate, it is his opinion that the Utah tax rate is fair when considering operating margins in that his company receives lower revenue for oil and natural gas produced in Utah compared to other states. He said that he would welcome an opportunity to present information on these questions at a future meeting.

Mr. Butcher distributed "Questar Exploration and Production Company."

MOTION: Sen. Niederhauser moved the following: (a) to report to the Revenue and Taxation Interim Committee at its meeting next week that the TRC has no recommendation on oil and gas severance taxes at this time; (b) to request that Questar present its information at the next TRC meeting; and (c) to continue the discussion and make a recommendation on this issue at the next TRC meeting.

Rep. McGee said that the TRC should continue discussion of this issue.

Ms. Dubno suggested that the TRC make a decision and conclude its study on this issue at its next meeting.

Rep. Dougall noted that the Revenue and Taxation Interim Committee meets next week and that the appropriate motion at this point is to take no action.

The motion passed with Mr. Crapo and Mr. Barusch voting in opposition and Sen. Hillyard absent for the vote.

The TRC returned to Agenda Item #2.

Ms. Rockwell discussed an amendment to 2009 General Session draft legislation, "Income Taxation of Pass-Through Entities and Pass-Through Entity Taxpayers."

MOTION: Comm. Johnson moved to amend 2009 General Session draft legislation, "Income Taxation of Pass-Through Entities and Pass-Through Entity Taxpayers" as follows:

Page 32, Lines 880-881: Amend to read as follows: "the pass-through entity pays or withholds the tax on behalf of the non-resident pass-through entity taxpayer and remits that tax to the commission"

Page 32, Line 961: After "pass through entity shall" delete "pay" and insert "remit to."

Comm. Johnson also moved to adopt the draft legislation as amended. The motion passed unanimously with Rep. Dougall, Sen. Hillyard, and Mr. Jones absent for the vote.

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

Due to lack of time this item was not discussed.

6. Other Items / Adjourn

Mr. Buchi reported that the sales and use tax working group has been meeting and hopes to bring back a recommendation to the TRC at a future meeting.

The next TRC meetings were set for December 18, 2008 and January 15, 2009 at 9:00 a.m.

Chair Prescott adjourned the meeting at 12:07 p.m.