IN THE SUPERIOR COURT FOR THE STATE OF ALASKA

THIRD JUDICIAL DISTRICT AT ANCHORAGE

TESORO CORPORATION
AND SUBSIDIARIES,

Appellant,

v.

STATE OF ALASKA,
DEPARTMENT OF REVENUE,

Appellee.

Case No. 3AN-09-8897 CI
OAH No. 05-0155-TAX

Decision on Appeal

Appellant Tesoro Alaska reminds us that a state "may not tax value earned outside its borders."[1] It argues that the Alaska Department of Revenue is ignoring the economic reality that most of the $89 million income that it has taxed wasn't earned in this state—$75 million in its view—and wasn't even connected to business activities conducted here. The State maintains that the taxpayer was properly deemed a unitary business, and that it fashioned appropriate relief under a catch-all provision of the statute[2] that reduced Tesoro's tax by a third. The parties filed (long) briefs in support of their positions, and the matter was argued last fall.[3]

[1] *ASARCO, Inc. v. Idaho State Tax Commission,* 458 U.S. 307, 315, 73 L.Ed.2d 787, 794, 102 S.Ct. 3103 (1982) (citations omitted), highlighted in Appellant's exhibits to oral argument, 9/17/10, and quoted in *Earth Resources Company of Alaska v. State, Department of Revenue,* 665 P.2d 960, 966 (Alaska 1983).
[2] AS 43.19.010, art. IV, § 18 [section 18].
[3] Appellant's Opening Brief [At. br.], filed 1/19/10; Appellee's Brief [Ae. br.], filed 3/19/10; Reply, filed 4/23/10; media no. B37, 8:32-11:08, 9/17/10.

Table of Contents

Statement of facts.[4]

As California Supreme Court Justice Werdegar wrote,

> Ours is a global economy. In contrast, government and the taxing authority used to fund it are national and local. This geographic disparity generates difficulties when each jurisdiction seeks its piece of the economic pie, a pie generated by economic activity that knows no borders.[5]

Administrative Law Judge Mark T. Handley sought to sort out these difficulties, hearing this matter on appeal from an informal conference decision of the Department of Revenue's Tax Division. He ruled that Tesoro failed to show that DOR's determination that it was unitary during the 1994-98 audit period was incorrect.[6] His discussion of the company's background cites the record and gives a good picture of how Tesoro developed into the company that it was during the relevant tax years.

As the price of oil declined significantly during the 1980s, Tesoro struggled and entered the 90s with a gas exploration and production unit [E&P] based in

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[4] *See also infra*, at 11-13.

[5] *Microsoft Corporation v. Franchise Tax Board*, 139 P.3d 1169, 1171 (Cal. 2006).

[6] *In the Matter of Tesoro Corp. f/k/a Tesoro Petroleum Corp., et al*, Tax Years 1994-98, OAH No. 05-0155-TAX, Decision and Order of 4/22/09 [Dec.], R. 5141 *et seq.*, at 41.

Texas, and an Alaska oil refinery and marketing unit [R&M], among other units. The corporate headquarters was in Texas, while most R&M activities were in Alaska.[7] Its brief sets forth in some detail what happened to the company during this period, as it sold assets, wrote off losses and restructured management, in an effort to become more efficient, evolving in its view from an integrated company to one that was non-unitary in nature.

The company was fortunate to have a contract with Tennessee Gas, and success in producing natural gas from the Bob West field in Texas, which, after litigation, yielded high revenues,[8] while its presence in Alaska consisted of its oil refinery, gas stations, and both marine and aviation fuel sales. In addition to E&P and R&M, Tesoro had three other segments: corporate, finance and marine services.[9] While refining oil purchased from others, Tesoro did not produce or transport oil in a pipeline until 1995, when it purchased the Kenai Pipeline Company [KPL], which changed its tax status under AS 43.20.072, which in turn requires apportionment. This occurred just as the company was realizing significant profits, enhanced by a settlement with Tennessee Gas and the sale of some of its proven reserves. Tesoro emphasizes the independence of its two principal divisions during this period, and its brief describes the personnel and operations of each in some detail.[10] There were, however, overlapping directors

[7] Dec. at 2-3; At. br. at 1-2, 9 *et seq.*
[8] Dec. at 3, At. br. at 13.
[9] Dec. at 4.
[10] At. br. at 13 *et seq.* *But see* dec. at 24-28.

and senior staff, and the ALJ found that the subsidiary boards rarely even met, with board-level decisions made by Tesoro's Board of Directors.[11]

Tesoro and its operating subsidiaries entered into an administrative services agreement that allocated costs in a manner it believed to approximate their value on the open market. The company emphasizes that these services were in no way operational, but rather included such things as compliance with federal law, filing necessary reports, cash management and accounting services.[12] While Tesoro views this as arms-length and about the same as if the divisions had contracted with an outside firm, both quantifiable and essentially immaterial, the ALJ saw it as a natural and highly beneficial example of centralized management.[13]

Tesoro maintains that the revenue stream that produced most of its income during the audit period came from events unconnected to Alaska and its R&M division. It prevailed in litigation over a contract with Tennessee Gas,[14] and, faced with an enforceable take-or-pay contract, this company bought out its contract, yielding altogether over $127 million. Tesoro also sold a gas field which it believed to be overvalued, generating another $68 million. So while the Department of Revenue looks at the factors which it believes satisfy the criteria to label Tesoro a unitary business, the taxpayer protests that DOR is missing the forest for the trees; that it is plain that for the years in question, we know exactly where the money was made. It argues that the record fully supports its analysis

[11] Dec. at 8-15, esp. at 10-11.
[12] At. br. at 25-27.
[13] Dec. at 12-19.
[14] *See Lenape Resources Corp. v. Tennessee Gas Pipeline Co.*, 925 S.W.2d 565 (Tex. 1996).

that only $14 of 89 million was attributable to Alaska operations during the audit period, with 1996 standing out as the poster child for unfairness—$6 of 60 million actually earned here in the company's view. The Department views those "Alaska" numbers as basically irrelevant in the context of the formula apportionment scheme that was applied, based on flows of value found by the ALJ to exist among the taxpayer's various divisions.[15]

Looking at factors used in the Uniform Division of Income for Tax Purposes Act [UDITPA],[16] Tesoro maintains that despite high gross sales numbers, the profit margin for its Kenai refinery was transparently thin, while its out-of-state income, due to the unique circumstances noted above, was very high. Similarly unfortunate, from its point of view, was the fact that the Alaska refinery was expensive to build, while its Texas gas fields were still valued at their acquisition costs, artificially low in light of later discoveries. Since the Department's response to these arguments is rooted in the Alaska Supreme Court cases of *Gulf Oil,*[17] *Earth Resources*,[18] and *Alaska Gold*,[19] it might help to begin with these cases, and then return to Tesoro's broad challenge to a scheme that it believes to be taxing income earned wholly outside the borders of this state.

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[15] *See also* quotation from *Gulf Oil, infra*, at 7.
[16] AS 43.19.010.
[17] *Gulf Oil Corporation v. State, Department of Revenue*, 755 P.2d 372 (Alaska 1988).
[18] *Earth Resources, supra* note 1.
[19] *Alaska Gold Co. v. State, Department of Revenue*, 754 P.2d 247 (Alaska 1988).

Gulf Oil.

What happened in *Gulf Oil* is not strictly analogous to what Tesoro claims here, but the general theme has some similarities. Gulf was hit by very high foreign taxes that amounted to nearly all the income it earned in those countries, and yet it was not allowed to deduct these taxes under AS 43.20.031(c). Leasehold interests here were also valued at cost, despite the failure to yield any product. The supreme court characterized both issues as matters of fairness,[20] and one remedy that was statutorily available—section 18—included separate accounting.[21]

The foreign countries, primarily members of OPEC, adjusted their taxes to the point where a company "would just barely continue to produce."[22] In 1977, for example, Gulf paid over $1 billion in income taxes to earn $13 million in after tax income, and in 1976, it claimed to have paid an effective rate of over 100% in those countries. Meanwhile, leases in Alaska that it had written off as worthless, were valued by the state at their acquisition cost at $33-94 million, far exceeding any other property that the company had. It had few or no employees in Alaska, it extracted no oil here, and it argued that it should pay no income taxes here.[23]

The court recognized that "the use of formula apportionment is the legislative decision that a certain degree of distortion will be tolerated," and the question raised "is whether the result is unfair to a degree that exceeds those

[20] 755 P.2d at 373-74.
[21] AS 43.19.010, art. IV, ¶ 18.
[22] *Gulf Oil, supra,* 755 P.2d at 376.
[23] *Id.* at 376-77.

tolerable limits."[24] After finding each of the solutions proposed by Gulf somewhat arbitrary, the court turned to the constitutionality of the state's taxing method.

It began with a 1920 opinion of the U.S. Supreme Court which upheld the scheme generally,[25] and it also cited *Container Corp.* for the proposition that proper allocation is not only difficult to achieve in practice, but also to even describe in theory.[26] It referred to "the steep burden of proof" required to establish a constitutional violation,[27] and declined to find a violation on the facts presented by Gulf. Further, citing *Amoco*[28] and *ARCO,*[29] it concluded that dry holes were useful to an exploration company. It concluded by commenting on Gulf's claim of a distortion ranging from 1100-53,000%:

> However, showing a difference between Gulf's calculation and the DOR's calculation is a far cry from showing that there is a "grossly distorted result." The existence of a distortion depends on the validity of the underlying assumption in Gulf's brief that "Gulf really earned nothing in Alaska." That assumption relies on Gulf's separate geographic accounting. In this case, the basic weakness of separate accounting is highlighted: Gulf's calculation fails to account for hard-to-quantify contributions of value resulting from activities such as the drilling of dry holes. Gulf did conduct business in Alaska: it explored for oil, entered into leases, drilled, and analyzed the results. Because these activities are integral to the production of income, a corresponding portion of Gulf's worldwide income can constitutionally be attributed to Alaska.[30]

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[24] *Id.* at 381. *See also* at 386 n. 41, referencing § 11 of UDIPTA, discussed *infra.*
[25] *Underwood Typewriter Co. v. Chamberlain,* 254 U.S. 113, 41 S.Ct. 45, 65 L.Ed. 165 (1920).
[26] *Gulf Oil,* 755 P.2d at 383, citing *Container Corp. v. Franchise Tax Board,* 463 U.S. 159, 164, 182, 103 S.Ct. 2933, 2949, 77 L.Ed.2d 545, 564 (1983).
[27] *Id.* at 384.
[28] *State, Department of Revenue v. Amoco Production Co.*, 676 P.2d 595 (Alaska 1984).
[29] *Atlantic Richfield Co. v. State, Department of Revenue,* 705 P.2d 415 (Alaska 1985).
[30] *Gulf Oil,* 755 P.2d at 387-88.

The state argues that the same is true here—Tesoro's contention that it earned very little in Alaska relies on separate geographic accounting, while the hearing officer found that it was a unitary business—a finding that DOR reminds us is entitled to deference from this court. The court in *Gulf Oil* acknowledged that the formula approach to taxation results in a somewhat arbitrary "smoothing of the bumps,"[31] which, the Department notes, does not invalidate the approach, even on facts that a taxpayer might view as extreme.

Earth Resources.

The opinion in *Earth Resources* was five years before *Gulf Oil*, and the issue was whether or not the taxpayer was properly found to be a unitary business and subject to the apportionment formula.[32] The court looked at whether the parent and subsidiary were functionally integrated, the degree to which management was centralized and whether the company benefitted from economies of scale. The court stated the burden for a taxpayer challenging DOR's application of the apportionment formula as one of "clear and cogent evidence," and affirmed the trial court's conclusion that Earth Resources had not met its burden.

While the facts are not set out in much detail, DOR relies heavily on this opinion, maintaining that the court found the companies to be unitary with less evidence than exists here.[33] Those facts included assistance with financing, a

[31] *Id.* at 389.
[32] *Earth Resources, supra,* 665 P.2d at 962.
[33] Ae. br. at 20-25.

shared retirement plan and an annual management meeting, attended by employees from both the parent and subsidiary. Tesoro disputes the characterization of the evidence, but the decision of the hearing officer discusses these findings at some length, with citations to the record, and they are entitled to deference on appeal.

Alaska Gold.

The taxpayer in this case did not dispute that *it* was in a unitary group, arguing instead that a different subsidiary was not, so that company's income shouldn't be considered. Alaska Gold claimed no Alaska income, while inclusion of the other companies produced a significant amount of taxable income. The court applied the factors discussed in *Earth Resources*, and once again sustained DOR—but this time with two dissenting justices.

The majority noted that the subsidiary maintained its own tax department, had its own insurance plan, retained its own counsel, and made its own operative decisions, but it found other facts to be sufficient: the subsidiary submitted its financial plan to the president of the parent company, capital expenditures over $100,000 and executive salaries over $30,000 were subject to approval, and an output contract was in place for the sale of copper, albeit at market price.[34] The court distinguished the U.S. Supreme Court case *Woolworth,*[35] relied on by Tesoro, where there were no intercompany sales of inventory, and cited *Earth*

[34] *See also* Ae. br. at 25-27.
[35] *F.W. Woolworth Co. v. Taxation and Revenue Department,* 458 U.S. 354, 102 S.Ct. 3128, 73 L.Ed. 2d 819 (1982).

Resources, noting the importance of the parent's involvement in the finances of the subsidiary.[36] The same was true with respect to the parent's control of the subsidiary's management, with overlapping boards of directors and the ability to name the subsidiary's president. Economies of scale were also achieved to some extent with the purchase of insurance and with regard to corporate administrative expenses.[37] Justices Burke and Moore dissented in *Alaska Gold*, distinguishing *Earth Resources* and finding the companies significantly more independent. They cited *Woolworth* to the effect that this "type of occasional oversight…that any parent gives to an investment" is not necessarily indicative of a unitary business.[38]

Standard of Review.

Tesoro recognizes that it had the burden to prove, by clear and convincing evidence, that its two divisions were not unitary.[39] It further recognizes that the findings made by Judge Handley are entitled to deference and must be upheld if supported by substantial evidence.[40] In *Earth Resources,* the trial court applied the substantial evidence test, but the supreme court didn't see any disputed facts.[41] It concluded that "the question of whether a taxpayer's business is unitary is a question of law which does not require agency expertise," so that the substitution

[36] *Alaska Gold,* 754 P.2d at 252.
[37] *Id.* at 252-53.
[38] *Id.* at 254-56, quoting *Woolworth,* 458 U.S. at 369.
[39] At. br. at 51 n. 248. *See* AS 43.05.435 and Dec. at 4-5.
[40] *Id.*; AS 44.62.570(c).
[41] 665 P.2d at 964.

of judgment standard would be applied.[42] In this case, too, there "was not a great deal of evidence in dispute."[43]

Did Tesoro prove that its divisions are not unitary?

Given the detailed findings of Judge Handley, the extensive briefing of the parties and the agreed upon burden of proof, a detailed analysis of the facts will not be attempted here. The parties have exhaustively discussed what it is they believed relevant to the factors of centralized management, functional integration and economies of scale. The presence of these factors create significant unquantifiable flows of value that will normally justify formula taxing schemes, providing a nexus between income here and that which might otherwise be viewed as unconnected to Alaska.[44]

The Department argues that Tesoro provided less evidence that its divisions were not unitary than was shown by the taxpayers in the Alaska cases discussed earlier, and Judge Handley appeared to agree. He found that the DOR experts were more convincing, and focused on the indicators that the Alaska Supreme Court has determined to be significant. He found that the subsidiaries were owned by the parent, that the boards and officers overlapped, that the boards of some subsidiaries didn't meet at all during the audit period, and he made other findings in support of the conclusion that there was centralized management.[45] He quoted

[42] *Id.* at 965 (citations omitted).
[43] At. br. at 51 n. 247-48 quoting Dec. at 8.
[44] Dec. at 6, citing testimony of Professor Pomp. *But see* Reply at 1.
[45] Dec. at 6-11.

the opinion in *Container Corp.*[46] which limited the language from *Woolworth*[47] about "occasional oversight," clarifying that mere decentralization of day-to-day management responsibility and accountability was insufficient to defeat a unitary business finding.[48] The examples used for this analysis[49] do not appear to be seriously challenged in this appeal.

While there was certainly some factual overlap, the ALJ also provided examples of functional integration, such as shared tax preparation and insurance coverage, consolidated budgeting, credit guarantees and shared services in the areas of environmental and safety compliance, risk management, computer services, legal affairs, purchasing and the like. Human resources were also shared, so that reports required by workers' compensation and the EEOC were prepared for all divisions, while compensation packages and retirement services were also administered collectively and made available to all employees. Judge Handley recognized that there was little or no flow of products or operational expertise between the E&P and R&M segments, but made his findings based on flows of value inherent in shared services that can occur without either horizontal or vertical integration.[50]

The final factor is economy of scale, and for this the ALJ cited borrowing and loan guarantees, consolidated purchasing, insurance coverage and other

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[46] *Container Corp, supra,* 463 U.S. at 180 n. 19, 77 L.Ed.2d at 562-63, citing *Exxon Corp. v. Wisconsin Department of Revenue,* 447 U.S. 207, 224, 100 S.Ct. 2109, 2120, 65 L.Ed.2d 66, 81 (1980).
[47] *Supra* note 38.
[48] Dec. at 12.
[49] *Id.* at 13-15.
[50] *Id.* at 17-20.

savings that result from a parent's provision of administrative and management services. Collective financing avoided the additional costs of negotiating on individual loans, and enabled the segments to obtain better rates. While Tesoro argued that many of these services were paid for at near-market prices through its ASA, Judge Handley found that the very fact that they were provided in house suggests that Tesoro concluded it was saving by doing it this way. These findings are fully supported in the record.[51] While consolidation of some services may have been required by federal law, Tesoro has not shown that all were, or that this distinguishes its situation in a way that is material to the issues posed. The same is true with respect to its argument that it was error to use the same facts for the separate factors;[52] no authority has been cited that says this is improper, and many of the cited cases appear to have been decided in the same way.

Tesoro's argument that the result of these findings is unfair is to some extent separate from its contention that the segments were not unitary, and will be addressed separately. But the ALJ did discuss many of the points that the taxpayer raises concerning the independence of the two segments: they ran day-to-day operations independently, they were distinct geographically, they didn't share employees, they were not integrated either horizontally or vertically in the usual sense, and they were in two quite different parts of the petroleum industry, with fewer opportunities for operational synergies.[53] While Tesoro's explanation of the

[51] *Id.* at 20-23.
[52] At br. at 56.
[53] At. br. at 1-2.

prototypical vertically and horizontally integrated businesses in its briefing and at argument was helpful and relevant, it was also factored in by Judge Handley, and simply found to be insufficient given the entire record. This conclusion is consistent with the Alaska cases discussed above.

Tesoro maintains that the ALJ failed to fully analyze the facts in light of the underlying policy, and argues that the first question is whether separate accounting is reliable, or whether the taxpayer's segments benefit from "factors of profitability" to such an extent that would render separate accounting unreliable.[54] This would, however, stand on its head the notion stated in *Earth Resources* that it is the taxpayer which bears the burden of proof, and requires a brief look at the U.S. Supreme Court opinions cited by Tesoro.

The question in *Mobil* was whether an aspect of an apportionment formula was constitutional, where the company's presence in Vermont consisted solely of marketing its products. The state applied the three factors of sales, payroll and property value to determine its share of taxes based on the taxpayer's federal return, but it included dividends from subsidiaries operating abroad. The question before the Supreme Court was limited to whether this income could be constitutionally included in the pie that would be sliced by the apportionment knife according to the state's taxing scheme. The issue of whether the segments of the company comprised a unitary business was practically conceded.[55]

[54] At. br. at 52-53, quoting *Mobil Oil Corporation v. Commissioner of Taxes of Vermont,* 445 U.S. 425, 100 S.Ct. 1223, 63 L.Ed. 2d 510 (1980) (other citations omitted).
[55] *Id.* at 435-36, 63 L.Ed.2d at 519-20.

In the course of trying to determine what would make dividends so unique as to disallow their inclusion in the income that might be apportioned, the court did indeed describe the two approaches to state taxation quoted by Tesoro in its brief. But Mobil neither challenged its designation as unitary nor argued that its tax liability was "out of all appropriate proportion"[56] to its in-state business. What the court did say was that the idea that apportionment was allowed only if the source of the income could not be ascertained by separate geographical accounting was an obsolete notion so long as the requisites for a unitary business were present.[57] So the first question is not whether separate accounting is reliable, as this issue would not even come up unless the taxpayer successfully establishes that it is not a unitary business. The taxpayer has the "distinct burden" of showing by clear and cogent evidence that the state scheme results in extraterritorial values being taxed.[58]

Container Corporation, on the other hand, preserved all its arguments, including whether it and its subsidiaries constituted a unitary business, and, if so, whether the state's 3-factor test was so inaccurate as to be unconstitutional. The company was vertically integrated in the paperboard packaging industry, and the Court looked to some of the same sorts of facts discussed here. It rejected the idea that a flow of goods should be required to support a unitary business, and deferred

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[56] *Id.* at 437, 63 L.Ed.2d at 521, quoting *Hans Rees' Sons v. North Carolina ex rel Maxwell,* 283 U.S. 123, 135, 51 S. Ct. 385, 75 L.Ed. 879 (1031).
[57] *Id.* at 438, 63 L.Ed.2d at 521 (citations omitted).
[58] *Exxon, supra,* 447 U.S. at 221, quoted in *Container Corp, supra,* 463 U.S. at 164, 77 L.Ed.2d at 552 (other citation omitted).

to the state's determination of whether there was a flow of value. It discussed purchasing, loan guarantees, substantial technical assistance and general guidance from the taxpayer's officers, and found them clearly sufficient to justify the conclusion that the business was unitary.[59]

There is nothing in the two opinions which came down the year before *Container Corp.* which is inconsistent with this analysis. Unlike Mobil, ASARCO preserved the argument, which had been sustained by a multistate audit, that its ties with certain companies in which it owned a partial interest were insufficient to justify unitary treatment. The court distinguished *Exxon* and *Mobil* on their facts, and held that the foreign investments were not unitary; that the activities of the dividend payers had nothing to do with the activities of the recipient in the taxing state.[60]

Woolworth was another UDITPA case in which the taxing state sought to include foreign subsidiaries within its reach, plus a paper gain from a hedging transaction the company undertook to protect it from currency fluctuations. A companion case to *ASARCO, Woolworth* also emphasized the economic realities of the business under review, as opposed to the mere potential of control through ownership of more than 50% of a subsidiary. Income alone is obviously not sufficient either, and the Court's analysis of the "factors of profitability" lead it to conclude that each subsidiary performed its functions autonomously and

[59] *Container Corp.*, 463 U.S. at 178-80, 77 L.Ed.2d at 561-62. *See also* Ae. br. at 6-8.
[60] *ASARCO, supra*, 458 U.S at 309-29, 73 L.Ed.2d at 790-803.

independently of the parent company. Each store selected where it would be located, and what it would sell, and there was no centralized purchasing, warehousing, accounting, legal, or personnel services. There was no uniform credit card system, packaging, brand names or displays. The dissenting justices were only able to point to communication between the upper echelons of management, the coordination of an annual report and the fact that the payment of dividends and the acceptance of substantial debt had to be approved by the parent company.[61]

Tesoro argues that, as in *Woolworth*, the value created by sharing administrative functions is trifling in comparison with the income involved,[62] but this was only one of the facts cited by Judge Handley. Further, as can be seen from the discussion above, the facts in *Woolworth* are quite different from those in this appeal, especially those relating to the footnote cited by the taxpayer, which addressed the subsidiary set up solely to hedge against currency fluctuations.

The issue of whether the taxpayer's segments constituted a unitary business is complex, but Judge Handley found the Department's experts to be persuasive.[63] Tesoro seek to distinguish individual criteria while ignoring the combination, and argues that the decision ignores corporate reality. It emphasizes operational control, and minimizes the other factors.[64] It contends that segments which are not

[61] *F.W. Woolworth, supra.*
[62] *Id.*, 458 U.S. at 369 n. 22; At. br. at 60. *But see* Ae. br. at 17-19.
[63] Dec. at 8.
[64] *See* Dec. at 12-13.

integrated either horizontally or vertically can never be found to be unitary.[65] It protests that the same facts used to show functional integration and centralized management are also used to demonstrate economies of scale.[66] But these contentions were addressed in the administrative decision, much of which is cited by the Department.[67] I conclude that Judge Handley did not err in his determination that the business was unitary.

Did Tesoro establish that separate accounting was required?

Once a business has been found to be unitary, a state may then proceed to apply an apportionment formula to determine the tax that is due, unless the taxpayer demonstrates that that there is "no rational relationship between the income attributed to the State and the intrastate values of the enterprise."[68] The question is whether Tesoro has shown that the income apportioned to Alaska is "out of all appropriate proportion to the business transacted by the Appellant in [this] State."[69] This constitutional limitation is to some extent codified in section 18 of the uniform act, which says that:

> 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:
> (a) separate accounting;
> (b) the exclusion of any one or more of the factors;
> (c) the inclusion of one or more additional factors which

a)

[65] Dec. at 19-20.
[66] *See Alaska Gold,* 754 P.2d at 253.
[67] *See also* Ae. br. at 28 *et seq.* addressing administrative decisions.
[68] *Container Corp, supra,* 463 U.S. at 180, 77 L.Ed.2d at 563, citing *Exxon, supra,* and quoting *Mobil Oil.*
[69] *Id.*, quoting *Hans Rees' Sons, supra.*

> will fairly represent the taxpayer's business activity in this state; or
> (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.[70]

In addition to its challenge to the presumption that its businesses were unitary, Tesoro objected to the inclusion of the income produced by the Bob West gas field in Texas, and to the way in which the settlement with Tennessee Gas was used in the apportionment formula. The ALJ rejected the argument on the former, and included in the income to be apportioned, but did grant relief on the latter, by including part of the settlement income in the sales factor as part of the denominator in the apportionment fraction, which did reduce the tax.[71] The Department had previously added an extraction factor to the property and sales factors, which the taxpayer maintains is wholly insufficient.[72] Tesoro argues that E&P's income should not be apportioned at all—that separate geographic accounting is the only fair relief under §18.

Section 18 and the Multistate Tax Compact were addressed in a 1999 opinion of the Alaska Attorney General.[73] The taxpayer produced oil and gas here, which triggers AS 43.20.072, and operated a pipeline out of state. Had this particular taxpayer also owned an interest in an in-state pipeline, its taxes would have been lower, due to the use of a three factor test rather than two. The opinion concluded that this failed the "internal consistency" test and so violated the

[70] AS 43.19.010, Art. IV, sec. 18.
[71] Dec. at 2, 30-33.
[72] At br. at 28-50. *See also* exhibits to oral argument at 16 *et seq.*
[73] Opinion of the Attorney General, File No. 223-99-0227, 1999 WL 1337804 (10/20/99).

Commerce Clause. The recommended course of action was to use section 18 to fashion relief.

Internal consistency was referred to in *Container Corp* as the first and obvious component of fairness in an apportionment scheme—the formula must be such, that if applied in all jurisdictions, it would result in no more than all of the unitary business' income being taxed.[74] The AG's opinion gave examples of how this test worked in other contexts, and recognized the complexity of determining the precise impact upon a taxpayer, given the Alaska law's unique combination of factors. It viewed §18 as well designed to rectify the problem in a given case, and cited opinions from other states that used the approach of a "constitutional circuit breaker."[75] The drafter of UDITPA noted that the provision was added "because no statutory pattern could ever resolve satisfactorily the problems for the multitude of taxpayers with individual business characteristics."[76] The way Alaska's law is drafted may make this even more true, and in fact the ALJ used §18 to fashion relief in this case.

It is readily apparent, however, that there are a multitude of ways in which §18 might be applied.[77] Tesoro's view is that §18(a) should be applied, separate geographic accounting for E&P's income, since it views that as straight-forward, easy to calculate and fair. The Department disagrees, for all the reasons that led to

[74] *Container Corp.*, 463 U.S. at 169, 77 L.Ed.2d at 556. *See also Gulf Oil, supra,* 755 P.2d at 381 n. 24.
[75] *Trinova Corp. v. Department of Treasury,* 445 N.W.2d 428, 434-35 (Mich. 1989), *Twentieth Century-Fox Film corp. v. Department of Revenue,* 700 P.2d 1035, 1039 (Or. 1985), *NCR Corp. v. Comptroller,* 544 A.2d 764, 778 (Md. 1988).
[76] Pierce, *The Uniform Division of Income for State tax Purposes,* 35 Taxes 747, 781 (1957), quoted in *Twentieth Century-Fox,* 700 P.2d at 1038-39.
[77] *See* Ae. br. at 35, quoting the ALJ's order for summary adjudication.

the creation of apportionment in the first place. Judge Handley denied the taxpayer's motion for summary judgment and sustained the Department's use of §18(c).[78] The question now is whether the taxpayer has shown that the income apportioned to Alaska is unfair under either the Due Process Clause or the Commerce Clause,[79] and if so, how that might best be remedied.

Tesoro first argues that the ALJ erred in allocating the burden of proof. Its contention is that once it is agreed that §18 must be invoked, the Department is the moving party and must therefore shoulder the burden of proof.[80] Without getting into a serious digression about the distinction between the burdens of production and proof,[81] it seems plain that in fact it is the taxpayer here who is seeking relief from the statutory formula. That was not so clear in *Twentieth Century-Fox*.[82] The broader rule is that the taxpayer bears the burden of showing unfairness,[83] and it is plain that Tesoro is not arguing in favor of the unadulterated version of the two-factor test. Under these circumstances, Alaska law requires the taxpayer to prove "that its proposed methods are more fair than the legislature's clearly-expressed

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[78] Order on Partial Summary Adjudication Motions, R. 4537-47.
[79] *Container Corp.*, 463 U.S. at 169, 77 L.Ed.2d at 554. *See also In the Matter of Magella Health Corp*, Case No. OTA-2003-01, 2004 WL 1363568 (Alaska Dept. of Revenue).
[80] At br. at 30.
[81] *See* J.W. Strong, *McCormick on Evidence*, §336 *et seq.* (5th ed. 1999) and 29 Am Jur. 2d Evidence, §155 (1994).
[82] *Twentieth Century-Fox, supra,* 700 P.2d at 1037-38. *See also Microsoft Corp., supra,* 139 P.3d at 1178, *Lakehead Pipe Line co., Inc. v. Department of Revenue,* 549 N.E.2d 598, 602 (Ill. App. 1989), *Union Pacific Corp. v. Idaho Tax Commission,* 83 P.3d 116, 119 (Idaho 2004), quoting *St. Johnsbury Trucking Company, Inc. v. State of New Hampshire,* 385 A.2d 215, 217 (1978) (state party seeking relief from three-factor test) and *Texaco Inv. v. Calvert,* 526 S.W.2d 630, 634 (Tex. Civ. App. 1975).
[83] *Container Corp.* and *Alaska Gold, supra.*

preference."[84] This of course does not mean that the Department need not choose a reasonable alternative.[85]

The Department's use of §18 was a logical response to the opinion of the Attorney General, AS 43.20.072 and the taxpayer's position. It operated to reduce Tesoro's apportionable income by a third. It sought to resolve the specific constitutional infirmity identified in the opinion without deviating more than necessary from the statutory model. Tesoro suggests that Alaska further adopt a test for reasonableness with three components: (1) the division of income fairly represents business activity and if applied uniformly would result in taxation of no more or no less of income; (2) it does not create or foster lack of uniformity among UDITPA jurisdictions; and (3) it represents the economic reality of the business activity engaged in by the taxpayer in the state.[86] While these sound like noble goals, the problem is, as these mathematical puzzles tend to be, complex. (One might liken this to reapportionment, with the Constitutional mandate for one person, one vote, the desire to keep districts more or less uniform and contiguous, and a Voting Rights Act thrown in for good measure.) Given this theoretical "smorgasbord" of methodologies,[87] there has to be process, a start and a finish, and Tesoro's approach would make this impossible. Judge Handley's reading of the supreme court's statements in *Gulf Oil*, leaving the safety valve in the Department's

[84] *Gulf Oil, supra,* 755 P.2d at 383. *See also* at 374, 381 n. 23.
[85] *See* Tesoro's discussion of *Magella, supra.*
[86] *Twentieth Century-Fox, supra,* 700 P.2d at 1043; *Magella, supra.*
[87] Order on Summary Adjudication, R. 4542.

control,[88] was not error, given a case in which the taxpayer agreed that §18 relief was necessary. As noted earlier, this does not mean that DOR can implement an unreasonable process, or one that is not internally consistent.

Even given the inherent inaccuracy of any allocation scheme, the taxpayer of course retains the right to demonstrate that a particular application is unfair. And while that doesn't mean we revisit the unitary business issue again in its entirety, Tesoro's argument in this regard is somewhat close—it contends that even the modified three-factor test is unfair because "the non-Alaska property and sales of E&P, which generated the vast majority of Tesoro's income during the Audit Period, are disproportionately dwarfed by the property and sales of the less profitable R&M," preventing them "from ever fairly approximating the amount of income generated in Alaska."[89] The factors applied "must actually reflect a reasonable sense of how the income is generated."[90]

Of course this taxpayer starts from the premise that it is clear what was earned where, ever resisting the conclusion that the segments were unitary.[91] As Tesoro notes, it is the Texas events themselves, and the very high profits earned by those events, which illustrate its claim of unfairness. Judge Handley recognized this, noting that the income from the buyout of the Bob West gas field was unusually large and qualitatively distinct from the income earned in a typical year.[92]

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[88] *Id.* at 4542-43.
[89] At. br. at 33.
[90] *Container Corp.*, 463 U.S. at 169, 77 L.Ed.2d at 556 (defining "external consistency").
[91] *See* Ae. br. at 55 n. 225.
[92] Dec. at 32.

But Tesoro argues that the segments were not horizontally or vertically integrated, which makes use of the property and sales factors unfair to it.

Tesoro's explanation of why this is so, however, brings to mind the Alaska cases discussed earlier. It is compelling evidence that the property factor uses the $5 million acquisition cost as the value of the Bob West gas field even though part of it was sold for $75 million, but, facing the other side of this dilemma, Gulf Oil was unable to convince the supreme court that it wasn't fair to value a dry hole at cost.[93] As one of the witnesses testified, gas exploration companies are not paid for finding gas, but rather for selling it; buying low and selling high is business at its best.[94] Further, taxing authorities are not generally in a good position to determine fair market value of corporate property.[95]

On the other hand, the supreme court did express a concern with fairness in the *ARCO* opinion,[96] and later observed that this was because it found distortion in each of the three components of the formula, and the cumulative effect was unfair.[97] Here, the taxpayer contends that its unique circumstances make both property[98] and sales[99] inaccurate indicators of profitability, as they would be with segments either horizontally or vertically integrated. It stresses that the (Alaska) R&M segment has a high property value, while the (Texas) E&P property is valued at cost despite it's

[93] *Gulf Oil, supra,* 755 P.2d at 385, quoting *State, Department of Revenue v. Amoco Production Co.*, 676 P.2d 595, 599-600 (Alaska 1984).
[94] *See id.* at 386.
[95] *See id.* at 387.
[96] *Atlantic Richfield Co. v. State, Department of Revenue,* 705 P.2d 418 (Alaska 1985).
[97] *Gulf Oil*, 755 P.2d at 386.
[98] At. br. at 33-37.
[99] At. br. at 37-40.

high profitability, and, further, that the formula fails to account for the highly valuable intangible property that it owned by virtue of its take-or-pay contract with Tennessee Gas. Similarly the sales factor fails to assist in apportioning income fairly because profit margins in R&M's retail operations are slim despite high sales, while E&P was a high risk gamble involving operational expertise that yielded the lion's share of the company's income during the audit period. It compares adjustment in this situation to cases in which §18 relief was granted with respect to the inclusion of full redemption proceeds from investment income in various other jurisdictions.[100]

As noted earlier, however, Judge Handley did sustain DOR's choice of §18 relief by adding an extraction factor, which reduced the taxpayer's income by a third. Tesoro maintains, however, that this was wholly arbitrary, and did not convert the formula into one which fairly reflected the economic reality of its business activity in this state. It argues that the ALJ did not even address this concern.

This dispute was prefaced earlier in the discussion of who bears the burden of proof. Judge Handley recognized that the Department chose to add the extraction factor to resolve the internal consistency problem referenced in the opinion of the Attorney General. It sought a global resolution, that it could apply to other taxpayers, a decision sustained by the ALJ on the basis of consistency and the

[100] *Microsoft Corporation*, supra, 139 P.3d at 1178-80, citing cases. *See* Ae. br. at 44-45.

inherent grant of discretion to the Department.[101] The legislative preference was not for separate geographic accounting, nor is it mandated by the Commerce Clause.[102] DOR argues that this method itself is fraught with potential problems, both in this case[103] and generally.[104] The use of the extraction factor reflected its inclusion in AS 43.20.072, it followed the AG's opinion, it directly recognized the contribution of E&P income and it operated to reduce Tesoro's taxable income significantly. It also serves to distinguish the facts here from those in ARCO, since there is not distortion in all three factors working against the taxpayer.

The parties both devote some time to explaining why the statute is or is not internally consistent, complete with tables. Suffice it to say that I agree with Judge Handley and the Department that, as modified by the use of the extraction factor,[105] applied to this taxpayer, the apportionment scheme is internally consistent.[106]

Tesoro's underlying premise may be that because it is so easy to determine the source of its income during the audit period, any method that does not apportion E&P income wholly out of state is unfair. But, having found the segments to be unitary and the Department's application of §18 to be reasonable, the taxpayer offers no alternative to the court but separate accounting.[107] While the test is

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[101] R. 4543-46, citing *Gulf Oil, supra.*
[102] *Exxon, supra,* 447 U.S. at 229-30, 65 L.Ed.2d at 85.
[103] *See* Ae. br. at 54 n. 223 and accompanying text.
[104] *See* Ae. br. at 49-50, citing *Earth Resources, supra,* 665 P.2d at 966.
[105] The Department calls this "TFAAM," the three factor alternative apportionment method. Ae. br. at 32 *et seq.*
[106] *See* At. br. at 48-50 and Appendix to Ae. br.
[107] Reply at 2.

somewhat subjective—is the result outside tolerable limits,[108] out of all appropriate proportion?[109]—the cases teach that pointing out a particularly rough application of the law, whether the valuation of a dry hole or confiscatory tax policies by OPEC, does not automatically entitle a taxpayer to relief. This is a difficult issue because of the taxpayer's combination of unfortunate circumstances relating to the property and sales factors as discussed above, and a somewhat compelling one because much of the income was due to unique events, but once the segments are deemed unitary, it is not wholly true or determinative to say that the taxpayer "had no operations" here.[110] Tesoro has not met its burden to show that the Department's refusal to grant §18 relief in the form of separate accounting[111] is unconstitutional.

If AS 43.20.072 is unconstitutional in part, can DOR impose penalties?

Adding insult to injury from the taxpayer's point of view, the Department assessed a penalty for Tesoro's intentional or negligent disregard of a law or regulation.[112] Judge Handley found that the taxpayer took a very aggressive position on the law, and reasonably should have paid the tax and then sought a refund.[113] For 25 years before purchasing the pipeline, the company had filed as a unitary business, and the ALJ found that it knew the KPL purchase would trigger application of AS 43.20.072, with its higher tax liability. The decision below illustrates Tesoro's contentions during the 1990s, which evolved into its present

[108] *Gulf Oil, supra.*
[109] *Mobil Oil v. Vermont, supra,* 445 U.S. at 437, 63 L.Ed.2d at 521.
[110] Reply at 14-15. *See Gulf Oil, supra* note 30.
[111] AS 43.19.010, Art. IV, sec. 18(a).
[112] AS 43.05.220(a), 15 AAC 05.220.
[113] Dec. at 36-41.

position that the segments were not unitary and that §18 relief in the form of separate accounting was required. He concluded that this was "not the filing history of a reasonably prudent taxpayer attempting to avoid the penalties that result from deficiencies," and that Tesoro had not demonstrated reasonable cause for the delay.[114] Penalties of 5% for negligence and 25% for failure to timely pay were imposed.

The taxpayer's answer is that AS 43.20.072 is unconstitutional, that both parties realized that back in 1997, and that had it paid before the §18 adjustment was made, it would have overpaid significantly.[115] It relies on the United States Supreme Court's venerable ruling in *Norton v. Shelby County*.[116]

DOR responds that the notion that the statute is a nullity is obsolete, that principles of severability would come into play and that the findings made by Judge Handley demonstrate that the taxpayer's deficiency was due to "at least negligence."[117] During the audit period, Tesoro was arguing that only KPL was subject to AS 43.20.072, and the statute was only applied to the taxpayer as modified by §18.

Tesoro maintains that DOR's reasoning left it with only two choices—pay too much under the unconstitutional statute or pay the penalties.[118] But what the ALJ found is that it did not face this choice, that its position was that only that KPL

[114] Dec. at 40, citing 15 AAC 05.200.
[115] At. br. at 79-80.
[116] 118 U.S. 425, 442 (1886).
[117] Ae. br. at 57-62.
[118] Reply at 31.

was subject to the statute. The penalties are only due on the amount that was finally determined to be due and owing. While it may not be unusual for a taxpayer's position to evolve over time, the fact is that Tesoro was not then arguing that E&P and R&M weren't unitary, or that §072 was unconstitutional. The taxpayer does not dispute the chronology outlined in the Department's brief in its reply, nor does it offer authority for its position in this context.

It is clear that Tesoro's position was aggressive. While I have, after spending some time seeking to reconcile the constitutional limitations of state taxation with the reality of modern apportionment schemes, some appreciation for the difficulty of the task facing the tax consultants for interstate concerns, the failure to pay was not due to an unconstitutional statute, and sustaining Tesoro's argument on this basis would undermine the requirement that taxpayers pay and then seek a refund if applicable. No authority has been presented that would allow abatement under these circumstances.

The decision of the ALJ is affirmed.

Dated: 4/28/11

Fred Torrisi, Judge

I certify that on 4/28/11 a copy of this document was sent/faxed to the attorneys of record or other

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