October 20, 1999

The Honorable Wilson Condon, Commissioner
Department of Revenue
MS 0400
Juneau, AK 99801

Taxpayer Refund Application --
AS 43.20.072(c)(2)
A.G. file no: 223-99-0227
1999 Op. Att'y Gen. No. 1

Dear Commissioner Condon:

You have asked whether, as applied to a specific taxpayer, a provision of the modified apportionment statute for oil and gas producers and pipeline transportation companies, AS 43.20.072(c)(2), violates the Commerce Clause of the United States Constitution[1] and, if the answer is yes, whether the Department of Revenue (DOR) may grant the taxpayer relief under article IV, section 18 of the Multistate Tax Compact. The answer to both questions is yes.

This issue arises from the taxpayer's request for a refund of taxes that it contends it overpaid. The taxpayer is a producer of oil and gas in Alaska and elsewhere. The taxpayer engages in pipeline transportation of oil and gas outside Alaska, but not in Alaska. Under AS 43.20.072(c)(2), the taxpayer is required to apply a two-factor apportionment formula of extraction and property to determine the amount of its apportionable income that is apportioned to Alaska. Under AS 43.20.072(c)(3), other taxpayers that both produce and engage in pipeline

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1 U.S. Const. art. I, §8, cl. 3.

transportation of oil and gas in Alaska apply a sales factor in addition to the property and extraction factors in determining income apportioned to Alaska. For each of the tax years at issue, the taxpayer's sales factor was lower than both its property and extraction factors.[2] If the taxpayer had owned even a small interest in a pipeline in Alaska, it would have been eligible to include the sales factor, which would have lowered the average used for determining the amount of the taxpayer's income apportioned to Alaska. The taxpayer contends that this taxing scheme violates the Commerce Clause in that it discriminates against interstate commerce, and fails the internal consistency test established by the United State Supreme Court for gauging the validity of state taxing schemes. We conclude that the internal consistency requirement is implicated by the statute and that the statute's denial of use of the sales factor based on the out-of-state location of the taxpayer's pipeline interests discriminates against interstate commerce. We recommend that DOR invoke article IV, section 18 of the Multistate Tax Compact to grant the requested refund.

Background

Before 1978, income of multistate corporations that conducted business in Alaska was taxed under the Multistate Tax Compact, AS 43.19, which is "basically a restatement of the [Uniform Division of Income for Tax Purposes Act]" (UDITPA) enacted in 1959.[3] Under UDITPA, the amount of a multistate corporation's unitary business income apportioned to Alaska is determined by applying three factors, which compare the value of the corporation's property, payroll, and sales in Alaska with its property, payroll, and sales everywhere.

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2 The taxpayer and DOR have stipulated to the amounts of the sales factors that the taxpayer would apply if it were permitted to apply the sales factor.

3 *State, Dep't of Revenue v. Amoco Prod. Co.*, 676 P.2d 595, 598 n.3 (Alaska 1984).

The legislature determined that the standard three-factor apportionment formula did "not fairly represent the extent of the business activities in this state of multistate corporations engaged in the production and pipeline transportation of crude oil and natural gas in this state."[4] A report to the legislature by DOR singled out the UDITPA sales factor as producing the greatest distortion of those corporations' activities. In 1978, the legislature enacted separate accounting to govern taxation of the oil and gas production and pipeline transportation income of those corporations.

Separate accounting was promptly challenged in court by the oil and gas producers in Alaska and their pipeline affiliates. One of the state's arguments in defending against the litigation was that the UDITPA sales factor, which credited the sales to the destination state, was particularly responsible for understating the amount of the corporations' income that was properly subject to taxation by Alaska because nearly all of the oil produced in Alaska was sold out of state.[5]

Although the state was ultimately successful in defending separate accounting, while the litigation was pending the legislature and the Hammond administration considered alternative tax schemes to maintain the state's revenue stream. In enacting the modified apportionment scheme in 1981, the legislature reconfirmed its findings that the UDITPA factors did not adequately represent the business activities of the oil and gas production and pipeline transportation industry in Alaska.[6] Under modified apportionment, all taxpayers that produce oil and gas in Alaska are required to apply extraction and property factors in determining income apportionable to Alaska.

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4 Sec. 1, ch. 110, SLA 1978.

5 *Atlantic Richfield Co. v. State*, 705 P.2d 418, 426-27 (Alaska 1985).

6 Sec. 1, ch. 116, SLA 1981.

Taxpayers that both produce and engage in pipeline transportation of oil and gas in Alaska are required to apply an additional sales factor that includes pipeline tariffs and the UDITPA sales factor.

Commerce Clause Internal Consistency Requirement

The U.S. Supreme Court has established a four-part test for judging the validity under the Commerce Clause of a tax that affects interstate commerce. To be valid, the tax must (1) be applied to activity with substantial nexus with the taxing state; (2) be fairly apportioned to the taxpayer's instate activities; (3) not discriminate against interstate commerce; and (4) be fairly related to services provided by the state. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). The "internal consistency" and "external consistency" tests have evolved in the application of the second requirement in *Complete Auto*, that a state's tax be fairly apportioned.

The internal and external consistency tests were first articulated in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 169-170 (1983).[7] In that case, the Court considered the constitutionality of California's application of its standard three-factor apportionment scheme to the income of a unitary multinational corporation. The Court called internal consistency "[t]he first, and again obvious, component of fairness in an apportionment formula" and explained that "the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed." The Court described the second requirement of external consistency as being a "more difficult requirement," and explained that the "factor or factors

[7] Although the Court first stated the internal consistency test in *Container Corp.*, it did not discuss its application to California's apportionment system, or even mention it again in the case. Of course, the three-factor apportionment scheme is internally consistent.

used in the apportionment formula must actually reflect a reasonable sense of how income is generated."[8]

Since the Court first described the internal consistency test in *Container Corp.*, it has not applied the test to determine the constitutionality of a state's income tax apportionment scheme. The Court has rephrased the test in order to apply it to other varieties of taxes, including gross receipts taxing schemes[9] (tax internally consistent when, if it were applied by all jurisdictions, "there would be no impermissible interference with free trade"); lump sum annual taxes on operation of trucks[10] ("[i]f each State imposed flat taxes for the privilege of making commercial entrances into its territory, there is no conceivable doubt that commerce among the States would be deterred"); and a gross charge on telephone calls originating or terminating in a state that were charged to an instate service address[11] ("tax must be structured so that if every State were to impose an identical tax, no multiple taxation would result"). In applying the internal consistency test, the Court has held that a taxpayer did not have to prove actual discriminatory impact on it.[12]

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8 The Court placed a heavy burden on the taxpayer to prove *external* inconsistency by "clear and cogent evidence," that "the income attributed to the State is in fact out of all appropriate proportions to the business transacted . . . in that State, or has led to a grossly distorted result." 463 U.S. at 170, quoting *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 274 (1978) (internal quotation marks omitted; citations omitted).

9 *Armco v. Hardesty*, 467 U.S. 638, 644 (1984) and *Tyler Pipe Industries, Inc. v. Washington State Dep't of Rev.*, 483 U.S. 232, 247 (1987).

10 *American Trucking Associations, Inc. v. Scheiner*, 483 U.S. 267, 107 S. Ct. 2829 (1987).

11 *Goldberg v. Sweet*, 488 U.S. 252, 261 (1989).

12 *Armco*, 467 U.S. at 644 (gross receipts tax system not saved by fact that 25 percent wholesale tax paid by wholesalers that did not manufacture in West Virginia was less than 88 percent manufacturing tax paid by instate manufacturers who were exempt from wholesaling tax); *Tyler Pipe*, 483 U.S. at 242; *Scheiner*, 483 U.S. at 286 (axle tax not "saved because some out-of-state

(…continued)

The Court most recently applied the internal consistency test in *Oklahoma Tax Commission v. Jefferson Lines Inc.*, 514 U.S. 175, 185 (1995). In that case, the Court upheld Oklahoma's imposition of a sales tax on the full value of bus tickets for travel originating in Oklahoma. The court explained that the internal consistency requirement looks to the structure of the tax, and that internal consistency

> is preserved when the imposition of a tax identical to the one in question by every other State would add no burden to interstate commerce that intrastate commerce would not also bear. This test asks nothing about the degree of economic reality reflected by the tax, but simply looks to the structure of the tax at issue to see whether its identical application by every State in the Union would place interstate commerce at a disadvantage as compared with commerce intrastate. A failure of internal consistency shows as a matter of law that a State is attempting to take more than its fair share of taxes from the interstate transaction, since allowing such a tax in one State would place interstate commerce at the mercy of those remaining States that might impose an identical tax.

The Court determined that Oklahoma's tax was internally consistent because "[if] every State were to impose a tax identical to Oklahoma's, that is, a tax on ticket sales within the State for travel originating there, no sale would be subject to more than one State's tax."[13]

A Tax Management Multistate Tax portfolio published by Bureau of National Affairs, Inc. analyzes the application of the internal consistency requirement to apportionment formulas and explains that "a clear example of apportionment lacking internal consistency would be one which

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carriers which accrue high mileage in Pennsylvania pay the axle tax at a lower per-mile rate than some Pennsylvania-based carriers"); *Goldberg*, 488 U.S. 263 at 261 ("internal consistency test focuses on the text of the challenged statute and hypothesizes a situation where other states have passed an identical statute").

13 514 U.S. at 185.

included a factor, such as inventory, only when that factor was present in the taxing jurisdiction."[14] The portfolio goes on to explain that "[i]t is important to note that internal consistency is an entirely theoretical concept. A taxpayer need prove only the inconsistency to be successful."[15] This interpretation is supported by dicta in the Alaska Supreme Court's decision in *Gulf Oil Corp. v. State*, 755 P.2d 372, 381 n.24 (Alaska 1988), in which the court stated

> A formula is internally consistent when, if used by every jurisdiction, it *could not* result in multiple taxation of the same value. The formula must allocate every dollar of income to no more than one jurisdiction.

(Emphasis added.)

Alaska Statute 43.20.072 Is Not Internally Consistent

When one examines the structure of the apportionment scheme, it takes only a simple example to demonstrate that universal application of Alaska's modified apportionment could result in multiple taxation of the Taxpayer, which has a low Alaska sales factor and which engages in oil and gas production in and outside Alaska and pipeline transportation of oil and gas only outside Alaska. The following example assumes that a taxpayer with oil and gas production and pipeline investments does business only in Alaska, California, and Louisiana; has only production in Alaska; has a small amount of sales in Alaska, with the remaining sales of the unitary business occurring equally in California and Louisiana; has pipeline interests in California and Louisiana; and has property and extraction divided equally among the three states.

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[14] Burgner, 1180-2nd T.M., *Income Taxes: Special Problems in Formulary Apportionment*, at 0003.

[15] *Id.*

	Property	Extraction	Sales
Alaska	33.33	33.33	2
California	33.33	33.33	49
Louisiana	33.33	33.33	49

Alaska would apportion income to Alaska by applying the property and extraction factors:

33.33 + 33.33 = 66.33 ÷ 2 = 33.33.

Assuming California and Louisiana had statutes that exactly mirrored AS 43.20.072, they would each apportion income by applying the property, extraction, and sales factors:

33.33 + 33.33 + 49 = 115.66 ÷ 3 = 38.55.

The total amount of the taxpayer's income that would be apportioned among the three states if Alaska's modified apportionment system were universal would be:

33.33 + 38.55 + 38.55 = 110.43 percent.

If in the above example the taxpayer had pipeline interests in only one of California or Louisiana, the amount of the taxpayer's income that would be apportioned among the three states under Alaska's modified apportionment system would be 105.21 percent. Yet, if Alaska allowed a sales factor, then only 100 percent of the income would be taxed.

The Taxpayer Should Not Be Required To Prove That Universal Application of AS 43.20.072(c)(2) Would Result In Multiple Taxation of the Taxpayer

Although it is simple to demonstrate that multiple taxation *could* result from application of Alaska's modified apportionment statute, multiple taxation is not inevitable. If the jurisdictions in which the taxpayer has pipeline interests have sales factors that are cumulatively less than or equal to the cumulative average of their extraction and property factors, no multiple taxation would result from universal application of AS 43.20.072(c)(2). Because the internal inconsistency is not inevitable, unlike gross receipts taxes that the U.S. Supreme Court has invalidated upon concluding that they were internally inconsistent, we do not expect a court to completely invalidate AS 43.20.072(c)(2). Arguably, the taxpayer should be required to establish that universal application of modified apportionment would result in multiple taxation of the taxpayer.[16] Since the Alaska modified apportionment factors are unique, this could require a substantial effort on behalf of the taxpayer to compile data to accomplish the "as if" computation for every jurisdiction in which it is taxed. However, the taxpayer should not be required to do this in this instance, because the taxpayer's request for refund is supported by an alternative argument under the third prong of the *Complete Auto* Commerce Clause test, which prohibits discrimination against interstate commerce.

The taxpayer's argument that the statute discriminates against interstate commerce is viable. The U.S. Supreme Court has long held that "[n]o State, consistent with the Commerce Clause, may impose a tax that discriminates against interstate commerce . . . by providing a direct commercial advantage to local business." *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 329 (1977) (*quoting Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 457, 79 S. Ct. 357, 362 (1959)). In striking down a state tax system found to have the effect of favoritism toward local interests by encouraging economic activity in the state rather than in other states, the Court stated that "[w]e need not know how unequal the tax is before concluding that it

[16] One state's high court accepted the state's argument that "the Supreme Court has never found a violation of internal consistency by relying upon 'the existence of a hypothetical taxpayer with a specific structure of factors and taxable income, to justify striking down a tax law which was not facially discriminatory.'" *In re Alternative Minimum Tax Refund Cases*, 546 N.W.2d. 285, 290 (Minn. 1996), *cert. denied,* 519 U.S. 964 (1996). In that case, the taxpayer relied on a mathematical model presented by a mathematical expert and a hypothetical corporation that the court noted "requires a very unusual combination of circumstances to demonstrate any violation at all." *Id.* The taxpayer showed "no existing taxpayer with the same financial circumstances as X Corporation, and none of the representative plaintiffs' tax situations reveal[ed] a similar constitutional violation." *Id.* Here, a simple and very plausible hypothetical, not a complicated mathematical construct, shows that AS 43.20.072(c)(2) could result in multiple taxation.

unconstitutionally discriminates." *Maryland v. Louisiana*, 451 U.S. 725, 760 (1981). Because application of the sales factor is beneficial to an Alaska oil and gas industry taxpayer, the statute that allows production and pipeline companies to apply the sales factor only if their pipeline interests are located in the state has the effect of favoring taxpayers that invest in Alaska pipeline activities. This

> has a forbidden impact on interstate commerce because it exerts an inexorable hydraulic pressure on interstate business to ply their trade within the State that enacted the measure rather than "among the several States."

Scheiner, 483 U.S. at 286-287.

Relief

The legislature has specifically granted the tax administrator the authority to depart from statutory apportionment requirements. Article IV, section 18 of the Multistate Tax Compact provides:

> If the allocation and apportionment provisions of this Article do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for, or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
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> (a) separate accounting;
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> (b) the exclusion of one or more of the factors;
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> (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
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> (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

By enacting section 18, the Alaska Legislature recognized that facts may occur under which the state's taxing scheme may result in unfair results, and it gave DOR authority to alter the apportionment requirements to achieve fairness. The language of section 18 does not preclude the tax administrator from considering the constitutional internal consistency requirement or discrimination against interstate commerce in determining whether to depart from statutory apportionment and allocation provisions to obtain a fair result. The limited case law we have found on this issue indicates that the tax administrator may invoke section 18 to alter an apportionment formula if "unfairness" is established by a statute's internal inconsistency or discrimination against interstate commerce.

In construing identical language in Michigan's tax statutes, the Michigan Supreme Court characterized the provision as a "constitutional 'circuit breaker,'" which allowed "the use of an alternate method of apportionment if the apportionment provisions result in the unconstitutional taxation of a unitary business." *Trinova Corp. v. Department of Treasury*, 445 N.W.2d 428, 434-35 (Mich. 1989). The court turned "to established constitutional doctrine to ascertain the guideposts of 'fairness,'" and identified internal consistency as "[t]he first component of fairness in an apportionment formula. . . ." *Id.* Although the court found that the apportionment provisions of Michigan's single business tax were internally consistent, it is implicit from the court's decision that failure to meet the internal consistency requirement would have tripped the "constitutional circuit breaker."[17] Discrimination against interstate commerce should also suffice to justify the tax administrator's invocation of section 18.

The Oregon Supreme Court has also construed language identical to section 18. In *Twentieth Century-Fox Film Corp. v. Department of Revenue*, 700 P.2d 1035, 1039 (Or. 1985), the court held that the Oregon statute gave the tax administrator authority both "to remedy unconstitutional results" and "to provide for alternatives to statutory allocation and apportionment

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[17] The court also determined that the taxpayer failed to show by clear and cogent evidence that the taxing scheme violated the external consistency requirement. That decision was affirmed by the U.S. Supreme Court. *Trinova Corp. v. Michigan Dep't of Treasury*, 498 U.S. 358 (1991).

in unusual cases where the UDITPA formula does not fairly represent the business activities of the taxpayer, particularly a taxpayer in a non-merchandising, non-manufacturing industry."

In *NCR Corp. v. Comptroller*, 544 A.2d 764, 778 (Md. 1988), the Maryland Supreme Court construed a Maryland statute that gave the comptroller "the right" to modify an apportionment formula "in those cases where circumstances warrant." The court stated, "[w]hen application of the formula yields an unconstitutional outcome, the right becomes a duty."

In accordance with these authorities, under the circumstances of this case, we advise DOR to invoke its authority under section 18 of the Multistate Tax Compact to allow the Taxpayer to apply the sales factor. Additionally, we recommend that DOR adopt regulations to put similarly situated taxpayers on notice of the availability of this relief.

Finally, we recommend that the Departments of Revenue and Law review AS 43.20.072 in its entirety and determine whether legislation should be proposed to cure constitutional deficiencies.

Sincerely,

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