BEFORE THE HEARING OFFICER
OF THE TAXATION AND REVENUE DEPARTMENT
OF THE STATE OF NEW MEXICO

IN THE MATTER OF THE PROTEST OF
CHEVRON USA, INC., FEIN 25-0527925
CORPORATE INCOME TAX ASSESSMENT
FYE December 31, 2004 through December 31, 2006
LETTER ID NO. L2023525760

DECISION AND ORDER

This matter comes for determination before Gerald B. Richardson, Hearing Officer on cross-motions for summary judgment filed herein, and their supporting memoranda of law. Chevron USA, Inc., hereinafter, "Taxpayer", was represented by Andrew J. Cloutier, Esq. The Taxation and Revenue Department, hereinafter, "Department", was represented by Tonya Noonan Herring, Esq. Argument was heard on the motions for Summary Judgment on November 18, 2010 and the matter was considered submitted for determination at that time. Based on the evidence and the arguments presented, IT IS DECIDED AND ORDERED AS FOLLOWS:

FINDINGS OF FACT

1. The Department conducted an audit of the Taxpayer for tax years 2004, 2005 and 2006, which was completed on October 28, 2008.

2. The Taxpayer is an integrated petroleum company incorporated in the state of Pennsylvania in 1922.

3. The Taxpayer engages in fully integrated petroleum operations, chemicals operations, mining operation of coal and other minerals, power generation and energy services.

4. About 90% of the products sold in New Mexico are natural gas which is either produced in New Mexico or transported into New Mexico through pipelines. Other products include jet fuel, diesel, lubricants, greases and fuel additives. These products are transported by pipeline, marine vessel, motor equipment or rail car.

5. During the time covered by the audit, Taxpayer operated approximately 800 oil and gas wells in New Mexico and owned working interests in approximately 1700 additional oil and gas wells in New Mexico.

6. The underlying oil and gas leases relating to Taxpayer's wells are up to eighty years old.

7. Taxpayer timely filed New Mexico Corporate Income and Franchise Tax ("CIT-1") returns for tax periods ending 12/31/04, 12/31/05 and 12/31/06.

8. Taxpayer filed its original 2004 CIT-1 return on November 7, 2005 using the separate corporate entity method and reporting tax due in the amount of $187,604.

9. Taxpayer filed its original 2005 CIT-1 return on November 13, 2006 using the separate corporate entity method and reporting an overpayment of the in the amount of $455,142.

10. Taxpayer filed its original 2006 CIT-1 return on November 8, 2007 using the separate corporate entity method and reporting tax due in the amount of $3,269.

11. The Department initiated and audit of the Taxpayer starting March 3, 2008 for tax periods 1/01/2004 through 12/31/2006.

12. In its CIT-1 returns, Taxpayer included in the property factor as rents the amounts it paid in royalties to lessors of natural resource interests and multiplied the amounts by eight.

13. The Department determined that the calculation of the "rented property" (annual rental value times eight) under the property factor for the tax periods at issue should be adjusted to exclude all royalty payments by Taxpayer to lessors of natural resource interests.

14. The rental values excluded by the Department's auditor were royalty payments made by Taxpayer to natural resource interest lessors during each reporting period.

15. On its 2004 CIT-1 return, Taxpayer reported "Everywhere" rented property (annual rental value times eight) in the amount of $12,093,936,864 and New Mexico rented property (annual rental value times eight) as $46,249,448.

16. For tax year 2004, the Department's auditor removed all oil and gas royalty rental values from the property factor, reducing the everywhere rental value by $8,554,576,752 and the New Mexico rental value by $9,690,088. This increased the property factor from 1.7591% to 1.9954%, and in turn, increased the average percentage factor from 1.1153% to 1.1930%. This resulted in an increase of the tax to $389,694. The resulting tax effect was an increase of tax principal owed for tax year 2004 of $301,087.

17. On its 2005 CIT-1 return Taxpayer reported "Everywhere" rented property (annual rental value times eight) in the amount of $12,867,226,592 and New Mexico rented property in the amount of $3,636,041,744.

18. For tax year 2005, the Department's auditor removed all oil and gas royalty rental values from the property factor, reducing the everywhere rental value by $9,231,184,848 and the New Mexico rental value by $16,481,008. This increased the property factor from 1.8207% to 2.0775%, and in turn, increased the average percentage factor from 1.1688% to 1.2547%. This resulted in an increase of the tax to $390,698. The resulting tax effect was an increase of tax principal owed for tax year 2005 of $272,765.

19. On its 2006 CIT-1 return, Taxpayer reported "Everywhere" rented property (annual rental value times eight) in the amount of $12,891,483,424 and New Mexico rented property (annual rental value times eight) in the amount of $91,655,576.

20. For tax year 2006, the Department's auditor removed all oil and gas royalty rental values from the property factor, reducing the everywhere rental value by $8,461,643,760 and the New Mexico rental value by $7,933,808. This increased the property factor from 1.9095% to 2.1607%, and in turn, increased the average percentage factor from 1.1714% to 1.2554%. This resulted in an increase of the tax to $450,065. The resulting tax effect was an increase of the tax principal owed for tax year 2006 in the amount of $228,119.

21. The Department issued a Notice of Assessment dated December 17, 2008, by Letter ID. No. L2023525760 in the amount of $802,971.00 tax principal and $237,348.81 interest for a total assessment amount of $1,076,320.81 for tax years ended 12/31/2004, 12/31/2005 and 12/31/2006. No penalty was assessed.

22. Taxpayer filed a timely protest to the Notice of Assessment, which was acknowledged by the Department on April 30, 2009, Letter ID L0960062080.

23. Taxpayer asserts that the apportionment property factor as originally calculated by Taxpayer on its 2004, 2005 and 2006 CIT-1 returns is correct and contends that the Department erred in not including the natural resource royalty expenses as a measure of the value of its rented property.

24. Taxpayer acquires rights to oil and gas property both by purchase and by lease. The typical instrument under which Taxpayer acquires the right to use oil and gas properties obligates the Taxpayer to pay the lessor different types of consideration such as lease bonuses, delay rentals and royalties.

25. Taxpayer estimates that it pays 13% of the wellhead proceeds from production in royalties.

26. All of Taxpayer's state and fee leases of which it is aware have royalty rates that are set in the lease at the time of the lease transaction.

27. The oil and gas leases have provisions regarding the payment of rentals and royalties.

28. The oil and gas leases provide for both royalties and rentals. For example, the Oil and Gas Lease between J. W. Simmons and wife Beulah H. Simmons, lessor and the Texas Company, lessee, provide that: "1st. To deliver to the credit of lessor, free of cost, in the pipeline to which he may connect his wells, the equal of one-eighth (1/8) part of all oil produced and saved from the leased premises. 2nd. To pay lessor for gas produced from each well where gas only is found, the equal of one eighth (1/8) part of the gross proceeds at the prevailing market rate, for all gas used off the premises,...." In addition, the lease provides: "If no well be commenced on said land on or before the 5th of July 1947, this lease shall terminate as to both parties, unless the lessee on or before

that date shall pay or tender to the lessor or to the lessor's credit...the sum of Three Hundred Twenty and no/100 Dollars, which shall operate as a rental and cover the privilege of deferring the commencement of a well for twelve months from said date." Exhibit L.

29. An application for Twenty Year Renewal of a lease dated January 7, 1998 provides that "[a]ll rentals or royalties due and payable under said lease to the United States of America have been paid,...." Exhibit J.

30. During the audit of the Taxpayer, Amy Ho, a Tax Analyst for the Taxpayer, worked with the Department's auditors conducting the audit. Prior to the issuance of the assessment at issue herein, Ms. Ho requested that the Department's auditor, Charles Langston, provide her with the basis for the Department's position that Chevron's capitalized royalty payments cannot be included in the property factor as rents.

31. In response to Ms. Ho's request, Mr. Langston faxed Ms. Ho a copy of the Multistate Tax Commission Regulation IV.11.(b). Mr. Langston had bracketed and underlined the portion of that regulation captioned ".25(4) Exclusions", which excludes from the definition of "Annual Rent" royalties based on extraction of natural resources.

32. The Department has not adopted the portion of the Multistate Tax Commission Regulation which was bracketed and underlined by Mr. Langston which excludes from the definition of "Annual Rent" royalties based on extraction of natural resources.

DISCUSSION

This case presents a new question of law in New Mexico concerning the application of the Uniform Division of Income for Tax Purposes Act ("UDITPA"), §§ 7-4-1 to 7-4-21 NMSA 1978. New Mexico adopted UDITPA in1965. Laws 1965, ch. 203. New Mexico joined the Multistate Tax Compact two years later. Laws 1967, ch. 56, now codified at §§ 7-5-1 to 7-5-7 NMSA 1978. The purposes of the compact are to: (1) facilitate the proper determination of state and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes; (2) promote uniformity or compatibility in significant components of tax systems; (3) facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration and (4) avoid duplicative taxation. § 7-5-1 NMSA 1978. Under UDITPA, a three factor formula is used to attempt to fairly measure a taxpayer's business activity within a taxing jurisdiction as a means to fairly apportion its taxable income among the taxing jurisdictions where it operates. The three factors considered are the taxpayer's sales, property and payroll in the taxing jurisdiction as compared to its sales, property and payroll everywhere. These three fractions are then added, and divided by three to arrive at the apportionment percentage to be applied to the business income of the taxpayer to apportion its income among the taxing jurisdictions where it conducts business. Section 7-4-10(A) NMSA 1978. This three-factor apportionment formula has become a widely accepted formula for apportioning a multijurisdictional taxpayer's income. As noted by the Supreme Court, "[N]ot only has the three-factor formula met our approval, but it has become...something of a benchmark against which all other apportionment formulas are judged." *Container Corp. of America v. Franchise Tax Board,* 463 U.S. 159, 170 (1983).

The issue in this case turns on the determination of the property factor to be used to calculate the apportionment factor to be applied to the Taxpayer during the years covered by the audit. Calculation of the property factor is governed by Section 7-4-11 NMSA, which provides:

> The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period.

The manner by which real and tangible personal property is valued in determining the property factor is governed by § 7-4-12 NMSA 1978, which provides:

> Property owned by the taxpayer is valued at its original cost. **Property rented by the taxpayer is valued at eight times the net annual rental rate.** Net annual rate is the annual rental paid by the taxpayer less any annual rental rate received by the taxpayer from subrentals. [Emphasis added]

Thus, under this provision, the "annual rental rate" is "capitalized" by multiplying it by eight, presumably to approximate a value of a similar property which is owned rather than rented.

The drafters of UDITPA felt it necessary to include the value of rented property in the property factor because of concerns that otherwise, a taxpayer who rents property rather than owns it would receive a tax advantage over other taxpayers who own property within a taxing jursidiction. For a discussion of the deliberations of the National Conference of commissioners on Uniform State Laws concerning the inclusion of rented property in the property factor, *see, William J. Pierce, Uniform Division of Income for State Tax Purposes, 35 Taxes 747, 750 (Oct. 1957).* Since the use of both owned property and rented property presumably benefit a taxpayer's business activities within a taxing jurisdiction, both should be considered in the calculation of the property factor. Given this background, the discrete issue presented herein can now be stated. It is whether the oil and gas royalty payments that the Taxpayer pays to lessors under various oil and gas leases are "rents" which are then capitalized (multiplied by eight) for purposes of calculating the Taxpayer's property factor.

Section 11 of UDITPA is identical to the language of § 7-4-12 NMSA 1978, quoted above, which governs the valuation of property for purposes of inclusion in the property factor. The commentary to §11 of UDITPA provides that:

> This section is admittedly arbitrary in using original cost rather than depreciated cost, and in valuing rented property as eight times the annual rental. This approach is justified because the act does not impose a tax, nor prescribe the depreciation allowable in computing the tax, but merely provides a basis for division of the taxable income among the several states. The use of original cost obviates any differences due to varying methods of depreciation, and has the advantage that the basic figure is readily ascertainable from the taxpayer's books. No method of valuing property would probably be universally acceptable.

West's Uniform Laws Annotated, Vol 7A, Pt. 1. Thus, the drafters of UDITPA opted for clear and easily calculated methods to arrive at the value of property to be valued in the property factor in the interest of simplicity and uniformity, while recognizing that the values assigned may not represent the actual value of the property.

Neither UDITPA, the Multistate Tax Commission Model Rules, or New Mexico's statutes or regulations under UDITPA define "rent" or "rented property". The Department argues that the royalties paid under oil and gas leases do not amount to rent and that property leased under oil and gas leases is not rented property under the ordinary and usual meaning of those terms. In support of this argument the Department has cited long established authority in New Mexico that, "an oil lease is not what is ordinarily denominated a lease, it is a sale of an interest in land." *Staplin v. Vessely,* 41 N.M. 543, 545, 72 P.2d 7,8 (1937)*, Padilla v. Roller,* 94 N.M. 234, 608 P.2d 1116 (1980), *Vanzandt v. Heilman*, 54 N.M. 97, 214 P.2d 864 (1950). In a similar vein, the court in *Sims v. Vosburg*, 43 NM. 255, 91 P.2d 434 (1939) stated that an oil lease does not create the ordinary relation of landlord and tenant. The Department also relies on the fact that in New Mexico, a lessee under an oil and gas lease acquires ownership of the oil and gas under the "ownership in place" theory. Under this theory, the oil and gas lease conveys to the lessee title to the oil and gas in place, subject only to the contractual obligation to pay the lessor a royalty on the oil and gas if and when it is produced. The ownership is place theory is the rule in six states: Texas, Pennsylvania, Mississippi, New Mexico, North Dakota and Alabama. *See, Brown, The Law of Oil and Gas Leases,* §3.02, (2nd Ed. 2010).

The Taxpayer relies on the Department's regulation under § 7-4-12 NMSA 1978. Specifically, it relies on the broadly worded definition of "annual rent" in NMAC 3.5.12.(C) to argue that the royalties it pays to lessors under its oil and gas leases are rents. Subsection C of the regulation defines annual rent as follows:

> C. "Annual rent" is the actual sum of money or other consideration payable, directly or indirectly, by the taxpayer or for its benefit for the use of the property and includes:
> (1) any amount payable for the use of real or tangible personal property, or any part thereof, whether designated as a fixed sum of money or a percentage of sales, profits or otherwise;
> (2) any amount payable as additional rent or in lieu of rents, such as interest, taxes, insurance, repairs or an other items which are required to be paid by the terms of the lease or other arrangement, not including amounts paid as service charges, such as utilities, janitor services, etc. If a payment includes rents and other charges unsegregated, the amount of rent shall be determined by consideration of the relative values of the rent and the other items.

Thus, it argues that royalties qualify as rents because they easily fit under the language of NMAC 3.5.12.9(C)(1) as "*any* amount payable *for the use of real ... property* ... whether a fixed sum or money or a percentage of sales, profits or otherwise." (emphasis added)

The Taxpayer also argues that the Department's interpretation of what constitutes rent or rented property is not reasonable because the Department has not adopted the Multistate Tax Commission Model Regulation IV.11(b). The language of NMAC 3.5.12.9(C), quoted above, and relied upon by the Taxpayer, is part of Multistate Tax Commission Model Regulation IV.11(b). On July 14, 1988, the Multistate Tax Commission adopted a resolution amending its Model Regulation IV.11(b) to exclude from the definition of "annual rent":

> (A) INCIDENTAL DAY-TO-DAY EXPENSES SUCH AS HOTEL OR MOTEL ACCOMMODATIONS, DAILY RENTAL OF AUTOMOBILES, ETC.; AND
>
> (B) ROYALTIES BASED ON EXTRACTION OF NATURAL RESOURCES, WHETHER REPRESENTED BY DELIVERY OR PURCHASE. FOR THIS PURPOSE, A ROYALTY INCLUDES ANY CONSIDERATION CONVEYED OR CREDITED TO A HOLDER OF AN INTEREST IN PROPERTY WHICH CONSTITUTES A SHARING OF CURRENT OR FUTURE PRODUCTION OF NATURAL RESOURCES FROM SUCH PROPERTY, IRRESPECTIVE OF THE METHOD OF PAYMENT OR HOW SUCH CONSIDERATION MAY BE CHARACTERIZED, WHETHER AS A ROYALTY, ADVANCE ROYALTY RENTAL OR OTHERWISE.
> (capitalization in the original)

The Department did amend its Regulation 3.5.12.9 to exclude from the definition of "annual rent" the items listed in subparagraph (A) of the MTC model regulation, *see,* NMAC 3.5.12.9(D), but it has never adopted the exclusion for royalties based on extraction of natural resources found in subparagraph (B), above. The Taxpayer argues that it is unreasonable for the Department to claim that royalties are not rents when the

Department has failed to adopt the portion of the MTC model regulation excluding royalties and where the definition of "annual rent" is so broadly written as to include such royalties. Additonally, the Taxpayer argues that treating the 1/8 royalty it pays as rent, and then multiplying it by 8 to arrive at the value of its leasehold interest results in a more fair and appropriate valuation of its leasehold interest.

There is scant law from other jurisdictions to guide the determination of this issue and the law that there is has come down on both sides of the issue. The Department cited to California Franchise Tax Board Legal Ruling 97-2, 1997 Cal. FTB LEXIS 15, for the portion of the ruling which cited to 18 Cal. Code of Regs. § 225130(b)(4)(B), for its statement that, "[T]hus, under the standard property factor rules, a royalty payment for extracted oil or timber would not qualify as "annual rent". The regulation cited is the same as the part of Multistate Tax Commission Model Regulation IV.11(b), which excludes royalties from the extraction of natural resources from the definition of "annual rents". Nonetheless, the California ruling went on to apply another general property factor rule in California concerning property owned by others but used by a taxpayer at no charge or rented by the taxpayer for a nominal rate, and California caselaw which equated rents and royalties to determine that the taxpayer's interest in an oil and gas lease, which the ruling determined to be a "profit a prendre" in common law, should be included in the property factor. I do not find this ruling particularly helpful because New Mexico has no regulation equivalent or similar to the one relied on in the ruling, and it does not have caselaw equating rents and royalties. It is noteworthy, however, that since the 1997 California Franchise Tax Board ruling, California has gone on to adopt a regulation which takes the opposite position of Multistate Tax Commission Model

Regulation IV.11(b). It now has a rule which specifically recognizes royalties paid for the extraction of timber, oil, gas or hard minerals from land owned by others "...shall constitute the net annual rental rate. The net annual rental rate shall then be multiplied by eight (8)." 18 Cal. Code Regs, Section 25137(b)(1)(c).

Similarly unhelpful is *Mobil Oil Corporation v. Commonwealth of Pennsylvania,* 813 F&R 1997, 1997 PA Tax LEXIS 2276, (1997). In that case, Mobil Oil argued that the failure of the Pennsylvania Department of Revenue to treat payments made on mineral leases as rent for property factor purposes did not give adequate representation to the nature of the taxpayer's business activities. In its decision, the Commonwealth Court of Pennsylvania did not address the issue of whether royalties or other payments that Mobil Oil made should be included in the property factor as rents. The Department of Revenue, Board of Appeals had concluded that royalties could not be included in the property factor. Rather, the court treated the appeal as a challenge to Pennsylvania's application of the factors as distorting the taxpayer's business activity. The court denied the appeal for a failure of evidence that the apportionment factors caused distortion.

There are two cases, however, which do address the issue herein. The Taxpayer relies upon *Comptroller of the Treasury v. Shell Oil Company,* 65 Md. App. 252, 500 A.2d 315 (1985). In that case, the Maryland Court of Special Appeals characterized the Comptroller's theory of the case as follows:

> The theory espoused by the Comptroller in rejecting a capitalization of royalty payments was and is, that such payments do not constitute rent. His argument is somewhat confusing. At times, he seems to regard the transaction between Shell and its lessors as not being the conveyance of a leasehold interest in the land, but rather a sale of the minerals being extracted. Under this approach, the property to be valued is not the interest in the land, but the minerals themselves. As stated in his brief before us,

> "[T]he Comptroller analogized the royalty payment to an amount paid for the purchase of oil and gas, and allowed the inclusion of the royalty in Shell's property factor at its cost, in much the same fashion that any other purchased property, including inventory, such as oil and gas purchased in the open market, cranes, drills and office equipment, would be includable at cost."

500 A.2d at 317. Essentially, the Comptroller took the position that the Shell's lease gave it "ownership in place" of the oil and gas extracted from the leased property, and valued it, as "owned property", which under UDITPA, is valued at its cost. *See,* § 11, UDITPA, West's Uniform Laws Annotated, Vol 7A, Pt. 1, § 7-4-12 NMSA 1978. The Maryland Court of Special Appeals rejected this argument, stating:

> [U]pon the record made in the Tax Court, we think it clear, as a matter of law, that the property to be valued is not the gas or oil extracted during the taxable year, but Shell's leasehold interest in the land itself. It is also clear that the royalty payments called for in the leases are in the nature of a percentage rent for that land and thus are not within the meaning of "gross rent," ...(citation omitted)...and that, in determining the value of Shell's leasehold interest, those royalty payments are to be capitalized by a factor of eight. To value the leasehold interest at the precise amount of the royalties paid, as the Comptroller suggests in his alternative argument, would create a substantial undervaluation of that property. The royalties amount to only 1/8 to 1/6 of the value of the minerals extracted; under any rational test, the value of the leasehold estate must surely approximate more the total worth of the minerals extracted than a small fraction of it.

Id. at 320.

The Department relies upon *In the matter of Acme Oil Company*, Decision No. 82-48 (October 26, 1982) 1982 Alas. Tax LEXIS 10, 1982 WL 11463 (Alaska Dept. Rev.). In that decision, the Alaska Department of Revenue Hearing Officer characterized the parties arguments as follows:

> The taxpayer has contended that its property factor should include the value of its oil and gas properties. The Audit division, however, believes that oil and gas royalties should not be capitalized. Both arguments have some merit.

> One view is that since oil and gas royalties represented an interest in real property for federal income tax purposes and since the apportionment factors have been closely tied to the Federal tax treatment accorded property, payroll or sales values, royalty payments which represent a depletable interest in real property should be treated like other real property owned by another person which a taxpayer uses (rents) in its business; and, accordingly, like rental property should be capitalized for property factor purposes. The other view is that oil and gas royalties are payments for the acquisition of a raw material inventory which is not used in the taxpayer's business in the same sense as tools, equipment and physical plant. Payments made for inventory are not capitalized, whereas rental payments made for the use of tools, equipment and physical plant owned by another are capitalized.

Id. at pp. 85-86. The Hearing Officer ultimately decided that oil and gas royalties are payments for the acquisition of inventory on the basis of various Alaska regulations which described rented property as having the character of tools, equipment physical plant or land which has a useful life beyond the immediate and instant use of the property and which distinguished such property from property which is consumed or treated as a raw material or a stock of goods to be held for sale in the ordinary course of business.

As noted by the Alaska Hearing Officer, both arguments have some merit. But New Mexico does not have regulations, like those in Alaska, which so define the character of rented property. As noted previously, New Mexico does not have regulations defining rent or rented property. But New Mexico does have a regulation which broadly defines "annual rent" as, "the actual sum of money or other consideration payable...for the use of the property and includes...*any amount payable for the use of real or tangible personal property, or any part thereof, whether designated as a fixed sum of money or a percentage of sales, profits or otherwise;..."* NMAC 3.5.12.9C(1) (emphasis added). Royalties paid under oil and gas leases easily fall under the broad wording of that regulation. Additionally, New Mexico has not adopted the part of MTC model regulation IV.11(b) which expressly excludes from the definition of "annual rent" the royalties paid for the extraction of natural resources. Had they done so, it is doubtful that this issue would be in litigation. Thus, under the Department's own regulations, it would be fair to conclude that the Taxpayer's royalties can be considered to be rents to be capitalized under UDITPA. Nonetheless, in resolving this matter, it is important to also consider the policies underlying UDITPA, the Multistate Tax Compact and their adoption by New Mexico and many other states.

Those policies are set out at § 7-5-1 NMSA 1978 and to briefly paraphrase, they are to facilitate the equitable apportionment of tax bases of multistate taxpayers, to promote uniformity among tax systems, to facilitate taxpayer convenience and to avoid duplicative taxation. It would do no damage to any of these policies to conclude that royalties paid under oil and gas leases are rents which should be capitalized. It would actually enhance the equitable apportionment of the tax base of taxpayers in the natural resource extraction industry because the royalties times eight formula results in a value of the mineral leasehold interests to be valued which equals the value of the minerals produced. This result, as noted by the court in *Comptroller of the Treasury v. Shell Oil Company, supra,* is surely fairer than to value the lease at a fraction of such value. Although treating royalties as rents would not promote uniformity among tax systems, it would not detract from it either. As demonstrated by the cases discussed above, uniformity on this issue does not exist. Additionally, it makes no difference with respect to facilitating taxpayer convenience whether royalties are treated as rents or as the cost of inventory as the royalty amounts paid are easily ascertainable. Finally, it would have no discernable effect with regard to avoiding duplicative taxation.

Determining the issue of law before this decision maker has been very difficult because there are sound arguments on both sides of the issue. Counsel for the parties wrote excellent briefs to assist me. To resolve this dispute, I have tried to understand the policies of the drafters of UDITPA, the National Conference of Commissioners on Uniform State Laws, in drafting the language concerning the property factor, to guide my determination. I have found no evidence that they gave any thought to how property interests of lessees of oil, gas or other mineral leases should be valued, or whether the property to be valued should be considered to be the leasehold interest itself, or whether it should be valued as the cost of inventory acquisition. The latter view is consistent with the rule adopted in New Mexico that an oil and gas lessee acquires ownership of the minerals in place (the "ownership in place" rule), but that rule has only been adopted in six states, making it a weak foundation to base an interpretation of a uniform law intended to be adopted by most states. The MTC model regulation excluding royalties on mineral leases from the definition of "annual rent" was never adopted by the Department and it has been rejected by at least one Multistate Tax Compact state, California. Nonetheless, it is an indication that the Multistate Tax Commission found that the issue was ambiguous enough, based on the definition in the model rules defining "annual rent", that the Commission felt the need to adopt a model rule to clarify the issue. Ultimately, I have been persuaded that the Taxpayer's view of this matter is the better position. The royalty payments easily fit within the definition of "annual rent" in NMAC 3.5.12.9C(1) . The Department has not adopted the portion of MTC Model Regulation IV.11.(b) excluding royalties from the definition of "annual rent". Treating royalties as rents and multiplying them times eight values the leasehold interest at a value which is equivalent to the production from that leasehold, which seems inherently reasonable. Additionally, because the leasehold interest is reasonably valued, presumably, there would be no distortion of the value of the taxpayer's property with respect to its role in the creation of the income subject to apportionment among the states. For the foregoing reasons, the Taxpayer's protest should be granted.

CONCLUSIONS OF LAW

1. The Tax Administration Act applies to and governs the administration and enforcement of the Corporate Income and Franchise Tax Act. NMSA 1978 §§7-1-2 through 7-1-82.

2. The Taxpayer filed a timely protest to the Department's assessment, pursuant to Section 7-1-24 NMSA 1978 and jurisdiction lies over both the parties and the subject matter of this protest.

3. No genuine issue of material fact exists and the Taxpayer is entitled to summary judgment on the legal issue presented as a matter of law.

4. Oil and gas leases held by the Taxpayer are interests in real property which are to be valued as rented property to determine the property factor of the Taxpayer pursuant to Section 7-4-11 NMSA 1978.

5. Oil and gas leases held by the Taxpayer are rented property which are required to be valued at eight times the net annual rental rate pursuant to Section 7-4-12 NMSA 1978.

5. Royalties paid by the Taxpayer to lessors of its oil and gas leases are "annual rent" under NMAC 3.5.12.9(C).

For the foregoing reasons, THE TAXPAYER'S PROTEST IS HEREBY GRANTED.

DONE, this ___ day of December 2010.