BEFORE THE STATE TAX APPEAL BOAD

OF THE STATE OF MONTANA

MCR, LLC.,	)	Docket No.: MT-2011-1
	)	
Appellant,	)	ORDER on
	)	MOTIONS FOR
DEPARTMENT OF REVENUE	)	SUMMARY JUDGMENT
OF THE STATE OF MONTANA,	)	
	)	
Respondent.	)	

This case comes to us on cross motions for summary judgment by Appellant, MCR, LLC (hereafter MCR) and the Respondent, the Montana Department of Revenue (DOR). This is an appropriate case for summary judgment as the parties agree there are no issues of fact to be resolved and their disagreement focuses on an interpretation of statute. Rule 56, M.R.Civ. P. The parties have submitted briefs supporting their motions and opposing each other's motions for summary judgment.

Facts Presented

1. MCR is a limited liability corporation, owned by members of the McDermott family, headquartered in Shelby, Montana. It develops and produces natural gas wells in Montana. (MCR, LLC's Memorandum in Support of Motion for Summary Judgment, p. 4.)
2. MCW Transmission, an unrelated company, owned contracts for the purchase of gas from at least 18 producers, including MCR, which it processed, "sweetened" and transmitted to the Montana Power Company

(later Northwestern Energy). (MCR, LLC's Memorandum in Support of Motion for Summary Judgment, p. 5.)

3. In 2000, MCW Transmission renegotiated its delivered natural gas contract with Montana Power, changing from a fixed rate price to an index price, so that the price fluctuated monthly according to the AECO-C price index established by the Alberta Energy Company in Medicine Hat, Alberta, Canada. AECO-C is the standard price index used for gas gathered on Montana Power's system. *Id.*

4. Shortly thereafter, MCW Transmission also renegotiated its supply contracts with the 18 wellhead producers from which it purchased gas, including MCR, so that the price at which they sold gas to MCW was also tied to the index. *Id.*

5. In 2005, members of the McDermott family formed MCR Transmission (MCR-T), a limited liability Montana corporation, which bought the supply contracts from MCW Transmission and now performs the gathering, processing and delivery tasks MCW had done. The contract price at which it purchased gas at the wellhead, as well as the contract price at which the processed gas was sold to Northwestern Energy, remained the same as the prices set by MCW in 2000 and have not changed since then. (MCR, LLC's Memorandum in Support of Motion for Summary Judgment, p. 6.)

6. At all times, MCR has filed and paid Montana taxes based on the value of its gas as determined by the contract price negotiated with MCW Transmission, which is the standard way that such taxes are calculated. It continues to be the method MCR-T's other suppliers use to calculate their taxes. (MCR, LLC's Memorandum in Support of Motion for Summary Judgment, p. 7.) Thus, of the 18 suppliers from which MCR-T buys gas at the wellhead, only the contract with MCR is at issue.

7. In 2008, MCR was the subject of a routine audit by the DOR. (MCR, LLC's Memorandum in Support of Motion for Summary Judgment, p. 9.)

8. In the course of the audit, DOR Auditor Melissa Quigley noticed that MCR (seller) and MCR-T (buyer) were owned by the same family, which she termed a "red-flag." (Quigley Depo: 33: 2-15.)

9. Citing the "business relationship" between the two corporations, the DOR determined that the contract was not an arm's length contract. (Final Determination Letter of May 13, 2010 from the Department to MCR, p. 4, MCR-DOR 000220.)

10. The letter stated "Our audit review shows there is no contract or a non arms-length contract at the wellhead and the wellhead isn't the point of sale. We define the point of sale as the point at which there has been a sale or transfer of the natural gas to an interstate or intrastate pipeline." (*Id.*, at p. 5.)

11. The DOR recalculated the price at which MCR sold its gas by taking the price at which MCR-T sold to Northwestern Energy and reducing it by the expenses the DOR considers allowable in gathering and transmitting the gas. Additional taxes were assessed of $435,689, plus penalty and interest of $254,597, for a total of $690,286. (*Id.*, at pp. 6-7.)

12. Taxpayer asserts the delivery price adjustment method used by the DOR during the audit to calculate the value of the gas is the "net proceeds tax" calculation contained in Section 15-23-602(d), MCA, which was repealed by the Legislature in 1995. Taxpayer cites for support the DOR's own internal Narrative memorandum of this case, "It is the department's determination to value the gas pursuant to the previous oil and gas net proceeds tax." (Deposition Exh. 33, p. 4, MCR-DOR 000347.) The Narrative also stated "This determination also follows the Administrative Rules of Montana of

6/30/88, 42.25.1001(17)," citing the DOR's regulations under §15-23-602(d), MCA, which had also been repealed, by the DOR, in 1996. *Id.*

Applicable Law and Legal Arguments.

1. The governing law during the tax years in dispute is contained in §15-36-305, MCA, enacted in 1995, which states:

> **Determination of gross value of product.** (1) The total gross value of all oil or natural gas produced and sold each quarter must be determined by taking the total number of barrels or cubic feet of oil or natural gas produced and sold each month at the average value at the mouth of the well during the month that the oil or natural gas is produced and sold, as determined by the department."

2. The Legislature repealed §§15-36-101 through 15-36-126, MCA, in 1995. The repealed code sections required that the tax would be based on the contract price of the gas or, in the case of sales between parties not acting at arm's length, the greater of the gross sales proceeds or the fair market value of the products sold. The language quoted above in §15-36-305, MCA, replaced this language and does not require an arms-length contract.

3. The DOR does not deny it used the net proceeds tax calculations in determining Taxpayer's deficiency. The DOR relies on the last phrase of the §15-36-305, MCA, "as determined by the department," as the basis for its authority to recalculate the value of the gas using the repealed statutes, and asserts that its interpretation of a statute which it administers is presumed to be controlling, citing *Christenot v. Dep't of Commerce*, 272 Mont. 396, 901 P.2d 545, 548 (1995).

4. The Legislature, in repealing §§15-36-101 through 15-36-126, MCA, in 1995 stated in §15-36-302, MCA:

> **Legislative findings and declaration of purpose.** (1) (a) The legislature finds that the extraction taxes imposed on the production of oil and natural gas have been exceedingly complex and confusing. Oil and gas producers have been required to file several tax forms and pay taxes at different time on the same production. (b) The legislature finds

> that it is in the best interest of the state and in the best interest of oil and gas producers to simplify the taxation of oil and natural gas production. (2) The legislature declares that the purposes of this part are: (a) to replace all net proceeds taxes, severance taxes, privilege and license taxes, and other extraction taxes on oil and natural gas production with a single production tax based on the type of well and type of production; (b) to ensure that the distribution of tax revenue to the state, counties, and school districts from the new production taxes is consistent with the distribution of tax revenue from the former extraction taxes; (c) to simplify the procedures for compliance with the administration of the taxation of oil and natural gas production;"

5. The DOR asserts that the legislative intent to maintain the revenues under §15-36-302(2)(b), MCA, supports its use of the gas valuation system established under the previous statutes and rules. (DOR Brief in Opposition to MCR's Motion, pp. 8 -9.)

6. Taxpayer asserts that the lynchpin of the DOR's audit revaluation was the finding of a non arm's-length contract, citing a question asked of Van Charlton, audit supervisor, in a deposition: "Q: and if the contracts between MCR and MCR, LLC were, in fact, arm's length contracts, did they correctly calculate their tax? A: Based on my involvement in the audit and the contract, what was reported on per return price, I believe yes." Charlton Depo: 38: 3-8.) *See also* Final Determination Letter of May 13, 2010 from the Department to MCR, p. 4, MCR-DOR 000220, describing the revaluation process as starting with DOR's finding a non arm's-length transaction.

7. Taxpayer claims that the DOR lacks authority for finding a non arm's-length contract because the code sections authorizing such a finding were repealed and the current code section, §15-36-305, MCA, enacted in place of those repealed sections, has no such provision, nor do the definitions of §15-36-303, MCA.

8. The DOR responds that finding a non arm's-length agreement was just one step in the audit, and that the deficiency resulted from an audit conclusion that the values "did not accurately reflect gross value" and the use of a "delivery price adjustment method of valuation" was justified.

9. Taxpayer asserts that "[I]t has long been the law that, when the Legislature amends a statute, we will presume that it meant to make some change in existing law." *State ex.rel. Mazurek v. Dist. Court of the Twentieth Judicial District*, 2000 MT 266, ¶ 18, 302 Mont. 39, 22 P. 3d 166. Therefore, Taxpayer argues, the phrase "as determined by the department" cannot be interpreted to mean that the Legislature intended to "replace all net proceeds taxes" and simultaneously grant the DOR discretion to continue to use the very method it repealed.

10. Taxpayer further notes that the regulations defining an arm's-length contract had also been repealed in 1996 by the DOR and no regulations were adopted which replaced the definition during the years at issue. With no published criteria in either statute or regulations for alternate methods of valuing the gas and determining whether the contract is arm's-length, Taxpayer claims that any intent by the Legislature to permit the DOR to use those repealed methods is void for vagueness. Taxpayer cites *Yurczyk v. Yellowstone County*, 2004 MT 3 ¶33, 319 Mont. 169¶33, 83 P.3d 266 ¶33 which held "[A] statute is void for vagueness on its face if it fails to give a person of ordinary intelligence fair notice that the statute does not permit the contemplated conduct."

11. Taxpayer cites Auditor Quigley, when questioned on this matter: "Q: Given the statute that was in effect in 2005, 2006 and 2007, the only way a taxpayer could figure out how to calculate the tax would be to call the State and ask? A: I believe so." (Quigley Depo.: 94:24 – 95:3.)

Issue

The issue presented is whether the Department appropriately adjusted the Taxpayer's returns for the years at issue. To determine that question, we review (1) whether the legislative repeal of statutory authority to calculate the value of gas using a net proceeds method while granting the DOR discretion to set those values permits the DOR to use the repealed methodology and (2) whether such a grant of authority is void for vagueness.

Discussion and Conclusions

To determine whether the Department has properly adjusted the Taxpayer's tax liability for the years at issue, we look to the taxing statutes at issue. The initial question is what statutory authority the DOR was given by the Legislature in 1995. The Legislative findings stated in §15-36-302(1)(a), MCA, are that the existing taxes have been complex and confusing and (b) it is in the best interest of the state and oil and gas producers to simplify the taxation of oil and gas.

The operative language in §15-36-302(2)(a), MCA, states that the purpose is to replace all net proceeds taxes, severance taxes, etc., "with a single production tax based on the type of well and type of production." The Legislature then created, in §15-36-304(2), a production tax: "(2) Natural gas is taxed on the gross taxable value of production based on the type of well and the type of production according to the following schedule for working interest and nonworking interest owners:" followed by eight different categories of production, such as stripper wells, first 12 months, horizontally drilled wells, etc., which are not here relevant. The plain meaning of the language of these sections is to repeal the old tax systems, including the net proceeds tax, and replace it with a simplified production tax based on the average, or market, value at the wellhead.

That brings us to the section conferring authority on the DOR, §15-36-305, MCA, which requires the determination of gross value by "taking the total number of barrels or cubic feet of oil or natural gas produced and sold each month at the average value at the mouth of the well during the month that the oil or natural gas is produced and sold, as determined by the department." The dispute between the Taxpayer and the DOR focuses on the meaning of that statutory phrase, the DOR interpreting it as a broad grant of discretion and authority, while the Taxpayer sees it as limiting the DOR to the average wellhead contract price.

The plain meaning of that single sentence is that the DOR is given the authority to determine the average monthly value at the mouth of the well. The methodology available to the DOR to determine the average value at the mouth of the well is limited by the express negative declaration of the Legislature that it considered the net proceeds tax complicated and unworkable. As a result, the sentence at issue is not a general delegation of authority that would allow the DOR to use any method of taxing gas production, but a very specific authority for the DOR or the Taxpayer to determine the average value at the wellhead, for tax purposes.

The average monthly price at the wellhead could be determined by reference to other contracts in effect at the time, such as those MCR-T has with its other suppliers, or by reference to a generally accepted price index, both of which were available to the DOR in this case. The DOR did not determine the average market price at the mouth of the well, however, but instead used the net proceeds tax calculations to determine a price for MCR based on MCR-T's final sale price to Northwestern Energy, less expenses of processing and delivery.

In general, the parties agree that the gross value of the gas at the mouth of the well is evidenced by the contract price paid for the gas. *See* FP #6. There is no disagreement that the contract price continues to be the basis of the tax for the other suppliers from which MCR-T purchases gas under the same pricing agreement as it does from MCR. That price is tied to a widely-used published index price. *See* FP #3. When auditing the Taxpayer, the DOR, however, did not look to the average value or fair market value at the mouth of the well as §15-36-305, MCA, requires. Rather, it denied the existence of the contract and calculated the value for MCR according to the repealed net proceeds tax methods. In so doing, the DOR clearly violated the intent of the 1995 statutes and exceeded its statutory authority.

In this instance, the legislature was very specific in its findings and directives. Had the Legislature meant to grant the DOR broad authority to calculate value by any means available, including the (now repealed) net proceeds tax, it would not have criticized and repealed the net proceeds tax. It could have simply increased the authority of the DOR to determine the tax by any appropriate method. It chose, instead, to repeal the net proceeds tax, expressly and with criticism, not simply augmenting it with a production tax but replacing it with that single, simplified tax calculation based on the gross value of the production measured at the mouth of the well. It is not for the Department to circumvent such direct legislative directive.

The DOR argues that the Legislative declaration of purposes in repealing "all net proceeds taxes" includes a goal of ensuring "that the distribution of tax revenue to the state, counties and school districts from the new production taxes is consistent with the distribution of tax revenue from the former extraction taxes." Section 15-36-302(2)(b), MCA. The DOR claims that this directive requires

they use the same methods of taxing in order to raise the same revenue and therefore represents a Legislative authorization to continue to enforce the laws that were expressly repealed in the previous section of the statute.

The Department misconstrues its directive. The legislative language is focused on the goal that the distribution of the new tax revenue be consistent with the distribution of the old tax revenue, that is, the shares of revenue be distributed in approximately the same proportions as before as a result of the simplified, unified tax system replacing a collection of complex taxes with one simple tax. Rules of statutory interpretation require that we read the sections of law in a manner that is harmonious, so we cannot interpret subsection (2)(b) to authorize the use of rules expressly repealed in subsection (2)(a) of the same code section, §15-36-302, MCA. Nor is it proper for the Department to use an expressly repealed methodology for the goal of maximizing tax revenues.

The Department asks for a partial summary judgment affirming that the "Department properly exercised its discretion to determine the gross value of the gas at the wellhead by utilizing the delivery price adjustment, a reasonable and well-accepted method of gas valuation." The DOR further asserts that the "application of that discretion is in harmony with the Oil and Gas Production Tax Act as a whole and consistent with the legislative and statutory history behind that Act." We cannot find or conclude that the DOR's actions enforcing rules expressly repealed by the Legislature to be in harmony with the act. Further, we see no evidence that the repealed net proceeds tax to be a "well-accepted method of gas valuation" as the Department has claimed[1].

[1] In fact, the Montana Supreme Court called the delivery price adjustment method used here "the least desirable method for determining market value." *Montana Power Co. v Kravik*, 179 Mont. 87, 586 P.2d 298 (1978).

By using repealed tax statutes to determine valuation, the DOR utterly fails to give notice to taxpayers. The lack of a published set of rules for the DOR's tax calculations, either in statute or regulations is particularly problematic in an audit situation. The disallowance of the MCR/MCR-T contract price was based on a finding of a non arm's-length contract. If the repealed language dealing with non arm's-length contracts were still in the code, Taxpayer would have been on notice that the identity of ownership of the two corporations might have caused a problem. As it is, they learned of the Department's interpretation only through the audit process, and were assessed $254,597 in penalty and interest for not having complied with an unwritten law. Furthermore, there is no applicable definition of arm's length in the code or regulations for the Taxpayer to address and challenge in its appeal. There was no ability for the Taxpayer to determine that it should have based its tax on an amount other than the contract price, or that the Taxpayer might be subject to substantial penalties and interest for a tax that it could not independently calculate. (*See* EP 23, citing the auditor's opinion that a taxpayer would have to contact the department to determine this tax.)

Further, we note an additional significant issue with the Department's interpretation. Had the repealed regulations still been in force, the definition of an arm's-length contract would have been "a contract . . . between independent, nonaffiliated parties of adverse economic interest not involving any consideration other than the sale." (ARM 42.25.1001(4).) Taxpayer's contract with MCR-T meets that standard of "arm's length" as the contract was negotiated by an unrelated buyer, MCW, years before the contract was purchased by MCR-T. Further, the contract is the same as the one in place for many other transactions, and is indexed to provide a market adjustment for price. While it is true that the two corporations, MCR and MCR-T, are both owned by the same family and could easily have changed the price at any time, the undisputed fact is that they did not

do so. They continue to operate under the same index-based price agreed to by MCR and MCW, and which matches other similar contracts with unrelated entities.

Another definition of a non arm's-length contract can be found in the tax statute at §15-23-801 MCA, (dealing with metal mines) which defines it as an agreement between parties when the sales price does not represent market value. In the instant case, the Taxpayer's contract is at market value, as evidenced by the fact that a dozen unrelated suppliers have the same price term, which is tied to a standard regional index. The uncontested facts presented to us also indicate that a more recent supply contract, entered into by MCR-T in a competitive situation, used the exact same price formula. (MCR Exh. 23, MCR-DOR 000232.) No evidence was submitted by the DOR that the contract price was not market value or had been manipulated by the parties for some tax advantage.

The DOR appears to be acting as if it is free to simply declare a contract to be non arm's-length without having to meet an actual definition. The Department provides no support for its position, and we conclude the position is unfounded in law.

It is clear that the Department of Revenue has broad authority and discretion in the administration of the tax laws. The DOR's discretion, however, must be rooted in a rule of law and operate under a standard of reasonableness. Our conclusion that the DOR does not have the authority to apply the rules that have been repealed by the Legislature obviates the need for a fuller discussion of the vagueness issues raised by the Taxpayer. Taxpayer's request for Summary Judgment is granted.

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Order

IT IS THEREFORE ORDERED by the State Tax Appeal Board of the State of Montana that the Taxpayer's Motion for Summary Judgment is hereby granted.

DATED this 7th day of June, 2012.

BY ORDER OF THE
STATE TAX APPEAL BOARD

(S E A L)

KAREN E. POWELL, Chairwoman

SAMANTHZ SANCHEZ, Member

NOTICE: You are entitled to judicial review of this Order in accordance with Section 15-2-303(2), MCA. Judicial review may be obtained by filing a petition in district court within 60 days following the service of this Order.

CERTIFICATE OF SERVICE

The undersigned hereby certifies that on this 8th day of June, 2012, a copy of the foregoing order was served on the parties hereto by the method indicated below and addressed as follows:

John G. Crist
Attorney at Law
CRIST KROUGH & NORD LLC
2708 1st Avenue North Suite 300
Billings, Montana 59101

✓ U.S. Mail, Postage Prepaid
___ Hand Delivered
___ E-mail

Keith Jones
David Stewart
Teresa Whitney
Tax Counsels
Legal Services Office
DEPARTMENT OF REVENUE
125 North Roberts Street
PO Box 7701
Helena, MT 59604-7701

___ U.S. Mail, Postage Prepaid
___ Hand Delivered
✓ Interoffice
___ E-mail
___ Telecopy

Donna Eubank by ja

DONNA J. EUBANK, paralegal assistant