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

STATE OF ALASKA, DEPARTMENT)
OF REVENUE, TAX DIVISION,)
)
Appellant,)
)
vs.)
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CONOCOPHILLIPS ALASKA, INC.,)
)
Appellee.) Case No. 3AN-10-05484CI
)

ORDER

Appellant, the State of Alaska, Department of Revenue, Tax Division ("DOR") conducted an audit in 2003 of Appellee ConocoPhillips Alaska, Inc. ("CPAI") and disallowed tax deductions for a payment related to the repurchase of an oil tanker and assessed an offset for costs associated with an oil transfer. CPAI appealed the administrative decision. After the DOR decision was affirmed in an informal conference, CPAI again appealed to the Office of Administrative Hearings ("OAH") who ruled in CPAI's favor. The DOR now appeals. Oral arguments were heard on July 19, 2011.

BACKGROUND FOR MAKE-WHOLE PREMIUM

CPAI's affiliate Polar Tankers bought an oil tanker, the *Polar Endeavor*, in 2001. CPAI immediately sold the tanker to Arctic Funding, LP for $205 million through a synthetic lease agreement. The synthetic lease allowed Polar Tanker to finance the purchase of the tanker by selling the tanker to Arctic Funding while simultaneously leasing the vessel. Appellant's Brief at 5. Polar Tanker was able to list the expense of the

tanker on its financial statement as a lease rather than as a debt for the purchase price, but the tanker could still be treated as an asset that could be capitalized and depreciated for tax purposes. Appellant's Brief at 5-6.

The lease agreement had a "repurchase" clause. The lease terminated in 10 years at which point Polar Tankers could buy back the tanker by paying the original financed price ($205 million) or Polar Tankers could terminate the lease early by paying $205 million plus a "Make-Whole Premium" ("MWP"). The MWP would compensate Arctic Funding's noteholders for the loss of interest caused by early termination of the lease. In December 2003, Polar Tankers terminated the lease and repurchased the tanker. The MWP paid was $32,156,402 and was derived using a pre-determined interest calculation.[1] Had the lease run the full 10 years, Polar Tankers would have paid $103.6 million in lease payments.

The DOR determined that the MWP was not a deductible transportation cost. The DOR concedes that the $205 million repurchase price as well as the yearly lease payments that *would* have been paid had the tanker not been repurchased qualified as deductible transportation costs.[2]

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[1] The MWP was calculated by taking the "difference between the 6.85% interest on the notes and the 4.165% reinvestment yield over the remaining [7.5 years on the lease] multiplied by $198.850,000, the principal amount of the notes." Appellant's Brief at 6-7.

[2] Appellant's Brief at 13 ("The transportation cost deduction permitted under the regulations for a cost-of-capital allowance specifically includes inputs for the lease payments under a synthetic lease and 'the repurchase price paid by the producer at the end of the lease….").

BACKGROUND FOR ADMINISTRATIVE FEE

CPAI and Williams Alaska, Inc. ("Williams") had an Exchange Agreement where CPAI would divert oil from TAPS to Williams to use in Williams' Fairbanks refinery. Williams would return the same volume of oil, but the oil Williams returned would be of a lesser quality. The Quality Bank imposes a fee whenever different qualities of oil get mixed together in the TAPS. The fee compensates the other shippers for the loss in value when the lower quality oil gets mixed in with the higher quality oil.

The Quality Bank sent a notice of the fee to CPAI and then CPAI paid the other oil shippers. CPAI was then reimbursed by Williams for the Quality Bank degradation fee. In addition, Williams paid CPAI an administrative fee for the exchange.

The DOR determined that this administrative fee was nondeductible compensation for oil transportation. CPAI argues that the administrative fee was not payment for the cost of transporting oil, but rather, was simply an administrative fee for channeling oil through Williams' refinery.

ISSUES

I. What standard of review applies to the DOR's interpretation of complex tax statutes?

II. Did the DOR have a reasonable basis for finding that the Make-Whole Premium was not an "ordinary and necessary business expense" incurred in the transportation of oil.

III. Did the DOR have a reasonable basis for finding that the Administrative Fee for the oil exchange was an offset of oil transportation costs?

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I. DISCUSSION OF STANDARD OF REVIEW

The DOR maintains that its adjustments to CPAI's "transportation cost deductions were well within reasonable interpretations of the production tax regulations." Appellant's Brief at 3. The DOR argues that "[a]n Alaska oil producer's production tax liability is not determined – as implied by the OAH decision – by the terms of a producer's third-party contracts, but by application of the applicable Alaska production tax statutes and regulations." Appellant's Brief at 3. The DOR argues that "the calculation of 'gross value at the point of production' involved 'interpretation of a complex tax statute and regulations that implicate the special expertise' of the Department, and is entitled to the rational basis standard of review." Appellant's Brief at 3, quoting *State, Dept. of Revenue v. Atlantic Richfield Co.,* 858 P.2d 307, 308 (Alaska 1993); Appellant's Brief at 8.

CPAI asserts that the OAH applied the correct standard of review in denying agency deference. Appellee's Brief at 1. CPAI argues that whether the MWP is part of the repurchase price and whether the administrative fee was compensation for oil production are factual determinations understood through contract interpretation. *Id.* at 15, 17, 18, 38, 48.

In an appeal from an agency decision, there are four principal standards of review: (1) questions of fact are subject to the "substantial evidence" test, (2) questions of law involving agency expertise are subject to the "reasonable basis" test, (3) questions of law where no agency expertise is involved are subject to the "substitution of judgment" test, and (4) review of administrative regulations is subject to the "reasonable and not

arbitrary" test. *State v. Public Safety Employees Ass'n,* 93 P.3d 409, 413 (Alaska 2004). "[W]here an agency interprets its own regulation…a deferential standard of review properly recognizes that the agency is best able to discern its intent in promulgating the regulation at issue." *West v. Municipality of Anchorage,* 174 P.3d 224, 226-27 (Alaska 2007) (quoting *Rose v. Commercial Fisheries Entry Comm'n,* 647 P.2d 154, 161 (Alaska 1982).

State, Dept. of Revenue v. Atlantic Richfield Co. concerned a tax assessment involving interest deductions for construction of the TAPS. *Atlantic Richfield,* 858 P.2d 307 (Alaska 1993). The Alaska Supreme Court noted that "[t]he rational basis standard is used where the questions of law involve agency expertise or where the agency's specialized knowledge and experience would be particularly probative as to the meaning of the statute." *Id.* at 308.The Court applied the rational basis standard because that "case center[ed] around the interpretation of a complex tax statute and regulations that implicate the special expertise of DOR." *Id.* The agency's interpretation of the statute was found to be inconsistent with the language of the statute.

State, Dept. of Revenue v. DynCorp involved the "application of the [DOR's] regulation defining reasonable cause for missing a tax deadline." *DynCorp,* 14 P.3d 981, 984 (Alaska 2000). Incorporated by reference in that regulation was a body of federal law interpreting the federal "reasonable-cause exception." *Id.* at 985. The Alaska Supreme Court found that the DOR was not owed any deference in its decision because the case only involved application of established federal law to undisputed facts and it did not depend on any particularized knowledge or experience of the DOR's staff. *Id.*

In *Kuzmin v. State, Commercial Fisheries Entry Comm'n, Mr.* Kuzmin was denied a crab permit because he had insufficient points. *Kuzmin,* 223 P.3d 86, 89 (Alaska 2009). This denial was based on an agency determination that he was not entitled to points from his son's commercial fishing operation because he was not in joint control of the business. The Alaska Supreme Court held that the agency's decision was based on a factual finding of who actually controlled the fishing operation. The Court applied the substantial evidence test and found that there was substantial evidence to support the agency's decision.

The OAH applied the substantial evidence test and viewed the issues as questions of fact. OAH Order at 7-8, 15. The OAH also analyzed the issues under the reasonable basis test and came to the same conclusions. *Id.* at 8, 16.

This case concerns application of complex tax statutes and is very similar to *Atlantic Richfield.* The rational basis test applies. The issue is whether the DOR had a reasonable basis for concluding, under the applicable statutes and regulations, that the MWP is not a deductible transportation cost and that the Administrative Fee constitutes compensation for oil transportation.

II. DISCUSSION OF MAKE-WHOLE PREMIUM

The DOR asserts that the tax at issue is the oil production tax imposed under former AS 43.55.011(b) on the "gross value at the point of production." This value is calculated by deducting "the reasonable costs of transportation" from the sales price. AS 43.55.150 (2003).The "reasonable costs of transportation" are "the ordinary and

necessary costs incurred to transport the oil or gas from the point of production to the sales delivery point." 15 AAC 55.191(a).

The DOR determined that the early termination of the synthetic lease was neither an "ordinary" nor "necessary" cost incurred to transport oil and argues that because the DOR's decision is reasonable, it should be given agency deference. Appellant's Brief at 2, 11, 12. The DOR identified the MWP as a "prepayment penalt[y]" and found that "[t]he unwinding of the synthetic lease activity is related to a financing activity… and not primarily driven by the acquisition or operation of a vessel." Appellant's Brief at 11; [R.292].

CPAI states that 15 AAC 55.191(b)(3) provides guidelines to calculate deductions when an oil tanker is owned by a taxpayer or its affiliate. Appellee's Brief at 10-11. CPAI argues that section 3(D) allows the taxpayer to deduct "an amount that … will provide a reasonable return…on the…invested capital as provided in 15 AAC 55.195(b)…." *Id.* at 10-11. CPAI points to section .195(b)(2) which states that "a cost of capital allowance will be allowed as provided in (d) or (f) of this section or 15 AAC 55.196…." Section .196 incorporates as references an agency publication titled *Computation of a Cost-of-Capital Allowance under 15 AAC 55.196, Incorporating Depreciation and Return on Invested Capital for Marine Vessels and Improvements* (Nov. 21, 2002).

CPAI argues that because the future lease payments and purchase price were deductable as part of the return-on-investment calculation, it was unreasonable to disallow the MWP because it is the functional equivalent of a lease payment. Appellee's Brief at 14. CPAI argues that *Computation of a Cost-of-Capital Allowance* identifies

synthetic leases as common financing mechanism and includes the lease in the cost-of-capital allowance under 15 AAC 55.196(d). *Id., Computation of a Cost-of-Capital Allowance* at 8.

The DOR concedes that the lease payments and repurchase price would have qualified as an ordinary and necessary transportation cost, but in this instance, asserts that the MWP does not qualify, although the repurchase price would still qualify. Appellant's Brief at 13. The DOR's interpretation is erroneous and inconsistent with the regulations. The lease payments under a synthetic lease and the re-purchase price of a vessel under a synthetic lease were specifically included in the regulations to calculate a cost-of-capital allowance.[3] Distinguishing between the lease being terminated early and the noteholders being compensated and the lease running its full course and the lease-holder being compensated is unreasonable. In this case, the taxpayer is actually taking *fewer* allowances terminating the lease early because it would have paid much more in yearly lease payments over the 10 years. All of those payments, along with the repurchase price, would have been deductible. The MWP is deductible for the same reasons the yearly lease payments are deductible.

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[3] In the calculation of in-puts section, cash flows associated with synthetic leases were to be listed as other non-taxable revenues and expenditures. *Computation of a Cost-of-Capital Allowance* at 7. The publication stated that "[non-taxable revenues and expenditures] include the producer's anticipated amounts of other non-taxable revenues and expenditures associated with the vessel, including cash flows associated with sale / leaseback agreements, or synthetic leases. Examples are the purchase price of a vessel paid to the producer by a lessor who intends to lease the vessel back to the producer, or the re-purchase price paid by the producer at the end of the lease, if the proceeds or the expenditures are not taxable or deductible for tax to the producer. The amount for any year is entered as the revenues minus the expenditures." *Id.* at 13.

Although the OAH applied the incorrect test, the OAH is AFFIRMED. The DOR's interpretation is REVERSED and REMANDED for recalculation of CPAI's 2003 tax liability to include the $34,156,402 Make-Whole Premium in the return-on-investment calculation.

III. Discussion of Administrative Fee

The DOR argues that because CPAI "failed to prove that the additional per-barrel fee from Williams was reimbursement for actual non-deductible costs, the Department properly treated it as an offset to transportation costs." Appellant's Brief at 2-3.

The DOR asserts that oil is taxed on its value at the point of production. That value is then adjusted for any consideration paid or received for quality differentials.[4] The DOR claims that the tax adjustments were upheld at the informal conference because there was no indication that the administrative fee was reimbursement for any costs, but rather, was simply additional compensation. *Id.* at 23. The DoR argues that the assessment was a reasonable interpretation of tax regulations and CPAI has not offered evidence to support its claim that the administrative fee was actual reimbursement for costs unrelated to oil transportation. *Id.* at 24.

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[4] 15 AAC 55.151(b) (2003) states that:

> The gross value at the point of production for a producer's oil or gas must be calculated as follows: …3) if oils of different qualities or oil and NGLs are commingled, the value [of oil] calculated under (2) of this subsection must be adjusted for any consideration paid or received for quality differentials, regardless of whether prescribed by a filed tariff;

The DOR cites AS 43.05.245 to argue that CPAI bore the burden to show that the administrative fee was actual reimbursement for costs. AS 43.05.245 states in relevant part:

> An assessment or a return subscribed by the department in accordance with this section is presumed sufficient for all legal purposes. However, nothing prevents a taxpayer from presenting evidence or other information in an informal conference under AS 43.05.240 or in an appeal under AS 43.05.241 in order to rebut the presumed sufficiency of an assessment or return subscribed by the department, nor does the presumption of sufficiency alter the parties' respective burdens of proof once the taxpayer has presented evidence or other material information to rebut that presumption.

CPAI argues that DOR incorrectly identified the Administrative Fee as "'additional compensation' for the degradation of exchanged oil…." Appellee's Brief at 35. CPAI claims that the "Tax Division based its determination on the factually incorrect basis that the Exchange Agreement was an agreement for the *sale* of oil." *Id.* CPAI states that the Exchange Agreement was for the exchange of oil, not sale of oil.[5] *Id.* at 36.

CPAI also asserts that the Informal Conference Decision contained a factual error when it suggested that the Quality Bank imposed the Administrative Fee on Williams. *Id.* CPAI states that the Quality Bank imposed the fee on CPAI. CPAI paid the other shippers and was reimbursed by Williams. Williams also paid CPAI the administrative fee. *Id.* at 37.

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[5] The relevant portion in the Exchange Agreement between CPAI and Williams stated:

> The exchange differential paid by Williams to [CPAI] shall be equal to any quality bank degradation charges per barrel as assessed by the quality bank administrator…. Williams also agrees, in addition to quality bank assessments, to pay an administration fee of $.0275 per exchange barrel."

CPAI believes that the OAH order is an accurate reflection of the facts and points to its hypothetical where if Williams had returned oil of the same quality, there would have been no Quality Bank fee but CPAI would still have been entitled to collect the administrative fee. *Id.*

CPAI argues that the administrative fee was "consideration for the administration of the contract," not consideration for quality differentials. *Id.* at 38. CPAI states that its administrative undertakings were coordinating the offtake and return of oil from TAPS, analyzing the Quality Bank fees to document those related to the exchange and then billing Williams for reimbursement. *Id.* at 40, 44.

CPAI voluntarily entered into the contract to loop oil through Williams. CPAI was reimbursed for the degraded oil. The DOR determined that CPAI did not meet its burden in showing that the administrative fee was not additional compensation for transporting oil. It was reasonable for the DOR to conclude that compensation gained in the exchange of oil is compensation for that oil, absent CPAI presenting convincing evidence to the contrary.

The OAH decision is REVERSED. The DOR's interpretation is AFFIRMED. The DOR had a reasonable basis for treating the Administrative Fee as an offset for transportation costs.

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IV. CONCLUSION

This Court HOLDS that:

1) the DOR did not have a reasonable basis for finding that the Make-Whole Premium was not an "ordinary and necessary business expense" incurred in the transportation of oil, and

2) the DOR did have a reasonable basis for finding the Administrative Fee for an oil exchange was compensation for oil transportation costs.

The OAH's decision is AFFIRMED as to the MWP and REVERSED as to Administrative Fee. The DOR's decision is REVERSED as to the MWP and REMANDED for recalculation of CPAI's 2003 tax liability to include the $34,156,402 Make-Whole Premium in the return-on-investment calculation. The DOR's decision is AFFIRMED as to the Administrative Fee.

IT IS SO ORDERED.

DATED at Anchorage, Alaska this 3rd day of August, 2011.

*Signed*__________________
ERIC A. AARSETH
Superior Court Judge

I certify that on 4th_ August, 2011, a copy
was mailed to: Taylor, Vance
Alisha Hilde, Law Clerk

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