June 18, 2003

Eric Wohlforth, Chair
Board of Trustees
Alaska Permanent Fund Corporation
P.O. Box 110410
Juneau, Alaska 99811-0410

Re: Questions Concerning the Accounting for Principal and Income of the Alaska Permanent Fund
AG File No. 663-03-0153

Dear Mr. Wohlforth:

This letter responds to a request from the Alaska Permanent Fund Corporation (the corporation) for an opinion interpreting the provisions of article IX, section 15, of the Alaska Constitution and implementing statutes. Particularly, the APFC trustees ask if their current policies correctly determine net income available for appropriation and the limitations, if any, properly placed upon the expenditure of income from the earnings reserve account.

Introduction

At the end of each fiscal year, AS 37.13.145(b) directs the corporation to transfer to the dividend fund established under AS 43.23.045 an amount that is equal to 50 percent of the "income available for distribution" under AS 37.13.140. In addition, AS 37.13.145(c) directs the corporation to transfer to the principal of the Alaska permanent fund an amount "sufficient to offset the effect of inflation" on the principal ("inflation-proofing"). These transfers are to be made from the permanent fund's

earnings reserve account established by AS 37.13.145(a). Separate appropriations authorizing those transfers for the current fiscal year (ending June 30, 2003) were approved by the legislature in the FY 2003 operating budget (sec. 10, ch. 94, SLA 2002).

Although the necessary appropriations for the transfer of money to pay permanent fund dividends and inflation-proofing in 2003 are enacted, possible declines in the financial markets can cause some uncertainty whether there will be a balance available for expenditure from the earnings reserve account to cover the amounts appropriated. The question arises for two related reasons. First, there is an apparent inconsistency between the provisions of AS 37.13.140 and AS 37.13.145, both adopted in the 1980's, and the accounting requirements of GASB 31,[1] which became effective in 1998, regarding how to determine the size of the earnings reserve account from which money may be transferred. Second, although the constitutional provision that created the permanent fund[2] has always been viewed as providing "protection" for the principal, the

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[1] "GASB 31" is shorthand for Statement No. 31 of the Governmental Accounting Standards Board, Accounting and Financial Reporting for Certain Investments and for External Investment Pools.

[2] Section 15, article IX of the Alaska Constitution provides:

> Section 15. Alaska Permanent Fund. At least twenty-five per cent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payments and bonuses received by the State shall be placed in a permanent fund, the principal of which shall be used only for those income-producing investments specifically designated by law as eligible for permanent fund investments. All income from the permanent fund shall be deposited in the general fund unless otherwise provided by law.

nature and extent of that protection are unclear. Accordingly, the corporation requested an opinion from this office to assist in determining how much is available for expenditure from the earnings reserve account to finance the 2003 appropriations for dividends and inflation-proofing.[3]

Questions presented:

Is the corporation's current policy that only realized income of the permanent fund is available for expenditure under AS 37.13.145 correct? If not, how should the amount available for expenditure from the permanent fund under AS 37.13.145 be determined?

Short answer: We believe that the corporation's policy that only realized earnings are available for expenditure is correct.

Is the corporation's current practice that both realized and unrealized income of the permanent fund should be taken into account in determining the amount that is available for appropriation correct? If not, how should the amount available for appropriation from the permanent fund be determined?

Short Answer: We believe that it would not be correct to compute the amount available for distribution by using unrealized gains and losses to determine

[3] Since it is clear under both AS 37.13.145 and the appropriations for permanent fund dividends and inflation-proofing that funding of the PFD appropriation has priority and must be fully paid before any amount is transferred for inflation-proofing, you did not request our advice on whether or how those two transfers should be prioritized or allocated.

income. Existing law clearly provides that only realized gains and losses are allocated to income and are thus available for distribution. Under the relevant constitutional provision, what is not principal is income; therefore any gain or loss not expressly allocated to income must be allocated to principal.

Do the constitution and statutes require that income of the fund may not be appropriated when doing so would bring the total value of the permanent fund including all unrealized gains and losses below the sum of the amounts deposited or appropriated to principal? If not, are there any other limitations with respect to the use of principal that are applicable in determining the amount that is available for expenditure or appropriation from the permanent fund?

Short Answer: We believe that principal is the total value of all deposits and appropriations adjusted for unrealized gains and losses that should properly be allocated to principal. There is no doubt that the principal of the permanent fund cannot be deposited in the general fund and must only be used for income producing investments. However, if unrealized gains and losses are allocated to principal, by definition there is no invasion or misuse of principal if only statutory income, realized gains, is deposited in the earnings reserve fund and available for appropriation.

Before we explain how we arrived at the answers set out above, it is necessary to consider the history of the permanent fund amendment and the actions of the legislature and the corporation to implement the amendment.

Legislative History Relevant to the Questions Presented.

1. Prior to Adoption of the Amendment.

The legislature passed the permanent fund amendment in the form of HJR 39 which was ratified by the voters at the 1976 general election. The effective date of the amendment was February 21, 1977.[4] The amendment was introduced by Governor Hammond.[5] The legislative history of consideration of the resolution is primarily devoted to the amount and kind of revenue to be dedicated to the permanent fund. The governor first proposed a 10 percent dedication of mineral revenues but later supported an increase to at least 25 percent.

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[4] The ballot summary read as follows:

> This proposal would amend Article IX, Section 7 (Dedicated Funds) and add a new section to Article IX, Section 15 (Alaska Permanent Fund) of the Alaska Constitution. It would establish a constitutional permanent fund into which at least 25 percent of all mineral lease rentals, royalties, royalty sale proceeds, federal mineral revenue sharing payment and bonuses received by the State would be paid. The principal of the fund would be used only for income producing investments permitted by law. The income from the fund would be deposited in the State's General Fund and be available for appropriation for the State unless law provided otherwise.

1976 Ballot Proposition No. 2.

[5] The resolution was introduced in January, 1976 as a sponsor substitute for the initial version of HJR 39, introduced by the governor the previous June, which had only proposed amending the dedicated funds provision of article IX, section 7 of the Alaska Constitution to permit the dedication of the proceeds of mineral lease bonuses. The sponsor substitute proposed adding a new section 15 to article IX to create a permanent fund by dedicating 10 percent of nonrenewable resource revenue. The resolution substituted by the governor also expressly provided that the legislature could make additional contributions to the fund. 1976 House J. at 39-40.

In a joint report of the House Judiciary and Finance Committees, the chairmen explained that the principal would be used only for income-producing investments that the legislature could change from time to time to meet the needs of the state. They explained that the effective date of the amendment was delayed somewhat to permit the legislature to provide by law for an investment structure for the fund. Finally, they explained that it was their intent to give future legislatures the maximum flexibility in using permanent fund earnings, ranging from adding to principal to paying out a dividend to residents.[6]

In supporting materials provided at the time of consideration by standing legislative committees, it appeared that the governor intended that the permanent fund could be used to invest in economic development projects with a long term net economic benefit.[7] This same view was repeated after adoption of the resolution when various proponents took their case to the voters.[8] Although the voters were told that it was up to the legislature to shape the permanent fund, it was explained that the "income producing"

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[6] Joint Chairmen's Report on CS SSHJR 39, 1976 House J. at 684.

[7] 1976 House and Senate J. Supp. (fiscal note comments dated January 12, 1976).

[8] Anchorage Daily News editorial, October 26, 1976 ("a percentage of the fund would go for direct use by Alaskans - for loans to businessmen, fishermen and builders.") The permanent fund was described as a "tool whereby Alaska can take some of today's mineral wealth and prepare for the future by investing in the development of human and material resources that will remain productive for many generations . . . ." *Quoting* Revenue Commissioner Sterling Gallagher.

requirement gave the state broad latitude and that local bonds could be purchased as a means of financing instate development.[9] The Revenue Commissioner reported

> I hear public support for the fund from three sectors, . . . from those who favor a savings account approach, those who want it used to provide assistance in community development and those who want it to provide economic diversity in the state. . . . [A] major goal [is] the strengthening of the state's economic base by investing in renewable resources and by policies which would reduce seasonality of employment.[10]

The voters were told that "the income from the fund will be available for general appropriation by the legislature but the principal of the fund may not be touched."[11] The permanent fund was described as "a lasting savings account."[12]

> The object is to prevent future legislatures from doing what previous legislatures did with the $900 million bonanza received by the state from the sale of Prudhoe Bay leases in 1969. That gigantic sum ran through the legislators' fingers like water, to the alarm of many who had pleaded at the time that the $900 million be invested, the principal preserved and the state spend only that money derived from interest.[13]

There is fairly strong evidence that the voters were aware that the legislature would have a role in providing the details for administration of the permanent

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9 Anchorage Times, October 24, 1976 ("Lawmakers Would Shape Permanent Fund").

10 Anchorage Times, October 14, 1976 ("Panel Mulls Permanent Fund").

11 Anchorage Times, October 27, 1976 ("Governor's Point of View").

12 Anchorage Daily News, October 24, 1976 (editorial, "Its Permanent").

13 Anchorage Times, October 24, 1976 (editorial, "No Easy Choice").

fund. Whether the fund was to be a savings account or a development bank was not resolved by the legislature until four years after adoption of the amendment.

2. Post Adoption

A. Legal Opinions

After the amendment took effect, the attorney general was asked to interpret its meaning for various purposes. Set out below are opinions discussing aspects of the permanent fund that are relevant to our consideration of the corporation's accounting practices.

In August of 1977, the attorney general answered whether money appropriated to permanent fund principal in excess of the amount required by the constitution is irretrievable. The attorney general confirmed that once money was deposited in principal by any means, it could not be removed without further amendment of the constitution.[14] The attorney general advised that the constitution's restriction on the use of fund principal is an implied restriction against the withdrawal of appropriated principal.[15] The attorney general speculated that the legislature probably could not condition appropriations to principal on the ability to withdraw at a future date or to

[14] 1977 Inf. Op. Att'y Gen. (Aug. 31; 663-78-0106).

[15] *See also* 1986 Inf. Op. Att'y Gen. (Mar. 6; no file number); 1987 Inf. Op. Att'y Gen. (Feb. 12; 663-87-0356).

specify that such amounts would not be considered principal. The attorney general observed that the permanent fund was a "peculiar -- perhaps unique -- quasi-trust."

In September of 1977, the attorney general again interpreted the amendment to determine whether the legislature was required to enact legislation which takes inflation into consideration in the management and investment of fund principal.[16] In this opinion, the attorney general restated the conclusion that the permanent fund was a trust or quasi-trust. This was based on a prediction that "the Alaska Supreme Court will follow a previously exhibited tendency to impose trust-like duties on the state's management of its patrimony" and the amendment "is extremely similar to the classic spendthrift trust both in its roots and causes and in its establishment . . . ."

The attorney general also concluded that the legislature acts as a trustee which must prudently exercise any duty in relation to administration of the permanent fund. In this regard, the legislature was advised that its power was not plenary but limited by the constitution and implied trust concepts. This office advised that there was no legal requirement that inflation be taken into account in statutes enacted to implement the permanent fund. The legislature was advised that the foregoing interpretation cannot be considered settled until the supreme court rules on the matter. However, the

[16] 1977 Inf. Op. Att'y Gen. (Sept. 16; 663-78-0107).

legislature was advised that it could resolve the question of status by making or treating the permanent fund as a trust.

In 1999, the attorney general contracted for an opinion from outside counsel on behalf of the board of trustees to advise on the possible transfer of permanent fund principal to the Constitutional Budget Reserve Fund (CBR). Morrison & Foerster Opinion, March 3, 1999. The advice was sought to assist the state in determining whether a proposed transfer of a portion of the permanent fund's assets to the CBR would involve an expenditure of principal. Similar to earlier legal opinions on the subject, Morrison & Foerster concluded that the permanent fund is not a true public or private trust fund. However, after rejecting the notion that the fund is a trust, the opinion resorts to trust law to support conclusions concerning the possibility of spending principal as a consequence of the transfer of principal to the CBR. Counsel observed that the board of trustees had a fiduciary obligation imposed by statute to preserve principal and to manage fund assets as prudent investors.

Morrison & Foerster accepted without comment the corporation's assumptions regarding principal. Under the corporation's longstanding practice, "principal" is reported as a notational number that changes only with further contributions to the fund - it does not fluctuate with changes in the market value of the

investments purchased with principal.[17] Counsel interpreted AS 37.13.140 as inconsistent with the principal and income allocation rules usually applicable to trusts. They determined that, after the adoption of GASB 31, an invasion of principal would occur if the amount paid out exceeded the balance of the earnings reserve account which, under GASB 31, would include both realized and unrealized gains and losses. It would not occur where, after a distribution, the balance of that fund turned negative. The critical difference, according to that opinion, is between an action of the trustees and the natural fluctuation of the investment markets. The opinion suggests that unrealized losses could not force an invasion of principal. Morrison & Foerster Op. at p. 16, n.7.

At the time of the opinion, the permanent fund was enjoying the benefits of a sustained period of capital appreciation which was accounted for in the earnings reserve. This fact permitted Morrison & Foerster to conclude that, because the fund's GASB 31 earnings reserve account was then substantially in excess of that amount, a $4 billion transfer of assets was possible to accomplish without "invading principal."

B. Principal and Income Accounting Practices

Next we consider the past principal and income accounting practices applied to the permanent fund and the sources from which those practices were derived.

[17] These contributions have included one-time legislative appropriations to the permanent fund of both income and general fund revenues and the annual inflation-proofing amounts, as well as the natural resource revenues dedicated under the constitutional provision.

These practices show that differing interpretations of principal and income prevailed under previous versions of the fund's enabling statutes.

For the period 1977 - 1980, the permanent fund was under the interim management of the Department of Revenue while legislation was pending to create the corporation. The fund was invested primarily in debt instruments with a fixed rate of return. Ch. 6, SLA 1977. In 1980, legislation was enacted providing for the management of the permanent fund by a public corporation within the Department of Revenue, managed by a board of trustees. Ch. 18, SLA 1980. This legislation modified the rate of dedication to the permanent fund from 25% to 50% of revenue received by the state from mineral leases issued after December 1, 1979, or, in the case of bonuses, after February 15, 1980. The 1980 legislation only authorized the corporation to invest in certain fixed return instruments.[18] Under this statute, income was defined to be the interest earned on investments and any realized gains or losses were to be allocated to principal.[19]

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[18] The corporation was given authority to place funds in direct obligations of the United States Treasury, federal agency securities, certificates of deposit, high-grade corporate bonds, quality short-term investments, and federally guaranteed loans. The fund was directed to give preference to Alaska investments as long as they met the standards of quality set out in law. Specifically, deposits could be made in Alaska banks, mutual savings banks, savings and loan associations, and credit unions. Residential real estate (owner occupied single family dwellings, duplexes, and condominiums) could also be purchased if the mortgage was privately insured by a company doing business in Alaska.

[19] This legislation was accompanied by a free conference committee report in which the joint committee chairmen explained "[t]he fund is designed to be a trust which focuses on the

(continued . . .)

In 1982, legislation was enacted making four amendments bearing on the corporation's accounting practices: (1) the authorized list of investments was expanded to include equities; (2) the concept of "net income" was established which included gain or appreciation in value determined by generally accepted accounting principles, excluding unrealized gains or losses; (3) a portion of each year's permanent fund income was targeted for reinvestment back into the fund to offset inflation; and (4) a valid permanent fund dividend program was established. Ch. 81, SLA 1982; ch. 102, SLA 1982.[20]

During the interim management period of 1977 - 1980, and after creation of the corporation until 1982, the accounting practices applied to the permanent fund distinguished between income and appreciation in the value of investments. For the first two accounting cycles of the corporation (1980 - 1982), income of the fund was defined as "the interest received in a year." Sec. 5, ch. 18, SLA 1980. For the entire period 1977 - 1982 during which the fund was limited to fixed income investments, appreciation

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safety of principal first and the maximization of earnings second." 1980 Senate J. at 671. It was intended that the fund would be held to a more restrictive list of investments than other fiduciary trusts.

[20] The authorized list of investments has since been expanded at least four more times by the legislature: in 1989 to include investments in non-U.S. securities; in 1992 to include A-rated corporate bonds; in 1994 to expand permissible real estate investments; and in 1999 to make a variety of adjustments to the authorized list, to authorize up to 5% of the fund to be invested in other prudent investments not specifically included in the list, and to increase the allocation limit placed on equity investments.

in value ("gain") was credited to principal, interest was credited to income.[21] However, if losses exceeded gains, interest was to be transferred to principal in an effort to cover some of the loss. Former AS 37.13.130 (repealed 1982); former 15 AAC 137.060 (repealed 7/12/92).

In 1982 after the fund was authorized to invest in equities, income was defined to include realized gain representing appreciation in value. Under then-applicable generally accepted accounting principles ("GAAP"), only realized gains (and losses) of the fund were recorded as income in the earnings reserve account established under AS 37.13.145. This former GAAP approach was consistent with the statutory requirement of AS 37.13.140 (in effect since 1982) for determining fund "net income" (from which the amount of the annual dividend transfer is then computed), which specifically excluded unrealized gains and losses from the determination.[22]

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[21] According to annual financial statements of the permanent fund, realized gain was credited to principal for fiscal years 1980 and 1981. When the permanent fund was under Department of Revenue management, income was deposited in the general fund. After the corporation was created, statutes called for income to be deposited in an undistributed income account.

[22] There were actually some minor differences in determining "net income" between the methods called for by GAAP pre-GASB 31 and by AS 37.13.140, but those differences did not affect the underlying requirement of each that only *realized* gains and losses be taken into account. The drafters of sec. 140 were aware of the potential that GAAP and state law might some day be inconsistent. In his transmittal letter, Governor Hammond made clear his intent that the statutory method for computing income should prevail over generally accepted accounting principles. Letter from Gov. Jay Hammond, regarding Sponsor Substitute for Senate Bill 684, 1982 Senate J. at 494, 496 (March 9, 1982).

This consistency in treatment ended with the implementation of GASB 31 in 1997. Under GASB 31, the corporation is required to record as revenue in its financial statements the permanent fund's readily marketable investments at current fair value. The corporation has interpreted this change in GAAP as requiring all unrealized market appreciation and depreciation (unrealized gains and losses) to be included in determining income for accounting purposes, potentially resulting in large differences between GAAP net income and "net income" under AS 37.13.140. As a result, the corporation now has two different ways to report income. The first method is to report realized income, as called for by the definition of "net income" under AS 37.13.140, to determine how much is available for distribution. The other method is to apply the GAAP definition and include both realized and unrealized gains and losses to determine net income for financial reporting purposes. Depending on the situation, the corporation applies both approaches in its financial statements. The inherent conflict between these two approaches is at the heart of the request for this opinion.

In late 2001, the audit committee of the corporation considered an issue paper prepared by APFC staff which discussed the policy for determining the amount available for expenditure to pay the dividend and inflation-proofing transfers provided for under AS 37.13.145. The issue paper did not resolve the matter, but recommended the trustees seek a legal opinion from the Department of Law. While the subject was briefly discussed by the trustees, they did not pursue an opinion from the Department of Law at

that time. In the absence of an attorney general's opinion, the corporation has applied a conservative "invasion test" under which realized income may not be spent if doing so causes the total value of the permanent fund and the earnings reserve account to fall below the historic dollar amount ("notational principal") contributed to principal from all sources. Although this limitation is not specifically addressed in the statutes, it was presumably applied in order to "protect" past contributions to principal from diminishment and has been subsumed in the corporation's accounting practices.

Notwithstanding this conservative "invasion test," there have been instances in the past when distributed earnings were more than offset by unrealized losses. These distributions to the state general fund occurred in fiscal years 1978 and 1979 and would have amounted to an expenditure of principal under the corporation's "invasion test." This is apparently why, beginning in 2001, the corporation and corporate counsel recommended obtaining a legal review of corporate accounting policy by this office.

For fiscal year 2002, there was enough realized income accumulated in the earnings reserve account and in excess of "notational principal" to fully pay the 2002 dividend and inflation-proofing distributions without having to apply the limitation regarding invasion of principal. However, given the current investment allocation of the fund, a sustained downward trend in financial markets could result in the total market value of the permanent fund at the end of a fiscal year totaling less than the sum of the

amount attributed to "notational principal," plus the amount of realized income in the earnings reserve account. If total market value of the permanent fund is less than the sum of those two figures, then current corporation accounting practices would limit the amount available for expenditure under AS 37.13.145 to the amount (if any) by which the total market value of the permanent fund on the last day of that fiscal year, including the earnings reserve, exceeds "notational principal" (the sum of all dedications and appropriations to the principal of the fund over time).

Discussion

At the outset we observe that the permanent fund has not yet experienced market conditions that required the trustees to apply an "invasion test" to limit appropriations from the earnings reserve. It appears, though, that the possibility of this happening caused the trustees to request this opinion. Notwithstanding the apparent lack of immediacy, this opinion is as appropriate and necessary now as it was in 2001 when staff and counsel first recommended it. It is important that the public and the trustees understand the correct application of the law and that the corporation's financial statements properly inform the public. It now appears that the financial condition of the fund and earnings reserve, barring some unforeseen and extraordinary financial event at the end of the fiscal year, will again not test the application of the concepts discussed here. Clearer opinions no doubt result when the law is not looked at through the fog of a looming crisis.

While the permanent fund is not a trust, we resort in part to trust principles to answer the corporation's questions, the central issue of which turns on construction of AS 37.13.140, defining income for purposes of the permanent fund corporation. The terms of every trust are governed by the governing document, statutes, court decision, and general trust principles. In the case of the permanent fund, the governing document is the Alaska Constitution and valid implementing statutes. In arriving at the correct interpretation of sec. 140, we will attempt insofar as possible to harmonize the provisions of that statute with trust principles.[23] However, if there is a conflict, existing law must prevail. An added complication is that the provisions of AS 37.13.140 can be read to be ambiguous regarding the treatment of unrealized gains and losses on assets of the permanent fund. We must determine whether unrealized gain or loss is an element of principal or income. This allocation is important for determining how much is available for distribution in a given year.

All who have considered the legal character of the permanent fund agree that it is not a trust. It is a constitutionally dedicated fund, the principal of which must be invested in income producing assets. However, each analysis inevitably turned to trust principles to support the advice given. Early in the life of the fund, this office advised the legislature that it was not obligated to protect the fund from inflation, but that it could

[23] We have located no case law in Alaska applying trust principles relevant to the questions presented.

undertake that responsibility and make clear that the fund will be operated according to trust concepts. We also advised that the legislature is a trustee when it provides for the administration of the permanent fund. This means that the legislature may be limited in its lawmaking power when it provides meaning to terms and concepts applicable to the permanent fund.

It appears that the legislature intended to act consistent with the advice of this office when it first enacted statutes to implement the permanent fund amendment. In a free conference committee report, the chairmen declared the permanent fund is ". . . designed to be a trust which focuses on the safety of principal first and the maximization of earnings second."[24] The corporation has also done its part to interpret both the constitution and the statutes. The corporation made specific the legislature's direction through various resolutions and policies. The corporation's powers to interpret and make specific the constitution are important. However, because we are interpreting the constitution and enabling statutes, it is not likely that a court will accord deference to interpretations by either the legislature or the corporation.[25]

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[24] 1980 Senate J. at 671 (Senate and House J. Supp. No. 7).

[25] In *Hickel v. Cowper*, 874 P.2d 922 (Alaska 1995), the Alaska Supreme Court declared that matters of constitutional construction are reviewed *de novo*. The court will determine what the constitution actually means and will approach this task as a question of law which requires the exercise of independent judgment. 874 P.2d at 926.

The constitution uses the terms "principal" and "income" in establishing the permanent fund. As a limited exception to the general constitutional prohibition on dedicated funds, the constitutional amendment creating the permanent fund is explicit in that only principal must remain dedicated for investment and that income should be made available for appropriation from the general fund. This requirement by implication prevents appropriation of principal but does not further define principal or income. It clearly does not require that principal be preserved in the manner contemplated by the "invasion test" or in any way subjugate the availability of "income" for expenditure to the dedication of "principal" to income producing investments.

Consistent with the constitutional dedication of fund principal to one purpose, income producing investment, the legislature has declared a general purpose to provide safety for principal and legislative committees have, in a non-binding way, expressed intent that principal must be preserved. Relying in part on this expression of intent, the corporation interpreted the constitution and enabling statutes to require that principal be recorded at the dollar amount historically deposited by dedication and appropriation without any diminishment for gain or loss on investments. However, in doing so it appears that the corporation failed to consider the potential effect on the constitutional requirement that income be made available for appropriation.

The pre-adoption history of the permanent fund amendment provides no evidence that a particular definition of income would be preferred over another. As

explained above, the amendment was promoted by some as a savings account that would serve as a form of development bank to help diversify an economy that was too dependent on non-renewable resource revenues. There was also a clearly stated purpose to dedicate oil revenue and prevent expenditure of the dedicated amounts. The amendment expressly provided that income is to be deposited in the general fund or other legislatively authorized purpose. After the amendment was adopted, the legislature abandoned the development bank approach in favor of an investment fund managed by a public corporation authorized to make conservative fixed income investments.[26]

At the time the permanent fund amendment was adopted in 1976, trust law traditionally allocated gain and loss on equity securities to principal rather than income.

> The proceeds of the sale of trust property are ordinarily to be treated as trust principal, even though they include profit in excess of cost price or inventory value. Losses on such sales fall on trust principal. The rule should govern sales of corporate stock where there is a gain in value due to undistributed earnings.

Bogert on Trusts, sec. 120 (6th ed. 1987). As recently as 1984, the legislature chose to adopt traditional allocation rules for common trusts.[27]

There has been a movement among the trustees of endowment trusts to change traditional allocation rules to permit investment in equity securities. This

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[26] *See* discussion of legislative history set out in 1994 Inf. Op. Att'y Gen. (Sept. 23; 663-94-0207).

[27] 1984 House and Senate J. Supp. No. 21; *see also* AS 13.18.020(b) and 13.38.050.

approach would authorize a trustee to consider capital gain as part of the total return, enabling distributions to beneficiaries without being restricted by whether the returns are accounting income or value appreciation. A uniform act was proposed in 1972 to permit trustees to allocate both realized and unrealized capital appreciation to income for distribution purposes.[28] The uniform act is the law in 46 states and the District of Columbia. The UMIFA contains an impairment rule very similar to the "invasion test" contemplated by the corporation. Realized and unrealized gains are offset to determine if the historic dollar amount of contributions to principal will be impaired by a planned distribution. Sec. 2 UMIFA. However, the uniform act is not the law in Alaska. Aside from the difference between the permanent fund and an endowment trust, the uniform act differs from existing law by permitting distributions based on unrealized appreciation. State law charts a different course for the permanent fund by not allowing such a distribution. For that reason, it is not appropriate to apply the impairment rule of the uniform act. When the legislature expanded authority for investments to include equity

[28] Uniform Management of Institutional Funds Act, 7A U.L.A. 316 (West Supp. 1997) (UFIMA).

securities, it added a definition of income. AS 37.13.140 provides in pertinent part:

> Net income of the fund shall be computed annually as of the last day of the fiscal year in accordance with generally accepted accounting principles, excluding any unrealized gains or losses.

(Emphasis added.) This hybrid definition of income is intended to "to allow the maximum use of disposable income." AS 37.13.020(3). By making clear that "gain" is to be an element of income, the definition of income was expanded to include capital appreciation, but it plainly prevented any distribution of unrealized gain. Section 140 does not explain the accounting treatment for unrealized gains and losses other than to provide that this form of appreciation or loss is to be excluded from the determination of income.

The limitation of income to that which is realized appears to be consistent with the text of both the constitution and statute. The constitution provides the income "shall be deposited in the general fund." Alaska Const., art. IX, sec. 15. The statute provides: "[I]ncome from the [permanent] fund shall be deposited by the corporation into the [earnings reserve] account as soon as it is received." AS 37.13.145(a). When interpreting these words, a court will attempt to discover the plain meaning and purpose of the provision.

> Because of our concern for interpreting the constitution as the people ratified it, we generally are reluctant to construe abstrusely any constitutional term that has a plain ordinary meaning. Rather, absent some signs that the term at issue has acquired a peculiar meaning by statutory definition or judicial construction, we defer to the meaning the people themselves probably placed on the provision. Normally, such deference to

> the intent of the people requires "[a]dherence to the common understanding of words."[29]

The words "deposit" and "received" convey a meaning that income is to be in hand, or realized.[30] By applying these common meanings there is no conflict between sections 140, 145, and the permanent fund amendment.

Section 140 defines income with reference to generally accepted accounting standards. Before 1997, these standards did not include unrealized gain or loss in the determination of income. These unrealized values were permitted to be reported in notes at the foot of an agency's financial statements. After 1997, accounting principles changed to require the depiction of investment income as the net increase or decrease in fair value. Fair value is what a willing buyer would pay for the security in an arm's length transaction and necessarily includes unrealized gain or loss on the valuation date of a security held in the corporation's portfolio. Para. 22, GASB 31. This change reflected a concern that the disclosure of fair value in the notes may not have allowed financial statement users to be sufficiently aware of the potential effect of investment gains and losses. Appendix A to GASB 31. Even though GASB 31 requires fair value

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[29] *Citizens Coalition for Tort Reform, Inc. v.McAlpine*, 810 P.2d 162, 169 (Alaska 1991) (citations omitted).

[30] "Deposit" means to "place, cache, or entrust", while "receive" means to "take possession or delivery." Webster's Third International Dictionary.

reporting, the National Council on Governmental Accounting recognized that state law requiring other methods for the computation of income governs when there is a conflict.[31]

The restrictive definition of income set out in AS 37.13.140 embodies a policy instituted by the legislature to allow distributions to be made from the appreciated value of investments in equity securities. However, the legislature permitted appreciation to be considered income only if it is realized. Unrealized capital appreciation is not expressly allocated to either principal or income by section 140. As recounted in our discussion of the accounting practices set out above, realized appreciation was allocated to the principal of the permanent fund until the corporation was authorized to invest in equity securities. It is unclear whether unrealized appreciation was allocated at all, but we presume it would have been allocated to principal as well. We find no evidence that the legislature intended to alter the traditional allocation rules as to unrealized gain or loss. Therefore, we decline to attribute a legislative intent to allocate unrealized appreciation to income for any purpose, including the use of unrealized losses to determine whether there has been an invasion of principal. We believe that this policy is not authorized and could possibly upset the balance in the accounting for principal and income. The better interpretation is to give a consistent meaning to the exclusion of unrealized appreciation

[31] "Conflicts between legal provisions and GAAP do not require maintaining two accounting systems. Rather, the accounting system may be maintained on a legal-compliance basis, but should include sufficient additional records to permit GAAP based reporting." (continued . . .)

or loss in section 140 and account for such gains and losses as an element of principal where it has traditionally been allocated.

In our opinion, authority to invest in equity securities does not imply that unrealized gain or loss becomes an element of income for any purpose. The legislature can establish allocation rules for common trusts under its plenary law-making powers. *See Bogert on Trusts and Trustees*, sec. 816 (2nd ed. rev.) (but the best criterion for making [allocation] decisions is the practical treatment of the topic by the courts or the legislature.) We believe that the legislature established such a criterion when it enacted section 140.

Under article IX, section 15 of the Alaska Constitution and the relevant implementing statutes, there is no basis for expanding the concept of principal by creating a notational number that serves as a limitation on the deposit of income for distribution purposes. Once dedicated or appropriated, the principal in the permanent fund is used only for income producing investments the value of which rise and fall in corporation financial statements as unrealized gains and losses dictate. Only through a constitutional amendment, like that currently proposed by the corporation trustees establishing a payout limit of 5 percent of the total fund value, can the rate of dedication be increased and the deposit of income available for distribution be limited. Absent such an amendment, the

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Para. 13, National Council on Governmental Accounting Statement No. 1 (Governmental Accounting and Financial Reporting Principles, issued March 1979).

full amount of income, made up of the realized gains and losses, is available for expenditure. It is up to the legislature, as it has done in the past, to appropriate excess permanent fund income to principal.[32] A corporate practice cannot operate to prevent the legislature from exercising discretion over the disposition of income.

Finally, we anticipate some will claim that our reading of the constitution and statutes serves to permit a silent invasion of principal when the permanent fund is carrying a large unrealized loss on its books. Realized income does not lose its character as income even if it were offset by unrealized capital losses. There simply is no basis in the history of the amendment or the enabling statutes for a liberal interpretation that

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[32] As of June 30, 2002 the permanent fund recorded net assets totaling $23.5 billion. Of that total, $21.8 billion was principal. Since 1982, $7.5 billion of permanent fund income has been added to principal for inflation-proofing, through June 30, 2002. In addition to the constitutionally and statutorily mandated dedicated revenues, the legislature has made special appropriations to the permanent fund totaling $6.9 billion. The amount and sources of these appropriations are set out below:

Permanent Fund
Special Appropriations
(amounts in millions)

Year	Amount	Source
FY 81-85	$2,700	Surplus Oil Revenues
FY 87	1,264	Earnings Reserve Account
FY 96	1,842	Earnings Reserve Account
FY 97	803	Earnings Reserve Account
FY 00	250	Earnings Reserve Account

In FY 03 the legislature appropriated and additional amount to principal which could not be determined as of the date of this opinion.

would expand the scope of the dedicated fund by foreclosing expenditure of traditional accounting or statutorily defined income. To do so would do violence to the plain meaning of the constitution and section 140 which require that income be determined by realized gains and losses and be available for expenditure.

The constitutionally required dedication of principal is more than satisfied by the prudent investing practices of the corporation in statutorily approved investments and the generous inflation-proofing and contributions to principal appropriated by the legislature. We decline to read into either the constitution or the statutes a broader exception to the general prohibition on dedicated funds than can be justified by the plain meaning of article IX, section 15 of the Alaska Constitution and relevant implementing statutory provisions and the history leading to the adoption or enactment of these provisions.

Sincerely,

Gregg D. Renkes
Attorney General

GDR:JLB:jn