IN THE SUPREME COURT FOR THE STATE OF ALASKA

TESORO CORPORATION AND SUBSIDIARIES, Appellants, vs. STATE OF ALASKA, DEPARTMENT OF REVENUE, Appellee.	)	Supreme Court No. S-14326 Superior Court No. 3AN-09-8897 CI OAH No. 05-0155-TAX

APPEAL FROM THE SUPERIOR COURT
THIRD JUDICIAL DISTRICT AT ANCHORAGE
THE HONORABLE FRED TORRISI, PRESIDING

APPELLANTS' OPENING BRIEF

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ALASKA STAT. 43.19.010. Multistate Tax Compact.

...

Article IV. Division of Income.

...

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

...

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

...

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

(a) separate accounting;

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

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

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

...

ALASKA STAT. 43.20.072. Oil and Gas Producers and Pipelines.

(a) All business income of a taxpayer engaged in the production of oil or gas from a lease or property in this state or engaged in the transportation of oil or gas by pipeline in this state shall be apportioned to this state in accordance with AS 43.19 (Multistate Tax Compact) as modified by this section.

(b) A taxpayer's business income to be apportioned under this section to the state shall be the federal taxable income of the taxpayer's consolidated business for the tax period, except that

(1) taxes based on or measured by net income that are deducted in the determination of the federal taxable income shall be added back; the tax levied and paid under AS 43.55 may not be added back;

(2) intangible drilling and development costs that are deducted as expenses under 26 U.S.C. 263(c) (Internal Revenue Code) in the determination of the federal taxable income shall be capitalized and depreciated as if the option to treat them as expenses under 26 U.S.C. 263(c) (Internal Revenue Code) had not been exercised;

(3) depletion deducted on the percentage depletion basis under 26 U.S.C. 613 (Internal Revenue Code) in the determination of the federal taxable income shall be

recomputed and deducted on the cost depletion basis under 26 U.S.C. 612 (Internal Revenue Code); and

(4) depreciation shall be computed on the basis of 26 U.S.C. 167 (Internal Revenue Code) as that section read on June 30, 1981.

(c) A taxpayer's business income shall be apportioned to this state by multiplying the taxpayer's income determined under (b) of this section by the apportionment factor applicable to the taxpayer among the following factors:

(1) the apportionment factor of a taxpayer subject to this section but not engaged in the production of oil and gas, or of gas only, as appropriate, from a lease or property in this state during the tax period is a fraction, the numerator of which is the sum of the property factor under AS 43.19 (Multistate Tax Compact) and the sales factor under (d) of this section for the taxpayer for that tax period, and the denominator of which is two;

(2) the apportionment factor of a taxpayer subject to this section but not engaged in the pipeline transportation of oil or gas in this state during the tax period is a fraction, the numerator of which is the sum of the property factor under (e) of this section and the extraction factor under (f) of this section for the taxpayer for the tax period, and the denominator of which is two;

(3) the apportionment factor of a taxpayer engaged both in the production of oil or gas from a lease or property in this state and in the pipeline transportation of oil or gas in this state during the tax period is a fraction, the numerator of which is the sum of the sales factor under (d) of this section, the property factor under (e) of this section, and the extraction factor under (f) of this section for the taxpayer for the tax period, and the denominator of which is three.

JURISDICTIONAL STATEMENT

The Superior Court entered its final judgment disposing of all claims on April 28, 2011. This Court has appellate jurisdiction under Alaska Statute § 22.05.010(c).

PARTIES TO THE CASE

The caption of the case on the cover of this brief contains the names of all parties.

ISSUES PRESENTED FOR REVIEW

1. The Superior Court erroneously upheld the Administrative Law Judge's ("ALJ's") conclusion that Tesoro Corporation's ("Tesoro's") Texas and Bolivian natural gas exploration and production business is unitary with Tesoro's crude oil refining and marketing business conducted in Alaska.

2. In the event this Court were to deem Tesoro a single unitary business, the Superior Court erred by concluding that taxing Tesoro under an apportionment formula consisting of the property, sales, and extraction factors did not result in extraterritorial taxation in violation of the United States Constitution.

3. The Superior Court wrongly upheld the ALJ's erroneous application of a deferential "reasonable basis" standard of review to the Alaska Department of Revenue's (the "Department's") decision to impose its alternative method of apportioning multistate business income to the State over Tesoro's proposed alternative method of apportionment. Both Tesoro and the Department agree that an alternative method of apportionment is required under AS § 43.19.010, Article IV, § 18. The question of whether an alternative method of apportionment is "fair" and "reasonable" under § 18 is a question of law that the ALJ should have determined in the exercise of his "independent judgment" under AS § 43.05.435(b). By instead deferring to the Department's determination, the ALJ failed

to consider whether Tesoro's particular facts and circumstances rendered the Department's apportionment method unfair or unreasonable.

4. The Superior Court wrongly upheld the ALJ's erroneous determination that the Department's alternative method of apportionment under § 18 was supported by a "reasonable basis," in view of the fact that the Department admittedly failed to consider any of the particular facts and circumstances of Tesoro's businesses, as required by § 18. Application of the Department's alternative method to Tesoro violated Tesoro's rights under the Due Process and Commerce Clauses of the United States Constitution.

5. The Superior Court erroneously rejected Tesoro's proposed alternative method of apportionment under § 18. Tesoro asserts that its alternative method, separate accounting of Tesoro's natural gas exploration and production income, is the only means of attributing an amount of income to Alaska that is fairly and reasonably related to the refining and marketing business activity that took place within the State.

6. The Superior Court erred in failing to hold that AS § 43.20.072 violated the Due Process or Commerce Clause of the United States Constitution; that Alaska statute accords differential tax treatment to taxpayers depending upon the in-state or out-of-state location of their business operations. At a minimum, this differential treatment violates the internal consistency and anti-discrimination requirements set forth by the United States Supreme Court in *Complete Auto Transit v. Brady*, 430 U.S. 274, 279 (1977).

7. The Superior Court erred by upholding the failure to pay and negligence penalties that the Department imposed upon Tesoro, in view of the fact that, inter alia, the amounts demanded were assessed under an unconstitutional statute.

8. The Superior Court erroneously upheld negligence penalties imposed upon Tesoro, on the ground that Tesoro should have paid the disputed taxes under protest and then sued for a refund. This conclusion was unsupported by the weight of the evidence because it did not account for the facts (1) that Tesoro, the Alaska Attorney General, the Department, and the ALJ all agree that AS § 43.20.072 was unfair as applied to Tesoro during the Audit Period, (2) that unfairness resulted in the apportionment by the Department of approximately $45 million in income to Alaska above and beyond the amount the ALJ held should be apportioned to the state, (3) that Tesoro notified the Department no later than 1997 that it believed AS § 43.20.072 was unfair and unconstitutional, and (4) that the Department did not publicly acknowledge nor attempt to take corrective action to alleviate the unfairness of AS § 43.20.072 until November 1999, after Tesoro had filed its tax returns for all years within the Audit Period.

STATEMENT OF THE CASE

The Alaska Department of Revenue seeks to tax $89 million of income and to impose penalties on Tesoro Corporation (Tesoro), a holding company that owned substantively and geographically diverse businesses between 1994 and 1998 (the "Audit Period"). The lion's share of that income is directly attributable to a Texas and Bolivia natural gas exploration and production segment (E&P) that conducted no business in Alaska, had no connection with Alaska, and shared little other than a common parent with the company's separate Alaska business, a crude oil refining and marketing operation (R&M) that barely turned a profit. In fact, the Department seeks to reach beyond Alaska's borders and to capture for taxation *six times* the income that R&M's Alaskan activities generated.

The ALJ's and Superior Court's decisions, which were rendered as a matter of law because "there was not a great deal of evidence in dispute in this case" [Exc. 11, 37], rest on a series of constitutional and legal errors that contravene binding precedents of this Court and of the United States Supreme Court. This Court should reverse those decisions and enter judgment for Tesoro for at least three reasons:

- *First*, the Department acknowledges that E&P and R&M were not horizontally or vertically integrated, and were engaged in different businesses in different locations. The ALJ found that Tesoro's executive management "was principally trained in finance and lacked the operational expertise . . . to run the operating segments," that E&P's and R&M's officers independently operated "dissimilar" businesses with no direct connection to each other, and that "there were not significant flows of product or personnel directly between E&P and R&M." [Exc. 41–49]. Yet the Superior Court held that E&P and R&M were "unitary" merely because they received routine oversight and administrative services from a common corporate parent. [Exc. 11–18].

- *Second*, the Department concedes that the two-factor apportionment formula prescribed by Alaska Statute § 43.20.072 is unconstitutional and that the resulting $134 million is a gross overcalculation of Tesoro's Alaska taxable income. But the Department rejected the remedy of separate accounting authorized by Alaska law, and contended that its belated interjection of a third factor into the formula cures the constitutional infirmity. The Superior Court improperly deferred to the Department's revised three-factor formula and shifted the burden of proof to Tesoro. [Exc. 21–22]. Compounding this error, the Superior Court upheld the Department's formula even though it violates the internal-consistency requirement and the resulting $89 million in Alaska taxable income is wildly disproportionate to the less than $14 million generated by Tesoro's in-state business activities. [Exc. 21–27].

- *Finally*, "both parties realized" that § .072 is unconstitutional and would have required Tesoro to "overpa[y] significantly," but the Department did not change the rules to its three-factor formula until the post-filing audit. [Exc. 28]. The Superior Court therefore erred when it upheld the Department's imposition of 30% failure-to-pay and negligence penalties on Tesoro.

STATEMENT OF THE FACTS

The following facts are established by the record and are not in dispute.

I. ALASKA'S PETROLEUM BUSINESS INCOME TAX

Because a state may not tax value earned outside its borders, taxing authorities have developed two principal methods to determine a state's taxable portion of a multistate business's income: separate accounting and formula apportionment. Separate accounting "attempts to carve out of the taxpayer's overall business the income derived from sources within a single state, and by accounting analysis, to determine the profits attributable to that portion of the business." *Atl. Richfield Co. v. State*, 705 P.2d 418, 422 (Alaska 1985). Formula apportionment instead applies a formula—traditionally incorporating the ratios of the business's in-state and total property, sales, and payroll—to determine the state's taxable "share" of the business's total income. *Id.* at 423.

Because formula apportionment sweeps in out-of-state income, a state may constitutionally apply it only to a "unitary" business. *Id.*; *Mobil Oil Corp. v. Comm'r of Taxes of Vt.*, 445 U.S. 425, 438 (1980). "Unitary" means that the business's "intrastate and extrastate activities" experience "contributions to income resulting from functional integration, centralization of management, and economies of scale." *Mobil Oil*, 445 U.S. at 438.

From 1978 to 1981, Alaska utilized a form of separate accounting for petroleum businesses. *See* AS § 43.21 (repealed 1982). This Court upheld that methodology, expressly noting its superiority to formula apportionment for the oil and gas industry. *See Atl. Richfield*, 705 P.2d at 422–27. The Court pointed out that the traditional criticisms of separate accounting "are inapplicable to the oil and gas industry," and that separate accounting "more accurately reflects income than formula apportionment" and recognizes "the precise geographical source of a corporation's profits." *Id.*

In 1982, the Legislature replaced the separate accounting this Court upheld in *Atlantic Richfield* with a form of formula apportionment in § .072. Section .072 purports to set out the tax scheme for "a taxpayer engaged in the production of oil or gas" or "the transportation of oil or gas by pipeline" in Alaska. AS § 43.20.072(a). But § .072 applies different apportionment factors depending on which of those activities the business conducts in Alaska. In particular, Section .072 prescribes (1) a two-factor property and extraction formula for a business conducting production activities in Alaska; (2) a two-factor property and sales formula to a business conducting pipeline activities in Alaska; and (3) a three-factor property, sales, and extraction formula for a business conducting both activities in Alaska. *See id.* § 43.20.072(c). A business conducting neither production nor pipeline activities in Alaska is subject to the traditional property, sales, and payroll formula under the Uniform Division of Income for Tax Purposes Act (UDITPA), even if it conducts either or both activities in another state. *See id.* § 43.19.010, art. IV, §§ 9–17.

Alaska also has enacted § 18 of UDITPA. *See id.* § 43.19.010, art. IV, § 18. Section 18 permits deviations from statutory formula apportionment where that approach "do[es] not fairly represent the extent of the taxpayer's business activity in this state." *Id.* In such cases, § 18 authorizes the use of "separate accounting" or "the inclusion of one or more additional factors" in the apportionment formula. *Id.* § 18(a), (c). A § 18 remedy must itself be reasonable and constitutional in the case in which it is applied. [Exc. 23, 75–76].

In an October 1999 opinion, the Alaska Attorney General acknowledged that § .072 violates the constitutional requirement of internal consistency, and advised the Legislature to review § .072 "in its entirety and determine whether legislation should be proposed to cure constitutional deficiencies." [Exc. 545, 549]. The Attorney General recommended that, in

the interim, § 18 be used as "a constitutional circuit breaker" in cases where § .072 "result[s] in the unconstitutional taxation of a unitary business." *Id.* While the Department had known of this constitutional infirmity at least since 1982 [Exc. 124–27], it issued a notice formally recognizing the infirmity only in November 1999 [Exc. 552–53]. It also has attempted to invoke § 18 to remedy § .072's unconstitutionality in individual cases. *Id.* The Department followed that approach when it retroactively assessed Tesoro's taxes for the Audit Period. To date, the Legislature has failed to cure this constitutional infirmity.

II. TESORO'S NONUNITARY BUSINESS DURING THE AUDIT PERIOD

In the early-to-mid-1980s, Tesoro was not the company that it was during the Audit Period. It was a large and sprawling, horizontally and vertically integrated business enterprise with over 3,000 employees. It operated oil refineries in Texas and Alaska, and explored for and produced crude oil and natural gas across the United States, Indonesia, Turkey, Bolivia, and Trinidad-Tobago. [Exc. 129–39]. During these years, Tesoro filed as a unitary non-petroleum business in Alaska because its operations were integrated, and it had no qualifying production or pipeline in the State. *See* AS § 43.20.072(a).

Tesoro during the Audit Period was a very different story, with a fundamentally different business structure. Due to a series of reversals in the global oil industry, Tesoro suffered losses of over $250 million between 1984 and 1989. To avoid bankruptcy, Tesoro sold all of its domestic production properties except for its interests in a natural gas discovery in South Texas, and it sold or wrote off its activities in Trinidad-Tobago, Indonesia, and Turkey. [Exc. 133, 566]. Tesoro also drastically restructured its management: of the 27 officers listed on Tesoro's 1984 10-K, only one remained by 1994. [Exc. 140, 253].

Tesoro thus emerged from the 1980s as a holding company for three discrete

business lines, instead of the sweeping integrated enterprise it once had been. During the Audit Period, Tesoro conducted no business operations. Instead, it owned E&P's natural gas production interests in Texas and Bolivia, R&M's crude oil and refined product activities in Alaska and along the West Coast, and a small number of marine services operations in Texas and Louisiana. [Exc. 241, 253].[1] Those segments had fewer than 1000 employees total.

A. E&P's And R&M's Autonomous Operations

As the ALJ found, E&P and R&M "were not integrated" horizontally or vertically and had no direct connection to each other. [Exc. 13.] "E&P was a gas business, while R&M was an oil business, and the two segments were in many ways dissimilar." [Exc. 49]. Thus, "there was little or no flow of products or operational expertise between" them, and there were few, if any, "opportunities for operational synergies." [Exc. 13]. E&P and R&M were centered in "different geographical locations," separated by thousands of miles—E&P in Texas and Bolivia, and R&M in Alaska. [Exc. 33].

Tesoro's executive management was what one might expect of a holding company. They were "principally trained in finance" and "lacked the operational expertise or experience to run its operating segments." [Exc. 41]. E&P and R&M therefore had strong, autonomous local management that ran each segment's "day-to-day operations independently" and made many long-term decisions without Tesoro's involvement. [Exc. 13, 41]. E&P's President, Bob Oliver, had authority to approve individual transactions of up to $2 million, which was 90-95% of all E&P expenditures. [5/5/08 Tr. 165–66]. R&M's President, Steve Wormington, had an authority limit of $45 million per transaction, which, at prevailing 1997 prices, allowed him to purchase enough crude oil in a single transaction to

[1] These marine services operations and income are not at issue in this appeal.

operate R&M's Alaska refinery for 49 days. [*Id.* at 227–28; R. 9483; Exc. 407]. Bob Oliver testified that Tesoro's Board of Directors *never* disapproved a single expenditure that E&P proposed for its approval. [5/5/08 Tr. 171–72].

E&P and R&M each had its own separate board of directors. Tesoro's top three executive officers regularly served as the sole members of these boards, but offered no operational input to E&P and R&M. [Exc. 667-68, 708, 655; 5/5/08 Tr. 163–65, 168–69, 222–26]. In fact, the E&P and R&M boards rarely, if ever, met during the Audit Period because the officers unique to each segment ran the separate businesses largely without the need of formal advice or approval. [*Id.* at 150, 226].

1. E&P's Texas And Bolivia Operations And Income

E&P had no employees, property, or activity in Alaska during the Audit Period. [R. 5399–5407, 5437–44, 5467–74, 5489–98]. E&P was a group of corporations and partnerships that explored for, produced, and marketed natural gas primarily in Texas and Bolivia. [R. 15168]. E&P had no companies in common with R&M. [*Id*].

Under his generous approval authority, Bob Oliver made all day-to-day decisions; executed natural gas purchase and sales contracts [R. 29703–09, 29930–37, 29938–51], mineral interest purchase contracts [R. 29729–56, 29762–29924, 29952–54], and litigation settlement documents [Exc. 392–95]; and authorized substantial domestic and international expenditures [Exc. 206–23]. Oliver was the "face" of E&P, both internally to the Board [Exc. 143–44, 324, 467B] and employees [Exc. 288, 306], and externally to the investment community and general public [Exc. 397, 398–404, 405].

E&P was enormously successful during the Audit Period: its domestic operations grew from a 12-person operation that passively oversaw another operator's domestic

development of a single field to a 40-person business that actively operated multiple fields. [R. 24727–28; R. 25031]. E&P's independent officers made a number of sound business decisions that generated the vast majority of the income that the Department now seeks to tax. Most of that income arose from two isolated events: (1) the 1995 sale of a portion of the Bob West Field in South Texas for $68 million in gross proceeds; and (2) the 1996 resolution of litigation that resulted in a $127 million payout to E&P.

Sale Of A Portion Of The Bob West Field. Until 1995, the Bob West Field was E&P's sole domestic production asset. [5/8/08 Tr. 175]. E&P Manager John Bissell discovered the field in 1989, and by 1996 it had become one of the largest natural gas finds in the United States. [*Id.*] E&P operated the field jointly with Coastal Oil & Gas ("Coastal"). Tesoro's role in the development of the field—essentially providing geological expertise—was carried out exclusively by Oliver, Bissell, and E&P staff.

In September 1995, E&P sold the C, D, and E natural gas units of the field to Coastal for $68 million. [Exc. 321]. Tesoro reinvested the proceeds in other E&P projects, reduced corporate level debt, and improved corporate liquidity. [*Id.*; Exc. 306].

Settlement And Buyout Of The Tennessee Gas Contract. E&P had a take-or-pay contract with Tennessee Gas Pipeline Company ("Tennessee Gas") that entitled it to an above-market price for the natural gas produced on the A and B units of the Bob West Field. [R. 10113–51; Exc. 178]. In 1990, Tennessee Gas filed suit challenging the validity of the contract and withheld payments. In August 1996, the Texas Supreme Court upheld the contract, and Tennessee Gas paid $67.7 million in accrued back payments pursuant to a settlement. [R. 10113–51]. In December 1996, Tennessee Gas bought out the remainder of the contract for an additional $60 million. [Exc. 379, R. 10177]. Tesoro used this

approximately $127 million to finance E&P's capital expenditure program and to fully redeem Tesoro's public debt issuances. [Exc. 378A–78B]. None of the proceeds went to Alaska R&M.

Tesoro's Sale Of E&P. On May 27, 1999, Tesoro announced its intention to sell E&P. [R. 11929–30]. The markets responded positively to the news, elevating Tesoro's stock price relative to the market and its peers by a statistically significant percentage. [*Id.*; R. 14892]. The offering memorandum touted the expertise of the fully-functional E&P management and staff with the talents necessary for a stand-alone operation. [Exc. 502–42; 5/8/08 Tr. 91–92]. Tesoro sold E&P's domestic and Bolivia operations as going concerns, each to a separate buyer, in December 1999. [Exc. 556].

2. R&M's Alaska Operations

R&M is a distinct group of corporations and partnerships that refined crude oil purchased from third parties into a slate of products and marketed those products to customers. [R. 15168]. At the start of the Audit Period, R&M's only refinery was in Kenai, Alaska, and its retail operations were solely in Alaska. [Exc. 167]. During 1998, R&M's operations expanded to include refineries in Washington and Hawaii and retail operations along the West Coast. [Exc. 474].

During the majority of the Audit Period, R&M realized very low profit margins. [Exc. 257–85]. In 1995, Tesoro CEO Bruce Smith hired Steve Wormington as R&M's President. [5/5/08 Tr. 219–20]. Wormington accepted because Smith wanted him to be responsible for operations, with full authority to make day-to-day decisions. [*Id.* at 221].

Wormington exercised operational authority and made decisions ranging from staffing to refinery processing rates to pricing policies. [Exc. 701]. Beyond day-to-day

decisions, Wormington was responsible for developing and presenting R&M's annual budget to Tesoro's Board. [Exc. 688–89]. Wormington and his team developed and implemented capital-intensive initiatives that had a long-term impact on R&M. [Exc. 722–39; Exc. 682; 5/5/08 Tr. at 228–30]. Those initiatives included:

- Installing a $25 million vacuum unit at the Kenai refinery—a project proposed, negotiated, installed, and operated solely by R&M employees [5/5/08 Tr. 217; Exc. 190, 192, 194, 196, 198, 202–04];
- Installing a $1.5 million facility to produce and market asphalt using a by-product from the vacuum tower [Exc. 256];
- Expanding the capacity of the Kenai refinery through a $17 million project coordinated and brought on-line by R&M employees [Exc. 326–29, 335–36; Exc. 380-83];
- Improving the quality and image of existing retail stations and expanding the number of retail stations from 88 to 129 [Exc. 243, 421].

R&M posted weak profits of $2.4 million in 1994 and $700,000 in 1995. [Exc. 441]. After implementation of Wormington's initiatives, R&M's operating profits rose to $6 million in 1996 and $20.5 million in 1997. [*Id.*] Because a portion of these earnings was attributable to R&M's operations elsewhere along the West Coast, the Alaska share of R&M's income during the Audit Period was less than $14 million.

B. Tesoro's Functions As A Parent Holding Company

Because "operational expertise of E&P's and R&M's day-to-day operations did not exist at the level of Tesoro's top management team" [Exc. 41], Tesoro's involvement with those segments consisted solely of executive oversight, administrative support, and arm's-length provision of administrative services.

Executive Oversight And Administrative Support. Tesoro's Board was not actively involved in strategic planning for any of the segments; it exercised only high-level

oversight over matters such as approval of business plans, financial reporting, major asset sales and acquisitions, capital budgets, and employee compensation. [5/7/08 Tr. 87–88; 5/9/08 Tr. 61–62; Exc. 153–54]. Because E&P's and R&M's officers made virtually all decisions, the Board approved only major financial decisions such as R&M's acquisitions of refineries [Exc. 414, 447] and the management of Tesoro's company-wide credit facilities and debt [Exc. 300].

Tesoro's executive management focused on addressing Tesoro's precarious financial position and providing oversight of the subsidiaries. Tesoro's CEO Bruce Smith was "singularly focused" on restructuring the company's balance sheet, and spent most of his early tenure in New York working with investment bankers. [5/9/08 Tr. 6–12]. Tesoro's stock also was not widely followed by major investment banks and analysts in the early 1990s, as Tesoro's nonintegrated structure was too complex for a company of its size. [*Id.* at 56; 5/5/08 Tr. 179–80]. This lack of comparability caused Tesoro's stock to trade at a discount relative to peer companies, making it difficult to attract shareholders and to raise capital. [Exc. 341; Exc. 711; 5/7/08 Tr. 101–04]. Many analysts advocated selling R&M to simplify the business. [Exc. 717]. A key responsibility of executive management, therefore, was to put on road shows and attend analyst meetings to explain the nature of Tesoro's disparate and non-integrated business operations to the investment community.

Arm's-Length Provision Of Administrative Services. Tesoro had an administrative services affiliate, Tesoro Petroleum Companies, Inc. ("TPCI"), that provided services to Tesoro's operating segments under an arm's-length administrative services agreement (the "ASA"). The services TPCI provided fell within a limited number of categories: environmental and safety, computer services and technology, internal audit, legal

affairs, insurance, accounting, tax, human resources, benefits, and purchasing. [Exc. 20]. Because E&P and R&M had their own staffs of accountants, centralized accounting handled accurate allocation of administrative costs and the consolidation and reporting of financial results. [Exc. 19; Exc. 644]. The only evidence of any centralized purchasing was a 1984 policy listing specific office equipment that should be ordered through a centralized department. [R. 9601–11].

TPCI's services generated no revenue for E&P or R&M. Indeed, public companies typically procure these types of services from a central provider. [5/9/08 Tr. 173:4-14]. The IRS considers these services to be "support services common among taxpayers in a variety of industry sectors," in recognition of their low-margin, commodity nature. [Exc. 631]. A substantial number of these services also relate to functions that state and federal law compel all corporations to perform on a consolidated basis, such as filing EEOC and Veterans Employment reports [R. 18809-19147]; SEC filings; federal tax filings, *see* 26 U.S.C. § 1501 (2008); and environmental compliance oversight [Exc. 251–52]. Other services, such as internal auditing and cash management, are necessarily company-wide because of the fiduciary obligation to shareholders. [Exc. 153, R. 19377].

The combined cost of all services provided under the ASA ranged between 1 and 2% of Tesoro's annual costs of doing business. [5/9/08 Tr. 185–86]. E&P's portion of these shared costs in 1996 was approximately $2.4 million, about the cost of drilling one of the 20 wells it drilled that year. [Exc. 356; *see also* Exc. 206–23]. R&M's portion of these shared costs in 1996 was approximately $4.3 million, less than the amount R&M spent to purchase crude for a week's operations at the Kenai refinery. [Exc. 407]. E&P's President testified that "[t]he allocation was so low that it impact[ed] us to such a low degree, I had more

important things to worry about. . . . They didn't have a significant impact on our performance or our results." [5/5/08 Tr. 178].

TPCI billed to E&P and R&M all costs related to its services. [Exc. 182–89]. TPCI increased most charges by a markup to reflect the cost E&P and R&M would have paid to obtain the services on the open market. [*Id.*; 5/12/08 Tr. 260–61]. TPCI's accounting staff consistently identified, tracked, and allocated all costs and appropriate markups for the services TPCI provided. [Exc. 354–76.] TPCI reported the expenses and allocations to the operating segments monthly, and conducted an annual "true-up" to confirm their accuracy. [Exc. 645–46, Exc. 647A; 5/9/08 Tr. 175; Exc. 224].

III. THE DEPARTMENT'S ASSESSMENTS AND THE DECISIONS BELOW

A. The Department's Assessments Relating To The Audit Period

Tesoro's amended tax returns for the Audit Period reflect the non-unitary nature of its Texas and Bolivia natural gas operations and its distinct Alaska crude oil operation: they treat R&M's income as Tesoro's only Alaska taxable income. R&M became subject to § .072 in 1995, when it purchased a short pipeline connecting its Kenai refinery to adjacent dock facilities that it had previously leased. Tesoro filed its amended returns from 1995 forward as a petroleum business, and accurately reported R&M's Alaska income of less than $14 million during the Audit Period. [Exc. 594, 606, 618, 630].

The Department sought to treat Tesoro's distinct operating segments as one single unitary business and to capture for taxation all income generated by those segments. Tesoro therefore filed formal petitions seeking separate accounting under § 18 as relief from (1) the Department's attempt to tax E&P and R&M as a unitary business, and (2) the unconstitutional effects of § .072. [Exc. 581, 594, 606, 618, 630].

The Department issued assessments on October 1, 1998 and September 18, 2001 covering tax years 1994–1995 and 1996–1998, respectively. The Department made three calculations to arrive at Tesoro's purported Alaska taxable income. *First*, relying on its position that E&P and R&M were unitary, the Department captured in Tesoro's taxable income the more than $200 million that E&P earned in Texas and Bolivia. *Second*, the Department applied § .072's unconstitutional two-factor formula to apportion to Alaska approximately $134 million of that income. *Third*, invoking its preferred approach to § 18, the Department later added a third factor,[2] extraction, and modified Tesoro's Alaska taxable income to approximately $89 million—still over $75 million more than and six times R&M's income during the Audit Period attributable to in-state activities.

Even though the Department had long been aware of § .072's unconstitutionality, and Tesoro would have "overpaid significantly" under that statute, the Department did not apply its three-factor formula until the audit. [Exc. 28]. Yet the Department assessed 30% failure-to-pay and negligence penalties on Tesoro. The total assessment of taxes, interest, and penalties was $10,789,138, more than 75% of R&M's in-state earnings.

B. The ALJ's Decisions

Tesoro appealed the Department's assessment to the ALJ. Tesoro filed a motion for partial summary adjudication seeking rulings that separate accounting is required, that the Department's three-factor formula was invalid under § 18, that § .072 is unconstitutional, and that § .072's unconstitutionality forecloses the imposition of penalties. The Department

[2] In fact, the Department's October 1, 1998 assessment did not apply the extraction factor to Tesoro. [Exc. 469]. It was applied by the Department later in the Informal Conference Decision.

also moved for partial summary adjudication, asserting that its use of the three-factor formula was not an abuse of discretion.

The ALJ failed to require the Department to prove that its three-factor formula was "reasonable" under § 18. [Exc. 79]. Instead, he deferred to the Department's "choice of relief" and shifted the burden to Tesoro to prove that the Department's approach was "unreasonable." *Id.* Thus, even though he recognized that § .072 is "unfair" and that § 18 does not permit "methodologies that would be unconstitutional," he held that Tesoro had not shown an abuse of the Department's "wide discretion in choosing a remedy." [Exc. 75–80]. The ALJ also concluded that he lacked authority to declare § .072 unconstitutional and rejected Tesoro's challenge to the imposition of penalties. He therefore denied Tesoro's motion and granted the Department's motion. [Exc. 82].

After a hearing on the remaining issues in the case, the ALJ entered a Final Decision on April 22, 2009. The ALJ found that Tesoro's management "was principally trained in finance and lacked the operational expertise or experience to run the operating segments," that E&P and R&M were not horizontally or vertically integrated and autonomously operated "dissimilar" businesses in different locations, and that "there were not significant flows of product or personnel directly between E&P and R&M." [Exc. 41, 49]. Yet the ALJ brushed aside his own findings and deemed E&P's Texas and Bolivia operation and R&M's Alaska operation "unitary" as a matter of law, thus allowing the Department to tax a share of E&P's $200 million out-of-state earnings. [Exc. 34].

The ALJ rested this holding almost exclusively on four facts: (1) Tesoro's ownership of E&P and R&M [Exc. 38–39]; (2) TPCI's arm's-length provision of administrative services [Exc. 42–52]; (3) the overlapping membership on Tesoro's, E&P's, and R&M's boards of

directors [Exc. 39]; and (4) Tesoro's centralization of certain, albeit limited, financial, budgeting, tax, human resources, and purchasing functions (Ex. 43–48). The ALJ counted each of these standalone facts multiple times in evaluating the three prongs of the unitary-business inquiry (centralization of management, functional integration, and economies of scale), with the result that two businesses having little more than a shared corporate umbrella in common were taxed as a single, unitary business. [Exc. 42–53].

The ALJ also upheld the Department's assessment of penalties despite § .072's undisputed unconstitutionality and the Department's failure to apply its preferred § 18 remedy until after Tesoro filed its returns. [Exc. 66].

C. The Superior Court's Decision

On Tesoro's appeal, the Superior Court affirmed. The Superior Court recognized that E&P and R&M "ran day-to-day operations independently," were "distinct geographically," "didn't share employees," "were not integrated either horizontally or vertically," operated in "two quite different parts of the petroleum industry," and had few, if any, "opportunities for operational synergies." [Exc. 13]. The Superior Court further acknowledged that "there was little or no flow of products or operational expertise between" E&P's Texas and Bolivia natural gas operation and R&M's Alaska crude oil operation, and that the ALJ "certainly" relied on "some factual overlap" in applying the factors of profitability. [Exc. 12]. Yet the Superior Court concluded that the routine parent-subsidiary oversight and support identified by the ALJ—such as "overlapp[ing]" boards, consolidated human resources and administrative services, and "[c]ollective financing"—were sufficient to establish that E&P and R&M were unitary. [Exc. 11–13].

The Superior Court also upheld the ALJ's deference to the Department's three-factor

formula and allocation of the burden of proof to Tesoro. [Exc. 21–22]. The Superior Court recognized that the Department may not "implement an unreasonable process, or one that is not internally consistent"—but it held that application of the extraction factor was internally consistent and comported with the Department's "inherent grant of discretion." [Exc. 23–26]. It therefore rejected Tesoro's showing that separate accounting is constitutionally and statutorily required in this case. [Exc. 27].

The Superior Court acknowledged that "both parties realized that . . . [§ .072] is unconstitutional," and that Tesoro "would have overpaid significantly" if it had paid taxes as prescribed by that statute. [Exc. 28]. The Superior Court also expressed "appreciation for the difficulty of the task facing the tax consultants for interstate concerns." [Exc. 29]. Yet it upheld the Department's imposition of penalties. [*Id.*]

Tesoro's timely appeal to this Court followed.

STANDARDS OF REVIEW

This Court reviews findings of fact for support by substantial record evidence, and applies the substitution-of-judgment test to questions of law. *Nw. Med. Imaging, Inc. v. Dep't of Revenue*, 151 P.3d 434, 438 (Alaska 2006); *see also* AS § 44.62.570. Where, as here, the evidence is not in dispute [Exc. 11, 37], the questions resolve to questions of law, making *de novo* review under the substitution-of-judgment test appropriate. *Earth Res. Co. v. State Dep't of Revenue*, 665 P.2d 960, 964–65 (Alaska 1983).

ARGUMENT

"As a general principle, a state may not tax value earned outside its borders." *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 315 (1982). "[A] state which controls the property and activities within its boundaries of a foreign corporation admitted to do

business there may tax them. But the due process clause denies to the state power to tax or regulate the corporation's property and activities elsewhere." *Conn. Gen. Life Ins. Co. v. Johnson*, 303 U.S. 77, 80–81 (1938).

The Department's decision to tax $75 million of income generated by Tesoro's Texas and Bolivia natural gas exploration and production operation ran afoul of this venerable constitutional principle.[3] The Superior Court's decision should be reversed.

I. TESORO'S TEXAS/BOLIVIA GAS-EXPLORATION BUSINESS AND ITS ALASKA OIL REFINING BUSINESS ARE NOT UNITARY

"The definition of a unitary business is a judicial concept designed to limit state taxation to constitutionally permissible boundaries." *Earth Res.*, 665 P.2d at 965. Thus, "the question whether a taxpayer's business is unitary is a question of law which does not require agency expertise for its resolution, and . . . the substitution of judgment standard of review should be applied by courts reviewing the Department's application of the unitary business concept to a taxpayer's business activity." *Id.*

The Due Process Clause allows a state to base its income taxes upon the entire apportioned income of a multistate business *only* if the business is "unitary." *Mobil Oil*, 445 U.S. at 441–42. "Unitary" means that "the intrastate and extrastate activities for[m] part of a single unitary business," where "contributions to income resul[t] from functional integration, centralization of management, and economies of scale." *Id.* at 438.

The mere fact that two or more activities occur within a common corporate structure

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[3] Excluding E&P's income from apportionable unitary income in 1996 yields Alaska an apportioned loss of approximately $4.5 million, while including E&P's income would yield Alaska apportionable income of $58.5 million. [R. 11973–74]. The unitary test was created to reliably estimate the "value earned" within a state, yet treating these businesses as unitary here would allow Alaska to tax far more than its fair share of Tesoro's income.

is not enough to satisfy the unitary-business inquiry. *See, e.g., F.W. Woolworth Co. v. Taxation & Revenue Dep't. of N.M.*, 458 U.S. 354, 362–63 (1982) ("the *potential* to operate a company as part of a unitary business is not dispositive" because the Court's cases under the unitary-business principle "demand more" than just "some economic benefit" from the out-of-state segment to the in-state segment). Here, the ALJ and the Superior Court erroneously relied on little more than ordinary incidents of a common corporate structure to hold that Tesoro's Texas/Bolivia gas exploration segment and its Alaska oil-refining segment were unitary.

A. No U.S. Supreme Court Case Has Upheld A Finding That Businesses As Disconnected As Tesoro's Are "Unitary"

The U.S. Supreme Court has developed the modern unitary business test in five cases over the last 30 years—*Mobil Oil*, *Exxon*, *Woolworth*, *ASARCO*, and *Container Corp.* It first articulated the modern test in its 1980 decision in *Mobil Oil*, where it held that business segments are unitary if they materially benefit from three "factors of profitability": (1) functional integration, (2) centralization of management, and (3) economies of scale. 445 U.S. at 438. Two segments are *not* unitary, however, if the income of one in one state is "earned in the course of activities unrelated" to the activities of the other in another state. *Id.* at 439. The Court held that Mobil's vertically integrated business enterprise materially benefited from the three unitary factors, allowing Vermont to tax a portion of income generated by Mobil's unitary foreign subsidiaries even though those subsidiaries did not conduct any business in the state. *Id.* at 441–42.

Three months later, the Court applied the same rationale in *Exxon Corp. v. Wisconsin Department of Revenue* and determined that the vertical (and horizontal) integration of Exxon's businesses authorized Wisconsin to tax an apportioned amount of income received from

Exxon's out-of-state operating divisions that had no independent connection with the state. 447 U.S. 207, 224 (1980).

Two years later, the Court decided *ASARCO* and *Woolworth*. Each case held that the respective taxpayers and their out-of-state subsidiaries were not engaged in unitary businesses (and, thus, the states could not apportion the income of each taxpayer's out-of-state subsidiaries). In *ASARCO*, the taxpayer and its subsidiaries were vertically integrated, but to a lesser degree than Mobil or Exxon.[4] Despite the elements of vertical integration, the Court held that the parent and its subsidiaries were not unitary because the parent did not exercise sufficient *actual control* over its subsidiaries' operations. 458 U.S. at 322. *ASARCO* is particularly relevant to this case because the Court there rejected Idaho's attempt to base unity upon the increased financial power that the parent could have exercised because of its ownership of the subsidiaries. *Id.* at 326.

In *Woolworth*, the Court first examined the unitary business principle as applied to a horizontally integrated enterprise, and determined that the taxpayer was not unitary with its out-of-state subsidiaries. *Woolworth* is significant because it (1) distinguishes *potential* from *actual* control, (2) rejects a finding of unity based upon an intermingling and use of funds for general corporate purposes, and (3) establishes that functional integration means the integration of *operations*. 458 U.S. at 362, 364 n.11, 371. *Woolworth* also crucially recognizes that, although the taxpayer and its subsidiaries were all engaged in retailing, local operational autonomy combined with oversight by executive management and provision of combined administrative services did not amount to a unitary business. *Id.* at 354, 369–70.

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[4] For example, the Court noted that the parent purchased about 35% of the output of one of the subsidiaries at issue. 458 U.S. at 321.

In 1983, the Court in *Container Corp.* again applied the unitary business principle to a horizontally integrated enterprise. The Court reached a different result than in *Woolworth*, largely because the parent indisputably shared managerial and manufacturing expertise (including manufacturing techniques, engineering, design, and architecture) with its affiliates, all of which were engaged in the exact same business—the manufacture of custom-ordered paperboard packaging. 463 U.S. 159, 173 (1983) ("[Taxpayer] also provided advice and consultation regarding manufacturing techniques, engineering, design, architecture, insurance, and cost accounting to a number of its subsidiaries, either by entering into technical services agreements with them or by informal arrangement."). The parent also helped acquire operating equipment, fill personnel needs, and obtain funding for its affiliates. *Id.* at 172–73. The Court concluded that the combination of these facts demonstrated a unitary business. *Id.* at 175–80.

B. The ALJ and the Superior Court Erred By Determining That Tesoro's Texas and Bolivia Natural-Gas Business Was Unitary With Its Alaska Oil-Refining Business Based On The Presence Of Typical Corporate Commonalities, Counted Multiple Times

Here, the facts of record, and those found by the ALJ, demonstrate that Tesoro's Alaskan oil business was a "discrete business enterprise" from its Texas and Bolivia natural gas operations, not a unitary enterprise as the ALJ and the Superior Court concluded. *MeadWestvaco Corp. v. Ill. Dep't of Revenue*, 553 U.S. 16, 25 (2008). Indeed, the U.S. Supreme Court squarely has held that common ownership is insufficient to establish unity, and *never* has deemed businesses unitary where, as here, they were not horizontally or vertically integrated, and had no flow of products between them. *See, e.g., Mobil Oil*, 445 U.S. at 438–

42; *Exxon*, 447 U.S. at 224; *ASARCO*, 458 U.S. at 322; *Woolworth*, 458 U.S. at 362; *Container Corp.*, 463 U.S at 172-80.

The ALJ and the Superior Court, however, contravened these binding precedents when they concluded that mere incidents of Tesoro's common ownership of E&P and R&M created "flows of value" sufficient to demonstrate unity. [Exc. 52]. The error in this conclusion is most plainly on display in (1) the ALJ's reliance on the identical evidence, multiple times, to demonstrate each of the three unitary factors, and (2) the ordinariness of that evidence, which showed scarcely more than that E&P and R&M were part of the same overall corporate structure.

As to the first point, the ALJ used the same standalone facts to prove the existence of each factor of profitability. He cited Tesoro's limited common administrative services as evidence of centralized management, ***and*** functional integration, ***and*** economies of scale. [Exc. 42, 44–45, 52]. He then did the same with credit facilities [Exc. 44, 51–52]and cash management [Exc. 44, 47, 53] citing each as evidence of ***both*** functional integration ***and*** centralization of management. He did the same with respect to Tesoro's budgeting and planning process tax strategizing, and purchasing policy. [Exc. 43–48].

As to the second point, these limited facts, even if counted multiple times, do not demonstrate that Tesoro's Texas/Bolivia gas business was unitary with its Alaska oil business. Rather, the only judgment that could be reached on this essentially undisputed record is that the two business lines were discrete, non-unitary enterprises such that the Department erred in imposing Alaska taxes on E&P's Texas and Bolivia income.

1. ***There Was No Functional Integration.*** The U.S. Supreme Court has never found "functional integration" to demonstrate a unitary business where, as here, the

companies' operations are neither vertically nor horizontally integrated.[5] This makes perfect sense: Absent such integration, no substantial value can be transferred between business segments. Horizontal integration may facilitate the sharing of operational functions, *see Container Corp.*, 463 U.S. at 166, while vertical integration allows a taxpayer to coordinate a "series of transactions" among affiliates, *Mobil Oil*, 445 U.S. at 438–39; *see also Exxon*, 447 U.S. at 226.

But even though vertical or horizontal integration is a *necessary* condition to functional integration, it is not a *sufficient* condition. Thus, in *Woolworth*, the Supreme Court recognized that the taxpayer's operations—despite being horizontally integrated—were not unitary. There, each subsidiary exercised autonomy with respect to its primary business activity, including "seeing to the merchandise, store site selection, advertising and accounting control," and the parent engaged in no "centralized purchasing, manufacturing, or warehousing of merchandise" on the subsidiaries' behalf, 458 U.S. at 365. Moreover, the parent's provision of administrative services did not establish functional integration because those services "may result in some savings, but in most instances the amount is trifling in comparison to the income involved." *Id.*

Here, the undisputed facts establish that Tesoro's Texas and Bolivia natural gas operation and its distinct Alaska crude oil operation were not functionally integrated. Indeed,

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[5] *Container Corp.*, 463 U.S. at 172 (taxpayer was horizontally integrated because its subsidiaries "were all engaged—in their respective local markets—in essentially the same business as appellant."); *Exxon*, 447 U.S. at 210–11 (finding Exxon's departments to be "a vertically integrated petroleum company"); *Mobil Oil*, 445 U.S. at 428 (recognizing that Mobil engaged in a vertically integrated petroleum business with its subsidiaries); *Butler Bros. v. McColgan*, 315 U.S. 501, 504 (1942) (taxpayer was a horizontally integrated wholesaler); *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271, 278–79 (1924) (taxpayer was vertically integrated and involved in both the brewing and selling of ale); *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113, 118–19 (1920) (taxpayer was a vertically integrated manufacturer, seller, and repairer of typewriters).

the fact that E&P and R&M "were not integrated either horizontally or vertically" [Exc. 13], without more, demonstrates that functional integration was not present. *See, e.g.*, *Container Corp.*, 463 U.S. at 166; *Exxon*, 447 U.S. at 226; *Mobil Oil*, 445 U.S. at 438–39.

In all events, the remainder of the ALJ's findings only underscore that E&P and R&M exhibited even less functional integration than the segments deemed non-unitary in *Woolworth*. Unlike Woolworth's segments that operated in similar retail industries, "E&P was a gas business, while R&M was an oil business, and . . . the two segments were in many ways dissimilar." [Exc. 49]. Thus, "there was little or no flow of products or operational expertise between" them; few, if any, "opportunities for operational synergies," [Exc. 13]; and no flow of personnel [Exc. 49]. E&P and R&M had strong, autonomous local management that made all day-to-day decisions without direction from Tesoro or each other. [Exc 41].

The ALJ rested his functional integration determination on two premises, both of which are fatally flawed. *First*, the ALJ held that "vertical or horizontal integration (except in the sense that all flows of value are a form of vertical or horizontal integration) is not required" [Exc. 49]—but that holding was legal error. *See, e.g.*, *Container Corp.*, 463 U.S. at 166; *Exxon*, 447 U.S. at 226; *Mobil Oil*, 445 U.S. at 438–39.[6]

Second, the ALJ concluded that "integrated management functions," "cash flow, loan grantees [sic] and shared services" forged E&P and R&M into a functionally integrated

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[6] To support the supposed rule that vertical or horizontal integration "is not required," the ALJ cited "*Container Corp.*, 463 U.S. at 967–70" [*sic*; we presume he meant "167–70"]. [Exc. 49 n.97]. Those pages contain no such holding. To the contrary, *Container Corp.* observes that "we recognized that the unitary business principle *could apply*, not only to vertically integrated enterprises, but also to a series of similar enterprises operating separately in various jurisdictions but linked by common managerial or operational resources that produced economies of scale and transfers of value" [*i.e.*, horizontally integrated enterprises]. *Container Corp.*, 463 U.S. at 166 (emphasis added). There is no suggestion that the unitary-business principle could apply to a non-integrated business, as is the case here.

operation. [Exc. 49]. Those factors, however, do not demonstrate functional integration because none relates to any actual *function* between E&P and R&M. Indeed, they do not demonstrate any synergistic operations, *see Container Corp.*, 463 U.S. at 166, or a "series of transactions" among affiliates, *Mobil Oil*, 445 U.S. at 438–39; *see also Exxon*, 447 U.S. at 226.

Moreover, the total amount of expense attributable to these administrative functions was 1–2% of Tesoro's annual costs of doing business. [5/9/08 Tr. 185–86]. E&P President Bob Oliver characterized this expense as "so low that it impact[ed] us to such a low degree, I had more important things to worry about. . . . They didn't have a significant impact on our performance or our results." [5/5/08 Tr. 178]. In sum, "trifling in comparison with the income involved," and therefore not indicative of functional integration. *Woolworth*, 458 U.S. at 369 n.22.

In short, Tesoro's two diverse operations were not functionally integrated.

2. ***There Was No Centralized Management.*** Centralized management exists only when the parent's role in managing its operating segments is "grounded in its own operational expertise and its overall operational strategy." *Container Corp.*, 463 U.S. at 180 n.19. In other words, the parent must exercise *actual* control over the subsidiaries. *See id.* at 179. "[T]he *potential* to operate a company as part of a unitary business is not dispositive"; rather, "the underlying economic realities" must show that the company is part of a unitary, integrated business. *Woolworth*, 458 U.S. at 362 (quoting *Exxon*, 447 U.S. at 223–23) (emphasis in original) (internal quotations omitted).[7] The Multistate Tax Commission model

[7] This Court's statement in *Earth Resources* that "[the taxpayer's] majority ownership interest in [the subsidiary] would also indicate that [the parent] *in fact* exercised control of over [the subsidiary]," 665 P.2d at 969 (emphasis added), is, on its face, exactly contrary to

regulations reflect this logic, by distinguishing between "stewardship oversight," which is not "evidence of centralization of management," and "activities that an owner may take to enhance value by integrating one or more *significant operating aspects* of one business activity with the other business activities of the owner." MTC Model Reg. IV.1.(b).(2).(B).2 (emphasis added).

Thus, in *Container Corp.*, the Supreme Court concluded that an enterprise was integrated where the parent conducted the exact same business as the subsidiaries, and provided "substantial" technical assistance in that business to its subsidiaries. 463 U.S. at 171–72, 180 n.19. By contrast, in *Woolworth*, there was no centralized management because each subsidiary, while in the same line of business, "operated as a distinct business enterprise at the level of fulltime management." 458 U.S. at 366. In that case, the parent's oversight included frequent mail and phone communication between upper echelons of management in the parent and subsidiary, approval of major financial decisions (including payment of dividends and creation of major debt), and sharing of a number of common directors, all of which the Court found were "the type of occasional oversight—with respect to capital structure, major debt, and dividends—that any parent gives to an investment in a subsidiary." *Id.* at 368–69.

The ALJ's findings illustrate that E&P and R&M did not exhibit any centralized management under this test. Tesoro was a holding company with no business operations of its own. In fact, its executive management was "principally trained in finance and lacked the

(continued...)

Woolworth's holding that merely "potential" control—as would come from majority ownership—is not enough to demonstrate unity.

operational expertise or experience to run its operating segments." [Exc. 41]. Its Board and executive management therefore offered *no operational input* to E&P's and R&M's independent officers, who ran the businesses. [5/5/08 Tr. 150, 163–69, 222–26]. Tesoro's oversight of its subsidiaries thus was *not* "grounded in its own operational expertise and its overall operational strategy" as required to demonstrate centralized management. *Container Corp.*, 463 U.S. at 180 n.19.

The ALJ rested his contrary conclusion on two sets of facts, neither of which comes close to establishing centralized management. *First*, the ALJ concluded that centralized management existed because Tesoro had majority ownership of both E&P and R&M, Tesoro and its subsidiaries had overlapping directors and officers, and the subsidiaries' boards of directors seldom met. [Exc. 39]. The ALJ stated that "[t]he fact that [Tesoro] wholly owned [E&P and R&M] is therefore a strong indication of . . . centralized control" because, in his view, "[a] parent's majority interest in a subsidiary is enough to indicate that the parent in fact exercised control over the management of the subsidiary." [Exc. 38–39]. That conclusion flatly contradicts the U.S. Supreme Court's clear holdings that common ownership is *not* sufficient to establish a unitary enterprise. *See, e.g.*, *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768, 781 (1992); *Container Corp.*, 463 U.S. at 177 n.16; *Woolworth*, 458 U.S. at 362. Moreover, the existence of overlapping officer and directors or the rare meetings of the subsidiaries' boards do not demonstrate centralized management where, as here, those facts are incidents of Tesoro's *ownership*, not any actual control over its subsidiaries' operations.

Second, the ALJ suggested that Tesoro exercised actual, rather than potential, control over the subsidiaries—but the facts on which he relied do not support that conclusion. The

ALJ invoked four facts: (1) the President of Tesoro hired the Presidents of the subsidiaries, (2) major decisions relating to the subsidiaries' activities were made by the Tesoro board, (3) the parent officers provided "financial operational expertise," and (4) the Tesoro board approved budgets and occasional major capital expenditures. These activities, however, are precisely "the type of occasional oversight—with respect to capital structure, major debt, and dividends—that any parent gives to an investment in a subsidiary" and that the Supreme Court has deemed insufficient to establish centralized management. *Woolworth*, 458 U.S. at 368–69. Indeed, the ALJ and the Superior Court offered no explanation as to *who* would perform these functions if not Tesoro, the parent holding company of E&P and R&M. The ALJ and the Superior Court, moreover, *never* explained how, if performance of these routine functions by a parent holding company is sufficient to establish unity, *any* companies under common ownership ever could be deemed non-unitary.

The fact that the parent hired the president of the subsidiary is alone insignificant because a parent holding company virtually *always* performs that function, either directly or through the subsidiary's board of directors that it controls. Although this Court did cite a parent's hiring of a subsidiary's president as evidence of centralized management in *Earth Resources*, 665 P.2d at 969, subsequent Alaska decisions have, consistent with *Woolworth*, cited the hiring of an independent president as evidence that there was no unitary business.[8]

The ALJ's reliance upon CEO Bruce Smith's testimony that "major decisions relating to the subsidiaries' activities were always made at the TPC board rather than the subsidiary board level" [Exc. 39–40] did not take into account the substance of "major decisions." The

[8] For example, in *In re: Husky Oil Co.*, No. 87-20, 1987 WL 61173 (Alaska Dep't Revenue June 9, 1987), as here, the parent's hiring of the subsidiaries' officers evidenced the parent's lack of operational expertise in the subsidiaries' business. *Id.* at *6.

minutes of board meetings showed that "major decisions" meant high-value *financial* decisions such as E&P's $68 million sale of a portion of the Bob West Field, E&P's settlement of the Tennessee Gas litigation, and R&M's purchase of refineries. [Exc. 718–21]. Such "[d]ecisions about major financial decisions [that] had to be approved by the parent" are the type of approval any parent would demand for its investment, and are categorically insufficient to establish a unitary business. *Woolworth*, 458 U.S. at 368–70.[9]

The ALJ also created the concept of "financial operational expertise" [Exc. 41] out of whole cloth. *Container Corp.* establishes a dispositive distinction between shared "operational expertise" in the subsidiary's business—which is an indication of centralized management—and financial expertise and oversight—which is not. Indeed, *Container Corp.* explained that the difference between *Exxon* and *Woolworth* "lies in whether the management role that the parent does play is grounded in its own *operational* expertise and its overall *operational* strategy." 463 U.S. at 180 n.19 (emphasis added). The ALJ's collapsing of this distinction turns the Supreme Court's test on its head because it treats financial support such as "capital structure, major debt, and dividends" as operational expertise indicating centralized management, when the Supreme Court expressly has held that such activities do *not* create a unitary business. *Woolworth*, 458 U.S. at 368–69.

Finally, Tesoro's approval of E&P and R&M's annual budgets and its decision to continue operating the subsidiaries and to sell E&P [Exc. 42–43] also do not demonstrate

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[9] The ALJ similarly found that CFO Bill Van Kleef managed the subsidiaries based upon a single document noting that Van Kleef "had acquired a good understanding of all operations from his work with the operating units." [Exc. 42 n.48]. The ALJ's stretched conclusion was directly contradicted by Van Kleef's testimony: "Certainly, I did not tell Bob Oliver that he needed to go accelerate natural gas production, nor did I tell Steve Wormington that he needed to increase run rates. I mean I wasn't in a position to be able to make those kind of decisions at all." [5/13/08 Tr. 25–26].

centralized management. The record establishes that Tesoro rarely made any adjustments to the segments' budgets before approving them. [5/13/08 Tr. 41–48; 5/5/08 Tr. 171–172; 5/7/08 Tr. 19–23]. In addition, the ability to continue the operations of, or sell, subsidiaries was insufficient to establish centralized management in *ASARCO*, *see* 458 U.S. at 329–30, or *Woolworth*, 458 U.S. at 356–57. Indeed, these decisions are precisely "the type of occasional oversight" incident to a parent-subsidiary relationship. *Id.* at 368–69.

In short, centralization of management is not present in this case.

3. ***There Were No Economies Of Scale.*** The ALJ determined that E&P and R&M benefited from economies of scale because of Tesoro's consolidated administrative services and collective financing. [Exc. 51–52]. But such consolidation was merely a function of Tesoro's size. The facts did not indicate an actual flow of *value* stemming from economies of scale.

Economies of scale that derive from functional integration or centralization of management will create unity only if they are actual and material. In *Woolworth*, the state argued that "[t]he possession of large assets by subsidiaries" is sufficient to show the economies of scale that demonstrate the presence of a unitary business. 458 U.S. at 363. The Court tersely, but emphatically, rejected that argument: "Our [unitary] cases demand more." *Id.* at 363. It determined that the state court's reasoning "would trivialize this due process limitation by holding it satisfied if the income in question adds to the riches of the corporation." *Id.* (internal quotations omitted). The Court similarly rejected the state's assertion that Woolworth's commingling of almost $40 million in dividends received from its subsidiaries (in one year) and use of those funds for general corporate purposes was an

indicator of unity: Such an analysis "likewise subverts the unitary-business limitation." *Id.* at 364 n.11.

In *ASARCO*, the Supreme Court rejected the Idaho Tax Commission's proposal to tax, as unitary business income, the income from the sale of a subsidiary if the subsidiary was "acquired, managed or disposed of for purposes relating or contributing to the taxpayer's business." 458 U.S. at 326. The Court responded:

> This definition of unitary business would destroy the concept. The business of a corporation requires that it earn money to continue operations and to provide a return on its invested capital. Consequently *all* of its operations, including any investment made, in some sense can be said to be "for purposes related to or contributing to the corporation's business." When pressed to its logical limit, this conception of the "unitary business" limitation becomes no limitation at all.

Id. (emphasis in original). Similarly, in *Container Corp.*, the Court stated that the requisite "concrete" unitary connection must be something "beyond the mere flow of funds arising out of a passive investment or a distinct business operation." 463 U.S. at 166. Mere use of funds derived from a taxpayer's otherwise discrete business operation is not enough; the proper inquiry "looks to the underlying unity or diversity of [the] business enterprise." *Woolworth*, 458 U.S. at 363 (citing *Mobil*, 445 U.S. at 440).

Despite clear U.S. Supreme Court holdings to the contrary, the ALJ cited to Tesoro's increased access to capital markets due to the "size/scale" of its overall business and its "diversified asset and revenue base" as economies of scale that dictate a unitary finding. [Exc. 52]. In particular, the ALJ cited to a central cash-management system and corporate-wide credit facilities secured by the assets of both E&P and R&M. [Exc. 46]. The ALJ failed to reconcile this conclusion with *Woolworth,* in which the parent and subsidiary were not unitary even though the parent required its subsidiaries to distribute $40 million of their

profits for Woolworth's use for general corporate purposes. *Woolworth,* 458 U.S. at 364 n.11. Despite the cash-management system, each Tesoro segment's budget was still predicated upon the cash flow generated from their own operations. [5/13/08 Tr. 41–49]. Tesoro's pledge of E&P and R&M's assets for a corporate revolving loan is no more indicative of a unitary business than Woolworth's direct utilization of its subsidiaries' profits for its own purposes. Each simply evidences a potential flow of money, not a flow of actual value. The standards applied by the ALJ and Superior Court would make every modern conglomerate business unitary, which would render the Constitutional standards meaningless.

In short, economies of scale are not present in this case.

C. Neither *Gulf Oil* Nor *Earth Resources* Nor *Alaska Gold* Supports Finding These Diverse Businesses Unitary

The Superior Court relied principally on three cases from this Court (and cited by the Department): *Gulf Oil Corp. v. State*, 755 P.2d 372 (Alaska 1988); *Earth Res.*, 665 P.2d 960; and *Alaska Gold Co. v. State*, 754 P.2d 247 (Alaska 1988). None supports finding a unitary business in Tesoro's two diverse companies. Moreover, if any of those Alaska decisions *would* support a unitary finding on this largely undisputed record, that would make them contrary to the unitary decisions of the U.S. Supreme Court.

To start, *Gulf Oil* was not a unitary-business case (the Superior Court acknowledged that it was "not strictly analogous" to Tesoro's case, but was cited for its "general theme," which in the court's view "has some similarities" to Tesoro). [Exc. 6]. Gulf's unitary nature was assumed by that decision, which instead focused on unfairness and distortion of taxable income. *Gulf Oil* is no help to the unitary analysis.

Earth Resources was this Court's first application of the Supreme Court's modern unitary-business test. There, this Court found Earth Resources' in-state refinery development and asphalt operations to be unitary with its out-of-state refining and marketing operation. 665 P.2d at 970. The taxpayer owned a vertically integrated refining and marketing business that operated a refinery in Tennessee. *Id.* at 968 n.18. The taxpayer formed an Alaska subsidiary "to expand its refinery operations"[10] by building a refinery in Fairbanks. *Id.* at 968. During construction, the Alaska subsidiary invested in an asphalt and paving business to help fund the refinery development and provide an interim return for shareholders of the Alaska subsidiary. *Id.*[11]

At that administrative hearing, the taxpayer argued that its Alaska asphalt business and refinery development had no connection to its out-of-state refinery operations, but the hearing officer found the operations to be in the same line of business and inseparable from one another.[12] The parent's out-of-state refining business was horizontally integrated with its development of the in-state refinery. Further, the business exhibited vertical integration because the taxpayer specifically planned to use residual petroleum products from the Fairbanks refinery as raw materials for the asphalt business.[13] The parent established the asphalt business solely to fund construction of the new refinery,[14] demonstrated by a $1.3

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[10] *Earth Res. Co. v. State, Dep't of Revenue*, No. 3AN-79-7099-Civ., at *5 (Alaska Super. Ct. Jan. 7, 1981), *aff'd*, 665 P.2d 960 (Alaska 1983).

[11] *See also In re: Energy Co. of Alaska*, No. 79-41, 1979 WL 5994, at *2 (Alaska Dep't Revenue Sept. 25, 1979), *aff'd sub nom. Earth Res. Co. v. Dep't of Revenue*, No. 3AN-79-7099-Civ. (Alaska Super. Ct. Jan 7, 1981), *aff'd*, 665 P.2d 960 (noting ECA's Board of Directors recognized that the refinery's construction was financially dependent on the income from the paving business).

[12] *Energy Co.*, 1979 WL 5994, at *11.

[13] *Earth Res. Co.*, No. 3AN-79-7099-Civ., at *6.

[14] *Energy Co.*, 1979 WL 5994, at *11.

million deduction for "refinery development" expenses.[15] These deep and integrated operational synergies between the business lines—wholly absent in Tesoro's case—supported a unitary finding under *Container Corp.*: "When a corporation invests in a subsidiary that engages in the same line of work as itself, it becomes much more likely that one function of the investment is to make better use—either through economies of scale or through operational integration or sharing of expertise—of the parent's existing business-related resources." 463 U.S. at 178.

Additionally, the parent in *Earth Resources* exercised managerial control over the development of the Fairbanks refinery.[16] The hearing officer noted that the parent's executives "utilized [their expertise] in developing the [Fairbanks] Refinery and acquiring the equipment, physical plant, and materials supply contracts necessary for its operation."[17] The parent's operational expertise in the subsidiary's business created substantial flows of value because the parent applied its knowledge and industry experience to aid its subsidiary in constructing and operating a similar enterprise. The fact that the subsidiary performed uncompensated services for the parent further evidenced the operational integration between the parent and its subsidiary. 1979 WL5994 at *2.

In *Alaska Gold*, this Court determined that the vertically integrated operations of UV Industries and its subsidiary Mueller Brass formed a unitary business. 754 P.2d at 249. UV sold all of its copper production to Mueller, which Mueller then used to manufacture brass. *Id.* at 253; *In re: Alaska Gold Co.*, No. 85-18-1, 1985 WL 15612, at *20 (Alaska Dep't Revenue July 15, 1985). UV began processing copper "as part of a program to make copper available

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[15] *Id.* at *10.
[16] *Id.* at *11.
[17] *Id.*

to Mueller in order to reduce its dependence on outside sources," *Alaska Gold*, 754 P.2d at 253, and Mueller was required to purchase this copper "regardless of whether a better price could be obtained elsewhere or for any other reason." *In re: Alaska Gold*, 1985 WL 15612, at *6. UV sold Mueller $22 to $32 million of copper each year. *Id.* at *9.

This Court concluded that UV and Mueller were in the same line of business and that the businesses collectively benefited from shared expertise and economies of scale. Similar to *Exxon*, the vertically integrated structure of the company provided UV with a guaranteed market for its copper and provided Mueller with an assured source of a critical input for its brass production. *Alaska Gold*, 754 P.2d at 253. While the court recognized that the sales were at prevailing market prices, it found "they are nonetheless evidence that the companies were not acting independently." *Id.* at 252.

The ALJ thus erred by viewing *Alaska Gold* as a case where vertical integration was not required to find unity and that mere majority ownership of a subsidiary and overlapping officers was adequate to find centralization of management. [Exc. 38–39, 49]. As with the U.S. Supreme Court's unitary cases, the presence of vertical or horizontal integration has always been a necessary (though, as *ASARCO* and *Woolworth* prove, not sufficient) condition for a finding of unity. Here, Tesoro's mere holding of two diverse non-integrated businesses is not enough, constitutionally, to demonstrate the presence of a unitary business.

The Superior Court's judgment should be reversed.

II. THE SUPERIOR COURT MISAPPLIED SECTION 18

Even if this Court were to uphold the Superior Court's determination that Tesoro's Texas and Bolivia natural gas exploration and production segment, and its distinct Alaska crude oil refining and manufacturing segment, were unitary—which it should not, *see supra*

Part I—it should still reverse the judgment below. "Both parties agree that Tesoro is entitled to relief under Section 18" [Exc. 76], and the Superior Court properly held that any § 18 remedy must itself be reasonable and constitutional [Exc. 23]. But for at least three reasons, the Superior Court misapplied that rule when it upheld the Department's allocation to Alaska of $75 million in income that E&P earned in Texas and Bolivia.

First, even though the law requires the Department to justify its proposed § 18 remedy, the Superior Court improperly deferred to the Department's approach, and misallocated the burden of proof to Tesoro. *Second*, the Superior Court disregarded the fatal flaws in the Department's formula, which does not accurately reflect the extent of R&M's Alaska business activities and is internally inconsistent. *Finally*, the Superior Court improperly rejected Tesoro's showing that separate accounting fairly taxes R&M's Alaska income and is internally consistent. Thus, in all events, the Court should reverse the judgment below and order separate accounting in this case.

A. The Superior Court Improperly Deferred To The Department And Shifted The Burden Of Proof To Tesoro

Section 18 of Alaska's version of UDITPA authorizes the adoption of a "reasonable" remedy where the "apportionment provisions . . . do not fairly represent the extent of the taxpayer's business activity in this state." AS § 43.19.010, art. IV, § 18. Authoritative case law from across the country uniformly holds that the taxing authority bears the burden, under § 18, to prove the reasonableness of its own proposed remedy.[18]

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[18] *See, e.g.*, *Microsoft Corp. v. Franchise Tax Bd.*, 139 P.3d 1169, 1178 (Cal. 2006); *Union Pac. Corp. v. State Tax Comm'n*, 83 P.3d 116, 119 (Idaho 2004); *Twentieth-Century Fox Film v. Dep't of Revenue*, 700 P.2d 1035, 1042–44 (Or. 1985); *Lakehead Pipe Line Co. v. Dep't of Revenue*, 549 N.E.2d 598, 602 (Ill. App. Ct. 1989); *Texaco Inc. v. Calvert*, 526 S.W.2d 630, 634 (Tex. Civ. App. 1975). The Department's own Office of Tax Appeals has confirmed this rule, pointing

The Department has not adopted its three-factor formula as a formal regulation and it "is not therefore entitled to any force or deference as a regulation." [Exc. 76.. Yet the ALJ inexplicably held that the Department's formula "is entitled to deference" [*id.*], and can be overturned only if the taxpayer establishes that it was "arbitrary, unreasonable," or an "abuse of discretion" [Exc. 80]. The Superior Court declined to "get[] into a serious digression" on this issue, and held that "the taxpayer bears the burden of showing unfairness." [Exc. 21].

Neither the ALJ nor the Superior Court articulated a sound basis for shifting the Department's burden to Tesoro. For example, in the case cited by the ALJ, *Gulf Oil*, this Court properly allocated the burden of proof to the taxpayer because it was the *taxpayer* who invoked § 18. *See* 755 P.2d at 383. Likewise, the Superior Court was wrong when it reasoned that "it is the taxpayer here who is seeking relief from the statutory formula" [Exc. 21] because the Department proposed the three-factor formula under § 18 as a remedy to § .072's unconstitutional requirements.

This erroneous shifting of the Department's burden had devastating effects on Tesoro. Rather than examining whether the Department had established that its three-factor formula was reasonable, the Superior Court interpreted § 18 to give the Department a choice of remedies entitled to judicial deference, and required Tesoro to prove the unreasonableness of the Department's choice. As a result, the Superior Court upheld the

(continued...)

out that "nothing in [Section 18] suggests that the standard for . . . relief differs depending on whether it is the taxpayer or the Department that seeks to modify the statutory formula." *In the Matter of Magella Healthcare Corp.*, No. OTA-2003-01, 2004 WL 1363568 at *4 (Alaska Dep't Revenue Jan. 2, 2004).

Department's three-factor formula even though it yields a tax burden wildly disproportionate to R&M's Alaska income and is internally inconsistent.

B. The Department's Three-Factor Formula Does Not Fairly Represent The Extent Of Tesoro's Alaska Business Activity

Regardless of the ALJ's and the Superior Court's improper deference to the Department and erroneous shifting of the burden of proof to Tesoro, the undisputed facts demonstrate that the Department's three-factor formula was not reasonable. To be reasonable, a § 18 remedy must "fairly represent the extent of the taxpayer's business activity in this state." AS § 43.19.010, art. IV, § 18. This inquiry examines both "the particular nature of the taxpayer's business" and any "unusual circumstances surrounding how the income was earned." *Magella*, 2004 WL 136568, at *6.

The disparate nature of E&P's and R&M's businesses and the unusual circumstances surrounding E&P's generation of income during the Audit Period demonstrate that the $89 million the Department seeks to capture for taxation comes nowhere close to fairly reflecting R&M's Alaska business activity. E&P and R&M "ran day-to-day operations independently," were "distinct geographically," "didn't share employees," "were not integrated either horizontally or vertically," operated in "two quite different parts of the petroleum industry," and had few, if any, "opportunities for operational synergies." [Exc. 13]. Moreover, the vast bulk of the income that the Department seeks to tax related to two "unusually large and qualitatively distinct" events realized exclusively by E&P operations in Texas, the sale of a portion of the Bob West Field and the resolution of the Tennessee Gas litigation. [Exc. 23].

The Department's formula is therefore flawed because the three-factor formula yields a tax burden wildly disproportionate to R&M's Alaska income. This flaw, moreover, is

fundamental because the Department's formula systematically overvalues R&M's Alaska activities and undervalues E&P's Texas and Bolivia activities that generated the income at issue in this case. Thus, the Department's formula can *never* fairly approximate the value of Tesoro's Alaska business activities. It should be rejected.

1. The Property Factor Magnifies The Value Of R&M's In-State Property And Discounts The Value Of E&P's Out-Of-State Property

The property factor, which values property by the original acquisition cost of the property, unfairly distorts the Department's formula in Alaska's favor because the original cost of R&M's property dwarfs the original cost of E&P's property, even though E&P's property generated far more income during the Audit Period. In fact, the property factor steers approximately 75% of E&P's income to states in which E&P had no business activities. [R. 5399–5407, 5437–44, 5467–74, 5489–98].

This significant diversion of E&P's Texas and Bolivia income to Alaska stems from two main shortcomings in the property factor. *First*, the property factor fails to account for the fact that E&P and R&M conducted disparate businesses with dramatically different property holdings. As a refining and marketing business, R&M owned a massive infrastructure consisting of refineries, pipelines, dozens of retail outlets, offices, marine terminals, trucks, product inventory, and leases on ocean tankers. In contrast, E&P held leases on natural gas-producing properties, partial ownership of production equipment and pipelines, specialized computers and software, and rented office space in Bolivia. For the years 1995–1998, the original cost of R&M's property was between 73% and 79% of the total cost of property owned by E&P and R&M. [R. 5399–5407, 5437–44, 5467–74, 5489–98].

Second, Alaska law steeply discounts the value of E&P's out-of-state property. In the first place, Alaska law values E&P's mineral interests at original acquisition price plus development costs, rather than at fair market value—an approach that valued the Bob West Field leases at less than $5 million when the field's net proven reserves exceeded $200 million. [Exc. 105; R. 1247–63; Exc. 244–45]. Moreover, the property factor includes only tangible personal property, *see* AS § 43.19.010, art. IV, § 10, and thus excludes the tremendous value of E&P's intangible take-or-pay Tennessee Gas contract.

This dual ratchet—overvaluing R&M's Alaska property and undervaluing E&P's property—systematically drives up Alaska's apportioned share of E&P's Texas and Bolivia income beyond any level even remotely reflecting the value of R&M's Alaska operation. The property factor therefore does not "fairly represent the extent" of Tesoro's Alaska business. *Id.* § 43.19.010, art. IV, § 18. It should be rejected.

2. The Sales Factor Fails To Account For E&P's And R&M's Disparate Cost And Profit Structures

The sales factor is based on gross receipts—so it also unfairly tips the scale in favor of Alaska because E&P and R&M exhibited significant disparities in sales and profit margins. R&M was engaged in the high-volume, low-margin refining and manufacturing business: although its stations sold a large volume of gasoline each day, its profit from each gallon ranged from nominal to nonexistent. E&P, on the other hand, was a small-scale operation that generated far more modest gross receipts but a disproportionately high net income. Over the Audit Period, R&M generated 89% of R&M's and E&P's combined sales, but only 20% of the combined profits. [Exc. 500]. In other words, E&P's non-Alaska

activities generated 80% of R&M's and E&P's combined profits, but the Department's sales factor distortively credits only 11% of the combined profit to E&P's activities. [*Id.*]

Such distortion in the apportionment of the income of a business whose profit margins vary significantly between states is one of the most widely recognized shortcomings of the sales factor and the UDITPA. *See, e.g.*, *Microsoft Corp.*, 139 P.3d 1169, 1180 (Cal. 2006) ("This situation, when one mixes apples—the receipts of low-margin sales—with oranges—those of much higher margin sales—presents a problem for the UDITPA. The UDITPA's sales factor contains an implicit assumption that a corporation's margins will not vary inordinately from state to state."); *see also Am. Tel. & Tel. Co. v. State Tax Appeal Bd.*, 787 P.2d 754 (Mont. 1990); *Sherwin-Williams Co. v. Johnson*, 989 S.W.2d 710 (Tenn. Ct. App. 1998). The sales factor further inflates Tesoro's Alaska taxable income and underscores the unreasonableness of the Department's three-factor formula.

3. The Department's Belated Interjection Of The Extraction Factor Does Not Save The Three-Factor Formula

The addition of the extraction factor does not remedy these fatal flaws. Even with the extraction factor, the Department's formula still incorporated the distorted property and sales factors, and yielded Alaska taxable income of $89 million—or more than 600% of the $14 million R&M earned in Alaska during the Audit Period. The U.S. Supreme Court has held that an apportionment formula "operated unreasonably and arbitrarily" where it calculated in-state income at 250% more than the amount attributable to the state under separate accounting. *Hans Rees Sons, Inc. v. N. Carolina*, 283 U.S. 123, 135 (1931). The Supreme Court clarified that even a unitary business may not be subjected to an

apportionment method "which, albeit fair on its face, operates so as to reach profits which are in no just sense attributable to transactions within its jurisdiction." *Id.* at 134.

The Superior Court did not seriously grapple with the gross disparity between the income calculated under the Department's method and the Alaska income actually earned by R&M, or the Department's concomitant failure to tie Tesoro's Alaska tax burden to its Alaska activities. Instead, it relied on two arguments to uphold the use of the extraction factor, neither of which withstands even minimal scrutiny.

First, the Superior Court misconstrued § 18's reasonableness test as a mathematical exercise, and suggested that the extraction factor redeemed the Department's formula because it "reduced the taxpayer's income by a third" compared to the income calculated under § .072. [Exc. 22, 25]. The Superior Court, of course, ignored that § .072 is indisputably unreasonable and unconstitutional—so it cannot serve as the starting point to determine the reasonableness of the Department's proposed § 18 remedy. Indeed, § 18's reasonableness test is not satisfied merely on a showing that the Department's formula resulted in lower taxes than § .072's unfair methodology would have demanded. Rather, the statutory test examines whether the Department's approach "fairly represents the extent of [Tesoro's] business activity in this state." AS § 43.19.010, art. IV, § 18. The Superior Court's departure from this test in favor of a mathematical computation contaminated by § .072's unconstitutional formula was error.

Second, the Superior Court attempted to sidestep this question by pointing out that formula apportionment is "complex" and "inherent[ly] inaccura[te]." [Exc. 22–23]. But in light of the controlling statute and case law, there is nothing difficult in the conclusion that the Department acted unreasonably when it captured for taxation more than $75 million in

income unquestionably generated in Texas and Bolivia even though the "transactions within [this] jurisdiction" yielded less than $14 million. *Hans Rees Sons*, 283 U.S. at 134.

C. The Department's Three-Factor Formula Violates The Internal-Consistency Requirement

Even if the Department's formula fairly represented the extent of R&M's Alaska business activity—which it does not—it still would be unreasonable under § 18 and unconstitutional because it is internally inconsistent. *See, e.g.*, *Container Corp.*, 463 U.S. at 169 (recognizing Constitution's internal-consistency requirement); *Magella*, 2004 WL 136568, at *6 (recognizing that a § 18 remedy must be internally consistent). The internal-consistency requirement obliges a state to structure its tax so that, if every state imposed the same tax, the states collectively would tax no more than 100% of the business's income. *See Container Corp.*, 463 U.S. at 169. "A failure of internal consistency establishes *as a matter of law* that a State is attempting to take more than its fair share of taxes from the interstate transaction, since allowing such a tax in one State would place interstate commerce at the mercy of those remaining States that might impose an identical tax." *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995) (emphasis added).

Because the internal-consistency requirement protects interstate commerce, it does not require proof of actual harm or discriminatory impact on the taxpayer because such impact "would depend on the shifting complexities of the tax codes of 49 other States, and . . . on the particular other States in which [the taxpayer] operated." *Armco Inc. v. Hardesty*, 467 U.S. 638, 644–45 (1984). Instead, the *risk* of multiple taxation to any taxpayer suffices to establish an internal inconsistency of an apportionment formula. *See id.*; *Goldberg v. Sweet*, 488 U.S. 252, 261 (1989).

The Attorney General and the Department concede that § .072 fails the internal-consistency test. [Exc. 551]. This failure reflects § .072's incorporation of formulas that utilize different apportionment factors based on where the taxpayer conducts certain activities:

1. a two-factor property and extraction formula for a business that conducts production activities in the State but not for a business that conducts such activities only outside the state;

2. a two-factor property and sales formula for a business that conducts pipeline activities in the State but not for a business that conducts such activities only outside the state;

3. a three-factor property, sales, and extraction formula for a business that conducts *both* activities in the State but not for a business that conducts such activities only outside the state; and

4. UDITPA's traditional three-factor property, sales, and payroll factor for a business that conducts neither activity in the State, even if it conducts either or both activities elsewhere.

See AS §§ 43.20.072(c); 43.19.010, art. IV, § 9. As the ALJ recognized, "[t]he problem with having a tax that would use a different number of apportionment factors in different states is that if this Alaska tax were used by other states, the result could be that more than 100% of the taxpayer's income could be apportioned between the states it does business in." [Exc. 75].

The Department's proposed § 18 remedy suffers from the same infirmity because it continues to use at least two formulas with different apportionment factors:

1. the Department's three-factor property, sales, and *extraction* formula for any business conducting production and/or pipeline activities in-state; and

2. UDITPA's property, sales, and *payroll* formula for any business that conducts neither activity in-state, even if it conducts one or both out-of-state.

See AS §§ 43.20.072(c); 43.19.010, art. IV, § 9. Thus, under the Department's proposed remedy, a multistate petroleum business with only out-of-state production and/or pipeline

activities would face an unreasonable and unconstitutional apportionment of more than 100% of its income in the following example:

Factor	Alaska	Texas	California	Total
Property	65%	30%	5%	100%
Extraction	0%	100%	0%	100%
Sales	75%	20%	5%	100%
Payroll	55%	25%	20%	100%

Alaska
Property 65%
Extraction 0%
Sales 75%
140% ÷ 3 (factors used) = 46.7%

Texas
Property 30%
Extraction 100%
Sales 20%
150% ÷ 3 (factors used) = 50%

California
Property 5%
Sales 5%
Payroll 20%
30% ÷ 3 (factors used) = 10%

46.7% + 50% + 10% = 106.7%

The Superior Court devoted a single paragraph of its 29-page decision to the internal-consistency inquiry, and merely "agree[d] . . . that, as modified by the use of the extraction factor, applied to this taxpayer, the apportionment scheme is internally consistent." [Exc. 26]. The Superior Court's cursory analysis overlooked that the question is not whether the Department's approach visits discriminatory impact on "this taxpayer" [*id.*], but instead whether it would interfere with interstate commerce by creating a risk of multiple taxation if it were adopted in all 50 states, *see Armco*, 467 U.S. at 644–45; *Goldberg*, 488 U.S. at 261. As demonstrated, such a risk exists for a business with production and/or pipeline activities outside but not inside Alaska.

The ALJ's upholding of the Department's three-factor formula fares no better. The ALJ correctly held that "[o]ne must look to the methodology *actually applied* under Section 18" to resolve the internal-consistency inquiry. [Exc. 76 (emphasis added)]. But the ALJ misunderstood the internal inconsistency in the Department's formula. Tesoro does not "theoriz[e] that the [three-factor] methodology used by the [Department] would not be applied by other jurisdictions" under § 18. *Id.* Instead, Tesoro points out that the "methodology actually applied" by the Department (*id.*) prescribes a property, sales, and *extraction* formula for a business with in-state production and/or pipeline activities, and a property, sales, and *payroll* formula for a business with one or both of those activities exclusively out-of-state. *See* AS §§ 43.20.072(c); 43.19.010, art. IV, § 9. It is precisely this use of different "apportionment factors in different states" that violates the internal-consistency requirement because it could result in "more than 100% of the taxpayer's income . . . be[ing] apportioned between the states it does business in." [Exc. 75].

D. Separate Accounting Is Reasonable And Internally Consistent

This Court previously upheld separate accounting as a superior methodology to formula apportionment for the oil and gas industry because it "more accurately reflects income" and recognizes "the precise geographical source of a corporation's profits." *Atl. Richfield*, 705 P.2d at 422–27. Section 18 authorizes separate accounting as a remedy for an unfair apportionment. AS § 43.19.010, art. IV, § 18.

Separate accounting should be applied in this case because it is reasonable and internally consistent. In the first place, separate accounting would allocate the nearly $14 million that R&M earned in Alaska for Alaska taxation. This amount much more "fairly represent[s] the extent" of R&M's Alaska business activities than the $89 million that the

Department attempts to capture for taxation, which includes more than $75 million E&P generated in Texas and Bolivia. *See id.*

Moreover, separate accounting comports with the internal-consistency requirement because if every state adopted that methodology, exactly 100%—no less, no more—of Tesoro's income would be subject to taxation. *See Container Corp.*, 463 U.S. at 169. Indeed, the nearly $14 million that R&M generated would be taxable in Alaska, while the more than $200 million earned by E&P out-of-state would be taxable elsewhere.

The ALJ and the Superior Court rested their rejection of separate accounting on the erroneous conclusion that the Department's formula was reasonable and internally consistent. [Exc. 26–27, 81]. The ALJ also suggested that the Department's formula "stick[s] as close as possible to the statutory scheme" [Exc. 80]—but this suggestion ignores that separate accounting is enumerated in the very § 18 that the Department relies on to justify its formula, *see* AS § 43.19.010, art. IV, § 18. The ALJ also offers no explanation as to why § .072's unconstitutional formula is the standard for judging reasonableness under § 18. [Exc. 80]. Separate accounting is required.

III. PENALTIES SHOULD NOT BE IMPOSED BASED ON TESORO'S ALLEGED NONCOMPLIANCE WITH AN UNCONSTITUTIONAL STATUTE

Finally, at a minimum, the Court should reverse the Department's imposition of negligence and failure-to-pay penalties because § .072 is unconstitutional. The Department imposed these penalties because Tesoro's initial tax returns did not apply the unconstitutional § .072 to all of its subsidiaries [Exc. 558–60]. The Department had known at least since 1982 that § .072 is unconstitutional [Exc. 124–27], and Tesoro informed the Department of its position that § .072 is unconstitutional in 1997 [Exc. 453–57]. Tesoro,

moreover, "would have overpaid significantly" had it applied § .072 to all of its subsidiaries. [Exc. 28]. Yet the Department did not formally recognize this constitutional infirmity until November 1999, *after* Tesoro had filed its returns for the Audit Period. [Exc. 552–53].

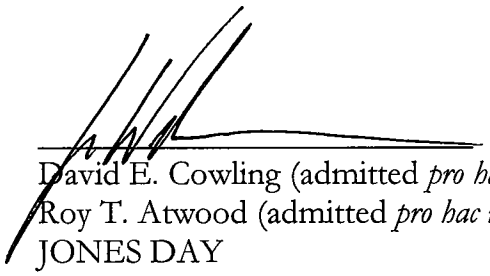
The Department also did not advocate its three-factor formula until the conclusion of the second audit—and even that formula is itself unconstitutional because it still violates the internal-consistency requirement. *See supra* Part II.C. The unconstitutionality of § .072 and the Department's formula, and the Department's delay in attempting to remedy the constitutional flaws, demonstrate that Tesoro should not be penalized for declining to pay even greater Alaska taxes under § .072. *See, e.g.*, *Norton v. Shelby Cnty.*, 118 U.S. 425, 442 (1886) ("An unconstitutional act is not a law; it confers no rights; it imposes no duties; . . . it is, in legal contemplation, as inoperative as though it had never been passed.").

Yet the ALJ and the Superior Court upheld the Department's imposition of 30% penalties, concluding that Tesoro's position was "aggressive" because it failed to apply the unconstitutional § .072 to the income of all of its subsidiaries. [Exc. 27, 66]. Instead, the ALJ and Superior Court concluded Tesoro should have paid Alaska tax on $134 million of Alaska income (50% more than the excessive $89 million of income the Department now seeks to tax), and then sought a refund. Imposing penalties for failing to take such a course of action is unjust and unconstitutional, *see, e.g.*, *Norton*, 118 U.S. at 442, and the Superior Court committed a legal error in concluding that in order to avoid negligence penalties Tesoro was required to "overpa[y] significantly" under § .072 and then seek a refund. [Exc. 28].

CONCLUSION

The Court should reverse the judgment below and enter judgment for Tesoro.

Respectfully submitted,



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