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United States Constitution, art. I, § 8

The Congress shall have Power ...

To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.

United States Constitution, art. I, § 10

No State shall ... pass any ... Law impairing the Obligation of Contracts,

United States Constitution, amend. XIV, § 1

nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.

Alaska Constitution, art. I, § 1

all persons are equal and entitled to equal rights, opportunities, and protection under the law.

Alaska Constitution, art. II, § 18

Laws passed by the legislature become effective ninety days after enactment. The legislature may, by concurrence of two-thirds of the membership of each house, provide for another effective date.

Alaska Constitution, art. IX, § 1

The power of taxation shall never be surrendered. This power shall not be suspended or contracted away,

Sec. 1, ch. 110, SLA 1978

* Section 1. LEGISLATIVE FINDINGS AND INTENT. The legislature finds and declares that the method of apportioning income for tax purposes under the "Uniform Division of Income for Tax Purposes" formula embodied in the Multistate Tax Compact (AS 43.19) and AS 43.20.065 does not fairly represent the extent of the business activities in this state of multistate corporations engaged in the production and pipeline transportation of crude oil and natural gas in Alaska. The legislature therefore intends that, in accordance with the provisions of art. IV, sec. 18 of the Multistate Tax Compact

(AS 43.19), the income tax of all corporations engaged in the production or pipeline transportation of oil or natural gas in or directly associated with this state shall be assessed by the tax administrator under this Act. The legislature further intends that the assessment of income tax against a multistate corporation engaged in the production or pipeline transportation of oil or natural gas shall be commensurate with the tax that would be assessed against a corporation owning and operating only those assets of the multistate corporation which are in or directly associated with this state.

AS 43.19.010 Article IV

Article IV. Division of Income.

1. As used in this Article, unless the context otherwise requires:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

(b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(c) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(d) "Financial organization" means any bank, trust company, savings bank, industrial bank, land bank, safe deposit company, private banker, savings and loan association, credit union, cooperative bank, small loan company, sales finance company, investment company, or any type of insurance company.

(e) "Nonbusiness income" means all income other than business income.

(f) "Public utility" means any business entity (1) which owns or operates any plant, equipment, property, franchise, or license for the transmission of communications, transportation of goods or persons, except by pipe line, or the production, transmission, sale, delivery, or furnishing of electricity, water or steam; and (2) whose rates of charges for goods or services have been established or approved by a federal, state or local government or governmental agency.

(g) "Sales" means all gross receipts of the taxpayer not allocated under paragraphs of this Article.

(h) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

(i) "This state" means the state in which the relevant tax return is filed or, in the case of application of this Article to the apportionment and allocation of income for local tax purposes, the subdivision or local taxing district in which the relevant tax return is filed.

2. Any taxpayer having income from business activity which is taxable both within and outside this state, other than activity as a financial organization or public utility or the rendering of purely personal services by an individual, shall allocate and apportion net income as provided in this Article. If a taxpayer has income from business activity as a public utility but derives the greater percentage of income from activities subject to this Article, the taxpayer may elect to allocate and apportion the taxpayer's entire net income as provided in this Article.

3. For purposes of allocation and apportionment of income under this Article, a taxpayer is taxable in another state if (1) in that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax, or (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

4. Rents and royalties from real or tangible personal property, capital gains, interest, dividends or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated as provided in paragraphs 5 through 8 of this Article.

5. (a) Net rents and royalties from real property located in this state are allocable to this state.

(b) Net rents and royalties from tangible personal property are allocable to this state: (1) if and to the extent that the property is utilized in this state, or (2) in their entirety if the taxpayer's commercial domicile is in this state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

(c) The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the taxable year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer, tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payer obtained possession.

6. (a) Capital gains and losses from sales of real property located in this state are allocable to this state.

(b) Capital gains and losses from sales of tangible personal property are allocable to this state if (1) the property had a situs in this state at the time of the sale, or (2) the taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs.

(c) Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.

7. Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state.

8. (a) Patent and copyright royalties are allocable to this state: (1) if and to the extent that the patent or copyright is utilized by the payer in this state, or (2) if and to the extent that the patent or copyright is utilized by the payer in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this state.

(b) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located.

(c) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located.

9. All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

10. The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period.

11. Property owned by the taxpayer is valued at its original cost. Property rented by the taxpayer is valued at eight times the net annual rental rate. Net annual rental rate is the annual rental rate paid by the taxpayer less any annual rental rate received by the taxpayer from subrentals.

12. The average value of property shall be determined by averaging the values at the beginning and ending of the tax period but the tax administrator may require the averaging of monthly values during the tax period if reasonably required to reflect properly the average value of the taxpayer's property.

13. The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation and the denominator of which is the total compensation paid everywhere during the tax period.

14. Compensation is paid in this state if:

(a) the individual's service is performed entirely within the state;

(b) the individual's service is performed both inside and outside the state, but the service performed outside the state is incidental to the individual's service within the state; or

(c) some of the service is performed in the state and (1) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in the state, or (2) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual's residence is in this state.

15. The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax

period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period.

16. Sales of tangible personal property are in this state if:

(a) the property is delivered or shipped to a purchaser, other than the United States Government, within this state regardless of the f.o.b. point or other conditions of the sale; or

(b) the property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States Government or (2) the taxpayer is not taxable in the state of the purchaser.

17. Sales, other than sales of tangible personal property, are in this state if:

(a) the income-producing activity is performed in this state; or

(b) the income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

18. If the allocation and apportionment provisions of this Article do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the tax administrator may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

(a) separate accounting;

(b) the exclusion of any or more of the factors;

(c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

(d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

AS 43.20.011(e)

(e) There is imposed for each taxable year upon the entire taxable income of every corporation derived from sources within the state a tax consisting of a normal tax equal to 5.4

per cent of taxable income, and a surtax which is equal to 4.0 per cent of taxable income. For purposes of this chapter the surtax exemption for a taxable year follows §§ 1561 and 1563 of the Internal Revenue Code. The tax of a corporation engaged in the production or transportation of crude oil or natural gas shall be determined and paid in accordance with ch. 21 of this title.

Chapter 21. OIL AND GAS CORPORATE INCOME TAX.

Sec. 43.21.010. APPLICATION [REPEALED EFFECTIVE JANUARY 1, 1982]. AS 43.21.010--43.21.120 applies to every corporation doing business in the state which derives income from the production of oil or gas from a lease or property in the state or from the pipeline transportation of oil or gas in the state. The tax calculated under AS 43.21.010--43.21.120 is measured by the total taxable income of the corporation during the tax period as determined under AS 43.21.020--43.21.040 and is calculated at the rates established under AS 43.20.011(e).

Sec. 43.21.020. DETERMINATION OF TAXABLE INCOME FROM OIL AND GAS PRODUCTION [REPEALED EFFECTIVE JANUARY 1, 1982]. (a) The taxable income of a corporation from the production of oil and gas from a lease or property in the state shall be the corporation's net income as calculated by the department in accordance with this section.

(b) Gross income of a corporation from oil and gas production shall be the gross value at the point of production of oil or gas produced from a lease or property in the state. The department shall by regulation determine a uniform method of establishing the gross value at the point of production. In making its determination the department may use the actual prices or values received for the oil or gas, the posted prices for the oil or gas in the same field, or the prevailing prices or values of oil or gas in the same field. In addition, in its determination of gross value at the point of production of oil or gas produced from a lease or property, the department shall determine the reasonable costs of transportation from the point of sale to the point of production of the oil or gas. Transportation costs set by a tariff properly on file with the Alaska Pipeline Commission or other regulatory agency shall be considered prima facie reasonable, but if a tariff properly on file with a regulatory agency is subsequently amended, changed, or overturned retroactively, the reasonable costs of transportation shall be recomputed for that period using the newly determined tariff.

(c) Net income from oil and gas production shall be determined by the department by deducting from gross income the following:

(1) royalties paid in kind or in value;

(2) taxes imposed under AS 43.55.011--43.55.150 and AS 43.57.010 which are actually paid or incurred by the corporation on the production from a lease or property in the state;

(3) taxes imposed under AS 43.56.010--43.56.210 and AS 29.53.010--29.53.460 which are actually paid or incurred by the corporation on property used directly in the production of oil or gas from a lease or property in the state, including property used in production, gathering, treatment, or preparation of the oil or gas for pipeline transportation, but only if those property tax payments were due and payable only after the date of commercial production from the lease or property with which the property was associated;

(4) the direct costs incurred by or for the corporation in operating the lease or property, including the direct costs of producing, gathering, treating, or preparing the oil or gas for pipeline transportation, but not of any payments received for those activities and not including any indirect cost or overhead expense;

(5) depreciation (using the unit of production method or such other reasonable methods as the department may by regulation establish) on property used directly in the production, gathering, treatment, or preparation of the oil or gas for pipeline transportation including amortization of capitalized interest for investments in this property at a rate not to exceed the average cost of borrowed capital to the taxpayer during the year in which it is capitalized;

(6) the amortization of lease acquisition payments and taxes paid or incurred under AS 43.56.010--43.56.210 and AS 29.53.010--29.53.460 (including capitalized interest on both) for or on producing properties before the commencement of commercial production from the lease or property for which the property is being used;

(7) interest expense of the corporation, not capitalized during construction, that was paid or incurred in connection with property in Alaska; however, unless (f) of this section applies, the interest expense may not exceed that portion of the total interest paid by the consolidated business of which the corporation is a part, determined by multiplying the total interest by a fraction, the numerator of which is the value of the corporation's real and tangible personal property used directly in the production of oil or gas from a lease or property in the state and the denominator of which is the value of all real and tangible personal property of the consolidated business;

in this subsection, "total interest paid by the consolidated business" does not include interest expense arising from intercompany obligations within the consolidated business except to the extent that the interest expense reflects a pass-through of interest on a third-party borrowing by the parent or other member of the consolidated business with the purpose, expressed at the time of the third-party borrowing, of financing Alaska business activity of the taxpayer corporation;

(8) expenses incurred by the corporation after December 31, 1977, of unsuccessful exploration of oil or gas in the state including the acquisition costs of abandoned properties, dry hole costs, and the costs of geologic and geophysical exploration related to those abandoned properties;

(9) general overhead or administrative expense incurred by the corporation attributable to deriving income from the production of oil or gas from a lease or property in the state to the extent, except as provided in (f) of this section, that it does not exceed that portion of the total general overhead or administrative expense incurred by the consolidated business of which the corporation is a part, determined by multiplying the total general overhead or administrative expense by a fraction, the numerator of which is the value of the corporation's real and tangible personal property used directly in the production of oil or gas from a lease or property in the state and the denominator of which is the value of all real and tangible personal property of the consolidated business;

(10) the amount of income from the production of oil and gas from a lease or property that is divided among the regional native corporations under sec. 7(i) of the Alaska Native Claims Settlement Act (P.L. 92-203);

(11) the tax imposed by sec. 4986 of the Internal Revenue Code that is paid or incurred by the taxpayer for oil production from leases or properties in the state.

(d) Deductions from gross income under this section shall not include expenses previously deducted on a return filed under AS 43.20.011--43.20.350.

(e) Where a corporation subject to AS 43.21.010--43.21.120 shares the production or proceeds of the production from a lease or property through a working interest, royalty interest, overriding royalty interest, production payment, net profit interest, joint venture or other agreement, the department shall allocate the deductions from gross income between the corporation and the persons with whom it has such an agreement in accordance with the terms of the agreement.

(f) If a corporation demonstrates to the satisfaction of the department that it paid or incurred actual expenses for interest or for general overhead or administration attributable to deriving income from the production of oil or gas from a lease or property in the state in an amount greater than the amount determined under (c)(7) or (c)(9) of this section, the department may allow the corporation to deduct the greater amount.

Sec. 43.21.030. DETERMINATION OF INCOME FROM OIL AND GAS PIPELINE TRANSPORTATION [REPEALED EFFECTIVE JANUARY 1, 1982]. (a) Except as provided in (c) of this section, taxable income attributable to the transportation of oil in a pipeline engaged in interstate commerce in Alaska shall be determined by the department and shall be the amount reported or that would be required to be reported to the Federal Energy Regulatory Commission or its successors as net operating income, less those portions of interest and general administrative expense attributable to the pipeline transportation of oil in the state, except that taxable income shall also include taxes on or measured by income. The department shall establish regulations governing the determination of interest and general administrative expense attributable to pipeline transportation of oil in the state.

(b) Except as provided in (c) of this section, taxable income attributable to the transportation of natural gas in a pipeline engaged in interstate commerce in Alaska shall be determined by the department and shall be the amount reported or that would be required to be reported to the Federal Energy Regulatory Commission as net operating income less that portion of interest and general administrative expense attributable to pipeline transportation in the state, except that the taxable income shall also include taxes on or measured by income. The department shall establish regulations governing the determination of interest and general administrative expense attributable to pipeline transportation of natural gas in the state.

(c) Taxable income attributable to the transportation of oil or natural gas in Alaska of any corporation not under the Federal Energy Regulatory Commission jurisdiction, or of a corporation under the jurisdiction of the Federal Energy Regulatory Commission but not reporting the operation of pipelines in Alaska separately from the operation of pipelines elsewhere, shall be determined by the department and shall be based upon an amount equal to that which would have been reported to the Federal Energy Regulatory Commission under (a) of this section in the case of oil pipelines, or (b) of this section in the case of natural gas pipelines, had the corporation been, in fact, under Federal Energy Regulatory Commission jurisdiction for the taxable year and required to report on the operation of Alaska pipelines separately from the operation of pipelines elsewhere.

Sec. 43.21.040. DETERMINATION OF INCOME FROM ACTIVITIES OTHER THAN OIL AND GAS PRODUCTION OR PIPELINE TRANSPORTATION [REPEALED EFFECTIVE JANUARY 1, 1982]. (a) Taxable income of a corporation subject to AS 43.21.010--43.21.120 from activities in this state other than the production of oil or gas from a lease or property in the state or the pipeline transportation of oil or gas in the state shall be determined in accordance with the method established in art. IV of AS 43.19.010 and in AS 43.20.071, as modified by (b)--(f) of this section.

(b) The total taxable income of the consolidated business is its entire income less the portion of that entire income attributable to worldwide production and pipeline transportation of oil and gas. In this section,

(1) for a member of a consolidated business who is required to file under the Internal Revenue Code, "entire income" means taxable income under Subtitle F and chapter 1 of Subtitle A of the Internal Revenue Code of 1954, as amended, except that those provisions adopted after December 31, 1975, which change or modify exemptions from tax are not adopted by reference as a part of this section until the second January 1 following the effective date of the federal law;

(2) for a member of a consolidated business who is not required to file under the Internal Revenue Code, "entire income" means book income, except that a taxpayer may elect to report his income as the income would be determined under (1) of this subsection.

(c) The numerator and denominator of the property factor, of the payroll factor and of the sales factor shall be calculated without reference to that portion of property, payroll or sales directly related to the production of oil or gas from a lease of property in the state or the pipeline transportation of oil or gas in the state.

(d) Repealed by § 17 ch 116 SLA 1981.

(e) Repealed by § 17 ch 116 SLA 1981.

(f) The value attributed to vessels transporting Alaskan oil or gas of the consolidated business which are not owned or effectively owned by the consolidated business shall be excluded from the property factor.

Sec. 43.21.050. ASSESSMENT OF INCOME AND TAX [REPEALED EFFECTIVE JANUARY 1, 1982]. (a) The department shall assess taxable income and the amount of tax payable on that taxable income.

(b) On or before August 15 of each year the department shall send to every corporation taxable under AS 43.21.010--43.21.120 a notice of assessment showing the amount of income taxable under AS 43.21.010--43.21.120 for the previous year and the amount of tax payable on that taxable income.

(c) For purposes of AS 43.21.010--43.21.120 the department may combine taxable incomes of corporations subject to tax under AS 43.21.010--43.21.120 who are part of the same consolidated business.

(d) If the methods of allocation and apportionment provided in AS 43.21.010--43.21.120 do not fairly represent the extent of a corporation's business activity in the state, the corporation may petition for or the department may require, in respect to all or any part of the corporation's business activity, if reasonable, the employment of any method authorized under art. IV, sec. 18, of the Multistate Tax Compact (AS 43.19.010) to effectuate an equitable allocation and apportionment of the corporation's income. The commissioner shall include in his annual report required in AS 43.21.110 a report on all relief granted under this subsection, including for each case a statement of the changes in tax liability resulting from the granting of relief, the tax years involved, and a description of the method of determining taxable income that was substituted for those provided in AS 43.21.010--43.21.120.

Sec. 43.21.060. RETURNS [REPEALED EFFECTIVE JANUARY 1, 1982]. On or before April 15 of each year, a corporation subject to tax under AS 43.21.010--43.21.120 shall submit a return in a form prescribed by the department setting out information required by the department to determine taxable income. For purposes of AS 43.21.010--43.21.120, the department may require corporations subject to tax under AS 43.21.010--43.21.120 who are part of the same consolidated business to file a single return.

Sec. 43.21.070. PAYMENT OF TAX [REPEALED EFFECTIVE JANUARY 1, 1982]. The tax levied under AS 43.21.010--43.21.120 is payable to the department on or before September 30 of each year or in installments, including prepayments of estimated tax, at the times and under the conditions the department may by regulation require. This tax is payable on the due date set out in this section even though the assessment is under appeal or the validity, enforceability or application of AS 43.21.010--

43.21.120 or any provision of AS 43.21.010--43.21.120 is challenged before the department or in the courts.

Sec. 43.21.080. TRANSITIONAL RULES [REPEALED EFFECTIVE JANUARY 1, 1982]. The department shall provide by regulation transition rules for corporations subject to tax under AS 43.20.011--43.20.350 before July 9, 1978 to avoid double taxation of the same income or double deduction of the same expense of those corporations as a result of becoming subject to tax under AS 43.21.010--43.21.120.

Sec. 43.21.090. REGULATIONS [REPEALED EFFECTIVE JANUARY 1, 1982]. The department may adopt regulations in accordance with the Administrative Procedure Act (AS 44.62.010--44.62.650) as appropriate to administer and enforce AS 43.21.010--43.21.120.

Sec. 43.21.100. PENALTIES [REPEALED EFFECTIVE JANUARY 1, 1982]. The penalties established in AS 43.20.011--43.20.350 apply to AS 43.21.010--43.21.120.

Sec. 43.21.110. PUBLIC REPORTING [REPEALED EFFECTIVE JANUARY 1, 1982]. (a) The commissioner of revenue shall compile and transmit to the legislature an annual consolidated report of state revenues and taxation policies under AS 43.21.010--43.21.120. This report shall include total aggregate income tax paid by corporations covered under AS 43.21.010--43.21.120 and aggregate income and deductions by category, so classified as to prevent the identification of particular returns or reports.

(b) The legislative auditor shall transmit to the legislature an annual report reviewing the actions of the department in administering AS 43.21.010--43.21.120.

Sec. 43.21.120. DEFINITIONS [REPEALED EFFECTIVE JANUARY 1, 1982]. Unless the context requires otherwise the definitions contained in AS 43.55.140 are applicable to AS 43.21.010--43.21.120. In addition, in AS 43.21.010--43.21.120

(1) "base of operations" means the closest point on land to the offshore oil or gas production operations from which goods, services and supplies flow to those offshore oil or gas production operations;

(2) "consolidated business" means a corporation or group of corporations having more than 50 percent common ownership direct or indirect, or a group of corporations in which

there is common control either direct or indirect as evidenced by any arrangement, contract or agreement.

JURISDICTIONAL STATEMENT

This is an appeal from a May 27, 1983, grant of summary judgment by the superior court. The lower court ruled that Alaska's separate accounting for oil and gas production and pipeline transportation, AS 43.21, is constitutional. This court has jurisdiction pursuant to AS 22.05.010 and AS 22.05.020.

ISSUES PRESENTED FOR REVIEW

Is the Alaska Legislature's decision to employ separate accounting to estimate appellants' in-state oil and gas production and pipeline transportation income consistent with the Commerce, Due Process, and Equal Protection Clauses of the United States Constitution and the Equal Protection Clause of the Alaska Constitution?

STATEMENT OF THE CASE

A. Introduction

On February 8, 1968, Atlantic Richfield Company struck the largest oil field ever discovered in the United States. The Prudhoe Bay field is so large that oil from the next three largest fields in America would not fill it. Its recoverable oil reserves exceed nine billion barrels, while estimates of total field size reach 20 billion barrels.

The single outlet for this oil is the Trans Alaska Pipeline ("TAPS"). This 900 mile long, 48-inch line carries 1.6 million barrels of oil each day to its destination at Valdez. There, the oil is loaded onto ocean tankers destined for refineries in Washington, California, the Gulf of Mexico and the eastern seaboard. The Prudhoe Bay Field and the Trans-Alaska Pipeline are owned virtually in their entirety by three corporations -- Atlantic Richfield Company, Exxon Corporation and Standard Oil of Ohio.

Prudhoe Bay operations were profitable when production commenced in June 1977. Since then, however, external economic and political factors -- including deregulation, the Iranian revolution, and OPEC pricing practices -- have more than doubled the value of Alaskan oil with no commensurate increase in costs. As a result, between 1978-81, and wholly apart from earnings in marine transportation, refining, and marketing, Arco, Exxon, and Sohio earned $21 billion in net income solely from production and pipeline transportation of Alaska oil. See Appendix A. These profits have had a profound effect on each of these companies, most notably on Sohio because it is the smallest of the three:

> Once severely short of crude, Sohio's bonanza from its huge reserves of Alaskan oil skyrocketed 1979 profits to $1.2 billion, a phenomenal 2,200% blast in just one decade.

R. 684.

Under the Oil and Gas Corporate Income Tax (AS 43.21), these companies paid approximately $2 billion in income taxes on that $21 billion profit. They have sued to get those taxes back.

This lawsuit involves three corporations that made substantial profits from valuable assets in Alaska, and that now object to paying taxes on that income at the same rate as any other corporation. The essence of this case is revealed in testimony during legislative consideration of AS 43.21:

> Senator [John] Huber: Does Sohio object to paying 9.4% on its true net income the same as they would have to if they were strictly an Alaskan corporation?
>
> [Sohio Vice President Richard] Donaldson: Yes.

R. 4661-62 [D.7-172, F. 27]

B. The Nature of This Case

Every state that imposes a net income tax must devise some method of determining the portion of a multistate taxpayer's income that is earned within the state. From 1959 to 1978, Alaska used a three-factor formula under the Uniform Division of Income for Tax Purposes Act ("UDITPA") for estimating the Alaska income of all multistate corporations. 1/ AS 43.19; AS 43.20.065; AS 43.20.051-.150 (repealed 1975). 2/

In Alaska's early statehood years, while its economy was marginal and diverse, the UDITPA formula was a satisfactory means of apportioning the income of all multistate corporations. The formula, however, was developed principally for mercantile businesses.

Over several years, the Alaska legislature was advised that the UDITPA formula systematically underestimated income attributable to oil production in Alaska. The legislature was told that, as a result of this underattribution, multistate oil companies paid income taxes on their Alaska production earnings at an effective 2%-3% rate, while in-state oil producers and other Alaska industries paid taxes far closer to the 9.4%

1/ Formulas such as UDITPA rely on certain indicators of business activity -- such as payroll, property, and sales -- to estimate in-state income. A multistate business' indicators, or factors, which are located in the taxing state, are compared with the business' factors located everywhere. The resulting fraction is multiplied against the business' overall income, producing an estimate of in-state income.

2/ UDITPA was approved by the National Conference of Commissioners on Uniform State Laws in 1957, and Alaska was the first state to adopt the model act. In 1970, Alaska adopted the Multistate Tax Compact, which also contains UDITPA, and joined the Multistate Tax Commission. Ch. 124, SLA 1970.

statutory rate. Moreover, under any formula, multistate oil producers owning and operating identical assets in Alaska would pay widely disparate taxes. The legislature enacted AS 43.21 to equalize effective tax rates both between multistate oil companies and other taxpayers, and among multistate oil companies themselves. Sec. 1, ch. 110, SLA 1978.

AS 43.21 changes only the method of estimating in-state income. Once that in-state income is determined, it is taxed at the same 9.4% rate applicable to all corporations. AS 43.20.011(e). AS 43.21 apportions the worldwide income of a taxpayer by separate accounting. Separate accounting identifies gross revenues from activities in the state and then deducts the costs associated with that income. If goods are shipped out of the state for further processing, separate accounting establishes an "arm's-length" price for the value of the goods as they leave the state. That transfer price is used to determine the taxpayer's gross income from the goods.

The legislature believed itself on safe ground in choosing separate accounting -- a method that (1) was, at one time, the only method used in the United States to apportion multistate income; (2) is still the method preferred by other states with substantial oil production activity; and (3) has been upheld by the supreme courts of those states. This lawsuit challenges that choice.

If the companies prevail, they will be entitled to a refund of their AS 43.21 taxes, but will have an alternate liability for tax years 1978-81 of approximately $620 million. Their net refund, including interest, would be approximately $1.8 billion. 3/ Affidavit of Robert D. Heath, attached as Appendix A.

On the state's motion for summary judgment, the superior court held that AS 43.21 is constitutional. R. 17460-62. The companies have appealed from that ruling.

C. <u>The Principles and Operation of AS 43.21</u>

AS 43.21 applies to any corporation that earns income from oil or gas production or pipeline transportation in the state. AS 43.21.010. The statute uses separate accounting to apportion income from oil production and pipeline transportation activities. AS 43.21.020-.030. Income from all other activities in the state is apportioned by a formula. AS 43.21.040. Together, this income is taxed at the statutory rate of 9.4%.

3/ In 1981, the legislature repealed AS 43.21 for tax years beginning after December 31, 1981, and replaced it with a modified formula. Ch. 116, SLA 1981. The legislature did so primarily to avoid further growth in the $2 billion contingent liability caused by this litigation. Although most believe that the companies stand little chance of success in this case, the legislature concluded that any chance was intolerable in light of the massive amounts in controversy. <u>See</u> Hearings Before the Joint Gas Pipeline Committee, May 29, 1984; R. 533, Memorandum by Comm'r Thomas K. Williams to Gov. Jay S. Hammond, October 1, 1980 at 2, R. 572.

1. Separate Accounting of Oil Production and Pipeline Transportation Income.

The separate accounting provisions of AS 43.21 measure only the net income from production and pipeline transportation of oil in Alaska. Income generated by production or pipeline transportation activities elsewhere, and subsequent profits earned from marine transportation, refining, and marketing of Alaska oil after it leaves the state, are excluded from the AS 43.21 tax base. As a result, the net income that Alaska taxes is only about 25% of the ultimate value of Alaska oil. See Chart 1. The remaining 75% represents value added by transportation, refining, and marketing activities "downstream" from Alaska production, and also includes the costs of producing the oil. Id.

The separate accounting of oil production income begins with the determination of gross income. AS 43.21 defines gross income as the value of the oil at the point of production -- that is, the wellhead. 4/ AS 43.21.020; 15 AAC 21.900(24). If the oil is not sold at the point of production, but instead is sold at an outside refinery, the refinery price is used as the first step in determining wellhead value. Finally, if the oil is

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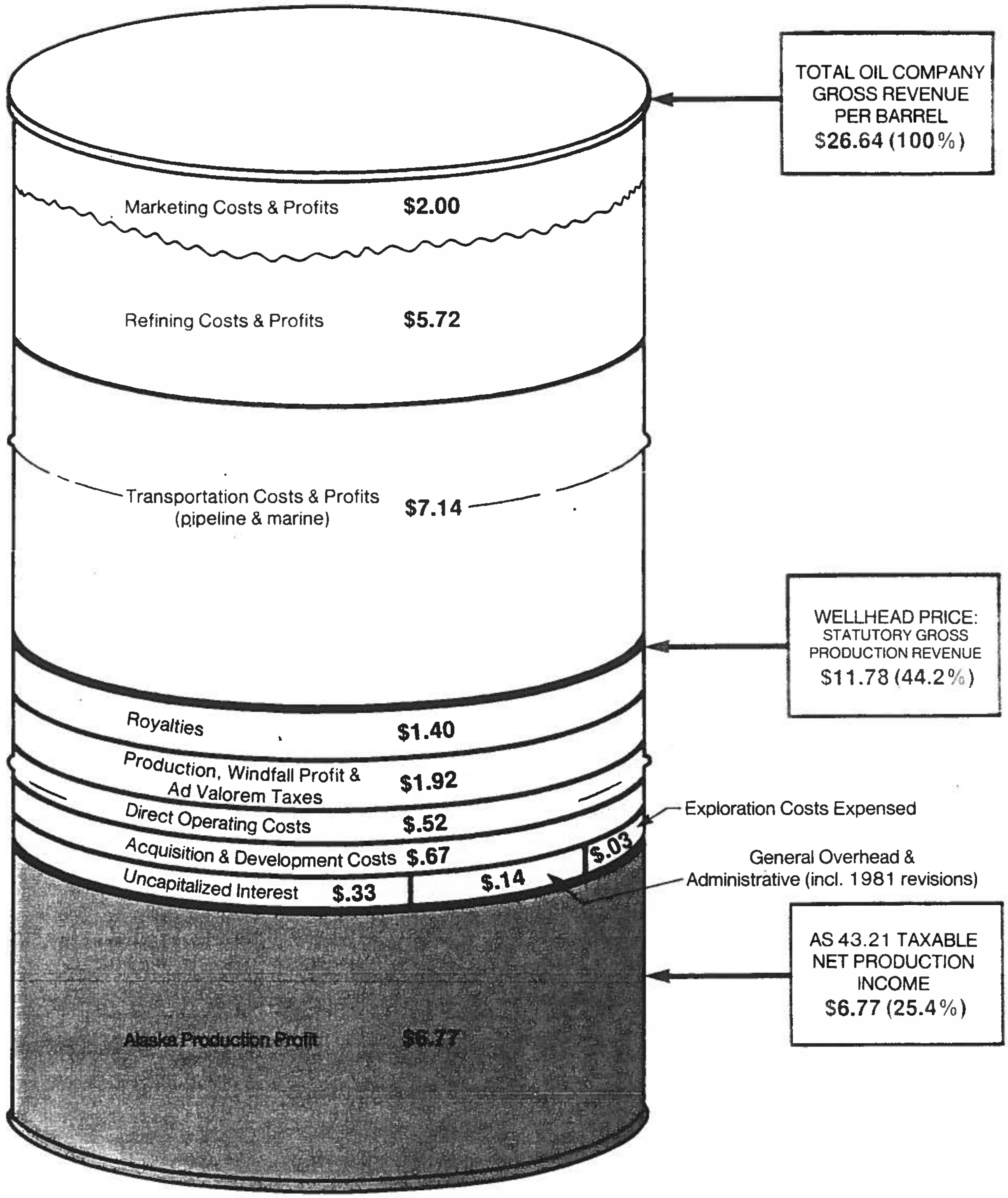
4/ In this brief, the word "wellhead" is used as a shorthand term for the point of production. It is not meant to be used in any technical sense, nor is it intended to distinguish between the point where the oil first comes out of the ground and the point at which the oil is accurately measured into a pipeline.

**ESTIMATED REVENUES AND COSTS
PER BARREL OF ALASKAN CRUDE OIL
1978 - 1980**



SOURCE: Deakin 2d Supplemental Affidavit ¶ 15, R. 16917, 16929.

CHART 1

transferred unsold to the producer's refinery, a transfer value is established based upon comparable arm's-length sales or other market indicators.

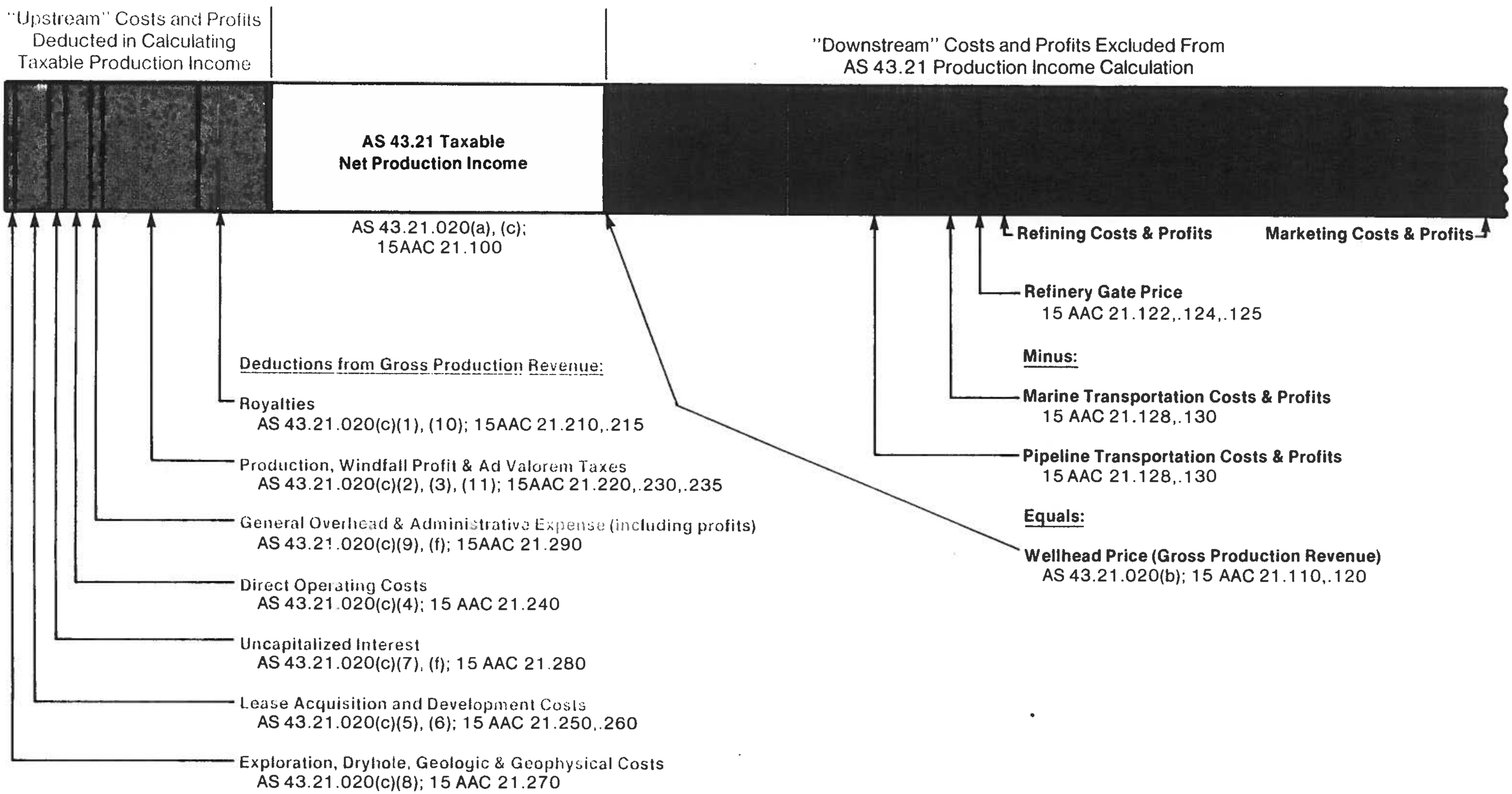
Whenever a refinery price or transfer value is used, the full costs and profits of transporting the oil between the wellhead and the refinery are subtracted, or "netted back," to arrive at wellhead value. AS 43.21.020(b); 15 AAC 21.120-.130. This "netback" process is common in separate accounting methodology. It is also the process used in calculating the state's severance tax and royalties, and the federal windfall profit tax.

Between 1978 and 1980, the refinery gate price of North Slope crude oil averaged $18.92 per barrel. See Chart 1; R. 16917, 16929 (Deakin). After "netting back" to the wellhead, the gross value of the oil at the point of production averaged $11.78. Id.

Once a wellhead value has been determined, the costs of producing the oil are deducted. AS 43.21 permits the taxpayer to deduct every cost associated with producing Alaska oil, regardless of where those costs are incurred. AS 43.21.020(c). The various cost components, and their relative significance, are best portrayed graphically. See Chart 2.

One particular cost component warrants note. The Act permits a deduction for "general overhead or administrative expense ... attributable to deriving income from the production of oil or gas ... in the state." AS 43.21.020(c)(9). These

AS 43.21 TAXABLE NET PRODUCTION INCOME CALCULATION EXCLUDES ALL COSTS AND PROFITS OF UPSTREAM AND DOWNSTREAM ACTIVITIES



costs -- which the companies would now make the focus of this lawsuit -- include corporate management, legal and accounting services, financing, personnel management, and research and development. They are deductible whether or not they are incurred in the state, so long as they are properly allocated to the production of oil and gas in Alaska. 5/ While these activities are large in number, they constitute only 2.8% of the cost of producing oil in Alaska. See Chart 2; R. 16929; Regulations also permit a deduction for reasonable profits attributable to these activities, if the taxpayer allocates profits in this manner on its own books of account. 15 AAC 21.290(b).

Oil and gas pipeline operators are required by federal and state regulatory agencies to maintain separate books for each pipeline system. Because all pipelines in Alaska are wholly in-state, the items of income and expense related to Alaska pipeline transportation can be easily ascertained. Under AS 43.21.030, a taxpayer's net Alaska income from pipeline transportation is keyed to the amount reported to the Federal Energy Regulatory Commission as net operating income.

5/ 15 AAC 21.290 allows the deduction of "general overhead and administrative expense ... which is properly allocated (on the basis of personnel time sheets, office space or another basis having general currency in the oil and gas industry)" to operations, lease acquisition or exploration in the state. If these expenses relate to both Alaska and out-of-state activities, continued

2. <u>The Use of a Formula For All Other Income</u>

AS 43.21.040 employs the UDITPA formula to apportion the other income of an AS 43.21 taxpayer to the state -- with one major difference. Worldwide oil production and pipeline transportation income is subtracted from the corporation's apportionable income, and the company's factors attributable to the production and pipeline transportation of oil in Alaska are excluded from the formula.

D. <u>Proceedings Below</u>

Appellants Arco, Exxon, and Sohio argued below that AS 43.21 violated the Commerce, Due Process, and Equal Protection Clauses of the United States Constitution, and the Equal Protection Clause of the Alaska Constitution. The case was decided on the state's motion for summary judgment. The record of that motion is divisible into three categories. Most of the record comprises the legislative history of AS 43.21, which was compiled and indexed by the state. R. 1628-12689. Second, there are competing affidavits from various economists and accountants presenting divergent economic theories on how oil production income is generally earned, and how, as a matter of policy, it

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5/ continued
the regulation allocates those costs on the basis of in-state and out-of-state acreage, or another basis "if that other basis is more appropriate."

should be apportioned. Compare, e.g., R. 13069 (Church), R. 12986 (Davidson), R. 13111 with R. 1538 (Deakin), R. 1512 (Horst), and R. 1269 (Conrad).

Finally, there are a large number of affidavits submitted by the companies which describe various activities performed outside Alaska, that the companies assert generate a portion of Alaska production profits taxed by AS 43.21. See, e.g., R. 13220-13476 (Sohio Affidavits); R. 13552-13808 (Arco Affidavits); R. 13811 - 14248 (Exxon Affidavits). The state did not contest those factual allegations because the mere existence of these support functions -- which is all that these affidavits demonstrate -- is of no constitutional importance. Conversely, the companies offered no evidence that these activities generated any actual portion of oil production profits, or for that matter that they were profitable at all.

To warrant a trial on a Commerce Clause challenge, the taxpayer must offer quantitative evidence which shows that a particular tax base for a particular year is grossly disproportionate to actual in-state earnings. Container Corp. v. Franchise Tax Board, ___U.S.___, 77 L.Ed.2d 545, 556 (1983); Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell, 283 U.S. 123, 125 (1931). The companies offered nothing in this regard. They did not even place their tax returns in the record. Rather, they rested their challenge upon the assertion that separate accounting inevitably fails to recognize that certain out-of-state activities generate some portion of oil production earnings, and is thus inherently invalid. For this reason, the companies informed the lower court that they were not obliged to undertake any "elaborate showing." R. 12763. See also Appellants' Opening Brief at 45 (hereafter the companies' brief is referred to as "C.B.").

On May 27, 1983, Judge Carlson granted the state's motion for summary judgment. R. 17460-62. He found that the only factual dispute between the parties involved the competing economic and accounting theories presented by the parties' expert affidavits. These divergent theoretical contentions "are facts only in the sense that they provide premises in the process of legal reasoning, they are not that type of fact for which trial is mandated." R. 17460.

SUMMARY OF ARGUMENT

The lower court concluded that separate accounting is a permissible means of apportioning the income of a multi-jurisdictional taxpayer. Shortly after that decision, the United States Supreme Court reached the same conclusion in Container Corp. v. Franchise Tax Board, ___U.S.___, 77 L.Ed.2d 545 (1983). The lesson of Container is that a Commerce Clause challenge to a state's use of separate accounting is subject to the same standards applicable to mathematical formulas. The companies have failed to meet, or even attempt to meet that standard, which requires the companies to prove by "clear and cogent evidence" that the amount of income attributed to Alaska by AS 43.21 is "grossly disproportionate" to actual in-state earnings. Accordingly, the judgment below must be affirmed.

When Alaska became a major oil-producing state, the legislature, after considerable study, adopted the traditional method of separate accounting long used by other oil-producing states -- including Louisiana, Oklahoma, and Mississippi -- to estimate in-state income from oil production. The separate accounting laws of these states are identical in all material respects to AS 43.21. Gross income is measured by the in-state value of locally-produced oil. Net income is then calculated by deducting the direct and indirect costs of producing that oil, whether those costs are incurred in or out of the state. This same method is used by the federal government to calculate the United States income of a foreign corporation producing oil in this country for sale abroad, and by various international tax conventions to which this country is a party.

The basis for this common preference for separate accounting is the recognition that this method of apportionment fairly estimates oil production income attributable to the jurisdiction. Further, it is commonly recognized that the three-factor UDITPA formula systematically underattributes income to the producing state. UDITPA assumes that oil production income is principally generated by a company's managers, geologists, accountants and salesmen, together with fixed assets such as office buildings and equipment. The oil reserves themselves, however, are not counted in the "property" factor as an income producing asset. By contrast, separate accounting looks to the amount and value of oil produced when apportioning income.

The supreme courts of other oil-producing states have sustained their separate accounting statutes against the same challenges that the companies make here. In so doing, they have affirmed that separate accounting is a more accurate method of apportioning oil-production income than is UDITPA. Webb Resources, Inc. v. McCoy, 401 P.2d 879, 889 (Kan. 1965); Texas Co. v. Cooper, 107 So.2d 676, 690-91 (La. 1958); Magnolia Petroleum Co. v. Oklahoma Tax Comm'n, 121 P.2d 1008 (Okla. 1941).

This litigation is an attack on the use of separate accounting by oil-producing states. The heart of the companies' case is their contention that these states are precluded from using separate accounting because other states in which they also do business employ mathematical formulas. Sohio thus alleged, as Count I of its amended complaint in this action, that

> [f]ormulary apportionment is constitutionally preferred, and the tax based on Alaska's separate accounting may not constitutionally coexist with taxes imposed by other states on the basis of formulary apportionment.

R. 261.

This core argument was rejected in Container. The Court there held that "both geographic accounting and formula apportionment are imperfect proxies" for the elusive goal of allocating income; neither is more or less prone to misallocation; and it would thus be perverse to force the states to substitute one inherently imprecise means for another. Container, 77 L.Ed.2d at 564.

The Court reiterated in Container that the Due Process and Commerce Clauses do not impose a single, uniform methodology on the states for attributing the taxable income of a multijurisdictional business. Only Congress has the ability to do so. Yet, despite repeated opportunities to enter this field over the past several decades, and after wide-ranging studies and legislative hearings, Congress has declined to require the states to use any particular method of income attribution.

After Container, the companies in this case had two options: either to withdraw their appeal, or to pretend that what they had attacked below as separate accounting was not in fact "true separate accounting" at all. The companies chose the latter, arguing here that the deference owed to state apportionment rules, including "true separate accounting," does not apply to AS 43.21. The Alaska law, they maintain, is not separate accounting because it fails to account for certain outside contributions to oil production income. And because of that peculiarity, it is not a form of apportionment.

The argument that AS 43.21 is not "true" separate accounting is ridiculous. It functions precisely like the laws of other oil-producing states, the Internal Revenue Code, and international tax conventions.

Moreover, AS 43.21, like every separate accounting statute, is very much a form of apportionment. It estimates that portion of a taxpayer's worldwide income which should be attributed to the taxing state, and in so doing "apportions" a part of that worldwide income to the state. Its purpose is the same as that of any mathematical formula. As the Court said in Container, the separate accounting "approach divides the pie on the basis of formal accounting principles. The formula apportionment method divides the same pie on the basis of a mathematical generalization." 77 L.Ed.2d at 568. Each is a method of "apportioning" a part of the oil company's worldwide income to a state.

The issue in this case, then, is not whether Alaska's tax is "apportioned" -- it certainly is that. The issue is whether the statute achieves a fair apportionment. And, as noted above, the test of fair apportionment is whether or not the statute has in fact grossly overattributed income to the taxing state.

The companies did not attempt to show that AS 43.21 in fact attributed substantially more income to Alaska than they actually earned here. Instead, they chose to rest their case upon the entirely theoretical objection that AS 43.21 inherently taxes some profits attributable to the activities of personnel in other states.

There are three fundamental failings to this argument. First, if one assumes that activities in one state contribute to profits in another, then contributions made to Alaska oil production by out-of-state activities are only one side of a two-way street. As these companies' annual reports and public pronouncements make clear, the steady profits available from Alaska production activities contribute to the profitability of these companies' operations in other parts of the world. Thus, profits from Alaska crude have permitted these companies to modernize refineries in California, acquire new production properties in the Gulf of Mexico, and diversify into other industries which have no connection with Alaska. However, AS 43.21, like all separate accounting laws, does not attempt to tax any of this added value.

Second, every separate accounting jurisdiction -- including other oil-producing states, other nations and the United States -- treats the expenses associated with the many activities discussed by the companies as deductible costs of production; no separate accounting system treats them as what accountants call "profit centers." Nothing in the United States or Alaska Constitutions requires Alaska, and Alaska alone, to view out-of-state support activities as "profit centers."

Third, an identical argument was made and rejected in Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978). In Moorman, the taxpayer argued that Iowa's single-factor sales formula inherently taxed income earned by manufacturing activities in Illinois. The Court, however, held that the constitution does not invalidate a state income tax simply because it reaches some income which does not have its source in the taxing state. Due process, the Court said, requires only that income attributed to the state be rationally related to in-state values. To establish that a state's income-allocation method fails this test, a taxpayer must prove that the state has attributed an amount of income which is grossly disproportionate to its actual in-state earnings.

The companies' argument regarding their outside support activities spins a circle from which one may only escape by recognizing it as such. The companies concede that no apportionment method is perfect; indeed, this inherent imprecision is the reason that a taxpayer must prove a grossly disproportionate result. The companies argue, however, that because AS 43.21 is not perfect, it is therefore not a form of apportionment and is thus *per se* invalid. Because the companies believe that AS 43.21 is facially invalid, they have placed nothing in the record which indicates whether they would attribute 30%, 3%, or 0.003% of the income taxed by AS 43.21 to outside activities.

Because the companies declined to make any showing of a grossly disproportionate attribution of income, the court below was presented with what amounted to a default, or total absence of proof. Despite an enormous record, there was no evidence which, if taken as true, would make the companies' *prima facie* case. There was, in short, no need for a trial to test allegations that were never made.

Since AS 43.21 is fairly apportioned, the companies' multiple taxation argument falls as well. Container confirmed that multiple taxation is simply the evil that the fair apportionment test is designed to avoid. If a tax statute is fairly apportioned, it does not create an unconstitutional risk of multiple taxation. The minimal risk of overlapping taxation that may arise from a diversity of apportionment rules is a matter for Congress to address.

The companies' principal multiple taxation argument -- that AS 43.21 taxes "100%" of production income from Alaskan oil, while other states which use a formula are also entitled to "tax a share" of that same income -- is based upon their belief that formulas and separate accounting are automatically asymmetrical. The Court in Container held that they are not. Separate accounting taxes "100%" only in the sense that every state taxes 100% of the income which it apportions to itself. Moreover, no other state has a "right" to tax a share of the income apportioned to Alaska by separate accounting. The inclusion of Alaska production income, and indeed all worldwide income, in the apportionable base of various formulas does not mean that mathematical formulas take a share of every extra-territorial component of income. Rather, the theory upon which apportionment formulas have been sustained is that they will, once all calculations are completed, produce an amount of net income which is an acceptable approximation of income from activities within the taxing state.

According to the companies, traditional geographical separate accounting is no longer a constitutionally accepted way of estimating the domestic income of a multijurisdictional company. That argument would, if accepted, invalidate the separate accounting statutes of a number of other oil producing states -- statutes consistently sustained by the highest courts of those states. It is an argument foreclosed by the United States Supreme Court in Container, and it should be rejected by this court as well.

ARGUMENT

I. THE ALASKA LEGISLATURE CHOSE SEPARATE ACCOUNTING AS THE MORE REASONABLE MEANS OF ESTIMATING THE IN-STATE INCOME OF MULTISTATE OIL PRODUCERS.

The Alaska Legislature's decision to replace UDITPA with separate accounting was made for two related reasons. First, the legislature learned that the three-factor formula, when applied to oil production activities, results in companies paying taxes on only a fraction of the income which they actually earn in Alaska. See Appendices B and C. 6/ Second, and

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6/ Appendix B is a compilation of representative citations to the legislative history of AS 43.21 which support the legislature's findings. Appendix C has two parts. Part 1 is a narrative summary of the legislative history which was submitted with the state's summary judgment motion. R. 1218-68. Part 2 is the state's response to the companies' legislative history narrative. R. 16931-59. That company narrative (R. 12840-83) was submitted as a separate appendix to their brief.

of that underattribution, use of the three-factor formulas bestows a benefit on multistate oil companies that is not shared by other Alaskan businesses. It allows those corporations to pay tax on only a fraction of their Alaska income, which substantially lowers their effective tax rate, while other businesses -- both local oil producers and other multistate industries -- pay taxes at the full statutory rate of 9.4% on all income earned in Alaska. Id. These conclusions are set out in the legislature's findings:

> 1. [The three-factor apportionment formula in UDITPA] does not fairly represent the extent of the business activities in this state of multistate corporations engaged in the production and pipeline transportation of crude oil and natural gas in Alaska; and
>
> 2. [T]he assessment of income tax against a multistate corporation engaged in the production or pipeline transportation of oil or natural gas shall be commensurate with the tax that would be assessed against a corporation owning and operating only those assets of the multistate corporation which are in or directly associated with this state.

Sec. 1, ch. 110, SLA 1978.

The legislature, in choosing an alternative to UDITPA, drew precisely the same conclusion reached by the taxing authorities of other producing states: that separate accounting is the most accurate way to measure the income of an oil producer. After four years of study, Alaska chose the system used by those other states, including Mississippi, Oklahoma, and

Louisiana. R. 3040 [D. 8-130, F. 14 at 48]; R. 1929 [D. 8-018, F. 4 at 10]; R. 7881 [F. 62 at 66]. 7/

Prior to 1978, Alaska used the UDITPA formula for the same reason other states use it. It is simple and easy to administer; it avoids the possibility of taxpayer manipulation associated with the setting of transfer prices under separate accounting; and as a general rule, it produces a fair, rough approximation of a taxpayer's in-state earnings. R. 5369-70 [D. 7-139, F. 35A at V-15, V-16]. During early statehood years, Alaska's economy was as diversified as it was marginal, and the state lacked the wherewithal to engage in sophisticated tax accounting. During the 1960's, for example, the state's limited auditing capabilities permitted only mathematical checks on tax returns. Appendix C at 10 (R. 1226). Using UDITPA as a rough norm was expedient. If it underattributed the income of a particular industry, the fiscal consequences were likely to be small. In short, when a state has a diversified economic base, misattribution for one segment of that economy will in all probability be diluted and absorbed by other economic activity. R. 5369-70 [D. 7-139, F. 35A at V-15, V-16]; R. 1546, 1554, 1558 (Deakin).

7/ Legislative history documents referred to in this brief are cited to the record and also to the filing system of that history. Thus, "D. 8-111, F. 22" means that the document originated in 1978, is the 111th document from that year, and is found in legislative history file 22.

The three-factor formula employed by UDITPA is based on two assumptions that are typically valid for most economic enterprises. The first is that all segments of an integrated enterprise are equally profitable. See, e.g., Container, 77 L.Ed.2d at 565 n.20. The second is that payroll, property, and sales are the only contributors to income, and each contributes equally. Id. UDITPA was developed principally for mercantile industries. Blind application of UDITPA to other industries may, as Professor Jerome Hellerstein has recently noted, sacrifice fairness on the altar of consistency:

> The methods used by the States in dividing income from interstate and international business could benefit from closer attention by the tax committees of State legislatures and tax administrators to the need to devise apportionment methods that respond to the characteristics of various industries. Some of the awkward and unsatisfactory apportionments of income that are currently being made by the States are due to the oft-forgotten fact that the standard three factor formulas were developed and designed to meet the needs of manufacturing and mercantile industries, and are poorly adapted to a good many other businesses.

J. Hellerstein, State Taxation: Corporate Income and Franchise Taxes 689 (1983).

The legislature concluded that UDITPA was indeed poorly adapted to the oil production industry. Sec. 1, ch. 110, SLA 1978. See generally Appendices B and C. It would attribute to the state only 20%-25% of the income earned in Alaska by oil producers. As even industry information demonstrated, oil producers would pay an effective tax rate of 2%-3%, while other businesses paid the statutory 9.4%. See Charts 3 and 4; R. 1700-01, 1703 [D. 8-125, F. 2 at 2-3, 5]. See also R. 2344, 2346-47, 2350, 2353 [D. 8-126, F. 5 at 23,25-26, 29, 32]; R. 1920-22 [D. 8-018, F. 4 at 1-3]. See also Appendix B.

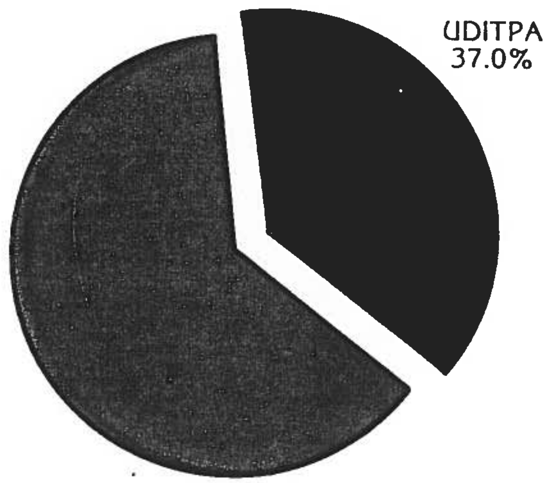
As early as 1971, the New York economics firm of Walter Levy and Associates began warning the legislature that the use of UDITPA to tax impending Prudhoe Bay production profits would result in a gross underattribution of income to Alaska. R. 9858-59. Levy, and his associates Milton Lipton and Richard Kilgore, advised the state that the sales, property, and payroll factors of the UDITPA formula were not suited for apportioning oil production income. 8/ Moreover, those factors were in turn applied against the taxpayer's income as determined under the Internal Revenue Code, which for the oil industry in particular was riddled with subsidies having little or nothing to do with Alaska's tax policies. R. 3831-32 [D. 7-018, F. 22 at 5-6]; R. 9858-59 [F. 36-37]; R. 9741-42 [F. 62 at 26-27]. They predicted that unless Alaska changed its income tax attribution method for oil production, most oil production income earned in Alaska would escape taxation. R. 9894 [F. 65 at 14].

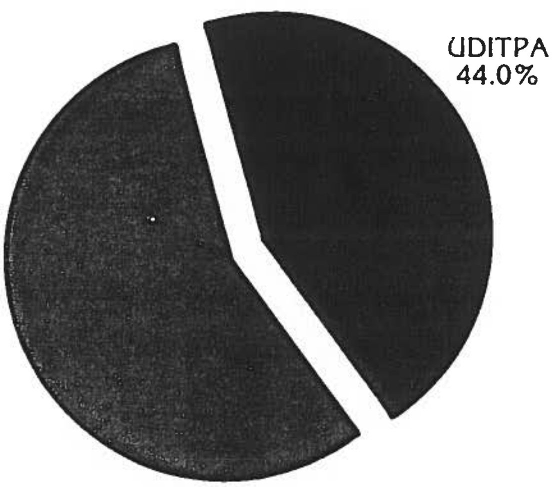
8/ R. 9226 [D. 5-014, F. 56 at 21-23]; R. 9307-08 [D. 5-045, F. 56 at 8-9]; R. 8450-51 [D. 6-107, F. 48 at 1-3]; R. 7172 [D. 6-031, F. 43 at 7]; R. 3858-59, 3864-65, 3878 [D. 7-019, F. 22 at 2, 3, 10, 11, 24]; R. 3982 [D. 7-022, F. 22 at 3];R. 1920-22 [D. 8-018, F. 4 at 1-3]; R. 2024-26, 2036-37, 2042 [D. 8-127, F. 4 at 15-17, 27-28, 33].

UDITPA Tax Base As A Percentage of Prudhoe Bay Net Income

From Exxon Estimates (1976—1990)

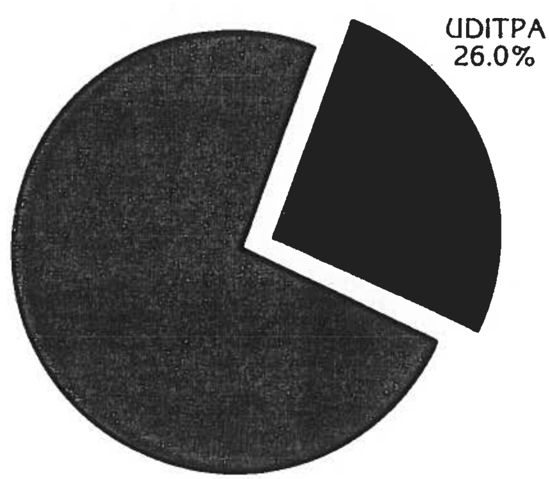
L.H. Doc. 7-036, File 26 at 13(R. 4348)
L.H. Doc. 7-037, File 26 at 18, 21(R. 4367, 4370)
See R. 16955





As Estimated By Arthur Anderson (Life of Field)

L.H. Doc. 8-080, File 13 at Exhibit VIII(a) (R. 2899)
See R. 16955—16956



As Estimated By W.J. Levy & Assoc. From Sohio Submission One (1978)

L.H. Doc. 6-124, File 50 at 1-4(R. 8527-8530)
See R. 16954-16955

CHART 3

In 1974, the legislature directed the Legislative Council to conduct an "interim study of the corporate tax structure in Alaska and of possible alternate systems ...." HCR 78, 8th Leg., 2d Sess. (1974 Alaska). In 1975, Senate President Chancy Croft created the Special Committee on Revenue and Taxation, beginning a four-year debate on the appropriate means of apportioning the income of Prudhoe Bay producers. R. 9322-23 [D.5-015, F. 57]. From 1975-78, 11 major tax bills were considered in the course of 63 hearings. R. 10453-10770; Appendix C at 3 (R. 1220). The legislative history of AS 43.21 is large and comprehensive, reflecting a breadth of analysis by tax experts, economists, and attorneys from all sides of the controversy. 9/

9/ The legislative history is before this court in a uniquely usable fashion. As part of its summary judgment motion, the state assembled every document which was before the legislature during its deliberations, and transcribed every hearing. A complete set of indices allows easy access by subject matter or witness. A separate binder contains all versions of every bill. The result is a research tool unique in Alaska litigation.

The companies would prefer that this court ignore this source, dismissing it as mere bulk. C.B. at 65. Rather, they suggest that the court rely upon a sparsely-cited, argumentative appendix prepared by their counsel. C.B. at 65 n.23. This appendix relies largely on two sources. One is a post-enactment analysis by Mike Bradner, who was not a legislator when AS 43.21 was enacted and who admits that his personal theories about legislative motivation are not supported by the legislature's deliberations on AS 43.21. See Appendix C at 72-75. (R. 16940-43). The second are the 1975 writings of one Prof. Witherspoon, who was briefly retained by the legislature to offer his thoughts on a then-pending property tax bill, and who disappeared from the scene in 1976. Appendix C at 66-67 (R. 16935-37).

The Senate relied extensively on Levy, Lipton, and Richard Kilgore. Appendix C at 3 (R. 1256). The House retained economist Michael Tanzer, who in 1977 issued a major report on projected Prudhoe Bay rates of return. The report was valuable to the legislature in deciding whether the underattribution of income inherent in UDITPA was necessary to maintain a healthy oil industry in the state. Tanzer concluded that Prudhoe Bay producers would earn a 35% rate of return, making it obvious that this incentive was not necessary. 10/ R. 6054-56 [D. 6-003, F. 39 at 5-7].

The Hammond administration retained Professors Jerome Zeifman and Kenneth Ainsworth, who had served, respectively, as chief counsel and staff economist to the congressional Willis Committee. R. 5356 [D. 7-139, F. 35A at V-2]. The Willis Committee's 1964 report on state income taxation remains one of the most comprehensive reviews of state apportionment rules. 11/ Zeifman and Ainsworth's 1977 report, "The Taxation of the Petroleum Industry Under Alaska's Corporate

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10/ Tanzer's estimates, in fact, were understated. Tanzer, after all, could not foresee the doubling of world oil prices which occurred after the enactment of AS 43.21.

11/ Report of the Special Subcommittee on State Taxation of Interstate Commerce of the Committee on the Judiciary, H. Rep. No. 1480, 88th Cong., 2d. Sess. (1964) (referred to herein as the Willis Report.)

Income Tax," is an invaluable source document in understanding the shortcomings of UDITPA. R. 3233-89 [D. 7-001, F. 18].

The oil industry, in turn, utilized Arthur Anderson & Co. and several law professors, as well as their substantial in-house resources. They also relied on the work of Wainwright Securities. Both Anderson and Wainwright submitted lengthy reports which, in fact, did much to substantiate the legislature's conclusions. R. 2839-2938 [D. 8-080, F. 13]; R. 4879-4963 [D. 7-061, F. 32].

From this pool of expertise, and the staff resources of the legislature and administration, the legislature concluded that the assumptions upon which UDITPA relied do not hold for oil production income, and, of the available alternatives, separate geographic accounting is the most fair, and most accurate.

A. The UDITPA Formula Does Not Fairly Apportion Oil Production Income.

1. The Sales Factor

Under UDITPA, sales receipts are credited solely to the destination state -- that is, the state where the goods are ultimately sold. AS 43.19.010 Art. IV, §§ 16-17. If Alaska oil is delivered to California and sold to a third party there, the full gross sales price is credited to California. Because that gross price includes all costs and profits earned to that point -- including production profits -- the destination sales factor irrebutably presumes that all income from the production of North

Slope oil is earned in California. R. 5371-72 [D. 7-139, F. 35A at V-17 to V-18]. If, however, the oil is merely transferred to a refining division in California, and then sold to a retailer in Arizona, Arizona becomes the destination state, and the presumption is that all North Slope production profits are earned in Arizona.

The destination sales factor of UDITPA originates not from economic reason, but from political influence. It was devised at the behest of manufacturing states in order to provide a more favorable climate for local industry. Willis Report, supra, at 123-28. A destination-state sales factor, as the United States Supreme Court has observed, is akin to a situsing rule, which specifically allocates income on the basis of a legal fiction, without taking a fair look at how income is actually generated. General Motors Corp. v. District of Columbia, 380 U.S. 553 (1965).

In mercantile industries, it may well be that the value of manufacturing activities in the state of origin is substantially enhanced by marketing activities in the state of destination. As Exxon has acknowledged, however, oil production income is "fully earned at the wellhead," largely because the price of crude oil is principally a function of external market conditions and scarcity value. R. 1554-55.

Under UDITPA, then, Alaska's sales factor would be virtually nothing, regardless of the amount of oil taken from Prudhoe Bay. R. 3865 [D. 7-019, F. 22 at 11]; R. 9226 [D. 5-014,

F. 56 at 21]. The companies acknowledge that only a "tiny fraction" of North Slope oil sales are credited to Alaska under UDITPA -- in the case of Arco, 1.5%. C.B. at 22, 50. Thus, as the Department of Revenue concluded in its comprehensive 1977 tax study:

> Although there are problems with each of the three factors, the use of the uniform sales factor produces the greatest distortion of oil and gas corporation activity in Alaska. That is, the total value of petroleum products is assigned only to the state where the final destination sale is made. No value is assigned to the state where the petroleum is produced.

R. 5371 [D. 7-139, F. 35A at V-17].

It is the function of the property and payroll factors of UDITPA to moderate the extreme effects of the sales factor, which by itself will lead to taxation of extraterritorial values. General Motors Corp. v. District of Columbia, 380 U.S. at 561. With respect to oil production, however, the remaining factors compound, rather than cure, the problem.

2. The Property Factor

In calculating the value of property to be placed in Alaska's numerator, UDITPA, by following industry accounting practice, does not include the value of the oil reserves. 12/ Instead, the property factor includes only the cost of the wells

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12/ The United States Securities and Exchange Commission has continued and appurtenances which produce that oil, and the acquisition cost of the lease. AS 43.19.010 Art IV, § 11; R. 1546-1550. As a result, and as the legislature was informed, Prudhoe Bay assets were valued under UDITPA at about <u>one percent</u> of their worth. R. 8377 [D. 6-096, F. 46 at 1]. The greatest income producing asset that an oil producer owns is its oil reserves. Alaska's property factor was largely unaffected by either the discovery or production of Prudhoe Bay reserves, although those reserves, rather than the value of the surface structures, are determinative of the profitability of the field.

In proceedings before the Federal Energy Regulatory Commission, the companies acknowledged the deficiencies in the valuation of production property:

> [A]ccounting for cost completely ignores the discovery value of assets added through exploration. For successful companies this can result in substantial understatement of the value of assets.
>
> As is generally the case for companies with oil and gas reserves, Sohio reports its Prudhoe Bay reserves on its balance sheet at cost, which is

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<u>12</u>/ continued
noted:

> The discovery of oil and gas is the most significant event in exploration, development, and production activities. Traditional accounting methods do not provide for recognition of this event in recording the assets or earnings of companies engaged in this industry ....

R. 1549.

> considerably less than informed estimates of the value of such reserves.

R. 1548.

There are, moreover, several accounting rules which further warp the UDITPA property factor. For example, the Internal Revenue Code allows many costs that are incurred in building surface structures -- intangible drilling costs ("IDC's") -- to be expensed rather than capitalized, as similar costs would be in any other industry. 26 U.S.C. § 263; R. 1550. Thus, they are both excluded from the value of the structure and subtracted from the companies' net income against which the UDITPA factors will ultimately be applied. IDC's, then, hit the producing state coming and going: the property value is reduced, and overall income is diluted.

3. <u>The Payroll Factor</u>

Under UDITPA, payroll is included in a state's numerator only if the employee is based in the state. AS 43.19.010 Art. IV, §§ 13-14; R. 1558-59. Many oil company employees working in Alaska are not based in the state, but are on temporary, remote-location assignment.

Moreover, much production work is done not by employees, but by independent contractors. R. 1550, 1559-60. Payments to independent contractors do not appear in the payroll factor. R. 1550, 1559-60. Rather, they are expensed as IDC's, which -- again -- dilute both the property factor and apportionable income.

Finally, oil production activities are not labor intensive. R. 3865 [D. 7-019, F. 22 at 11]; R. 3885 [D. 7-020, F. 22 at 3]. They are, instead, property intensive -- assuming, as UDITPA does not -- that "property" includes the oil reserves. Simply put, it takes far less labor to produce a dollar of production income than it does to produce a dollar of marketing income. Id. Sohio provides a telling example. Based on its 1978-80 annual reports, 90% of its total worldwide income was due to Alaska production profits. R. 1559 (Deakin). Nevertheless, less than 10% of its employees were based in Alaska. C.B. at 50.

4. The Disproportionality of Production Profits

Production activities are the most profitable segment of an integrated oil company's operations. R. 1561-64. At the same time, however, they account for the smallest contribution to UDITPA's factors. Id. With respect to Exxon in particular, and the oil industry in general, exploration and production accounts for only 20%-30% of an integrated companies' sales, property and payroll, but 70%-90% of the companies' net income. Id. For Alaska, with a sales factor close to zero, the disparity is unquestionably even more severe.

Edward Deakin, a professor of accounting at the University of Texas, has estimated the cumulative effects of this deflation of the UDITPA factors for a typical Alaskan oil producer. He concludes that UDITPA attributes to a producing state about 20% of income earned in that state. R. 1543, 1546-47, 1557, 1560-61. That is commensurate with the conclusion reached by the legislature three years before Deakin's study. It is also in accord with the companies' concessions in this litigation. According to the companies, between 1978-80, UDITPA would have attributed to Alaska only about 9% of Arco's total income, while separate accounting attributed 46%. Similarly, UDITPA would have attributed only 24% of Sohio's total income, while separate accounting attributed 91%. C.B. at 50. This disparity, moreover, has been frequently cited by courts when holding that the use of UDITPA for oil production income led to a manifestly unfair result. Texas Co. v. Cooper, 107 So.2d 676 (La. 1958) (UDITPA income: $1.5 million; separate accounting income: $13 million); Webb Resources, Inc. v. McCoy, 401 P.2d 879 (Kan. 1965) (UDITPA income: $40,000; separate accounting income: $157,000); Amoco Production Co. v. Armold, 518 P.2d 453 (Kan. 1974) (UDITPA income: 2.7% of worldwide; separate accounting income: 23% of worldwide).

The disproportionality of production profits to production factors undermines UDITPA's central assumption that all property, payroll, and sales are equally profitable. UDITPA's problems for oil production are intrinsic. For example, while production is responsible for some 70% of an average integrated oil company's profits, production sales as a percentage of all gross receipts average only 20% industry wide.

R. 1556-57. If all sales were equally profitable, 20% of gross receipts would represent 20% of the companies profits. Thus, even if Alaska were to modify UDITPA by employing an _origin_ sales factor, there would still exist a 350% margin of error as to that factor.

The weaknesses of UDITPA were corroborated by independent analysis. In a 1977 "Industry Review" of North Slope oil prepared for investors, Wainwright Securities concluded:

> From Alaska's standpoint, passage of the [income] tax would undoubtedly resolve some _glaring deficiencies_ in its current income tax treatment. Also, it would ensure that the North Slope Oil producers pay something resembling the 9.4% nominal tax rate imposed on domestic (Alaskan) corporations doing business only in the state -- _versus the 2-3% rate that otherwise would apply to a multinational oil company_.

R. 4911-12 [D. 7-061, F. 32 at 33-34] (emphasis added).

B. The Legislature Had Good Reasons For Choosing Separate Accounting Over a Modified Formula.

Realizing that UDITPA systematically distorts production income attributable to Alaska does not in itself compel the use of separate accounting. Indeed, much of the debate before the legislature centered on whether to employ separate accounting -- which was favored by the legislature -- or a modified formula, which was favored by the administration. _See_ Appendix C at 35-59; R. 1248-68 _et seq._ The Hammond administration initially opposed separate accounting for the very reasons that it is disfavored by some states -- the possibility of taxpayer manipulation in setting a transfer price. R. 3621-22 [D. 7-173, F. 19 at 15-16].

Separate accounting, however, is frequently utilized to apportion oil production income because crude oil is commonly traded and has an ascertainable value. The oil industry must report the wellhead value of its oil production for a variety of purposes -- including the state severance tax and lease royalties. See e.g., AS 43.55. In 1978, prior versions of separate accounting bills were amended by the legislature to allow the Department of Revenue to rely upon these independent calculations of wellhead value. R. 1846 [D. 8-132, F. 2 at 3]; SCS for CSHB 322. That satisfied the administration's objections. Id.

These two approaches -- a modified formula applied against book rather than federal taxable income, and separate accounting -- were each predicted to generate comparable amounts of additional revenue. 13/ R. 5174-76 [D. 7-153, F. 34];

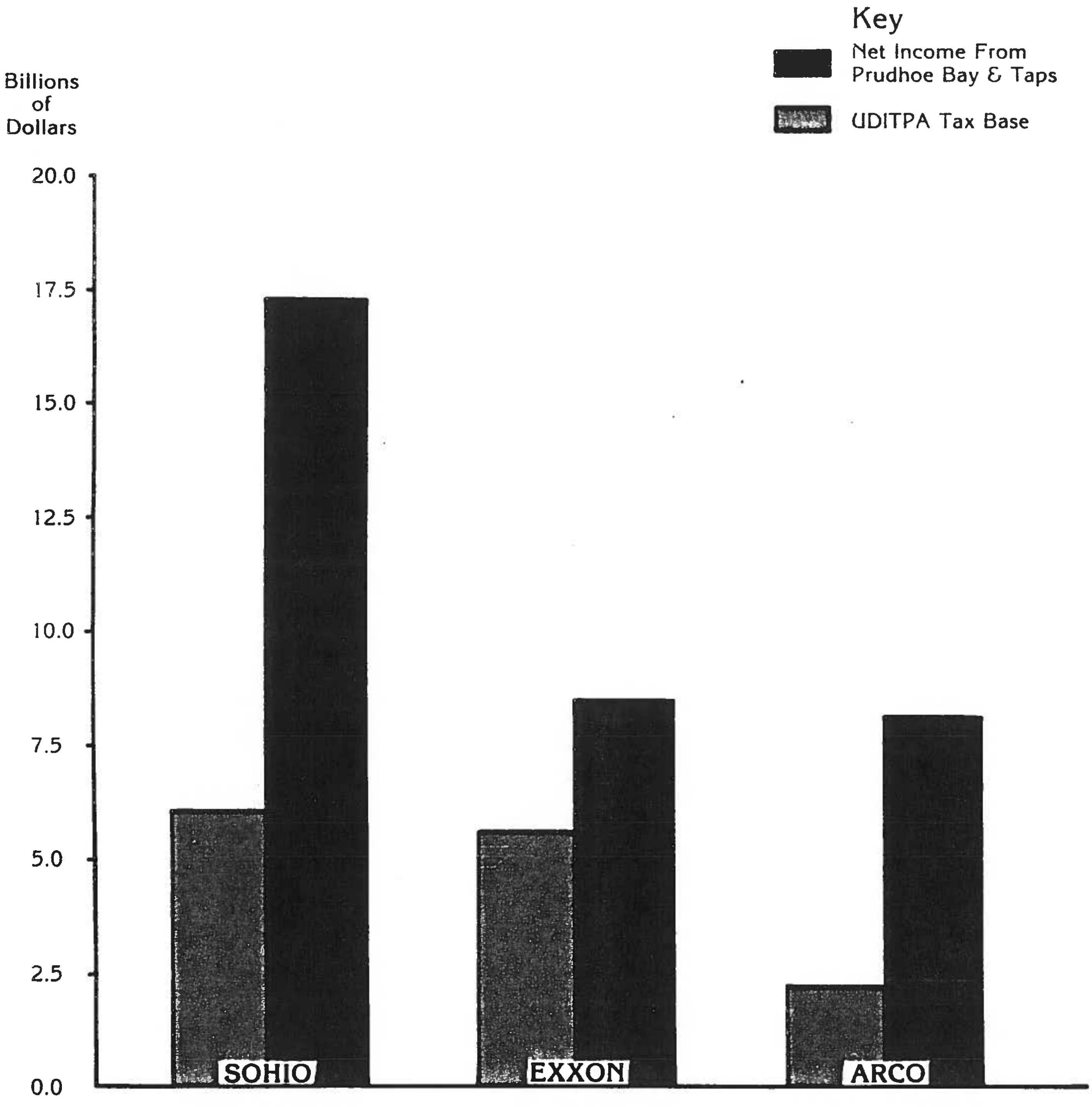
13/ Under UDITPA, a state's factors are multiplied against federal taxable income. Federal taxable income is reduced from book income (income reported to shareholders) by a variety of deductions which do not reflect actual costs. The oil industry enjoyed special subsidies, including the expensing of intangible drilling costs and the then-existing percentage depletion allowance. These were in addition to liberal use of early depreciation, net operating loss carryforwards and investment tax credits. As a result, the effective federal tax rate for the eight oil companies doing business in Alaska in 1977 was between 1.8% and 35.6%, instead of the 48% statutory rate. Sohio and Arco had effective federal tax rates of 4.2% and 14%, respectively. R. 5362 [D. 7-139, F. 35A at V-8].

R. 3132 [D. 8-101, F. 17]. The separate accounting approach was chosen because it squarely addressed the issue of tax equity. 14/ Under separate accounting, producers with equal volumes of production and equal costs in Alaska would pay the same tax, whether they were local or multi-state companies, and regardless of their worldwide company structure. See Chart 4. Under modified apportionment they would not, as industry reports themselves demonstrated.

Two industry reports in particular made the unintended point that companies with identical holdings would pay vastly different taxes under any formula. In 1976, Sohio presented "Sohio Submission One," which postulated three oil producers, each owning one-third of Prudhoe Bay, but each having very different configurations outside of Alaska. R. 8510 [D. 6-122, F. 50 at 4]. Although Alaska production income was identical for the three, the Alaska tax base attributed to each by UDITPA differed dramatically. R. 8518 [D. 6-122, F. 50 at Table 1A]; R. 8529

14/ R. 4759 [D. 7-054, F. 30 at 1] (Croft) ("the income tax is not designed to pick up additional money but to try to establish equal treatment between companies operating within the state"); R. 1704 [D. 8-125, F. 2 at 6] (Gallagher) ("If we're seeking to raise money -- I think the most effective way is through a severance tax."); R. 1661 [D. 8-006, F. 1 at 1] (Croft) ("the [modified formula] proposal is 'unfair' because it just tinkers with the formula ... separate accounting [is the] most equitable method because under it every corp[oration] pays [the] same effective tax rate."); R. 3309 [D. 7-004, F. 18 at 13] (Ziefman).

Net Income From Prudhoe Bay and Taps
Compared With UDITPA Tax Base
(Life of Field)



Source: Arthur Anderson Study, Exhibit VIII(a)(R. 2899)

CHART 4

[D. 6-124, F. 50 at 3](Lipton); R. 3829 [D. 7-018, F. 22 at 3] (Lipton); R. 8526 [D. 6-123, F. 50 at 3] (Tanzer).

A 1978 industry-sponsored report by Arthur Anderson & Co. illustrated the same point. Exxon and Arco, with nearly identical earnings from Prudhoe Bay and TAPS over the life of the field, would pay vastly different taxes both under UDITPA and the proposed modified formula:

(in millions)	Arco	Exxon	Sohio
Net income from Prudhoe Bay and TAPS:	$8,145	$8,510	$17,249
Taxable income under UDITPA:	2,208	5,639	6,065
Taxable income under modified formula:	4,623	9,013	12,336

R. 2899 [D. 8-080, F. 13 at Table VIII(a)]; R. 2947 [D. 8-081, F. 13 at Supplemental Table II]. <u>See</u> Chart 4. As the Legislative Affairs Agency advised the Subcommittee on Oil and Gas, the modified formula would increase state revenue, but "the issue of tax equity as raised by many legislators in the past has [not] been adequately addressed. Conversely, there is much in the [separate accounting] proposal to recommend it on the grounds of equity ...." R. 4697 [D. 7-041, F. 28 at 3]. <u>See also</u>, R.4704-05 (Lipton) [D. 7-042, F. 28 at 5 and 6].

Thus, separate accounting was chosen as the fairest means of apportionment precisely because it looked only at actual in-state earnings. A modified apportionment formula, the legislature concluded, would simply be "tinkering," that is, substituting one group of arguable assumptions for another. R. 1661 [D. 8-006, F. 1 at 1].

Separate accounting was not chosen because it would inherently cause more income to be attributed to the state. As Milton Lipton advised the legislature, separate accounting has no inherent bias, and could result in decreased taxation for less profitable enterprises. R. 2156 [D. 8-131, F. 4 at 12]; R. 1941 [D. 8-018, F. 4 at 22]. As it happened, oil prices rose dramatically after AS 43.21 was enacted, resulting in income to the producers and revenue to the state far beyond the highest projections of any 1978 forecaster. 15/ As the Department of Revenue told the legislature, had oil prices instead dropped as dramatically, income attributable to the state by separate accounting would also have declined. R. 5450 [D. 7-139, F. 35A at VI-16].

II. SEPARATE ACCOUNTING, AS EMPLOYED BY AS 43.21, FAIRLY APPORTIONS OIL PRODUCTION INCOME TO ALASKA

A. Introduction

The Commerce Clause issues raised by this appeal were recently decided by the United States Supreme Court. In

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15/ In 1976, the legislature projected that the 1981 OPEC-set price of crude oil at the refinery would be $16.82 per barrel. R. 8409 [D. 6-102, F. 47 at 3]. The actual 1981 price was $37.05 per barrel. *See* "Monthly Energy Review," Energy International Administration, United States Dep't of Energy, July 1983.

Container, the Court reaffirmed what the lower court here had already concluded -- that separate accounting, of the kind employed by AS 43.21, is a permissible means of apportioning a unitary business' worldwide income. It is compatible with the use of mathematical formulas by other jurisdictions, and it is no less fair than the three-factor UDITPA formula.

Without question, every state must divide, or "apportion," the income of multistate taxpayers in some manner. Ohio may not, for example, tax all of Sohio's income simply because the company is headquartered in that state. Sohio also does business in Alaska, which entitles Alaska to tax a portion of its multistate income. Because of the inherent imprecision of all income attribution methods, and the eminently debatable nature of the true source of income, no one apportionment system is superior:

> In the case of a more-or-less integrated business enterprise operating in more than one State, however, arriving at precise territorial allocations of "value" is often an elusive goal, both in theory and in practice. For this reason and others, we have long held that the Constitution imposes no single formula on the States.

Container, 77 L.Ed.2d at 552 (citing Mobil Oil Corp. v. Comm'r of Taxes of Vermont, 445 U.S. 425, 438 (1980), Butler Bros. v. McColgan, 315 U.S. 501, 507-509 (1942), Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, 121 (1920), and Wisconsin v. J. C. Penney Co., 311 U.S. 435, 445 (1940). To establish that a state has exceeded the bounds of the Commerce and Due Process Clauses, a taxpayer must meet the "'distinct burden of showing by "clear and cogent evidence" that [the state tax] results in extraterritorial values being taxed ....'" 77 L.Ed.2d at 552 (quoting Exxon Corp. v. Wisconsin Dep't of Revenue, 447 U.S. 207, 221 (1980), quoting Butler Bros. v. McColgan, 315 U.S. at 507, quoting Norfolk & Western Railway Co. v. North Carolina ex rel. Maxwell, 297 U.S. 682, 688 (1936)).

In reiterating the familiar standards of the Commerce and Due Process Clauses, the Court in Container held that a state's system for apportioning the income of a multistate taxpayer must meet two requirements. First, it must be "internally consistent," so that its use in every jurisdiction would result in the taxpayer being taxed on no more than 100% of his income. 77 L.Ed.2d at 556. Second, the state's system must actually reflect a reasonable sense of how income is generated. The burden of proof rests with the taxpayer to show by "clear and cogent evidence" that the tax is either "inherently arbitrary" or produces a "grossly distorted result" by taxing income "out of all appropriate proportions to the business transacted in that state." 77 L.Ed.2d at 556.

Alaska's separate accounting statute meets both of these requirements. First, it is internally consistent. If separate accounting were employed by all the states, a taxpayer would be taxed on exactly 100% of its income. 16/ Second, AS 43.21 "actually reflect[s] a reasonable sense of how income is generated." Id. It does so by foregoing the surrogates and assumptions of mathematical formulas and looking instead at actual revenues and costs of in-state operations. Moreover, despite ample opportunity to do so, the companies have not produced any evidence whatsoever that, if true, would show that AS 43.21 has produced "a grossly distorted result" in its attribution of income to this state. Id.

B. The Fair Apportionment Test Applies to Separate Accounting.

To avoid the deferential standards applied in Container and the many cases preceding it, the companies imply that this deference is due only to mathematical formulas, which is to say that separate accounting is not a permissible means of apportionment. That argument is hopelessly at odds with the court's decision in Container.

The taxpayer in that case did business overseas and in California. Its overseas operations were, true to the

16/ The companies here make an additional "internal consistency" argument, which involves the interaction of AS 43.21 and Alaska's general corporate income tax law -- AS 43.20. That argument is premised on the erroneous conclusion that separate accounting and UDITPA are theoretically incommensurate, and in tandem lead to multiple taxation. Therefore, responding to this particular matter is deferred until Section III of this brief, which deals with the companies' various multiple taxation claims.

international norm, taxed on the basis of separate accounting. California, on the other hand, applied its UDITPA formula to the company's worldwide income. The taxpayer argued that separate accounting and UDITPA were theoretically incommensurate, and thus would inevitably lead to multiple taxation. In other words, since foreign nations had already taxed foreign income in full under separate accounting, nothing was left for California to tax through UDITPA. Furthermore, because the United States courts could not control the tax structure of foreign nations, they therefore must force California to excise that separately accounted income from its UDITPA base.

The Court closely scrutinized the taxpayer's grievance, noting that foreign commerce was involved. Nonetheless, the court held that there was no "automatic 'asymmetry'" between the two methods. 77 L.Ed.2d at 572 (emphasis in original) (quoting from Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979)). Separate accounting and UDITPA were compatible alternate means of apportioning multijurisdictional income:

> One way of deriving locally taxable income is on the basis of formal geographical or transactional accounting .... The unitary business/formula apportionment method is a very different approach to the problem of taxing businesses operating in more than one jurisdiction.

77 L.Ed.2d at 553 (citations omitted). Although "very

different," the Court found neither more inherently reliable. 17/

> Both geographical accounting and formula apportionment are imperfect proxies for an ideal which is not only difficult to achieve in practice, but also difficult to describe in theory ....
>
> * * * *
>
> [W]e have seen no evidence demonstrating that the margin of error (systematic or not) inherent in the three-factor formula is greater than the margin of error (systematic or not) inherent in the sort of separate accounting urged upon us by appellant ....

77 L.Ed.2d at 564-565. It is of course true that separate accounting taxes 100% of a portion of the taxpayer's worldwide income, while UDITPA taxes a portion of the whole. That, however, means neither that separate accounting is in some manner unapportioned, nor that a separately accounted tax base reaches income that other jurisdictions have a right to tax. The two methods simply follow different routes to the same goal:

17/ Separate accounting "often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise," 77 L.Ed.2d at 553, while

> [E]ven the three-factor formula is necessarily imperfect ....
>
> * * *
>
> First, the one-third-each weight given to the three factors is essentially arbitrary. Second, payroll, property, and sales still do not exhaust the entire set of factors arguably relevant to the production of income. Finally, the relationship

continued

> Here ... we are faced with two distinct methods of allocating the income of a multi-national enterprise. The "arm's-length" approach divides the pie on the basis of formal accounting principles. The formula apportionment method divides the same pie on the basis of a mathematical generalization.

77 L.Ed.2d at 568. The "same pie," of course, is the company's worldwide income. Since neither is inherently more reliable, and both reach the same goal, there is no basis for elevating either separate accounting or mathematical formulas to constitutional primacy:

> Allocating income among various taxing jurisdictions bears some resemblance, as we have emphasized throughout this opinion, to slicing a shadow ... [I]t would be perverse, simply for the sake of avoiding double taxation, to require California to give up one allocation method that sometimes results in double taxation in favor of another allocation method that also sometimes results in double taxation.

77 L.Ed.2d at 571.

<u>Container</u> breaks no new ground in viewing separate accounting and formula apportionment as different in means, but identical in goal. In earlier cases involving oil production income, for example, courts have either required or upheld the use of separate accounting to satisfy the statutory and constitutional requirement of fair apportionment of an integrated

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<u>17/</u> continued

> between each of the factors and income is by no means exact.

77 L.Ed.2d at 565, and n.20.

multistate business. 18/ Indeed, UDITPA itself recognizes separate accounting as a permissible means of apportionment. Section 18 provides that if the three-factor formula does not achieve an equitable apportionment of income, alternative means of apportionment are authorized -- specifically including separate accounting. 19/

The commentators are in accord. "The purpose of separate accounting and of formula apportionment is exactly the same -- to divide the net income and assign portions of it geographically." W. Beaman, Paying Taxes to Other States: State and Local Taxation of Non-Resident Businesses ¶ 7.20 (1963). That same conclusion is reached throughout the literature. 20/

18/ Standard Oil Co. v. Thoresen, 29 F.2d 708 (8th Cir. 1928); Fisher v. Standard Oil Co. 12 F.2d 744 (8th Cir. 1926); Webb Resources, Inc. v. McCoy, 401 P.2d 879 (Kan. 1965); Texas Co. v. Cooper, 107 So.2d 676 (La. 1958); Skelly Oil Co. v. Comm'r of Taxation, 131 N.W.2d 632 (Minn. 1964); Magnolia Petroleum Co. v. Oklahoma Tax Comm'n, 121 P.2d 1008 (Okla. 1941); and Standard Oil Co. v. Wisconsin Tax Comm'n, 223 N.W. 85 (Wis. 1929).

19/ AS 43.19.010 Art. IV, § 18 provides that if UDITPA does not "fairly represent the extent of the taxpayer's business activity in the state" the department may use four alternatives, the first of which is "separate accounting."

20/ See Keesling and Warren, The Unitary Concept in the Allocation of Income, 12 Hast. L.J. 42, 43-45 (1960); G. Altman and F. Keesling, Allocation of Income in State Taxation, 89-90 2nd ed. (1950); Hellerstein, State Income Taxation of

continued

In short, courts and commentators understand that separate accounting is very much a form of income apportionment of equal dignity with mathematical formulas. As such, it is subject to the same standards that the Supreme Court applies to all income division systems.

C. AS 43.21 is "True" Separate Accounting and is Subject to the Fair Apportionment Test.

The companies have scrupulously avoided the term "separate accounting" in their brief. Their aim is to place some distance between themselves and Container. To this end, their brief refers to separate accounting only once, where AS 43.21 is contrasted to "true separate accounting -- i.e., a system ... that would have attempted to measure, and tax, only income actually earned in Alaska." C.B. at 65. In so doing, they imply that AS 43.21 is not separate accounting at all, but is rather a mutant of no known ancestry, and certainly of no relation to the arm's-length method at issue in Container.

AS 43.21 is "true" separate accounting, both generally, and with respect to the companies' principal complaints. Those complaints are that AS 43.21 looks to out-of-state sales to measure gross income, and that it fails to account for alleged

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20/ continued
Multijurisdictional Corporations; Reflections on Mobil, Exxon, and H.R. 5076, 79 Mich. L. Rev. 113, 117 (1980); Ebel, An Examination of State Worldwide Unitary Formula Apportionment, 1 Multistate Tax Comm'n Rev. 1 at 1 (March 1984).

contributions to production income from outside activities. On both counts, AS 43.21 is identical with the "arm's-length" method described in Container, the separate accounting methods used by several of our sister states, the United Nations and Office of Economic Cooperation and Development ("OECD") model treaties, and the Internal Revenue Code. It is also the same separate accounting system used by these companies when they file separate accounting tax returns, often by choice, in other states.

Separate accounting is simply this: revenues associated with an in-state activity are attributed to that state, and the costs associated with those revenues are deducted to arrive at net income. 21/ So far as possible, every cost is allocated to the income-producing activity that it supports. "[G]eneral overhead expense items are associated with specific revenue on some acceptable accounting basis." 22/ If a product or commodity is not sold in the state, but is instead shipped out-of-state for sale or further processing, separate accounting establishes a "transfer price" for that product as it leaves the state. 23/

21/ Keesling & Warren, supra at 43.

22/ P. Hartman, Federal Limitations on State and Local Taxation, 522 (1981). See also J. Hellerstein, supra, at 323.

23/ G. Altman & F. Keesling, supra, at 38; see also, testimony on behalf of oil industry by Gary Boren, R. 2214-2260 [D. 8-029, F. 5 at V-1]; R. 2244.

AS 43.21 does just that. Gross income attributable to Alaska is measured by the "value [of the oil] at the point of production." AS 43.21.020(b). If the oil is sold at the wellhead, that sale is the gross income attributable to Alaska from that oil. Since most North Slope oil is not sold at the wellhead, its value is netted back from the first point at which value can be established. This is done by deducting from the sales price those transportation costs and profits which are incurred from the point of production to the point of sale. AS 43.21.020(b). AS 43.21 then provides for the deduction of every cost associated with producing that income. AS 43.21.020(c). The taxpayer may allocate general overhead and administrative costs to Alaska production on any acceptable accounting basis. AS 43.21.020(c)(9).

Neither the fact that Alaska oil is sold out-of-state, nor the fact that an outside sales price must sometimes be used as the starting point for determining gross income, makes AS 43.21 different from other separate accounting laws. Nor does AS 43.21's treatment of out-of-state support activities distinguish it from "true" separate accounting. Under traditional separate accounting principles, precisely the same support activities marqueed in the companies' brief are universally accounted only as expenses, whether they occur in the income-producing state or in some other state.

The use of an imputed transfer value to establish the gross income of a separately accounted activity is the cornerstone of every separate accounting law. By definition, a transfer value must be imputed precisely because the commodity is not sold in-state.

The separate accounting provisions of other states are identical in setting a transfer value notwithstanding out-of-state sales. 24/ So, too, is the Internal Revenue Code (IRC) in determining the United States source income of foreign corporations, setting transfer values between commonly controlled entities, and calculating foreign tax credits. 25/

The OECD Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital, 26/ and the United States Draft Model Income Tax Treaty, 27/ employ an

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24/ *Compare* AS 43.21.020(b) and 15 AAC 21.110, .120 *with* *Louisiana*: La. Admin. Code art. 47:224.3.B.b. *Mississippi*: Miss. Code Ann. § 27-7-23(c)(2)(B)(iii); Miss. Reg. 1.27-7-23(7)(o). *Oklahoma*: Okla. Stat. Ann. tit. 68, § 2358, A.4.a; *See* Magnolia Petroleum Co. v. Oklahoma Tax Comm'n., 121 P.2d 1008, 1011 (Okla. 1941).

25/ IRC §§ 861-864; Treas. Reg. § 1-863-1(b) (income from United States oil well is United States income whether oil sold "within or without the United States"); Treas. Reg. § 1-863 (income from United States oil well is United States income whether oil sold "within or without the United States"); IRC § 482; Treas. Reg. § 1.482-2(e)(1),(2),(3) (gross income is transfer price even if there is no local sale); *See also*, Treas. Reg. §§ 1-482-2(e)(1)(ii) and (v), 1.613-3(a); IRC § 907 (foreign tax credits). *Compare* IRC § 907(d) *with* AS 43.21.020(b).

26/ Reprinted in 1 CCH Tax Treaties ¶151 (hereinafter OECD Model Convention).

27/ Model of June 16, 1981, reprinted in 1 CCH Tax Treaties, ¶158 (hereinafter United States Model Treaty).

arm's-length separate accounting methodology that is virtually identical in this respect to Alaska's, requiring production income to be attributed to the point of production, based upon its market or wellhead value irrespective of the point of ultimate sale. 28/

AS 43.21's treatment of support activities such as technical services, head office functions, and legal and accounting services is identical to that of other separate accounting laws. If anything, AS 43.21 is more liberal, and allows more flexibility in this respect than other separate accounting laws. Many overhead costs support more than one income producing activity, and most separate accounting laws apportion those costs under a rigid formula. AS 43.21, on the other hand, uses a formula method only as a presumption for allocating the expenses of these activities, permitting the taxpayer to show that actual overhead costs were greater. AS 43.21.020(f). Further, AS 43.21 is unique in that it allows an attribution of profit to these activities if the taxpayer in fact considers them profit generating. See 15 AAC 21.290(b). 29/

28/ United States Model Treaty art. 7, ¶2; R. 1514, 1520-23. OECD Model Convention art. 7, ¶2. R. 1520-23.

29/ The companies complain that the regulation allowing an attribution of profit, although retroactive, was not adopted until after their annual reports were filed, and that the regulation permits a reporting technique prohibited by Securities and Exchange Commission rules. In fact, SEC rules permit this continued

The separate accounting laws of our sister oil-producing states allow only the costs of these activities to be deducted. 30/ The Internal Revenue Code is the same: costs, wherever incurred, are subtracted from gross income with no attribution of profit. 31/ Interest and research expense is allocated to the income producing activities to which it relates. 32/ Overhead and supervisory expenses are apportioned to the activities which they support with no profit added. 33/

Federal transfer price regulations are substantially identical: "Marketing, managerial, administrative, technical, or other services" are deducted at cost with no profit; unless they are rendered solely in support of one geographic activity, they are apportioned among the activities which they support. 34/ Likewise, the OECD model treaty allows only the expense of

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29/ continued
type of reporting, and, on the issue of timing, annual reports can be amended. R. 16920-21 (Deakin). The companies' argument reduces to a claim that AS 43.21 is unconstitutional because it uses the same accounting rules that the companies themselves employ.

30/ Compare Alaska: AS 43.21.020(c)(9); 15 AAC 21.210-.290 with Louisiana: La. Admin. Code art. 47:244.3.A, B.3; Mississippi: Miss. Code Ann. § 27-7-23(c)(2)(B); Miss. Reg. 1.27-7-23(7)(c)(2); see also Webb Resources, Inc. v. McCoy, 401 P.2d at 890 (Kansas).

31/ Treas. Reg. §§ 1.863-1(c), 1.861-8(a)(1).

32/ Treas. Reg. § 1.861-8(a), (e).

33/ Treas. Reg. § 1.861-8(b)(3), (c)(1).

34/ Treas. Reg. § 1.482-2(b)(1), (3). See also § 1.482-2(b)(6).

outside support activities to be deducted. The commentary to the treaty specifically prohibits any "commission" being added above actual cost. Horst Deposition at 369-370.

In sum, the fair apportionment standards restated in Container apply to separate accounting, and, most assuredly, AS 43.21 is separate accounting. This section's remaining task is to demonstrate that AS 43.21 meets those standards.

D. AS 43.21 Meets the Fair Apportionment Standard

The means of apportionment employed by a state "must actually reflect a reasonable sense of how income is generated." Container, 77 L.Ed.2d at 556. The burden is on the taxpayer to establish that the tax statute is "inherently arbitrary." Underwood Typewriter Co. v. Chamberlain, 254 U.S. at 121. In other words, the taxpayer must show that there is not even a "modicum of reasonable relation" between the in-state activities which are used to measure the tax, and some rational sense of how income is generated. General Motors Corp. v. District of Columbia, 380 U.S. at 561. Alternatively, the taxpayer must "prove by 'clear and cogent evidence' that the income attributed to the State ... has 'led to a grossly distorted result,'" Container, 77 L.Ed.2d at 556 (citations omitted). This subsection shows first that AS 43.21 is anything but "inherently arbitrary," and, second, that this conclusion is not altered in the slightest by the companies' complaints regarding out-of-state contributions to Alaska income. Subsection E shows that the companies have declined to submit proof that AS 43.21 has produced a "grossly distorted result."

1. AS 43.21 Reflects a Reasonable Sense of How Income is Generated.

By relying directly on the value of the oil at the point of production, net of all direct and indirect costs incurred in producing it, AS 43.21's separate accounting reflects a "reasonable sense of how [production] income is generated." The highest courts of two other oil-producing states have held that "[w]here the direct method of income allocation can be employed, all suspicion of unconstitutional taxation is dispelled." Webb Resources, Inc. v. McCoy, 401 P.2d at 889; Magnolia Petroleum Co. v. Oklahoma Tax Comm'n, 121 P.2d at 1011. In contrast, these same courts, in the course of requiring or allowing separate accounting for integrated multistate oil companies as the fairest and most accurate means of apportionment, have held that the application of the UDITPA formula would produce a "manifestly unfair" result. Texas Co. v. Cooper, 107 S.2d 676; Magnolia Petroleum Co. v. Oklahoma Tax Comm'n, 121 P.2d 1008; Webb Resources, Inc. v. McCoy, 401 P.2d 879.

Oil production activities are particularly amenable to separate accounting because oil production accounting is done, for a wide variety of purposes, on a lease-by-lease basis. R. 1566-70 (Deakin). These purposes include net profit share leasing, percentage depletion, and accounting between joint owners of a lease. Id. Wellhead value must be calculated for the federal windfall profit tax, state severance tax, and royalties. Id. Both the United States Bureau of the Census and the Department of Energy require that oil production costs and revenues be reported separate from other operations. Id. Thus, every oil producer knows precisely the revenues and expenses that are associated with each lease.

The unique susceptibility of oil production income to separate accounting permeates applicable case law. The supreme court of Kansas has held that separate accounting produces a fair result because:

> [T]he gross revenues, drilling costs and operating costs could be determined by state lines .... [The taxpayer] knows the exact number of barrels of oil produced from each well; it knows the location of each well; the taxpayer can also determine the exact cost of drilling and the exact cost of equipping each well, as well as the direct costs of operation within the geographical area of the state.

Webb Resources, Inc. v. McCoy, 401 P.2d at 890.

For many industries the establishment of an "in-state value" may be difficult. Much depends upon whether the commodity produced in-state has an independent market value so that an arm's-length price can be determined. Horst Deposition at 155-156. If it cannot, the potential for profit shifting -- by attributing an artificially low price to the value of in-state activity -- is significant. Id. at 85. But because crude oil has an intrinsic value, and is commonly traded as crude oil (that is, without further processing) its value can be confidently established.

Crude oil value at the point of production separates in-state production income from any downstream income for two reasons. First, and as Exxon has noted, it is widely accepted within the industry itself that "exploration and production income is fully earned at the wellhead." R. 1554-55. To Exxon, viewing production income as fully earned in the production state "is in accordance with generally accepted accounting principles, because crude oil has a known, realizable value." R. 1555.

Second, wellhead value is an arm's-length price. An arm's-length price, of course, is one that allocates to the seller or transferrer of the crude a market rate of return on his producing activity. R. 1530 (Horst). It is also a price at which the refiner or buyer expects to purchase the crude and still earn a profit on refining and resale. Id. Use of a wellhead value therefore segregates and excludes from the AS 43.21 tax base any profit attributable to Alaska oil downstream of the point of production.

Because of its accuracy, separate accounting is the choice of other oil-producing states including Louisiana, Mississippi, and Oklahoma. 35/ The Comptroller General's report explains the reason:

> [T]he States generally use separate accounting only to determine the income of certain kinds of [multijurisdictional corporations] earned within their jurisdictions. These businesses, (primarily general merchandising, oil and gas, and construction companies) use separate accounting because it conforms more to their financial accounting procedures and, for these specific situations, more accurately reflects income than formula apportionment.

GAO Report to the Chairman, House Committee on Ways and Means: Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving, 3 (1982) (emphasis added); R. 17023.

Separate accounting is also preferred by the federal government for various purposes, including apportioning the income of multinational taxpayers, and this preference is shared by other countries. See Container, 77 L.Ed.2d at 565, 569-70. A similar preference is found in model international tax

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35/ Excluding Texas and Wyoming, which imposed no corporate income taxes, from 1976 to 1980 more than 91% of domestic crude oil was produced in eight states with 40 million barrels or more of annual production. Statistical Abstract of the United States at 730 (1983). The statutes of four of those states (Alaska, Louisiana, Mississippi, and Oklahoma) required separate accounting for oil production income. Of the top five producing states, Texas (first) had no income tax and California (fourth) required formula apportionment, while Louisiana (second), Alaska (third) and Oklahoma (fifth) all required separate accounting for oil and gas production income. Id.

conventions established to encourage international trade and investment by reducing double taxation. 36/

Finally, there are three other sponsors of separate accounting who warrant note -- Arco, Exxon and Sohio. For many years, these companies, of their own chosing, filed separate accounting returns in Alaska even though state law at the time required use of UDITPA. R. 873-1198. Moreover, historically and at least through 1981, these companies chose to file separate accounting returns in states where it was to their advantage to do so. R. 1605-08. In Texas Co. v. Cooper, 107 So.2d at 682, the court rejected the taxpayer's criticisms of separate accounting in light of the fact that the taxpayer "actually use[s] that method in those states where it wants to use it ...." The same critical eye would seem warranted here.

In short, the companies ask this court to heed what they say, and not what they do. More boldly, they seek a ruling that the income allocation method used by the United States, the United Nations, the OECD, and several of our sister states lacks even a modicum of reasonableness. That contention falls of its own weight.

36/ OECD Model Double Taxation Convention, supra, Art. 5, §2, Art. 7, §2; United States Model Treaty, supra, Art. 5, §2; United Nations Model Convention Between Developed and Developing Countries, Art. 7. See, R. 1514-15, 1520-22, 1523 (Horst).

But separate accounting need not be the best means of estimating local oil production income; the "inherently arbitrary" test is not nearly so demanding. Even the crudest of formulas has passed. See Moorman, 437 U.S. at 273, 274. In fact, the Supreme Court has never invalidated a state income tax law under this threshold requirement.

There are three distinct reasons for this judicial restraint. First, the Court has recognized that the task of ascertaining the true source of income is as difficult as "slicing a shadow." Container, 77 L.Ed.2d at 570. As the record in this case abundantly demonstrates, equally qualified economists and accountants disagree on whether separate accounting, or some variety of mathematical formula, is a fairer means of apportioning the production income of a multistate oil company. 37/ An effort to divine the true source of income, and hence the fairest means of apportionment, would be an exercise not only in judicial legislation, but in judicial alchemy.

Second, even if that theoretical bar could be surmounted, establishing a constitutional norm would require the judiciary to craft a lengthy and technical tax code. It would involve not only choosing a particular method, but also prescribing at length the precise rules relating to every element

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37/ Compare R. 1514-17, 1523-34 (Horst), R. 1542-48, 1564-70 (Deakin) with R. 12996-13001 (Davidson), R. 13072-74, 13082-84 (Church).

of that method. "[T]he adoption of a uniform code ... would require a policy decision based on political and economic considerations that vary from State to State ...." Moorman, 437 U.S. at 279. "Because that task [is] essentially legislative, we declined to undertake it ...." Container, 77 L.Ed.2d at 557.

Finally, any attempt to select between competing economic theories would restrict "the vastness of the state's taxing power and the latitude that the exercise of that power must be given before it encounters constitutional constraints." Norfolk & Western Railway Co. v. Missouri State Tax Comm'n, 390 U.S. 317, 326 (1968). With regard to state apportionment laws in particular, the Court has recognized that:

> At best, the responsibility for devising just and productive sources of revenue challenges the wit of legislators. Nothing can be less helpful than for courts to go beyond the extremely limited restrictions that the Constitution places upon the states and to inject themselves in a merely negative way into the delicate processes of fiscal policy-making. We must be on guard against imprisoning the taxing power of the states within formulas that are not compelled by the Constitution ....

Wisconsin v. J. C. Penney Co., 311 U.S. at 445 (emphasis added).

2. AS 43.21's Treatment of Out-of-state Activities Does Not Render the Statute Inherently Arbitrary.

In spite of this deferential standard, the companies argue that AS 43.21 is inherently arbitrary because it "inevitably" taxes out-of-state contributions to Alaska production income. The companies have catalogued an array of logistical, financial and support services which they claim occur principally out-of-state, and which they believe are responsible for an unspecified portion of profits attributable to the production of Alaska oil. Because AS 43.21 views the profits from production of Alaska oil as earned in Alaska, companies believe that the statute "inevitably" taxes out-of-state values, and hence is facially invalid. They also imply that AS 43.21 arbitrarily ignores the contributions of out-of-state sales activities and that the statute thus taxes value added downstream of the point of production. Their arguments fail for three reasons.

a. The Treatment of Out-of-state Support Activities is Merely a Matter of Economic Theory.

How one treats support activities is a matter of economic theory. Under the separate accounting approach, income is viewed as being earned when and where the principal operating activity occurs. In other words, production income is earned where the oil is produced, refining income is earned where the oil is refined, and marketing income is earned where the products are sold. Support segments are not treated as separate enterprises that could generate income on their own, but are instead viewed, by tax collectors and taxpayers alike, as "cost centers."

Separate accounting's refusal to go further and attribute a portion of oil production profits to outside management has been before the courts already. The companies' complaint, in fact, is old hat.

In Shaffer v. Carter, 252 U.S. 37 (1920), an Illinois resident who earned income from oil production in Oklahoma complained that his Oklahoma production income was at least partially a function of the management and financing skills of his Illinois office. The Court held, however, that his oil production income could fairly be viewed solely as local Oklahoma income. "At most," the court held, "there might be a question whether the value of the service of management rendered from without the state ought not to be allowed as an expense in producing the [Oklahoma] income." 255 U.S. at 55. AS 43.21, of course, resolves that question in favor of the taxpayer.

In Webb Resources, Inc. v. McCoy, 401 P.2d 879 (Kan. 1965), the court held that separate accounting was feasible for Kansas oil production because the oil company knew precisely how many barrels of oil were produced in Kansas and could "determine the exact cost of drilling and the exact cost of equipping each well, as well as the direct costs of operation" within the state. As to a lengthy list of out-of-state support activities virtually identical to the companies' illustrations in this appeal, the court held that "these expenses are ordinarily considered to be general or overhead type of expenses which are required in any type of business which crosses state lines." 38/ 401 P.2d at 890 (emphasis added). As with AS 43.21, the expenses, and only the expenses, of these out-of-state contributions were deducted -- an approach which survived challenge under the Commerce Clause.

Moreover, looking to out-of-state sales to compute local value does not convert a separate accounting statute into a tax on out-of-state sales. A subsequent sale merely determines when income is realized, and not where or how much income is earned. R. 1529-30 (Horst). This argument was dispensed with years ago in Texas Co. v. Cooper, where, in this regard, the taxpayer "bitterly assail[ed]" the transfer price set by Louisiana for oil shipped to the taxpayer's refinery in another state. He argued that there could be "no taxable gain upon the oil sent outside of the State to be refined, and not sold herein." 107 So.2d at 687. The court responded that:

> [B]y definition the use of the separate accounting method to determine net profits of an interstate corporation attributable to a given State utilizes the use of market value in assigning worth to

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38/ The uncontested facts in that case, like this one, indicated that the following functions were performed outside the taxing state: head office, geologists, landmen, production supervisors, company officers, decisions regarding exploration and drilling, legal services, hiring and firing of key personnel, contracting for services, equipment and supplies (which produced economies of scale), and financing. Webb Resources, Inc., 401 P.2d at 881, 884.

> products at a given stage shipped for further processing to another State ....

Id. at 688 (emphasis added). See also Magnolia Petroleum Co. v. Oklahoma Tax Comm'n, 121 P.2d at 1011-12 (even though there were no actual sales, value at time of shipment "clearly reflected the financial gain or loss at the time the oil left the state").

Additionally, the "netback" methodology of AS 43.21 does not tax value added downstream from the point of production. Transportation profits are attributed to transportation activities. The transportation costs deducted under AS 43.21 begin with the published rate for the Trans Alaska Pipeline. AS 43.21.020(b); 15 AAC 21.130(b)(1). That rate obviously includes a profit. Similarly, if marine transportation is done by a third party, the carrier's full rates (including, obviously, his profit) are deducted. 15 AAC 21.130(b)(2). If the company's own vessels carry the oil, the regulations allow the deduction of full costs, plus port fees, plus a management fee, plus a rate of return (either the one set out in the regulation or the one imputed by the taxpayer itself). 15 AAC 21.130(b)(3).

b. The Companies' Quarrel With AS 43.21's Treatment of Out-of-state Sales and Support Activities Ignores the Fact that Separate Accounting Does Not Capture the Value that Alaska Activity Adds to These Companies' Out-of-state Operations.

If it is true that activities in one state contribute to the profitability of activities in another, that principle is surely a two-way street. Just as Alaska may capture contributions flowing to it, it equally foregoes the contributions which it may make to other states. As the Wisconsin Supreme Court stated in Standard Oil Co. v. Wisconsin Tax Comm'n:

> We regard as unsound the argument submitted to sustain the commission's [preference for a formula] in this case. If the manufacturing profits of the plaintiff company are increased by means of the sales operations in the State of Wisconsin, the converse is true that the sales operations in Wisconsin benefit by the manufacturing operations of the plaintiff corporation in other states. The argument cannot be applied one way and not the other.

223 N.W. 85, 88 (Wis. 1929) (emphasis added). 39/

Indeed, the companies' annual reports illustrate contributions to profitability in other states derived from Alaskan activities. Alaska production may have been financed by out-of-state activities, but the great revenues these companies have earned from Alaskan crude has allowed them to enhance their portfolios, to revamp their refineries, explore and produce in other states and nations, and invest and diversify throughout the world. 40/ Undoubtedly these Alaska-financed activities

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39/ See also Webb Resources, Inc., 401 P.2d at 890 ("Whether the taxpayer could conduct its wildcatting operations in other states without the profits derived from the production of oil and gas in Kansas is not the question or the test [as to whether separate accounting is proper].").

40/ See e.g., Sohio 1981 Annual Report: "Over the next ten years the company's planned [nationwide] investment of about $30 billion in dollars of the day for exploration and production will

continued

generate additional corporate profits for the companies. Yet AS 43.21 does not capture any of the income which the companies' own economists would view as attributable to Alaska.

c. The Companies' Precise Out-of-state Contributions Argument was Made and Rejected in Moorman.

In Moorman, the taxpayer challenged the validity of Iowa's single-factor formula on the ground that it inevitably failed to account for outside contributions to income. The taxpayer's goods were sold in Iowa, while its manufacturing was conducted in neighboring Illinois. The Iowa statute taxed the full value of Iowa sales without recognizing the contributions made to that income from Illinois payroll and property.

The taxpayer argued that he could avoid a multiple tax burden only by moving his entire manufacturing operation from Illinois to Iowa. This is the same argument made by the companies here, through a hypothetical intended to show that Alaska's tax base is insensitive to the location of their support

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draw largely on cash flow from Alaska." Id. at 8. "[I]ncreases [in funds provided from operations], mainly a result of the company's Prudhoe Bay and Alaska-related projects, have been used to increase dividends, expand oil and gas exploration efforts.... [1981 capital expenditures included] "acquisitions of Kennecott and coal properties from United States Steel Corporation and the purchase of offshore leases in the Gulf of Mexico." Id. at 28. See also R. 687.

activities. C.B. at 21, 30. Justice Powell found that same hypothetical appealing in his dissent.

> This surcharge on Iowa sales increases to the extent that a business' plant and labor force are located outside Iowa. It can be avoided altogether only by locating all property and payroll in Iowa ....

Moorman, 437 U.S. at 283. The majority, however, held that this multiple tax burden was not a function of any intrinsic irrationality of Iowa's formula, but was due instead to the fact that Iowa and Illinois used different apportionment methods. Without proof that so great a portion of Illinois profits had been misattributed to Iowa that the latter's tax base was grossly distorted, the taxpayer could not show "that the method of apportionment was inherently arbitrary." 437 U.S. at 274.

The Court rejected the taxpayer's challenge for three reasons. First, even if one assumed that Iowa's tax inevitably touched income partially earned out-of-state. "[T]he Constitution does not invalidat[e] an apportionment formula whenever it may result in taxation of some income that did not have its source in the taxing State ...." 437 U.S. at 272.

That holding simply reflects practical reality. No apportionment rule accounts for all plausible contributions to income, and each is resultantly vulnerable to attractive hypotheticals illustrating its insensitivity and accordingly, to the companies, its "arbitrary" nature. For example, under UDITPA, a production well in state A which produces 100 barrels per day, and a production well in state B which produces 10,000 barrels per day, may be assumed to produce identical income. This is because the UDITPA property factor ignores the principal profit-producing asset in an oil company's portfolio: its oil reserves. At the same time it assigns income on the basis of property which produces little income, such as a moribund refinery, or no income whatsoever, such as expensive pollution control facilities. The point, simply, is that while hypotheticals may have a curiosity value, they are of little constitutional significance in judging the underlying rationality of a state's apportionment law.

Second, the Court in Moorman rejected the argument made by the companies here -- that contributions to local income from outside capital and labor were inherent, and that the taxing state's law therefore "inevitably" taxed out-of-state values. The Court viewed this as simply a debatable economic theory:

> Whatever merit such an assumption might have from the standpoint of economic theory or legislative policy, it cannot support a claim in this litigation that Iowa in fact taxed profits not attributable to activities within the State ....

437 U.S. at 272. "Doubts about the wisdom of the economic assumptions underlying the challenged formula," the Court ruled, were simply not relevant to the constitutional question. 437 U.S. at 275 n.8. Thus, the companies' premise here -- that out-of-state logistical, management, and planning activities are responsible for "earning" a portion of Alaska production profits

-- is only an economic theory that is not shared by those who employ separate accounting.

Finally, in Moorman the Court held that the taxpayer had failed to show that Moorman's Illinois manufacturing activities were, in fact, operated at so great a profit that Iowa's disregard for those activities by use of a single-factor sales formula led to a "grossly disproportionate" result. 437 U.S. at 271-272. Absent such evidence, the Court could not invalidate the statute.

Here as well, the affidavits submitted by the companies

> [do] not contain any separate accounting analysis showing what portion of appellant's profits was attributable to [its activities in other states]. But appellant contends that we should proceed on the assumption that at least some portion of the income from [in-state activity] was generated by [out-of-state] activities .... Indeed, a separate accounting analysis might have revealed that losses in [other states] prevented appellant from earning more income from [the taxing state].

Moorman, 437 U.S. at 272. It is to that absence of proof that we now turn.

E. The Oil Companies Have Offered No Evidence That AS 43.21 Produces a Grossly Distorted Result.

The companies are entitled to relief in this litigation only upon "clear and cogent evidence" that the income Alaska attributes to this state is in fact "out of all appropriate proportions to the business transacted in [the] State," or has "led to a grossly distorted result." Container, 77 L.Ed.2d at 556 (citations omitted). The taxpayer's burden is great.

Indeed, only twice this century has the Supreme Court invalidated a state income tax under the Commerce Clause. In Hans Rees' Sons, Inc. v. North Carolina, the Court struck down the application of North Carolina's single-factor formula which apportioned to the state between 66% and 85% of the taxpayer's net income, when no more than 22% of its income had its source in that state. 283 U.S. at 134. See Container, 77 L.Ed.2d at 564. In Norfolk & Western Railway Co. v. Missouri State Tax Comm'n, the second case, the Court found the requisite "grossly distorted result" because the statute attributed to the state more than twice the value of the taxpayer's rolling stock. 390 U.S. at 321-22.

Cases in which a taxpayer was unable to sufficiently establish the inaccuracy of the tax are perhaps more instructive. In each of the following cases, the result was "not unreasonable," and was therefore constitutional:

	Taxed Income	Actual In-state Income
Butler Bros, 41/	$93,000	Loss of $83,000
Bass Ratcliff, 42/	27,000	none
Underwood, 43/	630,000	43,000

41/ Butler Bros. v. McColgan, 315 U.S. 501, 506 (1942).

42/ Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n, 266 U.S. 271, 184 (1924).

43/ Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, 120 (1920).

The companies here cannot meet their burden of proof, and instead attempt to avoid it by misquoting the seminal case of Hans Rees' Sons, which they claim absolves them of the need for any factual showing. In fact the express holding of the case, which the companies consciously omit, is directly to the contrary. C.B. at 49. 44/ The companies have not disclosed how much income they believe they earned in Alaska, nor have they indicated by what percentage, or dollar amount AS 43.21 has misattributed income. They have certainly had ample opportunity

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44/ The full quote, with the omitted portions emphasized, reads:

> Evidence which was found to be lacking in the Underwood and Bass cases is present here. These decisions are not authority for the conclusion that where a corporation manufactures in one State and sells in another, the net profits of the entire transaction, as a unitary enterprise, may be attributed, regardless of evidence, to either State. In the Underwood case, it was not decided that the entire net profits of the total business were to be allocated to Connecticut because that was the place of manufacture, or, in the Bass case, that the entire net profits were to be allocated to New York because that was the place where sales were made. In both instances, a method of apportionment was involved which, as was said in the Underwood case, "for all that appears in the record, reached, and was meant to reach, only the profits earned within the State." The difficulty with the evidence offered in the Underwood case was that it failed to establish that the amount of net income with which the corporation was charged in Connecticut under the method adopted was not reasonably attributable to the processes conducted within the borders of that State; and in the Bass case the court found a similar defect in proof with respect to the transactions in New York.

283 U.S. at 132, 133.

to do so. They alone have access to their own detailed internal accounting information, and in Exxon v. Wisconsin and Exxon v. South Carolina, Exxon was able to disclose exactly how much income it earned in a particular state. 45/ Nonetheless, here the companies have declined to undertake what they have called "an elaborate showing," resting instead on the alleged theoretical failings of separate accounting. R. 12763. Indeed, they have not even placed their tax returns in the record.

The companies have amassed a compendium of affidavits describing various activities that occur outside Alaska, and which they believe are responsible for a portion of the AS 43.21 tax base. A summary of those functions consumes much of the companies' brief. Noticeably lacking, however, is any suggestion of the profits attributable to those activities -- or, for that matter, any evidence that these activities were profitable at all. The point is best illustrated by the "dramatic" examples highlighted at pp. 25-26 of the companies' brief:

1) Counsel assert that Arco's Alaska profits have increased as a result of reversing the flow of the Line 90 pipeline. That pipeline does not even carry Alaska crude, and

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45/ Exxon Corp. v. Wisconsin Dep't of Revenue, 447 U.S. 207 (1980), transcript of 1974 hearing before Tax Appeals Comm'n at A193 and A204; Exxon Corp. v. South Carolina Tax Comm'n., 258 S.E.2d 93 (1979), dismissed for want of substantial federal question, 447 U.S. 919 (1980), Exxon's Jurisdictional Statement to the United States Supreme Court at 5.

the record gives no indication of any particular savings attributable to that pipeline. R. 13075, 13637-38.

2) Alaska profits, counsel argue, are in part the result of a "slugging" technology developed elsewhere. Exxon's affiant, however, acknowledges that the technology has not been used for Alaska activities, saying only that if it were used in the future, it might result in some savings. R. 13866-67.

3) According to counsel, the Puerto Amuelles terminal is responsible for "millions of dollars" of Sohio profits which are included in the AS 43.21 tax base. Sohio's affiants, however, do not allege that Sohio even owns or financed that terminal, or that it has saved Sohio any money whatsoever. R. 13353, 13417.

4) Arco's AS 43.21 tax base, counsel say, includes Arco profits attributable to a drag reduction additive developed elsewhere. Arco's affiant, however, does not allege that Arco developed that additive, much less that it resulted in any particular income. R. 13568-69.

Apparently, this is the best that the companies can offer. 46/ Indeed, among the companies' affidavits, only the

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46/ Alternatively, the companies offer a comparison between the UDITPA factors of Arco and Sohio and the percentages of their book and federal taxable income which was taxed by AS 43.21 during 1978-80. C.B. at 50. The federal taxable income comparison (85% for Arco and 106% for Sohio) is meaningless. That measure of income includes numerous advantages such as early continued affidavit of William Baumol addresses the issue of quantifying misattributed profits. R. 13021-13068. Baumol states that Alaska's "overattribution" of income to itself, including the alleged capture of profits from out-of-state activities, "cannot be exactly measured but may well be extremely large." R. 13031. He suggests that the state be required to demonstrate the insignificance of these activities.

Although it is plainly not Alaska's burden to do so, the state accepted Mr. Baumol's invitation. Its affidavits show that the companies' own measures of Alaskan production income -- as reported in their filings with the United States Department of Energy and the Securities and Exchange Commission; in their tax returns filed in other states; and in their reports to the United States Census Bureau -- all calculate their Alaskan production

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46/ continued
depreciation, deduction for intangible drilling costs and the like which are not incorporated into AS 43.21. More importantly, profits in Alaska may be offset by losses in other states. In Webb Resources, Inc. v. McCoy, Kansas attributed 137% of the taxpayer's federal taxable income to that state by separate accounting. 401 P.2d at 891. The court merely noted that "the taxpayer's profitable business is located in Kansas" while its "expenses are being incurred primarily in other states." Id. The book income comparisons (46% for Arco and 91% for Sohio) fare no better; the companies have not told this court what they believe thay earned in Alaska or any other state, and the percentages cited in their brief may, in fact, represent precisely Alaska earnings. Finally, the comparison between UDITPA and separate accounting merely confirms the legislature's finding that UDITPA seriously underattributes oil production income to the state. See Charts 3 and 4.

income as equal to or as much as 20% greater than the AS 43.21 tax base. 47/ Moreover, that same evidence suggests that the contribution of outside activities to Alaskan income was *de minimis*, amounting to a conceivable misattribution of income of less than 1%. 48/

The companies took issue in the superior court with the state's affidavits, claiming that they were unreliable and irrelevant. Yet even assuming that this were true, and the state's evidence were discounted, this would still leave nothing on the companies' side of the evidentiary ledger. The burden of proof is upon them, and their failure to raise a genuine issue of fact inevitably resulted in the grant of summary judgment.

III. SINCE AS 43.21 IS FAIRLY APPORTIONED, IT DOES NOT IMPOSE AN IMPERMISSIBLE THREAT OF MULTIPLE TAXATION.

The very purpose of the fair apportionment test is to minimize or avoid multiple taxation. "Logically, it is impossible when the tax is fairly apportioned, to have the same income taxed twice." *Northwestern States Portland Cement Co .v.*

47/ Because some of this information was received under a protective order, it was submitted to the lower court under seal. A chart showing how these other measures compare with AS 43.21 appears at R. 16833. *See also* R. 16912-17 (Deakin).

48/ *Id.* at 16921-22 (Deakin).

Minnesota, 358 U.S. 450, 462 (1959). Thus, if the taxing state has made an honest effort to estimate in-state income, it has done all that the Commerce Clause demands. Container, 77 L.Ed.2d at 564-65.

In the practical world, where different division-of-income methods may be used, the potential for overlapping taxation exists despite fair apportionment by each state. The threat -- or reality -- of overtaxation lies not in any intrinsic fault with any of those divergent systems, but is simply the result of those systems being different. Only by imposing a uniform and detailed tax code could overlapping taxation be avoided. For reasons discussed before, that is a task the Court will not undertake.

Container disposes of the companies' multiple taxation arguments, holding that precisely the same friction alleged to exist in this case -- that is, the use of separate accounting by one jurisdiction and a formula by another -- in fact creates no friction at all. After determining that California's three factor formula was fair, the Court turned to whether California was obligated to exclude separately accounted foreign income from its formula in order to avoid double taxation.

The Court, relying on Moorman, held that if the disparity of systems were "entirely domestic," rather than international, that disparity would "make little constitutional difference ...." 77 L.Ed.2d at 556, 566.

In view of the international implications, however, the Court applied "additional scrutiny" to the differing methods. 77 L.Ed.2d at 566. Even under that intensified scrutiny, however, the Court found that (1) there was no "automatic asymmetry" between the two, and (2) the two methods of apportionment were equally fair means of measuring income:

> [I]t would be perverse, simply for the sake of avoiding double taxation, to require California to give up one allocation method that sometimes results in double taxation in favor of another allocation method that also sometimes results in double taxation.

77 L.Ed.2d at 571.

Container strips the companies of the theoretical underpinning of their principal multiple taxation arguments. These claims are: (1) if every state applied Alaska's tax laws, multiple taxation would inevitably result; and (2) because Alaska taxes 100% of oil production income earned in the state -- income that other states are also allowed to tax -- AS 43.21 inevitably results in multiple taxation. C.B. at 29-41. This second argument is made both as a matter of theory and purported "fact." Thus, various affidavits purport to demonstrate, inter alia, that while Alaska taxes 100% of North Slope production income, other states which employ a formula method tax 30% of that same income. The result, the companies say, is that as much as 130% of the companies' production income from Alaskan oil is being taxed in the aggregate.

These arguments hinge on the validity of the companies' assertion that Alaska, by separately accounting Alaska oil production income, and other states, by using a formula that apportions a percentage of worldwide income, are reaching the same income. If that were true, there would exist an "automatic asymmetry" (Container, 77 L.Ed.2d at 572) similar to that present in the property tax case of Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434 (1979). In that case, Japan, without apportionment, taxed the entire value of certain cargo containers. Because Japan taxed the full value of those containers, the Court held -- in the interest of international tax symmetry -- that even though California's tax was fairly apportioned, it could not tax a portion of the value of the same containers. Otherwise, two jurisdictions would be taxing more than 100% of the same value.

From the outset, the companies have rested their multiple taxation claims on their belief that the same friction that existed between Japan and California is present when one jurisdiction uses separate accounting and another uses formula apportionment. This is clearly not the case, as the Court held in Container:

> In Japan Line, we relied strongly on the fact that one taxing jurisdiction claimed the right to tax a given value in full, and another taxing jurisdiction claimed the right to tax the same entity in part -- a combination resulting necessarily in double taxation. 441 U.S., at 447, 452, 455. Here, by contrast, we are faced with two distinct methods of allocating the income of a multi-national enterprise. The "arm's-length"

> approach divides the pie on the basis of formal accounting principles. The formula apportionment method divides the same pie on the basis of a mathematical generalization. Whether the combination of the two methods results in the same income being taxed twice or in some portion of income not being taxed at all is dependent solely on the facts of the individual case.

77 L.Ed.2d at 568.

Thus, separate accounting of income, unlike a property tax, simply takes the whole of a portion, as formulas take a portion of the whole. In Container, California included Bolivia income in its apportionable base. That does not mean, however, that California taxed a portion of income which Bolivia, through its separate accounting, had already taxed in full. Instead, it merely looked at all the company's income as a first step in calculating California earnings. Similarly, Alaska, through separate accounting, is not taxing anything that other states also have a right to tax. As in Container, this case "involves a tax on income rather than a tax on property" -- a fact which makes it "clearly distinguishable." 77 L.Ed.2d at 568.

There is nothing remarkable or improper about Alaska -- or any other state -- taxing 100% of the income that it determines is earned within the state. Every state that uses UDITPA taxes 100% of the income attributed to it by the three-factor formula.

Conversely, no other state has a right to tax a share of the oil production income earned in Alaska. The fact that the companies' worldwide income, including Alaska income, is used in the tax base of the formula method does not mean that states using that method are licensed to or do engage in extraterritorial taxation. A 2% apportionment fraction in Wisconsin does not mean that Wisconsin is entitled to tax 2% of Exxon's profits in every other state, including Alaska. It means, instead, that 2% of Exxon's sales, property, and payroll are located in Wisconsin, and that inasmuch as income is presumed to follow these factors in precise proportion, Wisconsin may therefore presume that 2% of Exxon's overall income was earned in the state. Wisconsin no more taxes 2% of Exxon's income in each other jurisdiction than it foregoes taxing 98% of Exxon's income earned in Wisconsin.

The companies' misuse of Japan Line likewise explains their view of Mobil Oil Corp. v. Comm'r of Taxes of Vermont, 445 U.S. 425 (1980), and Exxon Corp. v. Wisconsin Department of Revenue, 447 U.S. 207 (1980). These cases involved claims that the Commerce Clause prohibits certain categories of income from being included in the apportionable base of the UDITPA formula. In Mobil, the exclusion sought by the taxpayer was premised on the legal fiction of the situs of intangibles. The taxpayer in that case argued that Vermont was required to exclude from its apportionable base all dividend income received from the taxpayer's unitary subsidiaries -- on the theory that intangible income should be deemed earned in the state of commercial domicile. The Court's response to this attempt to erode the unitary theory on the basis of "talismanic" fictions was predictable, and as the dissent noted, makes the case rather "unremarkable." 445 U.S. at 445. Mobil, then, had nothing to do with separate accounting.

In Exxon, the taxpayer urged that because its oil production income in one state could be accurately estimated by the taxpayer's own separate accounting, the Commerce Clause required all other states to excise that income from their formulary base. Again unremarkably, the Court held that, because Exxon's operations were unitary, each state could look to all of Exxon's profits as a first step in calculating that state's income.

The companies argue that Mobil and Exxon stand for the proposition that separate accounting is prohibited by the Commerce Clause, relying upon the statement in Mobil that fictional situsing of dividend income is "theoretically incommensurate" with apportionment (445 U.S. at 444), and the observation in both Mobil and Exxon that states are entitled to deference in defining the scope of the unitary business and need not recognize any "exclusive" right of certain states to tax segments of that unitary income. 445 U.S. at 446; 447 U.S. at 229-30. From that language, the companies jump to their conclusion that when Alaska has "exclusively" taxed income through separate accounting, it has done something "theoretically incommensurate" with other states' use of a formula. In other words, they argue that the "automatic asymmetry" of Japan Line is present here as well.

Container presented the facts that would have proved the companies' theory, if it were correct. The foreign jurisdictions in that case taxed the foreign income "in its entirety" by separate accounting. California then included that foreign income in its UDITPA apportionable income. As in Japan Line, the United States Supreme Court could not force the foreign jurisdictions to change. Also as in Japan Line, foreign commerce was involved, requiring "additional scrutiny." Finally, as in Japan Line, the foreign tax method was the international norm. If the two different methods were "theoretically incommensurate," or caused the "automatic asymmetry" present in Japan Line, then the Court would necessarily have stricken California's otherwise fair tax. Instead, the Court affirmed what Alaska has argued in this case -- that formula apportionment and separate accounting are simply two alternative ways to divide the same pie, and any asymmetry "depend[s] solely on the facts of the individual case." 77 L.Ed.2d at 568.

Mobil and Exxon are unexceptional extensions of an unbroken line of income tax cases that have allowed states wide latitude in fashioning their income tax systems. As noted by Professor Walter Hellerstein, a scholar relied upon by the companies, these cases have only a positive impact on the validity of AS 43.21:

> While Mobil and Exxon gave broad approval to formulary apportionment as a constitutionally permissible method of determining a corporation's state income tax base, those decisions did not

> denigrate all other methods the state might choose. Indeed, both Mobil and Exxon reflect the Court's long-standing view that the states enjoy broad leeway in their choice and implementation of division-of-income methods.
>
> It is true ... that Mobil implicitly ... indicated a constitutional preference for apportionment of ... dividends. But that was only because the two competing methods of income division at issue -- specific allocation to a single situs and formulary apportionment among the states -- were "theoretically incommensurate." By contrast, there is nothing "theoretically incommensurate" about separate accounting and formulary apportionment.
>
> Both methods recognize that more than one state may legitimately tax a share of a multistate enterprise's income, although they employ different techniques for determining that share. The Court's opinions thus provide doctrinal support for the proposition that the Constitution is indifferent to a state's choice of separate accounting versus formulary apportionment as a division-of-income method, and this certainly strengthens the case for Alaska's choice of separate accounting in AS 43.21.

R. 17092-93. Other commentators, including those also relied upon by the companies, agree. 49/

49/ See Recent Developments, State Taxation of Foreign-Source Income: Mobil Oil Corp. v. Commissioner of Taxes, 66 Cornell L. Rev. 805 at 807 n.13 (1980); The Supreme Court: 1979 Term, 94 Harv. L. Rev. 75 at 117 n.3 (1980); Recent Development, Taxation: Inclusion of Foreign Source Dividend Income in State Apportionment Formula, 22 Harv. Int'l. L.J. 492 n.1 (1981). The commentators lend more support to the state's position than they do the companies'. For example, they generally agree that the burden is on the taxpayer to demonstrate actual multiple taxation, and even if the taxpayer sustains that burden, some degree of multiple taxation is nevertheless constitutionally permissible. Recent Developments, State Taxation of Foreign-Source Income: Mobil Oil Corp. v. Commissioner of Taxes, supra at 809 n.19, 816 n.57, n.58; The Supreme Court: 1979 Term, supra at 122 n.40; Recent Development, Taxation: Inclusion of
continued

By blindly insisting that Mobil and Exxon hold that separate accounting poses the same "automatic asymmetry" created by the unapportioned property tax in Japan Line, the companies feel free to attack AS 43.21 on the basis of property and gross receipts tax cases, which simply do not bear on the issues presented by this appeal. The property tax cases cited by the companies all involve the taxation of property that moves from state to state: rolling stock, trucks, airplanes, barges, etc. It is unquestionably true that the Court has consistently prohibited any one state from taxing the full value of transient property, as it would have prohibited Japan's tax in Japan Line if imposed by a state. However, as the Court ruled in Container:

> We distinguished property from income taxation in Mobil Oil Corp., 445 U.S. at 444-446, and Exxon Corp., 447 U.S. at 228-229, suggesting that "[t]he reasons for allocation to a single situs that often apply in the case of property taxation carry little force" in the case of income taxation. 445 U.S. at 445.

The companies claim that AS 43.21 is indistinguishable from the state-of-origin gross receipts taxes found void in Evco v. Jones, 409 U.S. 91 (1972), J. D. Adams Mfg. Co. v. Storen, 304

49/ continued
Foreign Source Dividend Income in State Apportionment Formula, supra at 493, 496 n.36. These commentators also generally agree with the state that the courts show great deference to the states in the implementation of state tax policy. Hellerstein, supra, 79 Mich. L. Rev. at 118, 171; Recent Developments, State Taxation of Foreign-Source Income: Mobil Oil Corp. v. Commissioner of Taxes, supra at 817; Taxation of Multistate Corporations -- Mobil, Exxon, and Colorado, 9 Colo. Law 2058, 2059 (1980).

U.S. 307 (1938), and Gwin, White & Prince, Inc. v. Henneford, 305 U.S. 434 (1939). This argument is without merit for three reasons.

First, AS 43.21 is not a gross receipts tax; it is a tax on net income. From 1977 to 1981, the gross receipts from the ultimate sale of a barrel of Alaska oil averaged $26.00. The per barrel AS 43.21 tax base in those years, however, was $6.77. See Chart 1.

Second, inasmuch as gross receipts taxes are different from net income taxes, different apportionment rules have emerged. 50/ The Supreme Court

> [H]as taken the position that the difference between taxes on net income and taxes on gross receipts from interstate commerce warrants different results. Further, the rationale of the decisions striking down taxes involving gross receipts has not been applied to taxes imposed on net income derived from interstate commerce.

P. Hartman, Federal Limitations on State and Local Taxation 461 (1981). Thus, while a state-of-origin gross receipts tax is prohibited, an income tax using a state-of-origin sales factor is not. International Harvester Co. v. Evatt, 329 U.S. 416 (1947).

50/ Gross receipts taxes are imposed on the entire value of the final product, including any value that may have been added by other states through transportation, processing, packaging and marketing. Thus, a tax by either the origin or the destination state is, by its very nature, unapportioned. Therefore courts have established an admittedly arbitrary rule allowing only the destination state to levy the tax. Douglas v. Glacier State Telephone Co., 615 P.2d 580 (Alaska 1980).

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Third, even if AS 43.21 were a gross receipts tax, it would be constitutional. The Court has always distinguished between a gross receipts tax on interstate sales and a tax on manufacturing or production activities measured by gross receipts from interstate sales. P. Hartman, supra at p. 443. A gross receipts tax on oil production income is simply a severance tax; it is constitutional even though the measure of the tax is receipts from interstate sales. Commonwealth Edison v. Montana, 453 U.S. 609, 617 (1981).

As a result, the companies' premise that AS 43.21 taxes a base that other states have a right to tax is meritless. So, then, are their sundry factual claims. Their affidavits purporting to show "130% multiple taxation" are nothing more than illustrations of their erroneous premise that states using a formula method of apportionment are "taxing a share" of income earned in Alaska. Other states, with an aggregate apportionment fraction of 30%, do not tax, nor are they entitled to tax, 30% of the AS 43.21 tax base.

The companies' "internal consistency" argument 51/ is also based upon the assumption that separate accounting and

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50/ continued
Additionally, gross receipts tax liability arises even if the taxpayer incurs a loss, and this tax is thus "inherently more burdensome than income tax[es]." Moorman, 437 U.S. at 281.

51/ The companies' "internal consistency" argument arises out of the combination of AS 43.20 and AS 43.21. Because the former continued formula apportionment are automatically asymmetrical -- a view precluded by Container. The fact is that if all states were to adopt Alaska's taxing system no more than 100% of all income would be taxed -- notwithstanding the use of separate accounting under AS 43.21 and the use of a three-factor formula under AS 43.20.

The "internal consistency" requirement referred to in Container has its origin in W. Beaman, Paying Taxes to Other States: State and Local Taxation of Non-Resident Businesses at ¶ 3.20 (1963). Beaman makes it clear, as does the Court in Container, that the test is theoretical in nature -- proceeding as it does from a hypothetical, and focusing on whether overtaxation will logically and necessarily result. The test, as Beaman explains, would be violated if a state used an origin factor for sales originating in the state and a destination factor for sales consummated in the state. The combination of

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applies to a unitary group of corporations and the latter only to the corporation that produces oil, an AS 43.20 taxpayer (for example, Arco's marine transportation subsidiary) may be unitary with an AS 43.21 taxpayer. If, and only if, (1) the income from AS 43.21 production activities is included in the calculation of the AS 43.20 taxpayer's tax liability (which it is not, as discussed below); (2) the unitary business has a separate production subsidiary (which Exxon does not); and (3) the production activities are more profitable than the overall business of the unitary taxpayer, then that combination, if applied everywhere, could lead to multiple taxation.

Of course, if all of a taxpayer's Alaska activities are carried out by a single AS 43.21 corporation, all production income is explicitly excluded from the calculation of "other" income. AS 43.21.040.

these two formulas by every state would inevitably lead to 200% of all income being taxed.

Necessarily, the companies' affidavits, which purport only to show that -- for these particular taxpayers, with this particular corporate structure, in these particular years -- the universal adoption of Alaska's system would result in over-taxation, are irrelevant. For different taxpayers, with different corporate structures, under different economic conditions, undertaxation would result. These affiants' conclusions are therefore "dependent solely on the facts of the individual case." Container, 77 L.Ed.2d at 568 and are of no legal significance.

At the present time, production activities are more profitable industry-wide than are other activities. In Container, the Court accepted the obvious fact that if the more profitable components of an industry -- in that case its foreign operations -- are separately accounted, while less profitable segments are subjected to a formula, aggregate overtaxation might well result. 77 L.Ed.2d at 564-65. See Union Oil Co. of California v. State, Dep't of Revenue, ___P.2d___, Op. No. 7389 at 5 n.3 (February 10, 1984). This is the point of the Tompkins Affidavit (R. 13744-46; C.B. at 52-53), which, through 24,000 hypothetical computer runs, shows that the universal adoption of Alaska's tax system would be more likely to result in overtaxation as relative production profits increase.

The issue, then, is whether this demonstrates an inevitability of overtaxation from the universal adoption of Alaska's system. According to the dissent in Container, it does; given current economic conditions, overtaxation is "the logical expectation in a large proportion of the cases." 77 L.Ed.2d at 577 (Powell, J., dissenting). According to the majority, however, this is not enough. The Court is concerned only with "automatic asymmetry" caused by intrinsic theoretical inconsistency. 77 L.Ed.2d at 572. Thus, the taxpayer's individual circumstances are no more pertinent when they are recast -- through vehicles like the Tompkins affidavit -- as typical of current industry conditions.

Indeed, economic conditions can change. A drop in OPEC crude prices, unaccompanied by lower prices at the pump, may well make production profits disproportionately small in years to come, which means that Alaska's tax system would -- if universally adopted -- tend to undertax income in the aggregate. Thus, under the companies' view, Alaska's system may be facially and intrinsically invalid in 1978, but facially and intrinsically valid in 1990. That is a misuse of the internal consistency test, and the companies' affidavits do not prove their intended point.

What is of even greater importance, however, is that Tompkins -- like his counterparts at Exxon (Oscar Jones) and Sohio (E. Wayne Tanner) -- has based his affidavit on an erroneous interpretation of AS 43.20. See R. 13742-13808, 14204-08, and 13454-56 respectively. Properly interpreted, that law removes even the practical possibility of overtaxation caused by current industry circumstances. It does so because, in calculating AS 43.20 income, all production income everywhere is excluded from the apportionable base -- precisely the result demanded by the taxpayer in Container.

Alaska Tax Ruling 82-2 (ATR 82-2) recognized that, in enacting AS 43.21, the legislature chose to view production income as properly apportionable by the separate accounting method. 52/ Accordingly, the legislature intended to exclude production income from the apportionable base of AS 43.20. Each of the companies' affidavits, however, assumes that production income is included in the AS 43.20 tax base. This erroneous assumption makes the affidavits simply irrelevant.

The companies quarrel with the validity of ATR 82-2, raising procedural objections under the Administrative Procedures Act (AS 44.62). These arguments, however, fail to recognize that the ruling was not an exercise in rulemaking, but rather an

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52/ Alaska Tax Ruling 82-2 was adopted in the context of determining the AS 43.20 liability of Alaska Interstate Co. That company's AS 43.21 liability had already been determined under Rev. Dec. 81-29 which, contrary to the companies' assertion (C.B. at 53), specifically did not interpret AS 43.20. R. 17267. Thus, the first time the issue was raised before the department, the department ruled in favor of the taxpayer. That ruling was accepted by the department and incorporated into the superior court decision in AIA v. State of Alaska, No. 3AN-81-7286 (Super. Ct., 3rd Jud. Dist. at Anchorage, 1982).

adjudicatory decision adopted by the superior court. Thus, the arguments are indistinguishable from those rejected by this court in Wien Air Alaska, Inc. v. Dep't of Revenue, 647 P.2d 1087 (Alaska 1982). The validity of ATR 82-2 is not and cannot be a subject of this suit. The companies are not contesting their tax liability under AS 43.20; nor are they in a position to challenge ATR 82-2. Under that ruling, each of these companies will receive a substantial refund.

The companies' make one argument regarding ATR 82-2 that is silly. Recognizing that the internal consistency test is hypothetical, they ask the court to assume -- hypothetically -- that every state would adopt both AS 43.20 and AS 43.21. C.B. at 57. They then suggest, however, that the court should not assume that every state would interpret AS 43.20 as Alaska does, because that would be hypothetical. Id. The argument merits no response.

The companies' last multiple taxation argument is that if the UDITPA factors attributable to Alaska production, and the AS 43.21 tax base, are subtracted from the formulas of other states, the tax bases of those formula states will drop. C.B. at 57. This, they believe, shows that AS 43.21 has resulted in multiple taxation. In truth, it shows merely that, under the current economic circumstances of these companies, production profits are disproportionate to production factors -- leading to a result, as we have seen, which is "dependent solely on the facts of the individual case." Container, 77 L.Ed.2d at 568.

In conclusion, as long as states use different methods to apportion income, there will be risks of over- or undertaxation of the income. As the Supreme Court has noted: "... Congress has long debated, but has not enacted, legislation designed to regulate state taxation of income." Mobil Oil Corp. v. Comm'r of Taxes of Vermont, 447 U.S. at 448. Following the introduction of numerous bills 53/ and the holding of numerous hearings 54/ Congress has not found a risk of multiple taxation sufficient to warrant the imposition of uniform rules upon the states. Thus, the companies arguments as to multiple taxation must be rejected.

53/ H.R. 11789, 89th Cong., 2d Sess. (1966); H.R. 16491, 89th Cong., 2d Sess. (1966); H.R. 2158, 90th Cong., 1st Sess. (1967); H.R. 7906, 91st Cong., 1st Sess. (1969); S. 317, 92d Cong., 1st Sess. (1971); S. 1883, 92d Cong., 1st Sess. (1971); S. 4080, 92d Cong., 2d Sess. (1972); H.R. 977, 93rd Cong., 1st Sess. (1973); S. 1245, 93rd Cong., 1st Sess. (1973); H.R. 9, 94th Cong., 1st Sess. (1975); S. 2080, 94th Cong., 1st Sess. (1975); H.R. 669, 95th Cong., 1st Sess. (1977); H.R. 5, 96th Cong., 1st Sess. (1979); S. 983, 96th Cong., 1st Sess. (1979); H.R. 6402, 97th Cong., 2d Sess. (1982).

54/ State Taxation of Interstate Income: Hearings Before the Senate Select Comm. on Small Business, 86th Cong., 1st Sess. (1959); State Taxation of Interstate Commerce: Hearings on S.J. Res. 113, S. 2213 and S. 2281 Before the Senate Finance Comm., 86th Cong., 1st Sess. (1959); Hearings on H.R. 11798 Before the Special Subcomm. on State Taxation of Interstate Commerce of the House Judiciary Comm., 89th Cong., 2d Sess. (1966); Hearings Before the Subcomm. on State Taxation of Interstate Commerce of the Senate Finance Comm., 93rd Cong., 1st Sess. (1973) (cited in text as "the Mondale Committee"); Interstate Taxation: Hearings on S. 2173 Before the Senate Judiciary Comm., 95th Cong., 1st and 2d Sess. (1977-1978); State Taxation of Interstate Commerce and Worldwide Corporate Income: Hearings on S. 983 and S. 1688

continued

IV. THE COMPANIES' EQUAL PROTECTION CLAIM AMOUNTS TO AN ERRONEOUS ACCUSATION OF IMPROPER PURPOSE.

A. Introduction and Legal Standard

In enacting AS 43.21 after some four years of intensive debate, the legislature explained its intended goals -- to cure UDITPA's inability to accurately measure the oil production income of a multistate taxpayer, and to ensure that the effective tax rate paid by multistate oil companies approached the 9.4% rate applicable to all taxpayers. Sec. 1, ch. 110, SLA 1978.

The companies' response is two-fold:

1) The words of sec. 1, ch. 110, SLA 1978 are lies, and conceal a hidden motive to subject multistate oil companies to "specially heavy taxation" (C.B. at 60); and

2) Less discriminatory alternatives exist to accomplish the legislature's intended goals -- a point made both as an ostensible separate basis for invalidating the law, and as evidence of the legislature's alleged insincerity.

As a matter of legislative history, the companies are wrong on both counts. Moreover, as a matter of law, the companies' claims are irrelevant.

54/ continued
Before the Subcomm. on Taxation and Debt Management Generally of the Senate Finance Comm., 96th Cong., 2d Sess. (1980).

Alaska's equal protection standard involves a three-step analysis:

1) first, the nature of the constitutional interest involved must be identified;

2) second, in light of that interest, the validity of the purposes of the statute must be analyzed; and

3) third, also in light of that interest, an analysis must be made of whether the means chosen have a sufficient relationship to the goals of the statute.

ALPAC v. Brown, ___P.2d___, Op. No. 2789 at 10-11 (February 17, 1984). The importance of the interest involved is "the most important variable in fixing the appropriate level of review," and determines the degree of scrutiny required under the remaining components of the test. Id. at 10.

The companies have not, and do not quarrel with the fact that freedom from disparate taxation lies at the low end of those interests protected by the Equal Protection Clause. 55/ The state noted below -- without disagreement -- that in tax cases since Isakson v. Rickey, 550 P.2d 359 (Alaska 1976), this

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55/ Tax laws have certainly received minimal scrutiny under federal law. As the United States Supreme Court recently stated, "[l]egislatures have especially broad latitude in creating classifications and distinctions in tax statutes." Regan v. Taxation With Representation, ____U.S.____, 76 L.Ed.2d 129, 138 (1983). See also Austin v. New Hampshire, 423 U.S. 656, 661-62 (1975); Kahn v. Shevin, 416 U.S. 351, 355 (1974); Allied Stores of Ohio, Inc. v. Bowers, 358 U.S. 522, 526-27 (1959); Welch v. Henry, 305 U.S. 134, 144-45 (1938); Carmichael v. Southern Coal & Coke Co., 301 U.S. 495, 509, (1937).

court has applied little more than the traditional rational basis standard of review, finding it unnecessary to undertake that balancing of means and interest which is integral to state equal protection analysis involving more substantial rights. Pharr v. Fairbanks North Star Borough, 638 P.2d 666 (Alaska 1981); Ketchikan Gateway Borough v. Breed, 639 P.2d 995 (Alaska 1981); State v. Reefer King Co. Inc., 559 P.2d 56, 65 (Alaska 1976). See also Williams v. Zobel (Zobel I), 619 P.2d 422, 427 (Alaska 1980).

The companies have not asserted that the legislature's stated goals are illegitimate, or that the means chosen by the legislature are unfairly or insubstantially related to these ends. They have, in short, failed to make an equal protection claim. The companies portrayal of a dishonest legislature conspiring to single them out for specially heavy taxation is meant less to fit equal protection protocol, and more to make weight. 56/

56/ To that end, the companies imply that certain briefs written by the Attorney General in other cases "prove" that the legislatures' motives in enacting AS 43.21 were dishonest. C.B. at 62-64. According to them, if the Attorney General has ever defended the economic theory underlying UDITPA, the legislature is bound to accept that theory both before and after the brief is written. The companies have it backwards: the legislature enacts the laws, and the Attorney General enforces and defends them.

Moreover, the companies are hardly in a position to complain of inconsistency. They have not explained why their economic theories vary from year to year, and continue to vary from state to state. Each of these companies, for example, persistently tried to file separate accounting returns in Alaska when UDITPA was required by statute. R. 873-1198.

B. The Record Amply Demonstrates That The Legislature's Statutorily Identified Purposes Were Genuine.

The companies claim that the stated purposes of AS 43.21 (1) could not have been real because there were other means of accomplishing those ends; or (2) even if real, those purposes were not dominant. The companies shamelessly allege that the legislature's conclusion that UDITPA would underestimate oil income is "not supported by the record." C.B. at 66-67. They further assert that it is "unlikely" that the legislature was concerned about tax equity. C.B. at 68. These statements are simply wrong, and presume that this court will heed the companies' advice to ignore the legislative history before it. C.B. at 65. The legislature's consideration of the shortcomings of UDITPA for oil production income, and its concern with tax equity have been set out in Section I and Appendix C to this brief. Additionally, Appendix B lists 75 of the major documents that support the legislature's conclusions. Finally, between pages 1628 and 9923 of the record on appeal this court will find ample evidence, from many qualified and objective experts, supporting the legislature's conclusions.

The companies claim that the real motive behind AS 43.21 was the legislature's desire "to extract the maximum amount of money from the oil industry, and to shift from Alaska residents to the oil industry the burden of satisfying Alaska's revenue goals." C.B. at 69. 57/ For this proposition, the companies cite the opinion testimony of certain witnesses before the legislature. It should be recalled, however, that the legislative process leading to the enactment of AS 43.21 spanned four years. The state has assembled and submitted every document and transcript related to that debate, a record of some 8,300 pages. The state did not selectively include only those documents that buttress its litigation position. As a result, it is not surprising that one can find comments which would support a variety of alleged motives. Indeed, it is the very function of the legislative hearing process to encourage the expression of divergent views.

Over the course of some 63 hearings, the legislature was told by every conceivable interest what to do, and why it should do it. When it enacted AS 43.21, however, the legislature made its intent perfectly clear in section 1, chapter 110, SLA 1978. As this court has stated, a search for "real"

57/ Similarly, the companies argue that AS 43.21 should receive extra scrutiny because it is "tailored." C.B. at 47-48. The term "tailored tax" is used in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 289 n.15 (1977) to describe those state laws that impose peculiar tax burdens on particular industries. AS 43.21 is not a "tailored tax." It was enacted to end discrimination, not to create it. The tax was designed to equalize the tax rate paid by all industries in Alaska, and to end the advantage given to the oil industry, which was taxed at a much lower effective rate than any other industry. See sec. 1, ch. 110, SLA 1978.

legislative motive would transform equal protection jurisprudence "into a parade of legislator's affidavits containing their perceptions" of that motive. Alaska Public Employees Association v. State, 525 P.2d 12, 16 (Alaska 1974). See also Union Oil Co. v. Dep't of Revenue, 560 P.2d 21 (Alaska 1977), Lynden Transport, Inc. v. State, 532 P.2d 700, 716 (Alaska 1975). Thus, in Minnesota v. Clover Leaf Creamery Co., 449 U.S. 456 (1981), the Supreme Court refused to consider evidence of a discriminatory purpose, holding:

> In equal protection analysis, this Court will assume that the objectives articulated by the legislature are actual purposes of the statute, unless an examination of the circumstances forces us to conclude that they "could not have been a goal of the legislation".

449 U.S. at 463 n.7 (citations omitted). The same principle, the Court held, applied to the appellee's Commerce Clause challenge.

C. Once a Legitimate Purpose is Identified, The Legislature is Not Required to Choose the Means Most Favorable to The Taxpayers.

The companies ask this court to examine the means chosen by the legislature under a "least restrictive alternative" analysis. That is entirely inappropriate in a minimal scrutiny case such as this. "Less drastic means," as Professor Ed Gunther has pointed out, is only used by the United States Supreme Court when strict scrutiny is required. Under State v. Ostrosky, 667 P.2d 1184 (Alaska 1983) and ALPAC v. Brown, this analysis would be appropriate only when the nature of the constitutional right involved is extremely weighty. 58/ Here the nature of the right involved is insubstantial. There is no basis for "less drastic means" analysis.

Moreover, AS 43.21 actually furthers the legislature's goals more effectively than any available alternative -- including the modified formula suggested by the companies. C.B. at 67. Modifying UDITPA was, in fact, the principal alternative considered by the legislature. It was rejected because it did not further the legislature's goals. As discussed in Section I, the legislature concluded that separate accounting better achieves tax equity among oil-producing corporations than does any apportionment formula. Under any formula, the same Alaska properties operated by differently structured corporations produced vastly different tax results. R. 1934-35 [D. 8-018, F. 4 at 15-16]. *See* Chart 4.

Finally, the companies claim that they are entitled to special protection because their "potential influence [is] limited" in Alaska. C.B. at 60. This argument is without merit.

Multinational corporations are not a suspect class. It is true that these companies cannot vote; nor can any corporation. Corporate influence is exercised through the participation of employees in the political process, and by

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58/ *See* Gunther, *Forward: In Search of Evolving Doctrine on A Changing Court: A Model for a Newer, Equal Protection*, 86 Harv. L. Rev. 1, 21 (1972).

lobbying. In this regard: out of $2,352,203.29 spent by various organizations to influence legislative or administrative action during the 1978 Alaska legislative session, AS 43.21 taxpayers spent 49%, or $1,178,688.56. APOC 1978 Annual Report, Table 47.

The oil industry was also well represented in the political process during the deliberation and passage of AS 43.21. Dozens of oil industry representatives made the concerns of the industry known during the four years of legislative deliberation. 59/

59/ All together 95 separate documents in the legislative history involve industry comment. See "Author Index" under "Industry" for a complete listing of industry presentations to the legislature. R. 10868-10986. See for example, testimony of Crawford Thomas of the Alaska Oil and Gas Association (AOGA), R. 2384-95]D. 8-126, F. 5]; of Gary Boren (AOGA), R. 2188-2203 [D. 8-026, F. 5]; R. 2206-13 [D. 8-028, F. 5]; R. 2214-60 [D. 8-029, F. 5]; of John Warren for Union Oil, R. 2262-64 [D. 8-031, F. 5]; R. 2265-98 [D. 8-032, F. 5]; of Dick Donaldson of Sohio, R. 2605-30 [D. 8-050, F. 7]. The industry comments included an objection to an income tax as a disincentive to investment R. 6237-38 [D. 6-014, F. 40; R. 6242-72 [D. 6-016, F. 40; R. 7462-75 [D. 6-050, F. 43]; R. 4598 [D. 7-147, F. 27]; a request that Alaska maintain an attractive business climate R. 7413-26 [D. 6-048, F. 43]; R. 7427-61 [D. 6-049, F. 43]; a denial that the oil industry had refused to pay its fair share in taxation (R.7546 [D. 6-060, F. 43]; R. 2640-51 [D. 8-053, F. 7]); general criticisms of separate accounting (R. 4316-24 [D. 7-034, F. 26]; R. 2183-84 [D. 8-024, F. 5]; R. 2206-13 [D. 8-028, F. 5]; R. 2446-56 [D. 8-038, F. 6]); requests for no legislative change in order to stabilize taxes (R. 2605-30 [D. 8-050, F. 7]); criticism of the Tanzer Report (see R. 6039-6144, R. 7547-7553 [D. 6-061, F. 43]; R. 6311-14 [D. 6-010, F. 40]; R. 6234-36 [D. 6-013, F. 40]; R. 6277-85 [D. 6-018, F. 40]; R. 6306-27 [D. 6-021, F. 40]; R. 7222 [D. 6-034, F. 43); general comments about high tax burden (R. 8357-62, D. 6-091, F. 46); expressing preference for the then-existing system (R. 8470-73 [D. 6-112, F. 49]; R. 4109-16 [D. 7-027, F. 24]; R. 2262-64 [D. 8-031,

continued

The power to tax is a fundamental attribute of sovereignty, 60/ and the state's interest in the execution of its taxing structure is substantial. In view of the insubstantial nature of the companies' constitutional interest, the legitimacy of the purposes of the statute, and the closeness of the fit between the purposes and the statute, AS 43.21 easily meets equal protection requirements.

V. AS 43.21 DOES NOT DISCRIMINATE AGAINST INTERSTATE COMMERCE BECAUSE IT TREATS INTRASTATE AND INTERSTATE OIL COMPANIES EVENHANDEDLY.

AS 43.21 taxes all oil companies equally, no matter where they are domiciled or headquartered, and it fairly

59/ continued
F. 5]); a denial that the federal tax base was unduly eroded by federal subsidies (R. 2188-2203 [D. 8-026, F. 5]; R. 2459-2515 [D. 8-041, F. 6]; opinions that oil industry high profitability was a myth (R. 8709-23 [D. 6-146, F. 54]; R. 4292-4305 D. 7-032, F. 26]); opinions that stable oil tax policy would promote employment (R. 3183-3191 D. 8-106, F. 17]); comments on potential legal problems of separate accounting (R. 4122-82 D. 7-029, F. 25]; R. 4117-18 D. 7-028, F. 24]; R. 4825-73 D. 7-058, F. 31]; R. 2427-2445 [D. 8-037, F. 6]); criticism of Zeifman & Ainsworth report (R. 3233-89) (R. 4183-4229 [D. 7-030, F. 25]; R. 2265-98 D. 8-032, F. 5]); criticism of the Vanik report which concluded that the oil industry paid a 2%-3%effective tax rate (R. 2206-13 [D. 8-028, F. 5]; R. 2214-60 [D. 8-029, F. 5]; R. 2427-45 D. 8-037, F. 6]; R. 2598-2601 [D. 8-048, F. 7]).

60/ Merrion v. Jicarilla Apache Indian Tribe, 455 U.S. 130, 137 (1982); Bode v. Barrett, 344 U.S. 583 (1953); Kirtland v. Hotchkiss, 100 U.S. 558 (1879); Philadelphia & Reading R. Co. v. Pennsylvania, 82 U.S. 146 (1873); Dobbins v. Comm'rs of Erie County, 16 Pet. 435, 10 L.Ed 1022 (1842) apportions income to Alaska. A state tax that is facially neutral, and that is fairly apportioned, does not discriminate against interstate commerce. Container, 77 L.Ed.2d at 556.

In Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977) the requirement of fair apportionment and the prohibition against discrimination were set out as separate tests, 61/ and indeed the two are not coterminous. Westinghouse Electric Corp. v. Tully, ___U.S.___, Slip Op. at 10 (April 24, 1984). Yet aside from forbidding "obvious" facial discrimination, the court recently held in Container that Complete Auto's prohibition against discrimination

> [M]ight have been construed to require that a state apportionment formula not differ so substantially from methods of allocation used by other jurisdictions in which the taxpayer is subject to taxation so as to produce double taxation of the same income, and a resultant tax burden higher than the taxpayer would incur if its business were limited to any one jurisdiction. At least in the interstate commerce context, however, the anti-discrimination principle has not in practice required much in addition to the requirement of fair apportionment.

61/ In Complete Auto, the Court established a four-prong Commerce Clause test. The tax will be sustained when it (1) is applied to an activity with a substantial nexus with the taxing state; (2) is fairly apportioned; (3) does not discriminate against interstate commerce; and (4) is fairly related to the services provided by the state. 430 U.S. at 277-78. The companies do not contest that they have a substantial nexus with the State of Alaska, and, as has previously been demonstrated, Alaska's separate accounting is fairly apportioned. This section deals with the companies challenges based on the third and fourth prongs of the Complete Auto test: discrimination against commerce, and the relationship of the tax to services provided by the state.

Container, 77 L.Ed.2d at 557 (emphasis added).

The companies nonetheless argue that, quite apart from AS 43.21's fairness in apportioning their income, the statute discriminates against interstate commerce because in practice it threatens to result in multiple taxation -- a burden allegedly caused by the interaction of Alaska's laws and the more prevalent UDITPA formula employed by other states. In support of that argument, the companies use precisely the same "discriminatory impact" analysis relied upon by the dissent in Moorman. 62/ As both Container and Moorman held, however, avoiding the practical consequence of multiple taxation caused by divergent state apportionment rules is a job left to Congress.

In claiming that a facially neutral, fairly apportioned tax nonetheless discriminates against interstate commerce if it poses a practical threat of multiple taxation, or if the affected taxpayers are principally interstate businesses, the companies also rely on cases such as Maryland v. Louisiana, 451 U.S. 725 (1982) and Boston Stock Exchange v. State Tax Commission, 419 U.S. 318 (1977). That reliance is misplaced, for these cases involved "a tax [which], on its face, [was] designed to have discriminatory economic effects." Westinghouse Electric Corp. v. Tully, Slip Op. at 17 (emphasis added).

62/ Justice Powell, relying as the companies do here on cases such as Nippert v. City of Richmond, 327 U.S. 416, 429-432 continued

In Boston Stock Exchange, the state statute established lower tax rates for, and set a tax ceiling on in-state stock transfers. 429 U.S. 321-28. In Maryland v. Louisiana, the state's tax laws by their terms gave only local users a series of exemptions from and credits to a natural gas use tax. 451 U.S. 731-34. Similarly, in Westinghouse Electric Corp. v. Tully, the state of New York allowed a franchise tax credit for the export sales of Domestic International Sales Corporations ("DISC's"), but only if, in the words of the statute, the export goods were "shipped from a regular place of business of the taxpayer within [New York]." Slip Op. at 4. Indeed, in Westinghouse, the court confirmed that, in the tax field, it is a facial preference for local commerce, and not disproportionate consequences, which is constitutionally relevant. Slip Op. at 17.

Under these cases, AS 43.21 might discriminate against interstate commerce if, for example, it permitted the companies to deduct the cost of support activities related to Alaska oil production only if these activities were conducted in Alaska. That type of express "geographical limitation" would suffer from the same flaw at issue in Westinghouse, where the necessary effect of New York's discriminatory DISC credit was to predicate a company's New York tax liability on the percentage of its

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62/ continued
(1946), would have invalidated Iowa's law because of the practical risk of multiple taxation that it created. 437 U.S. at 288.

commerce undertaken locally. Slip Op. at 7, 10. Under AS 43.21, however, the location of deductible costs is a matter of indifference. Indeed, the companies' complaint is not that Alaska law creates any incentive for them to move operations into the state. By their own admission, if they did so their AS 43.21 liability would remain constant. C.B. at 21. Rather, they argue that the combined effect of Alaska's tax laws and the tax laws of other states together produces an incentive for such a move, since their total nationwide tax liability would be reduced if they moved their operations to Alaska. In the words of the Court in Container, the companies are arguing that they face a "resultant tax burden higher than [they] would incur if [their] business were limited [to Alaska]." 77 L.Ed.2d. at 557. As already noted, Container and Moorman rejected claims based on that precise argument.

The companies' assertion that AS 43.21 falls disproportionately on interstate businesses is barred by Commonwealth Edison v. Montana, 453 U.S. 609 (1981). The companies argue that the purpose of AS 43.21 was to favor local Alaska interests by shifting a disproportionate share of the cost of state government to a small number of multistate companies. C.B. at 73. This assertion of disproportionate burden, to the extent it concerns legislative motive, fares no better than it did under the Equal Protection Clause. Their claim, moreover, simply echoes that of the taxpayers in Commonwealth Edison -- a case decided after this lawsuit was filed. This litigation was initiated in large part on the companies' hope that the Supreme Court would reach the opposite result in that case. See companies' complaints. R. 289 (Exxon); R. 265 (Sohio); R. 12702 (Arco). The appellants in Commonwealth Edison -- Montana coal producers and their out-of-state customers -- argued that because 90% of Montana's coal was shipped out of state, Montana was discriminating against commerce by exporting its tax base to out-of-state consumers. They also argued that Montana was exploiting a "monopoly" position created by the geographic location of scarce natural resources. Id. at 619. Finally, they argued that they were shouldering too heavy a tax burden, because (1) the amount of their taxes, and as well their share of total state taxes collected, was disproportionate to their presence in the state; (2) the amount of their taxes was disproportionate to the services provided them by the state; and (3) the state was placing 50% of its tax revenues in a permanent fund, and not using it for current government expenses. Id. at 613.

Each of these arguments was rejected in Commonwealth Edison under the fourth prong of Complete Auto, which requires that the measure of the tax be reasonably related to the taxpayer's activities in the state. These same arguments were also rejected when recast as a discrimination claim. As the Court stated, the taxpayers' claims of discriminatory burden "ultimately collapsed" into fourth prong analysis. The court found "no real discrimination," since "the tax burden is borne according to the amount of coal consumed and not according to any distinction between in-state and out-of-state consumers." Id. at 619.

This case is Commonwealth Edison revisited. AS 43.21 on its face, treats intrastate and multistate oil-producing and pipeline companies uniformly. 63/ It taxes these companies evenhandedly -- in proportion to the profit they make in Alaska. The AS 43.21 tax base is not dependent upon whether the taxpayer is an Alaska or a multistate business, or whether the oil is consumed locally or out-of-state. Under Alaska's separate accounting, state borders are "essentially irrelevant," as Commonwealth Edison held was the goal of the Commerce Clause. 453 U.S. at 619.

Furthermore, and as the court held in Commonwealth Edison, the fact that multistate or "out-of-state" companies bear a large share of the tax burden of operating state government simply does not raise a discrimination claim. If AS 43.21 fairly apportions, as it does, the companies' tax base increases in direct proportion to in-state profit. If that base is large -- either in the absolute or as a percentage of all state taxes --

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63/ In an attempt to show that AS 43.21 was "contrived" to fall only on interstate business, the companies' counsel speculate, without personal knowledge, that no intrastate taxpayers filed an AS 43.21 return in three of the four years of the tax. C.B. at 68 n.27, 72-73. This is not true. See Affidavit of Thomas K. Williams, then Commissioner of Revenue. R. 17007-17009. Because of the confidentiality protections of AS 43.05.230, Commissioner Williams was unable to reveal taxpayer names. R. 17009.

the companies have only their own Alaska success to blame. Requiring Alaska to ameliorate the tax consequences of the companies' own profitability would place interstate commerce not in a position of equality, but a position of privilege.

> "It was not the purpose of the Commerce Clause to relieve those engaged in interstate commerce from their just share of state tax burden even though it increases the cost of doing business." 64/

Commonwealth Edison is thus dispositive of the companies' discrimination claims. The companies cannot help but agree, and simply seek to preserve the point for further appeal. C.B. at 43 n.13.

After Commonwealth Edison and Container, a fairly apportioned tax which does not facially discriminate between local and interstate components of the same industry does not discriminate against commerce. The fourth prong of Complete Auto imposes only one requirement beyond nexus with the taxing state -- that the measure of the tax must be "reasonably related to the extent of the [taxpayer's] contact [with the state]." 453 U.S. at 626. 65/ "The simple fact is that the appropriate level

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64/ Commonwealth Edison at 623-24, quoting Colonial Pipeline Co. v. Traigle, 421 U.S. 100, 108 (1975), quoting Western Live Stock v. Bureau of Revenue, 303 U.S. 250, 254 (1938).

65/ The Court held:

> [T]he fourth prong of the Complete Auto Transit test imposes the additional limitation that the measure of the tax must be reasonably related to the extent of the contract, since it is the

continued

or rate of taxation is essentially a matter for legislative, and not judicial, resolution." Id. at 627.

VI. AS 43.21 DOES NOT VIOLATE THE CONTRACT CLAUSE.

The companies claim that Alaska, by increasing taxes on oil production, has abridged the terms of their Prudhoe Bay leases in violation of the Contract Clause of the United States Constitution. The threshold inquiry under the Contract Clause is whether the state law operates "as a substantial impairment of a contractual relationship." Energy Reserves Group, Inc. v. Kansas Power & Light Company, ___U.S.___, 74 L.Ed.2d 569, 580 (1983).

The companies do not assert that there has been any impairment of any actual lease provision, much less a substantial impairment. C.B. at 75-77. In truth, in entering into those leases, the state could not, and did not, contract away its power as a sovereign to tax income earned in the state. The Alaska

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65/ continued

> activities or presence of the taxpayer in the State that may properly be made to bear a 'just share of the tax burden.' Western Live Stock v. Bureau of Revenue, 303 U.S. at 254.

Commonwealth Edison, 453 U.S. at 626. As the dissent pointed out, any ad valorem tax will now satisfy the fourth prong. Id. at 645.

Without explanation, the companies claim that Alaska's separate accounting is not related to the extent of their contacts with the state. C.B. at 42-43. AS 43.21 taxes profits made on the in-state production of oil, just as Montana taxed the gross value of local coal. If anything, then, Alaska's taxation of the net income from in-state production is fundamentally fairer than Montana's tax on the gross receipts from in-state production.

Constitution provides: "The power of taxation ... shall not be ... contracted away ...." 66/

The companies' argument that the state's oil lease contracts impliedly immunize its lessees from changes in the state's tax laws confuses the state's "role as commercial partner with its role as sovereign." Merrion v. Jicarilla Apache Tribe, 455 U.S. 130 (1982). Jicarilla disposes of this issue:

> Even where the contract at issue requires payment of a royalty for a license or franchise issued by the governmental entity, the government's power to tax remains unless "it has been specifically surrendered in terms which admit of no other reasonable interpretation." St. Louis v. United R. Co., 210 U.S. 266, 280 (1908).

Id. at 148. Accord, Lake Superior Consolidated Iron Mines v. Lord, 271 U.S. 577, 581-82 (1926). See also Exxon Corp. v. Eagerton, Comm'r. of Revenue of Alabama, ___U.S.___, 76 L.Ed.2d 497, 509-512 (1983).

VII. AS 43.21 IS PROPERLY RETROACTIVE TO JANUARY 1, 1978.

The companies believe that article II, section 18 of the Alaska Constitution and AS 01.10.070(a) and (f)(3) require that a retroactivity provision receive a two-thirds vote of the legislature in order to be valid. C.B. at 77-78. 67/ This

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66/ Alaska Const. art. IX, § 1.

67/ Section 4 of chapter 110, 1978 SLA provides that the Act applies retroactively to January 1, 1978. Section 5 provides that the Act was effective immediately.

argument has no basis in the constitution or statutes cited. 68/ It has also been rejected by the Utah Supreme Court (with respect to a similar Utah constitutional provision), 69/ and by Judge Kalamarides in North Slope Borough v. Gallagher, No. 3AN-76-4703 (Super. Ct., 3rd Jud. Dist. at Anchorage, August 22, 1977), rev'd on other grounds sub nom. North Slope Borough v. Sohio Petroleum Corp., 585 P.2d 534 (Alaska 1978). R. 17138-41.

The companies fail to distinguish between an effective date clause and a retroactivity clause. The former requires a two-thirds vote: the latter does not. Regardless of when an act becomes effective, it may govern transactions or events occurring prior to the applicable effective date, or, as in this case, may concern income earned prior to its enactment. AS 43.21 had an immediate effective date, and sec. 5, ch. 110, SLA 1978 -- which established that effective date -- was passed by the constitutionally requisite two-thirds vote. Once it became applicable law, by its terms it governed income earned beginning January 1, 1978. 70/ Nothing more is required by either statute or the Alaska Constitution.

68/ The only reference to retroactivity requirements in the Alaska statutes is at AS 01.10.090, which says "[n]o statute is retrospective unless expressly declared therein."

69/ Mecham v. State Tax Commission, 410 P.2d 1008, 1009 (Utah 1966).

70/ The 1977 edition of the Manual of Legislative Drafting
continued

VIII. THE LOWER COURT PROPERLY ENTERED SUMMARY JUDGMENT IN FAVOR OF THE STATE.

There are no genuine issues of material fact involved in this case. The state has not contested a single material allegation in the companies' factual affidavits, nor does it need to. The companies' claims that AS 43.21 is not a form of separate accounting, is an unapportioned tax, is inherently arbitrary, and leads to double taxation, are all issues of law. At most, these issues involve competing theories of economists and accountants on how income is earned. As the lower court properly ruled, the dispute among theorists here involves legislative facts for which a trial is neither necessary nor appropriate. State v. Erickson, 574 P.2d 1, 4-6 (Alaska 1978); Usery v. Tamiami Trail Tours, Inc., 531 F.2d 224, 244-45 (5th Cir. 1976). C.B. at 79.

70/ continued
(Legislative Affairs Agency) was used for both the 1977 and 1978 sessions of the legislature. That manual sets out the interplay between effective dates and retroactivity sections, clearly treating them as two distinct matters:

> The language [of a bill] providing for retroactive application should be set out in a separate section immediately preceding the effective date section, and where retroactive application of a portion or all of a bill is desired, an immediate effective date should be used in conjunction with the retroactivity section and the sections in the bill desired to be retroactive.

Id. at 11 (emphasis added). See Rule 10 of the Uniform Rules of the Alaska State Legislature (May 3, 1977); Rule 12, February 1973.

Only one triable issue could have been raised in this litigation -- that for these companies in these years, AS 43.21 produced a grossly distorted tax base. See Section E. The state's summary judgment motion forced the companies to "[t]ell us now what evidence you have to support your position." Braund Inc. v. White, 486 P.2d 50, 54 (Alaska 1971). "The theory underlying a motion for summary judgment is substantially the same as that underlying a motion for directed verdict." 486 P.2d at 53. The burden of proving a grossly distorted result is on the companies, and among their many affidavits, there exist no allegations which, if taken as true, would entitle the companies to relief. There is simply no need for a trial. Indeed, of the seven alleged material issues listed in the companies' brief, the issue of grossly distorted result is not to be found. C.B. 79-80.

As they did below, the companies seek to avoid summary judgment by quarreling with the state's evidence on the practical consequences of various out-of-state support functions. C.B. at 79-80. The state, however, bears no burden of proof on the merits of this lawsuit. Its motion seeks to test the companies' prima facie case. See 6 Moore's Federal Practice ¶ 56.08 at 56-136 (2d ed. 1983). Thus, even if the state's evidence were disbelieved in its entirety, the companies' evidentiary ledger would remain blank.

Finally, the companies suggest that summary judgment should not be granted in cases involving "important constitutional issues," suggesting that the state's motion is governed by Ault v. Alaska State Mortgage Ass'n, 387 P.2d 698 (Alaska 1963). C.B. at 78. Ault, however, stands only for the proposition that disputed legislative facts should not be resolved on the basis of one conclusory, seven-paragraph affidavit. 387 P.2d at 700. In this case, the court has a virtual library of material on any economic or accounting matter that it might find pertinent. This court has regularly approved the use of Civil Rule 56 to resolve important constitutional questions, and the companies' alleged exception to that rule simply does not exist. 71/

In summary, even if every material allegation in the companies' affidavits were considered to be true, and the state's affidavits were discounted, the state would nonetheless be entitled to judgment as a matter of law.

71/ See, e.g., Williams v. Zobel (Zobel II), 619 P.2d 448 (Alaska 1980); Douglas v. Glacier State Telephone Co., 615 P.2d 580 (Alaska 1980); Hicklin v. Orbeck, 565 P.2d 159 (Alaska 1977); State v. Lewis, 559 P.2d 630 (Alaska 1977); DeArmond v. Alaska State Development Corp., 376 P.2d 717 (Alaska 1962).

CONCLUSION

The judgment of the superior court is correct and should be affirmed.

Respectfully submitted April 27, 1984.

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