IN THE SUPERIOR COURT FOR THE STATE OF ALASKA
THIRD JUDICIAL DISTRICT AT ANCHORAGE

CONOCOPHILLIPS COMPANY AND SUBSIDIARIES, f/k/a PHILLIPS PETROLEUM COMPANY, Appellants, v. STATE OF ALASKA DEPARTMENT OF REVENUE, Appellee.	Case No. 3AN-10-12854 CI

DECISION ON APPEAL

ConocoPhillips and its subsidiaries ("ConocoPhillips") appeal a Decision on Summary Adjudication from the Office of Administrative Hearings. ConocoPhillips challenges the Notice of Assessment and Demand for Payment ("Notice") of additional oil and gas corporation income tax for the 2000 and 2001 tax years ("Years at Issue") from the State of Alaska, Department of Revenue ("Department"). The challenge specifically relates to the computation of depreciation on the assets of two limited liability companies in which ConocoPhillips or one of its affiliates holds an interest.[1]

I. FACTS AND PROCEEDINGS

A. Facts

ConocoPhillips is a multinational integrated energy company, incorporated in Delaware and headquartered in Oklahoma for the Years at Issue. ConocoPhillips is engaged in business in Alaska. [R. 217, 222]. Because of its activities in Alaska, ConocoPhillips filed the Alaska Oil and Gas Corporation Net Income Tax returns on a worldwide combined basis for the Years at Issue. [R. 222]. ConocoPhillips included in taxable income the partnership distributions from two limited liability companies in which it or one of its affiliates held an

[1] Because the issues decided here will control the ultimate decision in the consolidated Kenai LNG appeal, the Court does not separately address that appeal other than briefly in Section I.B. below.

interest. These two entities—taxed as partnerships—are Duke Energy Field Service, LLC ("DEFS") and Chevron Phillips Chemical Company LLC ("CPCC"). [R. 222].

DEFS is a joint venture engaged in gas gathering and processing. The two parties that formed DEFS are Duke Energy Field Services Corporation—an unrelated third-party, not obligated to file Alaska income tax returns—and an affiliate of ConocoPhillips. DEFS is headquartered in Colorado, with no depreciable assets in Alaska. [R. 217, 220]. DEFS adopted—pursuant to the terms of the limited liability agreement—the maximum allowable accelerated depreciation method with the shortest permissible life allowed under the Internal Revenue Code ("IRC"). [R. 221]. The distributions the ConocoPhillips affiliate received from DEFS where computed consistent with the accelerated depreciation method just mentioned and were included in Alaska taxable income without recomputation of that accelerated depreciation. [R. 332-336].

The other entity at issue—CPCC—is a chemical and plastics manufacturing joint venture formed by Chevron Corporation and ConocoPhillips.[2] ConocoPhillips and Chevron Corporation each own 50% of CPCC. [R. 218]. CPCC is headquartered in Texas, is a separate and distinct entity from ConocoPhillips, and has no facilities or assets in Alaska. [R. 218]. The limited liability company agreement ("CPCC Agreement") provided that all items of income, gain, loss, deduction, credits and tax preferences for state and local income tax purposes shall be allocated consistent with the allocation of those items for federal tax purposes. [R. 219]. The CPCC distributions received by ConocoPhillips were computed consistent with the terms of the CPCC Agreement and thus included deductions that utilized accelerated depreciation. [R. 281-7].

For the Years at Issue, ConocoPhillips and its affiliates received a distributive share of the income, deductions, and credits of DEFS and CPCC. [R. 222]. In computing Alaska worldwide taxable income, ConocoPhillips included the partnership distributions received from DEFS and CPCC in its income. [R. 222]. The amount stated in taxable income was the amount included in federal taxable income for the Years at Issue. [R. 222]. The controversy arises because the Alaska statute at issue in this case—AS 43.20.072(b)—prohibits the use of accelerated depreciation. Under federal standards, corporations are at liberty to use accelerated depreciation methods. But pursuant to the depreciation computation

[2] ConocoPhillips and its four affiliates will be referred to as "ConocoPhillips."

requirements lain out in AS 43.20.072(b)(4) ("Alaska Depreciation"), an oil and gas company must recompute the depreciation on its assets consistent with 26 U.S.C.167 as that section read on June 30, 1981. [3] Prior to June 30, 1981, Section 167 did not allow for the use of accelerated methods of depreciation.

ConocoPhillips computed depreciation on its corporate assets consistent with Alaska Depreciation. But it did not recompute the DEFS and CPCC partnership distributions to reflect Alaska Depreciation on the partnership assets. [R. 222]. ConocoPhillips' failure to restate its partnership distributions from DEFS and CPCC to reflect Alaska Depreciation gives rise to the matter before the Court.

B. Proceedings

The Department audited the corporate oil and gas income tax returns filed by ConocoPhillips for the Years at Issue and determined that ConocoPhillips should have recomputed the depreciation on the partnership's assets consistent with Alaska Depreciation. [R. 222-3]. In October 2005, the Department issued the Notice proposing to assess tax of $22,365,910. [R. 223]. ConocoPhillips requested an Informal Conference and paid the Department $14,406,459—representing the tax and interest due on the uncontested audit adjustments. [R. 224]. Shortly thereafter the Department issued the Informal Conference Decision ("ICD"), which upheld the Notice. [R. 224]. ConocoPhillips filed an appeal in March 2008 with the Office of Administrative Hearings. [R. 225].

In addition to ConocoPhillips itself, this case also concerns Kenai LNG Corporation ("Kenai LNG"). ConocoPhillips owns in excess of 50% but less than 80% of Kenai LNG. Therefore, Kenai LNG is required to file its own corporate income tax returns, rather than be included in the ConocoPhillips worldwide combined income tax returns. [R. 225]. But Kenai LNG must file its returns utilizing the ConocoPhillips worldwide income and apportionment factors. [R. 225]. The Department also audited Kenai LNG's returns for the Years at Issue and adjusted the returns consistent with the ConocoPhillips audit adjustments. [R. 225]. The Department similarly issued a Notice of Assessment and Demand for Payment in October 2005 proposing to assess tax in the amount of $68,458 plus interest. [R. 225]. Kenai LNG requested an Informal Conference. [R. 226]. The Department issued its ICD in February

[3] AS 43.20.072(b) (provides that a taxpayer who is engaged in the production of oil and gas or the transportation of oil and gas must compute depreciation in Alaska consistent with Internal Revenue Code Section 167 as that section read prior to June 30, 1981).

2008 reducing the tax due for 2000 to $38,480 and determined a refund in the amount of $29,891 for 2001. The result is net tax of $8,589. [R. 226]. Kenai LNG filed a Notice of Appeal shortly thereafter. The Office of Administrative Hearings issued an order in April 2008 consolidating the Kenai LNG matter with the ConocoPhillips matter. [R. 226].

The Office of Administrative Hearings issued its Decision on Summary Adjudication and Order ("Decision") on the above matters in September 2010. [R. 25-39]. The Decision affirmed in part the ICD conclusion that the DEFS and CPCC partnership assets must be depreciated using Alaska Depreciation. [R. 25, 34]. But the Decision also held that the Department erred in (1) totally reversing the federal depreciation associated with the partnership assets; (2) the failure to apply IRC § 704; and (3) the failure to use the Alaska basis of the partnership assets to compute the depreciation allowance. [R. 25, 34]. This matter was remanded to the Department to recalculate the depreciation allowance consistent with the Office of Administrative Hearings' findings. ConocoPhillips now appeals the findings made in the Decision and the subsequent Order Denying Reconsideration.

II. ISSUE PRESENTED

1. Whether the ALJ applied the correct standard of review to the Department's Informal Conference Decision.
2. Whether an oil and gas corporation that receives income from an investment in a limited liability company—which is treated as a partnership—must re-state that income based on the Alaska Depreciation schedule rather than the accelerated federal depreciation schedule.

III. LEGAL STANDARD

There are four standards of review for administrative appeals. The substantial evidence test is used for questions of fact. The reasonable basis test is used for questions of law involving agency expertise. The substitution of judgment test is used for question of law where no expertise is involved. The reasonable and not arbitrary test is used for review of administrative regulations.[4]

[4] *Handley v. State*, 838 P.2d 1231 (Alaska 1992).

Here, the Court is confronted solely with a question of law—statutory interpretation[5]—and both parties agree that it does not involve agency expertise. Therefore, the substitution of judgment test is appropriate. The Supreme Court of Alaska has held that in applying its independent judgment to questions of statutory interpretation, it adopts "the rule of law that is most persuasive in light of precedent, reason, and policy."[6] Moreover, when reviewing statutory interpretation, the Supreme Court of Alaska applies a sliding scale in which "[t]he plainer the meaning of the language of the statute, the more convincing any contrary legislative history must be."[7]

IV. DISCUSSION

A. It is immaterial whether the ALJ applied the correct standard of review.

The first issue raised by ConocoPhillips is whether the ALJ applied the correct standard of review in the Decision that this Court now reviews. As both parties agree that this Court ought to use a substitution of judgment standard, it is immaterial whether the ALJ used the proper standard below. Any error on the ALJ's part would be cured by the Court's use of independent judgment in this appeal.

B. ConocoPhillips must recalculate the partnership distributions.

The second and more substantial issue in front of the Court is whether ConocoPhillips must recalculate the income received from partnership distributions based on the Alaska Depreciation schedule rather than the accelerated federal depreciation schedule. The parties agree on a number of factual issues. The parties agree that DEFS and CPCC are treated as partnerships for federal income tax purposes. [R. 218, 220]. ConocoPhillips acknowledges that it used the federal standards to calculate depreciation for these partnerships and that it did not recalculate its share of depreciation from these two partnerships using Alaska Depreciation. If ConocoPhillips had done so, its tax liability would have been higher. Both parties accept that ConocoPhillips must recalculate its own assets to reflect Alaska Depreciation. But the parties are at odds as to whether ConocoPhillips must recalculate the

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[5] *State, Dept. of Natural Resources v. Greenpeace, Inc.*, 96 P.3d 1056, 1061 n. 10 (Alaska 2004)(de novo standard applies if the case concerns "statutory interpretation or other analysis of legal relationships about which courts have specialized knowledge and experience")(quoting *Kelly v. Zamarello*, 486 P.2d 906, 916 (Alaska 1971)).

[6] *Premera Blue Cross v. State, Dep't of Commerce, Cmty. & Econ. Dev., Div. of Ins.*, 171 P.3d 1110, 1115 (Alaska 2007).

[7] *Curran v. Progressive Northwestern Ins. Co., 29 P.3d 829, 831-32 (Alaska 2001).*

deductions to income received from the depreciation of DEFS and CPCC's assets when calculating its income received from the partnership distributions for Alaska tax purposes. The parties take two approaches in determining whether ConocoPhillips must restate its partnership distributions to reflect Alaska Depreciation. This is in large part because resolution of this issue involves the interpretation and application of both the IRC—which has been adopted by reference in Alaska[8]—and an Alaska specific statute, AS 43.20.072.

One approach is based on the understanding that the starting point for calculating ConocoPhillips' Alaska tax liability is federal taxable income.[9] Alaska statute provides that the IRC is adopted by reference—except as modified by other provisions of the statute.[10] One of those modifications is that Alaska Depreciation is to be employed by oil and gas taxpayers.[11] If the Court were to find that federal law dictates that partnership depreciation flows through to the partners, then the depreciation would be attributable to ConocoPhillips and Alaska Depreciation would apply. Another approach is to determine whether the Alaska-specific modifications to federal law—AS 43.20.072(b)(4)—specifically requires the recomputation of a partnership distribution using Alaska Depreciation. The Court finds this second approach to be more instructive and therefore addresses it first.

1. *AS 43.20.072(b)(4) requires ConocoPhillips to recalculate its partnership distributions to reflect Alaska Depreciation.*

Turning to the Alaskan statute at issue, the Court must determine whether AS 43.20.072(b)(4) requires the recomputation of ConocoPhillips' partnership distributions to reflect Alaska Depreciation. In interpreting a statute, Alaska courts "look to the plain meaning of the statute, the legislative purpose, and the intent of the statute."[12] The arguments made in the briefs and at oral argument focused primarily on the plain meaning and tangentially touched upon the legislative purpose.

a. Plain meaning

The statute at issue requires that an oil and gas taxpayer's apportionable business income "shall be the federal taxable income of the taxpayer's consolidated business for the

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[8] AS 43.20.021(a).
[9] AS 43.20.072(b).
[10] AS 43.20.021(a).
[11] AS 43.20.072(b)(4).
[12] *Premera Blue Cross v. State, Dep't of Commerce, Cmty. & Econ. Dev., Div. of Ins.*, 171 P.3d 1110, 1115 (Alaska 2007).

tax period, except that … depreciation shall be computed on the basis of [Alaska Depreciation].” At its most basic, the distinction the Court is confronted with is one of assets versus income. ConocoPhillips focuses on the ownership of depreciable assets while the Department looks at taxable income and permissible deductions from that income.

ConocoPhillips suggests that a reading of AS 43.20.072(b) and the regulations implementing Alaska Depreciation illustrate that Alaska Depreciation only applies to the assets of unitary corporations.[13] A unitary corporation in this context is one that is engaged in oil and gas production in Alaska. ConocoPhillips argues that the partnership assets subject to depreciation here are not the assets of a unitary corporation. Rather, the assets belong to two partnerships—which are separate and distinct entities.

To shore up this assertion ConocoPhillips points to AS 32.06.201(a), which states that a partnership is an entity that is distinct from its partners. Moreover, property acquired by a partnership is that of the partnership and not that of the partners.[14] DEFS and CPCC were formed by members contributing existing assets. [R. 220, 218]. Therefore, any assets contributed to DEFS and CPCC or acquired by those partnerships subsequent to their formation would be the assets of DEFS and CPCC—as distinct legal entities from ConocoPhillips. The DEFS Agreement even makes explicit the fact that “title to the assets shall be deemed to be owned by DEFS as an entity, and no member, director or officer, individually or collectively, shall have any ownership interest in the assets.” [R. 221]. ConocoPhillips argues that because the assets that are being depreciated belong to the partnerships, the depreciation expense at issue is actually that of DEFS and CPCC—not that of ConocoPhillips. Therefore, depreciation should be calculated at the partnership level, not the partner level. Ultimately, ConocoPhillips argues, there is no statutory or regulatory requirement to restate partnership depreciation under these circumstances.

The Department, in turn, argues that it is the federal taxable *income* of ConocoPhillips’ consolidated business that must be recalculated under Alaska Depreciation. Partnerships are simply flow-through entities. The income flows from the partnership to the partners. Neither party disputes that ConocoPhillips received distributive shares from DEFS and

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[13] Alaska Admin. Code 20.480(b) (“…a taxpayer shall report depreciation expense for all unitary corporations using the class life asset depreciation range system as applied under [Alaska Depreciation], applied to the depreciable basis determined under taxpayer’s method of reporting federal taxable income for that corporation as if all assets were used inside the United States.”) (emphasis added).
[14] AS 32.06.203.

CPCC, which it then included in its "federal taxable income" of its consolidated business. According to the Department though, depreciation deductions are embedded in those distributive income shares and thus flow through to the partners.

Looking to the plain meaning, the Court does not find that it needs to resolve the issue of whether the *assets* are those of ConocoPhillips or those of a partnership. Rather, the Court needs only look at ConocoPhillips' *income* and determine whether that income, including deductions to that income, is properly calculated under Alaska statute. Put simply, AS 43.20.072(b)(4) states that ConocoPhillips's apportionable business income "shall be the federal taxable income of [ConocoPhillips'] consolidated business … except that … depreciation shall be computed on the basis of [Alaska Depreciation]." Partnerships are conduits, with the income they generate passing through to the partners. As a partner, part of ConocoPhillips' federal taxable income included partnership distributions from DEFS and CPCC. The accelerated depreciation deductions for DEFS and CPCC's assets are part of those distributive shares and decrease the reported income to Alaska. This Court interprets AS 43.20.072(b)(4) to require ConocoPhillips to utilize Alaska Depreciation in calculating its Alaska taxable income. When paying Alaska taxes, ConocoPhillips must calculate all deductions to its income pursuant to the deductions that are allowable under Alaska statute, including deductions to its partnership income.

b. Legislative purpose

While the Court is able to reach a conclusion based on the plain meaning of AS 43.20.072, an examination of the legislative purpose does not diminish the Court's holding. ConocoPhillips points to the evolution of AS 43.20.072(b)(4) as evidence that it was not meant to apply to partnership distributions. The Department, on the other hand, argues that the legislative purpose of AS 43.20.072(b)(4) requires ConocoPhillips to compute all income from its consolidated business—including income received from its partnership shares in CPCC and DEFs—using Alaska Depreciation.

AS 43.20.072(b)(4) was enacted in 1981. The Department implemented AS 43.20.072(b)(4) in 1982 by issuing 15 AAC 20.480. That regulation—entitled "Depreciation Expense"—provides that Alaska Depreciation "applies only to assets used in the taxpayer's petroleum business."[15] Moreover, ConocoPhillips argues that the term "taxpayer" as defined

[15] At. R. Br., Ex D at 2.

in AS 43.20.340(10) means "a person subject to tax imposed by this chapter." ConocoPhillips points out that partnerships are not subject to the Alaska Net Income Tax Act.

ConocoPhillips then turns to the Department's 1985 revision of 15 AAC 20.480. Again, this revised regulation appears to reference only assets used in the taxpayer's petroleum business.[16] The regulation also provides guidance for the computation of depreciation by domestic and foreign corporations included in the petroleum business. There is no reference, in either the original version or the revised version of the regulation, to assets owned by a partnership—in which the taxpayer is a partner—or to the computation of depreciation for partnership distributions.

The most recent revision to the regulation became effective in 1998. It states in pertinent part that "a taxpayer subject shall report depreciation expense for all unitary corporations using the class life asset depreciation range system as applied" under Alaska Depreciation.[17] According to ConocoPhillips, the language is clear. The depreciable assets discussed in each version of the regulation are only those of the corporate oil and gas taxpayer. ConocoPhillips argues that the assets at issue here are the assets of two partnerships, not the assets of ConocoPhillips—the oil and gas taxpayer. Instead, ConocoPhillips contends, its assets are its *investments* in CPCC and DEFS.

While ConocoPhillips points to relevant statutory evolution, it is not sufficient to overcome the plain meaning of the statute. This court interprets AS 43.20.072(b)(4) to apply to *income* and *deductions to income* rather than *assets*. And, to the extent that this history may be helpful to ConocoPhillips, the Supreme Court of Alaska applies a sliding scale when reviewing statutory interpretation in which "[t]he plainer the meaning of the language of the statute, the more convincing any contrary legislative history must be."[18] Here, the Court finds that the meaning of the language of the statute is fairly clear and the legislative history is, at best, only marginally supportive of the contrary position.

The drastic changes found in the 1998 revision eliminate the "assets used in the taxpayer's petroleum business" language that may have been more persuasive to the Court. Instead, the 1998 revision reads much more like AS 43.20.072 in that it regards "depreciation

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[16] At. R. Br., Ex E at 2.
[17] 15 AAC 20.480(b).
[18] *Curran v. Progressive Northwestern Ins. Co., 29 P.3d 829, 831-32 (Alaska 2001).*

expense for all unitary corporations."[19] In other words, the implementing regulation supports the Court's decision to focus on income over assets as the regulation refers to the taxpayer's "depreciation expense" and does not even mention ownership of the depreciated assets.[20] Moreover, given the wording of AS 43.20.072(b)(4) and the timing of its inception alongside changes in federal taxation allowing for accelerated depreciation, it is apparent to this Court that the statute is meant to prevent oil and gas producers from taking advantage of accelerated depreciation and reducing their reportable income in filing their Alaska income taxes.[21] As such, none of the legislative history brought to the Court's attention outweighs the plain meaning of the statute's language.

c. Reason and Policy

As stated above, the Supreme Court of Alaska has held that in applying its independent judgment to questions of statutory interpretation, it adopts "the rule of law that is most persuasive in light of precedent, reason, and policy."[22] Therefore, the Court will touch briefly on reason and policy.

ConocoPhillips argues that simply based on reason and logic, it should not be required to restate its partnership distributions to reflect the use of Alaska Depreciation. According to ConocoPhillips, the ALJ failed to recognize certain significant implications when he concluded that it is the partner and not the partnership that must recompute the depreciation on the partnership assets. First, DEFS is not an Alaska oil and gas corporation. [R. 220]. A partner that is not an Alaska oil and gas taxpayer—such as DEFS—if subject to Alaska corporation income tax, would not be required to use Alaska Depreciation. Non-oil and gas partners are generally required by statute to compute taxable income using the federal depreciation allowance. Consequently, a non-oil and gas taxpayer would have a significantly different depreciation allowance on partnership assets than that of the Alaska oil and gas corporation partners.

Second, there is no Alaska uniform statutory or regulatory method for computing Alaska Depreciation. Even among Alaska oil and gas partners, depreciation computation

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[19] AAC 20.480(b).
[20] 15 AAC 20.480(b).
[21] This analysis is not based on Governor Hammond's June 24, 1981 letter, which when viewed in full context is not as supportive as the Department's quotation from it would indicate.
[22] *Premera Blue Cross v. State, Dep't of Commerce, Cmty. & Econ. Dev., Div. of Ins.*, 171 P.3d 1110, 1115 (Alaska 2007).

could result in a significantly different depreciation allowance for the exact same assets, simply depending on the method elected. According to ConocoPhillips, such a result is illogical, unreasonable and bad tax policy. A better one, ConocoPhillips contends, is consistency among similarly situated taxpayers all of who own an interest in the same partnership entity. Under this theory, consistency is only obtained by allowing the partnerships' depreciation to be calculated at the partnership level. ConocoPhillips ultimately contends that its argument for consistency is more reasonable than the Department's illogical statutory interpretation.

The Department responded by asserting that ConocoPhillips' argument—that requiring Alaska Depreciation in this manner is illogical, unreasonable, and bad tax policy—is better made to the Alaska Legislature.

The Court recognizes the potential for inconsistencies referenced by ConocoPhillips that may result when Alaska oil and gas taxpayers choose to enter a partnership or joint venture yet are required to separately depreciate assets on their individual corporate returns. But to interpret the statute as suggested by ConocoPhillips would eviscerate the legislative purpose and reasoning behind the statute. If Alaska oil and gas taxpayers could reduce their Alaska taxable income by simply placing assets in a partnership or joint venture's name, the clear revenue-generating purpose of the statute would be defeated. Such a scenario would circumvent AS 43.20.072(b)(4) in a severe way. Ultimately the Court agrees with the Department. Such issues are more appropriately brought to the legislature as opposed to the judiciary.

For the reasons outlined above, the Court find that AS 43.20.072(b)(4) requires ConocoPhillips to recalculate its partnership distributions to reflect Alaska Depreciation. In considering the other approach—the "flow through" approach—the Court agrees in part with the ALJ's conclusion.[23] Namely, a partnership's depreciation flows through to the corporate partners.

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[23] The Court does not find that partnership depreciation flows through and becomes attributable to corporate partners as a matter of federal law. This is not an issue that this Court is required to decide. But the Court holds that application of those federal statutes, after being incorporated alongside Alaska statute, results in partnership depreciation flowing through.

2. *A partnership's depreciation only flows through to the corporate partners as a matter of state law.*

A substantial portion of the parties' briefs—and the Decision and ICD below—concern the determination of whether each corporate partner must take into account separately its distributive share of depreciation. The Department's theory being that if a partnership's depreciation flows through to the corporate partner taxpayer as a matter of federal law, then that depreciation would be subject to Alaska Depreciation. ConocoPhillips argues that there is no requirement under federal law to separately state depreciation. According to ConocoPhillips, depreciation is calculated at the partnership level and attributable to the partnership—not the partners. Central to both the Department's and ConocoPhillips' argument here is the interpretation of IRC § 702. That section states as follows:

> (a) General rule.--In determining his income tax, each partner shall take into account separately his distributive share of the partnership's--
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> (1) gains and losses from sales or exchanges of capital assets held for not more than 1 year,
> (2) gains and losses from sales or exchanges of capital assets held for more than 1 year,
> (3) gains and losses from sales or exchanges of property described in section 1231 (relating to certain property used in a trade or business and involuntary conversions),
> (4) charitable contributions (as defined in section 170(c)),
> (5) dividends with respect to which section 1(h)(11) or part VIII of subchapter B applies,
> (6) taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,
> (7) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary, and
> (8) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.
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> (b) Character of items constituting distributive share.--The character of any item of income, gain, loss, deduction, or credit included in a partner's distributive share under paragraphs (1) through (7) of subsection (a) shall be determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.

The Department focuses on subsection (a)(7). Under the Department's interpretation, the gist of this statute is that ConocoPhillips must "take into account separately [its] distributive share of the partnership's … other items of income, gain, deduction, or credit to

the extent provided by regulations prescribed by the Secretary." One such regulation prescribed by the Secretary is Treas. Reg. § 1.702-1(a)(8)(ii). That section requires that

> Each partner must … take into account separately his distributive share of any partnership item which if separately taken into account by any partner would result in an income tax liability for that partner different from that which would result if that partner did not take the item into account separately….

According to the Department, the requirement placed on ConocoPhillips to use Alaska Depreciation results in "an income tax liability for [ConocoPhillips] different from that which would result if [ConocoPhillips] did not take [deductions] into account separately." The Department then reasons—somewhat circuitously—that because of the Alaska Depreciation requirement, this treasury regulation applies to ConocoPhillips, and therefore it must state its deductions separately. And because ConocoPhillips must state its deductions separately, it's deductions—including depreciation—are applicable to it, not the partnerships. And because ConocoPhillips' deductions are applicable to itself, rather than the partnerships, ConocoPhillips must recalculate its deductions according to Alaska Depreciation.

ConocoPhillips interprets IRC § 702 completely differently. ConocoPhillips contends that only in limited situations are specific items of partnership income or expense taken into account by each individual partner. Those situations, argues ConocoPhillips, are set forth in IRC § 702 and include situations such as the gain or loss of capital assets or property, charitable contributions, and certain dividends and taxes—not partnership depreciation. ConocoPhillips also argues that Treas. Reg. § 1.702-1(a)(8)(ii) does not apply to this circumstance. This is because under federal law, where accelerated depreciation is available to all parties, it is generally inconsequential whether the partnership or the individual partners calculate the depreciation. ConocoPhillips supports this contention by noting that a partnership is required to file a federal information return—despite not being a taxable entity. Schedule K on that information return lists those items that are required to be reported separately. Depreciation expense is not a separately listed item on Schedule K. [R. 222].

Ultimately, ConocoPhillips may be correct in arguing that a partnership's depreciation does not flow through to the corporate partner as a matter of *federal* law. But, when viewing § 702 and Treas. Reg. § 1.702-1(a)(8)(ii) as being part of the Alaska code, the Department's argument is persuasive. Because of the Alaska Depreciation requirement, if ConocoPhillips were not to take into account separately its distributive share of deductions, then the federal

standards would apply and it could use accelerated depreciation. If ConocoPhillips were to take into account separately its distributive share of deductions it could only use Alaska Depreciation. As such ConocoPhillips must "take into account separately [its] distributive share of [the depreciation deduction]" because when it is separately taken into account by ConocoPhillips it results "in an income tax liability for [ConocoPhillips] different from that which would result if [ConocoPhillips] did not take the item into account separately." This is not tantamount to reading the word "state" into the regulation—as ConocoPhillips argues. Rather, it is the consequence of incorporating the federal code and regulation into Alaska law, with the Alaska *exceptions and modifications*, as is called for in AS 43.20.021(a).

In short, a partnership's depreciation may not flow through to the corporate partner as a matter of federal law. But when that federal law is incorporated into the rest of the Alaskan tax framework, which depreciation flows through to the partner. Nevertheless, the Court focuses on the fact that AS 43.20.072(b)(4) is an explicit exception to Alaska's adoption of federal taxable income reporting. Regardless of the analysis of federal law, the Court finds that partnership distributions fall under AS 43.20.072(b)(4) in reviewing that statute specifically. As such, ConocoPhillips is required to recompute its partnership distribution to reflect Alaska Depreciation.

V. CONCLUSION

The Office of Administrative Hearings' Decision on Summary Adjudication and the subsequent Order Denying Reconsideration are **AFFIRMED**. The case is remanded to the Department to recalculate the depreciation allowance consistent with the Office of Administrative Hearings' findings.

ENTERED this 4th day of April, 2012, in Anchorage, Alaska.

Signed
Hon. Patrick J. McKay
Judge of the Superior Court

[This document has been modified to conform to the technical standards for publication.]