

1. Questions proposed 15 AAC 55.217(f) and whether the department has the authority to require that carried-forward annual losses must be deducted in the order earned and that carried-forward losses must be deducted in their entirety before a carried-forward loss from a later year may be deducted. Cites AS 43.55.165(m): "In a calendar year, after application of a producer's lease expenditures that are incurred in that calendar year, the producer may choose to apply all or a portion of a carried-forward annual loss or carry any unused portion forward. The department may not require a producer to apply all or a portion of a carried-forward annual loss in a calendar year."

DOR RESPONSE: The department believes the intent of the statute is that the department may not require a taxpayer to apply any amount of a carried-forward annual loss to reduce a producer's production tax value to an amount equal to, or less than, the amount of the minimum tax under AS 43.55.011(f), including down to zero. The department agrees that the total amount of a carried-forward annual loss that is to be applied in determining production tax value is at the discretion of the taxpayer. However, the department believes that as a function of administrative efficiency, it has the authority to require a taxpayer who chooses to use carried forward annual losses to use those carried forward annual losses established by adjusted lease expenditures that were incurred in earlier calendar years before those carried forward annual losses established by adjusted lease expenditures that were incurred in subsequent calendar years. For example, it's possible that over a period of time a taxpayer could accumulate multiple carried-forward annual losses under AS 43.55.165(a)(3). Rather than having to potentially track partial values for numerous losses involving several taxpayers over a period of years the department believes it is appropriate that a carried-forward annual loss be exhausted prior to applying a carried-forward annual loss earned in a subsequent year. Additionally, since under AS 43.55.165(p), carried-forward losses begin to lose value sequentially, based on the year earned, it also seems reasonable that a taxpayer would also want to apply carried-forward losses from earlier years that would naturally expire before those from later years.

2. Questions allocation of costs to gas used in-state. How are allocations performed under proposed 15 AAC 55.217(d)(1) & (2)? Does a producer need to allocate a prior year's

loss between gas used in-state and oil and other gas once they start producing and want to use their carried-forward annual losses?

DOR RESPONSE: Proposed 15 AAC 55.217(d) implements AS 43.55.165(o)(1) which provides that a carried-forward annual loss "may only be applied to determine the production tax value of oil or gas for a category for which a separate annual production tax value is required to be calculate under AS 43.55.160(a) or (h) if the lease expenditure resulting in the carried-forward annual loss was incurred in the same category." In the event that expenditures incurred to produce non-Cook Inlet gas used in-state results in a carried forward annual loss, that carried forward annual loss may only be applied to determine the production tax value of that non-Cook Inlet gas used in-state. The carried forward annual loss attributable to the non-Cook Inlet gas used in-state may not be applied to determine the production tax value of any other category listed in AS 43.55.160(a) or (h). Proposed 15 AAC 55.217(d) recognizes that existing 15 AAC 55.206(c)(1) applies to lease expenditures from the producer's leases or properties, whereas, exiting 15 AAC 55.206(c)(2) applies to exploration and development expenditures for an explorer or producer that does not produce any oil or gas in the applicable segment. For the former, the lease expenditures may be allocated in the year incurred. However, for the latter, the exploration and lease expenditures may not be allocated until the lease or property to which the expenditure relates commences regular production of oil or gas. The allocation of costs between oil and other gas and gas used in-state, as authorized by AS 43.55.165(h), is determined under existing 15 AAC 55.215(d) which provides that the allocation of costs is to be performed on a BTU equivalent basis.

3. The proposed regulations at 15 AAC 55.217(e) for exploration expenditures that are reasonably related to a lease or property appear to include both geographical and time restrictions? What is the meaning of the 25 miles?

DOR RESPONSE: HB 111, at new AS 43.55.165(o) and (p) established the statutory requirements for ring-fencing (geographical) and the period over which a carried-forward annual loss decreases in value (time), respectively. The paragraphs of 15 AAC 55.217(e)(1)-(5) describe how exploration and lease expenditures may be reasonably related to a lease or property over

various stages of exploration and development. Paragraph (e)(1) describes exploration activities to explore for oil or gas before a reservoir or any oil or gas deposits have been identified and would largely be composed of seismic and geological and geophysical (G&G) type costs. The 25 mile boundary that extends from the perimeter of the lease or property applies only to exploration expenditures under proposed 15 AAC 55.217(e)(1) and is intended to recognize that seismic and G&G exploration necessarily needs to occur over a greater area of land in order to determine an area of interest and which leases should be purchased in pursuit of oil or gas deposits that can be developed and produced. The reason for the 25 mile restriction is that the Department is trying to give meaning to the limitation established in AS 43.55.165(s) that exploration costs must be “reasonably” related to the lease or property. The Department believes that by including the word “reasonably” in AS 43.55.165(s), the legislature intended to put parameters on the deductibility of exploration expenditures to ensure that only expenditures attributable to leases or properties that commence regular production are eligible for the application of the carried forward annual loss. If the legislature had intended for all exploration expenditures to be eligible for the application of the carried forward annual loss, it would not have used the word “reasonably”. Finally, the language in proposed 15 AAC 55.217(e)(1) that provides, a lease expenditure "is reasonably related to that lease or property, beginning in the calendar year the land becomes part or all of that lease or property;" recognizes that at the point in time the expenditures were incurred there were no leases or properties. Accordingly, it's not possible to allocate costs or attribute expenditures to a lease or property prior to a lease or property being formed. In other words, an expenditure can only begin to be related to a lease or property once the lease or property comes into existence. In regards to the time restrictions, lease expenditures begin to decrease in value in accordance with AS 43.55.165(p) based on the "calendar year after the lease expenditure is carried-forward" under AS 43.55.165(a)(3).

4. AS 43.55.165(b)(2) provides that "an activity does not need to be physically located on, near, or within the premises of the lease or property within which an oil or gas deposit being explored for, developed, or produced is located in order for the cost of the activity to be a cost upstream of the point of production of the oil or gas;" Do the proposed regulations at 15 AAC 55.217(e)(1) violate this principle?

DOR RESPONSE: No, the proposed regulations do not violate the statutes. As explained in the previous response, the 25 mile boundary pertains only to proposed 15 AAC 55.217(e)(1) in regards to the amount of the seismic and G&G costs to be included in the allocation to what eventually becomes the lease or property. However, and for example, the analysis of core samples and interpretation of the seismic data necessarily occur outside of the lease or property, but are still allowable as lease expenditures and direct costs of the lease or property as provided in AS 43.55.165(b)(2).

5. How does the timing of the carried-forward annual losses work? When do carried-forward annual losses begin to decrease in value?

DOR RESPONSE: AS 43.55.165(p)(1) provides that a carried-forward annual loss decreases in value "beginning January 1 of the **11th** calendar *year after the lease expenditure is carried forward under (a)(3)* of this section[.]" AS 43.55.165(l) provides that a "carried-forward annual loss' means a loss established under (a)(3) of this section." Please note, however, that AS 43.55.165(p)(1) is in regards to carried-forward annual losses that are incurred prior to the commencement of regular production. Once regular production has commenced, AS 43.55.165(p)(2) provides that the decrease in value starts "beginning January 1 of the **eighth** calendar *year after the lease expenditure is carried forward under (a)(3)* of this section." [Emphasis supplied.]

6. Under proposed 15 AAC 55.217(i), what is the purpose of the factor 2.86?

DOR RESPONSE: If a company is acquired through either merger or acquisition the maximum tax benefit from any carried-forward losses that may be obtained is the lesser of the CFAL or the tax benefit of the purchase determined as the purchase price multiplied by 2.86, which represents the tax benefit to the purchasing company at 35%.

Example 1: Company A purchases Company B for \$100. Company B owns \$500 of carried-forward annual losses. The maximum carried-forward annual loss that Company A can use is the lesser of the \$500 carried-forward annual loss or \$286 ($\100×2.86). $\$286 \times .35\% = \100 .

Example 2: Company C purchases Company D for \$500. Company D owns \$100 of carried-forward annual losses. The maximum carried-forward annual loss that Company C can use is the lesser of the \$100 carried-forward annual loss or \$1,430 (\$500 x 2.86).

7. The language at proposed 15 AAC 55.217(j) that the department request the Alaska Oil and Gas Conservation Commission to determine the commencement of regular production appears to apply only to a determination under AS 43.55.165(r). Should similar language be included/adopted for a determination for properties eligible for a gross value reduction under AS 43.55.160(f) or 43.55.160(f) and (g)?

DOR RESPONSE: The department agrees and believes the public notice will allow the inclusion of similar language for requests related to the commencement of regular production for gross value reductions under AS 43.55.160(f) and (g).

8. Believes the intent of the ring-fencing was to prevent large producers/taxpayers from purchasing carried-forward annual losses, applying those losses against their taxable value, but never bringing those properties into production. Do the proposed regulations achieve this? Are the allocations too complex?

DOR RESPONSE: The department believes the statutes under AS 43.55.165(a)(3) and 43.55.165(o) effectively implement the ring-fencing. However, following the department's workshop on HB 111 regulations (Tuesday, August 22, 2017) the concern was expressed on how carried-forward annual losses would be allocated, and for example, how losses might be attributed to properties that either had, or did not have, production during the calendar year a carried-forward annual loss was incurred. Accordingly, the department determined that there were three potential groupings of oil and gas operations to which carried-forward annual losses could be attributed. These groupings are as described in proposed 15 AAC 55.217(b)(2):

- (A) lease expenditures to explore for, develop, or produce on leases or properties from which oil or gas *is* produced;
- (B) lease expenditures to explore for, develop, or produce on leases or properties from which *no* oil or gas is produced; and

- (C) exploration expenditures incurred on lands other than a producer's leases or properties.

The next paragraph (proposed 15 AAC 55.217(b)(3)) sets out formulas for determining the amount of a carried-forward annual loss that should be allocated to the aforementioned three groupings in proposed 15 AAC 55.217(b)(2). The allocation is based on the matching principle, to the effect that, if a property had little or no lease expenditures, then only that percentage of lease expenditures that contributed to the carried-forward annual loss would be allocated back to a particular segment or lease or property within the segment (category). One very important fact to consider and must be understood, is that *only one* of the calculations described in proposed 15 AAC 55.217(b)(3) needs to be performed for each calendar year when determining the amount of a carried-forward annual loss. Additionally, the regulations make clear that the ring-fencing provisions do not apply to an existing segment [proposed 15 AAC 55.206(h) and 15 AAC 55.217(b)(3)(D)]. For example, if a producer's revenues for a segment are sufficient to cover all of the producer's lease expenditures to explore for, develop, or produce oil or gas for that segment, regardless of where incurred (for example, exploration expenditures not on a lease or property but still within the segment), then there is no carried-forward annual loss and none of the calculations described in proposed 15 AAC 55.217(b)(3) need to be performed.

However, if the revenues are not sufficient to cover all of a producer's lease expenditures then the regulations establish a hierarchy for determining which of the calculations in proposed 15 AAC 55.217(b)(3) are required. This hierarchy is based on what level of lease and exploration expenditures are required to surpass GVPP such that production tax value is equal to zero. The structure of the proposed regulations helps to insure that those lease and exploration expenditures that contributed to a carried-forward annual loss would be allocated to only those properties or exploration projects that contributed to the loss. For example, if a producer incurred lease and exploration expenditures during a calendar year and the revenues from leases or properties from which oil or gas is produced were sufficient to cover the expenditures from (i) properties from which oil and gas was produced, (ii) properties from which no oil or gas is produced, and (iii) a portion of the exploration expenditures incurred on lands other than the producer's leases or properties, only that portion of the exploration expenditures not covered by the producing properties would be considered to create a carried-forward annual loss and all of that loss would

be attributable to the exploration that occurred on lands other than the producer's leases or properties.

The department does not consider the proposed calculations to be unnecessarily complex, but are required in order to meet the purposes of the ring-fencing as provided under statute. In addition, the proposed regulations provide numerous examples that describe many of the possible scenarios for determining the amount of a carried-forward annual loss.