BEFORE THE STATE TAX APPEAL BOARD

OF THE STATE OF MONTANA

WESTERN ENERGY COMPANY, Appellant, -vs- THE DEPARTMENT OF REVENUE OF THE STATE OF MONTANA, Respondent.	)))))))))	DOCKET NO.: MT-1994-1 FINDINGS OF FACT, CONCLUSIONS OF LAW, ORDER and OPPORTUNITY FOR JUDICIAL REVIEW

The above-entitled appeal came on regularly for hearing on the 4th day of February, 1997, in the City of Helena, Montana, pursuant to the order of the State Tax Appeal Board of the State of Montana (the Board). The notice of said hearing was duly given as required by law setting the cause for hearing. The taxpayer Western Energy Company (WECO), represented by John Alke, attorney, presented testimony in support of the appeal. The Department of Revenue (DOR), represented by Milo Vukelich, tax counsel, presented testimony in opposition thereto. At this time and place, testimony was presented, exhibits were received, a period allowed for post hearing submissions, and the Board then took the cause under advisement; and the Board having fully considered the

testimony, exhibits and all things and matters presented to it for its consideration by all parties in the Docket, and being well and fully advised in the premises, finds and concludes as follows:

FINDINGS OF FACT

1. Due, proper and sufficient notice was given of this matter, the hearing hereon, and of the time and place of said hearing. All parties were afforded opportunity to present evidence, oral and documentary.

2. The appellant raised the issues that are the subject of this appeal and which are described as follows:

(A) Was WECO entitled to reduce the delivered price of coal in accordance with 15-35-203(5), MCA, in the manner that it was calculated?

(B) Are there Montana coal production taxes and interest due for the production years 1987-1988, and 1989-1991 as claimed by the DOR? WECO asserts that the DOR is barred, based on prior settlement, from issuing a deficiency assessment for the production years 1987-1988.

3. The coal production taxes at issue are the coal severance tax, the coal gross proceeds tax, and the resource indemnity trust tax.

4. WECO exhausted the remedies available to it with the DOR and appealed to this Board from a decision of the Director issued on August 12, 1994. This Board has

jurisdiction over this matter pursuant to 15-2-302, MCA.

5. WECO presented the testimony of Dianna Tickner, a former employee, and Don Hoffmann and Peter J. Donnelly, DOR employees, in support of the appeal. The DOR presented the testimony of Don Hoffman, Natural Resources Bureau Chief, and Peter J. Donnelly, Tax Auditor, in opposition to the appeal.

6. WECO witness Dianna Tickner, former head of contract administration for WECO, testified concerning the calculation of new coal production incentive tax credits. She explained that in response to a legislative attempt to stimulate new production and purchase of Montana mined coal, a coal severance tax was adopted on new or incremental coal purchases. Each purchaser of coal had to individually qualify for the credit by increasing their purchases of Montana mined coal. The DOR is required to certify that the purchasers qualified for the incentive tax credit. The credit received was then utilized to reduce the price of the coal sold to that purchaser.

7. Ms. Tickner explained the "tax reimbursement clause" typically found in the coal contracts with their purchasers. She stated that each customer would pay their fair share of the taxes that WECO paid to various state and federal

agencies based on the coal price that they paid. The contracts also contained clauses for credits or "true up's" to the coal price for such things as "lower coal quality than expected" or "an overpayment of electric refunds." The amount of credit due was subtracted from the base price of the coal; that is how WECO viewed the incentive tax credit as well.

8. Ms. Tickner testified to her understanding of how the severance tax credit was determined. She stated that 1986 was considered the base production year for tonnage of coal purchased by a customer. Increases in tonnage over what the customer purchased in 1986, in subsequent years, would be eligible for the severance tax credit. The credit amounted to a 40% reduction in the period between July 1, 1988 through June 30, 1990, and a 25% reduction in the period between July 1, 1990 through June 30, 1991. The customer received the credit through a reduction in the coal price.

9. WECO exhibit #42 is a hypothetical demonstration of how the tax credit was used to adjust the coal price. WECO exhibit #43 is an example of an actual credit determination and subsequent price modification.

10. Ms. Tickner described several series of WECO exhibits wherein the DOR modified the taxes and interest due

for the period 1987-1988. Exhibits 1-3 dated April 14, 1992, refer to specific findings by the DOR and impose the additional taxes and interest due. Exhibit 4 dated May 6, 1992, further amends the amounts due as calculated by the DOR. Exhibits 5-7 dated June 2, 1992, detail further changes made by the DOR in the amount of taxes and interest due. Exhibits 8-10, dated June 23, 1992 detail another change in the amount of taxes and interest due as calculated by the DOR. Exhibits 11-13, dated June 30, 1992, constitute further revisions by the DOR in the amount of taxes and interest due. She testified that in none of these DOR letters that carried tax and interest modifications was the incentive tax credit raised as an issue by the DOR.

Exhibits 5-13 all contain a common paragraph stating, "This does not constitute finalization of this audit but rather a settlement of issues that Western Energy and the Department agree upon. This audit will be finalized in conjunction with the 1989-1991 audit to be conducted in Western Energy's offices in August 1992."

She stated that WECO agreed to the amount of taxes due but not the amount of interest due because of the amount of time that had passed for the DOR to conduct the audit. WECO

made payment to the state for the additional taxes due on August 6, 1992. WECO made payment to Rosebud County on August 12, 1992, but the county returned the payment on August 21, 1992 because they had been notified by the DOR that the audit was not final.(Ex 15)

11. Ms. Tickner testified concerning the August 26, 1992 "exit conference" stating that issues raised by the DOR for the 1989-1991 period were discussed, and that the only issue discussed concerning the 1987-1988 period was the interest amount due. That issue was not settled until September 16, 1992 (Ex 17), and WECO paid the amounts determined at that time. With those payments made WECO believed the 1987-1988 period was finally settled. If it had thought otherwise, WECO would not have made the payments, as it had not done so in the past. The amounts due were certified to Rosebud County on October 6, 1992 by the DOR.

12. Peter Donnelly, an auditor for the DOR, was called as a witness by WECO. He participated in the field work on both audits. He testified that WECO correctly calculated the amount of incentive tax credits for the amount of qualified coal sold. He referred to his deposition testimony and stated

that, in August or September of 1992, the bureau requested a legal opinion concerning the treatment of the incentive tax credit and whether it should be a deduction or not a deduction. The legal opinion was issued dated November 16, 1992. (Ex 20) It then became a matter of showing the coal companies what effect the opinion would have on them.

Mr. Donnelly stated that he believed the deficiency notice submitted to WECO on January 29, 1993 (Ex 25) would have been sent to WECO even if the legal opinion had not been sought. He stated the legal opinion confirmed what had been the "thought process" within the division. He agreed that incentive tax credits were not indicated as an issue in the prior DOR deficiency notices sent to WECO for the 1987-1988 period. He agreed that the DOR intent was to finalize the 1987-1988 audit during the August meeting to be held in Colstrip. The meeting in August was being held to begin the 1989-1991 audit and to conduct the exit conference for the 1987-1988 audit. He qualified his testimony by stating that he had told WECO that they (DOR) were going to review the incentive tax credit issue, but he could not remember whether he had identified that as being applied to the 1987-1988 period or specifically to the 1989-1991 period.

Mr. Donnelly responded to questions from WECO counsel that prior to this case he had not seen an audit "finalized", or more specifically "settled" more than once. He also stated that he did not know of a situation where the DOR had sent a letter to a county certifying additional assessments due until they were considered final.

Mr. Donnelly testified that WECO had been supplying the DOR with additional information through June 30, 1992, which was the date that the parties agreed on the amounts due.

13. Mr. Donnelly also testified for the DOR. He explained exhibit C for the Board, and indicated that there is no dispute over the amount of coal, the amount of revenue, the incentive tax credit revenue, the resulting total revenue, or the amount of the incentive tax credit. The dispute is over the indication of the contract sales price; and the amount of tax still due because of the method of the application of the incentive tax credit.

14. Don Hoffman testified that the DOR had promulgated Administrative Rules concerning the formula for how taxes are to be calculated concerning the actual taxes paid on production of coal. He specifically cited 42.25.1707(2) ARM as controlling how the incentive tax credit should be taken by a

coal producer. It is his opinion that in this case WECO has not followed the formula set out in this rule. Exhibit B was explained by Mr. Hoffman to illustrate the difference between what WECO has done compared to what the DOR considers the correct method of calculating the tax due and its effect on the contract sales price.

15. Mr. Hoffman testified that he was the person in his bureau that had the authority to settle or close audits. Revenue agents under his supervision do not have that authority. He stated that he had not closed the 1987-1988 audit of WECO. His testimony was that the DOR "usually try to provide some sort of correspondence saying that the audit period is closed, or is settled, or some reference along that line ." He stated that he had not sent or received a letter of agreement or a stipulation of agreement from WECO for 1987-1988.(Ex F&G)

16. Mr. Hoffman testified that the "statute is clear, despite what the regulation says." The calculation is done he said by, "first you determine what the incentive tax credit is, and you're entitled that as an incentive credit. Then you have to go back and apply that credit properly against those production taxes in 15-35-103. That tells you how to

compute the tax." In his opinion WECO only did one part of a two part calculation. "WECO only reduced the revenue side of it and left the tax deduction alone."(Hoffman testimony)

17. The DOR provided the *Black's Law Dictionary* definition of "settlement" as:

> In legal parlance, implies meeting of the minds of parties to transaction or controversy. To fix or resolve conclusively; to make or arrange for a final disposition.

18. The DOR presented exhibit C to demonstrate the method used by WECO and the method used by the DOR to calculate the production taxes due in this case.

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BOARD'S DISCUSSION

Is it possible for there to be a dispute between the seller of coal and the DOR over the contract sales price of the coal? If the arm's length nature of the sale is questioned, or if the DOR need impute the price of coal for the reasons outlined in statute, of course. Here we have agreement of the parties as to coal tonnage, revenues from the coal, the incentive tax credit revenue, and the amount of the incentive

tax credit due the coal mine operator which must, in turn, reduce the price of the coal to the qualified purchaser in accordance with 15-35-203(5), MCA. Even with all that agreement a dispute remains over the contract sales price because of proper application of the credit.

Incentive tax credit is a credit against the tax imposed under 15-35-103, MCA. Contract sales price is equal to the FOB mine price less the taxes paid, less government royalties, and less the 20,000 ton exemption. For there to be a credit against a tax, there has to be a tax paid and the amount of tax paid reduced. Otherwise the producer is lost in the middle between paying the required tax and reducing the price to the purchaser as required by statute.

Why is there such a thing as the incentive tax credit? We believe the incentive is to get qualified purchasers to purchase more Montana coal, via a tax reduction that affects a price reduction. The action might be viewed as a carrot and stick that results in Montana coal producers mining more coal. The tax incentive is not to get Montana producers to mine more coal that it would attempt to sell from increased inventory by reducing the price. It could be argued that the coal producer is at liberty to do that at any time,

with any customer. The incentive here is offered in the form of a tax reduction that reduces the price to a qualified buyer.

To the DOR the formula for the calculation of the contract sales price, use of the incentive tax credit, and the determination of production taxes due is a two part formula. In the first part 15-35-103, one determines the amount of the tax to be paid. The second part, the new coal production tax credit, is based on the previous year's production. The tax itself is a deduction that one is allowed to take to arrive at the price, a deduction that is lowered by the amount of the incentive tax credit. Contract sales price is the basis for the tax. The Board agrees with the position of the DOR as to the method for the calculation of the credit and the method of calculating the coal production taxes due.

If the Board agreed with the WECO method of treatment of the incentive tax credits it would not need to address the second issue raised by WECO of prior settlement of the audit period 1987-1988, since it would be moot. If the Board agrees with the DOR method, then the second issue of the 1987-1988 audit period must be addressed.

The trail of correspondence from the DOR to WECO and between WECO, Rosebud County, and the DOR, led the taxpayer,

and this Board to a conclusion that the additional assessments were determined, levied, certified, and paid, indicating a finality to the matter. It is also clear that, prior to the October 6, 1992 letter from the DOR to Rosebud County (Ex 19) detailing changes to the 1987-1988 audit, a notification that Rosebud County was waiting for before acceptance of the taxpayer payment, the DOR was still unclear itself as to proper incentive tax credit handling.

On September 22, 1992, the natural resource tax bureau was still seeking advice from the DOR legal department (Ex 18) as to the deductibility of incentive tax credits. Both exhibits are signed by the same individual, so it could not have been a situation where one person was unaware what another was doing. It is the opinion of this Board that if there was still some question as to the proper handling of the credits, the October 6, 1992 certification to the county should have been withheld. Certainly the issue should have been identified with the taxpayer. The issue was not raised by the DOR even then until the January 29, 1993 series of letters to the taxpayer. (Ex 23, 24, 25) A substantial amount of time was allowed to pass, even though the DOR had been discussing the issue internally throughout the spring and summer of 1992,

according to Mr. Donnelly.

The DOR submitted two exhibits as examples of what it considered a finalization of an audit to look like. Exhibit G is a signed settlement agreement. Exhibit F is presented as a finalization, yet there is no language in it that says it is final. It is, in fact, a letter to the DOR from a taxpayer who says they agree with an apparent tax adjustment. This is not that much different in content than exhibit 15, a letter from WECO to DOR stating agreement with a principal amount due but not the interest amount alleged as due. Exhibit 15 states clearly that WECO will pay the principal amounts and settle the interest issue at a meeting on August 17, 1992 with the DOR. Exhibit 16 reinforces that agreement and understanding of the outstanding matter of the interest.

Exhibit 17, a letter from DOR to WECO dated September 16, 1992, then asks, "Please advise us if you are in agreement with these numbers so as we may certify these amounts to Rosebud County." The numbers were then certified to the county and the amounts paid by WECO.

Mr. Hoffman stated that there was an exit conference in August of 1992 for the 1987-1988 audit but that he was not present. He stated that he had discussions following the

August 1992 meeting with WECO concerning the issue of the interest due.

He characterized the August, 1992 meeting as an "exit meeting." He described an "exit meeting" as one where the taxpayer and the DOR agent would discuss audit issues. A "settlement meeting" would be one to specifically resolve issues if there were any compromises that might be made between the parties. The discussion that followed with Ms. Tickner he considered as a "settlement conference". The record is clear that the issue of Incentive Tax Credits was not raised.

The testimony and evidence in this matter indicate that, although the statute may have seemed clear to the administrators of this tax, it was not clear enough. A question of doubt existed within the DOR, and it certainly was not clear to the practitioners who had to calculate the taxes for Montana.(Ex 34) There was no direct instruction to the coal producers as to the DOR position. The Administrative Rules are not specific or instructive to the position taken by the DOR. 42.25.1707 ARM, does not articulate the formula relied upon by the DOR for the tax computation. If it had, the problem of having various methods of calculation would not have occurred. It is because of this uncertainty and lack of

raising the issue of Incentive Tax Credits, even as a possible issue, during the 1987-1988 audit process, that the Board arrives at its decision. The Board is mindful of the statute of limitations on coal production taxes but is of the opinion that the issues raised during the audit period had been finalized. The practitioners need to know what is expected and when an issue is settled.

Ample opportunity existed for the DOR to indicate to WECO that there was an unresolved issue in 1987-1988 period, yet it was not raised; for example: a succession of nine letters to WECO, an exit meeting in August, 1992, a certification of amounts due to the county, the payment and acceptance of the payment of those additional amounts due.

There could not have been a "meeting of the minds" described in the definition of "settlement" as provided by the DOR because that definition makes it clear that both parties would be aware of the controversy. Here one party was aware of it and not until the other party believed that the only remaining issue had been settled was a new issue raised. There was, in fact, a "meeting of the minds" on the issues identified in exhibits 17 & 19. It is the opinion of this Board that the raising of the additional issue of Incentive Tax Credit

caluculation, following those actions, be barred for the 1987-1988 period.

It is therefore the opinion of the Board that the appeal, as to the calculation of tax liability from the New Production Incentive Tax Credit Act of 1985, is denied. It is also the opinion of the Board that the secondary issue in this appeal, that of barring the additional deficiency assessments for the 1987-1988 period, be granted because of the prior agreement of the issues raised.

CONCLUSIONS OF LAW

1. 15-35-203(5), MCA, states:
Each coal mine operator must reduce the delivered price of coal sold to each qualified purchaser by an amount equal to the credit received on incremental production sold to that purchaser.

2. 15-35-114, MCA, provides the statute of limitations:
(1) Except as otherwise provided in this section, no deficiency may be assessed or collected with respect to the year for which a return is filed unless the notice of additional tax proposed to be assessed is mailed within 5 years from the date the return was filed.

3. 42.25.1707 Administrative Rules of Montana states:
(2) In computing production taxes the operator may include that amount which he expects to pay or the amount charged to the purchaser. If the taxes actually paid on the production are more or less

than the production taxes deducted and affect the contract sales price, the difference shall be an adjustment in production taxes deducted for the following year.

4. In interpreting tax statutes it should always be kept in mind that they are to be strictly construed against taxing authorities, and in favor of the taxpayer. *Butte Country Club v. DOR,* 186 Mont. 430, 608 P.2d. (1980)

ORDER

IT IS THEREFORE ORDERED by the State Tax Appeal Board of the State of Montana that the appeal be denied in part and granted in part, and the decision of the Department of Revenue is reversed.

Dated this 16th of June, 1997.

BY ORDER OF THE
STATE TAX APPEAL BOARD

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PATRICK E. McKELVEY, Chairman

(S E A L)

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GREGORY A. THORNQUIST, Member

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LINDA L. VAUGHEY, 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.