The Battle over Taxation of Oil and Gas Moving in Interstate Commerce

John Brusniak Jr., Esq.

Three recent judicial decisions have resulted in a significant conflict in the taxation of oil and gas moving through the stream of interstate commerce in the United States. The conflict involves oil and gas products moving though Texas and Oklahoma. Natural gas (and potentially oil) producers that move products through interstate pipeline facilities are not required to pay ad valorem taxes on their products, while those products are located in Texas. Other oil and gas producers that opt to move their products through Oklahoma are required to pay this ad valorem tax. This discussion summarizes the three recent judicial decisions and describes the resulting irregular taxation of property traveling in the stream of interstate commerce.

Introduction

Billions of barrels of oil are produced annually in the United States. Trillions of cubic feet of gas are produced annually in the United States. Virtually all U.S.-produced oil and gas is transported through interstate pipeline systems. These pipeline systems span from the fields in which the oil and gas is produced to the refineries or plants where the oil and gas is converted to use. Throughout the transport process, the oil and gas reach transfer facilities along the pipeline system.

Examples of transfer facilities include the complex network of pipes and tanks located in Midland, Texas, the underground gas storage facilities owned by the Natural Gas Pipeline of America in Harrison County, Texas, or the facility owned by Panhandle Eastern Pipeline Company in Woods County, Oklahoma. Many such oil and gas transfer facilities are located across the United States.

The function of a transfer facility (or storage point) is to allow for the orderly transmission of oil and gas products through the pipeline system as they move from the field to the ultimate users. Without these facilities, the products would back up through the system and require systematic shutdowns of production until such time as the pipelines had sufficient capacity to move the product. At any given time, there can be between three million and six million barrels of oil in the Midland transfer point and between 70 trillion and 86 trillion cubic feet of gas in the storage facility in Harrison County.

The oil and gas products located at these facilities are produced both:

1. in the state in which these facilities are located and
2. in states other than where these facilities are located.

The products are also shipped to facilities both within the state and outside the state in which the facilities are located. The pipeline companies moving the products are all regulated by the Federal Energy Regulatory Commission.

Texas, Oklahoma, and many other states tax oil and gas once it has been removed from the ground. After removal, oil and gas is considered personal property and not real property. These oil and gas products are frequent targets of attempted taxation.

If these oil and gas products are wholly located within a state, they are taxable for property tax purposes by the taxing authorities in that state. Problems arise, however, when the products are

moving in the stream of interstate commerce. When that occurs, the Commerce Clause of the United States Constitution comes into play.

U.S. Constitution

The Constitution in Article I, Section 8, grants authority to the Congress of the United States: "To regulate Commerce with foreign Nations and among the several States, and with the Indian Tribes." The U.S. Supreme Court has said that this provision "gives exclusive power to the Congress to regulate interstate commerce, and its failure to act on the subject in the area of taxation nevertheless requires that interstate commerce shall be free from any direct restrictions or impositions by the States."[1]

How to interpret what constitutes an improper direct restriction or imposition has proven difficult for the U.S. Supreme Court. Since 1824, when the Supreme Court first addressed this issue,[2] this provision has been the subject of hundreds of opinions by the Supreme Court.

The U.S. Supreme Court's primary concern is that taxation places unnecessary burdens on property moving between the states. However, the Supreme Court has also recognized the rights of states to implement taxation regimens.

The Brady Case

Although there have been numerous cases since 1977, the Supreme Court's opinion in *Complete Auto Transit, Inc. v. Brady*,[3] was the clearest attempt at laying out a statutory test as to whether taxation on property that is moving in the stream of interstate commerce violates the Commerce Clause.

In the *Brady* case, the Supreme Court stated that a tax had to pass the following four tests to be valid under the U.S. Constitution:

1. The activity being taxed has to have a substantial nexus (i.e., connection) with the taxing state.
2. The tax has to be fairly apportioned.
3. The tax must be uniformly applied and not be implemented in a manner so as to discriminate against interstate commerce.
4. The tax has to be fairly related to the services provided by the state to the taxpayer.

If the tax fails to pass all four elements of the *Brady* test, it is unconstitutional.

On the other hand, simply establishing that property is moving in the stream of interstate commerce without failing any of the elements of the *Brady* test is insufficient by itself to exempt the property from taxation.

The *Brady* test is a critical element of proof, but it is only the starting point for a taxpayer seeking to escape state and local property taxation. Additionally, it is important for a taxpayer to prove that the item moving in the stream of interstate commerce is not being detained at a location at the request of—and for the benefit of—the taxpayer.

Recent Texas and Oklahoma Cases

Against this background, three court cases that took place simultaneously should be considered. This is because these cases significantly affect a major part of the U.S. economy: the oil and gas industry. Two of these cases arose in Texas. One case related to oil, and the other case related to natural gas. The third case arose in Oklahoma and related to natural gas.

Texas and Oklahoma are adjoining states, separated by a river, that both significantly depend on oil and gas to support their economies and tax structures. Both states tax oil and gas in their raw state as personal property once the products are removed from the ground. There is no question that these products are fully taxable if they (1) are located within these states and (2) are not in the stream of interstate commerce.

In Texas, the recent disputes were initiated by an earlier case, *Exxon Corp. v. San Patricio County Appraisal District*.[4] The *Exxon* case involved intrastate, as opposed to interstate, commerce. Oil coming in from fields through pipelines was being accumulated in San Patricio County until sufficient quantities were achieved to justify sending the oil on to Exxon's refinery in another county (via Exxon's own private pipeline).

The parties agreed that (1) over 400,000 barrels of oil were located at the facility at any given time during the tax year and (2) no particular barrel of oil was located there for longer than 17 days. Exxon argued that the oil had not acquired a tax situs in San Patricio County because it was only in the county temporarily.

The Appeals Court disagreed. It ruled that, "Property will acquire a situs when it has been located in the area with such permanence that it becomes part of the general mass of property within the boundaries of the taxing authority."[5] The Appeals Court disregarded the fact that no individual barrel of oil stayed within the county for longer than 17 days. Instead, the Appeals Court

focused on the fact that there was a constant presence of over 400,000 barrels of oil in the county.

Although the *Exxon* case was not directly reviewed by the Texas Supreme Court, the Texas Supreme Court quoted extensively, and approvingly, from it in *Diamond Shamrock Refining and Marketing Co. v. Nueces County Appraisal District*.[6]

That case involved oil that was coming into the United States from overseas on tanker ships and being offloaded in one county before being sent by pipeline to another county to be refined. The court found that the Commerce Clause was not violated. This was because the oil never left Texas once it was removed from the tankers.

The first of the two most recent Texas cases, *Midland Central Appraisal District v. BP America Production Co.*,[7] involved the transportation of oil from where it was produced in Texas and New Mexico through large tank farm facilities on its way principally to Oklahoma, with approximately 10 percent of the oil being sent to a refinery in Big Spring, Texas. The oil would leave the tank farms somewhere between 6 hours and 72 hours after it entered the facility. A certain minimum amount of oil was constantly kept in the tanks to float the roof of the tank and to meet emission standards.

Additionally, some blending and batching of the oil occurred. This allowed sour crude oil to be converted to sweet crude. The oil in issue was subject to trading (1) while it was in the pipeline on its way from the oil fields to the tank farms, (2) while it was at the tank farm, and (3) while it was on its way to its ultimate destination. The tax appraisal district in Midland valued the oil for taxation and assessed the tax to the owners of the oil being shipped and not to the pipeline company that was doing the shipping. Much of the oil being shipped was also produced by the same companies that were shipping it.

The court found that the oil in question, unlike the oil in the *Exxon* and *Diamond Shamrock* cases, was in the stream of interstate commerce because it was being transported by a common carrier pipeline system and remained in the interstate system throughout its transportation. The fact that 90 percent of the oil was destined to refineries outside the state of Texas confirmed the interstate nature of the oil. The fact that the oil remained in the tanks for 6 hours to 72 hours, that blending and batching occurred during these periods, and that 8,000 to 10,000 barrels of oil were required to remain in the tanks as cushion for safety and for emission purposes, did not constitute an interruption of the flow of the oil in the stream of interstate commerce so as to allow its taxation in Texas.

However, under the *Brady* case, the fact that oil is moving in the stream of interstate commerce is insufficient in and of itself to prohibit a state from imposing its ad valorem taxes on it. For the state to be able to impose ad valorem tax on the oil, it had to pass all four elements of the *Brady* test. The court found that the tax failed the first test, because there was insufficient nexus to the state.

Even though substantial quantities of the oil were produced in Texas and a small portion of it was destined to refineries in Texas, the oil itself was not being stored in the state. Oil that is merely moving across a state does not have a sufficient connection to that state to allow its taxation. To do so would violate the Commerce Clause of the Constitution. Having found that the tax failed the first test, the court did not review the tax under any of the three remaining *Brady* tests. The court held that the oil was not taxable in Texas.

The second case, *The Peoples Gas, Light, and Coke Co. v. Harrison Central Appraisal District*,[8] involved the transportation and storage of natural gas in Texas. Factually, the case was similar to the *BP* case, with a couple of significant differences.

The party upon whom taxation was being sought was the company that supplied users of natural gas in Chicago, Illinois. To supply its customers, Peoples purchased gas already in the interstate commerce pipeline system. It did not produce any of its own gas.

Peoples did not have any facilities or employees in Texas. The gas that it owned was located throughout the pipeline system in various storage facilities in different states. The gas being taxed was gathered from across Texas and placed in the interstate

pipeline owned by a common carrier. The carrier at its Texas facility constantly maintained a cushion of gas. Unlike the oil in the *BP* case, the natural gas in this case was stored at the Texas facility and at other locations along the pipeline.

The reason for the difference between the two cases is that there is a strong continuous demand for refined oil in the United States regardless of the season of the year. However, the need for natural gas is more seasonal.

The use of natural gas peaks during the winter months when it is used to heat homes and businesses. Because an insufficient quantity of gas could be produced during the cold weather months, and because it would be inefficient to open and shut gas wells, gas is produced continuously year-round and stored for usage during the peak months. The Texas appraisal district assessed taxes against Peoples for its pro rata share of the gas being held at the Texas facility.

As in the *BP* case, it was clear that the gas in question was in the hands of a regulated interstate pipeline common carrier and that the gas was moving across state lines. The question that was initially presented was whether the storage of the gas constituted an interruption of the flow of the gas in interstate commerce so as to allow Texas to tax it.

To constitute a taxable interruption of the gas flow in the stream of interstate commerce, the interruption had to occur for the business purposes of the owner of the gas. In this case, Peoples had no control over where the natural gas was stored or the quantities of gas that would be stored at any particular location. Therefore, the interruption was not made for the benefit of Peoples.

The court noted that the U.S. Supreme Court said that "Underground gas storage facilities are a necessary and integral part of the operation of piping gas from the area of production to the area of consumption."[9] Finally, the court found that, under Federal Energy Regulatory Commission regulations, the storage of natural gas was deemed to be part of the transportation of natural gas in interstate commerce. As a result, the court held that the storage of the gas in the underground cavern facilities in Texas did not constitute an interruption of the flow of the gas so as to allow its taxation in Texas.

Again, this fact was not sufficient to absolve the gas from potential taxation, and a review was required under the *Brady* test. In reviewing the nexus component of the *Brady* test, the court agreed with the taxing authorities that there was a substantial connection between the gas at the facility and its origination in Texas. However, the court noted that it could not be shown the specific location from which Peoples' gas originated. Given the fact that they have no offices, representatives, employees, or physical facilities within the state, the connection between Peoples and the gas subject to tax was too tenuous to show compliance with the nexus component of the *Brady* test.

Although it was not required to do so, the court also reviewed the applicability of the fourth element of the *Brady* test—whether the tax imposed bore a reasonable relationship to the services provided to the taxpayer.

To demonstrate compliance with this element of the *Brady* test, the taxing authorities offered evidence of police and fire protection that was provided to the facility by the local authorities. The court, however, was not persuaded. It pointed out that the pipeline company was responsible for the gas at its location and that the pipeline company paid ad valorem taxes on the value of its pipeline, the cavern, and the cushion gas that was located at the facility. Those taxes were sufficient to cover the services provided by the government. As a result, the court found that the tax failed both the first and fourth elements of the *Brady* test. Thus, the gas could not be assessed for taxation.

The third case, *In the Matter of the Assessment of Personal Property Taxes Against Missouri Gas Energy*,[10] involved the storage of gas in Oklahoma. Natural gas that was produced in Oklahoma was shipped by a regulated pipeline common carrier to an underground facility in Woods County, Oklahoma. The natural gas owner, Missouri Gas, had no facilities or employees in Oklahoma and did not sell any gas to customers in Oklahoma.

The facts and arguments in the *Missouri Gas* case are almost indistinguishable from those in the Peoples case. However, the Oklahoma Supreme Court came to the exact opposite conclusion. It found that the gas in issue was being stored in

Oklahoma for the benefit of Missouri Gas. The court ruled (1) that there was a substantial presence of gas in Oklahoma that was not "in transit" and (2) that Missouri Gas knew that the gas was going to be stored in Oklahoma for its benefit.

The court disagreed with the *Peoples* case as to the import of the Federal Energy Regulatory Commission regulation that stated that storage was a component of transportation. The court found that the rule had nothing to do with the issues in this case. Rather, the rule was intended to deal with issues pertaining to equal access of gas by customers on a nondiscriminatory basis. As a result, the Oklahoma court, unlike the two Texas courts, found compliance with the first element of the *Brady* test.

The Oklahoma court also found compliance with the second and third elements of the *Brady* test, which were not challenged in the two Texas cases. Finally, the Oklahoma court held that the fourth element of the *Brady* test was also met. The court stated that there did not have to be a correlation between the amount of governmental services provided and the tax imposed. This is because interstate commerce was not intended to be shielded from participating in the general cost of providing governmental services.

The Oklahoma court found that the tax was "reasonably related" to the services provided. As a result, the taxation was constitutional under the Commerce Clause.

The Texas Supreme Court declined to review its two appellate cases. Petitions for writs of certiorari were filed in all three cases with the U.S. Supreme Court. The Supreme Court initially reviewed the *Missouri Gas* case and asked the U.S. Solicitor General for advice as to whether it should take the case under review.

The Solicitor General[11] indicated that she did not believe the case raised any new or novel Commerce Clause issues. Thereafter, the Supreme Court declined the petition. After that, the two Texas taxing authorities sought review from the Supreme Court.

They pointed out the nature of the conflict between their decisions and those of the Oklahoma Supreme Court, but the Supreme Court also declined to review these cases.

Summary and Conclusion

As a result of these three court decisions, an anomalous situation now exists. Producers of natural gas (and potentially oil as well) in Texas who move products through storage facilities are not faced with paying ad valorem taxes on their products.

Others, opting to move their products through Oklahoma, will have to bear the burden of this tax. It remains to be seen whether

1. other state taxing authorities emboldened by the Oklahoma Supreme Court decision will undertake taxation of oil and gas products being moved by interstate commerce pipeline common carriers and
2. the U.S. Supreme Court will have another opportunity to address this bizarre and significant conflict in the taxation of oil and gas moving through the stream of interstate commerce in the United States.

Notes:

1. Northwestern States Portland Cement Co. v. Minnesota, 358 U.S. 450, 458 (1959).
2. Gibbons v. Ogden, 22 U.S. 1 (1824).
3. 430 U.S. 274 (1977).
4. 822 S.W.2d 269 (Tex. App.–Corpus Christi 1991, *writ denied*).
5. 822 S.W.2d at 274.
6. 876 S.W.2d 298 (Tex. 1994).
7. 282 S.W.3d 215 (Tex. App.–Eastland 2009, *pet. denied*) cert. denied, 139 S. Ct. 2097 (2011).
8. 270 S.W.3d 208 (Tex. App.–Texarkana 2008, *pet. denied*) cert. denied, 139 S. Ct. 2097 (2011).
9. Schneidewind v. ANR Pipeline Co., 485. U.S 293 (1988).
10. 234 P.3d 938 (Okla. 2009), cert. denied, 130 S. Ct. 1685 (2010).
11. Elena Kagen, now a sitting Justice on the U.S. Supreme Court.

John Brusniak Jr., Esq., is a nationally recognized property tax attorney. His ground-breaking appellate successes over the past 30 years and his active involvement with the legislature have significantly influenced Texas property tax law. He is a frequently sought speaker and publisher of property tax articles and texts. John has been recognized by his peers with election to the positions of chair of the American Bar Association's Property Tax Committee, chair of the State Bar of Texas' Property Tax Committee, and chair of the entire State Bar of Texas Section of Taxation. He has repeatedly been selected as one of "Texas' Super Lawyers" and one of "The Best Lawyers in America." John is the managing shareholder of the property tax specialty law firm of Brusniak | Blackwell PC and is president of the National Association of Property Tax Attorneys. John and his firm represented ExxonMobil Corporation and Natural Gas Pipeline of America, Inc., in the cases summarized in this discussion. He can be reached at (972) 250-6363 or at john@txtax.com.