M E M O R A N D U M

To: William A. Mogel

From: David J. Raphael

Date: May 4, 2007

Subject: AGIA Taxation Issues

As per your request, I have conducted preliminary research concerning whether the Alaska legislature may pass and successfully defend legislation that freezes taxes for developers of a gas pipeline for a period of ten years. This research includes analyses of taxation requirements under both the Constitution of the State of Alaska (Alaska Constitution) and the Equal Protection and Commerce Clauses of the United States Constitution (U.S. Constitution).

My research indicates that the Alaska Constitution may allow for the type of gas production tax exemption now being contemplated by the Alaska legislature under the Alaska Gasline Inducement Act ("AGIA"). Whether the gas production tax exemption survives state constitutional scrutiny will likely turn on whether such exemption is deemed to be a general law exemption under Article Nine, section 4. In short, additional factual information is necessary to complete this analysis. Alaska courts have not established a test (unlike certain other states) to determine when such legislation is deemed to be a general law. To make such a general law determination, Alaska courts may analyze the AGIA to determine whether the class it covers is rationally related to legitimate legislative purpose. Next, Alaska courts may analyze whether the class covered by the AGIA is legitimate and encompasses all relevant members of the class. Finally, Alaska courts may analyze whether members can move in and out of their respective class. Where, as here, AGIA's legislatives purpose is to expedite construction of a natural gas pipeline that: increases commercialization, exploration, and development of oil and gas resources on the North Slope, the courts will determine whether developers of the North Slope (as compared to gas developers of the entire state) are a legitimate class to be covered by this legislation. In other words, the courts will determine whether there is a legitimate reason for limiting the class of gas developers of the North Slope (as compared to gas developers of the entire state) and then determine whether the tax exemption applies uniformly to that class. Important to this analysis will be whether another similarly situated region of Alaska is excluded from the benefits of this legislation without good cause. Lastly, the courts may need to analyze whether gas develops can move in and out of the class defined by the AGIA.

I have also found no case law holding that the application of such an exemption for a period of ten years is unlawful or unreasonable. (Pennsylvania has passed legislation creating Keystone Opportunity Zones providing tax exemptions and incentives lasting up to ten years.) Also, as a general matter, Alaska Constitution prohibits the state from entering into contractual agreements between itself and private entities that create tax exemptions. To the extent that royalty and tax inducements would be deemed to be contractual exemptions, such exemptions will likely be barred under Article 9, Section 1 of the Alaska Constitution. .

With regard to my federal research, it is worth noting that the Commerce Clause of the U.S. Constitution, particularly as applied by the federal courts, may pose the most significant federal challenge to the AGIA. The Equal Protection Clause will pose less of a challenge.

Set forth below is a more detailed analysis of a number of these state and federal constitutional issues.

<u>Alaska Constitution</u>

A. Suspending or Contracting Away the Power to Tax

Article 9, section 4 of the Alaska Constitution provides the Alaska Legislature with the power to grant tax exemptions by general law. Article 9 section 4 states as follows:

> The real and personal property of the State or its political subdivisions shall be exempt from taxation under conditions and exceptions which may be provided by law. All, or any portion of, property used exclusively for non-profit religious, charitable, cemetery, or educational purposes, as defined by law, shall be exempt from taxation. <u>Other exemptions of like or different kind may be granted by general law.</u> All valid existing exemptions shall be retained until otherwise provided by law.

Alaska courts have interpreted Article 9, section 4 as providing broad powers of exemption to the legislature. *DeArmond v. Alaska State Development Corporation*, 367 P.2d 717 (1962). These broad powers cover exemptions of a "different" kind and character than those mentioned above. *Id.* However, the legislature may only achieve this type of exemption through the enactment of a general law.

Under Article 9, section 4, the legislature appears to have the constitutional power to grant a gas production tax exemption under the AGIA. This type of exemption falls within the broad exemption language of Article 9, section 4. Of course, the more important question is whether the legislature's AGIA is a general law statute capable of granting this exemption.

Alaska case law offers limited insights as to how Alaska courts will determine whether the AGIA is a general law, containing general law tax exemptions. *See generally Abrahams v. State of Alaska*, 534 P.2d 91 (Alaska 1975) To provide some context to this analysis, a review of Arizona's approach to this issue is helpful. Under Arizona law, a law is general, as opposed to special, if: (1) the classification is rationally related to a legitimate governmental objective, (2) the classification is legitimate, encompassing all members of the relevant class, and (3) the class is elastic, allowing members to move in and out of it. *Town of Gilbert v. Maricopa County*, 213 Ariz. 241, 141 P.3d 416 (2006). In *Town of Gilbert*, the Arizona Court of Appeals held that proposed legislation providing fire protection and emergency medical services to certain unincorporated communities, but not others, failed to meet the second and third prongs of the test. The appeals court reasoned that although providing fire protection and emergency medical services was a legitimate reason for the legislation, the legislature failed to articulate sufficient reasons for excluding similarly situated communities also in need of those services. Further, the appeals court held that although legislation contained a population-based classification, it was unlikely based on demographics that the excluded communities would increase their populations sufficiently to join the class of communities covered by the statute.

In the present case, it is likely the Alaska Legislature could satisfy the first prong by proving that the class defined by under AGIA relates to a legitimate state objective. That being to encourage construction of a natural gas pipeline promoting commercialization, exploration, and development of oil and gas resources on the North Slope. However, if another region with similar gas and oil resources is not being covered by the AGIA, the legislature would need to explain why that is the case. To satisfy the third prong, the legislature would need to prove that pipeline developers could move it and out of this class even with the restrictions provided under the AGIA. Of course, the Arizona's three prong test is only persuasive authority under Alaska law. More factual information is necessary to complete this general law analysis.

B. Equal Protection

Article I, section 1 of the Alaska Constitution states that "all persons are equal and entitled to equal rights, opportunities and protection under the law . . . ." Alaska utilizes a sliding scale to determine the appropriate level of review for equal protection challenges under its constitution. *State v. Ostrosky*, 667 P.2d 1184, 1192 (Alaska 1983). This scale ranges from strict scrutiny to relaxed scrutiny depending on the constitutional interest affected. *Id*. The constitutional interest in taxation challenges lies at the low end of the continuum of these protected interests and, therefore, is reviewed under relaxed scrutiny. *Atlantic Richfield Co. v. State*, 705 P.2d 418, 437 (Alaska 1985), *appeal dismissed*, 474 U.S. 1043 (1986). Alaska courts have held that, at a minimum, this standard of scrutiny requires that the legislation be based on legitimate public purpose and that the classification "be reasonable, not arbitrary, and…rest upon some ground of difference having a fair and substantial relation to the object of legislation." *Ostrosky*, 667 P.2d at 1193. Alaska's Supreme Court has reasoned that "a statute which secures the location within the state of immediate and useful industries by exempting them, though no others, from its taxes is not arbitrary and does not violate the Equal Protection Clause." *Katmailand, Inc. v. Lake and Peninsula Borough*, 904 P.2d 397 (1995)*; quoting K & L Distrib., Inc. v. Murkowski*, 486 P.2d 351, 359 (Alaska 1971). Under this relaxed scrutiny test, it is likely that courts will view legislation freezing taxes of developers of a pipeline as being based on legitimate economic purposes such as the further development of Alaska's natural resources and job creation, which bear a substantial relation to the objective of the legislation. The exemption period of ten years is also unlikely to be viewed as unreasonable based upon the massive scale of this project.

<u>U.S. Constitution</u>

A. Equal Protection

Where judicial scrutiny is sought under the Equal Protection Clause of the Fourteenth Amendment to the U.S. Constitution, it is well-settled that a rational basis analysis is appropriate for statutes affecting economic rights such as taxation. *See Exxon Corp. v. Eagerton,* 462 U.S. 176, 195-96 (1983). As is the case here, such tax statutes do not normally involve a fundamental interest or a suspect classification requiring heightened scrutiny. Alaska's Supreme Court and the United States Supreme Court have held that review of taxes under the rationale basis test is especially lenient. *Atlantic Richfield Co.* 705 P.2d at 347. Under the "rational basis" standard, a statute will be validated if the legislature could have reasonably concluded that the challenged classification would promote a legitimate state purpose. *Exxon Corp.*, 462 U.S. at 196. Courts are likely to hold that the legislature could have reasonably concluded that the challenged tax freeze for developers of the pipeline would promote legitimate state economic interests, including, but not limited to, further development of Alaska's natural resources, job creation, etc.

B. Commerce Clause

The United States Constitution authorizes Congress to "regulate Commerce with foreign Nations, and among the several states" under what is commonly known as the Commerce Clause. U.S. Const. art. I, § 8, cl. 3. Also, the "dormant" aspect of the Commerce Clause implicitly limits the State's right to tax interstate commerce. Tax legislation will satisfy the requirements of the Commerce Clause if: (1) the activity taxed has a substantial nexus with the taxing state; (2) the tax is fairly apportioned to reflect the degree of activity that occurs within the state; (3) the tax does not discriminate against interstate commerce; and (4) the tax is fairly related to the benefits provided by the state. *See Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977). Generally speaking, a challenged credit or exemption will fail to survive commerce clause scrutiny if it discriminates on its face or if, on the basis of a "sensitive, case-by-case analysis of purposes and effects," the provision "will in its practical operation work discrimination against inner state commerce," *West Lynn Creamery v. Healy*, 512 U.S. 186, 201 (1994), by "providing a direct commercial advantage to local business." *Bacchus Imports, LTD. v. Dias*, 460 U.S. 263, 272 (1984). Discrimination means differential treatment of in-state and out-of-state economic interest that benefits the former and burdens the latter. *Oregon Waste Sys., Inc. v. Dept'l of Envtl. Quality*, 511 U.S. 93, 99 (1994). A state tax that discriminates against interstate commerce is invalid unless "it advances a legitimate local purpose that cannot be adequately served by reasonable non-discriminatory alternatives." *Id*. at 101.

In *Maryland v. Louisiana,* 451 U.S. 725 (1981), the Supreme Court held that a Louisiana statute imposing a first-use tax on natural gas extracted from the continental shelf in an amount equivalent to the severance tax imposed on natural gas extracted in Louisiana unquestionably discriminated against interstate commerce in favor of local interest. There, tax payers subject to the first-use tax were entitled to a direct tax credit on any Louisiana severance tax owed in connection with the extraction of natural resources within the state. Most Louisiana consumers of off-shore gas were eligible for tax credits and exemptions, but the tax applied in full to off-shore gas moving through and out of state. *Id*. at 733. The court noted that the state severance tax credit "favored those who both own [off-shore] gas and engaged in Louisiana production" and that the "obvious economic effect of this severance tax credit [was] to encourage natural gas owners involved in the production of [off-shore] gas to invest in the mineral exploration and development within Louisiana rather than to invest in further [off-shore] development or production in other states."

In *Cuno v. DaimlerChrysler, Inc.*, the U.S. Court of Appeals for the Sixth Circuit struck down Ohio's income tax credit for new in-state investment on the grounds that it violated the Commerce Clause. (This decision was reversed in part by the U.S. Supreme Court because plaintiffs lacked standing to sue in federal court.) There, the Sixth Circuit agreed that the income tax credit discriminated against interstate economic activity "by coercing businesses already subject to the Ohio franchise tax to expand locally rather than out-of-state." The Circuit Court noted as follows:

> any corporation currently doing business in Ohio, and therefore paying the state's corporate franchise tax in Ohio, can reduce its existing tax liability by locating significant new machinery and equipment within the state, but it will receive no such reduction in tax liability if it locates a comparable plant and equipment elsewhere. Moreover, as between two businesses, otherwise similarly situated and each subject to Ohio taxation, the business that chooses to expand its local presence will enjoy a reduced tax burden, based directly on its new in-state investment, while a competitor that invests out-of-state will face a comparatively higher tax burden because it will be ineligible for any credit against its Ohio tax.

Cuno, 386 F.3rd 738, 743 (6th Cir. 2004), rev'd in part on other grounds sub nom. *DaimlerChrysler Corp. v. Cuno*, ____ US ______ (2006).

In this case, the courts will likely take a hard look at the legislation to freeze taxes for developers of the pipeline to determine whether, for example, these developers are already doing business in Alaska and are being coerced to build a pipeline there, instead of another state, based upon this tax incentive. Additional facts concerning the developers and proposed language for the legislation will need to obtained to determine how significant an obstacle this Commerce Clause scrutiny will be.