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STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION

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July 21, 1992

Honorable Bradley L. Jacobs
Assessor of Orange County
P.O. Box 149
Santa Ana, CA 92702

Re: Orange County Property Tax Escaped Assessment for 1987

Dear Sirs:

This is in response to letters to Mr. Richard Ochsner from the Orange County Assessor (the Assessor) dated September 30, 1991, October 3, 1991, October 23, 1991 and October 28, 1991 and from (SWEPI)) dated October 9, 1991 and November 15, 1991. Please excuse our delay in responding to your letters. Other matters requiring our attention have made such delay unavoidable.

The Assessor and SWEPI have requested our opinion as to the applicability of Revenue and Taxation Code Sections 107.2 and 107.3 under the following facts set forth in the above mentioned letters and in materials submitted therewith.

At issue here is the proper property tax valuation of SWEPI's five oil and gas leasehold estates in real property (the Leases) owned by the lessor, the State of California for 1987. If Sections 107.2 and 107.3 apply, the valuation of the Leases must exclude the value of any royalties or similar interests payable to the state. If not, the valuation of the Leases must include the value of such royalties or similar interests.

Before 1963, all assessors in California assessed oil and gas possessory interests in property leased from tax-exempt lessors by estimating the present value of recoverable hydrocarbons and deducting from that value the estimated present value of the costs of recovery and the estimated present value of the sums payable by the lessee to the lessor in money or in kind. (See Atlantic Oil Co. v. County of Los Angeles (1968) 69 Cal.2d 585, 592 [ARCO I]) Before 1964, the Orange County Assessor employed a substantially similar method. (Ibid.) Commencing in 1963, certain assessors in California and in 1964, the Orange County Assessor changed their method of assessing such oil and gas possessory interests by no longer deducting from the estimated present value of recoverable hydrocarbons the estimated present value of payments due from the lessee to the lessor. (Ibid.) This change in assessment methodology was based upon the assessors' interpretation of the California Supreme Court decision of DeLuz Homes Inc. v. County of Los Angeles (1955) 45 Cal.2d 546. (Id at p. 599.)

In Deluz, the California Supreme Court held that the proper method to assess the value of a possessory interest created by a lease on the property of a tax-exempt governmental entity is to calculate the "full cash value" of the possessory interest without deducting from that value the rent paid for the leasehold. This decision "disapproved" the valuation method previously approved by the California Supreme Court in Blinn Lumber Co. v. County of Los Angeles (1932) 216 Cal. 468. The Blinn method allowed the deduction of rent paid for the lease from its value for property tax purposes.

Application of the DeLuz valuation method to oil and gas possessory interests was determined to be appropriate by the California Supreme Court in ARCO I.

The change in assessment methodology described above caused a significant increase in the property taxes assessed against the holders of possessory interests in oil and gas lands leased from tax-exempt governmental entities. (Id. at p. 592.) While the ARCO I case was pending, the California Legislature adopted Revenue and Taxation Code sections 107.2 and 107.3 to limit the assessment and taxation of governmental royalty interests against oil and gas possessory interest holders. (See Atlantic Richfield Co. v. County of Los Angeles (1977) 68 Cal.App.3d 105, 113.) Those sections were signed into law by the Governor on September 2, 1967 and became effective November 8, 1967.

Sections 107.2 and 107.3 are set forth in their entirety in Exhibit A to this letter. Property Tax Rule 27 entitled "Valuation of Possessory Interests For The Production of Hydrocarbons" reflects the Board's interpretation of sections 107.2 and 107.3 and provides:

> "(a) The taxable value of all possessory interest for the production of gas, petroleum,

> and other hydrocarbon substances from beneath the surface of the earth shall be determined by application of the comparative sales or income approach in the manner prescribed in subsection (a) or (b) of section 25 except as provided in subsection (b) of this section.
>
> "(b) The taxable value of a possessory interest for the production of hydrocarbon substances from beneath the surface of the earth shall be determined by application of the comparative sales or income approach in the manner prescribed in subsection (a) or (b) of section 26 if:
>
> "(1) the interest was created or last extended or renewed on or before July 26, 1963, and the rate of royalties or other right to share in production was not reduced because of an increase in the assessed value of such interest or
>
> "(2) the interest was created on or before July 26, 1963, and has been extended or renewed thereafter pursuant to authority which prohibits reduction of the rate of royalty or other right to share in production because of an increase in the assessed value of such interest."

It is our understanding that the significance of the July 26, 1963 date is that on that date certain remedial legislation (SB 1489 (O'Sullivan/Teale)) was vetoed. Therefore, on that date persons entering into oil and gas leases with tax exempt public entities were placed on notice for the first time that even though the issue would ultimately have to be decided by the courts, assessors thereafter would take the position that the value of oil and gas royalty interests were not deductible for property tax purposes.

Under Property Tax Rule 27, the Leases must be valued without including the value of royalties or other similar rights payable to the state if either subdivision (b)(1) or (b)(2) applies. SWEPI and the Assessor agree that all five Leases were created before July 26, 1963 and that two of those Leases, Nos. 91.1 and 392.1, were extended or renewed <u>prior</u> to July 26, 1963. No. 91.1 was extended or renewed on November 12, 1957 and No. 392.1 was extended or renewed on September 25, 1958. Both were for an original term of 20 years and both were extended for a term of five years and for so long thereafter as oil and gas is produced in paying quantities or lessee shall be conducting producing, drilling, deepening, repairing or other necessary lease or well maintenance operations on the leased land. Since, according to SWEPI (and the Assessor does not dispute it) "the rate of royalties or other right to share in production was not reduced because of an increase in the assessed value of such interest" prior to November 8, 1967 these Leases must be valued excluding the royalty interest as required by Property Tax Rule 27(b)(1).

With respect to the other three Leases, SWEPI and the Assessor agree that such Leases were extended or renewed after July 26, 1963, i.e., August 18, 1964. They disagree, however, as to whether such extension or renewal was "pursuant to authority which prohibits reduction of the rate of royalty or other right to share in production because of an increase in the assessed value of such interest".

SWEPI cites two reasons why sections 107.2 and 107.3 (and Property Tax Rule 27(b)) are applicable to the subject Leases. First SWEPI contends that the issue of the applicability of Sections 107.2 and 107.3 to the subject Leases was litigated unsuccessfully by Orange County and that the Assessor is thus precluded from relitigating that issue by the doctrine of Res Judicata/Collateral Estoppel. Second, SWEPI contends that the extension or renewal of its Leases was pursuant to authority which permitted no reduction of the rate of royalty or other right to share in production upon the ground of an increase in the assessed valuation of the Leases.

I. <u>Res Judicata/Collateral Estoppel</u>

SWEPI acquired the Leases from Petroleum June 30, 1986 which previously acquired the Leases from A (Aminoil). According to SWEPI, Aminoil litigated the applicability issue regarding the Leases with Orange County for assessment years 1967 through 1976.

The Aminoil case was one of a group of cases which were litigated by a number of oil companies against several counties and other local governmental bodies. All of the cases were held in abeyance by stipulation while a test case was tried. The litigation of the test case resulted in a decision in favor of the taxpayers and against the governmental entities. In that case, <u>Atlantic Richfield Co.</u> v. <u>Los Angeles County</u> (1977) 68 Cal.App.3d 105, the Court of Appeal upheld the constitutionality of Sections 107.2 and 107.3 as a valid exercise of the Legislature's power to avert hardship caused by a retroactive application of a change in assessment practice.

Subsequent to the decision in the Atlantic Richfield case, Orange County stipulated to a Superior Court judgment awarding refunds to Aminoil and other taxpayers in case number 269746. These refunds were paid and according to SWEPI, the Leases were assessed thereafter without inclusion of the royalty interest until the escaped assessments for 1987 were recently issued.

The Assessor seems to take the position that he is not precluded from raising the applicability issue because only the constitutional issue decided in Atlantic Richfield was litigated and not the applicability issue. This argument, however, ignores the fact that in order for the court to reach the issue of the constitutionality of sections 107.2 and 107.3, it had to conclude that those sections were applicable in the case. The preclusive effect of a judgment affects not only the issues actually determined but also those necessary for the determination and those which should or could have been litigated in the first action. Teitlebaum Furs, Inc. v. Dominion Ins. Co. (1962) 58 Cal.2d 601. Moreover, the complaint in the Aminoil case alleged just two causes of action and both included allegations that any extension or renewal of the Leases after July 26, 1963 was pursuant to authority which permitted no reduction of the royalty or of the right to share in production on grounds of an increase in valuation.

As indicated above, the County entered into a stipulated judgment with respect to one or both of the two causes of action and thus necessarily stipulated to the applicability of Sections 107.2 and 107.3. A stipulated judgment on the merits is as conclusive of the matters in issue and determined by it as a judgment rendered after trial. Gates v. Superior Court, (1986) 178 Cal.App.3d 301; Ellena v. State of California (1977) 69 Cal.App.3d 245. Thus, since three of the Leases had been extended or renewed after July 26, 1963 at the time of the litigation, it seems clear that the stipulated judgment is as conclusive on the issue now in dispute as a judgment after a trial in which the issue was fully litigated.

The Court of Appeal in Frommhagen v. Board of Supervisors (1987) 197 Cal.App.3d 1292 summarized the doctrine of res judicata/collateral estoppel as follows at page 1299:

> "The doctrine of res judicata has a double aspect. First, it precludes parties or their privies from relitigating the same cause of action that has been finally determined by a court of competent jurisdiction. Second, although a second suit between the same parties

> on a different cause of action is not precluded by a prior judgment, the first judgment operates as an estoppel or conclusive adjudication as to such issues in the second action as were actually litigated and determined in the first action. (Citation omitted.) This second aspect of res judicata is commonly referred to as collateral estoppel. (Citations omitted.)"

In the foregoing case involving annual service charges levied by a county, the court, following federal income tax authority (see Commissioner v. Sunnen (1948) 333 U.S. 591, held that each year's tax is the origin of a new liability and a separate cause of action. Accordingly, a judgment against the taxpayer in a prior year is not a complete bar to a new action by the taxpayer. Instead, the prior judgment acts only as a collateral estoppel as to matters actually determined in the first suit.

Thus, Frommhagen makes it clear that it is collateral estoppel rather than res judicata that may be applicable when a tax liability for a year different from the one previously adjudicated is at issue.

The courts have recognized, however, that the collateral estoppel effect of a prior determination of a question of law may differ from a prior determination of a question of fact. (R. E. Spriggs Co. v. Adolph Coors Co (1979) 94 Cal.App.3d 419, 429.) Where the issue is a question of law rather than of fact, the prior determination is not conclusive if injustice would result or if the public interest requires that relitigation not be foreclosed. (Consumers Lobby Against Monopolies v. Public Utilities Commission (1979) 25 Cal.3d 891, 902; City of Los Angeles v. City of San Fernando (1975) 14 Cal.3d 199, 230; 7 Witkin, California Procedure (3rd Ed. 1985) § 274, p. 714.)

In Rutherford v. State of California (1987) 188 Cal.App.3d 1267, the Court of Appeal upheld the trial court's refusal to apply the doctrine of issue preclusion to a question of law where a new determination was warranted in order to avoid the inequitable administration of the laws. In reaching its conclusion,, the court relied upon the following pertinent parts of section 28(b) of the Restatement Second of Judgments and Comment C to section 28(2) thereof:

> "Although an issue is actually litigated and determined by a valid and final judgment, and the determination is essential to the judgment, relitigation of the issue in a subsequent action

> between the parties is not precluded in the following circumstances: [¶](2) The issue is one of law and ... (b) a new determination is warranted in order to ... avoid inequitable administration of the laws or [¶] ... [¶] ... [¶](5) There is a clear and convincing need for a new determination of the issue (a) because of the potential adverse impact of the determination on the public interest or the interests of persons not themselves parties in the initial action, ..."

Comment C to section 28(2) of the Restatement Second of Judgments restates this proposition as follows:

> "[T]he choice must be made in terms of the importance of stability in the legal relationships between the immediate parties, the actual likelihood that there are similarly situated persons who are subject to application of the rule in question, and the consequences to the latter if they are subject to different legal treatment. <u>In this connection it can be particularly significant that one of the parties is a governmental agency responsible for continuing administration of a body of law that affects members of the public generally, as in the case of tax law. Refusal of preclusion is ordinarily justified if the effect of applying preclusion is to give one person a favored position in current administration of a law</u>." (Emphasis added.)

With respect to the three Leases amended after July 26, 1963, the issue, in terms of Rule 27, is whether the extension or renewal of such Leases was pursuant to authority which prohibits reduction of the rate of royalty or other right to share in production because of an increase in the assessed value of such interest. Since determination of that issue requires the construction of statutes (applicable Public Resources Code provisions) and writings (the Leases), the question is one of law rather than of fact. (Evidence Code § 310(a); <u>Ruh</u> v. <u>State Board of Optometry</u> (1965) 235 Cal.App.2d 591; <u>Transport Oil Co.</u> v. <u>Exeter Oil Co.</u> (1948) 84 Cal.App.2d 616.)

In this case the Assessor states that he has consistently valued leases such as SWEPI's without excluding the value of the royalties. Thus, if the Assessor is precluded by the prior judgment from treating SWEPI as he treats other similarly situated assessees, SWEPI will have a favored position in the administration of property tax law in Orange County which results in inequitable administration of the law. Under the foregoing authorities, refusal of preclusion in such circumstances is justified. Accordingly, we are of the view that Orange County should not be precluded by collateral estoppel from relitigating the issue of the applicability of sections 107.2 and 107.3 and Property Tax Rule 27(b) as to the three Leases which were extended or renewed after July 26, 1963.

II. The Applicability Issue

With respect to the three Leases which were created prior to July 26, 1963 and which were extended or renewed thereafter, the applicability issue, in terms of Property Tax Rule 27(b), is whether such extensions or renewals were "pursuant to authority which prohibits reduction of the rate of royalty or other right to share in production because of an increase in the assessed value of such interest."

The Leases were entered into by the State of California as lessor under the authority of Public Resources Code (PRC) section 6801 et seq. More specifically, PRC section 6827 sets forth the rules for entering into such leases including bidding, terms of possession, extensions, royalties, etc. and is the statutory authority for extending or renewing the Leases.

SWEPI's predecessors entered into Lease No. 163 on November 15, 1944 and Lease Nos. 425 and 426 on February 10, 1950. Each was for a period of twenty years.

All three Leases were exchanged for new Leases pursuant to the express provisions of PRC section 6827 on August 18, 1964. Each new Lease was for the same term as the extensions of Leases 92.1 and 63.1 discussed above, i.e., for five years and so long thereafter as oil and gas is produced in paying quantities etc. as required by PRC section 6827. There was no reduction in the royalty payable under the Leases at that time or according to SWEPI at any time thereafter.

Neither PRC section 6827 nor any other provision of the Public Resources Code addresses the reduction of the rate of royalty or other right to share in production because of an increase in assessed value. PRC section 6827 does, however, state a minimum royalty of 16-2/3 percent. Thus, the statutory authority pursuant to which the three Leases were extended or renewed does seem to prohibit a reduction in the rate of royalty below the stated minimum for any reason.

The Assessor acknowledges the minimum royalty requirement of PRC section 6827 but argues that PRC section 6827.2 authorizes the State Lands Commission, in order to prevent the premature abandonment of a lease to renegotiate a lease to reduce the minimum royalty rate or to substitute such other consideration as would be in the best interests of the State if, after holding a public hearing, the commission finds that continued production is economically unfeasible under the terms set forth in the lease.

PRC section 6827.2 was added to Public Resources Code by Stats. 1975, Ch. 476 and did not become effective until January 1, 1976. Since PRC section 6827.2 was not in existence when the Leases were created or extended or renewed, it is obvious that it does not constitute authority pursuant to which the Leases were extended or renewed. Even if PRC section 6827.2 were in effect when the Leases were created, it is doubtful that it could be construed as authority pursuant to which the Leases could be extended or renewed. Assuming for the sake of argument, however, that PRC section 6827.2 was in existence when the Leases were created and could be construed as such authority we nevertheless believe that PRC section 6827.2 "prohibits reduction of the rate of royalty or other right to share in production because of an increase in the assessed value...." Our conclusion is based on the language of PRC 6827.2 which permits a reduction in the minimum royalty rate only to prevent the premature abandonment of a lease and only then upon a finding by the Commission after holding a public hearing that continued production is economically unfeasible under the terms set forth in the lease and that continued production from the lease is in the best interests of the state. There is no indication here that an increase in assessed value as contemplated by sections 107.2 and 107.3 and Property Tax Rule 27 would result in a finding by the Commission that continued economic production is economically unfeasible.

Accordingly, we conclude that the three Leases that were extended or renewed after July 26, 1963 were extended or renewed pursuant to statutory authority which prohibits reduction of the rate of royalty or other right to share in production because of an increase in assessed value.

SWEPI also contends that based on the terms of the Leases generally and the tax allocation clauses in particular, the Leases do not permit (i.e. prohibit) a reduction in the rate of royalty based upon an increase in the assessed value of the oil and gas interests. We agree.

The Leases state a term of twenty years but provide that "such term may thereafter be extended upon such terms and conditions and for such period of time as the State deems for its best interests." The Leases themselves, therefore, constitute authority for their extension or renewal. However, since the ultimate authority for creating and extending or renewing the Leases is found in PRC 6827, it would be anomalous to conclude that the Leases permit royalty reduction to any greater extent than the Public Resources Code.

Based on all of the foregoing, it is our opinion that sections 107.2 and 107.3 and Property Tax Rule 27(b) apply to the five subject Leases and that the valuation of such Leases should therefore exclude the value of any royalties or similar interest payable to the state.

The views expressed in this letter are, of course, advisory only and are not binding upon the assessor of any county.

Very truly yours,

Eric F. Eisenlauer

Eric F. Eisenlauer
Senior Tax Counsel

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cc: Mr. John Hagerty
Mr. Verne Walton