ALASKA LEGISLATURE COMMITTEE FILES 1993-1994 8672 455
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exchange since you offer to give up an issue which the state won in litigation with another taxpayer, you receive the benefit of the prospective assessment bar, and the state is forced to drop the one issue that precipitated the legislation in the first instance.

We remain open to other proposals that seek to resolve outstanding issues between the state and the industry prospectively in legislation (e.g. our initiative on gas processing plants) or in regulations (in which we are making progress by all accounts). On the other hand, we will actively oppose measures such as HB 547 that intentionally attempt to excuse oil companies from paying major portions of their past tax obligations under AS 43.21 and AS 43.55.

I appreciate your initiative and our ability to speak frankly with one another. I agree wholeheartedly with your sentiment that assessments are <u>claims</u> by the state and that industry has raised defenses to payment in good faith. I fervently wish that our debate over the statutes of limitation does not diminish our cooperative efforts to resolve our differences in a way that fosters a stronger resource industry and a healthier long-term relationship between it and the state.

Very truly yours,

Bruce M. Botelho
Attorney General

BMB:pml

cc: Richard Eliason, Senior Legislative Liaison, Office of the Governor

94041

QUESTIONS AND ANSWERS
Statute of Limitations Oil and Gas Taxation
CSSB 377 (former SB 185)

1. What is a statute of limitations?

A statute of limitations is a legislatively-created bar to the prosecution of a claim in a judicial or quasi-judicial proceeding based upon a specific lapse of time since the claim arose.

2. What are the current statutes of limitations involved in oil and gas taxation?

There are two. The first is a three year statute on assessments. That means that the department of revenue must issue an assessment within three years of the filing of a return by a taxpayer. The second statute requires the state to collect the tax within six years of the assessment.

3. Why is there a need for legislation about the statute of limitations?

Two separate lawsuits were filed by oil companies to challenge the department of revenue's application of these statutes. The first, filed by Exxon, and pending before the Alaska Supreme Court, challenged the department's use of amended assessments. While the department has always issued amendments within the three year period (or obtained waivers of the statute from the taxpayers), it has frequently issued amended assessments after the three year period has run. Exxon claims the state may not do this. Tesoro separately challenged the six year statute of limitations on collections, claiming that if the state has not completed the hearing process and collected the taxes within the six year period, the taxpayer is no longer obligated to pay. The purpose of the legislation is to confirm the statute's historic interpretation and application of these statutes.

4. If the matter is in the courts, why should the legislature deal with it?

There are three reasons. First, the Tesoro lawsuit involving the six year statute on collections was settled before the Alaska Supreme Court could reach a decision (the state had won in the Superior Court). Thus, there is no precedent that is binding and taxpayers remain free to litigate that issue. Second, the amounts at issue in the Exxon case before the Alaska Supreme Court make it extremely desirable to have an insurance policy. Finally, we anticipate many months to elapse between oral

argument and a decision (more than 13 months had gone by between oral argument in the Supreme Court and the parties' decision to settle in the Tesoro case without decision). That delay will adversely affect the ability of the state and individual companies to negotiate fair settlements.

5. What does the administration's proposal on the statute of limitations contained in CSSB 377 do?

The bill clarifies existing statutes of limitations. It makes clear that the same limitations on assessment and collection of oil and gas taxes are suspended for as long as a tax appeal is open. The bill also makes a prospective change to the statute of limitations on assessments, so that assessments may not be increased after five years, even if a tax appeal takes longer than that to resolve.

6. How does the proposal affect the three-year statute of limitations on assessments?

The bill ensures that for all <u>currently</u> pending oil company tax appeals, the department can amend its original assessments upwards or downwards. This means that, if information comes to the attention of the department of revenue during an appeal which requires an adjustment, the department can determine the correct tax amount. The bill merely confirms the department's longstanding interpretation of the statute of limitations in this regard.

7. What does the proposal do to the six-year statute of limitations on collections?

The bill confirms the department's interpretation of existing law on the six-year statute of limitations that the limitations period for tax collection is suspended until administrative and judicial appeals by the taxpayer have been completed, and the tax amount owing has been finally determined.

8. Does the proposal retroactively change the tax laws?

The basic tax laws remain the same. The proposed legislation merely improves the likelihood that the state will ultimately collect what is found to be owing under the existing tax statutes.

9. Does the proposal increase oil taxes?

No. It only affects the statute of limitations, not the tax rates or substantive rules of tax liability.

10. Is the proposed legislation fair to the oil companies?

Yes, it is. The bill ensures that the companies cannot avoid paying the correct tax after the department has all relevant information. The bill also ensures that the companies cannot delay payment of taxes by appealing the department's assessments, and then avoid payment altogether on the technical ground that the statute of limitations bars collection after the appeal is over. In fact, to not pass the legislation would be unfair to those companies who have settled the early years.

11. Does the proposed legislation affect all the oil companies equally?

The bill will affect all oil and gas taxpayers with open audits and assessments for tax years through 1993. The precise financial effect on individual companies will vary depending upon the number of tax years still in dispute, but all oil and gas producers will be affected by this proposed legislation.

12. How much money is really at stake?

Including interest and penalties, nearly three billion dollars in back tax assessments (claims) are at risk from the oil companies' statutes of limitations arguments. Final tax amounts owing the state have not been determined in all these cases, however.

13. Does the proposal allow any closed or settled cases to be reopened?

No. It affects only cases which are still open under an appeal brought by the taxpayer.

14. What do other states and the federal government do?

The federal statute specifically provides that the statutes of limitations are suspended when a taxpayer appeals an assessment. Other states have similar provisions, suspending the statute, as well. In addition, Alaska's other statutes of limitations have been interpreted consistent with the department of revenue's

position. See e.g. Civil Rule 15(c), Alaska Rules of Civil Procedure.

15. Why wasn't three years enough for the Department to complete the assessment in the past?

There are good historical, practical, and legal reasons that the process has taken so long. In brief, the tax owed depends on the "value" of the crude oil. Value was difficult to determine early on because the oil either was traded in distant markets or internally processed (so there was no arms-length transaction). In addition, the oil market was in a state of flux. The Department was not at first prepared for the size of the problem --over 5 billion barrels of oil had to be traced to final markets. And, the companies controlled the information.

16. The companies have asserted that the Department has always had plenty of resources to deal with the problems presented by these taxes. Is that true?

In 1977, the Department had one auditor; in 1979, three more were hired, but none had any special oil & gas experience. The number of auditors increased to ten by 1983. At that time, there were 19 taxpayers filing both monthly (production tax) and yearly (separate income tax) returns. Unfortunately, the state--having been unprepared at the beginning--spent the next decade playing catch-up.

17. The companies have complained about the delays in the process. Is there anything to these complaints?

The process has taken a lot of time. However, if any taxpayer thought the delays it was experiencing were unreasonable, it could have requested that appeal be taken to formal conference immediately. They have almost uniformly chosen NOT to do this. In fact, until 1990, when the interest rates increased, the taxpayers had no incentive to move the cases along because they don't have to pay until the appeals process is completed.

18. Are oil company taxpayers at the mercy of the department of revenue which can issue amended assessments ad infinitum?

No. In addition to requesting an accelerated process, each taxpayer has the right to pay the disputed amount and file a claim for refund, thus barring any additional assessments.

19. The companies have argued that this proposal enacted into law will further delay settlement of major tax litigation. Is that true?

No. The bill removes incentive to delay by making it clear that the statutes of limitations are suspended during the appeal process. This means that the taxpayers can no longer argue that they do not have to pay any tax if the process takes more than six years. This can only encourage settlement of these tax cases.

20. Many in the industry claim that the bill is unfair because it "changes the rules in the middle of the game." Is this true?

No. The underlying tax structure is not changed one iota. It is ironic, however, to hear this argument from industry. Its sense of fairness did not impede the industry's willingness to challenge Alaska's oil tax structure and demand refunds from the courts beginning in 1979. Though they lost at every stage of litigation (through the United States Supreme Court in 1986), they won the battle in 1981 by convincing the legislature that too much was at risk for it not to abandon the separate accounting income tax.

21. Does the statute of limitations bill affect any non-oil and gas taxpayer?

No. The bill is limited to taxpayers that were subject to the state's oil and gas separate accounting statute in effect between 1979 and 1981 and to the state's oil and gas production tax, AS 43.55.

22. Is the audit process really that complicated?

Yes, it is. Alaska's production and separate accounting taxes are based on the gross value of the oil at the point of production on the North Slope, thousands of miles away from the markets where the oil was used or disposed of. Verifying the value reported by a producer requires tracing each month's barrels of production to their ultimate market, valuing the oil in that market, and checking the transportation costs that are deducted to arrive at a point-of-production value.

Between 1977 and 1986 alone, the department of revenue was required to monitor

- over 5 billion barrels of oil produced on the North Slope;

- some 15,000 tanker voyages and over 26,000 pipeline tariff transactions to transport this oil;
- over 16,000 separate deliveries;
- delivery to third parties under more than 4,800 different contracts;
- ANS crude oil exchanges for 105 other crude oils.

23. Wasn't this information available because of the state's litigation with the oil producers over royalty obligations?

The state did collect this information in the litigation with the producers over royalty obligations. However, the royalty data base was not completed until 1989. The Department is now making extensive use of that data base.

24. Are ANCSA corporations affected by this legislation in any way?

No. No ANCSA corporation has an outstanding assessment pending before the department of revenue issued outside the three year statute of limitation on assessments.

25. Will collection of the disputed back taxes financially cripple any oil and gas taxpayer?

Generally speaking, the taxpayers have advised their shareholders that they have reserves specifically set aside for various tax claims, including Alaska's. Typically some variant of the following language is employed:

> Settlement of the open tax matters is not expected to have a material effect on the consolidated financial position of the company and, in the opinion of management, adequate provision has been made for income and franchise taxes either under examination or subject to future examination.

DEPARTMENT OF LAW

OFFICE OF THE ATTORNEY GENERAL

October 16, 1984

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1984 Atty Gen Op #02

Does the statute of limitations on assessments bar consideration of new issues during taxpayer appeals?
166-086-85

Dear Mr. Botelho:

You have asked whether the statute of limitations on assessments in AS 43.05.260 prohibits the Division of Petroleum Revenue ("Division") from raising new issues during administrative appeal proceedings. More specifically, you requested advice on the following issues:

> 1) Can the Division amend an assessment after the three-year statute of limitations in AS 43.05.260 has expired?
>
> 2) Is the statute of limitations tolled for both gas and oil production taxes if the assessment for either gas or oil is appealed by the taxpayer?
>
> 3) Can the conference or hearing officer adjudicating a taxpayer appeal under AS 43.05.240 consider evidence relating to new issues in arriving at a decision concerning the correct amount of tax due the state?

2-CSLH

For reasons discussed below, we have concluded that (1) if the taxpayer pays the amount of tax in the notice of assessment, the Division may not reopen the matter and issue an amended assessment after the statute of limitations expires. However, if a notice of assessment is timely issued within the period of limitation under AS 43.05.260 and the taxpayer appeals the assessment under AS 43.05.240, the statute of limitations is suspended for the duration of administrative appeal proceedings. The notice of assessment can be amended after conference and hearing to reflect the decision with respect to the correct amount of tax due the state.

(2) Oil and gas production taxes under AS 43.55 are separate taxes imposed by different statutes for the purpose of applying the statute of limitations. Therefore, if a taxpayer pays the assessed tax for oil and appeals only the assessment for gas, the Division may not issue an amended assessment for oil production taxes after the statute of limitations has run.

(3) The statute of limitations does not prohibit the hearing officer from considering evidence relating to new issues material to the tax on appeal in arriving at a decision concerning the correct amount of tax due the state. During administrative appeal proceedings the Division may introduce evidence concerning a different theory or method of valuation or new issues not addressed in the audit report and notice of assessment appealed by the taxpayer.

(4) The statute of limitations on assessments does not prohibit the hearing officer from determining that the correct amount of tax due the state is more than that stated in the notice of assessment from which the taxpayer appealed.

I. BACKGROUND

The factual situation giving rise to this request for advice is as follows. In the past few years the Division has conducted over 100 audits of returns filed by the oil and gas industry for oil and gas production taxes and oil and gas corporate income taxes. Very few of the audits resulted in no change reports. Where the audits indicated a deficiency, the Division gave the taxpayer notices of assessment and demand for payment within the three-year limitations period under 43.05.260, or an agreed-to extension of that period. In a few instances the taxpayer did not appeal the notice of assessment and paid the deficiency. In the great majority of cases, the taxpayer did appeal from the notice of assessment. Only four or five of those administrative appeals have progressed to formal hearing decisions. The remaining appeals (80-85) are still being heard at the informal or formal level.

As the Division has gained more expertise in conducting audits and more knowledge as a result of discovery during the administrative appeal process, it has identified additional material issues not discussed in the audit assessments conducted

within the three-year limitations period, and has issued many notices of amended assessment to the taxpayers more than three years after the returns were due. The total tax deficiencies due to the second assessments for all taxpayers is estimated to be approximately $66 million.

For example, in one case the Division initially issued timely Notices of Assessment to the taxpayer for gas production taxes for 1977 and for oil production taxes for the same time period. The taxpayer appealed the gas assessment and paid the oil assessment. Subsequently, the Division issued Notices of Amended Assessment for both gas and oil taxes which raised additional issues not included in the original assessments and increased the amount of tax. The notices of amended assessment were issued more than three years after the returns were due but prior to a decision after formal hearing in the taxpayer's gas tax appeal.

In the second case, after audit of a taxpayer's 1977 and 1978 production tax returns, the Division issued a timely notice of assessment which assessed additional oil taxes for 1977 based on disallowance of some transportation costs and additional gas taxes for 1978. The taxpayer appealed both the 1977 oil assessment and the 1978 gas assessment. The appeal is at the informal conference stage. The Division now proposes to issue an

amended assessment for oil taxes for 1977 and for 1978 based on the prevailing value of the oil.

In a third case the Division has issued a Notice of Amended Assessment for increased oil production taxes, based on the addition of new issues, at the informal conference stage of the taxpayer's appeal from the original timely notice of assessment for the oil production tax.

In each of these cases, the taxpayers have objected to the notices of amended assessment on the ground that the Division is barred by the statute of limitations in AS 43.05.260 from issuing amended notices of assessment or from introducing new issues during the administrative appeal proceedings.

II. LEGAL ANALYSIS

A. The statute of limitations on assessments is suspended for the duration of administrative appeal proceedings when a taxpayer appeals a timely notice of assessment.

AS 43.05.260 provides, in part:

> Limitation on assessment. (a) Except as provided in AS 43.20.200(b), the amount of a tax imposed by this title must be assessed within three years after the return was filed, whether or not a return was filed on or after the date prescribed by law. If the tax is not assessed before the expiration of the three-year period, no proceedings may be instituted in court for the collection of the tax.

Certain exceptions to the three-year limitation are described particularly in subsection (b). For the purpose of this

discussion, we will assume that none of the express statutory exceptions apply.

There is no express provision in AS 43.05.260 for suspending the running of the period of limitations during administrative appeal proceedings. The first question is whether the running of the limitations period under AS 43.05.260 is suspended by operation of law for the duration of administrative appeal proceedings when a taxpayer appeals a timely notice of assessment.

Cases from states with statutes similar to AS 43.05.260 hold that issuance of a notice of assessment within the statutory period for assessing taxes suspends the statute of limitations for the duration of administrative appeal proceedings, until there is a final departmental decision on the correct amount of tax, and that a change in the assessed amount as a result of the administrative appeal process is not barred by the statute of limitations.

In Protest of Pentecost and Hodges, 98 P.2d 606 (Okla. 1940), the Oklahoma Supreme Court upheld an additional assessment made after the statute of limitations had run. In that case, the Tax Commission gave notice of a proposed additional assessment of income tax within the two-year statutory period for assessing additional taxes. Three weeks later, after the statute of limitations had run but before the time for protesting the

initial assessment had expired, the Tax Commission notified the taxpayer that the initial assessment had been cancelled and an increased assessment, based on a different method of calculating tax liability, was proposed. The taxpayer contended that the increased assessment was invalid because it had been made after the statute of limitations had run. The Oklahoma statute of limitations on assessments did not expressly provide for suspension of the limitations period during administrative appeals.

The Oklahoma Supreme Court upheld the validity of the second assessment. The court impliedly held that the statute of limitations was tolled by the timely filing of an initial notice of assessment. The court said this about the amended assessment:

> Assuming that the commission by its second proposal did adopt a plan or method of assessment wholly unlike that pursued in the first proposal, both proposals related to the same income, and the last thereof can be considered in no other manner than a mere amendment of the first. The mere change in the process or plan of calculation cannot give to the last proposal the character of a new proceeding.

98 P.2d at 609.

The court apparently analyzed the amended assessment in terms of an amendment to a complaint filed in court prior to the expiration of the relevant statute of limitations to initiate a civil action. It is a well established rule of civil procedure that, once a complaint is timely filed, the statute of

limitations is tolled and does not bar amendments to add new claims, including increased damages, provided that the new claims arise from or relate to the same basic facts or transactions described in the original complaint. See, e.g., Jakoski v. Holland, 520 P.2d 569 (Alaska 1974) (amendment adding husband's consortium claim to wife's claim arising out of automobile accident related back to date of complaint so that expiration of limitations prior to amendment did not bar consortium claim.)

There are several other cases in which courts have held that a statute of limitations on assessments like AS 43.05.260, which does not make an express exception for administrative appeals, is tolled or suspended for the duration of administrative appeal proceedings, during which the tax liability may be adjusted, when the taxing authority issues an initial notice of assessment within the statutory period. First National Bank v. Department of Revenue, 364 So.2d 38 (Fla. App. 1978); In re Woods Corp., 531 P.2d 1381 (Okla. 1975); Conversions and Surveys, Inc. v. State, 521 P.2d 1203 (Wash. 1974).

The taxpayers who have argued that the statute of limitations in AS 43.05.260 bars the Department from issuing notices of amended assessment and from raising new issues rely on the case of Anaconda Co. v. Department of Revenue, 583 P.2d 421 (Mont. 1978), which held that amended tax notices, issued after

the expiration of the statutory five-year period for assessing tax deficiencies, were void.

In Anaconda the corporate taxpayers had agreed in writing to extend until May 14, 1976, the time for the assessment of taxes for the years 1966 through 1969. Before the May 14 deadline the Montana Revenue Department mailed notices of tax deficiencies to each of the corporations. The corporations protested. On January 25, 1977, the Revenue Department mailed amended notices of deficiency informing the corporate taxpayers that the Revenue Department was seeking deficiencies greater than those set forth in the initial notices and also that the theories for recovery were being changed. The corporations protested and filed a declaratory judgment action in court seeking a ruling invalidating the amended tax notices.

In Anaconda the Revenue Department argued that the Montana statute 1/ which limited the time for assessing tax

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1/ At issue in Anaconda was the Montana statute which provided in pertinent part:

> No deficiency shall be assessed or collected with respect to the year for which a return is filed unless the notice of additional tax proposed to be assessed is mailed within five years from the date the return was filed. ... Where before the expiration of the period prescribed for assessment of the tax the taxpayer consents in writing to an assessment after the time, the tax may be assessed

(footnote continued)

deficiencies was strictly a statute of limitations that was tolled (apparently indefinitely) if an initial assessment was served on the taxpayer within the five-year statutory period or within the additional time agreed upon by the parties in writing. The court rejected this argument and held the statute was not strictly a statute of limitations but was also a limitation on the power of the Revenue Department to reassess returns and make changes in assessments. The court concluded that the amended assessment notice issued in January 1977 was issued without authority and that the Revenue Department could only proceed against the corporations on the basis of the initial notices of assessment mailed within the stipulated extension of the statutory five-year period.

As you can see, the case law in this area is conflicting. Anaconda and Protest of Pentecost involve similar facts and similar statutes of limitations, but the Montana and Oklahoma Supreme Courts reached different conclusions concerning the validity of amended notices of assessment. The reasoning of each case seems valid, at least in part.

On the one hand, as reflected in Protest of Pentecost, the statute of limitations on assessments is like a statute of

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(footnote continued)
at any time prior to the expiration of the period agreed upon.

limitations on civil lawsuits because the purpose is to limit the time in which a proceeding to collect additional tax can be initiated, just as the purpose of a general statute of limitations is to limit the time in which an action for civil damages can be initiated. If the Department of Revenue has initiated a proceeding to collect a tax deficiency by giving the required notice of assessment within the statutory period, a change by the Department in the method of calculating the tax due does not constitute a new and separate proceeding to collect a deficiency, and therefore should not be barred by the statute of limitations.

On the other hand, as the court recognized in Anaconda, a statute of limitations on tax assessments is somewhat different than a "mere" statute of limitations because administrative agencies have only those powers specifically conferred upon them by the legislature. Thus, amendments to assessments must be authorized by statute to be valid. The court in Anaconda did not consider the effect of a taxpayer appeal and whether there was any statutory authority for the Montana Revenue Department to make changes in assessments as a result of administrative appeal proceedings.

The pertinent Alaska statutes do expressly authorize amendments to assessments as a result of administrative appeal proceedings. AS 43.05.240, 43.05.245 and 43.05.260 together

provide that (1) the Department will issue a Notice of Assessment within three years of the date the return is due or filed, (2) the proposed assessment will either become final within 60 days if the taxpayer does not appeal, or (3) if the taxpayer does appeal, the proposed assessment will be amended after hearing to reflect the conference or hearing officer's decision concerning the correct amount of tax due. AS 43.05.240 clearly authorizes the Department to amend assessments more than three years after returns are filed or due where amendment is pursuant to decision of the conference or hearing officer at the conclusion of the administrative appeal proceedings.

The statutes do not expressly provide for amendments to assessments by the auditor after the original notice of assessment is issued but before redetermination of the amount of tax due after conference and hearing of the taxpayer's appeal. However, the statute expressly authorizes the conference and/or hearing officer to redetermine tax liability. It follows that the audit staff must have some means of notifying the taxpayer and hearing officer of a change in position if the audit staff discovers an error in the original assessment before the conference or hearing in the taxpayer's appeal. As a practical matter, therefore, the Division may issue some form of notice during administrative appeal proceedings to notify the taxpayer, as well as the conference or hearing officer, of a proposed

change in the original assessment. Whether it is characterized as a "Notice of Amended Assessment," a "Notice of Proposed Assessment," or something else, the Division has authority, implicit in AS 43.05.240, 43.05.245, and 43.05.260 to notify the taxpayer and the hearing officer of changes it believes appropriate to make in the original assessment. 2/

3. The statute of limitations does not prohibit the conference or hearing officer adjudicating a taxpayer appeal from considering evidence relating to new issues.

2/ Even if we assume that the Division has no authority to issue amended assessments until the conference or hearing officer determines the correct amount of tax due, the Division may be able to raise new issues or claims for additional tax amounts during the appeal proceedings, and the conference or hearing officer may be able to consider new issues or claims.

This distinction is found in federal tax procedure. When the IRS issues a notice of deficiency within the three-year statutory assessment period, the running of the statute of limitations on assessment or collection is suspended for the 90-day period during which the taxpayer may file an appeal to the Tax Court, plus sixty days after the Tax Court decision becomes final. 26 U.S.C. § 6503. During this period of time the IRS is prohibited from assessing or collecting the deficiency. The IRS can redetermine the deficiency at any time within the regular statutory assessment period until the taxpayer files a petition with the Tax Court; from that moment on, power over the taxable year is exclusively with the Tax Court and the IRS cannot issue another notice asserting a second and larger deficiency. Commissioner of Internal Revenue v. Wilson, 60 F.2d 501 (10th Cir. 1932). However, the government can assert new claims for additional taxes during the Tax Court proceedings and the Tax Court has authority to redetermine the correct amount of the deficiency even if the amount so redetermined is greater than the amount stated in the notice of deficiency. 26 U.S.C. § 6214.

The next question is whether the Department of Revenue has authority to raise and consider new issues and claims for additional tax amounts during administrative appeal proceedings. This depends on AS 43.05.240, which provides, in part:

> Sec. 43.05.240. Taxpayer remedies. (a) a person aggrieved by the action of the department in fixing the amount of a tax or in imposing a penalty may apply to the department within 60 days from the date of mailing the notice required to be given to the person by the department, giving notice of the grievance, and requesting an informal conference. At the conference the person aggrieved may present arguments and evidence relevant to the amount of tax or penalty due the state. If the department determines that a correction is warranted, the department shall make the correction.
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> (b) A person aggrieved by the action of the department in fixing the amount of a tax or in imposing a penalty may apply to the department and request a formal hearing. ...
>
> (c) At the formal hearing the department may subpoena witnesses and may administer oaths and make inquiries necessary to determine the amount of the tax or penalty due the state. The person aggrieved may present arguments and evidence relevant to the amount of the tax or penalty due the state. If the department determines that a correction is warranted, the department shall make the correction.

AS 43.05.240 expressly provides for the presentation of arguments and evidence "relevant to the amount of tax or penalty due the state" at both the informal conference and formal hearing level of the administrative appeal proceedings. Furthermore, AS 43.05.240 expressly authorizes and directs the Department to correct the assessment if, on the basis of the evidence and

arguments presented, it determines that a correction is warranted.

The fact that the legislature provided in AS 43.05.240 for an administrative appeal from the notice of assessment necessarily implies that the amount of the taxpayer's liability for additional taxes, if any, is not final until the administrative appeal proceedings are over and the Department makes a final decision with respect to the tax assessment. Also implicit is the fact that the Department cannot take enforcement action to collect the total assessed deficiency until after the administrative appeal process is completed and there is a final assessment. 3/

AS 43.05.240 contemplates that the assessment of additional taxes due will be finally determined in the administrative appeal process on the basis of the evidence relevant to the amount of tax due which is submitted by the

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3/ The only express provision for delaying action to collect taxes until after the administrative appeal process is completed is found in AS 43.20.270, which concerns the remedy of distraint. That statute provides that the Department may collect taxes by distraint and sale of the property of the taxpayer who is liable for the taxes and who has neglected or refused to pay within ten days of receiving notice and demand for payment and "who has not appealed from the assessment of the taxes ... under AS 43.05.240." The remedy of distraint set out in AS 43.20.270 is made applicable to all state revenue statutes by AS 43.10.030.

taxpayer and the Department during the informal conference and formal hearing. Nothing in the language of AS 43.05.240 indicates that the Department is limited to presenting arguments and evidence related only to the issues and theories presented in the audit report issued in connection with the original notice of assessment. To the contrary, a literal reading of section 240 leads to the conclusion the department can consider any evidence available through the discovery process in order to determine the correct amount of tax due the state and is not limited to considering evidence relevant only to issues addressed in the audit report and appealed by the taxpayer. Nothing in the sparse legislative history of AS 43.05.240 indicates a contrary legislative intent. 4/

4/ AS 43.05.240 was enacted in 1976 by sec. 2, ch. 166, SLA 1976 (CSHB 211amS). The language of the taxpayer remedy section of the Act was unchanged from the language in House Bill 211 as introduced. The purpose of HB 211 was to provide uniformity in the administration of the tax laws by providing one set of administrative procedures with respect to taxpayer remedies, penalties, interest, payment of taxes, and disclosure of tax returns and reports, applicable to all tax laws, in lieu of the separate procedures that existed at that time for each tax.

The wording of AS 43.05.140 is very similar to the wording of a statute it replaced, former AS 43.20.280, which provided for taxpayer remedies under the Net Income Tax Act. Former AS 43.20.280 was derived from sec. 13, ch. 115, SLA 1949, which provided, in part:

(footnote continued)

Furthermore, the regulations interpreting and implementing AS 43.05.240 put the taxpayer on notice that new issues relevant to the amount of tax due the state may be considered during the formal hearing and that the tax liability as determined in the notice of assessment or the informal conference decision may be modified in the hearing decision. 15 AAC 05.030 provides in pertinent part:

> Formal Hearings. (a) A formal hearing may encompass all issues pertaining to the protest, even if an issue is not presented by the taxpayer, and may result in a decision which affirms, rejects, or modifies any informal conference decision or departmental action. The decision will provide any appropriate relief, including but not limited to, the remand of issues to the appropriate division of the department for further audit or investigation. If the department

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(footnote continued)

> TAXPAYERS' REMEDIES. A. Petition to Tax Commissioner. Any person aggrieved by the action of the Tax Commissioner in fixing the amount of any tax or in imposing any penalty hereunder, may apply to the Tax Commissioner within sixty days from the date of the notice required to be given him by the Tax Commissioner, giving notice of such grievance, and request a hearing thereon. At such hearing the Tax Commissioner may subpoena witnesses and may administer oaths and make such inquiries as may be necessary to determine the amount of the tax due to the Territory, and if a correction is warranted, the Tax Commissioner shall make same after such hearing.

The available legislative history for sec. 13, ch. 115, SLA 1949, does not shed any more light on legislative intent.

> determines that the result of the division's decision is correct, the decision may be upheld on grounds other than those given by the division.

The regulations also reflect the long-standing and consistent policy of the Department allowing a taxpayer to amend its protest to include new issues at the formal hearing level. 15 AAC 05.030(g).

Moreover, the Department's interpretation of section 240 to allow both the taxpayer and the audit staff to raise new issues and present evidence not treated in the audit assessment report is based on sound public policy. The administrative appeal proceedings should afford the Division as well as the taxpayer the opportunity to correct errors before the assessment becomes final. The oil and gas gross production tax, which is based on the value of oil and gas at the point of production, is not simple or easy to administer. The tax statutes were substantially amended several times in the late 1970's and regulations have also been amended. The taxpayers are, for the most part, multinational corporations with substantial oil and gas production in Alaska. A single error by an auditor or a taxpayer in applying the tax statutes and calculating the tax due during one three-year audit period can involve millions of dollars. Millions in potential liability to a taxpayer and potential revenue to the state should not hinge on a single auditor's audit and assessment. Both the taxpayer and the audit

staff should have a full and fair opportunity to present all issues and evidence relevant to the tax on appeal for consideration by the hearing officer in deciding the correct amount of tax.

Our conclusion that the broad language of section 240 authorizes the hearing officer to consider all relevant evidence and issues in determining the correct amount of tax on appeal, regardless of whether the issue or evidence was included in the audit assessment report, does not end our analysis. The next step is to consider AS 43.05.240 in connection with AS 43.05.260. In accordance with a well established rule of statutory construction, all sections of an act must be construed together so that all have meaning and the purpose of each is given effect. Matter of Hutchingson's Estate, 577 P.2d 1074 (Alaska 1978).

An argument can be made that AS 43.05.240 must be construed together with AS 43.05.260 to limit the Department hearing officers to considering only evidence relevant to issues addressed in the initial audit assessment and appealed by the tampayer in order to give affect to the intent of section 260 to limit the time beyond which additional assessments can be made. However, it is our opinion that construing section 240 literally to allow the Department hearing officers to consider all evidence relevant to the actual tax liability of the protesting tampayer, including consideration of new issues not addressed in the

initial audit assessment which might lead to a hearing decision increasing the amount of tax liability, does not contravene the purpose or intent of the section 260 limitation on assessments.

The purpose of the statute of limitations on assessments was discussed in Commissioner of Internal Revenue v. Wilson, 60 F.2d 501, 503, 504 (9th Cir. 1932), quoted by the Supreme Court of Montana in Anaconda, 583 P.2d at 424:

> The purpose of the limitations statute was to fix a time beyond which steps to enforce collection of a tax might not be initiated. Congress intended that when the period of limitation had run, the taxpayer should no longer be subject to uncertainty as to his liability to the government. ...
>
> ....
>
> The government had four full years in which to make the assessment, and it is not anomalous that Congress considered it fair, after the 4 years expired, to give the taxpayer the privilege of settling forever his tax liability for the year involved in return for prompt payment of the only deficiency asserted during the 4-year period. ...

Applying this reasoning to AS 43.05.260, the purpose of the statute of limitations on assessments in section 260 is to provide some measure of certainty to the taxpayer by fixing a deadline for the Department to initiate an action to collect a tax and by providing the taxpayer with the opportunity to settle forever his tax liability and close his financial books after three years. This purpose is served when the Department gives the taxpayer a notice of assessment, which initiates a claim for additional taxes, within the three-year statutory period. The

taxpayer has the opportunity to finally settle the question of tax liability by paying the assessed amount. If the taxpayer pays the assessed amount and does not appeal from the notice of assessment, the matter is closed and the Department cannot, after the three-year statutory period, take any further action to collect additional tax by issuing a notice of amended assessment.

If, however, the taxpayer chooses to contest liability by filing an administrative appeal under AS 43.05.240, the question of the amount of tax owing must necessarily remain open. The purpose of the limitations statute to provide some certainty and finality to the determination of the taxpayer's liability simply does not apply where the taxpayer himself chooses to contest tax liability.

Even when the taxpayer appeals, however, there is an end to the process of determining the tax liability. When the administrative appeal proceedings under AS 43.05.240 are completed and a final departmental decision is adopted with respect to the taxpayer's liability, the Department cannot initiate a new proceeding to collect additional taxes or recompute tax liability for the years adjudicated. Therefore, construing section 240 and section 260 to allow the Department to present, and the hearing officer to consider, all issues and evidence relevant to the actual liability of the taxpayer for the taxes being appealed does not create the possibility of an

unlimited series of additional assessments or uncertainty about the taxpayer's liability for an indefinite period of time.

We have found some cases which specifically consider the question of whether a statute of limitations on assessments restricts the evidence or issues that can be considered by a hearing officer in a taxpayer appeal. The cases support our conclusion that the limitation on assessments in AS 43.05.260 does not restrict or limit the hearing officer's consideration of new issues and evidence relevant to the correct amount of tax due during administrative appeal proceedings under AS 43.05.240.

In Cooper Smith v. Bragalini, 165 N.Y.S.2d 325 (N.Y. Sup. Ct. 1957), the court held that the statute limitations on assessments did not prevent the New York Tax Commission from considering new and additional evidence in determining the taxpayer's actual tax liability at a hearing on the taxpayer's application for refund. In that case, during the formal hearings on the taxpayer's appeal, information not previously possessed by the tax commission came to light, and on the basis of that new evidence, it was determined that the amounts of net income subject to tax were substantially greater than those upon which the original assessments were based. On the basis of this new evidence and theory of liability, the commission held that the taxpayer was not entitled to any revision or refund.

The taxpayer appealed to court, arguing that the original assessment could not be properly based upon or bolstered by new evidence which the taxing authority did not possess prior to the running of the three-year statute of limitations. The court rejected this argument, noting that the statute of limitations on assessments was concerned with the amount of the tax and not with the basis of its determination. 5/ 165 N.Y.S.2d at 328.

In Liebes v. Commissioner of Internal Revenue, 63 F.2d 870 (9th Cir. 1933), the court of appeals rejected the argument that the statute of limitations on assessments in the federal tax code limited the new claims which the commissioner could raise in proceedings before the Board of Tax Appeals when a taxpayer petitioned for a redetermination of deficiency assessment. At issue in that case was the interplay between two sections of the

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5/ Because this was an action for refund by the taxpayer, it is not clear whether the tax commission could have collected additional tax beyond the amount originally assessed from the taxpayer based on the determination of increased tax liability during the hearing on the taxpayer's appeal. The court's statement that the limitations statute was concerned with the amount of tax implies that the state might be limited to collecting the amount assessed within the statutory limitation period. However, the case does clearly establish that a statute of limitations on assessments does not limit the evidence, issues, or theories that a hearing officer may consider in deciding whether to affirm the amount of tax assessed.

federal tax code, the four-year statute of limitations on assessing taxes and the statute giving the Board of Tax Appeals jurisdiction to redetermine the correct amount of the deficiency even if that amount is greater than that asked for in the original deficiency notice, if a claim for the additional amount is asserted by the commissioner at or before the hearing. (Revenue Act 1926, Section 308(e), 26 U.S.C.A. § 1102(a).)

The taxpayer argued that the statutory provision allowing the commissioner to assert claims for additional tax amounts during the administrative appeal proceedings should be construed in conjunction with the statute of limitations provision to mean that the commissioner could only raise claims that were not barred by the statute of limitations. The court rejected this argument and held that Congress intended that the Board of Tax Appeals should have the power to redetermine the correct amount of tax, even if a claim for the correct amount was made by the commissioner after the statute of limitations on making assessments had run. This holding was affirmed in later federal tax cases. Teitelbaum v. Commissioner of Internal Revenue, 346 F.2d 266 (7th Cir. 1965); Weaver v. Commissioner of Internal Revenue, 25 T.C. 1067 (1956).

Although these federal cases are not controlling because of the differences in language between the state and

federal tax statutes, 6/ the cases are relevant for the reasoning by which the courts have held that the statute of limitations on assessments does not prohibit introduction of new claims during a taxpayer's appeal. For the purpose of our analysis, it is significant that in Liebes the court of appeals did not apply the rule that any doubt should be resolved in favor of the taxpayer where a taxing statute is susceptible of two constructions. See, e.g., Anaconda, 583 P.2d 421, 423. Instead, the court of appeals applied the rule that the rights of the government are never foreclosed, except by statutory language clearly indicative of such purpose. 63 F.2d at 372.

6/ The federal cases are not controlling with respect to the question of whether the Alaska Department of Revenue can raise new issues and claims for additional tax amounts during an administrative appeal hearing under AS 43.05.240 because the language of section 240 is substantially different from its counterpart in the federal tax code, 26 U.S.C. § 6214, which provides:

> DETERMINATIONS BY TAX COURT (a) Jurisdiction as to increase of deficiency, additional amounts, or additions to the tax. Except as provided by section 7463, the Tax Court shall have jurisdiction to redetermine the correct amount of the deficiency even if the amount so redetermined is greater than the amount of the deficiency, notice of which has been mailed to the taxpayer, and to determine whether any additional amount, or addition to the tax should be assessed, if claim therefore is asserted by the Secretary at or before the hearing or a rehearing....

C. The statute of limitations does not prohibit the conference or hearing officer from determining that the correct amount of tax due the state is more than that stated in the notice of assessment from which the taxpayer appealed.

The next issue raised by this opinion request is whether AS 43.05.240, construed with AS 43 05.260, authorizes hearing officers to determine that the taxpayer owes a greater amount of tax than that stated in the notice of assessment from which the taxpayer appealed. An increased assessment is a likely possibility whenever a hearing officer considers new issues or claims raised by the Division. However, that is not necessarily the result. If the taxpayer prevails on a major monetary issue, the original assessment would be abated even if the Division prevailed on a lesser, new issue. Under these circumstances, consideration of a new issue merely serves to offset an abatement.

Furthermore, an increased assessment may result from a hearing officer's decision without consideration of any new issues. For example, in a pending case a taxpayer appealed the audit staff's determination of the point of production for gas. The hearing officer decided the point of production is the sales meter - a point downstream from the point used by the audit staff in the original assessment. In this case, resolution of the single issue appealed by the taxpayer resulted in an increased assessment.

AS 43.05.240 authorizes the hearing officer to determine the correct amount of tax due the state; it does not specifically and expressly authorize hearing officers to increase the assessment beyond the amount stated in the notice of assessment appealed by the taxpayer. If the question is litigated, the outcome may well hinge on the rule of statutory construction that the court chooses to apply in interpreting AS 43.05.240 and AS 43.05.260.

If the court applies the rule that in construing tax statutes doubts should be resolved in favor of the taxpayer, the court would most likely conclude that AS 43.05.240, construed together with AS 43.05.260, does not authorize the Department to make corrections in the state's favor and increase the assessed amount. 7/ Although the Alaska Supreme Court has applied this rule of statutory construction in a tax case, Union Oil Company

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7/ We have found one reported case in which a state court held that language in a municipal charter authorizing the Board of Assessors to "review and make corrections" when an aggrieved taxpayer applied to have a property assessment reduced did not authorize the Board of Assessors to increase the assessment beyond the amount originally assessed. People ex rel New York and N. J. Telephone Co. v. Neff, 44 N.Y.S. 46 (N.Y. Sup. Ct. 1897), affirmed, 156 N.Y. 701. The municipal charter provision at issue in that case was substantially different than AS 43.05.240. Section 240 is broader in that it expressly authorizes the Department to discover and produce evidence necessary "to determine the amount of the tax or penalty due the state" as well as authorizing the Department to make a correction in the assessed amount if a correction is warranted.

v. Department of Revenue, 560 P.2d 21 (Alaska 1977), it applies an opposite rule in a tax case involving the statute of limitations on assessments.

In recent cases involving interpretation and application of AS 43.05.260, the Alaska Supreme Court has applied the rule that statutes of limitations barring assessment and collection of taxes are strictly construed in favor of the government. Department of Revenue v. Alaska Pulp America, Inc., 674 P.2d 268, 274 (Alaska 1983) (AS 43.05.260 does not apply to bar assessment of returns filed prior to January 1, 1976, the effective date of Section 260); Green Construction Co. v. Department of Revenue, 674 P.2d 260, 263 (Alaska 1983).

There is also support in federal case law for applying a rule of statutory construction resolving doubts in favor of the government, rather than the taxpayer, in cases involving the meaning or application of a statute of limitations on assessments. As previously discussed, in Liebes v. Commissioner of Internal Revenue, 63 F.2d 870 (9th Cir. 1933), the court of appeals applied the rule of statutory construction that the rights of the government are never foreclosed, except by statutory language clearly indicative of such purpose, instead of applying the rule that doubts should be resolved in favor of the taxpayer.

More recently, in Kahn v. United States, 590 F.2d 48, 51 (2nd Cir. 1978), involving the question of whether a statute of limitations on collection of taxes was tolled, the court of appeals stated:

> Although in the case of other statutes of limitations it may be argued that they should be construed liberally as statutes of repose, many courts have taken the view that limitations in the case of taxes will be strictly construed in favor of the Government.... Whether this is a rule of construction that is entitled to general applicability may be questionable, but it has real merit when applied to an assessment statute.

The court of appeals in Kahn cited 10 J. Mertens, Law of Federal Income Taxation, § 57.08 (1976), which states that statutes of limitations barring assessment and collection of taxes justly due and unpaid receive a strict construction in favor of the government, and limitations in such cases will not be presumed in the absence of clear legislation.

To summarize, consideration of the language of AS 43.05.240, the purpose of the statute of limitations, and application of the rule of statutory construction that the rights of the government are never foreclosed, except by statutory language clearly indicative of such a purpose, lead us to conclude that the statute of limitations does not prohibit a departmental hearing officer adjudicating a taxpayer appeal under AS 43.05.240 from deciding that the correct amount of tax due the

state is more than the amount stated in the notice of assessment from which the taxpayer appealed.

D. Oil and gas production taxes are separate taxes for the purpose of applying the statute of limitations on assessments.

Next, it is necessary to emphasize the limited circumstances under which new issues can be raised and assessments amended.

First, it should be emphasized that if no deficiency is assessed within the three-year statutory period, or if a Notice of Assessment is timely issued and the taxpayer pays the amount of tax assessed and does not appeal, the Department is prohibited by the statute of limitations from issuing a notice of amended assessment after the expiration of the three-year statutory period. Changes in assessments after the three-year statutory period under AS 43.05.260 are only authorized as a result of administrative appeal proceedings, and changes are limited to the particular tax and years on appeal.

Furthermore, for the purpose of applying the statute of limitations, the oil and gas production taxes must be treated as separate taxes. Although the oil and gas production taxes are

both contained in AS 43.55, they are separate taxes established by separate statute. 8/ AS 43.55.011 levies the tax on oil production and AS 43.55.016 establishes a separate tax, based on a different rate, for gas production.

8/ Our conclusion that oil and gas production taxes are separate taxes for the purpose of applying the statute of limitations in AS 43.05.260 does not consider, and is not intended to preclude, the possibility that there may be circumstances under which the Department can reopen a closed tax year to make an adjustment even though the tax was not appealed and none of the express exceptions in AS 43.05.260(b) apply. Assume, for example, that a taxpayer appealed an oil tax assessment for 1977 on the ground that part of the production is taxable as gas, not oil. The taxpayer did not include the disputed condensate in its 1977 gas tax returns and no gas assessment was made. If the taxpayer prevailed on this issue in the oil tax appeal, the gas tax assessment might be reopened and amended to reflect the additional gas tax from the disputed condensate. In such situation the courts would probably hold that the taxpayer is estopped from asserting the statute of limitations as a bar to reopening the gas production tax. See Stevenson v. Burgess, 570 P.2d 728 (Alaska 1977).

The IRS Code provides for reopening a tax year that otherwise is closed by the statute of limitations to the extent it is necessary to make an adjustment in the closed year to rectify a double exclusion of an item of income or double allowance of a deduction resulting from an adjudicatory decision with respect to the correct treatment of the item in another tax year. See mitigation of limitation provisions, 26 U.S.C. § 1311-1314. If a court allowed the Department to reopen a closed tax year on an estoppel theory, it would probably apply the federal law regarding mitigation of limitations. In this example the 1977 gas tax could be reopened only for the limited purpose of adding the volume of disputed gas to the gas tax base. The 1977 gas tax would not be open for general reassessment and consideration of other issues.

The conclusion that the oil production tax and gas production tax are separate taxes for the purpose of applying the statute of limitations is supported by cases in which state courts have consistently held that income taxes and excess profits taxes are two separate and distinct taxes for the purpose of applying the statute of limitations on assessments. See, e.g., Henk v. Columbus Auto Supply, Inc., 101 N.W.2d 415 (Minn. 1960), in which the court held that the statute of limitations on deficiency assessments did not start running with respect to the excess profits tax when the taxpayer filed income tax returns which provided all the information necessary to calculate any excess profits tax owing, but did not file excess profits tax returns.

The fact that the Department has required taxpayers to use one form with two reports in filing oil and gas production tax returns does not alter the conclusion that the two taxes are separate and must be treated as such for the purpose of applying the statute of limitations on assessments. The legal effect is the same whether two separate returns or one return with two reports are used.

For example, if a taxpayer provides all the required information on the return relating to oil tax liability but fails to complete the report for gas tax liability, the taxpayer has in

effect filed an oil tax return and has failed to file a gas tax return. The result is that the statute of limitations on assessments begins running for oil, but not for gas. In this situation the taxpayer could not reasonably contend that the statute of limitations begins running for gas because the taxpayer has filed a return for oil and gas taxes.

Applying the same rationale to another example, if the Division issued a notice of assessment for both oil and gas production taxes for the same tax year and the taxpayer paid the assessment for oil and appealed the assessment for gas, the statute of limitations would be suspended for the gas tax only. The Division could not issue a notice of amended assessment for oil after the three-year limitation period expires. Nor could the Division introduce evidence relating to new issues concerning oil tax liability in an administrative hearing on the taxpayer's appeal of a gas tax assessment because that evidence is not relevant or material to the correct amount of gas tax due the state.

Our conclusion that oil and gas production taxes must be treated as separate for the purpose of applying the statute of limitations is also supported by the rationale of Protest of Pentecost and Hodges, 98 P.2d 606 (Okla. 1940). In upholding the validity of an amended increased assessment for income taxes, the court in that case emphasized that the same income was involved

and the amended assessment merely changed the method of calculating the tax due. The court implied that, if the amended assessment had treated additional income from another source, the increased assessment would probably have been considered a new, time-barred assessment rather than a valid "amendment" to the original assessment. Thus, Protest of Pentecost strongly suggests that an assessment on the value of a taxpayer's gas production cannot be validly "amended" during the taxpayer's appeal of the gas tax assessment to include an additional assessment on the taxpayer's oil production.

III. CONCLUSION

Finally, we will apply the law and conclusions discussed above to the three example cases that gave rise to this opinion request. In the first case the taxpayer appealed a gas tax assessment for 1977 and paid an oil tax assessment for 1977. The Division issued Notices of Amended Assessment for both oil and gas taxes in February 1984, after informal hearing in the taxpayer's gas tax appeal. The Notice of Amended Assessment for the oil tax is invalid because a change in assessment is barred by the statute of limitations. The Notice of Amended Assessment for gas may properly be treated by the hearing officer as a motion to reopen the hearing record. Since the statute of limitations is suspended for the 1977 gas tax assessment until the hearing officer's decision is issued and adopted by the

Department, AS 43.05.260 does not prohibit the hearing officer from considerating new issues material to the 1977 gas tax liability. However, the considerations discussed in Informal Conference Decision No. 84-55-3 suggest that the new issues should not be considered at this late stage of the appeal proceedings. 9/

In the second case, the taxpayer appealed an assessment for oil for 1977 but not for 1978, and an assessment for gas for 1978. The statute of limitations has expired for 1978 oil tax liability and therefore, the 1978 oil tax cannot be re-opened for assessment based on prevailing value. However, the statute of limitations does not bar the Division from raising new issues regarding valuation of the taxpayer's 1977 oil production during informal conference. This same result applies to the third case

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9/ Although the statute of limitations in section 260 does not bar the audit staff from raising new issues during administrative appeal proceedings, the Director has decided as a matter of policy that the practice should be limited to situations where the audit staff can show good cause. Whether new issues should be introduced in an appeal proceeding requires consideration and balancing of a number of factors, including the reason the issue was overlooked by the audit staff in preparing the audit assessment report, the timing of raising new issues, and whether the taxpayer will have a reasonable and fair opportunity to respond to the new issues. Informal Conference Decision No. 84-55-3.

in which the Division has raised new issues concerning a taxpayer's oil tax liability at the informal conference stage of the oil tax appeal.

Sincerely yours,

NORMAN C. GORSUCH
ATTORNEY GENERAL

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SJH/ma

cc: Fred Boetsch, Director
Division of Petroleum Revenue
Department of Revenue

John K. SJONG, Appellant,

v.

STATE of Alaska, DEPARTMENT OF REVENUE, Appellee.

No. 4255.

Supreme Court of Alaska.

Jan. 23, 1981.

Taxpayer, a nonresident crab fisherman, appealed from an order of the Superior Court, First Judicial District, Thomas B. Stewart, J., upholding the State's assessment of net income tax against him. The Supreme Court, Burke, J., held that: (1) there was sufficient nexus to justify imposition of tax; (2) nonresident crab fisherman was not exempt from tax under interstate income law; (3) apportionment formula was valid; and (4) the Superior Court did not abuse its discretion in awarding attorney fees to the State.

Affirmed.

1. Taxation ⇐956

In order for the State to constitutionally tax a nonresident, the nonresident must be sufficiently involved in local events to forge some definite link, some minimum connection sufficient to satisfy due process requirements. U.S.C.A.Const. Amend. 14.

2. Taxation ⇐956

Where the state of Alaska was giving something to nonresident crab fishermen fishing off coast of Alaska in international waters for which he could ask a return, i. e., supplies, employment, and a market for sale of goods, and taxed income of fisherman was derived from sources in the State, there was sufficient nexus to justify imposition of income tax. AS 43.20.010–43.20.350; AS 43.20.130(e), (e)(1) (Repealed); U.S.C.A. Const. Amend. 14.

3. Commerce ⇐74.15

Under commerce clause, net income from interstate operations of foreign corporation may be subjected to state taxation provided the levy is not discriminatory and is properly apportioned to local activities within taxing state forming sufficient nexus to support the tax. U.S.C.A.Const. Art. 1, § 8, cl. 3.

4. Commerce ⇐62.75

A state may not impose a tax which discriminates against interstate commerce by providing a direct commercial advantage to local business relative to interstate business. U.S.C.A.Const. Art. 1, § 8, cl. 3.

5. Appeal and Error ⇐761

Where a point is not given more than cursory statement in argument portion of brief, the point will not be considered by the Supreme Court.

6. Commerce ⇐74.15

In order to qualify for exemption from imposition of net income tax under the interstate income law, a business must solicit orders which are sent out of state for approval and then make deliveries into the state. 15 U.S.C.A. § 381(a).

7. Commerce ⇐74.15

Activities of nonresident crab fisherman who fished off coast of Alaska in international waters and sold catch to Alaska processors was not exempt under the interstate income law from paying Alaska's net income tax, although activities of fisherman in state allegedly consisted solely of delivery of goods previously ordered under contracts negotiated outside of the state. 15 U.S.C.A. § 381(a).

8. Commerce ⇐62.80
Constitutional Law ⇐285.2
Taxation ⇐1005

Apportionment formula is valid under due process and commerce clauses only if, as a tax measure, it assigns to the state income that can reasonably be said to result from activities or properties within its borders. U.S.C.A.Const. Art. 1, § 8, cl. 3; Amend. 14.

9. Taxation ⇐1083

Heavy burden is placed on a taxpayer challenging a state's allocation of his in-

come for taxation purposes to prove by clear and cogent evidence that income attributed to state is out of all appropriate proportion to business transacted in that state or has led to a grossly distorted result.

10. Constitutional Law ⇐285.2
Taxation ⇐1005

Due process does not prohibit a tax apportionment formula which considers out-of-state activity in evaluating local activity of taxpayer. U.S.C.A.Const. Amend. 14.

11. Taxation ⇐956

Alaska's net income tax apportionment formula taking into account sales, property and payroll of nonresident was merely calculated to assign to the State that portion of net income reasonably attributable to business done in the State and as such was constitutional. U.S.C.A.Const. Art. 1, § 8, cl. 3; Amend. 14.

12. Taxation ⇐1005

In light of failure of taxpayer, a nonresident crab fisherman, to show that tax assessment was out of all appropriate proportion to business transacted in the State as a result of the State's use of port-day formula rather than voyage-day formula in the apportionment formula, employment of port-day formula was upheld.

13. Taxation ⇐1075

A 90% allocation of nonresident crab fisherman's income to the State did not produce gross distortion in apportionment of his net income tax, although over 95% of his business activity was conducted outside the State, as all of fisherman's sales were made in the State. AS 43.20.130(e)(1) (Repealed).

14. Taxation ⇐962

Because allocution formula was constitutional on its face and had not produced grossly distorted result in assessment of nonresident crab fisherman's net income tax liability, apportionment formula was valid. AS 43.20.010–43.20.350.

15. States ⇐215

In action involving assessment of net income tax against nonresident, trial court's award of attorney fees to the State was not an abuse of discretion. AS 43.20.010–43.20.350.

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

OPINION

BURKE, Justice.

This case involves the constitutionality of the Alaska Net Income Tax Act, AS 43.20.010–.350, as applied to non-resident crab fishermen who fish off the coast of Alaska in international waters and sell their catch to Alaska processors. Appellant John K. Sjong, on behalf of eleven other Washington State fishermen, claims that the State of Alaska has no jurisdiction to tax his net income, and that to do so would violate the due process and commerce clauses of the United States Constitution, and section 381 of the Interstate Income Act.[1]

John K. Sjong is a commercial king crab fisherman who resides in the State of Washington. He has fished commercially for at least ten years, and for eight of those years he has owned and operated his own fishing vessel. His fishing vessel is licensed, registered, and harbored in Washington with Seattle as its designated home port. He fishes exclusively in the international waters surrounding Alaska [2] and sells

1. 15 U.S.C. § 381 (1976).

2. Sjong testified at the revenue board hearing that he operates his fishing vessel between 5 and 150 miles from the coast line of Alaska. As provided by 43 U.S.C. § 1312 (1976), a state "may extend its seaward boundaries to a line three geographical miles distant from its coast line."

his catch only to Alaska processors and canneries.

In preparation for the fishing season, Sjong outfits his vessel and hires a crew in Seattle. Most of the crew members are Washington residents, but should a crew member quit or become sick during the season, emergency replacements will be hired in Alaska. Provisions are also taken on in Washington. Although Sjong tries to take enough food and fuel to last the entire voyage, he often purchases fresh food and extra fuel while in port in Alaska.

Prior to journeying to the fishing grounds, Sjong negotiates a market and a price for his catch in Seattle with representatives of various processing companies. Once the fishing season starts, Sjong will come into an Alaska port once every ten to fifteen days to deliver his catch to a processing plant. At that time, possession as well as risk of loss and title is transferred from the fisherman to the processors. Payment for the catch is made in Seattle after the fishing season has ended.

Depending upon the extent of his catch, Sjong will make anywhere from twenty to thirty trips into port each season to sell his crab. While in port, he obtains supplies which enable him to continue his fishing activities; the most important being bait which is purchased from the local canneries and processors. Sjong also enters Alaska ports to obtain emergency medical treatment for sick or injured crew members, or to have emergency repairs performed on his equipment. The ports are also open to his vessel in case shelter is ever needed from storms.

On October 10, 1974, the Alaska State Department of Revenue notified Sjong that they had assessed his personal net income tax for the years 1970, 1971, and 1972, and that he owed $32,481.89 in unpaid taxes. Pursuant to AS 43.20.280,[3] Sjong applied for a hearing on the matter. The Department concluded that Sjong had sufficient minimum contacts with the state to be subject to the net income tax statutes, that his activities in the State were not exempt from taxation under the Interstate Income Law, and that the exact amount of his tax would be determined by the apportionment formula provided for in the state tax statutes. Sjong appealed the Department's decision to the superior court; again, all issues were resolved against him and the taxation was upheld.

In this appeal he raises four arguments in opposition to the taxation of his net income: (1) the tax violates the fourteenth amendment due process clause; (2) the tax violates the commerce clause; (3) the tax violates section 381 of the Interstate Income Act; and (4) the apportionment formula employed by the state results in an unfair allocation of his income.

I. DUE PROCESS

[1] The first issue on appeal is whether the taxation of Sjong's net income constitutes a taking of property without due process of law. The fourteenth amendment

3. AS 43.20.280 (repealed in 1976) provided:

> (a) A person aggrieved by the action of the department in fixing the amount of a tax or in imposing a penalty may apply to the department within 60 days from the date of the notice required to be given to him by the department, giving notice of the grievance, and request a hearing. At the hearing the department may subpoena witnesses and may administer oaths and make inquiries necessary to determine the amount of the tax due to the state, and if a correction is warranted, the department shall make the correction after the hearing.
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> (b) Within 30 days after hearing and decision by the department, the taxpayer may file a complaint in the superior court in the judicial district in which he resides, naming the department as defendant, setting out the facts, and stating reasons why the action is erroneous, and praying relief from it, and the clerk of the court shall issue summons in the regular manner. . . .

AS 43.20.280 was repealed in 1976 by ch. 166, § 3 SLA 1976 and has been replaced by AS 43.05.240. A number of changes in the tax law were made in 1976, but since this case was initially brought under the old tax statutes, those statutes then in effect will govern the resolution of this matter.

due process clause[4] limits states from extending their powers of taxation beyond their borders. As such, any attempt to tax extra-territorial values would be an unconstitutional taking of property. In order for a state to constitutionally tax a non-resident, the non-resident must be "sufficiently involved in local events to forge 'some definite link, some minimum connection' sufficient to satisfy due process requirements." *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 465, 79 S.Ct. 357, 366, 3 L.Ed.2d 421, 431 (1959), *quoting Miller Brothers Co. v. Maryland*, 347 U.S. 340, 344–45, 74 S.Ct. 535, 538–539, 98 L.Ed. 744, 748 (1954). John Sjong contends that his contacts with the state are so minimal that there is an insufficient nexus upon which to base a tax.

In determining what constitutes sufficient minimum contacts for the purposes of taxation, the Supreme Court has adopted the following basic test first stated in *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 61 S.Ct. 246, 85 L.Ed. 267 (1940): "That test is . . . whether the taxing power exerted by the state bears fiscal relation to protection, opportunities and benefits given by the state. *The simple but controlling question is whether the state has given anything for which it can ask return.*" 311 U.S. at 444, 61 S.Ct. at 250, 85 L.Ed. at 270–71 (emphasis added). As we stated in *North Slope Borough v. Puget Sound Tug & Barge*, 598 P.2d 924, 928 (Alaska 1979):

> Due process requires that a tax be related "to opportunities, benefits, or protection conferred or afforded" by the taxing authority and such a relationship exists "if the tax is fairly apportioned to the commerce [there] carried on." *Ott v. Mississippi Valley Barge Line Co.*, 336 U.S. 169, 174 [69 S.Ct. 432, 434], 93 L.Ed. 585, 589 (1949).

Therefore, our task is to determine whether the protections, opportunities, and benefits given to Sjong by the state provide a sufficient nexus to uphold the taxation of his net income.[5]

[2] As the record in the case indicates, Sjong makes approximately twenty to thirty trips per season into various Alaska ports to sell and deliver his catch of crab to processors and canneries. While in port, Sjong purchases any and all needed supplies and, among other things, makes use of emergency services when necessary.

Sjong argues that all of the services and benefits alluded to by the state are available to any person who travels interstate and should not be the basis for the imposition of a tax. What must be recognized, however, is that unlike the services rendered to an ordinary traveler, the services, benefits, and protections offered to Sjong are directly related to generating his income. Without the opportunity to purchase fresh bait and supplies, he would be severely hampered in his ability to continue his fishing ventures. Further, the availability of emergency medical services, repair facilities, and crew replacement in Alaska clearly benefits his business operations, as does the opportunity to sell his crab without the expenditure and delay of a lengthy trip.

It is precisely this notion, that the benefits afforded to the taxpayer are directly

4. The due process clause of the fourteenth amendment provides:

> Section 1. All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the state wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; 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.

U.S.Const. Amend. XIV, § 1.

5. In previously decided cases, contacts which were adjudged to be sufficient to uphold taxation included: maintaining a leased office and several salesmen within a state to solicit orders, *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 79 S.Ct. 357, 3 L.Ed.2d 421 (1959); registering as a corporation to do business within a state, *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 61 S.Ct. 246, 85 L.Ed. 267 (1940); and maintaining a sales service office in the state which served five other states, *Williams v. Stockham Valves & Fittings, Inc.*, 358 U.S 450, 79 S.Ct. 357, 3 L.Ed.2d 421 (1950). *See also* the cases cited in note 15 *infra*.

related to "business income generation," which is central to a resolution of this issue. In *Alaska v. Petronia*, 69 Wash.2d 460, 418 P.2d 755 (1966), the Washington State Supreme Court applied this concept in upholding Alaska's taxation of the net income of a nonresident seaman employed on a vessel in Alaskan waters.

As in the instant case, the Washington Supreme Court was faced with the question of whether Petronia had sufficient minimum contacts with the State of Alaska so that taxation of his income would not violate due process. By applying the business income generation concept, the court determined that there were sufficient contacts to justify imposition of a net income tax.

> The defendants argue that . . . the benefits afforded seamen are *de minimus*; . . . that virtually the only benefits available from the state of Alaska to seamen such as the defendants are the protection and benefits they are afforded by the state when they are on shore in strictly a tourist or recreational capacity.
>
> This argument . . . is impressive; however, it overlooks a most significant element considered in applying the test of benefits in determining minimum connections. Probably the most significant benefits in the eyes of these defendant seamen are the wages they contemplated receiving for their services during the course of the vessel's voyage. The business productivity generated by Alaska was accountable for the wages earned by the defendants when they were in Alaskan waters.

418 P.2d at 758.

The court went on to conclude: "We are satisfied that the benefits of employment afforded by this economic activity of the state of Alaska constituted minimum connections within the rule to avoid a denial of due process under the Fourteenth Amendment to the United States Constitution." *Id.* at 759.

Similarly, the state in this case has argued that Sjong is also a direct beneficiary of the economic activity of the state. As Sjong testified, he fishes only off the Alaska coast and sells exclusively to Alaska processors. His income is derived solely from the market Alaskan canneries and processors provide for his fishing skills. Indeed, his crab fishing might be rendered totally uneconomic if he were foreclosed from selling to Alaskan processors and had to return to Seattle to sell his catch.

The main distinction between the instant case and the situation described in the *Petronia* case is that Petronia earned his income while employed on a vessel in Alaskan waters. Here, Sjong catches crab outside of Alaska in international waters and then sells them within the state. We do not believe this distinction presents a significant difference, for even though Sjong fishes in international waters, the activities of the state have a substantial effect on his activities. As the state has pointed out, the particular industry which Sjong is involved in, the crab industry, has been fostered by the policies of the state and protected by its various police powers. *See State v. Bundrant*, 546 P.2d 530 (Alaska 1976), *rehearing denied*, 547 P.2d 838 (Alaska 1976).[6]

What is of primary significance in determining the legality of the tax is whether the income was derived from sources in the state. AS 43.20.035(a) states that the income of non-residents is taxable income when it is "attributable to sources in the state." Since Sjong's income is derived from the sale of crab to Alaska processors, that income should be subject to the income tax. Where the crab were actually caught makes no difference.

Sjong also contends that income is earned where the skill is employed to earn that income. In *Petronia*, for example, that portion of Petronia's work performed while his ship was in Alaskan waters was considered to have been income earning and taxable in

6. In *State v. Bundrant*, we upheld certain state laws and regulations relating to crab fishing beyond the three-mile state jurisdictional limit in the Bering Sea on the grounds that the State had a legitimate objective in regulating the taking of crab outside the State in order to conserve the crab resources existing within the State. *Id.* at 554.

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Alaska. Applying the same reasoning, Sjong claims that since the labor to catch the crabs was employed in international waters, no taxable income can be attributed to the state. This argument, however, fails to draw a distinction between income which is the direct result of an individual's labor, and income derived from the sale of goods, such as crab. Absent a sale, the skill and labor used to catch crab would result in no profit or income to the individual.

In *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271, 45 S.Ct. 82, 69 L.Ed. 282 (1924), the United States Supreme Court upheld a state franchise tax assessment based on sales within the State of New York by a British corporation that manufactured ale outside the state. The corporation argued that because it was not incorporated in New York and did not maintain its principal place of business there, New York could not levy a tax merely by reason of its having sales in the state. The Supreme Court said that where "its profits were earned by a series of transactions beginning with the manufacture in England and ending in sales in New York . . .—the process of manufacturing resulting in no profits until it ends in sales,—the state was justified in attributing to New York a just proportion of the profits." 266 U.S. at 282, 45 S.Ct. at 84, 69 L.Ed. at 287. Similarly, the process of fishing results in no profits until the catch is sold to processors in Alaska.[7]

Sjong also argues that the actual sale of the crab catch takes place in Washington, *i.e.*, the contract is negotiated in Washington and payment is made there. The only sale-related activity occurring in Alaska is the delivery of the goods, and delivery alone should not subject him to taxation. In support of this he cites the Supreme Court's decision in *Miller Brothers Co. v. Maryland*, 347 U.S. 340, 74 S.Ct. 535, 98 L.Ed. 744 (1954), where the Court held that a Delaware store could not be held liable for Maryland use taxes on merchandise sold to Maryland residents because of a lack of minimum contacts. The only contact that the store had with the taxing state was that its truck occasionally entered the state to deliver the previously ordered goods. Sjong argues that since his boat enters the state only to make deliveries, this should not constitute a sufficient nexus to uphold taxation.

The situation in *Miller Brothers* is to be distinguished from the case at bar. First, in *Miller Brothers* the delivery truck entered the state sporadically; it did not make all deliveries. All sales were made outside the state, and the sales made to Maryland residents constituted only a portion of the total of Miller Brothers' overall sales. Here, the taxpayer admits that he has been fishing in Alaska for ten years, and sells exclusively to Alaska processors. His principal source of income is the money which he receives in payment for crab delivered to those processors. The amount of business activity is certainly more substantial than that in *Miller Brothers*.

Second, more than "mere delivery" of goods is taking place within Alaska. What in fact is occurring is the consummation of the *sale* of Sjong's crab. AS 43.20.130(e)(1)[8] states that "[s]ales of tangible personal property are in this state if (1) the property is delivered or shipped to a purchaser . . . inside this state . . . ." Therefore, a sale has taken place when the crab

7. In the alternative, Sjong argues that no income is earned until payment is made and since all payments were made in Seattle, no income should be attributed to the state. Various courts have held, however, that the actual place where income payments are turned over to the taxpayer is not determinative of the source of the income for purposes of state income tax. *See Petition of Union Elec. Co. of Mo.*, 349 Mo. 73, 161 S.W.2d 968, 972 (1942); *In re Kansas City Star Co.*, 346 Mo. 658, 142 S.W.2d 1029, 1039 (1940). Furthermore, a taxpayer cannot escape a tax on income from sources within the state by billing from the outside or by setting up his machinery so that the income is paid to him in another state. *Gross Income Tax Div. v. Bartlett*, 228 Ind. 505, 93 N.E.2d 174, 177 (1950).

8. AS 43.20.130(e) repealed by ch. 70, § 13, SLA 1975. However, since this case was instituted under the prior tax statutes, those statutes then in effect will govern the resolution of this matter.

are delivered to the processor in Alaska under a previously negotiated contract.[9]

In conclusion, because the state is giving something for which it can ask in return, in the form of supplies, employment, and a market for sale of goods, and the taxed income is derived from sources in the state, there appears to be a sufficient nexus to justify imposition of the tax.

II. COMMERCE CLAUSE

[3] The commerce clause of the United States Constitution [10] places restraints upon the taxing power of states similar to those of the due process clause. In fact, these two constitutional limits overlap to a great extent. The courts, however, have usually placed considerations of minimum contacts and sufficient nexus under the due process heading, while questions regarding the proper apportionment of income to the taxing state and the discriminatory impact of taxes are covered by the Commerce Clause. *Central Greyhound Lines v. Mealey*, 334 U.S. 653, 661, 68 S.Ct. 1260, 1265, 92 L.Ed. 1633, 1640 (1948). *See also Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 277–79, 98 S.Ct. 2340, 2346–2348, 57 L.Ed.2d 197, 207–08 (1978). Hence, "net income from the interstate operations of a foreign corporation may be subjected to state taxation provided the levy is not discriminatory and is properly apportioned to local activities within the taxing State forming sufficient nexus to support the [tax]." *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 452, 79 S.Ct. 357, 359, 3 L.Ed.2d 421, 424 (1959).

The test used by the United States Supreme Court to determine the validity of a tax under the Commerce Clause was recently expressed in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S.Ct. 1076, 1079, 51 L.Ed.2d 326, 331 (1977). There, four factors were analyzed to determine the validity of the tax: (1) whether the activity taxed had a sufficient nexus with the taxing state; (2) whether the tax is fairly related to benefits provided by the state to the taxpayer; (3) whether the tax was fairly apportioned to local activities; and (4) whether it discriminated against interstate commerce. As the nexus consideration and questions of the relationship to services provided by the state has been dealt with in the previous due process discussion *supra*, and the apportionment question will be discussed *infra*, the only issue which we will consider here is whether the tax discriminates against interstate commerce.

[4, 5] A state may not "impose a tax which discriminates against interstate commerce . . . by providing a direct commercial advantage to local business" [relative to interstate business]. *Boston Stock Exchange v. State Tax Commission*, 429 U.S. 318, 329, 97 S.Ct. 599, 606, 50 L.Ed.2d 514, 524 (1977), *quoting Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 458, 79 S.Ct. 357, 362, 3 L.Ed.2d 421, 427 (1959). There appears to be no indication that this situation is present here. As neither party has briefed this argument, this point will not be considered [11] and whether the commerce clause will be violated by imposition of the state net income tax

9. Under the Uniform Commercial Code the transaction which occurs in Alaska constitutes a sale. UCC § 2-106(1) provides that a "sale consists in the passing of title from the seller to the buyer for a price." Commenting on this section one authority states: "The transfer of title is the essential element or the distinguishing characteristic of a sale of goods." R. Anderson, Uniform Commercial Code § 2-106, § 2-106:5 at 235 (2d ed. 1970). In testimony before the Department of Revenue, Sjong's attorney said: "I think for the purposes of what we're discussing, the risk of loss passes at the time the crab is delivered. So I would say that title of the crab is with the vessel until such time as it is delivered to the processor."

10. The commerce clause is set forth in article I of the United States Constitution: "The Congress shall have the power to . . . regulate commerce with foreign nations, and among the several states, and with the Indian tribes; . . ." U.S. Const. art. I, § 8.

11. Where a point is not given more than a cursory statement in the argument portion of a brief, such point will not be considered by the supreme court. *Lewis v. State*, 469 P.2d 689 (Alaska 1970). *See also Kristich v. State*, 550 P.2d 796 (Alaska 1976); *Miller v. City of Fairbanks*, 509 P.2d 826 (Alaska 1973).

should be determined in light of the other overlapping areas of discussion.

III. INTERSTATE INCOME LAW EXEMPTION

Sjong's third argument in support of his contention that there is no jurisdiction to tax him is that the State is prohibited from taxing his activities under section 381(a) of the Interstate Income Law.[12] Public Law 86–272 was enacted in 1959 as a congressional limitation on the Supreme Court's decision in the *Northwestern States* case,[13] in response to a tremendous outcry from interstate businesses who saw themselves potentially subject to numerous state and local taxes.[14]

The pertinent part of section 381 states:

Imposition of net income tax

Minimum standards

(a) No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State . . . .

The only case in which the United States Supreme Court has interpreted the Interstate Income Law is apparently *Heublein, Inc. v. South Carolina Tax Commission*, 409 U.S. 275, 93 S.Ct. 483, 34 L.Ed.2d 472 (1972). The holding of that case, however, actually had very little to do with section 381. *Heublein* concerned a South Carolina liquor regulation and the interaction between that regulation, section 381, and the twenty-first amendment to the United States Constitution.[15] The Court concluded that even though the regulation required an interstate business to undertake activities within the taxing state which would take it beyond the ambit of section 381 protection, the state was not deliberately attempting to structure its regulations so as to justify imposition of a tax. The regulation was held valid and "§ 381 does not apply." 409 U.S. at 284, 93 S.Ct. at 489, 34 L.Ed.2d at 480.

Of the lower court cases which have interpreted Public Law 86-272, practically all have been concerned with interpretation of the word "solicitation." The strongest line of cases comes from decisions of the Oregon Supreme Court. The first case, *Smith, Kline & French Laboratories v. State Tax Commission*, 241 Or. 50, 403 P.2d 375, 377 (1965), interpreted the term broadly by holding that it included all "lesser, included phases" of solicitation, such as pre-solicitation promotional work, so that such activities alone would not cause an interstate business to lose its section 381 exemption. The Oregon Supreme Court has, however, in subsequent decisions, significantly narrowed its interpretation of this key term, and has excluded from interstate tax exemption any activities not directly leading to the placing of orders.[16]

12. Pub.L. 86–272, codified at 15 U.S.C. §§ 381–384 (1976).

13. 358 U.S. 450, 79 S.Ct. 357, 3 L.Ed.2d 421 (1959).

14. *See* S.Rep. No. 658, 86th Cong., 1st Sess., *reprinted in* [1959] U.S. Code Cong. & Ad. News, pp. 2548, 2549–50.

15. The twenty-first amendment gives to the states power to regulate sales of alcoholic beverages. Section 2 of the amendment provides that "[t]he transportation or importation into any State . . . for delivery or use therein of intoxicating liquors, in violation of the laws thereof, is hereby prohibited." U.S.Const. amend. XXI.

16. For example, in *Olympia Brewing Co. v. Dep't. of Revenue*, 266 Or. 309, 511 P.2d 837 (Ore.1973), *cert. denied*, 415 U.S. 976, 94 S.Ct. 1561, 39 L.Ed.2d 872 (1974), the presence of beer kegs by which retailers could dispense draft beer destroyed the section 381(a) exemption and was sufficient to justify imposition of the state corporation income tax. Other activi-

Sjong contends that because his activities in the state consist solely of the delivery of goods previously ordered under contracts negotiated outside of the state, he should be exempt from taxation. He argues that section 381(a) should not be read so narrowly as to require all those activities described in the section to be present for exemption from taxation. He relies heavily on *Smith, Kline* to support this view. However, as the Oregon court's interpretation of the basic holding of *Smith, Kline* has narrowed considerably, we feel his reliance on a broad construction of section 381(a) is untenable.

[6, 7] In their decisions, the superior court and revenue board held that in order for an interstate business to qualify for a section 381(a) exemption, the business activities must conform strictly to the language of the statute. We agree with this interpretation of section 381(a); that in order to qualify for the exemption, a business must solicit orders, which are sent out of state for approval, and then make deliveries into the state. Since Sjong's acts concern only the third part of the described activity—deliveries—it does not come within the statutory exemption.

Looking at the original legislative intent, this would seem to be a correct interpretation. As the bill was originally passed to cover the types of activities litigated in the *Northwestern States* case, and the activities there consisted of in-state solicitation coupled with out-of-state approval and delivery, the mere act of delivery should not be sufficient to bring an interstate business within the scope of section 381(a) coverage. In fact, the Senate Report specifically states, "[t]o qualify, however, all such orders must be sent outside the State for approval or rejection, and if approved, must be filled by shipment or delivery from a point outside the State." [17] This seems to indicate exactly what types of activities were intended to be protected by the bill. To interpret Sjong's activities as falling within the exemption of section 381(a) would controvert the legislative intent.

Furthermore, what is occurring in the case at bar is not the mere delivery of goods, but also the sale of tangible personal property within the state, and such sales are not covered by the section 381(a) exemption either. In conclusion, Sjong's activities go beyond the solicitation and delivery requirements of section 381, and are not exempt under the Interstate Income Law.

IV. THE APPORTIONMENT FORMULA

Having determined that the state has jurisdiction to tax Sjong's net income, the next issue we must address concerns the proper apportionment of the tax. Sjong contends that the apportionment formula adopted by the Department results in an unfair allocation of his income to the state.

[8] The purpose of apportionment is to ensure that only activities within the taxing state are subject to taxation. An apportionment formula is valid under the due process and commerce clauses only if, as a tax measure, it assigns to a state income that can reasonably be said to result from activities or properties within its borders. *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 462, 79 S.Ct. 357, 364, 3 L.Ed.2d 421, 429–30 (1959). In analyzing the apportionment formula, we utilize a two-step process. First, we must address the question of whether the apportionment formula as a whole is constitutional. Second, if it is found to be acceptable, it must then pass the test of fairness as applied to the individual taxpayer's situation. *Norfolk & Western Railway Co. v. North*

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ties which the court found went beyond solicitation included: replacing and servicing damaged merchandise, *Miles Laboratories, Inc. v. Dep't of Revenue*, 274 Or. 395, 546 P.2d 1081 (1976); holding consultations and contracts for sale of goods, *Iron Fireman Mfrg. Co. v. State Tax Comm'n*, 251 Or. 227, 445 P.2d 126 (1968); and collection by salesmen of initial deposits on merchandise, *Herff Jones Co. v. State Tax Comm'n*, 247 Or. 404, 430 P.2d 998 (1967). For a discussion on the Oregon line of cases, see Hartman, *"Solicitation" and "Delivery" Under Public Law 86–272: An Uncharted Course*, 29 Vand.L.Rev. 353, 364–77 (1976).

17. [1959] U.S. Code Cong. & Ad. News, p. 2548.

Carolina, 297 U.S. 682, 685, 56 S.Ct. 625, 627, 80 L.Ed. 977, 980 (1936).

Concerning the first step, the United States Supreme Court, in reviewing appeals on the proper allocation and apportionment of taxes, has refused to impose strict constitutional restraints on a state's apportionment formula. Recognizing the artificiality of such formulas, the Court states a readiness to sustain any formula reasonably designed to determine the net income attributable to business done in the taxing state. "[R]ough approximation rather than precision" is sufficient. *International Harvester Co. v. Evatt*, 329 U.S. 416, 422, 67 S.Ct. 444, 447, 91 L.Ed. 390, 395 (1947), *citing Illinois Central Railroad Co. v. Minnesota*, 309 U.S. 157, 161, 60 S.Ct. 419, 422, 84 L.Ed. 670, 674 (1940). "Unless a palpably disproportionate result comes from an apportionment, a result which makes it patent that the tax is levied upon interstate commerce rather than upon an intrastate privilege, this Court has not been willing to nullify honest state efforts to make apportionments." *International Harvester Co. v. Evatt*, 329 U.S. at 422-23, 67 S.Ct. at 447, 91 L.Ed. at 395.

[9] Therefore, a heavy burden is placed on a taxpayer challenging a state's allocation of his income to prove by "clear and cogent evidence" that the income attributed to the state is "out of all appropriate proportion to the business transacted ... in that State," or has "led to a grossly distorted result." *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 274, 98 S.Ct. 2340, 2345, 57 L.Ed.2d 197, 205 (1978), *quoting Hans Rees' Sons v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 135, 51 S.Ct. 385, 389, 75 L.Ed. 879, 908 (1931) and *Norfolk & Western Railroad Co. v. Missouri Tax Commission*, 390 U.S. 317, 326, 88 S.Ct. 995, 1001, 19 L.Ed.2d 1201, 1208 (1968).

In the original assessment of the tax, the Department of Revenue relied on Revenue Ruling 74-2[18] which stated:

> It must be remembered that the fishing vessel must have actual business activity in more than one taxing jurisdiction to apportion. The mere fact that a boat winters in Seattle or some other port does not give it nexus in that state ... If all fish products are taken in international waters and sold in Alaska only, apportionment shall not apply and all income from fishing is to be reported to Alaska....

On the basis of this Ruling, the Department originally refused to apportion Sjong's income and allocated the entire sum to the State. Following Sjong's protest, hearings were held and sufficient contacts with the State of Washington were found to require apportionment. The Department employed the formula outlined in AS 43.20.130(a),[19] resulting in an allocation of approximately 85-92% of Sjong's income to the State for the years in question.

The apportionment formula takes into consideration three factors: Sales, property, and payroll. AS 43.20.130(e)(1) provides that "sales of tangible personal property are in this state if (1) the property is delivered or shipped to a purchaser ... inside this state regardless of the f.o.b. point or other conditions of the sale ...." The Department concluded: "The crab are tangible personal property delivered to a purchaser within Alaska and regardless of the other conditions of the sale (for instance, a market negotiated outside the State) are assignable to Alaska for purposes of the sale factor." Because all of the sales of crab were made in Alaska, 100% of sales was allocated to the state.

18. Revenue Ruling 74-2, dated February 20, 1974, was promulgated in response to a request from Sjong on the question of the proper allocation and apportionment of income to the state from fishing operations. Revenue Ruling 74-2 is reprinted in [1974] Alaska Tax Reports (CCH) ¶ 200-160.

19. AS 43.20.130(a) (repealed ch. 70, § 13, SLA 1975) provided:

> (a) All business income which cannot be directly apportioned and allocated to this state shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

Applying the standard provided in AS 43.20.130(g),[20] the property factor was calculated on the basis of the "port-day" method. This consists of a ratio of the number of days spent in ports inside the state to the total number of days spent in ports inside and outside the state. For purposes of fishing vessels, the port-day method excludes idle time between fishing seasons or between charters, but does include time spent stocking the boat with supplies and readying it for departure on a fishing voyage, cleaning it up after a voyage, and time spent delivering fish and taking on additional supplies during the fishing season.

The hearing examiner noted two alternative means of calculating the payroll factor:

> [W]here the income producing activity is attributable to the operation of a vessel on the high seas as in fishing activities, . . . the payroll of employees engaged in operating the vessels, should be assigned to the State pursuant to the "port day" method .... [but] where the port day method does not reasonably approximate the value of wages accountable for by the business generated by Alaska, the payroll factor should be determined by reference to the corresponding sales of fish or crab.

Relying on the provisions of AS 43.20.130(g), the hearing examiner also apportioned the payroll factor pursuant to the port-day method. However, the Department of Revenue rejected the examiner's calculation and chose to adopt a different means of apportionment. In light of the fact that the earnings of the fishing crew were directly dependent upon the sale of the catch of crabs, the Department calculated the payroll factor on the basis of sales in Alaska, *i. e.*, 100%.

[10, 11] Sjong contends that since more than 95% of his business activity is conducted outside of Alaska, a formula which allocates approximately 85–92% of his income to the state is manifestly unfair. The courts, however, have upheld allocations which take into account income earned outside of the taxing state's borders, so long as the values can be "reasonably attributable" to activities occurring within the taxing state. In *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 445, 61 S.Ct. 246, 250, 85 L.Ed. 267, 271 (1940), the Court said there was nothing unconstitutional about a tax which is contingent upon events brought to pass without a state, so long as there is a nexus between such tax and transactions within a state for which the tax is an exaction. Due process does not prohibit a formula which considers out-of-state activity in evaluating the local activity. *International Harvester Co. v. Evatt*, 329 U.S. at 423, 67 S.Ct. at 447, 91 L.Ed. at 395. So, in the instant case, the mere fact that the sales of crab in Alaska are contingent upon negotiations in Seattle and crab fishing in international waters should not act to invalidate the tax. Our task is not to determine whether this formula is the best method of apportioning income, but merely whether it is fairly calculated to assign to the state that portion of net income reasonably attributable to the business done in the state. This it seems to have done.

The second step is to determine whether the formula as applied to the individual taxpayer has produced a fair apportionment. The taxpayer has made two challenges to the apportionment scheme. He first challenges the employment of the port-day formula in calculating the property fac-

20. AS 43.20.130(g) (repealed ch. 70, § 13, SLA 1975) provided:

> (g) The value of vessels operating on the high seas and compensation of employees engaged in operating the vessels shall be apportioned to the state in the ratio which the number of days spent in ports inside the state bears to the total number of days spent in ports inside and outside the state. The term "days spent in ports" does not include periods when ships are tied up because of strikes or withheld from the Alaska service for repairs, or because of seasonal reduction of service. Days in port are computed by dividing the aggregate number of hours in all ports by 24. The value of aircraft and automotive vehicles operating as freight and passenger carriers from, to, and inside the state and compensation of employees so engaged are apportioned to the state in the ratio which the number of days during which the services are rendered inside the state bears to the total number of days during which the services are rendered inside and outside the state.

tor, and argues that a voyage-day formula be used in its place. The "voyage-day" formula would apportion the vessel's income on the basis of a ratio of the number of days in the state to the number of days inside and outside of the state. *See Luckenbach Steamship Co. v. Franchise Tax Board*, 219 Cal.App.2d 710, 33 Cal.Rptr. 544, 547 (1963). This, he claims, would take into consideration time spent making repairs on the boat, and negotiating a market for his crab catch; factors which the "port-day" formula does not take into account.

[12] Sjong has not shown that the port-day method results in a gross distortion of his tax. True, he has argued that one formula may be slightly fairer than the other and may better represent his particular activities, but courts do not usually invalidate an assessment unless the tax is "out of all appropriate proportion to the business transacted . . . in that state." *Hans Rees' Sons v. North Carolina*, 283 U.S. 123, 135, 51 S.Ct. 385, 389, 75 L.Ed. 879, 908 (1931). This he has not shown, and in light of his failure to do so, the employment of the port-day formula should be upheld.

[13] Sjong's second argument is that the Department should not have allocated 100% of the sales and payroll to the state when over 95% of his business activity is conducted outside the state. The statute in question, AS 43.20.130(e)(1) provides that "Sales of tangible personal property are in this state if (1) the property is delivered or shipped to a purchaser . . . inside this state." All of Sjong's sales are made in Alaska and a 90% allocation of income to the state does not produce a gross distortion. In fact, failure to allocate sales to the state in which they are made would greatly underrepresent the extent of the taxpayer's activities within the state.

Finally, under AS 43.20.140,[21] the Department had the discretion to base the payroll factor on sales if it determined the port-day formula did not fully represent the extent of the taxpayer's business activity in the state. Given that Sjong's earnings were dependent upon sales, it is hard to conclude that there was no reasonable basis for its decision.

[14] Because the allocation formula is constitutional on its face, and has not produced a grossly distorted result in the assessment of Sjong's tax liability, we hold the Department's apportionment formula valid.

V. ATTORNEY'S FEES

The final issue in this appeal is whether the superior court abused its discretion in awarding $1,775 to the state for its attorney's fees. Because he had a statutory right to appeal the decision of the taxing authority to the superior court,[22] Sjong contends that the court erred. He relies upon our decision in *Crisp v. Kenai Peninsula Borough School District*, 587 P.2d 1168 (Alaska 1978).

In *Crisp*, we reversed an award of attorney's fees against a dismissed tenured teacher in his unsuccessful appeal to the superior court from his employer's decision to terminate his contract.[23] In our opinion, we stated: "Given Crisp's statutorily guaranteed right to contest his dismissal in the courts, we think it would be manifestly unreasonable to penalize the exercise of that right by allowing an award of *any* attorney's fees to the school district." *Id.* at 1169 (footnote omitted) (emphasis in original).

Upon further reflection we realize that our statement in *Crisp* may be subject to misinterpretation. In that case we were influenced by the importance of the right being asserted. In a very real sense Crisp's entire future was at stake, due to the damage likely to be done to his professional

21. AS 43.20.140 is repealed by ch. 70 § 13, SLA 1975.

22. *See* note 3, *supra*.

23. AS 14.20.205 provides tenured teachers a right to judicial review of their termination as follows:

> *Judicial review.* If a school board reaches a decision unfavorable to a teacher, the teacher is entitled to a de novo trial in the superior court. However, a teacher who has not attained tenure rights is not entitled to judicial review according to this section.

reputation by the school board's action. Because of this we concluded that the risk of liability for the employer's attorney's fees was an impermissible burden to place on one in Crisp's position. 587 P.2d at 1170, n. 7.

There are a multitude of administrative decisions, however, including the one in the case at bar, having consequences far less significant. Many of these decisions are appealable to the courts. As to these, the rule announced in *Crisp* does not apply. In such cases the courts may continue to assess reasonable attorney's fees against the losing party. *See* Rules 29(d) and 45, Alaska R.App.P.; *Kodiak Western Alaska Airlines, Inc. v. Bob Harris Flying Service, Inc.*, 592 P.2d 1200, 1204–05 (Alaska 1979).

[15] Since we are unable to say that the superior court's award of attorney's fees in this case amounted to an abuse of discretion, we uphold the award.[24]

The judgment of the superior court is AFFIRMED.

GOLDIES, INC., Appellant,

v.

ALASKA HOTEL & RESTAURANT EMPLOYEES HEALTH AND WELFARE FUND, Alaska Hotel and Restaurant Employees Pension Trust and Legal Trust, Appellees.

No. 5078.

Supreme Court of Alaska.

Feb. 6, 1981.

Suit was brought to recover payments allegedly owing to union trust funds. The Superior Court, Third Judicial District, Anchorage, Milton M. Souter, J., granted summary judgment for the trust funds, and employer appealed. The Supreme Court, Matthews, J., held that: (1) employer's obligation to pay into union trust fund was part of its employees' compensation, and thus actions of union in failing to perform condition of collective bargaining agreement whereby union orally agreed to attempt to organize and picket employer's competitor, whether or not such condition was legal, did not defeat employer's obligation to make employee benefit contributions, and (2) there was no error in award of liquidated damages.

Affirmed.

1. Labor Relations ⇐131.4

Employees, as beneficiaries of trust funds, were third-party beneficiaries of collective bargaining agreement between union and employer under which employer was required to make monthly payments to the trust funds.

2. Labor Relations ⇐131.6

Employer's obligation to pay into union trust funds was part of its employees' compensation, and thus actions of union in failing to perform condition of collective bargaining agreement whereby union orally agreed to attempt to organize and picket employer's competitor, whether or not such condition was legal, did not defeat employer's obligation to make employee benefit contributions; employer's remedy was to sue the union for damages or seek rescission of the agreement.

3. Labor Relations ⇐131.6

Invalidity or illegality of a collective bargaining agreement does not alter employer's duty to make employee benefit contributions.

24. Sjong also argues that because this appeal involves a question of genuine public interest brought in good faith, it would constitute an abuse of discretion to award attorney's fees against a losing party. *Gilbert v. State*, 526 P.2d 1131, 1136 (Alaska 1974). A tax dispute which primarily concerns the taxpayer's own tax liability is not the type of public interest suit contemplated in *Gilbert*. Such is the case here.

STATE OF ALASKA

DEPARTMENT OF REVENUE

OFFICE OF THE COMMISSIONER

BILL SHEFFIELD, GOVERNOR

POUCH S
JUNEAU, ALASKA 99811
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Feb. 1 thru 14, 1986

JAN 23 1986

January 20, 1986

The Honorable Pat Pourchot
Finance Committee
Alaska State Legislature
P.O. Box V
Juneau, Alaska 99811

cc: JVF
EWF
JCH
LBA

Re: Expedite Collection of Disputed Taxes

Dear Representative Pourchot:

Some members of the Legislature have expressed concern regarding the delay in collecting disputed taxes. Disputed taxes include all assessed taxes which have not been paid and which the taxpayers are appealing. A proposal has been raised in the Interim Report of the House Finance Subcommittee on Oil and Gas (January 17, 1986) to require prepayment of disputed taxes at some stage in the appeal process. The Oil and Gas Section of the Attorney General's Office has been involved in reviewing this proposal from a constitutional perspective.

The Department of Revenue has reviewed the Interim Report and the draft of the Oil and Gas Section's opinion. The Department is concerned that the Legislature may not be aware of the affect the prepayment of disputed taxes requirement will have on various types of taxpayers. The Interim Report mentions only the affect prepayment of disputed taxes will have on the oil and gas industry. However, as pointed out in a foot note in the draft decision by the Attorney General's Oil and Gas Section, a prepayment requirement will also affect non-oil and gas corporations. This is because the current income tax laws governing the oil and gas industry are under the corporate net income tax provisions of AS 43.20 et. seq. ever since the separate income tax provisions of AS 43.21 et. seq. regarding the oil and gas industry were repealed. Equal protection safeguards require that all taxpayers of the same class under each type of tax be subject to the same tax provisions. Lehnhausin v. Lake Shore Auto Parts Co., 410 U.S. 356 (1973); In the Matter of the Tax Appeal of Simpson Manor, Inc., 548 P.2d 246 (Haw. 1976). Therefore, corporations that will be affected by any requirement of prepayment of disputed taxes will include small corporations, fish processors, timber industry, nearly bankrupt corporations, etc., as well as the oil and gas corporations. Based on the Department's experience regarding the ability of these non-oil and gas corporations to pay assessments which they challenge in good faith, we find their inability to pay will prevent them from exercising their due process right to appeal.

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Additionally, we find that the due process rights of all corporate taxpayers, oil and gas corporations and non-oil and gas corporations, may be violated by requiring early prepayment of disputed taxes during the Department's administrative appeal process. There is a difference between the Department's appeal levels and due process protections afforded at each level, which is more pronounced concerning appeals under AS 43.20 et. seq.. Since the Attorney General's Oil and Gas Section deals with oil and gas production tax cases under AS 43.55 et. seq., it is not familiar with the difference in the appeal procedures under AS 43.20 et. seq.. Therefore, their draft decision does not consider these differences nor the practical aspects of the appeal process at a program level which need to be discussed.

Further, prepayment of disputed taxes after completion of the administrative appeal process may violate due process protections because of the inability to pay, as well as usurp the authority of the judicial branch of government. There are a number of legal restrictions and practical concerns which must be emphasized involving the judicial branch's authority to determine whether prepayment of disputed taxes should be required.

Most importantly, the prepayment of disputed taxes will have a monumental and detrimental effect on the Department's entire operation, emphasis, and ability to successfully litigate tax challenges.

We propose that the collection of disputed taxes may be expedited more successfully through other approaches than the prepayment requirement. Many of these approaches have been recently adopted. Other could be adopted through the assistance of the legislature.

In this letter, we outline the handling of disputed tax controversies by comprehensively examining the assessment and appeal process, discussing the reasons for delays, and comparing these procedures to the practices of the federal government and other states. We also address the affect the prepayment requirement will have on the various levels of the Department's and the court's appeal process. Lastly, but most importantly, we explain alternative approaches to prepayment currently adopted or proposed that will expedite the collection of disputed taxes.

I. The Assessment And Appeal Process

The tax administration procedures of the Department of Revenue are outlined through statutes, regulations, Internal Revenue Code, Treasury Regulations, Department hearing decisions, Department Tax Rulings, case law, etc.. However, the basic premise underlining effective tax administration is voluntary compliance by taxpayers. Thus, the duty to determine the amount of taxes due is upon the taxpayer, applying the various applicable tax provisions and guidelines. The Department serves a watchdog function in insuring compliance. This results in assessments

issued to taxpayers for additional taxes. Under current law, the taxpayer that agrees to the assessment is required to pay. If the taxpayer disagrees with the assessment and appeals, payment is not required until the appeal is finally resolved. The appeal process includes both administrative and judicial levels of review. AS 43.05.240; 15 AAC 05 et. seq.. There are two levels of administrative appeal within the Department, the informal conference and the formal hearing. Appeal after the formal hearing decision is to Alaska Superior Court. The appeal process can proceed through the courts to the U.S. Supreme Court. Final resolution of the appeal occurs after exhaustion or waiver of judicial appeal rights. This is when the disputed taxes must be paid as well as attorneys fees, if the final determination is against the taxpayer.

This section comprehensively examines the Department's assessment and appeal processes, reasons for delays, and the affect prepayment of disputed taxes will have. Additionally, we compare the assessment and appeal process and prepayment requirements to the federal and other state tax processes.

A. The Assessment Level Of Review

The Audit Division is responsible for reviewing tax returns and monitoring taxpayers through audits to insure that taxable income is properly calculated and reported. If the Division determines that an adjustment is required, it will inform the taxpayer that either more taxes are owed or a refund is warranted. If more taxes are due, an assessment notice will be issued. This notice is required within three years of the filing of the return, although there is no time limit if no return or a fraudulent return is filed. AS 43.05.260. This three year limit is referred to as the statute of limitations for assessments. This statute of limitations can be waived if the taxpayer agrees to an extension of time for assessment.

As a practical matter, assessments are often made when the three year statute of limitations period is about to expire. The reason is that there are very few auditors compared to taxpayers, and that audits of taxpayers, especially large multi-state and multi-national taxpayers like the oil and gas companies, can take years to complete. These assessments are often very high as compared to the final adjusted assessment made during the appeal period. The reason is that auditors must make an aggressive although reasonable evaluation in order to insure that the State receives the money it is entitled to. They can not later amend the assessment after the statute of limitation for assessments has expired. Cf. Attorney General's Opinion No. 2 (Oct. 16, 1984) at 35 (under certain conditions assessments can be amended, but as a matter of policy, there must by a showing of good cause by the Audit Division, considering the reasons why the issue was overlooked by the Audit Division, timing of the newly-raised issue, and the taxpayer's ability to respond).

1. Reasons for Delay

There a number of reasons for delays during the assessment period. Waivers of the statute of limitations for assessments do occur. This results in assessments being issued much later than three years after the tax return is filed. Many taxpayers realize it is in their best interest to be cooperative and have an adequate audit performed. Otherwise, an auditor will charge the maximum tax because there has not been time enough to thoroughly review the taxpayer's records which may reveal deductions and credits for business expenses. Additionally, the waiver may be signed because a tax issue may affect several years or it is such a new issue that more time is needed to evaluate its tax consequence (market price of oil, prevailing values, transportation costs associated with transporting oil and gas). Also, there may be other taxing jurisdictions at a state or federal level or other audits underway that are dealing with the same issue or taxpayer. It is not an administratively sound practice to litigate the same issue for each taxpayer for each tax year considering the expenditure of money and staff. The delays are calculated to save administrative costs and juggle the limited audit staff.

The taxpayer has the right to appeal an assessment. AS 43.04.240; 15 AAC 05.010. The taxpayer has 60 days after being notified of an assessment to file a written appeal with the Department. 15 AAC 05.010(a). The taxpayer can request an informal conference, or bypass the informal conference and proceed to a formal hearing. 15 AAC 05.010(a)(5). The Taxpayer is not required to pay the disputed taxes, but must pay all undisputed taxes.

It should be clarified that prepayment of disputed taxes does not occur after the audit stage. There has been some disagreement whether the Oil and Gas Corporate Income Tax provisions of AS 43.21.070 required a prepayment of taxes that could later be appealed. This provision only addresses the initial payment of the Oil and Gas Corporate Income Taxes by the taxpayer. Unlike other taxes in which the taxpayer submits the tax payment with the return, under the Oil and Gas Corporate Income Tax provisions, the taxpayer files the return with the Department which notifies it of the amount to pay. AS 43.21.070. This does not constitute a prepayment of assessed taxes resulting from an audit. Even under the Oil and Gas Properties Production Tax provisions of AS 43.55 et. seq., there is no prepayment of disputed taxes. What does occur is a requirement to make estimated tax payments under 15 AAC 55.165. These estimated tax payments only apply to taxes due after 1984 concerning the oil valuation. There is an expedited appeal process through the refund and credit provision of 15 AC 55.165 to handle any later dispute concerning overpayment.

2. Prepayment after Assessment

The taxpayer is not required and should not be required to pay the assessment at this stage in the Department's administrative procedures because no hearing has been held. In cases involving desk audits, the taxpayer may never have even been contacted by the Department until the assessment notice is received. It is well established that before the payment of disputed taxes and the taking of any property right, due process requires that adequate notice and a hearing occur. Commissioner v. Shapiro, 424 U.S. 614 (1976); Fuentes v. Shevin, 407 U.S. 67 (1972); Goldberg v. Kelly, 397 U.S. 254 (1970).

As a practical matter, if prepayment was required after the assessment, taxpayers would not be as cooperative in providing the information during the three year audit period, or in waiving the statute of limitations. This would require more employment of discovery devises (subpoenas, summons, interrogatories, depositions, etc.), which would be costly in both time and money to the state. Additionally, the prepayment requirement may prescribe a different assessment approach than the aggressive approach now followed. Since disputed taxes are often reduced at later stages of the administrative process, it may not be reasonable to require the maximum perceived assessment. This could result in the State losing millions of dollars of taxes.

Additionally, the assessments would not be as well prepared as they now are because of the uncooperative feelings which would begin to permeate the process. The Audit Division may not be able to sustain their initial burden of proof that the assessment is warranted. Thus, tax cases will be irreparably lost at the assessment level.

B. Informal Conference

The informal conference is the first level of review of a challenged assessment. A conference officer discusses the assessment with the taxpayer through correspondence, in-person, and/or through telephone conferences. A number of contacts may be required to complete review. A written decision will be issued upon completing the informal conference. 15 AAC 05.020(c). The taxpayer has 30 days after an informal conference decision to file written notice requesting a formal hearing. 15 AAC 05.030(b).

One point that must be emphasized is that the informal conference is not a hearing in which the due process protections regarding the right to appeal apply. In the matter of Taxpayers (Pseudonymed), Revenue Hearing Decision 84-27 (Oct. 17, 1984) at 21-23. The actual conduct of the hearing is a one-on-one conference between the taxpayer's representative and the division's representative. We emphasis in the terminology employed that this level of review is a "conference" rather than a hearing. No rules of evidence are employed. There is no impartial hearing officer to examine the evidence presented by both sides of the

controversy. In fact, in many of the previous informal conferences before the development of the Appeals Section of the Audit Division, the informal conference officer often participated in the assessment for which he/she was now reviewing.

There is another reason why the first level of review after assessment is designated as a "conference" and not a hearing. This level of review was established to provide a review level which would be non-adversarial. Unlike the formal hearing in which the Appeals Section does take an adversary role on behalf of the Audit Division, the atmosphere of the informal conference is to provide an opportunity for discussion. At this stage of review, the taxpayer often supplies documents or other forms of evidence to support its position, or presents a legal analysis why it disagrees with the assessment. In many cases in which only a desk audit occurred, this is the first opportunity that the taxpayer has had to discuss the matter with a Department representative. The informal conference decision often results in abatement or partial abatement of the original assessment due to new evidence. In recent years with the development and maturing of the Appeals Section, they have been authorized to negotiate and settle cases that realistic from a practical viewpoint the State would not likely prevail. As a result of this nonadversarial approach, the expertise of the Appeals Section, and the ability to settle cases, nearly 90% of all assessment disputes are resolved at the informal conference level of review.

1. Reasons For Delay

There are a number of reasons for delay at the informal conference level. Many of these reasons are identical to those experiences at the assessment level, which have already been discussed. The time frame for holding an informal conference may vary, depending on the number of informal conference officers, the complexity of the issues, stays and consolidations of appeal, the availability of the pertinent officials of the taxpayer, etc. Limited staff to review each appeal request has been a major contributing factor to delays. For example, before the Petroleum Revenue Division was merged into the Audit Division in 1985, only one informal conference officer existed to handle all tax appeals under the Oil and Gas Corporate Income Tax provisions of AS 43.21 et. seq., Oil and Gas Properties Production Tax provisions of AS 43.55 et. seq., and the Oil and Gas Exploration, Production and Pipeline Transportation Property Taxes provisions of AS 43.56 et. seq.. Additionally, a great deal of the assessment actions were stayed until resolution of certain basic issues. For example, nearly all appeals arising under assessments of Oil and Gas Corporate Income Taxes (AS 43.21 et. seq.) were stayed due to the constitutionality challenge which has only been recently resolved by ARCO v. State of Alaska, Department of Revenue. ___ P.2d __, Supreme Ct. No. 2965 (August 16, 1985), appeal denied by the U.S. Supreme Court on January 13, 1986. As previously mentioned, it would be cumbersome, expensive and non-effective for the Department to litigate all cases

involving the same issue. Even if the Department was successful in each case it separately pursued, administrative costs are not reimbursable when attorney fees and costs are awarded. Additionally, it allows the Department to carefully screen its similar cases and proceed with the "best" test case. Further delays are due to the fact that the informal conference officer is faced with issues of first impression or cases which require more development to successfully litigate.

2. Prepayment after Informal Conference

If prepayment of disputed taxes is required after the informal conference decision, the State will not be as successful in resolving tax controversies at this early stage of review. The nature of the informal conference will become adversarial. With the weight of payment breathing down the taxpayer's neck, the taxpayer will be more defensive and less informative in providing information and discussing its tax position. Part of the reason for this change in atmosphere will be that attorneys will enter the tax appeal process at an earlier stage of review. Currently, the taxpayers' representatives involved in the informal conference are accountants, CPA, internal tax counsel, or officers and officials of the corporation. The presences of attorneys will create a procedural nightmare of discovery tactics, objections, motions, and briefs. This will require the Audit Division's Appeal Section staff to be attorneys or represented by attorneys in order to effectively respond. The administrative costs of the informal conference will soar because of the delays and the expense of hiring attorneys.

Additionally, if prepayment is required after the informal conference decision, the informal conference procedures will require amendment in order to adhere to due process requirements. The entire format of the conference will change to a hearing, with an impartial hearing officer and advocates from the Audit Division, recorded, etc. This will cause additional expenses. In reality, though, this will simply be a duplicate of the formal hearing process. Therefore, this stage of review will be revoked. This is the stage of review that is conducive to settling 90% of all tax disputes. Thus, the case load facing the formal hearing level will overwhelming.

If the informal conference procedures are not amended to resemble a hearing level of review, another practical result is that taxpayers will be inclined to waive this level of review and proceed to formal hearing. Taxpayers will want to be afforded their full due process rights and safeguards provided in a formal hearing if prepayment is required. Many taxpayers even now waive informal conference because they wish to have the matter resolved by a non-division representative in a quasi-judicial forum that adheres to a trial approach to review. It has been our experience that appealed tax cases that have not been subject to an informal conference level of review are ill-prepared for the type of review procedures conducting at the formal hearing level. The facts are

not organized nor agreed to. The issues are not formulated. Both parties, the taxpayer and the Audit Division, are not familiar with the dispute. Lengthy delays in the formal hearing process occur because a number of prehearing conferences are required for stipulations of facts, to prepare, mark and exchange the exhibits, narrow the issues, order discovery, respond to motions, present briefs, and summons witnesses. Even after the formal hearing, the record must often remain open to address new evidence or issues that arise at the hearing. It has often taken a couple of years from assignment of a formal hearing to closing of the record in these types of cases. The chaos that can be created at the formal hearing level by such universal waiver of the informal conference could jeopardize the trial level status which the formal hearing level now maintains. If the courts determine that procedurally the formal hearing is inherently defective in not being able to be conducted review in a manner reflective of a trial with its organized format, de novo review may be exercised by the courts. It is not likely these cases would simply be remanded because of the inherent nature of the problem at the formal hearing level. De novo would very likely result in the need for a new court system established exclusively to hear complex tax cases.

C. Formal Hearing

The formal hearing is the trial level for tax disputes. A Revenue hearing examiner is appointed by the Commissioner to serve as a hearing officer for the appeal. A formal hearing is often preceded by a prehearing conference, briefing, and discovery requests. A formal hearing, like an informal conference, can be conducted through correspondence, in-person, and/or by a telephone conference. Usually, the actual hearing is in-person regarding tax matters, with the Appeals Section representing the Audit Division and the Taxpayer represented by one or more representatives (attorneys, CPAs, accountants, corporate officers and officials). The Alaska rules of evidence are followed although relaxed concerning such issues as admission of hearsay evidence. The procedural rules established in 15 AAC 05.030 are followed. Full due process safeguards are provided with adequate notice and full opportunity to be heard by an impartial hearing officer. For large taxpayers, major disputes, or when a number of taxpayers request consolidated hearings, the actual hearing can take days. The record often remains open after the hearing to allow both sides to present all the evidence they want into the record or additional briefing, and to allow the opposing party the opportunity to examine and state any objection to any such new evidence and to file a responding brief.

A formal hearing decision is issued after the record is closed and reviewed. Formal hearing decisions have precedential value and must be followed by taxpayers and the Department. Although the decision in its original form is confidential unless confidentiality is waived by the taxpayer or is appealed, a pseudonymed and abstracted version of the decision will be released. Taxpayers are often successful at the formal hearing level of review. From 1982 - 1984, the taxpayer has won nearly

50% of the tax cases or tax amounts at issue. Unsuccessful taxpayers have the right to appeal this final administrative decision to Superior Court. These taxpayers are required to pay all undisputed taxes. The courts review is limited to an appeal on the record, with the taxpayer and the Department not allowed to raise new issues nor present new evidence.

1. Delays In The Formal Hearing Process

Delays have occurred in the formal hearing process for some of the same reasons previously mentioned. Limited staff and a growing backlog of cases are major explanations for delays. The Hearing Examiner Section handles not only tax appeals, but other revenue appeals including permanent dividend appeals, games of chance and skill appeals, enforcement appeals, child support appeals, etc. Until recently, there was only one to two hearing examiners. There are now four. There was a large backlog of cases which has now been greatly reduced. The goal, which should be reached this year, is for issuance of a decision within six months of the closure of the record.

Delays have also resulted because of stays pending resolution of a number of tax cases before the courts, both at the federal and state levels. Additionally, as previously mentioned, delays occur because the hearing officers have left the records open in cases in order to insure that both the taxpayer and Audit Division have presented their entire case.

2. Prepayment of Disputed Taxes After Formal Hearing

The Department's concern regarding requiring prepayment of disputed taxes after the formal hearing decision is that it will jeopardize the right of taxpayers to appeal to the courts because they are unable to pay the taxes. This factor is addressed under current court rules by the right to file a supersedeas bond. In particular, the small corporations and corporations which are experiencing economic depressions (fisheries business, timber industry, etc.) will suffer. Bankruptcy, reorganizations, or curtailing of business operations may result in order for these corporations to attempt to raise the money to appeal. Many will never be able to appeal because of the lack of money.

It has been our experience that the type of issues that taxpayers continue to appeal to the courts are issues of first impression and/or which the taxpayers bring in good faith. The court process of review is too costly and lengthy for most taxpayers to argue a frivolous or non-meritorious appeal, and their business operation and tax strategy too interdependent to make a novel and unsupportable tax position. A taxpayer who brings a frivolous appeal or who stonewalls the Department's official position can be sanctioned through penalties. This is because formal hearing decisions have the precedential force of law, and all taxpayers are required for all later tax years to adhere to the decision.

Additionally, the Department is concerned the atmosphere of the formal hearing may change because of the pressure of prepayment. Many of these concerns are expressed in the last section concerning the informal conference. The taxpayers may attempt to postpone payment by instigating a "circus" approach to the hearing. The hearing process may be besieged by motions, discovery requests, delay tactics, objections and jurisdictional challenges, etc. Again, as previously mentioned, this could jeopardize the trial level status of the formal hearing and allow de novo review at the court level. The courts do not have the same degree of expertise and specialized knowledge concerning tax matters as the Department, nor the amount of personnel required to handle de novo review of tax cases. Additionally, these types of delays will gravely affect the administration of taxes. The Audit Division relies upon the formal hearing decisions being issued as soon as possible in order to give the Audit Division direction involving other similar tax cases.

Other concerns of the Department center around the authority of the judiciary to determine if prepayment should be required. This will be discussed in the next section.

D. Judicial Review

An appeal from a formal hearing decision is to Alaska Superior Court. AS 43.05.240; 15 AAC 05.040. The appeal is on the record, with no de novo review. This means there is no trial at the court level of review, but an appellate review. As previously noted, this means both parties will not be able to introduce new issues, facts or evidence. The only time the court would provide de novo review generally involves when abuse of discretion by a hearing officer occurs. In most cases, the case will simply be remanded to the Department for review by another hearing officer. However, if the court finds the formal hearing appeal procedures inherently inadequate, it will conduct its own de novo review. Appeal from a superior court decision is to Alaska Supreme Court, and from there to U.S. Supreme Court if cert is accepted.

1. Delays In The Judicial Review Process

There have been a number of cases appealed to superior court. The major bulk of appealed cases are resolved through settlement and negotiations at the superior court and even the Alaska Supreme Court levels. Settlements are encouraged by law based on the costs of litigation and the delays and confusion of the law while a case is pending. Based on the ritualistic procedures of judicial review, the limited number of judges, and the complexity of the tax issues, it can easily take five to seven years to proceed to Alaska Supreme Court. There are few Alaska Supreme Court decisions involving Department of Revenue tax appeals, particularly in relationship to the number of cases that are appealed. Nearly two-thirds of all the Alaska Supreme Court decisions involving these tax appeals have occurred in the last four years. All of these cases were resolved in the Department's favor, with one remand.

2. Prepayment After Judicial Review.

The courts do not require prepayment of disputed taxes. Appellate Rules 204(d) and 602(c) specify that a supersedeas bond is all that is required to be posted. This usually results in simply a surety bond being posted.

The Court requires bonding in both civil and criminal cases. In criminal cases, bonds are required to insure the appearance of a defendant in court proceedings. In civil cases, bonds are required to insure that parties do not spend the disputed moneys. Thus, in requiring bonding in tax disputes, the court is insuring that payment will occur if the matter is resolved in the State's favor.

The Department, through the Attorney General's Office, challenged the substitution of bond for prepayment of the disputed taxes through motions filed in at least one superior court case. BP Alaska Exploration, Inc. v. State of Alaska, Department of Revenue, 3 AN-80-7289 (November 1980). The motions relied upon a regulation of the Department, 15 AAC 05.653, which required payment even if the taxpayer appeals, and the refund provisions of AS 43.05.240 to cure improper payment. The court rejected the arguments. Court rules take precedent over any other conflicting statutes or regulations. Alaska Const. Art. IV, § 15. Thus, if the Legislature proposes prepayment of disputed taxes, it will be required to repeal or amend the appellate rules by a 2/3 majority vote of the members of both houses. Alaska Const. Art. IV, § 15.

It should be noted that the court rules do not require payment in full in other administrative appeal disputes. There may also be an equal protection challenge regarding why taxpayer disputes warrant prepayment while other disputes do not. There has not been any tax case in which a taxpayer has exercised its appeal rights to the courts and has not paid. Therefore, it may be difficult to find a rational basis for requiring prepayment of disputed taxes.

One possible basis for requiring prepayment is suggested in the Interim Report, to prevent either frivolous appeals and delays. It has been the Departments experience that cases challenged in the courts involve issues of first impression, often involving interpretation of new laws. Many of the issues that are now beginning to appear before the courts concern oil and gas tax issues which are often extremely unique to Alaska and of first impression.

Even if the court justified the prepayment of disputed taxes, there may be the ramification that the court may require other disputed moneys to be paid before court challenges can be filed in order to prevent equal protection challenges. This may effect the State challenges, and require the State to prepay disputed moneys to challenge actions of others.

Even if the Legislature is successful in amending the court rules, due process and even equity concerns may overrule any statute if a taxpayer is unable to appeal because it lacks the disputed tax amount. It is evident from the recent federal case of Texaco, Inc. v. Pennzoil, Inc. that courts are conscious of preserving the appellants right to appeal, even to the point of not requiring full bonding. In that particular case, a U.S. District court ruled that a one billion dollar bond was sufficient for Texaco, Inc. to appeal the twelve billion dollar trial judgment against it. Part of the court's position was that a twelve billion dollar bond would paralyze Texaco's business.

E. Federal Tax Assessment And The Appeal Processes

The tax assessment and appeal procedures concerning corporate income taxes for Alaska and the federal government are similar. The reason is that Alaska has incorporated the federal provisions and case law under AS 43.20.021(a) and AS 43.20.300, with some modifications. Both the State and federal systems operate on a voluntary assessment system. There are also different administrative review levels for processing appeals in both systems. Additionally, prepayment of disputed taxes is not required by the IRS while the taxpayer is administratively appealing the assessment. In fact, the taxpayer need not pay upon completing the IRS administrative appeal if it appeals to Tax Court rather than U.S. district court or Court of Claims. If the taxpayer wishes to pay, it has the same option as provided by Alaska law in paying under protest and filing a refund claim.

There are major differences between the Alaska and federal tax systems that explains the federal requirement for prepayment of taxes if a taxpayer proceeds from an administrative appeal to a refund claim in U.S. district court or Court of Claims. The types of issues appealed in the federal system vary from those addressed in Alaska appeals. Our appeals reflect issues that are unique to state taxing authorities (unity, apportionment, etc.), and are often unique to Alaska or oil and gas production states. Additionally, based on the number of major changes in our tax laws in the recent years, particularly involving the oil and gas industry, interpretive issues constantly arise. These issues are of first impression. The success rate of these types of cases is difficult to determine. The federal system, which has operate for years under the same basic laws with some amendments, does not experience the variety and large percentage of "new" issue cases. Often, the issue centers around application of the law because of distinguishing facts rather than new issues.

Another major difference between Alaska and the federal tax system is that the federal government can operate at a deficit. Therefore, if the disputed tax monies are spent and a refund is later ordered by the court, the budget will simply reflect a deficit for the spent monies. However, Alaska operates on a balanced budget. If taxpayers were ordered to pay disputed taxes which were later determined not to be owed, the monies would have to be available for refund out of the current budget or reserved monies.

F. Other State's Assessment And Appeal Processes

Many of the other states also adopt the federal provisions and case law concerning corporate income tax assessment and appeal procedures. Many states provide for different levels of review, the earlier level being more informal than the final appeal level. Most states do not require prepayment during the administrative appeal process, although some require payment at later levels of judicial review. The prepayment requirement for disputed taxes is often limited to certain types of taxes that would therefore effect a limited group of taxpayers. See In the Matter of the Tax Appeal of Simpson Manor, Inc., 548 P.2d 246 (Haw. 1976) (excise taxpayers required to pay before proceeding to Tax Appeals Court, although net income, real property, public service company and bank franchise taxpayers could appeal without prepayment of disputed taxes).

G. Escrow

If prepayment of disputed taxes is required, how the funds will be handled requires an in-depth review. The major concern is that the monies must not be spent. Our balanced budget requires that the funds be reserved to insure reimbursement if the taxpayer wins the appeal. The method to preserve the funds may cause some constitutional problems. A dedication of funds issue may arise. Whatever system is developed, an escrow account system or separate fund, it must be emphasized that the moneys not be spend before resolution of the appeal. Resolution of cases can take years, especially those involving the oil and gas companies in which the facts and issues are still evolving and developing based on marketing data and refined production techniques. Court review alone could take years considering the complexity of the issues. It will be difficult in the lean years ahead to reimburse moneys that have already been spent if the taxpayer is victorious in its appeal.

The type of method implemented to reserve the money also requires thorough review. Whether the Department of Revenue, another State agency, or a third party custodian should be in charge of the funds is of consideration. Part of that determination will depend upon how the funds are characterized, as trust moneys or State income. Concerns such as investment prohibitions regarding trust funds, administrative costs, and ownership of excess investment income must be addressed.

It should be acknowledged that one of the best systems of insuring payment currently exists through the court's bonding requirement. The State has not experienced the problem that tax monies are not available once the appeal is finally resolved against the taxpayer. Surety bonds, in particular, insure against such problems.

H. Retroactive Application Of Prepayment Requirement

The major problem with applying retroactively the prepayment requirement at an administrative level is that due process violations

will occur if taxpayer are unable to continue with their appeal. At a court level, this requirement could also violate bonding agreements.

One point should be emphasized. Retroactive provisions are not encouraged when they curtail the public's rights. The right to appeal is a substantive and substantial right that should not be abridged.

II. Alternative means to Expedite Collections

There are a number of alternative proposals to prepayment of disputed taxes which could expedite the collection process for appealed taxes. Most of these proposals have already been implemented. Others will require the support of the Legislature. We maintain these proposals will expedite collections of disputed taxes.

A. Existing Changes To The Department's Assessment And Appeal Processes

At the audit level, assessments are progressing at a more rapid rate, particularly concerning oil and gas businesses. The major reason for this change from previous practices is that several years have now past since passage of the various types of tax laws affecting the oil and gas industry (AS 43.21 et. seq., AS 43.55 et. seq., AS 43.20 et. seq.). Through experience, advanced marketing data, familiarity with the various taxpayers' businesses, and firming of legal issues and positions, audits are shorter in duration and more thorough. Also, resolution of certain issues has resulted in fewer contested issues. Additional staff has also been hired. Thus, the audits are better prepared, the facts stipulated, and the issues clarified which expedites the assessment as well as later appeal processes.

At the informal conference level, a major breakthrough in the dam of backlogged cases was the judicial resolution of the constitutionality of the separate accounting approach under AS 43.21 et. seq.. ARCO v. State of Alaska, Department of Revenue, Alaska Supreme Ct. Op. No. 2965 (August 16, 1985, appeal dismissed by the U.S. Supreme Ct on January 13, 1986. Now, the other issues involved in these challenged assessments are progressing through informal conferences. Since there are two major issues, transportation costs and valuation, resolution of these two issues alone will nearly deplete the remaining backlog of cases.

Additionally, the ARCO settlement will greatly impact the amount of taxes disputed under the Oil and Gas Properties Production Tax provisions of AS 43.55 et. seq., currently at the informal conference stage of appeal. Additionally, settlement with one taxpayer often spurs other taxpayers to settle. The remaining tax cases may be more quickly resolved.

Another major change is the transfer of the informal conference functions concerning oil and gas matters to the Appeals Section of the Audit Division. Under the old Petroleum Revenue Division, there was only one conference officer. The Appeals Section has five conference staff members who are generally attorneys, CPAs, or audit staff with extensive years of experience in tax matters. This is the same Appeals Section which in recent years has been instrumental in negotiating settlements or resolving disputes of corporation tax appeals. Nearly 90% of all assessment disputes are now resolved by this Appeals Section.

At the formal hearing level, the major change has been additional staff. For years, one to two hearing examiners handled all appeals. It often took years to issue a decision after the record had closed. Now, the staff has expanded to four hearing examiners and a para-legal assistant. The backlog of cases has been greatly reduced. The Hearing Examiner Section, though, now handles a wider variety and larger volume of cases than in past years. Permanent fund dividend appeals, child support appeals, and games of chance and skill appeals have created an impact on how quickly decisions are issued. Even with the increased variety and amount of case load, the Hearing Examiner Section should be able to issue a decision within six months of closure of the record by the end of 1986.

At the Court level, a great deal of the appeal issues have been addressed in recent year. Within the last four years, approximately two-thirds of all decisions of the Alaska Supreme Court concerning Department of Revenue tax appeals have been issued. Previously, only a few tax cases had been decided by the Court. Additionally, there are not that many remaining court appeals. The number of cases on appeal to the superior courts and Alaska Supreme Court have been drastically reduced in the last couple of years because these prior decisions resolved a number of tax appeals and fewer formal hearing decisions are being appealed.

Another major change affecting the collection of disputed tax monies was the increase in the tax interest rate. AS 43.05.225, establishing the interest rate on delinquent taxes, was amended in 1982 from eight percent to twelve percent. As a result, taxpayers no longer have the incentive not to pay and spend the disputed taxes expanding their business or on other investment opportunities while the appeal is pending. The current interest rate is more compatible with the interest rates charged by commercial lending institutions. We have been experiencing a larger percentage of taxpayers paying the tax to stop the interest from running while they are appealing.

B. Additional Proposed Changes

A proposal that could have the greatest impact in facilitating the collection of disputed taxes is additional Department of Revenue staff. The major need is for auditors at the assessment level. Better prepared and expedited assessments will impact the successful collection of

disputed taxes at every level of appeal, and shorten the delay time between assessment and collection. As the challenged assessment proceed to informal conference, additional conference staff may be needed. Since the informal conference staff usually resolves most disputes and will be able to narrow the issues and select the test cases for formal hearing, an expansion in the Hearing Examiner staff will probably not be required.

III. Summation

The requirement to prepay disputed taxes at some level in the review process will not expedite the resolution of disputed tax cases. Rather, constitutional rights of due process will be violated if taxpayers are unable to appeal because they do not have the ability to pay, or are not afforded a proper hearing. Additionally, it will detrimentally impair the strategy and ability of the Department to successfully defend its assessments. The extent of the detrimental effect will be amplified depending upon how early in the appeal process the requirement is imposed. An adversary relationship will permeate the assessment and appeal process which will end the practice of voluntary compliance, endanger the ability of the Department to obtain needed information, jeopardized the Department's success rate in defending its assessments and decisions, delay the resolution process, and require additional staff at every level of the assessment and appeal process.

Additionally, it is the Department's experience that artificial deadlines for completing the various stages of the assessment and appeal processes will not expedite the collection process concerning disputed taxes. The reasons for delays in the audit and appeal processes are generally not because of stall tactics exhibited by taxpayers. We find that taxpayer appeals are generally brought in good faith. Most appeal issues, particularly those which survive the initial stages of appeal, concern issues of first impression. The State and the taxpayers both want quick resolution of these issues because they impact the State's tax administrative process, affecting a number of taxpayers and tax years, and the businesses' tax and operational strategy for later years. The delays that due occur often result from strategy decisions exercised by the State to select the best test case to litigate. Additionally, stays and consolidations pending decisions in other jurisdictions on the same issue cause delays but result in saving non-reimbursable administrative costs.

We also emphasize that the precedent does not exist at other state or the federal level to require prepayment of disputed taxes, particularly during the administrative appeal process. Assurances would be required to insure the safeguarding of the money, which is now adequately taken care of by the bonding requirements of the court.

The expedition of collecting disputed taxes is better accomplished through other proposals. Most of these proposals have already been

implemented. Greater experience and knowledge at the audit level in administering the new tax programs, recent settling of major cases, more proficient appeals staff and negotiated settlements of cases at the informal conference level, reduction of appeal backlog at the formal hearing level, and recent Alaska Supreme Court cases have and will greatly expedite the resolution of disputed tax cases. An increase in the interest rate has already spurred early payment of disputed taxes. Legislative funding of additional staff at the assessment and informal conference levels will also greatly expedite resolution of current and future disputed tax controversies, and insure earlier payment of taxes owed the State.

Sincerely,

Bruce M. Botelho
Deputy Commissioner, Taxation

By:
Theresa Hillhouse
Revenue Chief Hearing Examiner

cc: Members of the House Finance Committee

Karen L. Loeffler
Shelly J. Higgins
Oil and Gas Section
Department of Law

BB:TH
86-14

SB-371

OUTLINE OF PROPOSED COMPROMISE

I. Adopt Administration's proposals for 5-year statute on assessment and 6-year statute on collection, on a prospective basis beginning 1/1/94. No retroactive provisions relating to the statute of limitations; no amendments to AS 43.05.260 affirming purported "longstanding" practices of the Department of Revenue; and no legislative findings and purposes.

II. Adopt Administration's basic proposal on gas processing plants and gas plant liquids.

III. Adopt Administration's proposal, with non-substantive clarifying changes, for establishing through regulations a methodology for valuing oil in the future. [ALTERNATIVE: Allow royalty settlement amounts to be used as the taxable value prospectively, as currently proposed in HB 547.]

IV. Allow past royalty settlement prices to be used as the final taxable value of oil for purposes of AS 43.55 and former AS 43.21, except for oil to which the state's claims for value over ceiling price apply.

V. Items 1 - IV would be embodied in "compromise" legislation, which both industry and the Administration would support.

VI. BP commits to exercise the option to use royalty settlement prices for past oil taxes, assuming the "compromise" legislation passes and becomes law.

VII. BP agrees not to claim defenses based on AS 43.05.260 and AS 43.05.270 in settlement negotiations.

VIII. The Department of Revenue agrees to adopt regulations similar to those under consideration in the state-industry working groups reviewing the Department's proposed new production tax regulations.

IX. Items V - VIII would be embodied in a "memorandum of understanding" executed by the Attorney General on behalf of the State and by duly authorized representatives of BP.

OUTLINE OF PROPOSED COMPROMISE w/ HB547

recv'd 5/8

Testimony of G.T. Theriot
Before the House State Affairs Committee
May 8, 1994

Mr. Chairman, members of the Committee, my name is Tom Theriot. I am the Manager of the Alaska Interest Organization for Exxon Company, U.S.A. In this position, I have management stewardship for Exxon's production interests on the North Slope of Alaska. Let me thank you up front for allowing me the opportunity to testify before you.

I am here this afternoon to voice strong opposition to SB 377 because of the unfavorable statute of limitations provisions, which were formerly SB 185. As you may be aware, Exxon has strongly opposed the legislation since it was first introduced in April of last year, for reasons I'll cite in a moment. Obviously, we support the position of the Alaska Oil & Gas Association in opposition to the bill, and we do appreciate the efforts of many others from the business community, including Alaska Native corporations, and others who have come out in opposition to this legislation. Our General Tax Counsel, Mr. Paul Sullivan, has testified in opposition to this legislation on two occasions - In April of 1993 before the Senate Judiciary Committee, and then again in April of this year before Senate Labor and Commerce. I have provided copies of the more expansive 1993 testimony for your reference. As you study it, should you have any questions I will be happy to try to answer them.

I'll be very brief this afternoon, and I really only want to touch on the negative effects of the legislation from a businessman's point of view. As Manager of Exxon's Alaska production assets , a primary responsibility of mine is one of ongoing planning and consideration of future investments. In looking at the legislation from the standpoint of

managing the business and making investment decisions on how best to develop the oil and gas reserves, it is bad policy, it sets a bad precedent in the State, and this legislation sends the wrong signal in terms of the business climate here in Alaska. The retroactivity aspects of the bill, back to 1976, are particularly onerous, and certainly erode our confidence in my ability to do business in the state.

We recognize this is a business that involves risk, and we are prepared to deal with what I call the traditional risks. For example, will the recovery of oil live up to our production expectations? Can we reasonably estimate the investments required to recover that oil? What is a reasonable range of future prices to expect? Those are risks we accept and learn to deal with to help us assess the economic viability of investment opportunities.

What is very difficult to contemplate are the risks that materialize for me as a businessman as a result of legislation like SB 377. Specifically, what are the tax and other state rules that effect the project? When we invest, can we have the confidence that those rules won't change? Or are we at risk that they might change? Not just for the future, but maybe for the past too. It would clearly be desirable that our investment decisions would not have to include this added risk - a risk that further diminishes the attractiveness of that investment.

Obviously, we need clarity and stability in the legislative and regulatory climate in fiscal and other matters. We will always want that, and will always ask the legislature to do what they can to help build that climate.

I am aware of some of the concepts that have been offered up in the committee substitute, that purportedly add certainty to what taxpayers

and investors can expect in the State prospectively. Indeed, these provisions may be beneficial, but at the same time, they are tainted as they are part of legislation which provides for retroactive changes to other aspects of the tax law. While these provisions lay out some ground rules for doing business in the future, one would have to question for how long? A year, two years, or until the State decides to change them again? With passage of this legislation, precedent in the State would suggest that the policy makers truly don't value the stability and certainty that the business community so desperately desires.

For the reasons I've stated, Exxon strongly opposes legislation containing retroactive statute of limitations provisions as currently written in SB 377. We urge this committee and legislature to reject SB 377.

Thank you for the opportunity to express Exxon's views on this bill. I'd be glad to answer any questions you may have.

May 3, 1994

Honorable Ramona Barnes, Speaker
Alaska House of Representatives
State of Alaska
Juneau, Alaska

Dear Madam Speaker:

SB 377 was described to me this past weekend by a knowledgeable O&G Audit staff member as nothing more than a continuation of the decade old problems between the A.G's office (law) and the D.O.R., except in this case a billion dollars is at stake.

It is the position of experienced senior staff in the O&G Audit Division of Revenue that their collection efforts and hearing process protects the state on the issue of a six year statute of limitations. They would like to see the matter adjudicated in Court.

Never in the history of the subject litigation process (from audit to assessment to collection efforts and hearings) has the Department of Law or their expensive outside counsel advised the State that a problem was believed to exist as to a defense by taxpayers of a statute of limitations expiration.

In my forty plus year career I have never heard of a taxing authority revising the statute of limitations on a retroactive basis. Such an action flies in the face of logic and fair play.

If, in fact, Law has failed in their counsel to Revenue over the years, then a proper investigation would reveal their shortcomings and the appropriate people, including outside counsel, could be held responsible. Attorneys are always quick to litigate against other professionals for malpractice. It's about time their feet were held to the fire when they screw up. They have insurance coverage and careers at risk.

My previous correspondence contained several germane points which bear repeating.

...The basic problem between Law and Revenue for the past decade has been the issue of "control" over the collection process.

...Tax issues were seldom debated during this bickering.

...The deep and expensive involvement of outside legal counsel has cost the state tens of millions of dollars.

...Parties representing the state were and are more interested in perpetuating this litigation -- lifetime employment -- career enhancement -- retirement benefits.

...The termination of Bill Floerchinger was purely retribution by Charley Cole and left the state without appropriate experienced leadership.

DOR LTR. 5/3/94

...Billings by outside counsel represent either (1) padded hours or (2) inefficient workmanship.

...Gov. Hickel was counseled by his two immediate predecessors that his greatest problem as Governor would be reducing the power structure and personnel/budget build-up in the AG's office.

...Cole's settlements during the past two years do not resolve tax issues. These same disputed audit issues will be back to haunt us in the future, employing more attorneys, costing retirement benefits, etc.

...The working agreement between Revenue (Rexwinkel) and Law (Cole) in early 1992 has effectively destroyed the functions the two departments were designed by the Legislature to perform by Statute and Regulation. If the agreement isn't illegal, it is certainly illogical and has destroyed the professional moral of the Oil & Gas Audit Division.

The statute of limitations problem may be paramount at this moment, but ugly problems will continue to haunt the Administration and the Legislatur until someone pulls the plug on the excessive power held by the AG's office and personnel. THEY ARE THE PROBLEM.

Best personal regards,

Lee E. Fisher, Commissioner
Department of Revenue (1991)

TESTIMONY OF

THE ALASKA OIL AND GAS ASSOCIATION

ON SENATE BILL NO. 185

March 22, 1994

Good afternoon, Mr. Chairman and Members of the Committee. My name is Joe Householder. I am General Tax Counsel for Unocal Corporation, and I am here today to testify on behalf of the Alaska Oil and Gas Association ("AOGA") as chairman of the AOGA Tax Committee. Thank you for this opportunity to testify on Senate Bill 185.

AOGA is a trade association whose 18 member companies account for the majority of oil and gas exploration, production, transportation and marketing activities in Alaska. AOGA absolutely opposes SB 185. This bill represents unwise and unfair tax policy. It would set terrible precedent. It will provoke more litigation than it would resolve. Even the findings it purports to make as justification for what it does are incomplete, misleading or simply untrue. Let me examine what SB 185 would do, in order to explain our reasons for such strong opposition.

SB 185 proposes to amend the statutes of limitations for taxes. There are two of these statutes. One gives the Department of Revenue three years from the time a tax return is filed, in which to audit the return and issue an assessment for additional tax. The other gives the Department six years from the time it

issues a tax assessment, in which to go start legal proceedings to collect the tax claimed in the assessment. There is no need for this legislation. Under current law each of these statutes provides that the time period may be extended by mutual agreement between the Department and the taxpayer, and there is no limit to the number of times an extension may be further extended by mutual agreement. Since the very beginning of oil & gas production in Alaska, it has been the general practice of oil and gas taxpayers to agree to extensions whenever the Department asked for them. This is common practice both within and outside Alaska. It is also fairly well settled law, at least in the U.S., that once a statute of limitations period has expired, it cannot be resurrected, despite the willingness of the parties. That brings me to an interesting point with respect to the subject matter here. While I am not personally knowledgeable about the tax affairs of other AOGA members, I am familiar with those of Unocal. Unocal has typically received its assessments on, or after, the very last day of the extended limitations period - which, by the way, may have been 10 years after the taxable period. How then, could our appeal of the assessment be found to extend the limitations period which has already expired by the time we file the appeal? I'll tell you - the fact is that the Department is asking you to enact legislation which will likely be unsuccessful in the Courts. It is only the retroactivity they can be interested in because they have not asserted a problem with receiving waivers under current law.

Speaking of the courts, let me tell you what they say:

"[T]he purpose of statutes of limitations is to encourage promptness in the prosecution of actions and thus avoid the injustice which may result from the prosecution of stale claims. Statutes of limitations attempt to protect against the difficulties caused by lost evidence, faded memories and disappearing

witnesses." These aren't my words, nor the words of anyone else with AOGA. They are the words of the Alaska Supreme Court in *Byrne v. Ogle*, reported at page 718 in Volume 488 of the Second Series of the Pacific Reporter.

Think about that for a minute. The purpose is "to encourage promptness ... and thus avoid the injustice which may result from the prosecution of stale claims." How might this "injustice" occur? Because of "the difficulties caused by lost evidence, faded memories and disappearing witnesses." In other words, as time passes it gets harder and harder to prove what exactly you did and why you did it. Statutes of limitations are supposed to let you defend yourself while you still have the evidence available to do it. AOGA members are facing tax claims based on events 15 years and more in the past. Not only do memories fade and witnesses disappear during such a long time, but people may die and documents may be lost or difficult to locate. Even corporate taxpayers may merge and disappear altogether during such a long time.

Now, what does SB 185 propose to do? Well, section 2 would amend the three-year statute of limitations to allow the Department of Revenue to "increase or decrease the amount of tax due by issuing or amending an assessment at any time during the administrative consideration of a taxpayer grievance on an assessment[.]" In other words, instead of requiring the Department to do its audits and make its claims while the evidence is still fresh, it will allow the tax audits to drag on while the Department and its outside consultants try to invent new ways of viewing the past. All it will need to do is issue an assessment for substantial sums that is full of mistakes or questionable claims, and that will force the taxpayer to appeal. Under the proposed changes, there is no restraint on how long the appeal process can go on and the Department could make

assessments indefinitely so long as it held the appeal within the Department's procedures.

But SB 185 goes beyond being an open invitation for the Department of Revenue to ignore the quest for prompt and reasonable audits. So far only a handful of tax appeals have made it into court and become public. But it is clear from those that have become public, that the Department at various times in the past has told taxpayers what the tax rules mean and how they should comply with the law. Sometimes this advice came from the Department's auditors during an audit of the taxpayer. Sometimes it came from the Commissioner of Revenue. Sometimes it came in the form of instructions on the tax return forms. One would expect taxpayers to follow such advice when it is given. Indeed, if they don't follow it and don't have a reasonable cause for not following it, they can be subject under AS 43.05.220 to negligence and failure-to-pay penalties of up to 30% of the amount of their underpayment.

But as the years passed and the tax appeals dragged on and on, something bad started to happen. The Department began getting new advice from outside consultants and lawyers about how much more taxes could have been due if the Department hadn't given its original advice. Some of its own auditors also found ways to claim additional taxes if only the Department hadn't given that inconsistent earlier advice. And so the Department began issuing new assessments which repudiated its earlier positions and its advice that taxpayers had relied on. Instead, the new assessments asserted different positions under strained and unexpected re-interpretations of the tax statutes and regulations.

SB 185 would ratify this process of retroactive revisionism. As long as the Department still has a taxpayer's appeal pending before it, its audit and litigation

teams would be free to develop radical new theories for yet more taxes and, under SB 185, they could amend the assessment to incorporate those new positions.

How does this square with the idea of "avoid[ing] injustice" due to "difficulties caused by lost evidence, faded memories and disappearing witnesses" which the Alaska Supreme Court said was the purpose of a statute of limitations? Well, of course, that's a rhetorical question because it's obvious SB 185 doesn't square with that idea at all. Until a tax appeal finally makes it out of the Department and into court — which could be 10, 15 or perhaps even 20 years or more after the fact — there would effectively be no three-year statute of limitations at all under section 2 of SB 185 and no limit on the exposure that a taxpayer may face simply for having appealed an assessment containing mistakes.

Section 3 of SB 185 effectively removes the six-year statute of limitations as well while a tax appeal is pending before the Department. That section proposes to amend the six-year statute so that the six years don't begin to run until "the final administrative determination of the grievance[.]" In other words, the six years don't start until the Department finally issues its final decision in the tax appeal and the matter moves on to court.

So, between sections 2 and 3 of the bill, there would effectively be no statute of limitations at all until the Department has finished its consideration of the tax appeal.

We in AOGA do not believe this is sound policy for Alaska. It's not fair because a taxpayer who gets an assessment with mistakes in it, whether major or minor, and appeals to have them corrected, should not be exposed to

unlimited liability for an open-ended period of time simply for making that appeal. Taxpayers should not be penalized for exercising their right to appeal.

It's also not a wise policy for Alaska. This is not an easy time for the Alaskan oil industry. Prudhoe Bay production has been in decline for five years and is down by 25% despite billions of dollars of continued capital investment during that same period. This year and in the coming years other fields on the North Slope will begin their own production declines. Cook Inlet oil production has been in decline for over 20 years. On top of this, we have been hit by low oil prices, which makes it that much tougher to continue the investments that need to be made to slow down the rate of decline.

Each company up here is competing for money against other parts of the same company. None of us can afford to make all the good investments that we have opportunities for. So we only choose the best investments. Not just the best economically — often the opportunities elsewhere are economically comparable to the ones here. In such cases, if we are to make the Alaskan investment instead of the other one, there has to be something else that gives Alaska a competitive edge. SB 185 would take away some of Alaska's current edge in these decisions because it would increase the uncertainty about what our tax obligations are. We can pay today exactly what the Department of Revenue tells us to pay, but we would have no assurance that the Department will not change its position in the future and try to apply the new position retroactively back to today through the audit and appeals process.

Both ARCO and BP have said that half the North Slope production they expect to see in the year 2000 — just six years from now — could come from investments that have not yet been made. I submit that if Alaska destabilizes its