



Marie P. Evans  
Sr. Counsel Taxation Alaska

ATO-1668  
P. O. Box 100360  
Anchorage, AK 99510-0360  
phone 907.265.6534

marie.p.evans@conocophillips.com

RECEIVED  
AUG 16 2016  
TAX DIVISION  
Department of Revenue  
Anchorage, Alaska

August 16, 2016

Mr. John Larsen  
Audit Master, Department of Revenue  
550 W. 7<sup>th</sup> Ave., Ste 1820  
Anchorage, AK 99501

Re: Department of Revenue, Notice of Scoping for Potential Changes to Regulations  
15 AAC 56 Oil & Gas Exploration, Production and Pipeline Transportation  
Property Tax

Dear Mr. Larsen:

This letter responds to the Department of Revenue's ("Department") request for comments on the existing oil and gas property tax regulations. Specifically, the Department inquired about thoughts on "the duration of replacement value for a certified assessment roll, the determination of proven reserves, the application and calculation of the municipal tax cap, and the meaning of "intangible drilling expenses" in AS 43.56 in its notice dated July 27, 2016.

ConocoPhillips participated in the public hearing on August 12, 2016, reviewed the Department's Notice and submits the enclosed comments and suggestions.

General Comment: Other than implementing the tax cap revisions the legislature passed in Senate Bill 138, the scoping notice did not indicate the underlying purpose for the Department considering new or revised property tax regulations. The past and present litigious environment surrounding property tax creates a difficult situation for a collaborative discussion on implementing new or revising existing regulations. Yet, absent change to statute and/or regulations new property tax disputes are likely to arise and require litigation for resolution and upon expiration of settlements, differences will also likely remain unresolved.

We believe the Department should consider implementing prospective regulations, allowing existing settlements to remain, with an intent to minimize future disputes and the need for the courts issue decisions after years of contentious litigation.

First, the Department could promulgate objective definitions for terms in regulation (terms that are not in current litigation) like "proven reserves" where objective definitions based on industry accepted formulas are readily available from multiple industry and government sources, define the types of "depreciation" that are typically considered in a replacement cost new less depreciation method, or at 15 AAC 56.110 for pipeline property in section (c) provide examples of the "standard appraisal methods" and define how "capitalization of estimate future net income" is calculated.

Second, the Department could promulgate regulations consistent with the statute, legislative history to redefine the role of the Department and the State Assessment Review Board in appeals.

Duration of a Replacement Value: The Department's notice suggests that it is considering a regulation that the replacement cost, "once established as certified on the assessment roll and except for application of an inflation adjustment, should not be revisited more often than once every five years." We strongly recommend against adopting a regulation that is (1) limited by time or (2) considers only one factor of many that impact the replacement cost less depreciation appraisal method because such a regulation would not be in accord with the requirement to find "full and true value" on the lien date and must allow for generally accepted appraisal principles.

First, time limitations will not resolve the disagreements. It is objective and measurable definitions that are needed to eliminate the widely varying interpretations and applications of terms. Second, property tax is an annual process with more factors than simply inflation impacting the value of the subject property. While the purpose and function of many oil and gas properties on the North Slope may remain generally the same year after year, the properties still have physical wear, are subject external factors, may be repaired, replaced or decommissioned. The approach of only looking at an inflation adjustment for five years is fraught with issues.

Determination of Proven Reserves: The Department's consideration to remove the regulation pertaining to proven reserves is unlikely to eliminate controversy because AS 43.56.060(d)(2) and (e)(2) use the term "proven reserves" in determining the estimated life of assets in determining respectively their replacement cost less depreciation and economic value. However, the Department's consideration to objectively define the term and amend the regulation may alleviate future disputes over defining "proven reserves." We recommend the Department uses an industry standard definition for reserves or relies on a public source that the public may access.

Mr. John Larsen  
August 16, 2016  
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If the Department would like to discuss the above recommendations, please feel free to contact me.

Sincerely,  


Marie P. Evans

# BRENA, BELL & CLARKSON, P.C.

ROBIN O. BRENA, MANAGING ATTORNEY  
JESSE C. BELL  
KEVIN G. CLARKSON  
DAVID W. WENSEL  
ANTHONY S. GUERRIERO  
LAURA S. GOULD  
FREDERICK H. HAHN V  
MATTHEW C. CLARKSON  
KELLY M. MOGHADAM  
JON S. WAKELAND  
JAKE W. STASER

ATTORNEYS AT LAW

810 N STREET, SUITE 100  
ANCHORAGE, ALASKA 99501  
TELEPHONE: 907.258.2000  
FACSIMILE: 907.258.2001  
WEB SITE: BRENALAW.COM

Robin O. Brena  
rbrena@brenalaw.com

## MEMORANDUM

TO: John Larsen (john.larsen@alaska.gov)

C: Bill Walker (bill.walker@alaska.gov)  
Randall Hoffbeck (randall.hoffbeck@alaska.gov)  
James Greeley (james.greeley@alaska.gov)

FROM: Robin Brena on behalf of the City of Valdez *ROB*  
Jill Dolan on behalf of the Fairbanks North Star Borough

DATE: August 16, 2016

RE: Written comments of the City of Valdez and Fairbanks North Star Borough  
in response to the Department of Revenue's notice of possible updates and  
revisions to DOR regulations 15 AAC 56

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### Introduction

The Alaska Department of Revenue ("DOR") has requested "ideas and suggestions for possible changes" to its regulations under 15 AAC 56, including, but not limited to, "the duration of replacement value for a certified assessment roll, the determination of proven reserves, the application and calculation of the municipal tax cap, and the meaning of 'intangible drilling expenses' in AS 43.56." The City of Valdez and Fairbanks North Star Borough ("Valdez/FNSB") offer the following joint comments on the first three of these particular topics.

At the outset, Valdez/FNSB urge DOR not to use its regulatory process to revisit any disputed issues from the recently settled litigation on the Trans Alaska Pipeline System (“TAPS”) tax assessments and the related tax cap litigation. In particular, the duration of replacement value and the determination of proven reserves were repeatedly litigated before the State Assessment Review Board (“SARB”) and the courts, and DOR’s positions on those issues did not prevail. With regard to the application and calculation of the municipal tax cap, Valdez/FNSB understand that DOR is completing a memorandum of understanding that confirms the authority of the State Assessor in the Department of Community, Commerce, and Economic Development over the municipal tax cap, and urge the Department to avoid any regulatory changes beyond those necessary to conform to statutory amendments.

Any regulatory action beyond the narrow scope of statutory and judicial conformance risks reigniting the conflicts between the TAPS litigants and undermining the intention and the stability of the recent five-year settlement. All of the litigants, including DOR, invested significant time and resources into achieving the settlement, which has thus far allowed a cessation of the intensive litigation that spanned the last ten years. As they did at the public workshop on August 12, 2016, Valdez/FNSB urge DOR to avoid any regulatory action that revisits litigation positions that should be at a standstill under the settlement.

#### **1. Duration of Replacement Value for a Certified Assessment Roll**

According to its scoping notice, DOR “may propose that replacement cost, once established as certified on the assessment roll and except for application of an inflation adjustment, should not be revisited more often than once every five years.” DOR also uses the term “replacement value” in the first paragraph of its notice so that the parameters of the proposal are unclear. Regardless, annual adjustment from a prior replacement cost is

contrary to appraisal theory<sup>1</sup> and also deviates from the holdings of SARB and the courts.<sup>2</sup> Moreover, a current well-supported cost study, if available, offers the best information on current value and should be relied upon.<sup>3</sup> Furthermore, the statutes require an annual administrative process within each tax year, as recently confirmed by the Alaska Supreme Court in its opinion that SARB has exclusive jurisdiction over all AS 43.56 appeals.<sup>4</sup>

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<sup>1</sup> American Society of Appraisers, *Valuing Machinery and Equipment: The Fundamentals of Appraising Machinery and Technical Assets* 51 (3d ed. 2011) (cautioning that “use of indexes and trending can easily lead to erroneous results” and that trending “should not be applied to anything other than a historical cost, that is, the cost of the property when it was first placed into service by its first owner.”).

<sup>2</sup> Amended Decision Upon Reconsideration Following Trial De Novo, Case No. 3AN-06-08446 CI (2006 Tax Year) ¶ 135 (October 26, 2010) (“[T]his Court finds that the appellants have persuasively demonstrated that the Department and SARB’s reliance on the trended 2005 Mustang cost study for the 2006 TAPS assessment resulted in an improper valuation of TAPS.”); Certificate of Determination, OAH No. 15-0360-TAX at 18-19 (June 1, 2015) (“It is difficult for the Board to see, at this point in time, how a 2016 assessed valuation of the TAPS based on a trended 2009 RCN would meet the standard of review set out in AS 43.56.130(f), or address the Board’s concerns contained within this 2015 determination.”).

<sup>3</sup> Decision Following Trial De Novo, *BP Pipelines (Alaska Inc.) v. State of Alaska Department of Revenue*, Case No. 3AN-06-08446 CI (2007/08/09 Tax Years) ¶¶ 155, 157 (December 30, 2011) (“Reliance on a trended original cost as the basis for valuing TAPS is not warranted because TAPS’ original design has been substantially updated and a trended original cost would not capture the value of the asset in place as of the lien dates . . . [a] replacement cost analysis replaces TAPS’ current equivalent utility based on modern design, materials, and construction techniques.”); Certificate of Determination, OAH No. 14-0555-TAX at 8 (May 23, 2014) (“In this situation, it was improper to compute current value by trending forward a 2009 value. More recent estimates of cost, based on actual quotes from vendors and research in the market, are preferable to trending forward old studies.”).

<sup>4</sup> *City of Valdez v. State*, 372 P.3d 240, 255 (Alaska 2016) (“Thus in the timeline established by the legislature, all appeals from AS 43.56 initial assessment notices . . . are to be resolved at the administrative level within approximately three months, by no later than June 1 of each year.”). As noted in the public workshop, the supreme court’s opinion necessitates revision of 15 AAC 56.015 to reflect the jurisdictional holding; specifically, subsections (b), (c), and (d) should be removed.

Valdez/FNSB remain open to finding ways to make the use of current cost studies more efficient for the annual statutory process and reiterate that once a cost model has been agreed upon, the exercise should become merely an update of the cost inputs. Valdez/FNSB are more than willing to work with DOR in refining the annual assessment process to minimize administrative burden while satisfying the requirements of the statutes.

## **2. Determination of Proven Reserves**

The notice states only that DOR “will consider comments on removing or amending regulations related to the determination of proven reserves.” Valdez/FNSB cannot comment in detail without knowing what changes are being contemplated, but the definition and determination of proven reserves has been adjudicated by the courts and is clear.<sup>5</sup> DOR should not attempt via regulation to deviate from the clear “Reserves Law” holdings of the superior court, which included thorough discussion and analysis of the parties’ competing estimates,<sup>6</sup> and were twice affirmed by the Alaska Supreme Court.

The statutory interpretation of the courts is controlling, and the standard for determining proven reserves under AS 43.56 is clear: “Thus, so long as oil in each of the three categories of [Alaska North Slope] production established by [DOR] – producing, under development, and under evaluation – was economically, technically, and legally

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<sup>5</sup> Amended Decision Upon Reconsideration Following Trial De Novo, Case No. 3AN-06-08446 CI (2006 Tax Year) ¶¶ 394-97 (October 26, 2010) (construing the “Reserves Law” under AS 43.56 and holding that “no one industry, regulatory, or other definition of ‘proven reserves’ need be adopted and read into the Reserves Law” and that “the Department was not required to adopt a ‘reasonable certainty’ confidence level as urged by the Owners.”); *BP Pipelines (Alaska) Inc. v. State, Dep’t of Revenue*, 325 P.3d 478, 491 (Alaska 2014) (“The Owners have not shown that the superior court’s definition of ‘proven reserves’ is inconsistent with the statute or any widely accepted industry definition of the term.”)

<sup>6</sup> See Decision Following Trial De Novo, *BP Pipelines (Alaska Inc.) v. State of Alaska Department of Revenue*, Case No. 3AN-06-08446 CI (2007/08/09 Tax Years) ¶¶ 439-506 (December 30, 2011) (finding that the Municipalities’ production forecasts and reserves estimates were reasonable, the Owners’ forecasts and estimates were not persuasive, and DOR’s forecasts and estimates were unreliable).

deliverable into TAPS as of the lien date, as proven by a preponderance of the evidence, that oil should be included when estimating the economic life of TAPS for ad valorem tax purposes.”<sup>7</sup> There is no lack of clarity as to the “Reserves Law” under AS 43.56 and thus no need for regulation on this point.

### **3. Application and Calculation of the Municipal Tax Cap**

Based on the notice, it appears that DOR intends only “[c]onforming changes ... required to bring the regulation into compliance with the statute and also recognize that a new subsection (f) was added to AS 29.45.080.” As stated above, DOR should go no further in changing its regulations with regard to the tax cap, as that dispute was also part of the TAPS settlement and the issue is within the authority of the State Assessor in the Department of Community, Commerce, and Economic Development.

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<sup>7</sup> Decision Following Trial De Novo, *BP Pipelines (Alaska Inc.) v. State of Alaska Department of Revenue*, Case No. 3AN-06-08446 CI (2007/08/09 Tax Years) ¶¶ 459 (December 30, 2011).



August 16, 2016

Mr. John Larsen  
Alaska Department of Revenue  
550 W. 7<sup>th</sup> Ave., Suite 500  
Anchorage, AK 99501-3555

**Re: Comments Related to Potential Draft Regulations Under 15 AAC 56**

Mr. Larsen:

Glacier Oil and Gas Corporation (Glacier) appreciates the public scoping workshop held on August 12, 2016 to solicit ideas, suggestions and comments related to potential new and amended regulations related to property tax issues under 15 AAC 56. Glacier respectfully submits the following comments for the Department of Revenue (DOR) to consider as part of their regulatory review.

Glacier would like any new regulations to clarify the definition of “intangible drilling expense” and make sure any new definition is consistent with the applicable statutes.

In order to be valid, a regulation must be consistent with the statutes authorizing the regulations.<sup>1</sup> To the extent that a regulation is inconsistent with statutory law, the executive branch agency that promulgated the regulation has exceeded its rule-making power.<sup>2</sup> Therefore, if a regulation is inconsistent with its governing statutes, the regulation is invalid.<sup>3</sup>

Under AS 43.56.010, DOR must levy an annual tax of 20 mills on the full and true value of oil and gas property. Alaska Statute 43.56.020 lists a number of exemptions that cannot be taxed, including “the value of intangible drilling expenses and exploration expenses.” AS 43.56.020(a)(5). And AS 43.56.210(4) provides that “intangible drilling expenses means those expenses defined in 26 U.S.C. 263(c) (Internal Revenue Code) as defined on January 1, 1974.”

Thus, the Alaska legislature spoke clearly: 26 U.S.C. 263(c) expenses are exempt from taxation under AS 43.56. Alaska Supreme Court precedent is equally clear: legislative definitions are binding, and cannot be ignored, rewritten, or reformed, through regulation. DOR therefore does not have the authority to promulgate a regulation that redefines “intangible drilling expenses” to mean anything other than 26 U.S.C. 263(c) expenses.

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<sup>1</sup> *O'Callaghan v. Rue*, 996 P.2d 88, 94 (Alaska 2000).

<sup>2</sup> *State v. Kenaitze Indian Tribe*, 83 P.3d 1060, 1064 (Alaska 2004).

<sup>3</sup> *City of Valdez v. State*, 372 P.3d 240, 256 (Alaska 2016) (finding Department of Revenue's regulation was inconsistent with AS 43.56 and therefore invalid).

Again, thank you for the opportunity to participate in the public process and give input into the drafting of potential new regulations. If you have questions or need any clarification on our position on these matters, please do not hesitate to contact me.

Sincerely,

A handwritten signature in blue ink, appearing to read "Carl Giesler". The signature is fluid and cursive, with a large initial "C" and "G".

Carl Giesler  
CEO  
Glacier Oil and Gas Corp.

LAW OFFICES

# DILLON & FINDLEY

A PROFESSIONAL CORPORATION

1049 W. 5<sup>th</sup> Ave., Suite 200  
Anchorage, Alaska 99501  
Telephone (907) 277-5400  
Facsimile (907) 277-9896

Attorneys

Ray R. Brown  
Mauri Long  
Jessica Dillon  
Meg Simonian  
Molly Brown

Legal Assistants

M. Benita Raymond  
Shelley Eggert  
Lisa Kusmider  
Hailey Imlach

August 16, 2016

Via Email: [john.larsen@alaska.gov](mailto:john.larsen@alaska.gov)

John Larsen  
Alaska Department of Revenue  
550 W. 7<sup>th</sup> Ave., Suite 500  
Anchorage, AK 99501-3555

Re: *Public Scoping and Workshop*

Dear Mr. Larsen:

This firm represents the North Slope Borough ("Borough"). Please accept this letter and the attached proposed regulations as the Borough's response to the Department of Revenue's ("Department") Notice of Public Scoping and Workshop.

The Borough is the northernmost municipal government in Alaska (and the United States). Most of the oil and gas development that occurs in Alaska is within the Borough's 95,000 miles. The revenue generated by the taxation of oil and gas properties makes up most of the the Borough's annual budget, which is approximately \$385 million. The Borough is also one of two local municipalities that are affected by the tax cap provision in AS 43.56.010. As such, the Borough has a vested interest in the outcome of the property tax assessment scheme in AS 43.56 and 15 AAC 56.

The Borough and its residents benefit from a consistent and fair application of AS 43.56 and 15 AAC 56. As such, the Borough has always advocated for legal and factual positions that are fair, equitable to all parties, and supported by past precedent, the legislative history and the plain language of the regulations and statutes that dictate the annual assessment process in Alaska.

The Borough joins in the comments by the City of Valdez, and urges the Department to reject using this regulatory process to revisit disputed issues related to the Trans Alaska Pipeline System ("TAPS"). The Borough, like the City of Valdez and the Fairbanks North Star Borough, spent millions of dollars in legal costs to appeal the

final value of the TAPS. The success in that litigation resulted in significant increases in taxes for the municipalities and the State of Alaska. Issues including the determination of proven reserves and the calculation of the replacement value of oil and gas property were litigated before the State Assessment Review Board ("SARB"), the trial court and the Alaska Supreme Court. Those issues are resolved, and should not be disturbed in a regulatory docket. The Borough urges the Department to embrace comments made by members of the industry, the State of Alaska, and municipal representatives at the Friday, August 12, 2016 workshop. Those comments indicated a universal appreciation and respect for court decisions, settlements and the legislative history behind the assessment of oil and gas property in the Alaska. The Borough supports those comments.

**1. Proposed Changes to 15 AAC 56.015.**

On April 29, 2016, the Alaska Supreme Court issued Opinion No. 7100 in *City of Valdez v. State of Alaska, North Slope Borough and Fairbanks North Star Borough*, finding that the provisions in 15 AAC 56.015(b)-(d) are invalid. The Borough has proposed a regulatory change that conforms to the Alaska Supreme Court's decision. The changes to 15 AAC 56.015 proposed by the Borough are consistent with the procedure the Borough and several taxpayers followed during the SARB proceedings in May 2016. The proposed changes to 15 AAC 56.015 are attached as Exhibit A.

**2. Proposed Changes to 15 AAC 56.120 & 15 AAC 56.900.**

Currently pending before the Alaska Superior Court are appeals by three taxpayers regarding whether intangible development expenses are taxable under AS 43.56 and 15 AAC 56.120. The taxpayers in those cases argue that the intangible drilling expense exclusion for property tax purposes under Alaska law should be applied exactly the same as the option to expense intangible drilling *and development* expenses from income taxes under the Internal Revenue Code. The plain language of AS 43.56, legislative history, and the Department's long-standing interpretation of AS 43.56 demonstrate that (1) intangible drilling expenses do not include intangible or tangible development expenses under AS 43.56 and 15 AAC 56.120; and (2) intangible and tangible development expenses are taxable. In short, non-drilling costs capitalized in the development of an oil or gas project, "development costs," whether tangible, or intangible but allocable to tangible property, are taxable.

The Borough has litigated this issue before the Office of Administrative Hearings and the SARB. On April 5, 2016, the SARB upheld the Department's informal decision on this issue, stating that the "history shows the legislature intended to depart from federal income-tax law and make intangible development expenses taxable." See Exhibit B, Decision on Taxability of Intangible Development Expenses at 6, April 12,

2016. The SARB further rejected the “taxpayers’ proposed limitation that the word development means only the production-related activities that federal law would exclude from intangible drilling and development costs.” *Id.* The SARB determined that the taxpayers’ proposed limitation would “not be consistent with common sense, the legislative history from 1973, the terms of the Alaska Administrative Code, or the practice of the Department’s assessors.” *Id.*

In light of this decision, which is consistent with the Department’s assessment practice, the Borough proposes that the Department adopt the changes to 15 AAC 56.120 and 15 AAC 56.900 attached to this letter as Exhibit C. The Borough’s proposed changes to 15 AAC 56.120 explain that “intangible drilling expenses” are those incurred during the “boring of a well.” The Borough has proposed a change to 15 AAC 56.900 that provides a definition of “boring a well” as “digging a hole into the earth in order to find or extract water, oil, natural gas, or natural gas liquids.” See Exhibit D, Proposed Changes to 15 AAC 56.120. The Borough proposes deleting language from 15 AAC 56.120(b) to conform to the legislative history and industry norms related to “boring a well.” The remaining proposed changes to 15 AAC 56.120 and 15 AAC 56.900 explain that the process of completing a well is not excluded from tax.

**3. Proposed Changes to 15 AAC 56.047 & the Tax Cap.**

The Borough supports the Department’s attempt to conform the regulation to the changes to AS 29.45.080. The Borough joins the City of Valdez in urging the Department in going no further than those changes. It is the Borough’s understanding that the Department has completed or is completing a Memorandum of Understanding that confirms the authority of the State Assessor, with the Department of Community, Commerce, and Economic Development, as the individual responsible for issues related to the municipal tax cap. It is the Borough’s understanding that the State Assessor supports the Memorandum of Understanding, as it memorializes the traditional role of the State Assessor, and is in accord with historical administrative practice.

**4. The Determination of Proven Reserves & Replacement Cost.**

The Borough joins the comments submitted by the City of Valdez related to any change to the determination of proven reserves and the duration of replacement value for a certified assessment roll. These issues have been litigated and resolved by the courts and should not be disturbed.

John Larsen  
August 16, 2016  
Page 4

The Borough thanks the Department in advance for its commitment to promoting and providing a clear and equitable assessment process for all Alaskans.

Sincerely,

DILLON & FINDLEY, P.C.

A handwritten signature in cursive script that reads "Molly C. Brown".

Molly C. Brown

MB/hi  
Enclosures as noted

# **EXHIBIT A**

**Proposed changes to 15 AAC 56.015**

- (a) An owner of taxable property, or a municipality where the property is located, may object to the assessed value of the property set out in a notice of assessment issued under 15 AAC 56.010 or in a notice of supplementary or amended assessment issued under 15 AAC 56.045 by filing an appeal with the department as provided in 15 AAC 56.020 or 15 AAC 56.047, as applicable.
- [(B) AN OWNER OF TAXABLE PROPERTY MAY OBJECT TO THE DEPARTMENT'S DETERMIANTION THAT PROPERTY IS TAXABLE OR NOT TAXABLE UNDER AS 43.56 BY FILING AN APPEAL UNDER 15 AAC 05.001 - 15 AAC 05.050 WITHIN THE PERIOD PROVIDED UNDER 15 AAC 05.010(b)(3).]
- [(C) A MUNICIPALITY THAT BELIEVES CERTAIN PROPERTY THAT SHOULD BE TAXED UNDER AS 43.56 WAS NOT INCLUDED IN A NOTICE OF ASSESSMENT MAY NOTIFY THE DEPARTMENT BY FILING AN APPEAL UNDER 15 AAC 05.001 - 15 AAC 05.050 WITHIN THE PERIOD PROVIDED UNDER 15 AAC 05.010(b)(3)].
- [(D) AN OWNER OF TAXABLE PROPERTY MAY OBJECT TO A STATEMENT OF THE AMOUNT OF TAX OR PENALTY DUE BY FILING AN APPEAL WITH THE DEPARTMENT UNDER 15 AAC 05.001 - 15 AAC 05.050 WITHIN THE PERIOD PROVIDED UNDER 15 AAC 05.010(b)(4). FOR PURPOSES OF THIS SUBSECTION, A "STATEMENT OF THE AMOUNT OF TAX OR PENALTY DUE" IS THE STATEMENT ISSUED BY THE DEPARTMENT UNDER AS 43.56.135 AFTER THE DEPARTMENT ISSUES THE FINAL ASSESSMENT.]
- (b)[(E)] An owner of taxable property or a municipality where the property is located may appeal a notice of supplementary or amended assessment as provided in 15 AAC 56.047.
- (c) [(F)] The department will not accept an appeal that is not timely filed.

# **EXHIBIT B**

**BEFORE THE STATE ASSESSMENT REVIEW BOARD  
STATE OF ALASKA**

In the Matter of	)	
	)	
PIONEER NATURAL RESOURCES USA INC.	)	OAH No. 11-0154-TAX
	)	OAH No. 12-0091-TAX
Oil & Gas Property Tax (AS 43.56)	)	Appeal of Revenue Decisions
<u>2011 &amp; 2012 Assessment Years</u>	)	Nos. 11-56-10/12-56-05
In the Matter of:	)	
	)	
ENI US OPERATING COMPANY INC.	)	OAH No. 12-0090-TAX
	)	OAH No. 14-0586-TAX
	)	OAH No. 15-0452-TAX
Oil & Gas Property Tax (AS 43.56)	)	Appeal of Revenue Decisions
<u>2012-2015 Assessment Years</u>	)	Nos. 12-56-03/14-56-08/15-56-08
In the Matter of:	)	
	)	
CAELUS NATURAL RESOURCES ALASKA LLC	)	OAH No. 14-0589-TAX
	)	OAH No. 15-0450-TAX
Oil & Gas Property Tax (AS 43.56)	)	Appeal of Revenue Decisions
<u>2014 &amp; 2015 Assessment Years</u>	)	Nos. 14-56-11/15-56-07

**DECISION ON TAXABILITY OF INTANGIBLE DEVELOPMENT EXPENSES**

**A. Procedural history of the taxability issue**

Pioneer Natural Resources USA, Inc., Caelus Natural Resources Alaska, LLC, and ENI US Operating Company, Inc., all appealed oil-and-gas property tax assessments for years ranging from 2011 through 2015. The primary issue in each case was the taxability of intangible development expenses.

The properties in question are located in the North Slope Borough. The North Slope joined in the appeals as permitted under AS 43.56.

Because these appeals involved taxability issues, they were originally routed through both the State Assessment Review Board and the Commissioner of Revenue. Under the regulations that governed property tax appeals at the time these cases were filed, taxability appeals were to be decided by the Commissioner.<sup>1</sup> Following this process, after the Commissioner determined whether a property was taxable, the Board would then hear and determine issues of valuation. Therefore, as each appeal was referred to the Board, the Board stayed the appeal to allow the Commissioner to determine the taxability of intangible development expenses.

<sup>1</sup> 15 AAC 56.015.

The Commissioner referred the appeals to the Office of Administrative Hearings so that an administrative law judge could conduct a hearing on behalf of the Commissioner. A hearing was held for one of the taxpayers, Pioneer (the other cases were stayed). Before a final appealable decision was issued in the Pioneer case, however, the Alaska Supreme Court invalidated the regulation that had bifurcated “taxability” from “valuation”:

Following briefing and argument, we conclude that the statutory scheme composed of AS 43.56.060-.135 grants to the State Assessment Review Board the exclusive jurisdiction to hear appeals regarding assessments from the Department of Revenue for the tax levied under AS 43.56.010(b) and AS 29.45.080, including issues of taxability. 15 AAC 56.015 is inconsistent with this statutory scheme and invalid to the extent it requires or allows a municipality or property owner to pursue a taxability appeal using a different procedure within the Department.<sup>2</sup>

Following the court’s order, the Board lifted the stay on the appeals for the tax years described above. The Board notified the parties that it would consolidate the hearings for all of the taxpayers who had pending property tax appeals.<sup>3</sup> The taxpayers were told that the Board would hear and determine the issue of taxability in April 2016. It would then hold a hearing on, and decide, any remaining issues of valuation in May 2016.

A hearing on taxability was held on April 5, 2016. Each party was given 1 hour and 45 minutes to make a presentation to the Board limited to the issue of taxability. No witness testimony was permitted. Board Chair Steve Van Sant presided over the hearing. Board members James Mosley, Bernie Washington, and Bill Roberts attended the hearing and deliberations. The Board was assisted by Administrative Law Judges Neil Slotnick and Cheryl Mandala.

#### **B. Background on the dispute over taxability of intangible development expenses**

Under the property tax imposed by AS 43.56, the value of oil and gas production property is generally determined by actual cost (during construction) or replacement cost less depreciation (for production property).<sup>4</sup> Intangible drilling expenses, however, are excluded from taxable value.<sup>5</sup>

<sup>2</sup> Order, *City of Valdez v. State of Alaska*, Supreme Ct. No. S-15840 (Alaska, January 29, 2016).

<sup>3</sup> Two other taxpayers were included in the original consolidation. Later, however, one of those taxpayers dismissed its appeal. For the other, the parties stipulated to a stay to allow the division to perform an audit.

<sup>4</sup> AS 43.56.060(f).

<sup>5</sup> See AS 43.56.060(f), which states:

(f) For purposes of this section, "actual cost" and "replacement cost" do not include interest capitalized before or during the period of construction nor the value of intangible drilling expenses.

See also 43.56.020(a)(5).

The state oil-and-gas property tax was adopted in 1973 during a special session on oil and gas taxation just before construction of the pipeline began. The exclusion of intangible drilling expenses from value was patterned after a provision in federal income tax law. This provision allows an oil and gas taxpayer to elect to expense, rather than capitalize, intangible drilling and development costs during the same year in which the taxpayer incurred the expense.<sup>6</sup>

In transplanting the deduction from federal income tax law to state oil-and-gas property tax law, however, the legislature deleted the word “development.” Thus, the state exemption found in AS 43.56 applies only to intangible *drilling* expenses.<sup>7</sup> This is different from the terminology used in federal income tax, which allows expensing of drilling *and development* costs. Yet, the definitional statute in the property tax code, AS 43.56.210(4), defined “intangible drilling expenses” to mean “those expenses defined in 26 U.S.C. [§] 263(c)” —the subsection of the Internal Revenue Code that established the option to expense intangible drilling and development costs. This array of differing and inexact terminology created the potential for confusion regarding what is included in the property tax exemption.

In 1975, however, the Department of Revenue issued a regulation, 15 AAC 05.900, interpreting the term “intangible drilling expenses.” That regulation clarified that the definitional statute’s reference to 26 U.S.C. § 263 applied only to drilling:

For purposes of AS 43.56, “intangible drilling expenses” means only the intangible drilling expenses defined in section 263(c) of the United States Internal Revenue Code as defined on January 1, 1974, and does not include any intangible development expenses defined in section 263(c) of the United States Internal Revenue Code as defined on that date.<sup>8</sup>

Thus, this regulation made clear that, in the Department’s view, the omission of the word “development” in AS 43.56.060(f) established a substantive difference between state property tax law and federal income tax law. The incorporation of federal law in the definitional statute, AS 43.56.210(4), was not intended to negate the substantive statute.

<sup>6</sup> Since World War I, the federal government has allowed oil-and-gas companies the option of an accelerated deduction for intangible drilling and development costs. The option encouraged drilling, and recognized the risk undertaken in drilling for oil. The option of an accelerated deduction is a significant benefit to the companies because under normal accounting rules, these costs would have to be amortized over a period years. See, e.g., *Gates Rubber Co. v. Commissioner of Int. Rev.*, 74 T.C. (Tax Ct. 1980) (“the IDC option was enacted to encourage risk-taking”); *Exxon Corp. v. United States*, 547 F. 2d 548, 556 (Cl. Ct. 1976) (finding that in adopting option to expense intangible drilling and development costs, Congress intended very broad-based incentive to counteract risk inherent in oil industry).

<sup>7</sup> In one section, “intangible drilling and exploration expenses” are exempt from local tax. AS 43.56.020(a)(5). This is yet a further example of differing terminology for determining what expenses are included in taxable value.

<sup>8</sup> 15 AAC 05.900(a).

Over the forty years since this regulation was adopted, the wording and the numbering of the regulation has changed from time to time. The current version of the regulation, 15 AAC 56.120, continues to require that intangible development costs are taxable under Alaska property tax law.<sup>9</sup>

### C. The assessments

Each of the assessments in this case addresses the issue of the taxability of intangible development expenses.<sup>10</sup> In each case, the taxpayer filed a tax return that deducted all intangible drilling and development costs, equivalent to what the taxpayer had expensed on its federal income-tax return. In each case, the assessor, citing AS 43.56.060(f) and 15 AAC 120, determined that “intangible development expenses” are taxable, and must be included in value.<sup>11</sup> The assessor increased the assessment for each of these taxpayers by adding intangible development costs back into the taxpayers’ assessments. As described above, each of the taxpayers then appealed its assessment.

### D. Discussion of the taxpayers’ arguments

The taxpayers make three arguments to support their view that intangible development expenses are not taxable:

1. The plain language of AS 43.56.210(4) incorporates the federal code lock, stock, and barrel. Because federal law includes both drilling and development costs in the option to expense, then, by definition, all of those expenses must be included in the property tax exemption. In the taxpayers’ view, this makes sense because it simplifies the reporting and calculation of “IDC”—a taxpayer can simply lift the IDC from its federal return to complete its Alaska property tax deduction calculation. Under this approach, the plain language of the statute is so clear and convincing that any legislative history to the contrary would not be sufficient to overcome the plain meaning. The taxpayers conclude that to the extent that the Department’s regulations are inconsistent with the statute, the Board would be required to follow the statute, not the regulation.
2. The regulation, 15 AAC 56.120(c)(1), can be harmonized with the plain language of AS 43.56.210(4) if the word “development” in the regulation is read to mean “development of production-related property and equipment.” This reading would mean

<sup>9</sup> 15 AAC 56.120(c)(1) (“Intangible drilling expenses’ does not include (1) intangible development expenses”).

<sup>10</sup> See Revenue Decision Nos. 11-56-10; 12-56-05; 12-56-03; 14-56-08; 15-56-08; 14-56-11; 15-56-07.

<sup>11</sup> Revenue Decision Nos. 11-56-10; 12-56-05; 12-56-03; 14-56-08; 15-56-08; 14-56-11; 15-56-07.

that development of the well is not taxable, which would make the state property-tax deduction consistent with the federal income-tax option to expense.

3. Even if the plain language of AS 43.56.210(4) does not control the outcome, the plain language of AS 43.55.017(a)(3) does. This statute provides that

Except as provided in this chapter, the taxes imposed by this chapter are in place of all taxes now imposed by the state or any of its municipalities, and neither the state nor a municipality may impose a tax on:

- (1) producing oil or gas leases;
- (2) oil or gas produced or extracted in the state;
- (3) the value of intangible drilling and development costs as described in 26 U.S.C. 263(c) (Internal Revenue Code), as amended through January 1, 1974.<sup>12</sup>

As originally adopted, AS 43.55.017(a)(3), like AS 43.56.020(a)(5), prohibited tax on “intangible drilling and exploration costs.”<sup>13</sup> In 2006, however, the legislature amended AS 43.55.017(a)(3) by deleting the term “exploration” and replacing it with “development.” In the taxpayers’ view, the prohibition of tax on the value of intangible drilling and development costs in AS 43.55.017(a)(3) applies to *all* tax types, including property tax. Under this approach, the amendment to AS 43.55.017(a) would supersede all other laws regarding exemptions to the property tax, thus making intangible development expenses nontaxable.

These three arguments are discussed below.

**1. Does AS 43.56.210(4) compel a finding that intangible development expenses are not taxable?**

The Board agrees that plain language and clarity in tax statutes is important. Taxpayers should be able to read a statute and understand what their tax liability is without confusion and uncertainty. The Board does not agree, however, that AS 43.56.210(4) necessarily means that intangible development expenses are not taxable.

First, the Board understands the taxpayers’ grammatical argument. When reading a definition in a dictionary, the word or phrase being defined is not usually part of the definition. That approach, however, does not necessarily apply to legislation. In reading legislation, we sometimes must use common sense. Here, we have a phrase being defined as meaning “those expenses defined in 26 U.S.C. [§] 263(c).” To the extent that there is a mismatch between the

<sup>12</sup> AS 43.55.017(a)(3) (emphasis added).

<sup>13</sup> AS 43.55.017(a) (1997) (§ 1 ch 136 SLA 1977).

phrase being defined and the statutory definition being incorporated, the Board believes that it opens the door for further inquiry—such as inquiry into legislative history. Moreover, given that 26 U.S.C. § 263(c) does not actually define any expenses, AS 43.56.210(4) is not, unfortunately, necessarily clear or plain. Therefore, the Board may appropriately review legislative history, and take note of the historical interpretation of these terms by the Department in its regulations, when the Board is construing AS 43.56.210(4).

Second, the Board has reviewed the legislative history from 1973. The discussions that took place in the House Finance, Senate Finance, and Free Conference Committees are significant legislative history.<sup>14</sup> This history shows that the legislature intended to depart from federal income-tax law and make intangible development expenses taxable. In general, the legislative committees were influenced by, and wanted to conform to, the tax practices of the Kenai Peninsula Borough.

Third, the Board understands its obligation to follow governing regulations.

Fourth, and perhaps most important, the Board respects the 40 years of consistent interpretation, codified in the Alaska Administrative Code, that intangible development expenses are taxable. Given the long-standing interpretation in the code, consistent with the intent of the 1973 legislature, reversing course at this time would require legislative, not adjudicative, action.<sup>15</sup>

**2. Is the phrase “intangible development expense” in 15 AAC 56.120(c)(1) limited to production-related property?**

In this decision, the Board did not determine which activities are included or excluded in “intangible development expenses,” as that phrase is used in 15 AAC 120(c)(1). The Board does not, however, accept the taxpayers’ proposed limitation that the word development means only the production-related activities that federal law would exclude from intangible drilling and development costs. This proposed limitation would not be consistent with common sense, the legislative history from 1973, the terms of the Alaska Administrative Code, or the practice of the Department’s assessors.

<sup>14</sup> See North Slope Exhibits N-T.

<sup>15</sup> See, e.g., *Bullock v. State, Dep’t of Cmty. & Reg’l Affairs*, 19 P.3d 1209, 1216 (Alaska 2001) (granting some deference to longstanding administrative interpretation of oil-and-gas property tax statute and noting that “twenty-three years easily qualifies as long-standing”).

**3. Does AS 43.55.017(c)(3) apply to AS 43.56?**

The Board does not agree that AS 43.55.017(c)(3) applies to the property tax imposed under AS 43.56. Given the Board's emphasis on clarity of tax statutes, it would be incongruous to hold that an unclear provision in one tax type controls the interpretation of a different tax type. This result is confirmed by the absence of legislative history or consistent administrative directive that would provide notice or indication to taxpayers that the state is interpreting AS 43.55.017(c)(3) to amend or control the property tax. Moreover, the language that the taxpayers point to as controlling—"the state may not impose a tax on intangible development costs"—would be in conflict with another statute—AS 43.56.060 (which does impose a tax on intangible development costs)—if the Board were to find that AS 43.55.017(c)(3) applies to the property tax.

**E. Conclusion**

The taxpayers have not met their burden of proving that the assessor erred when he determined that intangible development expenses are included in value and taxable under AS 43.56, the Alaska oil-and-gas property tax.

DATED: April 2, 2016



Steve Van Sant, Chair  
State Assessment Review Board

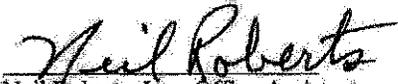
**Certificate of Service:** I certify that on the 12<sup>th</sup> day of April, 2016 a true and correct copy of this decision was served on the following by e-mail and mail to the following listed below:

F. Steven Mahoney  
Manley & Brautigam  
845 K Street  
Anchorage AK 99501  
[steve@mib-lawyers.com](mailto:steve@mib-lawyers.com); [donna@mib-lawyers.com](mailto:donna@mib-lawyers.com)

Jessica Dillon/Molly Brown  
Dillon & Findley PC  
1049 W. 5<sup>th</sup> Ave., Ste. 100  
Anchorage AK 99501  
[jessica@dillonfindley.com](mailto:jessica@dillonfindley.com); [molly@dillonfindley.com](mailto:molly@dillonfindley.com); [lisa@dillonfindley.com](mailto:lisa@dillonfindley.com)

Martin Schultz, AAG  
Katherine Swanson, AAG  
Dept. of Law, Oil Gas & Mining  
1031 W. 4<sup>th</sup> Ave., Ste. 200  
Anchorage AK 99501  
[martin.schultz@alaska.gov](mailto:martin.schultz@alaska.gov); [katherine.swanson@alaska.gov](mailto:katherine.swanson@alaska.gov); [jennifer.ditcharo@alaska.gov](mailto:jennifer.ditcharo@alaska.gov)

James H. Greeley, Jr.  
Petroleum Property Tax Assessor  
550 W. 7<sup>th</sup> Ave., Ste. 500  
Anchorage AK 99501  
[james.greeley@alaska.gov](mailto:james.greeley@alaska.gov)

By:   
Neil Roberts, Law Office Assistant  
Office of Administrative Hearings

# **EXHIBIT C**

## Proposed changes to 15 AAC 56.900

In this chapter,

- (1) “board” means the State Assessment Review Board established by AS 43.56.040;
- (2) “department” means the Department of Revenue;
- (3) “director” means the director of the tax division of the department and an authorized representative or agent of the director;
- (4) “error” means a mistake, due to any reason, that may affect the amount of tax levied or collected under AS 43.56,
  - (A) including a mistake by the department in assessing or collecting property tax resulting from
    - (i) a mistake in reporting or entering information a mistake in reporting or entering information, whether caused by the property owner or the department;
    - (ii) an incorrect description or designation of the property, its use, or its location, whether caused by the property owner or the department;
    - (iii) the department applying a classification or valuation schedule to the property that was incorrect under, or inconsistent with, the department's usual practice and policy at the time of the original assessment;
  - (B) including any other objectively verifiable mistake, whether caused by the property owner or the department, that does not, in the department's judgment, require the department to exercise discretion, judgment, or opinion as to the classification, valuation schedule, use, or value of the property;
  - (C) but not including
    - (i) a change to the value of a previously assessed asset based on the department's subjective reclassification of the property, retrospective application of a policy change or practice, or use of a classification or valuation schedule that did not exist at the time of the original assessment; or
    - (ii) a property owner's or municipality's disagreement or dissatisfaction with the department's discretionary judgment concerning application of a classification or factor schedule;

- (5) “investigation” means a systematic examination of books, records, property, and accounts to verify that all property taxable under AS 43.56 has been identified and reported as required by 15 AAC 56.005, that the information reported is correct, and that the property has been valued in conformity with applicable statutes, regulations, and departmental procedures; “investigation” may include observation, inquiry, audit, and confirmation, as necessary, to obtain information to establish the full and true value of all taxable property;
- (6) “omitted property” means property or property value that is omitted from an assessment roll because the property owner files an inaccurate or incomplete property statement or fails to file a property statement;
- (7) “property owner” means the owner of property taxable under AS 43.56 and the authorized representative or agent of the owner;
- (8) “supplementary or amended assessment roll” means an assessment roll issued after the original assessment roll is certified for a tax year;
- (9) “tax year” means a period beginning on January 1 and ending on the following December 31; [.]
- (10) “boring a well” means digging a hole into the earth in order to find or extract water, oil, natural gas, or natural gas liquids;**
- (11) “intangible development expenses” mean those expenses incurred in preparing the wells for the production of hydrocarbon once the process of boring a well has ceased and the well completion process begins.**

# **EXHIBIT D**

## Proposed changes to 15 AAC 56.120

### 15 AAC 56.120. Intangible Drilling Expenses

- (a) In valuing property upon the basis of actual cost or replacement cost, the department will exclude the value of intangible drilling expenses.
- (b) For purposes of AS 43.56 and this chapter, “intangible drilling expenses” means the intangible drilling expenses defined under 26 U.S.C. 263(c) (Internal Revenue Code) in effect on January 1, 1974, and includes only expenditures for items **incurred in boring a well** that do not have a salvage value even if those items are used in connection with the construction or installation of physical property that has a salvage value. “Intangible drilling expenses” includes expenditures made by an operator, or under contract to an operator, for labor, fuel, repairs, hauling, **rentals, services** and supplies incident and necessary to **boring a well**.
- [(1) DRILLING WELLS];
  - [(2) CLEARING GROUND, DRAINING, ROAD MAKING, SURVEYING, AND GEOLOGICAL WORKS NECESSARY TO DRILLING WELLS; and]
  - [(3) CONSTRUCTION OF DERRICKS, TANKS, PIPELINES, AND OTHER PHYSICAL STRUCTURES NECESSARY TO DRILLING WELLS.]
- (c) “Intangible drilling expenses” does not include
- (1) intangible development expenses;
  - (2) expenditures for tangible property ordinarily considered to have a salvage value, such as drilling tools, pipe, casing, tubing, tanks, engines, boilers, machines, and the actual materials used in the construction or installation of physical structures in the wells or on the property;
  - (3) expenditures made by an operator, or under contract to an operator,
  - (A) for wages, fuel, repairs, hauling, and supplies that are not incident and necessary to **boring a well** [DRILLING WELLS]; [OR]
  - (B) that are properly allocable to the cost of preparation of the wells for the production of hydrocarbon once the process of boring the well has ceased and the well completion process begins; or**
  - (C)**[(B)] that are properly allocable to the cost of depreciable property ordinarily considered to have a salvage value.
- (d) In addition to the expenditure items described in (b) of this section, intangible drilling expenses for offshore oil platforms include expenditures incident and necessary to transport the platform to the well site and to position, erect, and permanently anchor the platform to the ocean floor.