BEFORE THE ALASKA OFFICE OF ADMINISTRATIVE HEARINGS

In the Matter of	)	
	)	
PHILLIPS PETROLEUM COMPANY &	)	
SUBSIDIARIES	)	
	)	OAH No. 08-0143-TAX
Oil & Gas Corporate Income Tax	)	
Tax Years 2000 and 2001	)	

ORDER DENYING RECONSIDERATION

After careful review, Taxpayer's motion for reconsideration is denied.

The decision does not assume that "depreciation [of the partnership assets] is that of the Taxpayer."[1] The decision observes that the partner's distributive share of the depreciation is the partner's, and that this distributive share must be taken into account separately by the partner in some circumstances.

Taxpayer is correct that the decision was written with the assumption that using Alaska depreciation will result in increased tax liability,[2] in part because it would be unusual for a taxpayer to resist using a methodology that would lower its liability. Taxpayer challenges this assumption. *Nothing in the decision should be construed to prevent Taxpayer from benefiting from any reduction in tax liability that may result from the recalculation that has been ordered.*

Taxpayer is incorrect in asserting that the decision fails to recognize that partners may use different methods to compute depreciation on the same asset.[3] This argument is noted in the decision and addressed on page 9.

Finally, the administrative law judge is mindful of the possibility that the Department's interpretation of AS 43.20.072(b)(4) could impose a compliance burden. The potential legal significance of such a burden, if sufficiently onerous, is noted at pages 9-10 of the decision. There was no evidentiary showing on this issue in the present case, however. The decision does

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1 Motion at 3, ¶ 6(a).

2 *See id.*, ¶ 6(b).

3 *See* Motion at 4, ¶ 6(c).

not foreclose a future litigant from making a showing on the issue and, if the showing is sufficient, obtaining a different construction or application of the statute by that means.

DATED this 3rd day of November, 2010.

By: *Signed*______________________
Christopher Kennedy
Administrative Law Judge

Certificate of Service: The undersigned certifies that on the 3rd day of November, 2010, a true and correct copy of this document was mailed to the following: Marilyn A. Wethekam, counsel for ConocoPhillips (formerly Phillips Petroleum Co. & Subsidiaries); and Martin T. Schultz, counsel for the Department of Revenue. A courtesy copy was hand-delivered to Hollie Kovach, Chief of Appeals, Tax Division.

By: *Signed*______________________
Linda Schwass/Kim DeMoss

[See below DECISION ON SUMMARY ADJUDICATION]

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DECISION ON SUMMARY ADJUDICATION

I. Introduction.

This tax appeal has been consolidated with *In the Matter of Kenai LNG Corporation*, OAH No. 08-0144-TAX. Phillips Petroleum Company and Subsidiaries[4] (Phillips) and Kenai LNG Corporation (Kenai) are referred to collectively as Taxpayer. The Department of Revenue (Department) and Taxpayer agree upon all relevant facts, and have stipulated that the only issues are legal ones resolvable by motion. Each has filed a motion for summary adjudication.

The first question in this matter is whether a 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 an Alaska depreciation schedule rather than the accelerated federal depreciation schedule. This decision concludes that Alaska law does require the use of an Alaska depreciation schedule in this situation. However, the depreciation must be recalculated on remand to give Taxpayer the full benefit of the Alaska depreciation rules.

The second question is whether sales between a taxpayer and a partnership in which the taxpayer holds an interest are "intercompany income and expenses" and thus excludable – to the extent of the corporation's interest in the partnership – when calculating the sales apportionment factor used in determining Alaska tax liability. The Department has correctly interpreted its regulation on this issue.

[4] Phillips Petroleum Company and Subsidiaries is now known as ConocoPhillips.

II. Background.

In a document dated September 16, 2009, the parties stipulated to a wide range of facts. The background facts below are drawn from that stipulation and its exhibits.

A. Legal entities involved in this matter

Phillips is an international, integrated energy company. Kenai owns a liquefied natural gas (LNG) plant in Alaska. Phillips, through a subsidiary, owns 70% of Kenai stock. The remaining 30% is owned by Marathon Oil Company, an unrelated company.

Chevron Phillips Chemical Company LLC (CPCC) is a chemical and plastics manufacturing joint venture created by Phillips and Chevron Corporation. Chevron is not related to Phillips. Phillips owns 50% of CPCC through four separate subsidiaries of Phillips. CPCC has no facilities or depreciable assets in Alaska.

Duke Energy Field Services, LLC (DEFS) is a joint venture in gas gathering and processing formed between Duke Energy Field Services Corporation and an affiliate of Phillips. Through the affiliate, Phillips has a 30.3% interest in DEFS. DEFS has no depreciable assets in Alaska and does not own or operate processing plants in Alaska.

B. Tax Filings

Phillips filed Alaska Oil and Gas Corporation Net Income Tax returns for the years at issue here, 2000 and 2001. It filed on a worldwide basis under AS 43.20.072. As a part of these returns, Phillips included income from CPCC and DEFS based on the income reflected in the federal K-1 form prepared by each of them. This form stated income based on federal depreciation rules rather than the Alaska depreciation rules. Phillips did not recalculate its share of income from these entities based on the Alaska depreciation rules. Phillips also apparently included certain Phillips sales to CPCC, and DEFS sales to Phillips, in the total sales figure used to calculate its Alaska tax.[5]

Kenai filed separate Alaska Oil and Gas Corporation Net Income Tax Returns using the worldwide combined reporting method. It is required to use Phillips' worldwide income on its returns because Phillips owns more than 50% of Kenai, but Kenai must file its own return because Phillips' ownership interest is less than 80%. The Kenai returns reflected the same handling of CPCC and DEFS as the Phillips returns.

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[5] The Stipulation of Facts does not cover this point, but the parties appear to agree upon it.

On audit, the Department adjusted the tax liability of Phillips and Kenai by approximately $13.5 million in principal on account of the two issues that gave rise to this appeal.[6] The adjustments were upheld at Informal Conference.

III. Discussion.

A. Standard of Review

The parties agree that the only questions to be resolved in this case are questions of law. The legislature has prescribed a pair of standards of review for such questions. As a general matter, the administrative law judge (ALJ) is to "resolve a question of law in the exercise of [his] independent judgment."[7] At the same time, the ALJ must "defer to the Department of Revenue as to a matter for which discretion is legally vested in the Department of Revenue, unless not supported by a reasonable basis."[8]

This pair of standards is intended to track the normal approach to review taken by appellate courts, including the deference owed to the agency on certain matters of statutory or regulatory interpretation.[9] As the attorney general opined when this language first came into Alaska's tax statutes, the reasonable basis standard of review was to be used whenever there was an "application of the tax law to complex factual circumstances *or other matters* of Revenue expertise."[10]

1. Deference Regarding Interpretation of State Statutes

When a case presents questions of statutory interpretation that involve "agency expertise" – that is, where the agency's specialized knowledge and experience are helpful in giving meaning to the statute – a deferential standard of review is appropriate.[11] In such cases, "[a] 'statutory construction adopted by those responsible for administering a statute should not be overruled in the absence of weighty reasons.'"[12] When the agency claims special expertise and requests deference, the claim must be tested against a set of Alaska Supreme Court precedents

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6 *See* Stipulation of Facts Ex. G, H. These show adjustments for Phillips; corresponding adjustments for Kenai are not shown in the record, but they appear to have been quite small. As the exhibits reflect, there were many other adjustments that are not at issue on appeal.

7 AS 43.05.435(2).

8 AS 43.05.435(3).

9 *See State, Dep't of Revenue v. DynCorp and Subsidiaries,* 14 P.3d 981, 984 (Alaska 2000).

10 Bill Review Letter for HB 341, June 10, 1996 (italics added).

11 *State v. Jeffery,* 170 P.3d 226, 229-30 (Alaska 2007); *see also Northern Timber Corp. v. State,* 927 P.2d 1281, 1284 n.10 (Alaska 1996).

12 *State v. Jeffery,* 170 P.3d at 230 (quoting prior authority).

that seek to identify the kinds of questions that are better decided with the benefit of the agency's insight.[13]

In the present case, the Department has not requested deference on the basis of agency expertise. In the absence of a timely request, accompanied by an exploration of the agency expertise or other basis being asserted for deference, a deferential standard of review will not be applied in this case.

Although a deferential standard will not apply to interpretation of state statutes in this case, the Alaska Supreme Court has made it clear that the administrative resolution of these matters below is always entitled to "some weight."[14] Thus, if the Department's interpretation of a statute is as good as any competing interpretation, the Department's interpretation will stand.

2. Deference Regarding Interpretation of State Regulations

The preceding discussion covered only Departmental interpretations of state statutes. As for state regulations, regardless of whether agency expertise is implicated, the reasonable basis standard applies to the agency's "interpretation of its own regulations . . . unless plainly erroneous or inconsistent with the regulation."[15] Part D below turns primarily on interpretation of a Department regulation.

3. Deference Regarding Federal Law

There is no deference to the Department of Revenue in the interpretation of federal tax provisions, whether in statute or regulation.[16] This will be relevant in Part C below, which turns in large part on federal law.

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[13] *Compare Gulf Oil Corp. v. State, Department of Revenue,* 755 P.2d 372, 378 n.19 (Alaska 1988) (whether a tax is "based on or measured by net income" is a matter benefiting from the experience and knowledge of Tax Division personnel) and *State, Department of Revenue v. Parsons Corp*., 843 P.2d 1238, 1241 (Alaska 1992) (interpreting the Multistate Tax Compact involves questions of tax policy benefiting from Tax Division expertise) *with Earth Res. Co. v. State, Dep't of Revenue,* 665 P.2d 960, 965 (Alaska 1983) (no need for agency expertise in ascertaining "whether a taxpayer's business is unitary," notwithstanding that correctly applying the unitary business concept can entail a sophisticated grasp of financial relationships).

[14] *See, e.g., Alaska Gold Co. v. State, Dep't of Revenue*, 754 P.2d 247, 251 (Alaska 1988); *National Bank of Alaska v. State, Dep't of Revenue*, 642 P.2d 811, 815 (Alaska 1982).

[15] *Lake & Peninsula Borough v. Local Boundary Comm'n*, 885 P.2d 1059, 1062 & n.11 (Alaska 1994) (quoting prior authority); *see also Lakloey, Inc. v. University of Alaska*, 157 P.3d 1041, 1045 (Alaska 2007).

[16] *State, Dep't of Revenue v. DynCorp and Subsidiaries,* 14 P.3d at 984-5 (predecessor of Office of Administrative Hearings owed no deference to Alaska Department of Revenue on interpretation of federal tax law that had been incorporated into state law).

B. Applicable Tax Provisions

For oil and gas producers such as Phillips, the starting point for calculating state tax liability is federal taxable income.[17] Alaska has adopted much of the federal Internal Revenue Code (IRC), and provisions in that code have full force and effect unless a state statute expressly or implicitly provides otherwise.[18] The exception to the federal tax code relevant in this case is found at AS 43.20.072(b)(4), requiring that depreciation used in calculating federal tax liability must be restated based on the provisions of 26 USC § 167 as that provision existed on June 30, 1981.[19]

Alaska seeks to tax its share of a corporation's income, and tax it once, leaving to other jurisdictions the taxation of the income attributable to activity elsewhere. Alaska's approach is found in the Multistate Tax Compact, incorporated into Alaska Law by AS 43.20.065,[20] and is called formula apportionment. Total income[21] is multiplied by a fraction representing Alaska's share of the enterprise's overall activity.[22]

Taxpayer was subject to a version of formula apportionment whereby this fraction is generated by averaging three preliminary fractions based on property, sales, and extraction of oil and gas.[23] The numerator of each of these preliminary fractions is based on Alaska activities and the denominator relates to the corporation's activities everywhere.[24] The average of these three fractions is then multiplied by the corporation's federal taxable income – with certain adjustments – to determine the amount of state-derived income subject to the Alaska corporation tax rates set out in AS 43.20.011(e).

Under provisions of the federal tax code that have been adopted by Alaska, partnerships are not taxed; instead each individual partner is separately taxed on its share of the partnership's

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17 AS 43.20.072(b).

18 AS 43.20.021(a); AS 43.20.200; *cf. In re Schlumberger Technology Corp. and Subsidiaries,* OAH No. 08-0577-TAX (2010) (addressing implied exceptions).

19 Federal depreciation after June 30, 1981 allows an accelerated depreciation schedule which typically results in lower taxes during the earlier years of depreciation.

20 The MTC is an Alaska law in its own right, located in Title 43, Chapter 19. The significance of its incorporation into ANITA is that it thereby also becomes a "provision[] of this chapter"—Chapter 20—and hence is within the chapter whose provisions can except to or modify IRC provisions. *See* AS 43.20.021(a).

21 In the present case, the enterprise's overall activity was calculated on a worldwide basis. Stipulation of Facts ¶ 49.

22 AS 43.19.010, art. IV.

23 *See* AS 43.20.072(c)(3); Stipulation of Facts ¶ 50.

24 AS 43.20.072(c), (d), (e), (f).

income.[25] The partner reports its distributive share of the partnership income except that certain items must be accounted for separately on the partners' own tax return.[26]

C. Depreciation Issue

The dispute in this matter centers on two limited liability companies in which Phillips has invested. The parties agree that these limited liability companies are treated as partnerships for federal and state income tax purposes.[27] A federal Form K-1 shows the Phillips share of income, deductions, and credits for each of these partnerships.[28] The K-1 for each partnership does not have a separate line showing Phillips' share of depreciation, and Phillips did not recalculate depreciation pursuant to AS 43.20.072(b)(4).[29] If it had done so, its and Kenai's overall taxable income (the base income figure to which formula apportionment is applied) would have been higher, and the ultimate tax liability would have been higher.

Taxpayer is a group of corporations.[30] There is no question that Taxpayer's income, before apportionment, is its federal taxable income with a few specific adjustments, including recalculation of depreciation under former IRC § 167. The depreciation of CPCC and DEFS has to be recalculated if it is *Taxpayer's* depreciation—that is, if it is depreciation attributable to one or more of the *corporations* comprising the Taxpayer. Moreover, since the starting point is federal taxable income as adjusted, the depreciation must be attributable to the corporations under federal law. Thus, the question is whether the partnerships' depreciation flows through to the corporations, as a matter of federal law.

To show that partnership depreciation does flow though to become attributable to corporate partners, the Department points to 26 U.S.C. § 702, which provides in relevant part:

> (a) General rule
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> In determining his income tax, each partner shall take into account separately his distributive share of the partnership's -
>
> * * *
>
> (7) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary . . . .

The Department then cites Treas. Reg. §1.702-1(a)(8)(ii), a regulation of the Secretary requiring

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25 26 U.S.C. §§ 701 – 709.

26 26 U.S.C. § 702(a).

27 Stipulation of Facts ¶ 11.

28 Stipulation of Facts ¶ 51.

29 Stipulation of Facts ¶¶ 53 & 54.

30 *See* AS 43.20.072(h)(2).

that “[e]ach 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.” From the context, “partnership item” encompasses deductions.[31] Thus, while a deduction may be calculated at the partnership level to produce an apportioned income figure as ordinarily reported on a K-1 form, if a partner’s tax liability would be different if its share of the deduction were taken by the partner itself, the tax liability must be determined with the deduction applied in that manner.

Phillips objects that the regulation relied on “was not in effect during the Years at Issue” and that, in any event, it was “added to affect only United States shareholders of controlled foreign corporations.”[32] Oddly, the Department seems to acquiesce in the first half of this assertion and responds only by claiming the regulation is an interpretive one that should be relied on as “persuasive” authority.[33] Both litigants are wide of the mark.

Treasury Regulation §1.702-1(a)(8)(ii) is not an interpretive regulation. It is a substantive provision adding to the list of items that must be taken into account separately, which the Secretary has added pursuant to the substantive authority granted him under 26 U.S.C. § 702(a)(7), quoted above; once the Secretary has added it, the item must be accounted for separately under that statute. But it is also quite wrong to say that §1.702-1(a)(8)(ii) was “not in effect” in 2000 and 2001 and to assert that it was added only to affect U.S. shareholders of controlled foreign corporations. Section 1.702-1(a)(8)(ii) has been around for decades. In 2000 and 2001, it read, in its entirety:

> (ii) Each partner must also 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. Thus, if any partner would qualify for the retirement income credit under section 37 if the partnership pensions and annuities, interest, rents, dividends, and earned income were separately stated, such items must be separately stated for all partners. Under section 911(a), if any partner is a bona fide resident of a foreign country

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[31] For example, the last last sentence of §1.702-1(a)(8)(ii), as it existed in 2000, mentioned “items . . . of deduction” among the “items” that must be taken into account separately in the context of the hobby losses example being discussed there. Likewise, deductions are expressly mentioned among the partnership “items” dealt with in §1.702-1(b). There are many other contextual indications that “partnership items” encompasses deductions.

[32] Taxpayer’s Response in Support of Taxpayer’s Motion for Summary Judgment and in Opposition to the Department’s Motion for Summary Judgment, at 6-7.

[33] Department of Revenue’s Memorandum in Opposition to Taxpayer’s Motion for Summary Judgment, at 11.

> who may exclude from his gross income the part of his distributive share which qualifies as earned income as defined in section 911(b), the earned income of the partnership for all partners must be separately stated. Similarly, all relevant items of income or deduction of the partnership must be separately stated for all partners in determining the applicability of section 270 (relating to "hobby losses") and the recomputation of tax thereunder for any partner.[34]

Moreover, Taxpayer's assertion that the provision "was specifically added to affect only United States shareholders of controlled foreign corporations"[35] is spurious. Taxpayer has cited misleadingly to the stated purpose of a 2002 amendment to this regulation that added a sentence to address such shareholders;[36] nothing in the regulatory history suggests that the main text, quoted above, was adopted for so limited a purpose.

To be sure, the fact that a partnership's depreciation flows through to the corporate partners, in accordance with their shares, would rarely have federal tax consequences, because federal tax law does not require restatement of depreciation under former 26 USC § 167. The significance arises at the state level: all depreciation pertaining to a corporate oil and gas taxpayer under federal law must, in determining state tax, be restated under the old method.

Taxpayer objects that CPCC and DEFS had no business activities in Alaska and were not required to file partnership returns in Alaska, "let alone use Alaska Depreciation."[37] This is certainly true, but it is irrelevant. The question is how *Taxpayer's* depreciation—some of which it derives from CPCC and DEFS—must be calculated. The partnerships themselves are unaffected.[38]

Similarly, Taxpayer observes that the Alaska Legislature "has adopted, without exception, the partnership provisions" of the Internal Revenue Code.[39] It contends that the Department cannot, therefore, impose additional requirements on partnerships beyond those

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34 Treas. Reg. 1.702-1(8)(ii) (2000 version). This wording was in effect from 1992 to 2002.

35 Taxpayer's Response in Support of Taxpayer's Motion for Summary Judgment and in Opposition to the Department's Motion for Summary Judgment, at 7.

36 *See* 67 F.R. 48023 (July 23, 2002).

37 Memorandum in Support of Taxpayer's Motion for Summary Judgment, at 20.

38 For this same reason, Taxpayer's argument at pages 33-37 of its motion—to the effect that CPCC was not "engaged in" the production or transportation of oil and gas—is beside the point. No requirement is being imposed on CPCC.

39 Memorandum in Support of Taxpayer's Motion for Summary Judgment, at 28.

imposed by federal law. The premise is debatable, but even if accepted it is beside the point. The recalculation requirement falls on the corporate taxpayer, not the partnership.[40]

Taxpayer observes that it did not control the two partnerships and could not compel them to compute Alaska depreciation. Again, this may be true but is irrelevant. It is Taxpayer, not the partnerships, that must compute Alaska depreciation. Both partnership agreements entitle the relevant Taxpayer affiliates to obtain from the partnership the underlying information necessary to prepare their state returns.[41]

Taxpayer objects that if individual corporate partners must recompute depreciation on partnership assets under former IRC § 167, two partners with Alaska tax liability might choose to depreciate their shares of the same asset using different methods (one might choose the useful-life method, the other the class-life ADR system).[42] Taxpayer has not explained how this hypothetical situation (which is not presented by the fact of this case) would lead to an inherently unfair or incoherent result.

Finally, Taxpayer makes an argument under the due process and commerce clauses of the United States Constitution that any requirement that increases Taxpayer's liability "based on two entities that have no connection with Alaska" would effectively be improper extraterritorial taxation.[43] As argued by Taxpayer, this appears to be a facial attack, albeit an implausible one, on the constitutionality of Alaska's system of unitary group reporting and formula apportionment. Such a facial attack is beyond the scope of this proceeding and would need to be addressed through a court appeal.[44] Notably, Taxpayer has neither argued nor attempted to make an evidentiary showing that Alaska's formula apportionment system, when coupled with the requirement for special handling of depreciation, represents a "[c]compliance burden . . .

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[40] The case Taxpayer has relied heavily on, *Kidde America and Subsidiaries v. Director of Revenue,* 198 S.W.2d 153 (Mo. 2006), is off point. In *Kidde*, a statute required the state taxing authority to conform its regulations as closely as practicably to the corresponding federal regulations. The court struck down a regulation that effectively imposed an additional requirement on corporate taxpayers that was not compelled by practicality. Here, the Alaska Department of Revenue has acted to implement a statute, AS 43.20.072(b)(4), that requires *departure* from current federal methodology.

[41] DEFS Amended and Restated Limited Liability Company Agreement [Ex. D to Stipulation of Facts] § 4.2(b)(i), (ii); CPCC Amended and Restated Limited Liability Company Agreement [Ex. B to Stipulation of Facts] § 9.4(b); *see also* § 9.6 (Phillips affiliate the "tax matters partner" for CPCC).

[42] Memorandum in Support of Taxpayer's Motion for Summary Judgment, at 32.

[43] *Id.* at 37-39.

[44] *See, e.g., In re Holiday Alaska, Inc.,* OAH No. 08-0245-TOB (Commissioner of Commerce, Community & Econ. Development, adopted Sept. 4, 2009), Decision at 5 (http://aws.state.ak.us/officeofadminhearings/Documents/TOB/TOB080245%20appeal%20pending.pdf).

disproportionately imposed on out-of-jurisdiction enterprises" of the kind that might create a commerce clause issue as discussed in Part II of *Barclays Bank PLC v. Franchise Tax Bd. of California.*[45]

In sum, all of Taxpayer's arguments to the effect that it may benefit from CPCC and DEFS depreciation without restating that depreciation under former IRC § 167 are unconvincing. The Department's decision to require Taxpayer to restate that depreciation must stand.

With that said, the Department's application of the requirement for recalculation of depreciation must be revisited. Taxpayer has pointed out one error that the Department now concedes, and has made one observation about the starting point for any future recalculation with which the Department agrees. First, the amount of income from CPCC and DEFS that the Department added in an effort to reverse the federal depreciation deduction was excessive, because it was calculated without taking into account IRC § 704(c), under which Taxpayer's share of the CPCC and DEFS depreciation was actually less than its ownership percentage in the partnerships. Second, in calculating the Alaska depreciation that Taxpayer is entitled to substitute for the federal depreciation, the basis used should be the basis under Alaska law, not the federal basis.[46] Taxpayer is entitled to summary adjudication on these issues, and the case must be remanded for the appropriate adjustments.

D. Intercompany Sales Issue

The Department has moved for summary adjudication on a second issue raised in Taxpayer's notices of appeal, relating to the treatment of a portion of certain sales between Taxpayer and the partnerships as intercompany sales. Taxpayer did not include this issue in its own motion for summary adjudication.

1. Waiver

The hearing specifically scheduled in this case was vacated when the parties came to agreement that the case raised only questions of law and that they "anticipate[d]" that cross-motions for summary adjudication would bring the case to resolution.[47] The parties later stipulated to a set of facts for use in the anticipated motion practice. That stipulation expressly

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[45] 512 U.S. 298, 313-14 (1994).

[46] Taxpayer asserts that the Alaska basis is approximately $163,000,000 higher for CPCC and approximately $243,000,000 higher for DEFS. Stipulation of Facts Ex. I. These figures have not been established in this case and are subject to Department verification on remand.

[47] Joint Motion to Revise Scheduling Order (Aug. 27, 2008), ¶ 4; Amended Scheduling Order (Sept. 2, 2008).

contemplated, however, that additional facts might be introduced "at a hearing."[48] There was no stipulation or order providing that the case would be resolved upon a written record and briefs. Instead, this case remains nominally on the hearing track (albeit with no hearing scheduled), with a provision for prior consideration of dispositive motions.

Taxpayer subsequently omitted the intercompany sales issue from its motion for summary adjudication, moving for judgment only on the depreciation issue. The Department's simultaneous motion for summary adjudication in its own favor covered both issues, and when it opposed that motion Taxpayer argued both issues. In its final brief (the reply brief on its own motion), the Department contended that by failing to move affirmatively for summary adjudication on the intercompany sales issue, Taxpayer had "waived" that issue for purposes of appeal.

There is no basis in law or equity to find a waiver simply because a party, in the circumstances of this case, did not move for summary adjudication on an issue prior to the hearing. Summary adjudication motions are optional, not required. The Department has chosen to proceed with a summary adjudication motion for this issue, and has had its full briefing opportunity – an initial memorandum and a reply opportunity giving it the last word on the issue. It will in no way be prejudiced if the tribunal finds no waiver and takes the issue up on the merits.

2. The Merits

The parties agree that during the relevant tax years Phillips made some sales to CPCC and DEFS made some sales to Phillips.[49] The question on appeal is whether those sales should be excluded in calculating Taxpayer's total sales to the extent of the corporation's interest in the partnerships.

The proportion of a taxpayer's sales attributable to Alaska is one of the three preliminary fractions, discussed above, used in generating a taxpayer's state tax liability. In essence, the sales fraction is the taxpayer's Alaska sales over its total sales.

The smaller these fractions are, the smaller the tax liability. A larger denominator makes the fraction smaller. Under AS 43.20.072(d)(2)(B), the denominator of the sales fraction includes "the total sales of the taxpayer's consolidated business everywhere." Thus, it is in a

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48 Stipulation of Facts at page 1.

49 Phillips Notice of Appeal at 11; Kenai Notice of Appeal at 12; Stipulation of Facts Ex. J at 12.

taxpayer's interest to maximize the transactions that can be counted as sales of the consolidated business. In this case, Taxpayer included sales of feedstock Phillips made to CPCC as part of its total sales for use in the denominator. Taxpayer also included sales of natural gas liquids that DEFS made to Phillips subsidiaries as part of Taxpayer's total sales for use in the denominator.

In a regulation, 15 AAC 20.500(d), the Department of Revenue has provided that neither the numerator nor the denominator of the sales fraction may "include intercompany income and expenses," with certain exceptions that do not apply here. On audit and at informal conference, the Department removed (to the extent of the corporation's interest in the partnership) the sales by Phillips to CPCC and the sales by DEFS to Phillips from the denominator on the ground that they were "intercompany" sales.

Taxpayer argues that the Department has misinterpreted the term "intercompany" in its own regulation. Taxpayer offers a single line of argument in support of this view. First, it notes that there is no definition of "intercompany" in Alaska statutes or regulations. It then proposes that it is "logical" to look instead to Treasury Regulation § 1.1502-13(b)(1). That federal regulation provides that, in general, "[a]n intercompany transaction is a transaction between corporations that are members of the same consolidated group immediately after the transaction." In this federal context, the term "consolidated group" means "a group filing (or required to file) consolidated returns for the tax year."[50] Taxpayer reasons that since CPCC and DEFS are not corporations, transactions between them and Phillips would not be "between corporations" and thus could not be "intercompany" transactions under Treas. Reg. § 1.1502-13(b)(1).[51]

Treasury Regulation § 1.1502-13(b)(1) has nothing to do with the fair apportionment of income among jurisdictions, however. The purpose of that regulation is to identify when income will be deemed to have occurred for purposes of taxation, primarily by way of a set of timing rules.[52] Taxpayer has offered no explanation for importing a definition from that context into this dissimilar context, and the ALJ is unable to think of one on his own.

The Department has applied a different interpretation of "intercompany" as it appears in

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50 I.R.C. § 1.1502-1(h).

51 No view is expressed here as to whether Taxpayer's interpretation of the federal provision is a fully accurate rendering of how it would be applied in context if federal law contained an analog to apportionment and to 15 AAC 20.500(d). *Cf.* IRC § 702(a)(7), Treas. Reg. § 1.702-1(a)(8)(ii).

52 *See* Treas. Reg. 1.1502-13(a).

15 AAC 20.500(d). In the Department's view, a transaction between a partnership and a corporation is an "intercompany" transaction with respect to the corporation to the extent of the corporation's interest in the partnership. Thus, if a corporation owns a 99 percent interest in a partnership, 99 percent of the corporation's sales to that partnership are "intercompany" sales. Only when the partnership re-sells the goods in question would the remaining 99 percent become a "sale" used in calculating apportionment fractions. In short, the Department has treated partnerships as pass-through entities for purposes of calculating apportionment.

The question presented here is one of interpreting a single word, "intercompany," as it appears in a Department regulation.[53] As has been discussed previously, even if no agency expertise is involved, the reasonable basis standard always applies to reviewing the agency's "interpretation of its own regulations . . . unless plainly erroneous or inconsistent with the regulation."[54] Taxpayer has not supplied a persuasive argument that the Department's reading of "intercompany" has no reasonable basis, is plainly erroneous, or is inconsistent with the regulation itself.

On the contrary, the Department's interpretation appears to be the more reasonable of the two presented in this proceeding. Under Taxpayer's interpretation, a sale to a 99-percent-owned partnership as described above could be counted almost twice over in calculating apportionment factors: initially, 100 percent of the sale would be a counted sale at the time the goods were sold to the partnership, and subsequently, 99 percent of the resale of the same goods would again appear as sales of the corporation upon resale by the partnership.[55] Indeed, were the goods transferred back and forth between partnership and corporation more than once, additional sales could be counted. This could artificially inflate the total sales of the corporation beyond any

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[53] Although the regulation is an interpretive one adding specificity to a statute, Phillips has not contended that the regulation, even if interpreted as the Department proposes, is outside the bounds of the statute or otherwise invalid. Thus, the sole question in this case is one of regulatory interpretation.

[54] *Lake & Peninsula Borough v. Local Boundary Comm'n*, 885 P.2d 1059, 1062 & n.11 (Alaska 1994) (quoting prior authority); *see also Lakloey, Inc. v. University of Alaska*, 157 P.3d 1041, 1045 (Alaska 2007).

[55] In the present case, Phillips supplied feedstock to CPCC which CPCC used in manufacturing products. Phillips counted as part of its total sales 100 percent of the feedstock it sold to CPCC, and then (according to an unchallenged factual finding in the Informal Conference Decision (ICD)) also counted as Phillips sales 50 percent of the downstream sales by CPCC of products made with the feedstock. The example used in the text is more starkly illogical than the Phillips-CPCC situation, but it shows the result for other taxpayers if the law were interpreted as Phillips proposes.

reasonable approximation of the true economic activity generated by that corporation, and thereby allow manipulation of the sales factor for various purposes.[56]

Under these circumstances, Taxpayer has failed, as a matter of law, to meet its burden of demonstrating that the Informal Conference Decision should be overturned on this issue.[57]

IV. Conclusion and Order

Summary Adjudication is granted to the Department and to Taxpayer as set forth above. Taxpayer has established that the Department erred in calculating depreciation under federal law in connection with CPCC and DEFS without taking account of IRC § 704(c), and has established that on remand Alaska depreciation attributable to CPCC and DEFS assets must be calculated using the Alaska basis for those assets. In all other respects the Informal Conference Decision is affirmed. Provided Taxpayer provides the necessary information and any requested verification, the Department shall recalculate the Oil and Gas Corporate Income Tax for Phillips Petroleum Company and Subsidiaries and for Kenai LNG Corporation for 2000 and 2001 in a manner consistent with this decision.

This matter is remanded to the Department for purposes of the recalculation required above. This decision shall become final for purposes of appeal as described in the Notice below,

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[56] Insofar as these transactions might inflate the numerator of a sales factor fraction in another state using a similar apportionment formula, the potential manipulation could entail the transfer of tax liability from Alaska to a lower-tax jurisdiction.

[57] With respect to DEFS, there is a wrinkle to this issue that requires a limiting note. The ICD indicates that the Department eliminated from the sales factor DEFS sales to Phillips only "to the extent of [Phillips'] . . . 33.3% ownership interest[]." ICD at 14 n.14. This suggests that some DEFS sales to Phillips were left in the sales factor. Assuming the ICD has correctly reported this history (the record is too limited to allow verification), Taxpayer may have benefited from an error in its favor.

As the administrative law judge understands this issue, sales by a partnership to one of its partners (as occurred with DEFS) must be handled differently from sales *by a partner to the partnership* (as occurred with CPCC). A percentage of the latter are indeed sales *by the partner* outside the intercompany group and should appear in the partner's sales factor. However, sales *by the partnership to the partner,* to the extent that they are not intercompany transactions, are also not sales *by the partner*, and thus no part of them contributes to the sales factor. No portion of any DEFS sale to Phillips ought to have been counted in the sales factor denominator, because any such sale should be characterized as being comprised of two elements: (1) a 33.3% portion which is a sale to Phillips by Phillips and thus is an intercompany transaction; and (2) a 66.7% portion which is a sale to Phillips by the other partners*,* and thus is likewise not includable in a *Phillips* sales figure. Insofar as the Department has permitted element (2) to remain in the sales factor, this decision should not be construed to endorse such an approach in the future.

but the Office of Administrative Hearings retains jurisdiction over this matter to the extent necessary, if at all, to resolve any dispute over whether the recalculation is correct.

DATED this 24th day of September, 2010.

By: *Signed*
Christopher Kennedy
Administrative Law Judge

NOTICE

This is the decision of the Administrative Law Judge under AS 43.05.465(a). Unless reconsideration is ordered, this decision will become the final administrative decision 60 days from the date of service of this decision.

A party may request reconsideration in accordance with AS 43.05.465(b) within 30 days of the date of service of this decision.

When the decision becomes final, the decision and the record in this appeal become public records unless the Administrative Law Judge has issued a protective order requiring that specified parts of the record be kept confidential. A party may file a motion for a protective order, showing good cause why specific information in the record should remain confidential, within 30 days of the date of service of this decision.

Judicial review of this decision may be obtained by filing an appeal in the Alaska Superior Court in accordance with AS 43.05.480 within 30 days after the date on which this decision becomes final.

Certificate of Service: The undersigned certifies that on the 27th day of September, 2010, a true and correct copy of this document was mailed to the following: Marilyn A. Wethekam, counsel for ConocoPhillips (formerly Phillips Petroleum Co. & Subsidiaries); and Martin T. Schultz, counsel for the Department of Revenue. A courtesy copy was hand-delivered to Hollie Kovach, Chief of Appeals, Tax Division.

By: *Signed*
Linda Schwass/Kim DeMoss

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