ALASKA LEGISLATURE SPECIAL COMMITTEE / SUBJECT FILES 8672
1520 SCOMM 55: JNT. SPEC. COMM. ON STATE TAX POLICY, 1986-1987 1320

Table of Authorities

Page(s)

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES

CONSTITUTIONAL PROVISIONS AND STATUTES

REGULATIONS AND ADMINISTRATIVE RELEASES

Table of Authorities

Other

In the

Supreme Court of the United States

October Term, 1985

ATLANTIC RICHFIELD COMPANY, *et al.*,

Appellants,

vs.

STATE OF ALASKA, *et al.*,

Appellees.

On Appeal From the Supreme Court of Alaska

This appeal is from the final judgment of the Supreme Court of Alaska, dated August 16, 1985, upholding Alaska's Oil & Gas Corporate Income Tax, AS 43.21 ("the Oil Tax"), as against appellants' claims that as applied to them the Oil Tax is (1) repugnant to the Commerce Clause of the United States Constitution, and (2) deprives them of due process of law and of the equal protection of the laws.

OPINIONS BELOW

The opinion of the Supreme Court of Alaska, App. 2a, is reported at 705 P.2d 418 (1985). The opinion of the Alaska Superior Court is not reported. App. 45a.

JURISDICTION

The final judgment of the Supreme Court of Alaska, rejecting appellants' claims that the Oil Tax was unconstitutional, was entered on August 16, 1985. App. 2a. Notice of Appeal to this Court was duly filed in the Supreme Court of Alaska on November 6, 1985. App. 49a. This appeal is being docketed within 90 days from the entry of judgment below. Jurisdiction of this Court rests on 28 U.S.C. § 1257(2).

CONSTITUTIONAL AND STATUTORY PROVISIONS

U.S. Const., Art. I, § 8, cl. 3:

"The Congress shall have Power . . . to regulate Commerce . . . among the several States. . ."

U.S. Const., 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."

Oil & Gas Corporate Income Tax Act, AS 43.21:

The text of the Oil Tax is set forth in the Appendix, together with the relevant Regulations (15 AAC 21).

STATEMENT OF THE CASE

Appellants are the principal owners of the Prudhoe Bay oil field on the North Slope of Alaska, and of the Trans Alaska Pipeline. Oil was first discovered at Prudhoe Bay in 1968. From 1968 to 1978, appellants spent in excess of $15 billion to build the pipeline and develop the oil field. R. 13369, 14163-64.*

While appellants were incurring these huge expenses in Alaska, and before any oil flowed from the North Slope, Alaska taxed the income of all corporations, including appellants, by the method used by most states — three-factor apportionment. R. 12844-88; 13749-53. The effect of Alaska's pre-1978 apportioned tax system was to attribute substantial profits to Alaska for taxation, although any focus on appellants' activities in Alaska alone would have shown

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*The facts in this section are taken from the more than 4000 pages of affidavits and exhibits appellants filed in the Alaska Superior Court. Since this is an appeal from the grant of summary judgment, the facts set out in those affidavits must be taken as true under Alaskan (as under federal) law. Braund, Inc. v. White, 486 P.2d 50, 54 (Alaska 1971).

Emphasis is supplied throughout except where otherwise indicated. The operation of the Oil Tax is generally described in the present tense although, as discussed *infra*, it was repealed in 1981.

heavy losses. R. 253, 292, 12697. Throughout the period when apportionment worked to Alaska's advantage, Alaska insisted on taxing oil companies by apportionment. *State v. Amoco Production Co.,* 676 P.2d 595 (Alaska 1984).

Things changed in 1977 when oil began to flow from the North Slope and through the Trans Alaska Pipeline. Effective January 1, 1978, Alaska enacted Alaska Statute ("AS") 43.21, the Oil and Gas Corporate Income Tax ("the Oil Tax"), and changed its tax system as applied to appellants. Unsurprisingly, the new system produced vastly larger revenues for Alaska than would have been generated by the pre-1978 system of taxation by apportionment.

During the four years in issue here (1978-81), the Oil Tax resulted in payments to Alaska by these taxpayers of approximately $2 billion. R. 16153. By 1981, 95% of Alaska's revenues came from the oil industry, and 83% from these taxpayers *alone.*[1] Passage of the Oil Tax allowed Alaska to repeal its personal income tax, repeal its school tax, repeal its gross receipts tax, reduce the tax rates on local businesses, and adopt a program to pay each resident a cash dividend every year, starting at $1,000 per person. R. 12919. As Alaska noted in its 1981 Financial Report, "the citizens of Alaska no longer make a direct monetary contribution to the cost of state government." R. 13126.

The Oil Tax has three main features.

First, the Oil Tax attributes to Alaska 100% of appellants' interstate *production income.* AS 43.21.020. This is the net income appellants earn by selling, in the Lower 48 states, crude oil that comes from Alaskan wells. The catch is that appellants' income from selling that oil is also subject to tax and is taxed, in the Lower 48 states as well. R. 13448-49,

[1]App. 182a. When it enacted the Oil Tax, Alaska projected that in 20 years its oil taxes would result in a state surplus, over and above all projected expenditures, of $184 *billion* — a jackpot of $450,000 each for every man, woman, and child in Alaska. Alaska Executive Budget (Operating), FY 1981, at 14, Col. 7, line 20. Amassing that sum would have involved a transfer of wealth from the Lower 48 to Alaska equal to $1,000 for every American. The truly remarkable fiscal and economic consequences of Alaska's overreaching oil tax policy are described in detail in the Mieszkowski Affidavit, App. 172a.

13744, 14247-48. Alaska's attribution of 100% of that income to itself thus inevitably produces double taxation.

Second, the Oil Tax attributes to Alaska 100% of appellants' *pipeline income*. AS 43.21.030. This is the net income appellants earn from pipeline transportation of Alaskan oil. The Oil Tax also results in double taxation of pipeline income, since appellants are unitary businesses and pipeline income is subject to tax, and is taxed, in the Lower 48 states as well as in Alaska.[2]

Third, in contrast to its treatment of production and pipeline income, the Oil Tax retains three-factor apportionment in order to attribute to Alaska a share of all of appellants' *other income*. AS 43.21.040. This income is primarily from refining and marketing operations. Since appellants have neither refineries nor retail gas stations in Alaska, this branch of the Oil Tax snares for Alaska taxation profits that have no connection to Alaska other than the fact that appellants are unitary businesses.

The production and pipeline income that Alaska taxes is the result of activities in all states, not only Alaska. Approximately 90% of the crude oil from Alaskan wells is sold, not in Alaska, but in the Lower 48. App. 294a, 335a; R. 13225, 13414, 12692-93. The capital to develop the Prudhoe Bay field and build the pipeline came almost exclusively from outside Alaska. R. 13369-75, 13670-75, 14164-70. The technology that made possible production of oil under Arctic conditions was developed outside Alaska. R. 13559-67. Operation and management of the Prudhoe Bay oilfield and the pipeline is the responsibility of thousands of appellants' employees, some of whom are located in Alaska but many more of whom work in California, Ohio, Texas, and elsewhere. R. 13219-14202; see App. 291a-367a. The record includes an estimate that no less than 80% of the expenses

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[2]Since the issues as to pipeline income are generally similar to those affecting production income, for convenience this Jurisdictional Statement analyses the issues in terms of production income. See App. 6a.

necessary to earn production income from Alaskan oil were incurred *outside* Alaska. App. 285a.

Despite the out-of-state contributions that make possible the earning of production income, the philosophy of the Oil Tax is to attribute to Alaska all production income appellants earn by selling crude oil from Alaskan wells. The Oil Tax does this by defining "net production income" as equal to the sales price of crude oil at the refinery inlet in the Lower 48, less the costs of extracting that oil and the costs of shipping it from the North Slope to the point of sale.[3] All net production income is attributed to Alaska by the Oil Tax. App. 5a-6a. The Oil Tax makes no effort to ascertain what part of that net production income is attributable to the contributions of Alaska, as the state of origin, and what

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[3]The Regulations take a fairly circuitous route to accomplish this result. "Taxable production income" is defined as "gross production revenue" less "deductions under 15 AAC 21.200-15 AAC 21.290." 15 AAC 21.100. "Gross production revenue," in turn, is defined as "value at the point of production" of the oil produced, 15 AAC 21.110, and "value at the point of production," in turn, is defined as the "sales price" less "reasonable costs of transportation" from the "point of production to [the] sales delivery point." 15 AAC 21.120.

"Sales price" is defined in 15 AAC 21.122. In general, the sales price is the "cash value of the full consideration being given in receipt for that oil." 15 AAC 21.122(a). If the oil is sold to an affiliate of the taxpayer, or if it is transferred from one division to another, the transfer price shown on the taxpayer's books is treated as the sales price. 15 AAC 21.122(b), (c). (Since the Oil Tax treats as sales transfers of oil from one division of a taxpayer to another, such transfers are included as "sales" herein.) From the sale price of the oil, "reasonable costs of transportation" are deducted in order to arrive at gross production revenue. 15 AAC 21.110, 21.120. Transportation costs are to be calculated "from the point of production to the sales delivery point." 15 AAC 21.130(a). The Oil Tax also permits deduction of certain other costs from gross production revenue in arriving at net production revenue. 15 AAC 21.200.

It is of interest to notice that although the term "value at the point of production" is used in the Oil Tax Act and the Regulations, in the practical operation of the Oil Tax it represents (as the Alaska Court conceded, App. 6a) nothing more than the mathematical result of subtracting transportation costs from the Lower 48 sales price. 15 AAC 21.120. The record shows without dispute that there is not a market for crude oil on the North Slope, and therefore that there can be no market price at the wellhead. App. 264a-265a, 308a. "Value at the point of production" is thus merely a construct. It has no role to play in the statutory scheme except to obscure momentarily the fact that Alaska's calculation of "taxable production income" actually begins with the price for which the crude oil is sold in the Lower 48.

part is attributable to the contributions of the states of sale and of the other states where the activities took place that made possible the extraction of Prudhoe Bay oil. The Oil Tax makes no effort to divide net production income among those states; it asserts that *all* of it belongs to Alaska.[4]

In this context it is important to notice that the deductions allowed by the Oil Tax are deductions only for *costs*. Despite the suggestion to the contrary in the opinion of the Alaska court, App. 10a-11a, this does not mean that the tax is in any way apportioned. It means only that the Oil Tax is a tax on net income, not on gross receipts. *By definition*, a net income tax allows deductions for costs; the relevant point is that the Oil Tax makes no effective allowance for the fact that some of the profits — i.e., the *net* income — it taxes are earned outside Alaska. Whether profits from the production and sale of crude oil originating in Alaska are earned inside Alaska or outside, they are treated as "Alaska" income and attributed 100% to Alaska.[5]

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[4]Because appellants, as the Alaska court found, App. 15a, are functionally integrated unitary businesses, it is difficult or impossible to measure with confidence the exact contributions of the various states. That is why apportionment formulas are used to tax unitary business income. See, e.g., Mobil v. Vermont, 445 U.S. 425, 438 (1980); F. W. Woolworth Co. v. Taxation and Revenue Dept., 458 U.S. 354, 364 (1982). The record, however, includes a number of dramatic examples of how the Oil Tax has attributed to Alaska substantial income that manifestly was earned outside the state. For example, Sohio's marketing department, operating from Cleveland, was able to secure a Virgin Islands refiner as a customer for millions of barrels of Alaskan oil. Because the Jones Act does not apply to shipments to the Virgin Islands, Sohio's transportation costs for this oil were $2 per barrel less than if the oil had been shipped by American flag tanker; Sohio's income was correspondingly greater. R. 13417-18. This additional $2 per barrel has absolutely nothing to do with Alaska, but the Oil Tax attributes 100% of it to Alaska. Or again, Arco, operating from California and Texas, carried out a project to reverse the so-called "Line 90" pipeline that had been built to carry oil from New Mexico to California, thus reducing the cost of transporting Alaska crude to refineries in the mid-continent states. This decrease in Arco's cost of transportation was made possible solely by a pipeline in the Southwestern Desert. Yet the Oil Tax treats that decrease as income and allocates every penny of the additional profit to Alaska. R. 13075, 13637-38.

[5]To this rule there is only one exception, and it is apparent rather than real. In 1982, the Department of Revenue issued a regulation that pretended to allow deduction of profits on overhead. The regulation, however, was designed so no taxpayer could take advantage of it. See pp. 16-17, infra.

The Oil Tax was in effect for only four years. Following the institution of this litigation, and based on the legal advice it was given, the Alaska Legislature recognized that appellants' challenges to the Oil Tax were substantial. R. 10539-40. In 1981, accordingly, it repealed the Oil Tax and replaced it with a modified apportionment formula. 1981 SLA Ch. 116. Despite the repeal, the Legislature is actively considering a bill to reimpose the tax, or something very similar, if it is not ruled unconstitutional. House Bill 353.

HOW THE FEDERAL QUESTIONS WERE RAISED

Appellants raised each of the questions presented (except Question 6(c)) in their amended complaints and counterclaim, R. 241, 273, 12690,[6] in their memoranda in opposition to Alaska's successful motion for summary judgment, R. 12718-839, 17150-70, and at pages 19-76 of their brief in the Alaska Supreme Court. Question 6(c) was raised at pages 59-62 of appellants' Reply Brief in the Alaska Supreme Court, filed July 13, 1984. It could not have been raised earlier, because it depends on an interpretation of Alaska law first announced by the Department of Revenue on April 27, 1984. App. 420a-421a.

THE QUESTIONS ARE SUBSTANTIAL

This case involves Alaska's attempt to arrogate to itself *all* the net income that results when crude oil from Alaskan wells is sold in the Lower 48 states, even though that income results entirely from interstate sales and is subject to tax, and is taxed, by many states besides Alaska. Although Alaska concedes that appellants are unitary businesses, App. 15a, R. 14836, Alaska has abandoned the method — apportionment — that virtually all states use to tax unitary businesses, R. 13213, and has adopted a tax system tailored

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[6]This litigation was commenced on March 22, 1979 by the filing of a complaint by Arco and Sohio challenging the Oil Tax on the grounds that it was repugnant to the Commerce, Due Process, Equal Protection, and Contract Clauses. R. 196. Alaska later sued Exxon, praying for a declaration that the Oil Tax was constitutional. R. 1. In 1980, the cases were consolidated, Arco and Sohio filed amended complaints, and Exxon filed a counterclaim. R. 241, 273, 12690.

to maximize revenue from Alaska's principal export, and to enrich Alaska at the expense of the rest of the country.

The legal questions presented in this case are undoubtedly substantial. The Oil Tax violates each of the tests this Court has set forth to detect impermissible overreaching by a state: it is unapportioned; it causes multiple taxation; it discriminates against interstate commerce; it taxes extraterritorially; and it is internally inconsistent. The judgment below is inconsistent with *Exxon v. Wisconsin,* 447 U.S. 207 (1980), *Mobil v. Vermont,* 445 U.S. 425 (1980), *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434 (1979), and *J.D. Adams Mfg. Co. v. Storen,* 304 U.S. 307 (1938). It is also contrary to principles to which this Court has adhered for eighty years which forbid unapportioned taxes and prevent multiple taxation of interstate commerce.

The questions in this case are also of great public importance because they involve the constitutional limits on Alaska's taxation of income earned from crude oil produced on the North Slope of Alaska. That oil, this Court has already said, is a "resource of profound *national* importance." *Hicklin v. Orbeck,* 437 U.S. 518, 533-34 (1978). Oil production at Prudhoe Bay is almost exclusively the product of *interstate* commerce. For 150 years, this Court has interpreted the Commerce Clause as prohibiting states from imposing taxes that disproportionately burden interstate commerce. Alaska, however, has succumbed to the temptation of shifting to interstate commerce almost the entire burden of supporting state government.[7]

Finally, the questions in this case are substantial because of the danger to interstate commerce that the decision below represents. The decision of the Alaska court is an open invitation to all exporting states, and especially to other

[7]And Alaska's tax policy is only the latest in the long series of protectionist measures by which Alaska has sought to ensure that no Americans but Alaskans may share fairly in gains related to the resources that Providence has placed in Alaska, even though those gains arise not only from Alaska's resources but from the skills and labor of citizens of all the states. See, e.g., South-Central Timber Development, Inc. v. Wunnicke, 467 U.S. 82 (1984); Zobel v. Williams, 457 U.S. 55 (1982); Hicklin v. Orbeck, 437 U.S. 518 (1978).

resource-rich states, to follow Alaska's example. It gives carte blanche to states to tailor their taxes to impose unapportioned levies on income from the state's principal export, even though interstate businesses must pay taxes on that same income to the state of sale as well. Unless this Court intervenes, the consequence of the Alaska court's decision will be multiplication of taxes on interstate commerce, and an increasing threat to the historic Commerce Clause policy of free interstate trade.

I. THE OIL TAX IS INVALID BECAUSE PRODUCTION INCOME OF APPELLANTS' UNITARY OIL BUSINESSES IS PROPERLY SUBJECT TO APPORTIONMENT AMONG MANY STATES AND MAY NOT BE ATTRIBUTED ENTIRELY TO ALASKA.

The broad purpose of the Commerce Clause is to make sure that interstate commerce is not penalized merely because it is interstate. An enterprise doing business in only one state necessarily exposes no more than 100% of its income to taxation. In comparison to such an intrastate enterprise, an enterprise doing business in two or more states will be disfavored economically if the states in which the enterprise does business become entitled collectively to tax more than 100% of its income. This Court has historically recognized that a state tax is unconstitutional as an undue burden on interstate commerce if it causes the taxpayer to be subjected to multiple taxation.[8]

The danger of multiple taxation in this case is not merely theoretical. The Oil Tax is contrary to the method of taxing oil production income by apportionment which this Court endorsed in *Exxon v. Wisconsin,* 447 U.S. 207 (1980). The result, as might be expected, is actual double taxation of appellants' production income, as well as a direct conflict with the settled law of this Court that a state may not

[8]Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 446-47 (1979); Evco v. Jones, 409 U.S. 91, 93-94 (1972); Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 462-63 (1959); Michigan-Wisconsin Pipe Line Co. v. Calvert, 347 U.S. 157, 170 (1954); J.D. Adams Mfg. Co. v. Storen, 304 U.S. 307, 311-12 (1938); Western Live Stock v. Bureau of Revenue, 303 U.S. 250, 255-56 (1938).

attribute to itself for taxation 100% of something other states are entitled to tax by apportionment.[9]

A. The Oil Tax Is Inconsistent with This Court's Decision in Exxon v. Wisconsin.

In *Exxon v. Wisconsin*, 447 U.S. 207 (1980), Justice Marshall held for a unanimous Court that the production income of a unitary oil business was subject to taxation by apportionment in all states where the corporate taxpayer operated. This Court rejected the contention that because a "separate accounting" approach might assign all production income to the state where the wells were located, that state had an exclusive right to tax production income from those wells. On the contrary, said this Court, when more than one state has a nexus to production income, such income must be apportioned among all states with the requisite nexus:

> "[T]here is nothing 'talismanic' about the concept of situs for income from exploration and production of crude oil and gas. . . . Presumably, the States in which appellant's crude oil and gas production is located are permitted to tax in some manner the income derived from that production, there being an obvious nexus between the taxpayer and those States. However, 'there is no reason in theory why that power should be exclusive when the [exploration and production income as distinguished through separate functional accounting] reflect[s] income from a unitary business, part of which is conducted in other States. In that situation, the income bears relation to benefits and privileges conferred by several States. These are the circumstances in which apportionment is ordinarily the accepted method.'
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> ". . . The geographic location of . . . raw materials does not alter the fact that such income is part of the unitary business of the interstate enterprise and is

[9]Appellants do not contend that three-factor apportionment, or any other particular formula, is constitutionally required. The space the Alaska court devotes to the supposed deficiencies of the UDITPA formula is knocking down a strawman. App. 15a-20a. The problem is not that Alaska fails to use standard three-factor apportionment, but that it does not apportion at all.

> subject to fair apportionment among all States to which there is a sufficient nexus with the interstate activities of the business." 447 U.S. at 229-30. (Brackets and internal quotes in original.)

Alaska concedes, and its Supreme Court found, that each of the appellants is a unitary business. R. 14836; App. 15a. This case is thus the converse of *Exxon v. Wisconsin.* Wisconsin, a state with no producing wells, sought to apportion to itself a slice of Exxon's production income attributable to wells in other states; Alaska, where producing wells are located, seeks to keep for itself all of the production income from those wells. In *Exxon v. Wisconsin,* this Court upheld Wisconsin's claim to a fairly apportioned share of the taxpayers' production income from wells in other states; the decision in *Exxon,* as the Court has said, "*required* an apportionment of the tax based on the portion of the activity properly viewed as occurring within each relevant state." *Merrion v. Jicarilla Apache Tribe,* 455 U.S. 130, 158 n.26 (1982). Alaska and Wisconsin cannot both be right. Given the right of Wisconsin and other states to tax a share of appellants' production income from Alaskan wells, Alaska's claim to all of it must be rejected.

B. The Oil Tax Results in Actual Double Taxation of Interstate Commerce.

Since appellants are unitary businesses, the decision in *Exxon v. Wisconsin* gives all states where appellants operate the right to tax a share of their production income from selling oil from Alaskan wells in the Lower 48 states. Not surprisingly, most states do so, and the Oil Tax thus causes actual multiple taxation.[10]

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[10]In the case of Exxon, for example, the record shows that not only Wisconsin but 42 other states actually tax a share of Exxon's production income from Alaskan oil: those states treat a total of 30% of that income as "their" income, in addition to the 100% that Alaska says is "its" income. App. 406a-407a. The result is that 130% of Exxon's production income from Alaskan crude (or 30% more than Exxon's actual earnings) is being taxed somewhere. The same is true for the other appellants. App. 381a, 370a.

Multiple taxation of production income from Alaskan oil may also be measured in a somewhat different manner. Sohio, the smallest and least complex of appellants, conducted an elaborate study that demonstrated that

The kind of double taxation found in this case is particularly dangerous to interstate commerce since Alaska's tax is carefully tailored to its principal export, oil. If Alaska may attribute to itself for taxation 100% of the income resulting from sale in other states of oil extracted in Alaska, every other state may do the same for *its* favorite export. Michigan may allocate to itself 100% of income from the manufacture and interstate sale of automobiles. California may claim 100% of the income from the production and interstate sale of wine. Pennsylvania may do the same for steel; Florida for oranges; West Virginia for coal; Kansas for wheat; Oregon for lumber; and so forth. Yet the other states, the states of sale, will also be entitled to levy taxes by apportionment and thus to tax a share of that same income. Adoption by all 50 states of Alaska's notion that a state has a right to tax 100% of the income from production and interstate sale of its principal export, even though other states tax that same income by apportionment, would necessarily result in the multiple taxation of interstate commerce. The principle of Alaska's tax thus cannot be sustained without violating the fundamental policy of the Commerce Clause.

C. The Long-Established Law of This Court Recognizes That Where One State Is Entitled to Tax by Apportionment, No Other State May Tax by Allocating 100% of the Activity to Itself.

For over eighty years, this Court has recognized that a state may not tax 100% of something that other states are entitled to tax by apportionment, and has regularly invalidated state taxes that contravene that principle.[11] The his-

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Sohio was actually taxed in all states on 120% of its Alaska-taxed income in 1978, 123% in 1979 and 111% in 1980, and that, if all states in which Sohio was taxable had exercised their full taxing power, all states would have taxed between 149% and 171% of Sohio's Alaska-taxed income. The results of this study were submitted to the Alaska courts in the affidavit of E. Wayne Tanner, which is set forth in full at p. 380a of the Appendix.

[11] Japan Line, Ltd. v. County of Los Angeles, 441 U.S. 434, 446-47 (1979); Standard Oil Co. v. Peck, 342 U.S. 382, 384 (1952); Central R. Co. v. Pennsylvania, 370 U.S. 607, 613-14 (1962); J.D. Adams Mfg. Co. v. Storen, 304 U.S. 307, 311-12 (1938); Union Refrigerator Transit Co. v. Kentucky, 199 U.S. 194, 210-11 (1905).

toric rule applicable to this case was stated clearly by Justice Blackmun for the Court in *Japan Line*:

> "In order to prevent multiple taxation of interstate commerce, this Court has required that taxes be apportioned among taxing jurisdictions, so that no instrumentality of commerce is subjected to more than one tax on its full value. The corollary of the apportionment principle, of course, is that no jurisdiction may tax the instrumentality in full. 'The rule which permits taxation by two or more states on an apportionment basis precludes taxation of all of the property by the state of the domicile. . . . Otherwise there would be multiple taxation of interstate operations.' The basis for this Court's approval of apportioned property taxation, in other words, has been its ability to enforce full apportionment by all potential taxing bodies." 441 U.S. at 446-47 (citations omitted).

Again, in *Mobil v. Vermont,* 445 U.S. 425 (1980), this Court reiterated that "taxation by apportionment and taxation by allocation to a single situs are *theoretically incommensurate,* and if the latter method is constitutionally preferred, a tax based on the former cannot be sustained." 445 U.S. at 444-45. In that case, this Court based its decision allowing apportioned taxation of dividend income on the conclusion that the state of commercial domicile could not validly assert the right to tax 100% of that income.

Recognizing the overriding dangers of multiple taxation, moreover, this Court has been careful throughout its history to balance its gradual expansion of the power of states to tax by apportionment with corresponding restrictions on the power of other states to make multiple taxation inevitable by taxing 100% of something this Court has said is subject to taxation by apportionment.[12] Recognition of the right of

[12]E.g., compare Pullman's Palace Car Co. v. Pennsylvania, 141 U.S. 18 (1891) (allowing property tax on apportioned fraction of railroad cars running through Pennsylvania) with Union Refrigerator Transit Co. v. Kentucky, 199 U.S. 194 (1905) (forbidding tax by Kentucky on 100% of value); compare Ott v. Mississippi Valley Barge Line Co., 336 U.S. 169 (1949) (allowing for the first time apportioned taxation of vessels) with Standard Oil Co. v. Peck, 342 U.S. 382 (1952) (forbidding states, despite

nonproducing states to tax production income by apportionment, upheld in *Exxon v. Wisconsin,* necessarily implies a limitation on the claim of a producing state to tax all of it.

D. The Oil Tax Cannot Be Justified By The Alaska Court's Spurious Distinction Between "Separate Accounting" And "Specific Allocation."

The Alaska court in effect conceded that after *Exxon v. Wisconsin* Alaska could not validly allocate to itself 100% of appellants' production income from Alaskan oil. App. 35a. The court nevertheless purported to justify the Oil Tax on the basis that Alaska's tax was "separate accounting," not "specific allocation," and that the constitutional rules set out in *Exxon v. Wisconsin, Mobil v. Vermont,* and *Japan Line* did not apply to "separate accounting." App. 35a.

With all respect to the Alaska court, its notion that *Exxon v. Wisconsin* did not involve "separate accounting" is exceedingly eccentric. This Court's opinion made plain that the income at issue was Exxon's "exploration and production income as distinguished *through separate functional accounting,*" 447 U.S. at 229; the claim this Court rejected was precisely that "separate accounting" should be used to attribute all production income to the states where the wells were located.[13] See 447 U.S. at 218-19, 222-23, 223 n.7, 226, 229-30; see also *Wisconsin Dep't of Revenue v. Exxon Corp.,* 281 N.W.2d 94, 107-109 (Wis. 1979).

More fundamentally, the Alaska court's purported distinction is without constitutional substance. To accept it would trivialize the Commerce Clause and reduce to a game of labels the historic policy favoring free interstate trade.

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prior contrary law, from taxing 100% of value of vessels domiciled there); compare Standard Pressed Steel Co. v. Washington Department of Revenue, 419 U.S. 560 (1975) (allowing tax on interstate sales if "apportioned exactly to the activities taxed") with J.D. Adams Mfg. Co. v. Storen, 304 U.S. 307 (1938) (unapportioned tax on interstate sales impermissible); see also Braniff Airways, Inc. v. Nebraska State Board, 347 U.S. 590 (1954) (limiting unapportioned taxation of air commerce to situations where no state has a right to tax by apportionment).

[13]Alaska's lawyers acknowledged this point unequivocally when they withdrew Alaska as amicus curiae on a brief filed with this Court in support of Wisconsin. R. 16549.

This Court has repeatedly held that constitutional inquiry under the Commerce Clause must be directed not to the label given by the state, but to the "practical effect" of the tax. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977). The Alaska court, however, did not look at the facts. It treated the issue as purely one of law, as to which the label given by the Legislature was controlling. It ignored entirely the taxpayers' careful factual showing that the Oil Tax in fact attributed to Alaska all of the taxpayers' interstate oil production income, and that the result was actual multiple taxation.

The failure of the Alaska court to consider the way in which the Oil Tax actually works is especially astonishing since the supposed distinction the Alaska court was making — that between "separate accounting" and "specific allocation" — is, at best, a very fine one.[14] Despite the constitutional significance it attached to the distinction, the Alaska court was forced to concede that what it called "the separate accounting methodology" was "very similar" to the "specific allocation approach." App. 8a-9a. Indeed, the court's opinion was at several points self-contradictory,[15] and reflected the Alaska court's inability to explain consistently the crucial distinction it said it was making.

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[14]Neither the Alaska Attorney General nor the Alaska Department of Revenue believes in the distinction their Supreme Court drew between separate accounting and allocation. On March 3, 1981, the Attorney General told Governor Hammond that "[d]irect *allocation — sometimes called separate accounting* — is a method by which specific items of income . . . are attributed to specific states." R. 16191. The Department recently acknowledged that "*Allocation* is the term generally used to describe the direct assignment of income or expense unrelated to the corporation's regular business to the state within which the income or expense has its source. This *is commonly called the separate accounting method.*" Alaska Department of Revenue, Alaska Taxation — Policy and Structure 25 (1985).

[15]Thus, at App. 9a, the court said that separate accounting "looks to the activities in the state and seeks to determine the income related to that activity," while specific allocation "attributes income according to situs, or some other specific characteristic of the business enterprise, rather than on the basis of where the income itself was earned." At App. 28a, however, the court says that "under the separate accounting approach, income is viewed as earned when and where the principal operating activity occurs," and that "[s]upport activities are universally accounted for only as expenses, whether they occur in or outside the income-producing state."

The Alaska court itself exposed the fallacy of its approach at the only point where it dealt with the facts. In holding that the Oil Tax was "separate accounting," the court relied principally on its assertion that "the Oil Tax does not attribute income from the production of oil *in its entirety* to Alaska." App. 10a. But the list the court gave of the deductions that Alaska allowed, App. 10a, n. 16, is precisely to the contrary, and shows just what the taxpayers claim — namely that under the Oil Tax *all* net income from production of oil from Alaskan wells is attributed to Alaska.[16] Even under the Alaska court's definition, that makes the Oil Tax "situs allocation," not "separate accounting," and invalid.

Equally remarkable was the Alaska court's attempt to save the Oil Tax by proposing that the appellants should do what the federal securities laws forbid. In March, 1982, nine months after the Oil Tax had been repealed, the Department of Revenue made an effort to pretend that a small portion of interstate oil production income had been excluded from Alaska's tax. The Department did so by issuing a regulation that purported to allow, as part of a deduction for general and administrative costs, "a reasonable amount of profit, if

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[16]Thus the court noted that refining and marketing income are omitted in calculating production income under the Oil Tax. This is beside the point, since the question the court claimed to be addressing was whether the Oil Tax attributes all interstate oil *production* income to Alaska, App. 10a, and since production income *by definition* does not include refining and marketing income. (Although the court's statement that refining and marketing income are not included *as production income* under the Oil Tax is literally true, the Court omits to add that the Oil Tax also taxes, by apportionment, appellants' worldwide refining and marketing income. AS 43.21.040.) The court also listed a number of *costs* that are deductible. App. 10a, n. 16. This, too, proves nothing. No one contends that the Oil Tax is a tax on gross receipts. On the contrary, it is a *net income* tax. Costs are therefore deductible — again, *by definition*. The only relevant question is whether, after deduction of costs, the Oil Tax attributes 100% of the *net* production income to Alaska. The court's own calculation shows that it does.

The Alaska court's contrast of the figure of $26.64 in "total revenue" and $6.77 in "net production profit" shows the same confusion. App. 5a, 10a. The first figure represents gross receipts (and includes refining and marketing income to boot); the latter is *net* production income. The court's example thus concedes what appellants assert — that their net production income is 100% attributed to Alaska.

any, that is *actually allocated* to general overhead and administrative activities *for purposes of reporting that year's* earnings and profits *to stockholders."* 15 AAC 21.290(b). The new regulation was, of course, quite limited in scope; it did not even purport to allow attribution of profit to sales outside Alaska, to operating costs incurred in other states, to development expenses incurred in other states, or to anything other than general overhead expenses. Even as to overhead, moreover, the new regulation was a sham. It was carefully designed so that no taxpayer could take advantage of it. First, although the Department's new regulation applied only if the taxpayers had attributed profits to overhead in making their annual reports to shareholders, the regulation was issued only *after* annual reports for all the tax years in issue had already been sent.[17] Second, generally accepted accounting principles ("GAAP") do not allow the attribution of profit to overhead, App. 154a n.2, App. 282a, and appellants, as public companies, are required to prepare their annual reports in accordance with GAAP. 17 C.F.R. § 210.4-01(a)(1). It would thus have been legally improper for appellants to report to their shareholders in the way the new regulation suggested.[18]

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[17]The Alaska court's response to this problem, its suggestion that since the regulation was "retroactive" appellants could amend "their tax reports and returns," App. 12a, simply missed the point. Amending the tax return is not the difficulty; the difficulty is that the regulation allows a deduction only if profits *were actually allocated* to overhead on appellants' annual reports. Those reports, as Alaska well knew, *had already been issued* when the regulation was promulgated. The regulation in force prior to that time, like the Oil Tax itself, allowed deduction only of general overhead *expenses*, not of any profit attributable thereto. AS 43.21.020(c)(9); compare Register 69, April 1979, 15 AAC 12.290(b) with Register 81, April 1982, 15 AAC 21.290(b); App. 282a-283a.

[18]The Alaska court's discussion of this issue, App. 11a, suffered from its failure to deal with the most relevant SEC materials. These provide that financial statements not prepared in accordance with GAAP are "presumed to be misleading or inaccurate." 17 C.F.R. § 210.4-01(a)(1). This regulation, in varying forms, has been in existence since 1938. See Accounting Series Release No. 4, 11 F.R. 10913 (April 25, 1938), Accounting Series Release No. 150 (December 20, 1973), Accounting Series Release No. 280 (September 2, 1980). The Alaska court chose instead to discuss the "other criteria" language of 15 U.S.C. § 78m(b)(2)(B)(ii), and to imply that this language permitted the filing of annual reports not in accordance with GAAP. The

The Alaska court simply failed to come to grips with the central facts of this case. Appellants are unitary businesses; as Justice O'Connor has observed, "The net income of an organic, unitary business . . . is indivisible." *ASARCO, Inc. v. Idaho State Tax Commission,* 458 U.S. 307, 333 n.1 (1982) (dissent). Crude oil from Prudhoe Bay is sold in the Lower 48, and activities in the Lower 48, as well as in Alaska, are required in order for the crude oil to be produced. The net income from production and sale of Alaskan crude oil is necessarily attributable, in part, to *all* of those states, as the unitary business concept recognizes.[19] The Oil Tax, however, refuses to attribute any part of the income to any state other than Alaska, and thereby inevitably produces double taxation. Loose talk about "separate accounting" or "specific allocation" cannot change how the Oil Tax works or remove the double taxation it causes. Labels do not alter facts.

II. THE OIL TAX IS INVALID BECAUSE IT TAXES VALUES EARNED OUTSIDE ALASKA.

A second basic constitutional principle applicable to interstate taxation is that a state may not impose a tax on "values earned outside its borders." *Container Corp. v. Franchise Tax Board,* 463 U.S. 159, 164 (1983); *ASARCO, Inc. v. Idaho State Tax Commission,* 458 U.S. 307, 315

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cited section, however, was enacted in 1977 as part of the Foreign Corrupt Practices Act; its point was not, as the Alaska court mistakenly thought, to allow deviations from GAAP in reporting to shareholders, but to require *additional* internal auditing controls to make sure that financial statements prepared in accordance with GAAP accurately reflect a company's operations. See S.Rep.No. 95-114 (95th Cong., 1st Sess.) at 7-8; 1977 U.S. Cong. & Adm. News 4104-05 (1978).

[19]Alaska understands this concept well enough when it is in Alaska's interest to do so. In cases where production is primarily from wells outside Alaska, the state has repeatedly argued, and the Alaska Supreme Court has held, that production income cannot be separately accounted for by multistate oil companies because it forms an integral part of their unitary income. See State v. Amoco Production Co., 676 P.2d 595, 599-600 (Alaska 1984); Earth Resources Co. v. State, 665 P.2d 960, 968 (Alaska 1983); R. 12836-38. In Sjong v. State, 622 P.2d 967 (Alaska 1981), Alaska identified the contributions of the state of sale as the most important factor in apportioning 92% of a Washington-based crab fisherman's income to Alaska, when the only contact with Alaska was delivery of his catch to Alaskan ports.

(1982); *Connecticut General Life Ins. Co. v. Johnson,* 303 U.S. 77, 80-81 (1938). The Oil Tax violates this principle as well.

A. The Oil Tax Is an Unapportioned Tax on Interstate Sales.

Appellants' net production income is derived virtually in its entirety from interstate sales of crude oil: it represents the difference between the sales price received for the crude oil in the Lower 48 states, and the costs — incurred both in Alaska and elsewhere — of producing that oil and transporting it to the refinery where it is sold. A state, of course, may levy a tax on such sales; it may do so, however, only if the tax is "fairly apportioned." *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279 (1977); *Evco v. Jones,* 409 U.S. 91, 93-94 (1972). Alaska has failed to apportion.

In *J. D. Adams Mfg. Co. v. Storen,* 304 U.S. 307 (1938), an unapportioned tax indistinguishable from Alaska's was ruled unconstitutional as applied to interstate sales. That case involved a tax on gross income received by Indiana businesses.[20] The taxpayer manufactured road machinery in Indiana for sale to customers throughout the United States and abroad; 80% of its production was sold to customers outside of Indiana. This Court held that the tax was unconstitutional as applied to income from interstate sales.[21] To

[20]It is now settled that there is no difference for constitutional purposes between gross income and net income taxes. Moorman Mfg. Co. v. Bair, 437 U.S. 267, 280-81 (1978); Armco Inc. v. Hardesty, 52 U.S.L.W. 4787 (June 12, 1984). Nor has the distinction made in some of the early cases between gross receipts taxes and income taxes survived the demise of the distinction between direct and indirect taxes on interstate commerce. See Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977); Washington Dep't of Revenue v. Ass'n of Washington Stevedoring Cos., 435 U.S. 734 (1978).

[21]"The vice of the statute as applied to receipts from interstate sales," the Court said, "is that the tax includes in its measure, without apportionment, receipts derived from activities in interstate commerce; and that the exaction is of such a character that if lawful it may in substance be laid to the fullest extent by States in which the goods are sold as well as those in which they are manufactured. Interstate commerce would thus be subjected to the risk of a double tax burden to which intrastate commerce is not exposed, and which the commerce clause forbids. We have repeatedly held that such a tax is a regulation of, and a burden upon, interstate commerce prohibited by Article I, § 8 of the Constitution." 304 U.S. at 311-12.

the same effect are *Gwin, White & Prince, Inc. v. Henneford,* 305 U.S. 434 (1939), *Michigan-Wisconsin Pipe Line Co. v. Calvert,* 347 U.S. 157, 170 (1954), *Evco v. Jones,* 409 U.S. 91 (1972), and *Washington Dep't of Revenue v. Ass'n of Washington Stevedoring Cos.,* 435 U.S. 734, 749 n.18 (1978).

To be sure, this Court has sometimes allowed a destination state to impose a tax on income from interstate sales, on the theory that the tax was in fact apportioned to the commerce taxed. Never, however, has this Court allowed an *origin* state, like Alaska, to impose an unapportioned tax on interstate sales. For constitutional purposes, crude oil is plainly no different from the road machinery involved in *J.D. Adams* or the apples involved in *Gwin, White & Prince v. Henneford.* The Oil Tax makes no more effort at apportionment of income from interstate sales than did Indiana in *Adams* or Washington in *Gwin.* What is relevant is that the taxpayers' interstate production income comes from interstate sales of crude oil and that Alaska, an origin state, purports to tax all of it without apportionment. This Court has forbidden taxes of that sort for forty years.

B. There Is No Proportion Between the Oil Tax's Measure of Taxable Production Income and Appellants' Contacts with Alaska.

Even if the Oil Tax were apportioned, this Court's cases require that an apportioned tax "actually reflect a reasonable sense of how income is generated," *Container Corp. v. Franchise Tax Board,* 463 U.S. 159, 169 (1983), so that the income attributed to the state is not "out of all appropriate proportion" to the taxpayer's in-state activities. *Hans Rees' Sons, Inc. v. North Carolina,* 283 U.S. 123 (1931).[22]

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[22]As the Court said in the *Hans Rees* case:

> "[The] 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 [*Underwood Typewriter Co. v. Chamberlain,* 254 U.S. 113 (1920)], 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 [*Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission,* 266 U.S. 271 (1923)], that the

The extent of the disproportion created by Alaska's decision to attribute to itself all interstate oil production income from Alaskan wells may readily be seen by comparing Alaska's taxes with the standard three-factor formula. The latter has become, as this Court has said, "something of a benchmark against which other apportionment formulas are judged" because "payroll, property, and sales appear in common to reflect a very large share of the activities by which value is generated." *Container Corp. v. Franchise Tax Board,* 463 U.S. 159, 170, 183 (1983). By that standard, overtaxation here ranges from 279% to 804%[23] as compared with the overtaxation of 250% found to be "out of all appropriate proportion" in *Hans Rees,* or the overtaxation of between 162% and 205% that was sufficient to invalidate the apportionment formula in *Norfolk & Western Ry. Co. v. Missouri State Tax Comm'n,* 390 U.S. 317 (1968).[24]

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entire net profits were to be allocated to New York because that was the place where sales were made." 283 U.S. at 132-33.

The effect of the Oil Tax is to attribute to Alaska the "net profits of the entire transaction" — the taxpayers' entire income from pumping oil from the ground in Alaska and selling it in other states. That is just what this Court, in *Hans Rees,* said cannot be done. Yet the Alaska court upheld that attribution not only "without evidence" but in the teeth of the evidence presented in this record, which showed that 90% of the sales and 80% of the expenses that generated the production income occurred outside Alaska. App. 294a, 335a, 285a.

[23]The three-factor formula would have attributed to Alaska only 9.4% of Arco's income, R. 12699; the Oil Tax thus resulted in an overtaxation of Arco's income of 804% on a federal taxable basis and 389% on a book basis. That is, the percentage of Arco's income actually taxed (an average of 85% on a federal taxable basis, R. 13744-46) was 904% of the 9.4% properly taxable under the benchmark formula, or 804% greater than it should have been. The same is true for the calculation on a book basis; both calculations correspond to the method of measuring overtaxation used in *Container,* 463 U.S. at 184. Comparable calculations for Sohio show that the Oil Tax resulted in an overtaxation of Sohio's income of 279% to 342%. R. 13450-51, 13459. Substitution of the Oil Tax for the standard three-factor formula increased Exxon's tax by 326%. R. 293.

[24]The enormous variance between the Oil Tax and the three-factor formula confirms, moreover, that the Oil Tax cannot stand after *Exxon v. Wisconsin.* The two methods of taxation unquestionably produce results out of all appropriate proportion *to each other.* It follows that either Wisconsin was wrong in using the three-factor formula to tax production income, or Alaska is wrong in using the Oil Tax. Since the first alternative is foreclosed by *Exxon v. Wisconsin,* it is Alaska's tax that must give way.

Alaska's own studies confirm that no reasonable apportionment formula could come anywhere near assigning to Alaska the amount of income allocated to Alaska by the Oil Tax. Alaska's Commissioner of Revenue testified that his department did its best to devise an apportionment formula that would generate as much money for the state as the Oil Tax did.[25] Despite the Department's best efforts, it failed. No "reasonable" formula it could devise could produce more than 50% of the income generated by the Oil Tax. Williams Deposition at 57-58; also R. 16187-88. It would be difficult to imagine more dramatic proof that the Oil Tax was out of all proportion to any income properly taxable by Alaska.

III. MULTIPLE TAXATION IS PRESENT HERE AND IS THE CONSTITUTIONAL FAULT OF ALASKA.

A. Decisions Approving Apportionment Do Not Justify the Oil Tax.

The Alaska court attempted to justify the Oil Tax on the basis of this Court's decisions in *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978), and *Container Corp. v. Franchise Tax Board*, 463 U.S. 159 (1983). Both of those decisions, however, upheld *apportionment*, not separate accounting. Neither can justify Alaska's insistence on attributing to itself 100% of interstate oil production income properly subject to apportionment among many states. Indeed, this Court said in *Container* that when a unitary business has contact with more than one state, each taxing state "must then apply a formula apportioning the income of that business within and without the State." 463 U.S. at 169. Alaska has not apportioned here.[26]

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[25]Williams Deposition at 52-61 and Exhibits 87, 94; also R. 16187-88. In Container Corp. v. Franchise Tax Board, 463 U.S. 159, 183, this Court explained that the showing of disproportion in *Hans Rees* was based on comparison with an "analysis purposely skewed to resolve all doubts in favor of the State." Appellants have made an equally compelling showing of disproportion by comparing the Oil Tax with the apportionment formula that the Alaska Department of Revenue itself had designed to be "skewed . . . in favor of the State."

[26]Particularly wide of the mark was the Alaska court's reading of *Container*, a case having to do with the intersection of domestic and *foreign* taxation, as justifying unapportioned taxation by an American state. The

The Alaska court was equally wrong in believing that *Moorman* controlled this case. *Moorman* dealt with a situation where the state effected an apportionment and where there was no proof of *actual* double taxation. 437 U.S. at 276. In that context, the case held that the mere *risk* of multiple taxation caused by one state's use of an apportionment formula different from another state's formula was not sufficient to invalidate either formula. 437 U.S. at 277. *Moorman* has nothing to do with this case, since the record here shows *actual* double taxation. See pp.11-12, *supra*.

Even if the analysis of *Moorman* were applicable, moreover, *Moorman* makes clear that a state's method of apportionment will only be upheld, even assuming no actual double taxation, if the *risk* of double taxation is "not the fault, in the constitutional sense" of the taxing state. The Alaska court paid its respects to this rule by acknowledging that the validity of the Oil Tax depended on a finding that the double taxation caused by the Oil Tax was not constitutionally "the fault" of Alaska. App. 41a. But the court below ignored the evidence showing that Alaska is indeed at fault.

B. Multiple Taxation Is the "Fault" of Alaska Because the Oil Tax Is Unapportioned, Is Tailored to Interstate Commerce, And Is Internally Inconsistent.

In the first place, it is clear that an unapportioned tax renders a state at "fault." The practical basis of *Moorman* is the fact that "rough approximation" is inherent in the

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Commerce Clause, of course, does not apply abroad. When this Court is faced with an unapportioned foreign tax that causes double taxation, as happened in both *Japan Line* and *Container*, it cannot invalidate the foreign tax, as it would a similar state tax. This Court can do one of only two things: either it can restrict the ordinary right of American states to tax by apportionment, or it can tolerate some double taxation. In *Japan Line*, the Court did the former, in *Container* the latter. And in *Container* the Court explained the difference between the two cases by saying that "the 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," 463 U.S. at 188. Apportionment, in other words, is *more* favored in income tax than in property tax situations, and unapportioned taxes less so. In *Japan Line*, however, it was conceded that the unapportioned foreign tax would have been invalid if levied by an American state. *Container* necessarily implies that Alaska's unapportioned Oil Tax, being on income, is even *more* vulnerable to constitutional challenge than the *concededly* invalid property tax levied by Japan.

concept of apportionment. 437 U.S. at 273. This Court made clear in *Japan Line, Ltd. v. County of Los Angeles,* 441 U.S. 434, 455 (1979), that in *Moorman* "the problem arose, not from lack of apportionment, but from mathematical imprecision in apportionment formulae." *Moorman* has no application, as Justice Blackmun said for the Court, "where true apportionment does not exist." 441 U.S. at 455.[27]

Second, the apportionment formula upheld in *Moorman* was one of general applicability, which covered all, or virtually all, taxpayers in the state. When an apportionment formula is generally applicable, this Court can have some confidence that the normal pull and haul of the political process will result in rough justice for everyone, that the formula involves no discrimination against interstate commerce as such, and that the formula responds only to the inevitable difficulties of trying to divide the essentially indivisible income of a unitary business.

Not so here. The Oil Tax is not a generally applicable enactment. It falls only on interstate businesses, and only on Alaska's principal export. For all practical purposes it is a special levy on the three appellants in this case. As this Court said in *Complete Auto Transit,* "A tailored tax, how-

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[27]Considerations of a proper federalism reinforce this conclusion. If the legislature of a state has recognized, by enacting an apportionment formula, that it must share a particular subject of taxation with other states also entitled to tax that subject, it is hard for a court to articulate and apply a standard for saying that one apportionment formula is better than another. Even if the simultaneous existence of conflicting formulas creates some possibility of multiple taxation, the difficulty of finding a neutral basis for preferring one formula to another means that a court cannot easily determine which of the conflicting formulas is "at fault." 437 U.S. at 277.

None of these considerations applies, however, when a state seeks, like Alaska, to levy a tax on 100% of a subject matter that other states are entitled to and do tax. Not only is double taxation certain in such a case, but there is no difficulty in ascertaining, in a perfectly neutral fashion, which of the states is at fault: obviously it is the state that has made double taxation certain by trying, despite the rights of other states, to allocate a taxable subject matter exclusively to itself. Little deference is appropriate for a state that refuses to share. On the contrary, the mutual accommodation among states that lies at the heart of American federalism is strengthened by enforcing a rule that requires states to take account, in designing their tax systems, of the legitimate and competing rights of other states.

ever accomplished, must receive the careful scrutiny of the courts to determine whether it produces a forbidden effect . . . ." 430 U.S. at 289 n.15. Whatever judicial deference may ordinarily be afforded to an apportionment formula, deference is inappropriate when a state has tailored its tax to raise revenue from a specific interstate business or a specific group of interstate taxpayers. In that situation careful scrutiny, not deference, is required. *Ibid.*

Finally, this Court pointed out in *Moorman* that the risk of double taxation was not inherent in either apportionment formula; it could "be avoided by the adoption of any uniform rule." 437 U.S. at 277 n.12. While the Oil Tax was in place, Alaska's tax system was different: even if it had been adopted by all 50 states, it would have produced double taxation by subjecting appellants' *total* income to more than 100% taxation. Alaska thus violated the constitutional requirement of "internal consistency": the requirement that a tax "must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed." *Container Corp. v. Franchise Tax Board,* 463 U.S. 159, 169 (1983); *Armco Inc. v. Hardesty,* 52 U.S.L.W. 4787 (June 12, 1984).[28]

There can be no dispute in this record that, throughout the period the Oil Tax was in force, Alaska's tax laws were

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[28]Affidavits filed in the Superior Court showed that if all states adopted Alaska's laws, more than 100% of the total book income of each taxpayer would have been taxed in each year in issue — e.g., in 1980, the states would have taxed 160% of Exxon's total income, 116% of Arco's, and 162% of Sohio's. R. 13455, 13746, 14207. The reason that Alaska's tax system, if applied by all 50 states, would inevitably have produced more-than-100% taxation is readily understood. If a taxpayer had wells in Alaska, under the Oil Tax Alaska taxed 100% of the taxpayer's production income from Alaskan oil, as well as an apportioned share of the taxpayer's refining, marketing, and other income. AS 43.21.040. If, however, a taxpayer had no producing wells in Alaska, Alaska applied apportionment to the taxpayer's *total* income, including not only refining, marketing, and other income but *also* oil production income arising from wells in states other than Alaska. AS 43.20; App. 408a. If all states had used the Alaska system, the production states together would have taxed 100% of production income. The other states where a taxpayer operated would also have taxed, by apportionment, a share of that same production income. And all states would have used apportionment to divide up refining and marketing income. The necessary result would have been more-than-100% taxation of total income.

applied in exactly this manner. The Director of the Division of Audit of the Alaska Department of Revenue, the responsible state official, so testified. App. 408a. The double taxation of appellants caused by the Oil Tax in those years was unmistakably the result of a tax system that was internally inconsistent, and therefore "at fault" under *Moorman.*[29]

IV. THE MEASURE OF ALASKA'S TAX IS NOT REASONABLY RELATED TO APPELLANTS' CONTACTS WITH ALASKA.

In *Commonwealth Edison Co. v. Montana,* 453 U.S. 609 (1981), this Court considered the claim that Montana's severance tax on coal violated the Commerce Clause because the amount of the tax was not reasonably related to the value of the services provided by the state. The Court rejected the taxpayer's claim of invalidity, holding that the question was not whether the *amount* of the tax is reasonably related to the services provided by the taxing state, but whether the *measure* of the tax is reasonably related to the taxpayer's contacts with the state. 453 U.S. at 626.

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[29]After the repeal of the Oil Tax and the close of all the tax years in issue, and following the filing of appellants' papers in the Superior Court which showed that Alaska's tax laws were internally inconsistent, Alaska unveiled a "Tax Ruling" that purported to modify retroactively the way Alaska taxed companies, unlike appellants, that did *not* have wells in Alaska. Alaska chose, in effect, to pretend that it had applied its tax laws differently than was in fact the case. This "ruling" was transparently no more than a piece of litigation strategy, intended to defeat the internal inconsistency argument and save the Oil Tax by giving small refunds under a different tax. This disingenuous administrative afterthought cannot, however, defeat appellants' constitutional claims. Those claims are based on the double taxation that was caused by the Oil Tax between 1978 and 1981; the relevance of the internal consistency test is to help this Court determine whether Alaska, or some other state, was responsible for the double taxation occurring in those years. Alaska's tax system, as it applied in the years when the double taxation occurred, did not and could not meet the internal consistency test. It follows that Alaska, not the other states, was responsible for the double taxation, and that Alaska, not the other states, was "at fault."

In any case, the internal consistency test would lose much of its practical meaning if it assumed that all states will adopt Alaska's priorities by abandoning the use of apportionment to tax oil production income. They plainly will not. Rather, they will conform their own versions of the Oil Tax to whatever is *their* principal export and tax other industries, such as oil, by apportionment. See p. 12, *supra.*

Montana's was a severance tax. The "operating incidence" of that tax, this Court held, was "on the mining of coal within Montana," 453 U.S. 626. The "operating incidence" of Alaska's tax, however, is not on the extraction of oil, but on the earning of income, and specifically on the earning of income from the sale in other states of oil from Alaskan wells. The activities that result in that income take place in many states, and the income is subject to tax in many states.

The measure of Alaska's tax, however, is not related to the income-producing activities that take place in Alaska. It makes no difference if a taxpayer alters its business so that more, or less, of that business is done in Alaska.[30] However the taxpayer's business may be organized in fact, the Act allocates to Alaska 100% of the taxpayer's production income from Alaskan oil. The measure of the tax is not proportioned in any way to the quantity of business that is done in Alaska, and the Oil Tax cannot pass muster under *Commonwealth Edison.*

V. THE OIL TAX IMPROPERLY DISCRIMINATES AGAINST APPELLANTS AND PROVIDES A DIRECT COMMERCIAL ADVANTAGE TO LOCAL ALASKA INTERESTS.

There is no room for dispute as to what the Oil Tax does on its face: it singles out a handful of interstate oil companies for significantly different and more burdensome treatment than that accorded all other corporate taxpayers. As Alaska's Governor acknowledged in his first Budget Message after the Oil Tax Act was passed, "there is no question but that oil has been taxed unequally compared to other resources." R. 15010. In recent years, this Court has been especially vigilant to protect interstate commerce against taxes that involve economic protectionism and unfair treat-

[30]The Appendix contains a careful analysis, by Sidney Davidson, Arthur Young Professor of Accounting and former Dean of the Business School at the University of Chicago, of the consequences of a taxpayer's altering its business operations to shift activities into or out of Alaska. App. 158a.

ment of out-of-state business.[31] Examination of the Oil Tax shows plainly that it has forbidden effects.

To start with, there is the obvious fact that the Oil Tax provides a direct commercial advantage to local interests by throwing on interstate commerce alone the task of satisfying Alaska's appetite for funds, and freeing Alaska's citizens from the responsibility of paying for the services they enjoy. The facts on this point are set out in the Statement of the Case, are examined in detail in the Mieszkowski Affidavit, App. 172a, and need not be repeated again here.

In addition, the effect of the Oil Tax is to subject interstate business to a discriminatory burden of double taxation. An oil company with all its operations in Alaska will pay tax on the basis of 100% of its production income at most. A company operating in more than one state must pay taxes on 100% of its production income to Alaska, and must pay additional taxes on that same income to other states. Once again, the relevant facts have been set out above. They are discussed in detail by Professor Davidson, who shows that the Oil Tax results in a *continuing* tax advantage for local firms. App. 164a.

Finally, the Oil Tax operates to penalize exploration outside Alaska.[32] Alaska has thus used its "power to tax an

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[31]Such taxes may offend both the Commerce Clause and the Equal Protection Clause. Bacchus Imports, Ltd. v. Dias, 52 U.S.L.W. 4979 (June 29, 1984); Armco Inc. v. Hardesty, 52 U.S.L.W. 4787 (June 12, 1984); Westinghouse Electric Corp. v. Tully, 466 U.S. —, 52 U.S.L.W. 4485 (April 24, 1984); Metropolitan Life Insurance Co. v. Ward, 53 U.S.L.W. 4399 (March 26, 1985).

[32]A firm subject to the Oil Tax that drills a well outside Alaska may not deduct the cost of doing so on its Alaska return. If the well is drilled in Alaska, however, the cost of drilling it is deductible. 15 AAC 21.270. Alaska's tax thus creates a penalty if a taxpayer subject to the Oil Tax Act drills a well in any state other than Alaska. If, on the other hand, a taxpayer is not subject to the Oil Tax (because it has no producing wells in Alaska) and its income is taxed by three-factor apportionment, Alaska interprets the Oil Tax as requiring the exclusion of all exploration losses from the apportionable base. App. 411a, 412a, 420a. The effect of these provisions can easily be seen to be discriminatory if one follows this Court's teaching by applying the internal consistency test of Armco Inc. v. Hardesty, 52 U.S.L.W. 4787 (June 12, 1984), to Alaska's tax laws. If all states enacted Alaska's laws, each state where a taxpayer has production income would tax under the Oil Tax and

in-state operation as a means of 'requiring other business operations to be performed in the home State.'" *Boston Stock Exchange v. State Tax Comm'n,* 429 U.S. 318, 336 (1977). Like the tax in *Westinghouse Electric Corp. v. Tully,* 466 U.S. —, 52 U.S.L.W. 4485 (April 24, 1984), the Oil Tax violates "the prohibition . . . against using discriminatory state taxes to burden commerce in other states in an attempt to induce 'business operations to be performed in the home state that could more efficiently be performed elsewhere' and to 'impose an artificial rigidity on the pattern of an industry.'" 52 U.S.L.W. at 4490.

CONCLUSION

This is an important case which raises substantial federal questions. The Court should note probable jurisdiction and set the matter for full briefing and argument.

November 13, 1985

Respectfully submitted,

[Counsel Listed on Following Page]

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would allow deduction only of exploration losses in that state; states where the taxpayer has no production income would tax by apportionment and would allow no deductions for exploration losses at all. The effect of universal application of Alaska's laws therefore is to make the cost of drilling a well in a state where a taxpayer has no producing wells more expensive than the cost of drilling in a state where a taxpayer has production. The obvious consequence is to channel exploration activities into states that already have oil, and away from states that might compete with them if oil were found.

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No. 85-773

IN THE

Supreme Court of the United States

OCTOBER TERM, 1985

ATLANTIC RICHFIELD COMPANY; ARCO PIPELINE COMPANY; EXXON CORPORATION; EXXON PIPELINE COMPANY; BP ALASKA INC.; SOHIO ALASKA PETROLEUM COMPANY; and SOHIO PIPE LINE COMPANY,

Appellants,

v.

STATE OF ALASKA, *et al.*,

Appellees.

On Appeal from the Supreme Court of Alaska

MOTION TO DISMISS OR AFFIRM

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TABLE OF CONTENTS

TABLE OF CONTENTS—Continued

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES—Continued

TABLE OF AUTHORITIES—Continued

TABLE OF AUTHORITIES—Continued

MOTION TO DISMISS OR AFFIRM

The State of Alaska respectfully moves this Court to dismiss this appeal on the ground that the appeal does not present a substantial federal question, or, in the alternative, to summarily affirm the judgment below.

INTRODUCTION

The State of Alaska imposes on every corporation a 9.4% tax on net income derived from sources within the State. This tax applies uniformly to multistate corporations and to those doing business only in Alaska, but it is levied only on the portion of a multistate corporation's income earned within the State.

For most industries, Alaska uses the standard three-factor apportionment formula to estimate the income earned in the State by a multistate taxpayer. In 1978, when oil production became Alaska's predominant economic activity, the Alaska Legislature determined that continued use of a formula unsuited to oil production would attribute to Alaska only about one-quarter of the oil production income actually earned in the State. The Legislature found that as a result, oil producers would pay an effective tax rate on Alaskan income of only 2 to 3%, far below the statutory 9.4% uniform rate. To equalize effective tax rates for all corporate taxpayers, the Legislature enacted the Oil and Gas Corporate Income Tax, Alaska Stat. §§ 43.21.010-.120 (1978) [hereinafter "AS 43.21"]. Instead of a formula, AS 43.21 used the division-of-income method widely recognized to be the most accurate for oil production income: arm's length geographical separate accounting.[1]

In an attempt to mislead this Court into believing a substantial issue is presented here, appellants [herein-

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[1] See pp. 7-8 *infra*. AS 43.21 also applies separate accounting to determine the income generated by natural gas production and by pipeline transportation of oil or gas within the State. For simplicity, however, we refer only to "oil production income."

after "taxpayers"] portray Alaska's adoption of traditional separate accounting as an aberrational overreaching of the State's legitimate taxing authority. This position is wholly disingenuous. The majority of major oil-producing States require use of separate accounting to divide the oil production income of multistate companies,[2] as does the Internal Revenue Code for determining the U.S. oil production income of multinational corporations that produce oil in this country for sale abroad.[3] Tax conventions and treaties to which the United States is a party also require separate accounting.[4] Alaska's separate accounting statute is *identical* to these other separate accounting laws in all material respects.

The leading experts in state taxation acknowledge that separate accounting, not formula apportionment, is "the prevailing method . . . for reporting income from oil production." [5] In the most comprehensive federal study of state taxation in several decades, the Comptroller General of the United States explained that oil-producing States generally require separate accounting for oil production

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[2] Of the five largest oil producing States, three (Oklahoma, Louisiana, and Alaska) require separate accounting. *See* Appendix to Jurisdictional Statement 17a n.25 [hereinafter "App."] and notes 13 & 16, *infra*. Texas does not have a corporate income tax. Only California requires formula apportionment. *See Statistical Abstract of the United States* 730 (103d ed. 1982-83).

[3] 26 U.S.C. §§ 861-64; Treas. Reg. §§ 1.861-8(a)(1), 1.863-1(b)(1), -1(c); Treas. Reg. §§ 1.482-2(b)(1), (3), (6), and -2(e)(1)(ii). The foreign tax credit provisions of the Code also employ separate accounting for oil and gas production. *Compare* 26 U.S.C. § 907(d) *with* AS 43.21.020.

[4] OECD Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, *reprinted in* 1 Tax Treaties (CCH) ¶ 151; U.S. Treasury Dep't Draft Model Income Tax Treaty, June 16, 1981, *reprinted in* 1 Tax Treaties (CCH) ¶ 158.

[5] Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Corporate Groups*, 25 Tax L. Rev. 171, 191 (1970); *see* J. Hellerstein, *State Taxation: Corporate Income and Franchise Taxes* 396 n.309 (1983), *quoted infra* p. 6.

income because it "conforms more to [oil production companies'] financial accounting practices and, for these specific situations, *more accurately reflects income than* formula apportionment." [6]

There is also unanimity among the courts. Every court that has considered the constitutionality of separate accounting for oil production income has not only upheld its use, but has found that it is a *more* accurate method of attributing oil production income than formula apportionment.[7]

The central issue actually presented by this appeal is whether the Constitution prohibits Alaska from using traditional arm's-length separate accounting, and instead requires formula apportionment. That issue was foreclosed by this Court's decision just two years ago in *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983). To avoid the clear controlling force of that precedent, taxpayers distort the facts and mischaracterize this Court's recent key decisions on state taxation. Their arguments reduce to two simple—but clearly erroneous—propositions, neither of which merits plenary review.

Taxpayers' first claim is that AS 43.21 is an "unapportioned" tax which taxes "100% of something that other states are entitled to tax by apportionment." Jurisdictional Statement at 9, 12 [hereinafter "J.S."]. This argument is based on a conceptual trick: the false notion that other States' formula apportionment laws entitle them to reach into Alaska and tax a share of the same income Alaska taxes. This Court has already seen through and soundly rejected an identical mischaracteri-

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[6] U.S. General Accounting Office, *Key Issues Affecting State Taxation Of Multi-Jurisdictional Corporate Income Need Resolving* 3 (1982) (emphasis added) [hereinafter "GAO Report: Key Issues"].

[7] *Webb Resources v. McCoy*, 194 Kan. 758, 401 P.2d 879, 889 (1965); *Texas Co. v. Cooper*, 236 La. 380, 107 So.2d 676, 690 (1958); *Magnolia Petroleum v. Oklahoma Tax Comm'n*, 190 Okla. 172, 121 P.2d 1008, 1011-13 (1941).

zation of the purpose and operation of separate accounting and formula apportionment in *Container Corp.*

Second, based solely upon this conceptual error, taxpayers argue that use of separate accounting and formula apportionment by different States inevitably causes multiple taxation; and that since most States use formula apportionment, the Commerce Clause should now be interpreted to forbid other States' use of separate accounting. This misguided argument was squarely rejected in *Container Corp.* This Court's holding there that the concurrent use of separate accounting and formula apportionment is perfectly acceptable, 463 U.S. at 188, 195, is fully controlling here.

Container Corp. reaffirmed this Court's long tolerance of different methods of income allocation, as long as such methods do not result in a grossly disproportionate attribution of a multistate taxpayer's income to the taxing State. As the Court there said, "we have long held that the Constitution imposes no single formula on the States." 463 U.S. at 164. For that reason, the Court has consistently imposed upon a taxpayer "the 'distinct burden,' " *id.* at 164 (citations omitted), of proving "*by 'clear and cogent evidence'* that the income attributed to the [taxing] State is in fact 'out of all appropriate proportions to the business transacted . . . in that State,' or has 'led to a grossly distorted result.' " *Id.* at 170 (emphasis added) (quoting, *inter alia, Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 274 (1978)).

Taxpayers in this case made a deliberate, strategic judgment below not even to try to adduce such evidence. Instead, taxpayers litigated this case as a *per se* attack on separate accounting. But as the court below recognized, *Container Corp.* has flatly foreclosed that approach. Taxpayers offer no reason why just two years later this Court should reconsider *Container Corp.*, abandon its longstanding deference to the States in the field of taxation, or invalidate a division-of-income method favored by the United States, by international treaty and practice, and by the majority of major oil-producing States.

STATEMENT OF THE CASE

At Statehood in 1959, Alaska became the first State to adopt the Uniform Division of Income for Tax Purposes Act [hereinafter "UDITPA"], now used by many States. In general, UDITPA (and the Multistate Tax Compact, which incorporates UDITPA) estimates the in-state income of a multistate company by use of a mathematical formula incorporating certain indicators of business activity within the State. The formula averages the fractions (or percentages) of the taxpayer's nationwide property, sales, and payroll that are found within the taxing State, and then multiplies the resulting average percentage by the taxpayer's nationwide income.[8]

UDITPA's formula assumes that for most mercantile and manufacturing industries, income is generated in equal proportions by these three "factors" or sources of profit, and therefore uses them to approximate roughly the income earned in the taxing State. It has long been recognized, however, that the "three-factor" formula is the product of political compromise,[9] and that for some industries it does not produce a fair estimate of in-state income.[10] UDITPA therefore permits a State to require "in respect to all or any part of the taxpayer's business activity" reasonable alternative methods of income allocation—including separate accounting. UDITPA § 18. Most States have, in fact, enacted exceptions to the three-factor formula for various industries, including natural

[8] Thus, for example, if 2% of a company's nationwide property, 3% of its nationwide sales, and 7% of its nationwide payroll are located in Wisconsin, then under UDITPA's formula, Wisconsin would be entitled to assume that 4% of the company's nationwide income was earned in Wisconsin, and levy a tax on that amount.

[9] *See* Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 Taxes 747, 750 (1957).

[10] J. Hellerstein, *State Taxation*, *supra* n.5, at 689; *see* App. 16a.

resource extraction, financial oragnizations, utilities, construction, and transportation.[11]

Most major oil-producing States have chosen separate accounting for oil production income because the UDITPA formula grossly *underattributes* the in-state income of a producing company. As the leading academic commentator in the field of state taxation has observed, "[t]he three-factor formula may be inappropriate to such industries as petroleum . . . in failing to give adequate weight to the State of origin of the natural resource on which the industry is based, and which is basic to the profit of the enterprise." J. Hellerstein, *State Taxation*, *supra* n.5, at 396 n.309.

This underattribution is the result of the fact that none of the three UDITPA factors measures the major source of oil production profits, the value of the crude oil itself. The property factor grossly undervalues an oil-producing company's in-state assets because, under oil industry accounting practices only lease acquisition costs —and not the value of the oil reserves themselves—are carried on the taxpayers' books as "property". Thus there is no dispute, as the court below found, that "the Prudhoe Bay field is valued [in the UDITPA property factor] at about *one percent* of its actual worth." App. 17a (emphasis added). The payroll factor also underrepresents oil production activities, because oil production is not labor-intensive. And the sales factor severely underattributes income to an oil-producing State like Alaska, which has little market for the resource it produces.

When oil began to dominate the Alaskan economy it was imperative that Alaskan oil production income be determined accurately. The Alaska Legislature responded to the formula's defects by enacting an exception to UDITPA, AS 43.21, that required use of separate accounting to calculate the portion of a company's oil pro-

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[11] *See* Appendix for a partial listing of more than sixty such industry-specific allocation rules.

duction income earned in the State. Under separate accounting, a taxpayer's gross income from oil production is the value of the oil produced in the State, before it leaves the State's borders. In other words, under AS 43.21, Alaskan *gross* oil production income equals the number of barrels of crude oil produced in the State multiplied by the wellhead value of each barrel, *i.e.*, the crude oil's market value at the point of production.[12] This concept of gross oil production income is the same as that used by other oil-producing States that require separate accounting,[13] and in various provisions of the Internal Revenue Code and U.S. Treasury Regulations.[14] Contrary to taxpayers' misleading innuendos, by using the in-state market value of the crude oil, *separate accounting completely excludes from taxation all profits earned by taxpayers from all activities occurring "downstream" from the wellhead, i.e.*, transportation profits, profits from refining the crude oil, and profits from distributing and marketing retail products.[15]

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[12] AS 43.21.020(b). When the oil is sold in Alaska, that sale price is used to determine wellhead value. When there is no such sale—for example, when taxpayers transfer the crude oil from their production departments to their own refining departments, and "deem" the transfer to have taken place outside Alaska—the in-state market value of the oil must be derived. This is done by taking the closest available out-of-state market price, and deducting all costs of transporting the crude oil from the wellhead to that point (including the transporter's profit). 15 Alaska Admin. Code § 21.130(b) [hereinafter "AAC"]. This "net-back" approach has traditionally been used throughout the oil industry for purposes such as calculating windfall profit taxes, royalty payments, and severance taxes. *See, e.g.*, U.S. General Accounting Office, *Response to Questions About the Windfall Profit Tax on Alaskan North Slope Crude Oil*, 1 & appendix 10 (1984).

[13] La. Admin. Code art. 47:244.3.B.1.b (1975); Miss. Code Ann. § 27-7-23(c)(2)(B)(iii) (7 Supp. 1985); Okla. Stat. Ann. tit. 68, § 2358, A.4.a. (West Supp. 1984).

[14] 26 U.S.C. §§ 861-64; Treas. Reg. § 1.863-1(b)(1).

[15] Under AS 43.21.040, the in-state *refining* and *marketing* income of oil companies is separated out from production income and deter-

To arrive at net (taxable) income, separate accounting deducts from gross income *all* of the direct and indirect costs of producing Alaskan oil, whether they are incurred in or out of the State. Deductible costs include all direct operating costs, all taxes (including federal windfall profit taxes, severance taxes, conservation and property taxes), royalties, current amortization, unsuccessful exploration costs, lease acquisition costs, and capitalized interest. AS 43.21.020(c). General corporate overhead and administrative expenses attributable to the production of Alaskan oil are also deducted. AS 43.21.020 (c)(9). The expenses and deductions permitted by Alaska's separate accounting statute are substantially identical to those permitted by the separate accounting laws of other oil-producing States, and by the Internal Revenue Code.[16]

Alaska's separate accounting law was in effect from 1978 through 1981. During that period, these taxpayers earned over $21 billion in profits from the production of oil in Alaska, and paid approximately $2 billion in corporate income taxes to the State. In light of taxpayers' contention that Alaska has singled them out for "burdensome" taxation, it is important to recognize that these taxpayers paid a large amount of taxes for no other reason than that, because of an unanticipated *four-fold in-*

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mined by an apportionment formula that *excludes* all oil production income, and all the payroll, property and sales associated with oil production. Since these taxpayers have no refineries in Alaska, and sell virtually no refined products there, Alaska taxes only a negligible fraction of taxpayers' worldwide refining and marketing income, corresponding to the refining and marketing factors found in the State. *See* pp. 23-24 *infra*.

[16] La. Admin. Code art. 47:244.3.A, B.3 (1975); Miss. Code Ann. § 27-7-23(c)(2)(B) (7 Supp. 1985); Okla. Stat. Ann. tit. 68, § 2358, A.4.a (West Supp. 1984); Miss. Admin. Reg. 1.27-7-23(7)(c)(2) (1979); Treas. Reg. §§ 1.863-1(c), 1.861-8(a)(1), -8(b)(3) and -8(c)(1).

crease in world crude oil prices,[17] they realized a phenomenal increase in oil production profits in the late 1970's and early '80's.

Although the State was not required to do so, it introduced in the court below substantial evidence showing that the income *taxpayers themselves* attributed to Alaskan oil production—in their own annual reports, in reports to federal agencies (including the SEC and the Department of Energy), and in income tax returns filed with other States—was equal to or greater than their Alaskan income as determined by AS 43.21. R. 16912-17. That evidence confirmed that the Alaska Legislature was right on the mark in finding that separate accounting is a far more accurate division-of-income system for oil production than formula apportionment.

It is also essential to realize that taxpayers paid, and would pay under any division-of-income method, a very high percentage of all Alaskan corporate income taxes simply because their profits dwarf all other corporate earnings in Alaska. Alaska is not blessed with a diverse economy. Prior to the first production of oil from Prudhoe Bay in 1977, Alaska's economy was that of a struggling frontier. When oil production began, it virtually eclipsed all other economic activity in the State.[18] Thus,

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[17] In 1976, before Prudhoe Bay production began, American crude oil had an average wellhead value of $8.19 a barrel. In 1978, when AS 43.21 was enacted, oil was at $9.00 a barrel. By 1981, domestic crude had risen to $31.77 a barrel, with no commensurate increase in the *cost* of producing this oil. *See* U.S. Energy Information Administration, *Monthly Energy Review* 86 (Sept. 1983).

When the *increase* in crude oil prices over the four tax years is multiplied by the prevailing rate of North Slope production—approximately 1.6 million barrels per day—the *additional profit bonanza* realized by *all* North Slope producers *attributable to skyrocketing oil prices alone* was over $24 billion.

[18] An "essentially complete" description of the manufacturing sector in the State is: two pulp mills, three small refineries, two natural gas plants, and several seafood processing plants. R. 16970. Alaska's only significant corporate tax base is the harvesting of natural

even if taxpayers' Alaskan income had been estimated by the three-factor formula, these three taxpayers would *still* have paid approximately 83% of *all* the income taxes collected by the State.[19]

In this litigation, despite an ample opportunity to do so, taxpayers never submitted evidence of any kind from which the trial court could reasonably have found that AS 43.21 attributed income to Alaska that was in any way different from what taxpayers actually earned there —much less "out of all appropriate proportion" to it. Taxpayers were thus left with an entirely theoretical challenge to separate accounting, a challenge now completely foreclosed by the recent *Container Corp.* decision. Recognizing this, the Alaska Supreme Court affirmed the trial court's order granting summary judgment to the State.

THE QUESTIONS PRESENTED ARE INSUBSTANTIAL

I. THE CENTRAL QUESTION PRESENTED—WHETHER SEPARATE ACCOUNTING MAY CONSTITUTIONALLY CO-EXIST WITH FORMULA APPORTIONMENT—WAS ANSWERED BY THIS COURT IN THE AFFIRMATIVE IN *CONTAINER CORP.*

The cornerstone of taxpayers' appeal is their assertion that the use of separate accounting (or the "arm's-length

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resources. *Id.* The impact of oil production activity on Alaska's otherwise marginal economy can be appreciated by comparing it with the State's next most valuable resource, seafood. In 1981, the gross value of fish harvested in Alaska waters was approximately *one-twentieth* of the wellhead value of oil produced in that year. Dep't of Education, *Alaska Blue Book* 275 (1985).

[19] Taxpayers claim that under AS 43.21 the oil industry paid 95% of the income taxes in Alaska, J.S. at 3, and under UDITPA they would have paid about one-quarter of that amount, App. 181a. If, out of $100 of total State income tax revenue, oil companies paid $95 under AS 43.21, they would pay only $23.75 (one-quarter) under UDITPA. That would be 83% of the sum of $23.75 and $5 (non-oil income tax revenue).

method") by one State combined with the use of formula apportionment by other States inevitably leads to multiple taxation. But that precise contention was expressly rejected by this Court in *Container Corp.*:

> Here . . . we are faced with two distinct methods of allocating the income of a multinational 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.

463 U.S. at 188 (footnote omitted). This holding—that the two methods are not inherently incompatible, and, in the Court's words, do not "create an automatic 'asymmetry' "—controls this case. *Id.* at 194-95.

Ignoring *Container Corp.*, taxpayers repeatedly assert that "a state may not attribute to itself for taxation 100% of something other states are entitled to tax by apportionment," J.S. at 9-10 (footnote omitted); *see* J.S. at 12, 13, 13-14, and that, in using formulas, other States tax "a share" of that "something". J.S. at 11, 12; *see* J.S. at 13, 13-14.

This argument is nothing but a conceptual trick. Quite simply, neither apportionment formulas nor separate accounting are intended to—or do in fact—operate the way taxpayers contend.

A. Taxpayers' Arguments Are Based On A Conceptual Trick.

1. *It Is Perfectly Proper For Alaska To Levy A Tax On 100% Of Income Earned In The State.*

There is absolutely nothing wrong with Alaska applying its 9.4% tax rate to 100% of the income that its division-of-income rule reasonably attributes to the State. Every State, no matter what method it uses to divide income, levies a tax on *all* of the income it estimates was generated within its borders. Thus, taxpayers' litany that "Alaska taxes 100%" is true only in the same sense that California, Oklahoma, and Wisconsin also tax "100%" of California-, Oklahoma-, and Wisconsin-generated income, respectively. Each taxes 100% of the *portion* of a taxpayer's multistate net income that the State's division-of-income rules attribute to that State.

Taxpayers also mischaracterize the nature of the portion that Alaska taxes. AS 43.21 does *not*, as taxpayers allege, tax "all the net income that results when crude oil from Alaskan wells is sold in the Lower 48 States." J.S. at 7. Rather, it defines oil production gross income as the market value of the crude oil at the wellhead. It thereby excludes *all* income derived from the subsequent transportation, refining, distribution, marketing and final sales of Alaskan crude oil and its products. All production costs are then deducted. The remainder is clearly *not* all of the income taxpayers ultimately derive from Alaskan oil. As demonstrated in the oil barrel chart set out in the opinion below, App. 5a n.6, the total revenue taxpayers derived from the sale of a barrel of Alaskan crude oil was $26.64. Alaska levied its tax on only $6.77 of this amount, the net profits derived solely from the production of oil in Alaska.[20]

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[20] Taxpayers would like this Court to believe that AS 43.21 is flawed because most of the oil produced in Alaska is not "sold" in the State. It is not clear, however, what this purported flaw is. First, most Alaskan crude is not *sold* at all—it is transferred to the taxpayers' self-owned refineries in the lower 48 States. R. 12692, App. 296a. Second, AS 43.21 is not a forbidden unapportioned gross receipts tax levied by the origin state "on" interstate sales. It is a *net* income tax that sometimes must use an out-of-state value (refinery gate price) in deriving the market price of crude oil before it leaves the State. *See Texas Co. v. Cooper*, 107 So. 2d at 687. A *net* income tax *may* use an origin-state sales factor (*Moorman*, 437 U.S. at 278 n.13), or may ignore the contribution of sales to income entirely. *Underwood Typewriter v. Chamberlain*, 254 U.S. 113, 118 (1920).

2. *No Other State Is Entitled To "Tax A Share" Of Oil Production Income Earned In Alaska.*

Contrary to taxpayers' misleading contention, States that use formulas do not—and may not—tax a share of the income generated by taxpayers' activities in Alaska. An apportionment formula is not a license to engage in extraterritorial taxation. Rather, it is a method that a State constitutionally may use to estimate (albeit roughly) the income earned by activities *within* the State.

The common three-factor formula estimates a State's tax base by assuming that a State's percentage of a business's total net income is roughly equal to the average of the fractions of its total payroll, property, and sales that are located in the State. *Container Corp.*, 463 U.S. at 170, 183. The sole purpose of the formula, however, is to arrive at "a rough approximation of a corporation's income . . . *within the taxing State*," *Moorman*, 437 U.S. at 273 (emphasis added), not to tax a share of the income it earns in every other State.[21]

Taxpayers claim to have proved "actual" double taxation in this case because, in their words, "42 other states actually tax a share of Exxon's production income from Alaskan oil: those states treat a total of 30% of that income as 'their' income, in addition to the 100% that Alaska says is 'its' income," J.S. at 11 n.10 and 11-12. This 30% figure is nothing more than

[21] If Wisconsin averages the fractions of Exxon's property, sales and payroll found in Wisconsin and arrives at an apportionment fraction of 2%, which it then multiplies by Exxon's income earned in all fifty States, Wisconsin is still only estimating and taxing—indeed, is constitutionally *bound* only to tax—income earned in Wisconsin. It is *not* taxing 2% of Exxon's income earned in Alaska, as appellants claim, any more than it is taxing 2% of Exxon's income earned in California (which also uses a formula), in Texas (which has no income tax), or in Oklahoma (which, like Alaska, separately accounts). Rather, if 2% of Exxon's factors are in Wisconsin, then Wisconsin may constitutionally assume for tax purposes that income follows those factors in rough proportion, and may therefore levy a tax on 2% of Exxon's nationwide income.

the sum of the apportionment percentages calculated by the 42 States that use formula apportionment. App. 407a. In other words, the 42 formula States attribute to themselves (and thus tax) 30% of Exxon's nationwide production, refining and retailing income. Alaska, of course, does not tax 100% of Exxon's nationwide income; rather, it levies its tax on 100% of the *portion* of Exxon's *production income* that it determines was *earned in Alaska*. It is thus a trick and a deception to claim the 130% "double taxation" taxpayers claim here by adding together the 30% of Exxon's *total nationwide income* that formula States tax and the 100% of *Alaskan production income* that Alaska taxes. The two are simply apples and oranges.

That 42 formula States collectively levy taxes on 30% of Exxon's nationwide income says nothing about whether Exxon is subjected to actual multiple taxation. In fact, based upon appellants' 1978 to 1980 tax returns in all the States, including Alaska, it is undisputed that during these years Exxon was actually taxed on only 51.4% of its total nationwide income, R. 16923, and therefore benefited from remarkable *undertaxation*. Similarly, ARCO was taxed on only 63.0% of its total income by all the States. *Id.*[22]

B. The *Container Corp.* Decision Controls This Case.

Two years ago, in *Container Corp.*, this Court was confronted with the same erroneous argument made by taxpayers here: that formula apportionment and separate accounting are constitutionally incompatible and necessarily generate double taxation because California's formula taxed a portion of income that was taxed in full by other countries' separate accounting.[23]

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[22] Although Sohio's complicated corporate structure makes a similar straightforward calculation difficult, it appears that Sohio was taxed by all the States on about 95% of its total nationwide income during 1978-80. R. 16925.

[23] *See* Appellant's Brief On The Merits at 9, *Container Corp. v. Franchise Tax Bd.*, No. 81-523 (U.S. July 30, 1982); Brief for Gulf

Applying the "additional scrutiny required by the Foreign Commerce Clause," the Court declined to hold that one division-of-income method is constitutionally preferred. 463 U.S. at 185. Noting that both separate 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," 463 U.S. at 182, the Court concluded, "[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 . . . separate accounting . . . ." *Id.* 183-84.

The Court categorically rejected the contention that the combination of separate accounting and formula apportionment inevitably results in multiple taxation. "Whether the combination of the two methods results in the same income being taxed twice or in some portion not being taxed at all is dependent solely on the facts of the individual case." *Id.* at 188 (footnote omitted). Thus, even though the parties in *Container Corp.* did not dispute that *actual* double taxation had occurred on the particular facts of that case, *id.* at 187 n.22, the Court concluded that "it would be perverse" to hold that the Constitution forbids the use of either method. *Id.* at 193.

C. Taxpayers Misrepresent This Court's Decision In *Exxon v. Wisconsin* And Misapply Cases Dealing With Gross Receipts And Property Taxes.

It is ironic that in attempting to avoid *Container Corp.*, taxpayers rely almost entirely on the decision in *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207 (1980). *See* J.S. at i, 10, 11. There, one of these same taxpayers attempted unsuccessfully to persuade this Court that separate accounting for oil production income was constitutionally *required.* Having failed in that attempt, taxpayers here contend that the same method is constitutionally *forbidden.*

Oil Corporation as Amicus Curiae at 5, 17; Brief of Phillips Petroleum Company as Amicus Curiae at 3.

In that case, Exxon argued that because its internal accounting system could separately account for oil production income with accuracy, Wisconsin was constitutionally required to exclude that income from the total income pie against which the State applied its apportionment fraction. In rejecting that contention, the Court reaffirmed a long line of precedents granting wide latitude to the States in their choice of division-of-income methods. 447 U.S. at 219-23; *see Container Corp.*, 463 U.S. at 164.

In upholding Wisconsin's particular application of formula apportionment, the Court recognized that Wisconsin was not attempting to tax a portion of Exxon's production income in Alaska or elsewhere; the Court simply upheld Wisconsin's use of Exxon's nationwide income as the total income pie to which Wisconsin applied an apportionment fraction in order to arrive at an estimate of Wisconsin income. 447 U.S. at 226-27. Thus, the Court did not hold, nor in any way suggest, as taxpayers claim, that "separate accounting may not be used" by some States when other States are constitutionally permitted to use formula apportionment.[24] J.S. at i.

Taxpayers' heavy reliance on property tax cases and gross receipts tax cases[25] is also entirely misplaced. In

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[24] Neither does the holding of *Mobil Oil Corp. v. Comm'r of Taxes*, 445 U.S. 425 (1980), support the taxpayers' argument. In *Mobil*, the exclusion sought by the taxpayer was premised on the legal fiction that dividend income could be taxed only by the State of commercial domicile. Mobil accordingly argued that Vermont was required to exclude from its apportionable base all dividend income from foreign subsidiaries received by the parent company, which was domiciled in New York. The Court's rejection of this attempt to erode the unitary theory on the basis of a legal fiction was predictable, and, as the dissent noted, makes that holding rather "unexceptional." *Id.* at 450 (Stevens, J., dissenting). *Mobil*, then, had nothing to do with separate accounting.

[25] J.S. at 12-14, 19-20 & nn.11-12, citing, *e.g.*, *Japan Line v. County of Los Angeles*, 441 U.S. 434 (1979); *Standard Oil v. Peck*, 342 U.S. 382 (1952); *J.D. Adams Mfg. v. Storen*, 304 U.S. 307 (1938); *Evco v. Jones*, 409 U.S. 91 (1972).

those cases, unlike in net income tax cases, one taxing jurisdiction taxed the whole pie while another taxed a slice, a situation inevitably producing double taxation.

The property tax cases are exemplified by *Japan Line v. County of Los Angeles*, 441 U.S. 434 (1979). In that case, Japan taxed the full value of cargo containers used in international trade, while California taxed a part of the value of those same containers. The result was inevitable double taxation. However, in *Container Corp.*, this Court distinguished the overlapping property taxes found in *Japan Line* from the compatibility of separate accounting and formula apportionment of net income:

> 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. . . . Here, by contrast, we are faced with two distinct methods of allocating the income of a multinational enterprise. . . . 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.

463 U.S. at 188 (citations and footnote omitted).[26]

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[26] Similarly, a gross receipts tax is levied on the total gross proceeds from sale of an article. If a manufacturing State taxes the total gross receipts from out-of-state sales, and a retail-sales State also taxes those total proceeds, multiple taxation is inevitable. This Court has resolved that overlap by permitting the destination State to tax all the gross proceeds, but prohibiting the production or manufacturing States from taxing gross receipts at all. As we have seen, there is no equivalent double taxation when *net* income is divided by separate accounting and by formulas. "The court has almost always been of the opinion that the difference between a tax on gross income and a tax on net income derived from multistate business required a different result when resisted on commerce clause grounds." P. Hartman, *Federal Limitations on State and Local Taxation* § 8:1 (1981).

II. THIS COURT SHOULD DISMISS TAXPAYERS' APPEAL BECAUSE THEY DID NOT EVEN ATTEMPT TO SHOW THAT AS 43.21 DISPROPORTIONATELY ATTRIBUTES INCOME TO THE STATE.

This Court has long recognized that there is a "substantial margin of error inherent in any method of attributing income among the components of a unitary business." *Container Corp.*, 463 U.S. at 184. *See, e.g., Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 121 (1920). "[A]rriving at precise territorial allocations of 'value' is often an elusive goal, both in theory and in practice," and it is "[f]or this reason" that this Court "ha[s] long held that the Constitution imposes no single formula on the States." *Container Corp.*, 463 U.S. at 164 (citing *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 445 (1940)).

Thus, a State's determination that a particular methodology accurately allocates the income of a multistate business must be given considerable deference. *See, e.g., Container Corp.*, 463 U.S. at 176; *Moorman*, 437 U.S. at 274. The Constitution does not invalidate an apportionment method "whenever it *may* result in taxation of some income that did not have its source in the taxing State." *Container Corp.*, 463 U.S. at 169-70 (emphasis in original; quoting *Moorman*, 437 U.S. at 272). Instead, the taxpayer must prove, "by 'clear and cogent evidence' that the income attributed to the State is in fact 'out of all appropriate proportions to the business transacted . . . in that State,' or has 'led to a grossly distorted result.'" *Id.* at 170.[27] Absent such evidence, no substantial constitutional question is presented.

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[27] Quoting *Moorman*, 437 U.S. at 274, quoting in turn *Hans Rees' Sons v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 135 (1931) and *Norfolk & W. Ry. v. Missouri State Tax Comm'n*, 390 U.S. 317, 326 (1968).

A. Taxpayers Have Presented No Evidence Showing That Alaska's Separate Accounting Method Disproportionately Attributes Income To The State.

In the trial court, taxpayers resolutely refused to offer any evidence showing that AS 43.21 attributed to Alaska more oil production income than they in fact earned in the State. The sole "evidence" of disproportionality relied upon by taxpayers here is their calculation of the difference between the taxable income that UDITPA's three-factor formula would have attributed to Alaska, and their taxable income as measured by AS 43.21. Based on this calculation they allege "overtaxation . . . rang[ing] from 279% to 804%." J.S. at 21.

There is absolutely no dispute between the parties that the UDITPA formula would attribute to the State only a fraction of the oil production income measured by separate accounting. Indeed, it was precisely because the Alaska Legislature found that the formula would grossly *underattribute* oil production income to the State, and taxpayers would thus pay only a 2-3% effective tax rate, that it enacted AS 43.21.

As the court below found, the disparity between the results reached by the two income-division methods is caused by marked deficiencies in the accuracy of the three-factor formula when applied to oil production—not by any failing in the separate accounting traditionally favored by major oil-producing States. App. 15a-20a. The Alaska court broke no new ground with that conclusion. All the highest State courts that have considered the question have reached the same conclusion.[28] Alaska has shown (and taxpayers have never disputed) that the

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[28] *See* n.7 *supra*. Those courts found underattribution by the formula comparable to that found here. *E.g.*, *Texas Co. v. Cooper*, 107 So. 2d at 690 (UDITPA income: $1.5 million; separate accounting income: $13 million); *Webb Resources v. McCoy*, 401 P.2d at 890-91 (UDITPA income: $40,000; separate accounting income: $157,000).

formula's assumptions break down when used to attribute oil production income. Taxpayers' inference that UDITPA income is their "actual" Alaska income is, then, no evidence at all.

Taxpayers presented no evidence of what they actually earned in Alaska because they litigated this case as a *per se* attack on separate accounting. As they told the trial court, their theory of the case "requires no elaborate showing that [the tax] is disproportionate to the taxpayer's business within the jurisdiction." R. 12763.

To the contrary, this Court has repeatedly held that a detailed showing of taxpayers' actual in-state income is *exactly* what taxpayers must offer if they are to discharge their burden of showing by "clear and cogent" evidence that a State's method has produced a "grossly distorted result."[29] Indeed, in the only two cases in which this Court has invalidated a State attribution method, the taxpayer used a detailed *separate accounting* analysis to prove overattribution by the formula.[30] Here, however, as in *Moorman*,

> "[The taxpayer] did not attempt to prove the amount of its actual net income from [in-state] activities. . . . *In this era of sophisticated accounting techniques, it should not be impossible for a unitary corporation to prove its actual income from activities in a particular state.* However, [taxpayer] showed only that its tax liability would be substantially less if [the State] employed a three-factor apportionment formula. We have no basis to assume

[29] *Butler Bros. v. McColgan*, 315 U.S. 501, 509 (1942); *Underwood Typewriter v. Chamberlain*, 254 U.S. 113, 121 (1920); *Norfolk & W. Ry. v. North Carolina ex rel. Maxwell*, 297 U.S. 682, 690 (1936); *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271, 283 (1924).

[30] *Hans Rees' Sons, Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 134-35 (1931); *Norfolk & W. Ry. v. Missouri State Tax Comm'n*, 390 U.S. 317, 321-22 (1968).

> that the three-factor formula produced a result equivalent to the corporation's actual [in-state] income. . . ."

437 U.S. at 275 n.9 (emphasis added) (quoting with approval *Moorman Manufacturing v. Bair*, 254 N.W. 2d 737, 757 (Iowa 1977) (McCormick, J., concurring)). Thus, taxpayers here simply declined to shoulder the burden of proof placed upon them by this Court's precedents.

B. AS 43.21 Properly Accounts For Out-of-State Contributing Activities.

Instead of proving their actual Alaskan income, taxpayers cite examples of managerial and support activities that take place outside the State. J.S. at 4-6 & n.4, 20 n.22. They then assert that AS 43.21 is invalid because it does not permit a deduction for some unspecified amount of profit allegedly earned by these activities. This argument fails for two reasons.

First, the Constitution simply does not require an income allocation system to account for each and every activity or factor that a taxpayer's choice of economic theories says contributes to net income. In *Moorman*, this Court upheld a single factor sales formula that ignored entirely the contributions to income of both *labor* (the payroll factor) and *capital* (the property factor) outside the State:

> Whatever merit [the assumption that at least some portion of the income from Iowa sales was generated by Illinois activities] might have from the standpoint of economic theory or legislative policy, it cannot support a claim . . . that Iowa in fact taxed profits not attributable to activities within the State . . . . [E]ven were we to assume that the Illinois [manufacturing] activities made some contribution to the profitability of the Iowa sales, appellant's claim that the Constitution invalidates an apportionment formula whenever it may result in taxation of some income that did not have its source in the taxing State is incorrect.

Moorman, 437 U.S. at 272; *accord*, *Underwood Typewriter v. Chamberlain*, 254 U.S. at 120.

Container Corp. confirmed that no income allocation system can take into account all arguable contributions to income. "[E]ven the three-factor formula is necessarily imperfect." 463 U.S. at 182-83 & n.20. Indeed, in the instant case, the three factors ignore entirely the value of the oil, the predominant source of an oil company's production profits. *See* pp. 5-6, *supra*.

Similarly, as the Court said in *Container Corp.*, 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." 463 U.S. at 164-65. Indeed, *no* separate accounting law—including those of other oil-producing States and the federal tax code[31]—attributes profit to such activities as research and development, management, and accounting that are ordinarily treated in taxpayers' own books as "cost centers" rather than "profit centers." R. 1527-28.

Here, as in *Moorman*, taxpayers have produced no separate accounting analysis or *any* quantified assessment of the profit, if any, assignable to outside contributing activities under their economic theory.[32] Absent any such

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[31] La. Admin. Code art. 47:244.3.A, B.3 (1975); Miss. Code Ann. § 27-7-23(c)(2)(B) (7 Supp. 1985); Miss. Admin. Reg. 1.27-7-23 (7)(c)(2) (1979); Okla. Stat. Ann. tit. 68, § 2358, A.4.a (West Supp. 1984); *see Magnolia Petroleum Co. v. Oklahoma Tax Comm'n*, 121 P.2d at 1101. *See* Treas. Reg. § 1.482-2(b)(1), (3), (7).

[32] Only one item of "proof" merits discussion. The taxpayers repeatedly assert that the record contains evidence that "80% of the expenses necessary to earn production income from Alaskan oil were incurred *outside* Alaska." J.S. at 4-5, 20-21 n.22 (emphasis in original). This assertion is based solely on one conclusory paragraph in an affidavit submitted by the taxpayers. App. 285a. Their affiant, however, confused the cost of *producing* Alaskan oil with the post-production cost of *transporting* the oil to refineries. Of the $380 million he assigned out of the State (his "80%"), fully $350 million were tanker charges incurred in transporting the oil from Alaska to refineries.

showing, taxpayers' anecdotes cannot raise a substantial question as to the constitutionality of AS 43.21.

Second, despite their protests to the contrary, taxpayers *can* deduct such outside profits as they report to their own shareholders.[33] 15 AAC 21.290(b). In allowing such a deduction, AS 43.21 goes beyond traditional separate accounting and far beyond what *Moorman* and *Container Corp.* require—in taxpayer's favor. Taxpayers claim, however, that SEC regulations forbid them to allocate oil production profits to out-of-state support activities in their shareholder reports because it would be "misleading or inaccurate" to do so. J.S. at 17 n.18. In essence, then, taxpayers assert that the Constitution requires Alaska to permit an attribution of profits to outside support activities that taxpayers themselves contend is "misleading or inaccurate." That is absurd.

In sum, taxpayers did not attempt an actual accounting of just how much they *did* earn in Alaska. Because they failed even to try to make the required showing of gross overattribution of income, their appeal does not raise a substantial federal question.

III. NONE OF TAXPAYERS' OTHER POINTS IS SUBSTANTIAL.

A. Alaska's Corporate Income Tax Statute Is Internally Consistent.

Every State's income tax law must have "internal consistency"—that is, "if [the State's law were] applied by every jurisdiction, it would result in no more than all of the unitary business' income being taxed." *Container Corp.*, 463 U.S. at 169.

[33] On this matter of state law, the decision of the Alaska Supreme Court is conclusive and unreviewable. Taxpayers

> may amend their tax reports and returns to deduct any outside-generated profits attributable to general overhead and administrative activities associated with Alaskan oil production not previously deducted.

App. 12a.

AS 43.21 met this test. It divided a taxpayer's income into two categories. First, oil production income was determined by separate accounting. Obviously, if every State used the same separate accounting method for oil production income, each taxpayer would be taxed on exactly 100% of its nationwide production income.

Second, Alaskan income from other activities was estimated by an apportionment formula in which (1) *worldwide* oil production income was *excluded* from the apportionable base; (2) all sales, property and payroll associated with oil production in Alaska were *excluded* from the in-state factors in the formula (*i.e.*, the numerators); and (3) all sales, property and payroll associated with oil production *outside* Alaska were *included* in the *worldwide* factors contained in the formula's denominators. AS 43.21.040. The effect of the formula used by Alaska to estimate taxypayers' non-production income was thus to slightly underestimate non-production income. If all States used this system, it is mathematically inevitable that *less* than 100% of a corporation's non-production income would be subject to tax. Consequently, AS 43.21 more than satisfied the "internal consistency" test.[34]

B. Alaska's Division-of-Income Method Does Not Discriminate Against Interstate Commerce.

Alaska's 9.4% corporate income tax applies uniformly to the Alaskan income of every corporation doing business in the State, regardless of where the company is headquartered, or whether it is a domestic or an interstate business. Thus, in contrast to the laws at issue in the cases relied on by taxpayers,[35] Alaska has treated in-

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[34] Incomprehensibly, taxpayers' argument to the contrary—and the affidavits cited in support of it—explicitly assume that other States would *not* apply exactly the same rules as Alaska's. J.S. at 25-26 & n.29. The internal consistency test articulated by this Court, however, is designed to determine what happens when the taxing State's rules *are* identically applied by all States.

[35] *Metropolitan Life Ins. Co. v. Ward*, 105 S. Ct. 1676 (1985) (statute imposed lower gross premiums tax rate on domestic insur-

state and out-of-state taxpayers in an identical fashion.[36]

In *Container Corp.* this Court recognized that if a facially-neutral tax law like AS 43.21 fairly apportions income, that is, does not produce a "grossly distorted result," 463 U.S. at 169-70, the law does not violate the Commerce Clause's anti-discrimination principle.

> Aside from forbidding the obvious types of discrimination against interstate or foreign commerce, [the anti-discrimination] principle might 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.

Id. at 170-71. The Court thus reaffirmed the conclusion it had earlier reached in *Moorman*—that to eliminate "all overlapping taxation would require this Court to establish not only a single constitutionally mandated method of taxation, but also rules regarding the application of that method in particular cases." *Id.* at 171 (citing *Moorman*, 437 U.S. at 278-80). Because that

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ance companies); *Armco, Inc. v. Hardesty*, 104 S. Ct. 2620 (1984) (wholesale gross receipts tax exempted local manufacturers); *Westinghouse Elec. Corp. v. Tully*, 104 S. Ct. 1856, 1860 (1984) (tax credit limited to products shipped from the State); *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318 (1977) (transfer tax taxed out-of-state securities transactions more heavily).

[36] Taxpayers make the baseless allegation that enactment of AS 43.21 "allowed Alaska to . . . reduce the tax rates on local businesses." J.S. at 3. This grave charge is absolutely false: Alaska does *not* impose different tax rates on local businesses. There is no basis in fact for taxpayers' allegations, and the part of the record cited by taxpayers does not offer even the slightest support for their charge.

function is constitutionally reserved to Congress, the Court expressly declined to undertake it. *Id.*

Taxpayers assert that the Commerce Clause forbids a State to "tailor" a tax by using a different division-of-income method for one industry than it uses for other industries. But as set forth above, UDITPA expressly contemplates that States will modify their prevailing division-of-income method where that method does not "fairly represent the extent of [a] taxpayer's activity in [the] State." *See* pp. 5-6, *supra*. The vast majority of States *do* use special division-of-income methods, including separate accounting, to determine the in-state income of businesses in a broad variety of industries. *See* Appendix, listing a sampling of more than sixty industry-specific division-of-income rules used by the States.

The necessary result of the argument proposed by taxpayers would be to require every State to use a single division-of-income system for all industries, and thus hold unconstitutional *all* of these provisions. That result is flatly inconsistent with this Court's refusal in *Container Corp.* and *Moorman* to mandate uniform division-of-income rules, out of deference to the proper role of the States, and to Congress. *See Container Corp.*, 463 U.S. at 171; *Moorman*, 437 U.S. at 278.

C. The Measure Of Alaska's Income Tax Is Reasonably Related To Taxpayers' Alaskan Activities.

In *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 628-29 (1981), this Court held that Montana's coal severance tax satisfied the Commerce Clause because the measure, or incidence, of the tax was reasonably related to the taxpayer's coal-mining activities, or presence, in the State as measured by the number of tons of coal produced.[37] Thus, because Alaska's tax is reasonably re-

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[37] Both the majority and the dissenters in *Commonwealth Edison* agreed that a general revenue measure—such as a corporate income tax—necessarily satisfies this requirement. *See* 453 U.S. at 622 (majority opinion) and *id.* at 651 (Blackmun, J., dissenting).

lated to appellants' oil production activities in the State, as measured by the amount and value of oil produced, it fully satisfies the *Commonwealth Edison* standard.

Taxpayers' argument to the contrary rests on the assertion that Alaska's use of separate accounting is unconstitutional because a taxpayer's Alaskan oil production income may remain the same regardless of whether certain support services take place in or out of the State. But as stated above, the *Moorman* decision explicitly recognized that a division-of-income method need not take into account all factors that may contribute to the earning of income, so long as the method does not lead to a grossly distorted result.[38] 437 U.S. at 273. Because Alaska's separate accounting reasonably estimates taxpayers' Alaskan income, the measure of Alaska's tax is reasonably related to in-state activities.[39]

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[38] Indeed, the one-factor sales apportionment formula upheld in *Moorman* necessarily attributed the same income to Iowa regardless of whether all or none of the taxpayer's payroll and property were located in the State.

[39] There is no truth whatsoever to taxpayers' intimation that by using separate accounting, Alaska is taking anything from other States, or imposing a tax on a national resource that will somehow be exported to consumers in other States. No other formula apportionment State's tax calculation is affected by whether Alaska uses separate accounting or a formula. And since the price of crude oil is determined by the world market, taxpayers cannot and do not "export" the income tax they pay to out-of-state consumers. If this Court were to hold that Alaska was constitutionally required to use formula apportionment for oil production income, the only results would be an additional windfall of $2 billion to these three oil companies, and a devastating blow to the State.

Finally, taxpayers' claim that "[w]hen it enacted the Oil Tax, Alaska projected that in 20 years its oil taxes would result in" an alleged "transfer of wealth from the Lower 48 to Alaska equal to $1,000 for every American," J.S. at 3 n.1, is also completely false. The budget projection to which taxpayers refer was made in 1981, when AS 43.21 was *repealed, not* when it was enacted. The projection was for increases in Alaska's Permanent Fund, which derives from *royalty* receipts, and interest on those receipts, *not*

IV. PRUDENTIAL CONSIDERATIONS OFFER ADDITIONAL REASONS FOR NOT GIVING PLENARY REVIEW TO THIS APPEAL.

In addition to the insubstantiality of the questions presented, significant prudential factors—the unbroken line of court decisions upholding the constitutionality of separate accounting; the constitutional allocation of primary responsibility for regulating interstate commerce to Congress; the broad discretion afforded States in matters of taxation; and the pendency of presidential and congressional initiatives to limit the use of worldwide formula apportionment—counsel against giving plenary consideration to this appeal.

Separate accounting has long been the prevailing method oil-producing States have used to determine instate oil production income. Yet *every* court that has considered the constitutionality of using separate accounting to determine oil production income has upheld its use.[40] Indeed, as the Supreme Courts of Kansas and Oklahoma both found, "[W]here the direct method of income allocation [separate accounting] can be employed, all suspicion of unconstitutional taxation is dispelled." *Webb Resources v. McCoy*, 401 P.2d at 889; *Magnolia Petroleum v. Oklahoma Tax Commission*, 121 P.2d at 1011. In light of the lower courts' unanimity on the question presented by this appeal, plenary review is unnecessary.

In *Moorman*, this Court recognized that the development of uniform rules for dividing the income of multistate businesses "would require a policy decision based on

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from corporate income or other tax revenues. AS 37.13.010(a). At that time, oil prices were expected to continue to rise. Royalties are due the State because the oil is produced from State land. None of this relates to income taxes, and in any event, not a penny of "wealth" would have been "transferred" from the lower 48.

[40] *See Texas Co. v. Cooper*, 107 So. 2d at 688; *Magnolia Petroleum v. Oklahoma Tax Comm'n*, 121 P.2d at 1011-12; *Webb Resources v. McCoy*, 401 P.2d at 889-91.

political and economic considerations that vary from State to State. . . . *It is to [Congress], and not this Court, that the Constitution has committed such policy decisions.*" 437 U.S. at 279-80 (emphasis added). "Congress has long debated, but has not enacted, legislation designed to regulate state taxation of income." *Container Corp.*, 463 U.S. at 196-97 (quoting *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 448 (1980)).

This Court has repeatedly recognized that in the absence of congressional action, the States must be given broad discretion in matters of taxation.[41] In their appeal, taxpayers would have this Court drastically constrict the States' traditionally broad taxing power by imposing a uniform division-of-income method, even though Congress has refused to do so. In the face of Congress' persistent refusal to require States to use formula apportionment, this Court should not give plenary consideration to an appeal requesting such a result.

While Congress has not adopted legislation requiring the States to use uniform division-of-income methods, recent developments suggest that some limitations on the use of worldwide formula apportionment may soon be enacted. On November 8, 1985, the President announced his support for prohibiting the States from applying formula apportionment to the worldwide income of a taxpayer who operates both in a State and abroad, thereby requiring the use of separate accounting to divide a taxpayer's foreign income from its U.S. income. In so doing, he instructed "the Secretary of the Treasury to initiate the process of crafting Federal legislation to incorporate these principles into law and to work with the Congress for passage."[42] Congress currently has pending before it

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[41] *See, e.g., Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 445 (1940); *Norfolk & W. Ry. v. Missouri State Tax Comm'n*, 390 U.S. 317, 326 (1968).

[42] Statement by the President, State Taxation of Multinational Corps., 21 Weekly Comp. Pres. Doc. 1368 (Nov. 8, 1985).

legislation introduced earlier this year that would essentially adopt those principles. S. 1113, 99th Cong., 1st Sess. (1985).

Plenary consideration of taxpayers' wholesale attack on separate accounting would be particularly unfortunate at this time because it would cast a cloud of constitutional uncertainty over the current climate of active presidential and congressional initiatives to restrict the use of formula apportionment.

CONCLUSION

For the reasons stated above, this Court should dismiss this appeal or summarily affirm the judgment below.

Respectfully submitted,

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APPENDIX

Examples of State Statutes and Regulations Embodying Division-of-Income Rules Different From UDITPA Formula Apportionment

Construction: Miss. Admin. Reg. 1.27-7-23(7)(m) (1979) (separate accounting); [Oregon] St. & Loc. Tax Serv. (P-H) ¶ 65,325.10 (Aug. 11, 1943), ¶ 65,330.20 (Dec. 14, 1955) (separate accounting); Va. Code § 58.1-419 (1984).

Mining and Natural Resource Production: La. Admin. Code art. 47:244.3.B(1975) (separate accounting); 1985 Minn. Sess. Law Serv. art. 1 § 45 (West) (amending Minn. Stat. Ann. § 290.19 (West Supp. 1985)); Miss. Admin. Reg. 1.27-7-23(7)(o) (1979) (separate accounting); Okla. Stat. Ann. tit. 68, § 2358, A.4.a (West Supp. 1984) (separate accounting).

Realty Management: [Oregon] St. & Loc. Tax Serv. (P-H) ¶ 65,330.30 (Nov. 1, 1960) (separate accounting).

Financial Organizations: Ill. Ann. Stat. ch. 120, § 3-304 (c) (Smith-Hurd Supp. 1985); 1985 Ky. Rev. Stat. & R. Serv. § 141.120(10) (Baldwin); La. Rev. Stat. Ann. § 47:245(E) (West 1970); Mich. Stat. Ann. § 7.558(65) (Callaghan 1984); N.D. Corp. Income Tax Return, [1985] St. Corp. Income Tax Forms (CCH), at 17,102 (1984); Or. Admin. R. 150-314.280-(E) (1977); Va. Code § 58.1-418 (1984); Wis. Admin. Code § [Dept. of Rev.] 2.49 (1973).

Insurance: Conn. Gen. Stat. Ann. § 12-218a (West 1983); Fla. Stat. Ann. § 214.72(1)(a) (West Supp. 1985); Ill. Ann. Stat. ch. 120, § 3-304(b) (Smith-Hurd Supp. 1985); Mich. Stat. Ann. § 7.558(62) (Callaghan 1984); Or. Admin. R. 150-314.280-(E) (1977).

Public Utilities: 1985 Ky. Rev. Stat. & R. Serv. 141.-120 (10) (Baldwin); Miss. Admin. Reg. 1.27-7-23(7)(l) (1979); Mo. Ann. Stat. § 143.451(6) (Vernon 1976);

N.C. Gen. Stat. §§ 105.130.4(n),(q),(r) (1979); N.D. Cent. Code § 57-38-13(8) (1983); Or. Admin. R. 150-314-280-(E) (1977); S.C. Code Ann. § 12-7-640 (Law. Co-op. Supp. 1985); Wis. Admin. Code § [Dep't of Rev.] 2.50 (1973).

Transportation (general): Fla. Stat. Ann. § 214.72(2) (West Supp. 1985); Ill. Ann. Stat. ch. 120, § 3-304(d)(1) (Smith-Hurd Supp. 1985); La. Rev. Stat. Ann. § 47:245 (C) (West 1970); Mich. Stat. Ann. § 7.558(57) (Callaghan 1984); Or. Admin. R. 150-314.280-(G) (1983); Pa. Cons. Stat. Ann. § 7401(3)(2)(b) (Purdon Supp. 1985).

Air Carriers: Cal. Rev. & Tax Code § 25101.3 (West 1979); Conn. Gen. Stat. Ann. § 12-244 (West 1983); La. Rev. Stat. Ann. § 47:245(A) (West 1970); Miss. Admin. Reg. 1.27-7-23(7)(j) (1979); Wis. Admin. Code § [Dep't of Rev.] 2.46 (1973).

Motor Carriers: Conn. Gen. Stat. Ann. § 12-218(c) (West 1983); Kan. Stat. Ann. § 79-3279 (1984); Miss. Admin. Reg. 1.27-7-23(7)(k) (1979); N.C. Gen. Stat. § 105-130.4(o) (1979); Va. Code § 58.1-417 (1984); Wis. Admin. Code § [Dep't of Rev.] 2.47 (1973).

Pipelines: Ill. Ann. Stat. ch. 120, § 3-304(d)(2) (Smith-Hurd Supp. 1985); La. Rev. Stat. Ann. § 47:245 (B) (West 1970); Mich. Stat. Ann. § 7.558(58) (Callaghan 1984); Miss. Admin. Reg. 1.27-7-23(7)(i) (1979); Pa. Cons. Stat. Ann. § 7401(3)(2)(c) (Purdon Supp. 1985); Wis. Admin. Code § [Dep't of Rev.] 2.48 (1973).

Railroads: Kan. Stat. Ann. § 79-3279 (1984); Miss. Admin. Reg. 1.27-7-23 (7)(l) (1979); Mo. Ann. Stat. § 143.451(4) (Vernon 1976); N.C. Gen. Stat. § 105-130.4(m) (1979); Va. Code § 58.1-420 (1984).

Water Transportation: Or. Admin. R. 150-314.280-(H) (1984), (J) (1973).

Passenger Carriers: Mo. Ann. Stat. § 143.451(3) (Vernon 1976); N.C. Gen. Stat. § 105-130.4(p) (1979).

Service Enterprises: La. Rev. Stat. Ann. § 47:245(D) (West 1970).

(16) **[Effective February 1, 1981]** Repealed by § 11 ch 1 SSSLA 1980.

(17) **[Effective February 1, 1981]** Repealed by § 11 ch 1 SSSLA 1980.

(am § 11 ch 1 SSSLA 1980)

Effect of amendment.
The 1980 amendment effective February 1, 1981, repealed paragraphs (4), (7), (13), (14), (16) and (17), which define "fiduciary," "individual," "domicile," "nonresident," "residence," and "resident," respectively.

Editor's note. — For legislative findings and purpose of the 1980 amendment, see § 1, ch. 1, SSSLA 1980, in the 1980 Temporary and Special Acts and Resolves.

Chapter 21. Oil and Gas Corporate Income Tax.

Editor's note. — As to legislative findings and intent, see § 1, ch. 110, SLA 1978, in the 1978 Temporary and Special Acts and Resolves.

Section 4, ch. 110, SLA 1978, provides: "This Act applies to taxable income earned or received after December 31, 1977."

Sec. 43.21.010. Application. This chapter 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 this chapter is measured by the total taxable income of the corporation during the tax period as determined under ~~defined in~~ AS 43.21.020 — 43.21.040 and is ~~determined~~ calculated at the rates established under AS 43.20.011(e). (§ 3 ch 110 SLA 1978; am § 28 ch 113 SLA 1980)

Effect of amendment. — The 1980 amendment, effective June 21, 1980, and retroactive to January 1, 1978, deleted "or directly associated with" following "a lease or property in" near the middle of the first sentence.

Editor's note. — Section 50, ch. 113, SLA 1980, effective June 21, 1980, makes this section applicable to tax years beginning after December 31, 1977.

Sec. 43.21.020. Determination of taxable income from oil and gas production. (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 and AS 43.57 which are actually paid by the corporation on the production from a lease or property in the state;

or incurred

(3) taxes imposed under AS 43.56 and AS 29.53 which are actually paid 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 and AS 29.53 (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 [TO THE EXTENT THAT IT DOES] 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 [(REDUCED BY INTERCOMPANY TRANSACTIONS WITHIN THE CONSOLIDATED BUSINESS)] 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 [THE LESSER OF:

(A)] 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 [OR,

(B) THE SUM OF $0.12 FOR EACH BARREL OF OIL AND $0.02 FOR EACH THOUSAND CUBIC FEET OF GAS PRODUCED FROM A LEASE OR PROPERTY 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.

(e) Where a corporation subject to this chapter 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. (§ 3 ch 110 SLA 1978; am § 29 ch 113 SLA 1980)

(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.

Effect of amendment. — The 1980 amendment, effective June 21, 1980, and retroactive to January 1, 1980, in paragraph (7) of subsection (c), inserted "of the corporation" and substituted "during construction" for "of the corporation", both near the beginning of the paragraph.

Editor's note. — Section 52, ch. 113, SLA 1980, effective June 21, 1980, makes this section applicable to tax years beginning after December 31, 1979.

Sec. 43.21.030. Determination of income from oil and gas pipeline transportation. (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. (§ 3 ch 110 SLA 1978)

Sec. 43.21.040. Determination of income from activities other than oil and gas production or pipeline transportation. (a) Taxable income of a corporation subject to this chapter 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.

repealed

(d) Compensation earned by employees of the consolidated business who are employed in the United States but not in any state shall be included in the numerator of the payroll factor if the employees are directly supplied from a base of operations maintained in this state.

(e) The value of oil or gas production facilities or other properties of the consolidated business which are located in the United States but not in any state shall be included in the numerator of the property factor if the property is serviced or supplied from a base of operations maintained in the state or if that property relies on onshore facilities in this state for storage of the oil or gas produced.

(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. (§ 3 ch 110 SLA 1978; am §§ 30 — 32 ch 113 SLA 1980)

Sec. 43.21.050. Assessment of income and tax. (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 this chapter a notice of assessment showing the amount of income taxable under this chapter for the previous year and the amount of tax payable on that taxable income.

(c) For purposes of this chapter the department may combine taxable incomes of corporations subject to tax under this chapter who are part of the same consolidated business. (§ 3 ch 110 SLA 1978)

(d) If the methods of allocation and apportionment provided in this chapter 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 this chapter.

Sec. 43.21.060. Returns. On or before April 15 of each year, a corporation subject to tax under this chapter 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 this chapter, the department may require corporations subject to tax under this chapter who are part of the same consolidated business to file a single return. (§ 3 ch 110 SLA 1978)

Sec. 43.21.070. PAYMENT OF TAX. The tax levied under this chapter 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 this chapter or any provision of this chapter is challenged before the department or in the courts.

Sec. 43.21.080. Transitional rules. The department shall provide by regulation transition rules for corporations subject to tax under ch. 20 of this title 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 this chapter. (§ 3 ch 110 SLA 1978)

Sec. 43.21.090. Regulations. The department may adopt regulations in accordance with the Administrative Procedure Act (AS 44.62) as appropriate to administer and enforce this chapter. (§ 3 ch 110 SLA 1978)

Sec. 43.21.100. Penalties. The penalties established in ch. 20 of this title apply to this chapter. (§ 3 ch 110 SLA 1978)

Sec. 43.21.110. Public reporting. (a) The commissioner of revenue shall compile and transmit to the legislature an annual consolidated report of state revenues and taxation policies under this chapter. This report shall include total aggregate income tax paid by corporations covered under this chapter 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 this chapter. (§ 3 ch 110 SLA 1978)

Sec. 43.21.120. Definitions. Unless the context requires otherwise the definitions contained in AS 43.55.140 are applicable to this chapter. In addition, in this chapter

(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. (§ 3 ch 110 SLA 1978; am § 33 ch 113 SLA 1980)

No. 85-773

In The
Supreme Court of the United States
October Term, 1985

Atlantic Richfield Company; Arco Pipe Line Company; Exxon Corporation; Exxon Pipeline Company; BP Alaska Inc.; Sohio Alaska Petroleum Company; and Sohio Pipe Line Company,

Appellants,

vs.

State of Alaska, *et al.*,

Appellees.

On Appeal From the Supreme Court of Alaska

BRIEF IN OPPOSITION TO MOTION TO DISMISS

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES

CONSTITUTIONAL PROVISIONS, STATUTES AND REGULATIONS

OTHER

BRIEF IN OPPOSITION TO MOTION TO DISMISS

Alaska's Motion to Dismiss or Affirm ("M.D.") shows that it will not address and cannot avoid the issue that makes this case unmistakably worthy of the Court's plenary consideration: the consequences for the historic free trade policy of the Commerce Clause of accepting Alaska's rationale for its Oil Tax. Alaska's arguments confirm that it claims the right to arrogate to itself for income taxation all the profit that results when crude oil originating in Alaska is sold in other states — even though that same profit is properly subject to tax, and is taxed, in other states as well. If Alaska may do that, every state may similarly tailor its taxes, similarly burden its principal export, and similarly enrich itself.[1]

I. ALASKA'S ARGUMENTS IGNORE THE COMPETING RIGHTS OF OTHER STATES TO TAX A SHARE OF APPELLANTS' PRODUCTION INCOME.

The Supreme Court of Alaska knew that Alaska could not properly tax 100% of interstate production income that other states are entitled to tax by apportionment, and sought to save the Oil Tax by denying that Alaska was taxing 100%. App. 35a. Appellants' Jurisdictional Statement showed that this reasoning was an evasion of the issue and could not be sustained. J.S. 14-18. Implicitly conceding that appellants were right, and that the judgment of the Alaska Supreme Court cannot be defended on the basis of what that court said, Alaska now boldly takes the position that it does not matter if Alaska takes for itself 100% of

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[1] Alaska indignantly denies that it has been enriched, and asserts that the $184 billion surplus which it projected from its taxes was "for increases in Alaska's Permanent Fund which derives from royalty receipts." M.D. 27 n.38. This is untrue, as can be seen from the projection itself, a copy of which is included as Exhibit A. As correctly stated in the Jurisdictional Statement, column 7 shows a balance of $184 billion in the General Fund. The balance in the Permanent Fund is shown in Column 8: it is an *additional* $13 billion. The projection was made in late 1979 or early 1980 for Fiscal Year 1981 (which ran from July 1980 to June 1981), again contrary to Alaska's indignant protestation. Equally false is Alaska's denial that it reduced tax rates on local businesses. M.D. 25 n.36. Compare 1975 SLA Ch. 70, § 1 with 1981 SLA Ch. 116, § 3-4. And Alaska's suggestion that, even without the Oil Tax, appellants would have paid a high share of Alaska's taxes, M.D. 10 n.19, assumes implausibly that without the Oil Tax Alaska would still have repealed its personal income tax, school tax, and business license tax.

production income from wells in Alaska. M.D. 11-13. On the contrary, the State now says, the Constitution allows Alaska to take 100%, even though other states also have the right to tax and even though the inevitable consequence is multiple taxation.[2]

Alaska argues that it may tax 100% of appellants' production income on the ground that all of the income, as a matter of law, was "earned in Alaska." M.D. 7, 11, 13. The obvious question is — Why? Why is income that results from crude oil sales in California and Texas earned, entirely, in Alaska? Why is income from crude oil that would never have been produced except for the skill and labor of appellants' employees throughout the country earned, entirely, in Alaska? Why is income from the sale in California of crude oil that would have had no value but for the existence of a market outside Alaska earned, entirely, in Alaska? And why is the answer to these questions so clear that Alaska is entitled to prevail on them as a matter of law and the taxpayers are not even entitled to a trial?

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[2] It is worth stating again exactly what production income is, and how the Oil Tax works. Take the case of Sohio, which has over half of appellants' Prudhoe Bay production. Only 1.6% of Sohio's oil is sold for consumption in Alaska; the rest is sold or exchanged, as crude oil, to third parties in California and in other Lower 48 states. R. 13414-15. The Sohio employees responsible for marketing the crude oil, like many of those responsible for operating the Prudhoe Bay field, are located in California. R. 13410. Sohio's profit is the difference between the sales price of the crude oil, on the one hand, and the cost of extracting the oil and shipping it to the point of sale, on the other. This profit is Sohio's "production income." If Sohio's profit from a sale in California is $1 million, it will have Alaska taxable income from the transaction of $1 million, California taxable income of at least $333,000 (since the sale and at least some of Sohio's property and payroll are in California), and additional taxable income in other states as well. Over 133% of its real income from the transaction will be taxable somewhere. Multiple taxation is real and obvious.

Alaska's statement that "most" Prudhoe Bay oil is transferred to appellants' own refineries, M.D. 12 n.20, is false. Most of the oil is in fact sold or exchanged to third parties in the Lower 48. R. 13410, 13415, 12692, 12736-37. All transfers to appellants' refineries, moreover, are at market prices, and are treated by the Oil Tax as sales. 15 AAC 21.122(b), (c). Alaska can hardly treat the transfers as sales for purposes of the Oil Tax and then deny the constitutional consequences of doing so.

Alaska's principal (and only honest) answer is: "Because we say so." Most of Alaska's argument begs the question. It simply assumes, without discussion and without evidence, that production income is earned entirely in Alaska. Alaska proclaims that "it is perfectly proper for Alaska to levy a tax on 100% of income earned in the state." M.D. 11. And so it is. But the question to be decided is whether the production income Alaska taxes — income resulting from the sale in California and other states of crude oil from wells in Alaska, oil produced by virtue of activities that take place in many states — can constitutionally be said to be earned in Alaska *alone*. About that question, Alaska's papers have nothing to say.

Only this calculated refusal to face the issue of where production income is earned allows Alaska to deny that the Oil Tax inevitably results in multiple taxation. Contrary to Alaska's argument, however, California's use of an apportionment formula to tax production income does not mean that California is taxing a share of income "earned in Alaska"; it means only that California has concluded (correctly) that production income is earned in part by activities in California, and that California may therefore attribute a share of that income to California. *Sjong v. State*, 622 P.2d 967, 972 (Alaska 1981). Similarly, when this Court allowed Wisconsin to tax a share of Exxon's production income, it did so on the ground that since Exxon is a unitary business Exxon's activities in Wisconsin contribute to the earning of production income. 447 U.S. at 224-26. Wisconsin and 41 other states tax an apportioned share of Exxon's production income because they believe (correctly, this Court has held) that the income is earned, in part, by activities in those states.[3] Only Alaska refuses to recognize the contributions of other states, or to apportion.

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[3] Alaska's treatment of the facts as to double taxation is notably disingenuous. M.D. 14. First, Alaska entirely ignores the Tanner Affidavit, obviously for the reason that Alaska cannot rebut its showing that Sohio is double-taxed. App. 380a. Second, Alaska says, quite falsely, that Exxon is adding together shares of production income and shares of total income to arrive at 130%; the figure of 130% reflects rather the 100% of *production* income that Alaska takes, and the 30% of *production* income that their formulas attribute to other states. And Alaska appears to argue that all states may tax whatever

As for Alaska's suggestion that it reaches no interstate values because it taxes only "value at the wellhead," that argument is little better than a play on words. The record shows without dispute that there is no market for crude oil at the wellhead at the North Slope and therefore no market price at the wellhead. See J.S. 5 n.3. What Alaska calls "value at the wellhead" is merely the mathematical result of subtracting, from the sales price of crude oil in the Lower 48, the cost of transporting the oil from the North Slope to the place where it is sold. J.S. 5 n.3. Alaska's tax therefore reaches every bit of the value created up through the time the crude oil is sold outside Alaska — value resulting, not only from the sale of the crude in the Lower 48, but also from the fact that the crude has been transported to California or Texas (where there is a market for it) from Alaska's North Slope — where there is not.[4]

Alaska tries, finally, to defend itself by claiming that the Oil Tax is "identical" to methods used in international taxation. This is simply not so.[5] And Alaska's purported state court authority is, if anything, slighter. It comprises only three cases,

they want until such time as more than 100% of total income has been taxed somewhere. Why should Texas' lack of an income tax give Alaska the right to tax more than its share?

[4] Alaska only underlines this point when it complains that appellants count the cost of transporting crude oil to the Lower 48 as part of the costs of earning production income. M.D. 22 n.32. Transporting crude oil from the North Slope of Alaska to refineries in the Lower 48 required building and running an enormously expensive pipeline and a tanker fleet; without them, no one would have profited from Prudhoe Bay oil, which would have been almost worthless if left on the North Slope.

[5] Alaska relies, for example, on the OECD Model Convention for Avoidance of Double Taxation. Although Alaska does not bother to cite the portion of the Convention it relies on, in the Alaska Supreme Court it cited Art. 7 ¶ 2:

> "Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."

although Alaska cites them over and over again. M.D. 3 n.7, 12, 19, 22, 28. One of them does not even involve a state seeking to impose separate accounting.[6] The other two both depend on factual findings that the taxpayers were not unitary, and that operations in the taxing state were separate and distinct from operations in other states.[7] Under such circumstances, of course,

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Unlike the Oil Tax, this language clearly requires the attribution of market profits to each of the taxpayers' facilities outside Alaska. If it were applied to the taxpayers' production income, some profits would be attributed to each of the states where the taxpayers maintained a "permanent establishment." Under the Oil Tax, Alaska takes all of the production income for itself.

This method of dividing income is sometimes called the "hypothetical subentity" or "arm's length" approach. See Container Corp. v. Franchise Tax Board, 463 U.S. 159, 184-85 (1983). The Affidavit of William J. Baumol, Professor of Economics at Princeton and NYU, and formerly President of the American Economics Association, discusses this approach in detail, considers its defects as compared with apportionment, and shows that the Oil Tax indefensibly contravenes the "arm's length" approach by engaging in a "profit assignment procedure with no basis in logic . . . which is inherently biased toward over-assignment of profit toward Alaska." App. 216a, 218a-222a, 223a-235a.

[6] Magnolia Petroleum Co. v. Oklahoma State Tax Comm'n, 121 P.2d 1008 (Okla. 1941) did not hold that separate accounting was proper or that apportionment was improper. It held that the Oklahoma Tax Commission had failed to follow Oklahoma's statute by trying to apportion the income of a single department of the taxpayer's business, rather than its entire income. 121 P.2d at 1012-13.

[7] Texas Co. v. Cooper, 107 So.2d 676, 681-83 (La. 1958); Webb Resources, Inc. v. McCoy, 401 P.2d 879, 890 (Kan. 1965). Alaska fails to report that the *Webb Resources* case is no longer good law in Kansas, which uses apportionment to tax oil production income. Amoco Production Co. v. Arnold, 518 P.2d 453 (Kan. 1974). It is also unlikely that *Texas Co. v. Cooper* has survived this Court's decisions in *Exxon v. Wisconsin* and *Mobil v. Vermont*, since the result depended heavily on the Louisiana court's 1958 view that no decisions could be found "holding that corporations engaged in the petroleum industry are unitary in character." 107 So.2d at 681.

What is most remarkable about Alaska's effort to show that separate accounting is widespread is the paucity of the examples Alaska can find. Apart from Oklahoma, Louisiana, and Kansas, where the cases Alaska cites have already been discussed, the long list in Alaska's Appendix includes a grand total of *four* instances in two states that Alaska can claim as separate accounting. Two involve Oregon; Alaska has failed to notice that Oregon repealed the statutes in question twenty years ago and replaced them with no other state would have the right to tax income from in-state operations, and the problem of double taxation present here could not arise. By contrast, in this case Alaska stipulated, and its Supreme Court found, that the taxpayers were unitary. R. 14836; App. 15a. The cases Alaska cites, by their terms, would have been decided differently on the factual record present here.[8]

II. ALASKA DISTORTS THE CASES IT CITES.

A. The Container Decision Does Not Support Alaska.

Despite what Alaska says, the rationale of *Container* is not that states have free rein to cause whatever double taxation they please. *Container* did not, as Alaska's arguments necessarily imply, wipe out at one blow the constitutional rules that for 80 years have forbidden unapportioned taxes and have avoided double taxation by denying states the right to tax 100% of something held by this Court to be properly subject to taxation by apportionment elsewhere.

Container reflects instead the Court's judgment that, despite the double taxation that sometimes arose because of the conflict between California's worldwide unitary apportionment system and taxes levied abroad, California had no reasonable alternative available to it that would have removed double taxation. The Court noted that, unlike the Oil Tax, California's tax system did not "inevitably" produce double taxation,[9] and that

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apportionment. See Donald M. Drake Co. v. Dep't of Revenue, 500 P.2d 1041 (Ore. 1972).

[8] Few words are necessary about Alaska's analogies to calculations used for severance taxes, royalty payments, the Windfall Profit Tax, and the like. A severance tax can be imposed by only one state; no double taxation is possible and therefore no issue as to apportionment can arise. Commonwealth Edison Co. v. Montana, 453 U.S. 609, 617 (1981). Nor must the United States apportion the taxes it levies on Windfall Profit or anything else. The fact that the Oil Tax makes calculations similar to those of these concededly unapportioned taxes merely confirms that the Oil Tax is unapportioned.

[9] Since the Oil Tax taxes 100% of production income from Alaskan wells, double taxation of production income is inevitable if any state exercises, as almost all do, its constitutional right to tax that production income by apportionment. Under California's apportioned tax, however, foreign-source

the myriad of foreign tax systems made deference to them on a case-by-case basis administratively unworkable. The holding of *Container* is that the Constitution "does not require [of California] forbearance so extreme or so one-sided." 463 U.S. at 193. Nothing like that is required of Alaska here. Alaska need do nothing more than apportion its tax.[10]

B. The Requirement of Apportionment Applies to Net Income Taxes as Well as to Other Taxes.

Appellants' Jurisdictional Statement cites a long line of cases for the twin propositions that a state may not tax extraterritorial values and that a state may not tax 100% of a value that other states are entitled to tax by apportionment. J.S. 12-14. Alaska's sole answer to these cases is to shrug them off with the comment that they are gross income tax cases or property tax cases, while the Oil Tax is levied on net income. M.D. 16-17. The inconsequence of this response betrays Alaska's inability to find any meaningful ground for distinguishing the cases. For it is indisputable that no modern case from this Court has ever suggested

income was not subjected to any California tax (let alone *double* taxed) unless the addition of foreign-source income to the domestic apportionable base outweighed the effect of including foreign property, payroll, and sales in the denominator of the formula. As Justice Brennan pointed out, the taxpayer in a companion case to *Container* paid less under a worldwide than a domestic apportionment. 463 U.S. at 188 n.25. Whether California's tax resulted in double taxation of foreign source income thus depended on the facts of the individual case. That is not true of Alaska's taxation of production income.

[10] As Alaska has since 1982. Alaska now uses a modified apportionment formula designed to cure the defects Alaska saw in UDITPA. (These are largely illusory: despite Alaska's trumpeting of the supposed "2-3% effective tax rate," Commissioner of Revenue Gallagher told the Legislature before the Oil Tax was passed that the oil industry was "meeting its fair share of taxes" and that its effective tax rate was "very close to 9%." R. 6962, 12907.) The Legislature also provided that if the Oil Tax is declared unconstitutional, modified apportionment will apply for the tax years 1978-81 as well. This legislation disposes of Alaska's scare tactic of claiming that invalidating the Oil Tax would be a "devastating blow" to Alaska. On the contrary, Alaska carefully arranged the repeal of the Oil Tax so that, as the State has said, its exposure in this litigation would be limited to a sum it "could afford without disastrous financial consequences." R. 16153. If Alaska prevails, on the other hand, it can seek to reimpose the Oil Tax.

that the requirement of apportionment is limited to property or gross receipts taxes.[11]

On the contrary, in *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978), Justice Stevens' opinion for the Court held that to draw a distinction between gross income and net income taxes would be "an exercise in formalism." 437 U.S. at 280-81. "[F]or purposes of constitutional review," as Justice Brennan said agreeing with the Court, "there is no distinction between a corporate income tax and a gross receipts tax." 437 U.S. at 281. Alaska's position to the contrary is indefensible.[12]

C. The Oil Tax Involves Disproportionate Taxation.

Alaska astonishingly argues that this appeal should be dismissed because "in the trial court, taxpayers resolutely refused to offer any evidence" that the Oil Tax disproportionately taxes their income. Alaska conveniently ignores the fact that its own Revenue Department could concoct no apportionment formula

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[11] The Court regularly cites gross receipts and property tax cases as stating principles applicable to net income taxes. See, e.g., ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 316 (1982); Merrion v. Jicarilla Apache Tribe, 455 U.S. 130, 158 n.26 (1982); Mobil v. Vermont, 445 U.S. 425, 443-46 (1980); Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 462 (1959). Alaska cites Professor Hartman for the proposition that the Court "has almost always been of the opinion" that there is a difference between gross income and net income taxes. Alaska fails to reveal that the quotation comes from a section of Professor Hartman's treatise entitled "Early Development," and that he is discussing the historical development of the law, *prior to 1938*. M.D. 17 n.26.

[12] Alaska also pretends to discuss the internal consistency test, but what it says is entirely beside the point. M.D. 23-24. As the Jurisdictional Statement points out clearly, Alaska's tax system was internally inconsistent while the Oil Tax was in place because under its ordinary apportionment law (AS 43.20) Alaska applied apportionment to the total income (including production income) of a taxpayer with *no* wells in Alaska, while using the Oil Tax (AS 43.21) to capture 100% of the production income of a taxpayer *with* wells in Alaska. See J.S. 25 n.28. Alaska's "response" to this point entirely omits any reference to Alaska's ordinary apportionment law — the combination of which with the Oil Tax is the source of the problem. Alaska discusses only AS 43.21, and thus pretends the problem is non-existent. This cannot have been accidental: the issue of internal consistency was canvassed extensively in the briefs before the Alaska Supreme Court. Alaska simply preferred not to address it.

that raised half what the Oil Tax did. J.S. 22. And Alaska forgets that appellants were precluded from offering evidence in the trial court only by Alaska's own successful summary judgment motion. Even more fundamentally, Alaska's argument rests on a clear mistake of law. It reduces to the proposition that the *only* way a tax may be invalidated on grounds of duplicative or extraterritorial taxation is by quantitative proof that the income taxed is "out of all appropriate proportion" to income actually earned in the taxing state.[13]

Contrary to Alaska's argument, the cases hold that a state tax is invalid if a taxpayer proves either (1) that it necessarily involves taxation of extraterritorial values[14] or (2) that it inevitably causes duplicative taxation that is the taxing state's fault.[15] In these situations the Court does not require the quantitative showing that Alaska says is absolutely essential;[16] if the

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[13] The State purports to derive this sweeping test from the decisions in Hans Rees' Sons Inc. v. North Carolina, 283 U.S. 123 (1931), and Moorman Mfg. Co. v. Bair, 437 U.S. 267 (1978). Those cases, however, dealt with the question of the standard of proof required to show that an apportionment formula was invalid. Alaska cites no case — and could cite none — that has ever applied the test outside the context of a challenge to an apportionment formula.

[14] ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 (1982); F.W. Woolworth Co. v. Taxation & Revenue Dep't, 458 U.S. 354 (1982). These cases are particularly instructive since, if Alaska's theory were correct, the only relevant question in ASARCO, for example, would have been whether the total income taxed by Idaho (including a share of dividend income) was "out of all appropriate proportion" to the income earned by ASARCO in Idaho, and ASARCO could have prevailed only by offering proof of ASARCO's actual earnings in Idaho. ASARCO did nothing of the sort. And the Court invalidated Idaho's tax based on no proof other than a showing that extraterritorial value was being taxed.

[15] J.D. Adams Mfg. Co. v. Storen, 304 U.S. 307 (1938); Gwin, White & Prince, Inc. v. Henneford, 305 U.S. 434 (1939); Standard Oil Co. v. Peck, 342 U.S. 382 (1952); Michigan-Wisconsin Pipe Line Co. v. Calvert, 347 U.S. 157 (1954); Central R. Co. v. Pennsylvania, 370 U.S. 607 (1962); Evco v. Jones, 409 U.S. 91 (1972).

[16] It is easy to see why no court has ever accepted Alaska's argument that a quantitative showing of disproportionality is the only basis for invalidating a state tax. Assume, for example, that the Oil Tax were amended so that it attributed to Alaska not only 100% of net production income from the

State's argument were correct, each of the cases cited in notes 14 and 15 would have to be overruled.[17]

III. CONCLUSION

For the reasons given here and in appellants' Jurisdictional Statement, the Court should note probable jurisdiction and set this matter for full briefing and argument.

DATED: December 26, 1985

Respectfully submitted,

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taxpayers' wells in Alaska, but 100% of net production income from their wells in Mississippi as well. It is plain that such a tax would be unconstitutional. On the State's theory, however, there would be nothing wrong with it. If net production income from wells in Alaska was $100 million, and net production income from wells in Mississippi was $1 million, addition of the Mississippi income to the Alaska pool would raise total taxable income only by 1%, plainly not enough to render it "out of all appropriate proportion" to Alaska income. While such a hypothetical is not this case, it shows that the principle on which the State purports to rely is mischievous and wrong. Quantitative proof of overtaxation is not the only way to invalidate a tax.

[17] Alaska's suggestion that the Court refuse plenary consideration to this appeal because Congress may take some unspecified action in the future is baseless. The only bill Alaska cites as evidence of "active congressional initiatives," S.1113, is Senator Mathias's bill to restrict apportionment. He has introduced a similar bill, with no success whatever, in every Congress since 1965. As for President Reagan's proposals, they address solely whether states may use worldwide apportionment, an issue that is not remotely present in this case. The President's proposals would leave apportionment of *domestic* income entirely unaffected. Moreover, Alaska's reference to such "prudential considerations" overlooks the fact that this is an appeal, not a petition for certiorari.

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EXHIBIT A

alaska

EXECUTIVE BUDGET

BOOK I - OPERATING BUDGET

FISCAL 198

JAY S. HAMMOND,
GOVERNOR

General Assumptions:	Inflation of 9% in early years, dropping to 7% long term. Rate of interest on both funds: rate of inflation plus 1%. Petroleum revenues include Beaufort bonus, include gas pipeline.
Specific Assumptions:	Growth rate of real, per capita appropriations is 0%. Growth rate of real, per capita sustainable revenue is 1%. Permanent Fund contribution rate is 25%.
Note:	All values are expressed in nominal dollars. Figures are expressed in millions (e.g. 100.0 = $100,000,000)

Year	Total State GF Revenues	Sustainable Revenues	Interest Revenues	Petroleum Revenues	State GF Expenditures	GF Balance	PF Balance
1981	3563.35	353.499	139.395	3067.73	1200.64	3535.72	788.515
1982	5303.07	398.947	416.915	4480.54	1341.58	7016.18	1272.21
1983	6373.65	455.603	752.586	5159.36	1516.94	11310.7	1834.42
1984	7327.37	506.321	1193.58	5622.57	1669.11	16349.0	2454.33
1985	8437.51	545.653	1631.38	6259.38	1780.96	22310.0	3149.92
1986	9405.37	597.166	2054.61	6753.79	1929.80	29028.8	3906.71
1987	10628.6	658.707	2657.89	7313.16	2107.60	36727.5	4728.92
1988	11838.6	726.759	3345.54	7768.39	2302.31	45388.9	5603.82
1989	13149.4	801.757	4115.11	8235.74	2514.75	55094.5	6532.84
1990	14306.0	884.407	4973.33	8452.60	2746.52	65698.3	7488.62
1991	15400.9	976.219	5906.18	8523.66	3001.63	77130.7	8455.39
1992	15933.7	1077.44	6906.80	7955.81	3280.05	88876.5	9363.37
1993	15731.5	1189.88	7927.95	6620.90	3586.50	100256.	10129.2
1994	16017.1	1315.78	8908.06	5801.55	3926.70	111666.	10808.9
1995	16475.8	1454.74	9883.75	5146.67	4298.42	123239.	11413.1
1996	16931.8	1608.10	10866.5	4467.58	4704.52	134936.	11943.7
1997	17499.6	1778.54	11853.2	3879.24	5151.65	146818.	12409.6
1998	18180.4	1966.70	12849.7	3376.36	5640.25	158948.	12819.6
1999	18962.5	2175.80	13861.7	2938.40	6178.15	171372.	13180.5
2000	19841.8	2406.68	14893.4	2556.19	6766.05	184130.	13498.1

ATLANTIC RICHFIELD COMPANY; Arco Pipe Line Company; BP Alaska, Inc.; Exxon Corporation; Exxon Pipeline Company; and Sohio Pipe Line Company, Appellants,

v.

STATE of Alaska; Alaska Department of Revenue; Alaska Department of Administration; Commissioner of Revenue Robert D. Heath, and Commissioner of Administration Lisa Rudd, Appellees.

No. S–52.

Supreme Court of Alaska.

Aug. 16, 1985.

Taxpayers challenged constitutionality of oil and gas corporation income tax and sought refunds of taxes paid. The Superior Court, Anchorage, Victor D. Carlson, J., granted summary judgment in favor of State, and taxpayers appealed. The Supreme Court, Burke, C.J., held that: (1) the tax did not deny taxpayers due process of law on ground that it taxed extraterritorial values; (2) the tax comported with requirements of United States Supreme Court's *Complete Auto Transit* test and created no impermissible burden on interstate commerce; and (3) the tax did not violate state and federal equal protection nor did it impair State's lease contracts with taxpayers.

Affirmed.

1. Taxation ⚖1076

Oil and gas corporation income tax, AS 43.21.010 et seq. (Repealed), used separate accounting method for dividing income, distinct from both the specific allocation by situs and formula apportionment methods.

2. Taxation ⚖1076

Separate accounting method employed in oil and gas corporation income tax, AS 43.21.010 et seq. (Repealed), more accurately attributed income generated from Alaskan oil than did traditional formula apportionment, and thus was proper.

3. Trial ⚖136(1)

Characterization of oil and gas corporation income tax, AS 43.21.010 et seq. (Repealed), was, at most, a "legislative fact" which was not the type of factual issue for which trial is necessary.

4. Taxation ⚖956

An income attribution method, be it a single-factor or three-factor formula apportionment or separate accounting, is not constitutionally invalid merely because it may result in taxation of some income that did not have its source in the state.

5. Constitutional Law ⚖280

Any attempt to tax extraterritorial values would be an unconstitutional taking of property by state under due process clause of Federal Constitution, U.S.C.A. Const. Amend. 14, § 1.

6. Constitutional Law ⚖285.2

Due process imposes two requirements before a state may tax income generated in interstate commerce: first, a minimal connection must exist between interstate activities and taxing state; second, income attributed to taxing state must bear rational relationship to intrastate values of the enterprise. U.S.C.A. Const.Amend. 14.

7. Constitutional Law ⚖281.5

Due process requirement of minimal connection between interstate activities and taxing state is established if corporation avails itself of substantial privilege of carrying on business within the state. U.S.C.A. Const.Amend. 14.

8. Constitutional Law ⚖285.2
Taxation ⚖956

Oil and gas corporation income tax, AS 43.21.010 et seq. (Repealed), did not deny taxpayers due process of law on ground that it taxed extraterritorial values, as clear nexus existed between oil production and transportation activities of taxpayers and state of Alaska, and as tax made a reasonable attempt to attribute only that income to Alaska that was generated in Alaska, while excluding expenses and profits generated beyond Alaska's borders. U.S.C.A. Const.Amend. 14.

9. Commerce ⇨62.70

If state tax is applied to activity with substantial nexus with taxing state, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to services provided by state, there is no impermissible burden on interstate commerce. U.S.C.A. Const. Art. 1, § 8, cl.

10. Commerce ⇨74.15
Taxation ⇨956

Oil and gas corporation income tax, AS 43.21.010 et seq. (Repealed), did not violate federal commerce clause on ground that it inevitably resulted in overlapping or duplicative taxation, thus discriminating against businesses engaged in interstate commerce, as the separate accounting division-of-income method employed by the tax did not automatically conflict with an apportionment method and result in double taxation. U.S.C.A. Const. Art. 1, § 8, cl. 3.

11. Commerce ⇨74.15
Taxation ⇨956

Oil and gas corporation income tax, AS 43.21.010 et seq. (Repealed), comported with requirements of United States Supreme Court's *Complete Auto Transit* test and created no impermissible burden on interstate commerce, as location of oil fields in Prudhoe Bay created substantial nexus between taxpayers' activities and state of Alaska, as the tax was fairly apportioned to represent only that part of taxpayers' income generated from its Alaskan activities, namely, oil and gas production and transportation, and as the tax did not inevitably result in multiple taxation. U.S.C.A. Const. Art. 1, § 8, cl. 3.

12. Constitutional Law ⇨229.2
Taxation ⇨956

Oil and gas corporation income tax, AS 43.21.010 et seq. (Repealed), did not violate state and federal equal protection on ground that it arbitrarily and rationally subjected a special group of taxpayers to treatment not accorded taxpayers at large. U.S.C.A. Const.Amend. 14.

13. Constitutional Law ⇨121(1)
Taxation ⇨956

Oil and gas corporation income tax, AS 43.21.010 et seq. (Repealed), was not invalid on ground that it impaired obligation of State's lease contracts with taxpayers, as no lease provision had been impaired, and as, by entering into the leases, state could not, and did not, contract away its power as a sovereign to tax income earned in state. U.S.C.A. Const. Art. 1, § 10, cl. 1; AS 38.05.005 et seq.

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Bobby R. Long, Jackson, Miss., for amicus curiae Mississippi State Tax Comn.

Before BURKE, C.J., and RABINOWITZ, MATTHEWS and MOORE, JJ.

OPINION

BURKE, Chief Justice.

This is an appeal brought by several major oil producing companies in Alaska [1] challenging the constitutionality of the Oil and Gas Corporate Income Tax, Former AS 43.21 (repealed 1982) ("the Oil Tax").[2] The issue is whether the State of Alaska must, as a matter of constitutional law, use the formula apportionment method to determine the portion of each corporation's worldwide oil production and pipeline transportation income that can be attributed to Alaska. During the tax years 1978 to 1981 the state used separate accounting, instead of formula apportionment, to determine taxable production and pipeline transportation income.

Various actions challenging the constitutionality of the Oil Tax were consolidated on August 27, 1980, in the superior court.[3] Appellants ARCO, Exxon, and Sohio argued below that the Oil Tax violated the commerce, due process, contract, and equal protection clauses of the United States Constitution, as well as the equal protection clause of the Alaska Constitution and the state constitutional and statutory provisions against retroactivity. They sought a refund of taxes paid under the Oil Tax.

On November 12, 1981, the state moved for summary judgment seeking a declaration that the Oil and Gas Corporate Income Tax Act is constitutional. The trial court rejected the oil companies' claims of unconstitutionality and granted the state's motion for summary judgment. We affirm.

I. THE OIL TAX

In 1959, Alaska adopted the three-factor apportionment formula of the Uniform Division of Income for Tax Purposes Act (UDITPA) to determine the share of income of an integrated (unitary) interstate business subject to Alaska income taxation. AS 43.20.130 (repealed 1975).[4] The apportionment formula relies on three indicators of business activity—payroll, property and sales—to compute Alaska's share of taxable income. *Id.* The value of property, payroll and sales in Alaska is compared to the value of property, payroll and sales of the corporation worldwide. The resulting ratio is then multiplied by the corporation's apportionable net income worldwide to arrive at an approximation of Alaska's share of taxable income.

Prior to the enactment of the Oil Tax in 1978, all of the income tax liability of oil companies was determined under the formula apportionment method. Under the Oil Tax, a different methodology, separate

1. Atlantic Richfield Company and ARCO Pipeline Company (collectively "ARCO"), Exxon Corporation and Exxon Pipeline Company (collectively "Exxon"), and BP Alaska, Inc. and Sohio Pipe Line Company (collectively "Sohio").

2. AS 43.21 (Ch. 110, § 3, SLA 1978; am. ch. 113, §§ 28-32, SLA 1980; am. ch. 116, §§ 6-11, § 17 SLA 1981) was repealed effective January 1, 1982. Ch. 116, § 19, SLA 1981. For convenience, we refer to the Oil Tax by the former statutory section numbers throughout this opinion. *See* Appendix 1 for the full text of AS 43.21.

3. Other oil companies were also involved initially in the litigation, but were dismissed upon agreeing to defer their constitutional claims pending resolution of this case.

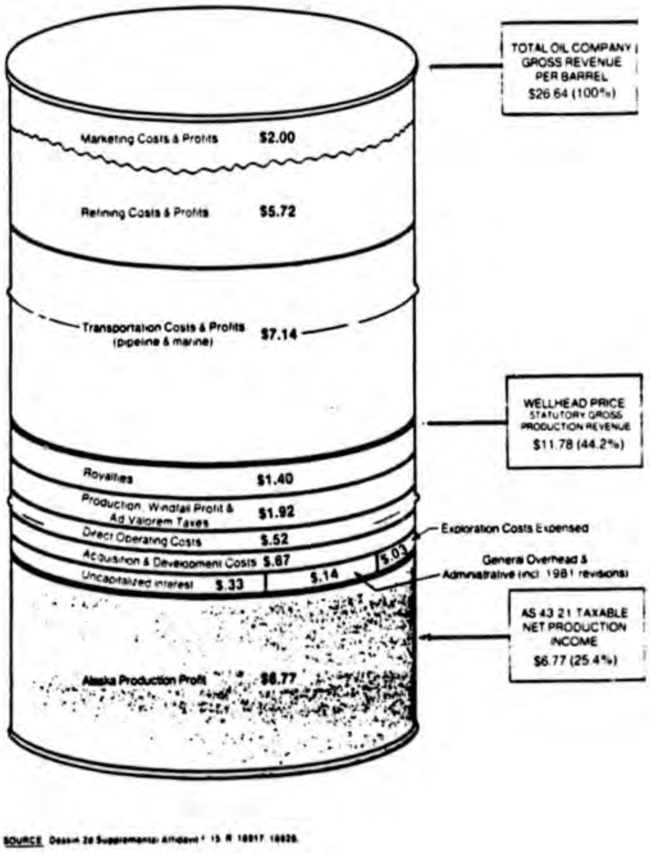
4. In 1970, Alaska adopted the Multistate Tax Compact, enacted as AS 43.19.010. It is basically a restatement of UDITPA with a few minor changes. The three-factor apportionment formula is now described at AS 43.19.010, art. IV, §§ 9-15.

accounting,[5] was implemented to calculate the production and pipeline transportation income subject to Alaska taxation. The goal of the separate accounting method was to determine that portion of the value of a barrel of oil attributable to the oil being produced, i.e., taken from the ground. AS 43.21.020.

The separate accounting of oil production income began with the determination of gross production revenue or "gross income."[6] The Oil Tax defined gross income as the value of the oil at the point of production, i.e., the well-head price. AS 43.21.020(b). Essentially, gross income equalled the price at which the oil was sold, or could be sold, to a refinery less transportation expenses. AS 43.21.020(b). The price at which oil was sold, or could be sold, to a refinery obviously did not include refining and marketing costs and profits. These costs and profits were thus excluded in determining the gross income figure for Alaskan oil. In addition, a number of other costs were deducted from gross income. "Upstream" costs, such as exploration expenses, royalties, lease acquisition and development costs, and general overhead and administrative expenses, and "downstream" costs, such as transportation and marketing costs were deducted from gross income. AS 43.21.020(c). The end result was net production income, which was

5. The oil companies dispute whether the methodology of the Oil Tax is in fact "true" separate accounting. *See infra* section II.B.

6. The following graph, submitted by the State of Alaska, illustrates the estimated revenues, costs and profits contained in each barrel of Alaskan oil during the years 1978–80:



SOURCE: [illegible]

CHART 1

taxed at the 9.4% rate applicable to all other corporate income at that time. Former AS 43.20.011 (amended, repealed and reenacted 1981).

The Oil Tax used a similar methodology to tax income from the pipeline transportation of oil and gas in Alaska. The items of income and expense related to Alaska pipeline transportation were keyed to the amount reported by the oil companies to the Federal Energy Regulatory Commission as net operating income. AS 43.21.030. The validity of this portion of the Oil Tax is also at issue in this case, though the parties focus primarily on the taxation of production income.

Under AS 43.21.040, all other income of the oil companies continued to be taxed under the UDITPA formula apportionment method. Such other income was primarily from marketing and refining operations. In computing this income, worldwide oil production and pipeline transportation income was subtracted from the total amount of income subject to apportionment by Alaska. Then the three-factor formula was applied, again with the production and pipeline income in Alaska deleted. The result attributed to Alaska a portion of worldwide refining and marketing income of the oil company approximating the share of such activities occurring in Alaska. This income, like the production and pipeline income, was taxed at the rate of 9.4%. Former AS 43.20.011 (amended, repealed and reenacted 1981).

The Oil Tax was repealed effective January 1, 1982. Ch. 116, § 19, SLA 1981. It was replaced with a modified apportionment formula for the ensuing tax years. AS 43.20.072. The legislature took this step primarily to avoid a further increase in the possible $1.8 billion liability caused by this litigation.

II. THE OIL TAX IS "TRUE" SEPARATE ACCOUNTING

There are three basic methods by which the income of a multistate enterprise can be divided among the states entitled to tax the enterprise's income: separate accounting, specific allocation by situs and formula apportionment. The state claims the Oil Tax is true separate accounting, while the oil companies contend it is specific allocation by situs.

A. *The Three Methods For Division Of Income*

1. *Separate Accounting*

Separate accounting attempts to carve out of the taxpayer's overall business the income derived from sources within a single state, and by accounting analysis, to determine the profits attributable to that portion of the business.[7] Income within the state is determined without reference to the success or failure of the taxpayer's activities in other states.[8] In the case of goods (such as crude oil) sent to another state for processing, separate accounting values these goods at the price which could be obtained for them in their unprocessed form when leaving their state of origin.[9] In other words, separate accounting recognizes that crude oil has a marketable value before it is refined.

2. *Specific Allocation by Situs*

Specific allocation by situs refers to the method of dividing a tax measure (in whole or in part) by tracing particular property, receipts, or income to their source state, and attributing the item *in its entirety* to that state.[10] This method is troublesome because more than one state is likely to have a legitimate basis for taxing the same item, especially when the tax is one measured by income.[11] The specific allocation

7. *See generally* J. Hellerstein, State Taxation: Corporate Income and Franchise Taxes ¶ 8.3, at 323-327 (1983).

8. P. Hartman, Federal Limitations on State and Local Taxation § 9.17, at 522 (1981).

9. G. Altman & F. Keesling, Allocation of Income in State Taxation 38 (2d ed. 1950).

10. J. Hellerstein, *supra* note 7, ¶ 8.4, at 328.

11. *Id.*

method has been used commonly with "non-business" income such as income from dividends, patent and copyright royalties, and gains or losses from the sale of capital assets.[12] Under UDITPA, some non-business income of this nature is allocated in its entirety to the situs state. *See* AS 43.19.010, art. IV, §§ 5–8.

Confusion may arise because the separate accounting methodology is very similar to the specific allocation approach. Both methods attempt to trace income to an identifiable source. The primary difference in the two methods is that separate accounting looks to the activities in the state and seeks to determine the income related to that activity. Specific allocation attributes income according to situs, or some other specific characteristic of the business enterprise, rather than on the basis of where the income itself was earned. Moreover, specific allocation results in *all* of a specified type of income and *all* associated profits being allocated to one state. Separate accounting, on the other hand, attempts to segregate out *only* those profits attributable to activities within the state for taxation by that state.

3. *Formula Apportionment*

Formula apportionment is the method commonly used to divide the income of a unitary business [13] among various jurisdictions in which the business operates. The formula method, "unlike separate accounting, does not purport to identify the precise geographical source of a corporation's profits; rather, it is employed as a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing State." [14] The formula method assumes that the total income of a business enterprise results from certain income producing factors—typically property, payroll and sales. The value of the corporation's property, payroll and sales within the taxing state is compared with the value of these factors outside the taxing state. The resulting ratio is then multiplied by the total apportionable net income worldwide of the multi-state corporation.[15]

B. *The Oil Tax Is Separate Accounting*

The oil companies equate the Oil Tax with the specific allocation by situs method. They contend that the Oil Tax attributes *all* of the income and profits from oil production and transportation to Alaska. Their argument ignores the difference between the Oil Tax and the specific allocation method. The Oil Tax does not attribute income from the production of oil *in its entirety* to Alaska, the source state. Instead, it attempts to tax only that portion of income from the oil which is fairly related to Alaskan production activities. While total revenue for a barrel of oil during 1978–80 was approximately $26.64, only $6.77 was deemed production income attributable to Alaskan activities and subject to the Oil Tax.[16] In segregating from total income a portion related only to activities in the state, the Oil Tax operates as a separate accounting system.

The companies argue that the Oil Tax is not true separate accounting because it fails to take into account the profit-producing nature of activities occurring outside

12. *Id.* at 329.

13. "[A] unitary business may be defined simply as any business which is carried on partly within and partly [outside] the taxing jurisdiction." Keesling & Warren, *The Unitary Concept In the Allocation of Income*, 12 Hastings L.J. 42, 46 (1960).

14. *Moorman Mfg. v. Bair*, 437 U.S. 267, 273, 98 S.Ct. 2340, 2344, 57 L.Ed.2d 197, 204 (1978).

15. P. Hartman, *supra* note 8, § 9.18, at 523–524.

16. The wellhead price did not include refining and marketing costs and profits. The following deductions were also taken from the wellhead price: royalties, native corporation revenue sharing, production, *ad valorem* and windfall profit taxes, direct operating expenses, exploration, acquisition, and development costs, uncapitalized interest and general overhead and administrative expenses inside and outside Alaska (including a reasonable profit). AS 43.21.020(c); 15 AAC 21.200 (Eff. 2/22/79). *See* graph *supra* note 6.

Alaska. For example, the geological and geophysical analysis of the Prudhoe Bay area was conducted primarily outside Alaska. The companies argue that only the expenses associated with these outside activities are deductible in computing income subject to the Oil Tax. Thus, in their view, the Oil Tax taxes profits earned outside Alaska.

The state contends that oil companies can deduct profits attributable to general overhead or administrative activities outside of Alaska. Under Department of Revenue regulations, profits associated with such activities could be deducted if the taxpayer in fact considered them profit generally and reported them as such to the stockholders. 15 AAC 21.290(b) (Eff. 2/22/79, am. 3/26/82). The oil companies claim that the Security Exchange Commission prohibits the allocation of profits in this manner, citing 15 U.S.C. § 78m(b)(2)(B)(ii) (1982). This section provides that every issuer of a security subject to the provision must have an internal accounting system that permits preparation of financial statements "in conformity with generally accepted accounting principles or any other criteria applicable to such statements." The parties' experts disagree on the acceptability, under general accounting principles, of allocating profits to general overhead and administrative activities. Even if we assume that the allocation of profits to these activities is not generally accepted, 15 U.S.C. § 78m(b)(2)(B)(ii) allows the use of "other criteria" in financial statements. If, as the oil companies claim, profits exist that are actually attributable to general overhead and administrative activities outside of Alaska, the Securities Exchange Act does not prevent them from reporting such profits to their shareholders, and then deducting them from their Alaska income tax.

Although amended after the repeal of the Oil Tax in 1982, 15 AAC 21.290(b) (Eff. 2/22/79, am. 3/26/82) operates retroactively.[17] The oil companies, therefore, may amend their tax reports and returns to deduct any outside-generated profits attributable to general overhead and administrative activities associated with Alaskan oil production not previously deducted in computing Alaskan taxable income.

The companies also assert that the Oil Tax is an inappropriate methodology because it presumes that crude oil has a value, i.e., that income has been generated when the oil is merely brought out of the ground. The oil companies argue that oil has no value whatsoever until it is sold.

The oil companies cite our decision in *Sjong v. State, Department of Revenue*, 622 P.2d 967 (Alaska 1981), *appeal dismissed*, 454 U.S. 1131, 102 S.Ct. 986, 71 L.Ed.2d 284 (1982), for the proposition that the oil has no value until it is sold. We find their reliance misplaced. In *Sjong*, we upheld an apportioned net income tax as-

17. The only logical interpretation of the 1982 amendment to 15 AAC 21.290(b) is that it operates retroactively for the tax years 1978–81. It cannot be meaningfully applied prospectively because it was adopted *after* the Oil Tax was no longer in effect. We must assume that the process of amending 15 AAC 21.290(b) was intended to be operative. We cannot imagine that the Department of Revenue ("Department") would engage in a futile act. *See* 2A C. Sands, Sutherland Statutory Construction § 45.12, at 54 (4th ed. 1984).

The retroactivity of the Department's regulations is governed by the Alaska Administrative Procedure Act, AS 44.62.240. Under this statute, an "interpretative regulation," such as 15 AAC 21.290(b), may be retroactive only if the agency "has adopted no earlier inconsistent regulation and has followed no earlier course of conduct inconsistent with the regulation." The Department's earlier omission of a deduction for outside-generated profits attributable to general overhead and administration associated with Alaskan oil production could be construed as inconsistent conduct with the 1982 amendment to 15 AAC 21.290(b). AS 44.62.240, however, is concerned with the issues of fairness and notice. *See, e.g.*, AS 43.21.050(d) (authorizing Department to fashion an equitable tax if relief from an unfair allocation is required). In this case, a retroactive interpretation of the 1982 amendment confers a benefit on the oil companies by allowing an additional tax deduction not previously available. Unlike many retroactive enactments, 15 AAC 21.290(b), as amended, does not create a harsh or unfair result for the affected parties. Therefore, the 1982 amendment to 15 AAC 21.290(b) operates retroactively for the tax years 1978–81.

sessed against a nonresident crab fisherman, who fished exclusively in the international waters surrounding Alaska and sold his catch only to Alaska processors and canneries. Sjong claimed that no taxable income could be attributed to the state because he caught the crabs in international waters. We responded that "the process of fishing results in no profits until the catch is sold to processors in Alaska." 622 P.2d at 972 (footnote omitted). Obviously, profits do not result from crab fishing or oil production until the product is sold. This does not negate the fact that profits generated by the sale are partly attributable to the inherent value of the crab or oil at its point of production.

In the state's view, the extraction of a natural resource, in and of itself, generates income. Thus, it argues that it is reasonable to attribute the income identified with the extraction of oil, measured in terms of "well-head value," to the state in which the oil was extracted. The state is joined in this position by Amicus Curiae, the states of Louisiana, Mississippi and Oklahoma, all which have long employed separate accounting to tax oil production income.[18]

The United States Supreme Court has likewise recognized the inherent value generated by the extraction of natural resources. In upholding the constitutionality of Montana's severance tax on coal mined in the state, the Court reasoned that "[t]he entire value of the coal, before transportation, originates in ... [Montana], and mining of the coal depletes the resource base and wealth of the State, thereby diminishing a future source of taxes and economic activity." *Commonwealth Edison v. Montana*, 453 U.S. 609, 624, 101 S.Ct. 2946, 2957, 69 L.Ed.2d 884, 898 (1981) (footnote omitted). Before it is transported for sale, oil, like coal, has inherent value, to which profits and income can properly be attributed.[19]

[1] We hold that the Oil Tax is fundamentally a separate accounting method for dividing income, distinct from both the specific allocation by situs and formula apportionment methods.

C. *Separate Accounting More Accurately Attributes Income Generated from Alaskan Oil Than Does Formula Apportionment*

The use of separate accounting to apportion the income of a unitary business, such as each of the companies in this litigation, has been roundly criticized.[20] The United States Supreme Court has noted:

> The problem with this method is that formal accounting is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of

18. *See also Texas Co. v. Cooper*, 236 La. 380, 107 So.2d 676, 687–91 (1958) (rejected argument that production of oil in absence of sale, does not result in taxable income); *Magnolia Petroleum v. Oklahoma Tax Comm'n*, 190 Okl. 172, 121 P.2d 1008, 1013 (1941) ("[O]il produced in the state had an easily ascertainable market price that would represent the value of the product attributable wholly to Oklahoma.").

19. While party to a tax suit in South Carolina, Exxon recognized the existence of oil's wellhead value. In its brief, Exxon asserted that "E & P [exploration and production] income is fully earned at the wellhead, and ... [is] functionally independent of ... refining and marketing operations." Appellant's Opening Brief at 19, *Exxon v. South Carolina Tax Comm'n*, 273 S.C. 594, 258 S.E.2d 93 (1979), *appeal dismissed*, 447 U.S. 917, 100 S.Ct. 3005, 65 L.Ed.2d 1109 (1980). Exxon went on to note that their witness

> testified that the posted field price was also accepted by the accounting profession as a reliable, independent measure of the value of crude oil at the wellhead. Using this value, ... the net income earned by exploration and production could be and is accurately measured. This is in accordance with generally accepted accounting principles, because crude oil has a known, realizable value.

Id. at 26.

20. *See, e.g.*, G. Altman & F. Keesling, *supra* note 9, at 38 ("It is obvious, however, that a separate accounting, no matter how detailed, is basically false if the business done in more than one state is of a unitary character, ..."); Dexter, *The Unitary Concept in State Income Taxation of Multistate—Multinational Businesses*, 10 Urb. Lawyer 181, 207 (1978) ("[T]he use of separate accounting to attribute unitary income to a taxing jurisdiction is conceptually inconsistent.").

value that take place among the components of a single enterprise.

Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 164–65, 103 S.Ct. 2933, 2940, 77 L.Ed.2d 545, 553 (1983) (citation omitted). For instance,

> while it [separate accounting] purports to isolate portions of income received in various States, [it] may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable "source." Although separate geographical accounting may be useful for internal auditing, *for purposes of state taxation it is not constitutionally required.*

Mobil Oil v. Commissioner of Taxes, 445 U.S. 425, 438, 100 S.Ct. 1223, 1232, 63 L.Ed.2d 510, 521 (1980) (emphasis added; citations omitted).

These criticisms, however, are inapplicable to the oil and gas industry. The standard three-factor formula apportionment method was "developed and designed to meet the needs of manufacturing and mercantile industries, and [is] poorly adapted to a good many other businesses." [21] The United States Supreme Court has noted that 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.*

Container Corp. of America v. Franchise Tax Board, 463 U.S. at 183 n. 20, 103 S.Ct. at 2949 n. 20, 77 L.Ed.2d at 565 n. 20 (emphasis added). An assumption made in the use of formula apportionment is that "*major* income-producing elements can be identified and that these major elements contribute the largest portion of the unitary income of the taxpayer." [22]

A unique characteristic of unitary oil and gas businesses is that the major income-producing element is the value of the oil and gas reserves in the ground. While this element can be readily identified, it is not recognized under traditional formula apportionment methods.[23] Instead, the typical factors used are property, payroll and sales, none of which accurately reflects the oil and gas corporations' activities in Alaska. The property factor includes only the original cost of the wells and the lease, which do not necessarily represent the value of the oil reserves themselves. *See* AS 43.19.010, art. IV, § 11. As a result, the Prudhoe Bay field is valued at about one percent of its actual worth.[24] Under UDITPA, the payroll factor includes only wages paid to employees based in the state. AS 43.19.010, art. IV, §§ 13–14. Oil production, however, is not a labor-intensive industry. Moreover, much of the production work is done by employees based in other states, or by independent contractors, whose earnings do not appear in the payroll factor. Finally, and most importantly, the sales receipts under UDITPA are credited solely to the destination state. AS 43.19.010, art. IV, § 16. The oil companies and the state agree that only a "tiny fraction" of the oil produced in Alaska is actually sold within the state.

For all of the above reasons, separate accounting, not formula apportionment, is the prevailing method throughout the United States for reporting income from oil production.[25] The Comptroller General's

21. J. Hellerstein, *supra* note 7, ¶ 10.9, at 689.

22. A. Cohen, Apportionment and Allocation Formulae and Factors Used by States in Levying Taxes Based on or Measured by Net income of Manufacturing, Distributive and Extractive Corporations 14 (1954). [Record 1561]

23. *Id.*

24. *See* B. Sorensen, Memorandum to the Honorable Nels A. Anderson, Jr. (May 27, 1976) (discussing state corporate income tax).

25. Rudolph, *State Taxation of Interstate Business: The Unitary Business Concept and Affiliated Groups*, 25 Tax L.Rev. 171, 191 (1970). Of the top five producing states, three—Alaska, Louisiana and Oklahoma—require the use of

report explains that states use separate accounting to determine the income division for unitary oil and gas businesses "because it conforms more to [the businesses'] financial accounting procedures and ... more accurately reflects income than formula apportionment." [26]

Alaska has not employed separate accounting to divide the income of all unitary businesses. According to the state, the Alaska legislature turned to separate accounting for oil producing businesses only after it determined that the use of formula apportionment to compute Alaska's share of oil production income would seriously underestimate the production income that was rightly subject to taxation by this state.[27]

The oil companies cite portions of legislative history to show that the Oil Tax was imposed in an effort to unilaterally effect a renegotiation of oil leases so as to shift the cost of Alaska's government to the oil industry. The legislature, however, formally declared that the income tax of corporations engaged in oil production or pipeline transportation would be computed under the Oil Tax because the formula apportionment method did not fairly represent the extent of those corporations' oil production and transportation activities in Alaska. Ch. 110, § 1, SLA 1978. To look beyond this articulated basis would lead to a "parade of legislators' affidavits containing their perceptions" of the Oil Tax's purpose. *Alaska Public Employees Association v. State*, 525 P.2d 12, 16 (Alaska 1984). We have recently disapproved of such inquiries. *Id.* The United States Supreme Court has also declined to search for the "real" motive beyond the legislature's expressed purposes when adjudicating equal protection and commerce clause challenges. In *Minnesota v. Clover Leaf Creamery*, 449 U.S. 456, 101 S.Ct. 715, 66 L.Ed.2d 659 (1981) the Court stated that it would

> 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, 101 S.Ct. at 723 n. 7, 66 L.Ed.2d at 668 n. 7 (quoting *Weinberger v. Wiesenfeld*, 420 U.S. 636, 648 n. 16, 95 S.Ct. 1225, 1233 n. 16, 43 L.Ed.2d 514, 525 n. 16 (1975)). Nothing in the record leads us to conclude that accurate and fair allocation could not have been the legislature's goal in enacting the Oil Tax.[28]

[2] The fact that the traditional formula apportionment method inaccurately reflects the oil companies' income and profits derived from Alaskan production activities is

separate accounting to determine income attributable to oil production. Texas imposes no corporate income tax, and California requires formula apportionment. Statistical Abstract of the United States at 730 (1983). *But see* Cal.Rev. & Tax Code Ann. § 25137 (West 1979) (allowing separate accounting, or other alternative methods of apportionment, when total formula apportionment does "not fairly represent the extent of the taxpayer's business activity in this state.").

26. GAO Report to the Chairman, House Committee on Ways and Means: Key Issues Affecting State Taxation of Multijurisdictional Corporate Income Need Resolving 3 (1982). [Record 17,023].

27. The Oil Tax was enacted only after it was considered by two legislatures over a four year period. Sixty-three hearings were held and dozens of studies and reports were made.

28. *See, e.g.*, Minutes of Senate Finance Committee (May 21, 1977): "[T]he income tax is not designed to pick up additional money but to try to establish equal treatment between companies operating within the state." (Statement of Senator Chancy Croft) [Record 4759]; Minutes of Senate Resource Committee (February 22, 1978): "If we're seeking to raise money—I think the most effective way is through a severance tax." (Statement of Commissioner Sterling Gallagher [Record 1704]); Office Memo to Senator Rader from Kay Brown (December 22, 1977): "[S]eparate accounting [is the] most equitable method because under it every corp[oration] pays [the] same effective tax rate." (Statement of Senator Chancy Croft) [Record 1661]; Testimony Before House/Senate Resources Committees (January 25, 1978): "[T]he purpose [of separate accounting] is not to get higher taxation, but it gives you a direct fix on what the profitability of the industry's operations are." (Statement of consultant Milton Lipton) [Record 1941] illustrated in the case of Sohio. The oil companies maintain that during 1978–80, when the Oil Tax was in effect, an average of only 10% of Sohio's payroll, 12% of its sales and 50% of its property were in Alaska. At the same time, Sohio indicated in its 1980 annual report that over 90% of its total oil production derived from the reserves in Alaska. [Record 1559] A media report offered by the state, with which the oil companies did not take issue, indicated that Alaskan oil had elevated Sohio from seventeenth to seventh in earnings in the oil industry:

> 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.[29]

Clearly the traditional formula apportionment method would inadequately reflect the phenomenal value of the companies' oil reserves in Alaska.

III. SUMMARY JUDGMENT WAS PROPER

[3] The oil companies argue that there are numerous disputed issues of fact which preclude summary judgment for the state. Several of the alleged disputed issues of fact are irrelevant to the constitutional challenge and do not preclude summary judgment.[30] Other claims by the oil companies reduce to the assertion that the characterization of the Oil Tax as a separate accounting methodology is a disputed issue of fact. The state argues that the question as to whether the Oil Tax is a form of separate accounting is a question of law. We agree with the state that a trial is not required in this case. The characterization of the Oil Tax is at most a "legislative fact" which is not the type of factual issue for which trial is necessary. *See State v. Erickson*, 574 P.2d 1, 4–6 (Alaska 1978). As the trial court held, "the asserted issues of material fact do not preclude summary judgment in any event because they 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 a trial is mandated."

[4] Finally, the oil companies claim that it is a disputed issue of fact whether the Oil Tax results in double taxation because it reaches income earned outside Alaska. An income attribution method, be it single-factor or three-factor formula apportionment or separate accounting, is not constitutionally invalid merely because it may result in taxation of some income that did not have its source in the state. *See Moorman Manufacturing v. Bair*, 437 U.S. 267, 272, 98 S.Ct. 2340, 2344, 57 L.Ed.2d 197, 204 (1978). Even if facts demonstrate that the Oil Tax reaches income earned outside Alaska, as alleged by the oil companies, the statute will be stricken only upon "clear and cogent evidence" that the income Alaska attributes to itself is "out of all appropriate proportions to the business transacted in [the] State," or has "led to a grossly distorted result." *Container Corp. of America v. Franchise Tax Board*, 463 U.S. at 170, 103 S.Ct. at 2942, 77 L.Ed.2d at 556 (citations omitted). Nothing in the record demonstrates that the Oil Tax led to a "grossly distorted result" or that it is "out of all appropriate proportions" to the business of extracting billions of barrels of oil from reserves located within Alaska.

Disposition by summary judgment was appropriate in this case because no issue of material fact remained. The record provided the trial judge with a sufficient background to reach a decision.[31] *See Kelly v.*

29. *Investing a Mountain of Cash Before the Oil Runs Out: An Oil Giant's Dilemma*, Bus. Wk. 60 (August 25, 1980). [Record 684]

30. For example, whether the oil companies had, themselves, measured their income by methods similar to those used by the Oil Tax is irrelevant.

31. An extensive record was developed, which is divisible into three categories. First, the bulk of the record consists of the legislative history of the Oil Tax. Second, competing affidavits from various economists and accountants present divergent economic theories on how oil production income is generated, and how, as a matter of policy, it should be divided among the states for taxation purposes. Finally, a large number

Zamarello, 486 P.2d 906, 914 (Alaska 1971); *cf. Ault v. Alaska State Mortgage Association*, 387 P.2d 698, 701-02 (Alaska 1963).

IV. CONSTITUTIONAL CHALLENGES TO THE OIL TAX

A. *Background*

When state corporate income taxes were first adopted,[32] separate accounting was regarded as the most precise method for dividing the income of a multistate corporation for taxation purposes.[33] Although apportionment formulas were employed by states and their use approved by the United States Supreme Court,[34] separate accounting was initially viewed as a benchmark by which to judge the reasonableness of state apportionment formulas. Thus, in *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123, 128, 51 S.Ct. 385, 387, 75 L.Ed. 879, 905 (1931), the Supreme Court invalidated a state's apportionment formula under federal due process because the taxpayer showed that under separate accounting only 17% of the income was attributable to the state, whereas under the apportionment formula used, the state taxed from 66% to 85% of the corporation's income.

The use of separate accounting as a basis for challenging state formula apportionment methods was eventually rejected in *Butler Brothers v. McColgan*, 315 U.S. 501, 62 S.Ct. 701, 86 L.Ed. 991 (1942). There, the Court acknowledged that an apportionment formula could be invalidated only if the taxpayer established by clear and cogent evidence that the formula taxed extraterritorial values. The Court held that the fact that no net income would be attributable to the state under separate accounting was insufficient to invalidate an apportionment formula.

> It is true that appellant's separate accounting system for its San Francisco branch attributed no net income to California. But ... [that] does not prove appellant's assertion that extraterritorial values are being taxed.

315 U.S. at 507, 62 S.Ct. at 704, 86 L.Ed. at 996.

The Court developed the doctrine that if a multi-state business is unitary, then the use of a formula apportionment method by the state is presumptively valid.[35] In the instant litigation, all of the companies involved are unitary businesses. Thus, it is undisputed that the use of an apportionment formula would have been a permissible means of attributing a portion of the companies' income to Alaska.

This case presents an interesting twist on previous constitutional challenges to state taxation methods by corporate taxpayers.

> In the past, apportionability often has been challenged by the contention that income earned in one State may not be taxed in another if the source of the income may be ascertained by separate geographical accounting.

Mobil Oil v. Commissioner of Taxes, 445 U.S. at 438, 100 S.Ct. at 1232, 63 L.Ed.2d at 521. Conversely, in this litigation, the oil companies seek to defeat Alaska's separate accounting method by arguing that formula apportionment is *required* for unitary businesses. In recent years, the Court's endorsement of formula apportionment as the preferred method to divide income of a unitary business has become increasingly apparent.[36] However, we do not interpret

of affidavits submitted by the companies describe the various activities associated with oil production which occur outside Alaska.

32. Wisconsin adopted the first corporate income tax in 1911. J. Hellerstein, *supra* note 7, ¶ 1.2, at 5.

33. *Id.* ¶ 8.3, at 324.

34. *Underwood Typewriter v. Chamberlain*, 254 U.S. 113, 41 S.Ct. 45, 65 L.Ed. 165 (1920).

35. *See* J. Hellerstein, *supra* note 7, ¶ 8.7, at 338-343.

36. *See, e.g., Exxon v. Wisconsin Dep't of Revenue*, 447 U.S. 207, 229-30, 100 S.Ct. 2109, 2123-2124, 65 L.Ed.2d 66, 85 (1980); *Mobil Oil v. Commissioner of Taxes*, 445 U.S. 425, 446, 100 S.Ct. 1223, 1236, 63 L.Ed.2d 510, 526 (1980).