

THE SUPREME COURT OF ARKANSAS HOLDS THAT AN AD VALOREM TAX ON GAS, OIL, AND MINERALS EXTRACTED FROM PROPERTY IS NOT AN ILLEGAL EXACTION AND DOES NOT VIOLATE EQUAL PROTECTION.

In *May v. Akers-Lang*,¹ Appellants May and other taxpayers (“Taxpayers”) appealed from a White County Circuit Court order that dismissed their complaint, on behalf of owners of oil and gas royalty and production interests in various counties in the state of Arkansas, against appellees, which were the tax assessors and collectors from the various counties.² The appeal argued that the circuit court erred in dismissing their claim by finding that it did not state a claim of illegal exaction under the Arkansas constitution.³ The Supreme Court of Arkansas affirmed the circuit court’s order.⁴

The Taxpayers owned all or a portion of the gas, oil, and minerals located in, on, and, under their property in the various counties.⁵ They filed a complaint on April 1, 2010, seeking declaratory judgment and injunctive relief.⁶ They filed an amended complaint, adding additional parties, on October 7, 2010.⁷ The taxpayers claimed:

- (1) the Taxpayers are the owners of all or a portion of the oil, gas, and other minerals in, on, and under their real property;
- (2) the Taxpayers have leased the oil, gas, and other minerals to third-party oil and gas exploration and production companies that, pursuant to the lease agreements, have installed wells and pipelines on the Taxpayers’ property, or lands utilized therewith;
- (3) those third-party companies are producing oil or gas from the wells and selling the oil or gas at market value, which fluctuates substantially over short periods of time, to one or more third-party purchasers;
- (4) the Taxpayers are paid royalties on the oil or gas, or both, that is produced from their properties and lands utilized therewith, while the production com-

1. 2012 Ark. 7, __ S.W.3d __.

2. *Id.* at 2, __ S.W.3d __.

3. *Id.*, __ S.W.3d __.

4. *Id.*, __ S.W.3d __.

5. *Id.* at 3, __ S.W.3d __.

6. *May*, 2012 Ark. 7, at 3, __ S.W.3d __.

7. *Id.*, __ S.W.3d __.

panies are paid the remainder of the purchase price of the gas as their “production” or “working interest”; (5) the produced oil or gas resulting in the in the royalty and working interest payments is also subject to a severance tax assessed by the State of Arkansas and to income tax assessed by the United States government and the State of Arkansas; (6) the tax assessors of the Counties obtain the amounts of royalty paid on an annual basis by the third-party companies to owners of the oil, gas, and other minerals pursuant to leases under which those companies produce and market oil or gas, and which show the amounts received by the gas exploration and production companies as their “working interests”; (7) the tax assessors of the Counties assess owners and companies an ad valorem tax on behalf of their respective counties by using an “average contract price” for the sale of the oil or gas derived from the owner's property; multiplying that price by the “working interest percent”; subtracting therefrom the production expenses (arbitrarily set at 13%), multiplied by a .20 assessment rate to obtain an “Assessment Value per Thousand Cubic Feet (“MCF”) of Average Daily Production (“ADP”)”; (8) the tax assessors of the Counties used the figure of \$6.60 per MCF as the average contract price to be used in applying the above-stated formula for assessing the ad valorem for the taxable year 2009 and, the Taxpayers believe, beginning in the taxable year 2008; and (9) the “ad valorem royalty tax” is an illegal exaction prohibited by Arkansas Constitution article 16, section 13.⁸

8. *Id.* at 3–4, ___ S.W.3d ___.

The Taxpayers argued that the tax was an illegal exaction for the following reasons: it was only taxed on properties from which oil and gas were produced, which violated the Equal Protection Clauses of both the Arkansas and United States Constitutions; the money was “intangible personal property” and Arkansas statute prohibits levying ad valorem tax on it; the royalty money is included in the ad valorem tax assessed against the Taxpayers prior to the oil or gas being extracted, those results in multiple taxation; a severance and income tax is assessed on the royalty money, which results in multiple taxation; the tax is a privilege or excise tax because it is assessed after extraction and violates Arkansas statute; the royalty payments are assessed an income tax by the United States Government and the state of Arkansas and the Counties are not authorized by law to assess an income tax; and “the average contract price” that determines the ad valorem tax is not the actual contract price paid for the oil or gas produced, which violates Arkansas Constitution article 16, section 5.⁹

Motions to dismiss were filed, and the circuit court had a hearing on January 14, 2011.¹⁰ After the hearing, the court dismissed the Taxpayers lawsuit after determining that they had not made an illegal exaction challenge.¹¹ The court held that the Arkansas Constitution allows that all real and tangible property shall be taxed according to the value, which the General Assembly determines how to calculate.¹² This value includes both surface and mineral rights.¹³ The General Assembly has determined that the value of oil and gas deposits is to be assessed when they are removed from the land.¹⁴ The circuit court determined that the tax was not an income tax and was instead a valid ad valorem tax on the mineral rights.¹⁵ Therefore, the court found that the Taxpayers had not brought a proper illegal exaction challenge and entered its order dismissing the suit on February 18, 2011.¹⁶

The Taxpayers filed a motion for a new trial or rehearing on February 28, 2011, which the circuit court denied on March 18, 2011.¹⁷ Consequently, the Taxpayers appealed.¹⁸ The Court first determined what the appropriate standard of review was.¹⁹ Because the circuit court made its ruling based on the pleadings as well as arguments of counsel, the Court must treat the

9. *Id.* at 4–5, __ S.W.3d __.

10. *Id.* at 5, __ S.W.3d __.

11. *Id.* at 5–6, __ S.W.3d __.

12. *May*, 2012 Ark. 7, at 6, __ S.W.3d __.

13. *Id.*, __ S.W.3d __.

14. *Id.*, __ S.W.3d __.

15. *Id.*, __ S.W.3d __.

16. *Id.*, __ S.W.3d __.

17. *Id.*, __ S.W.3d __.

18. *May*, 2012 Ark. 7, at 6, __ S.W.3d __.

19. *Id.*, __ S.W.3d __.

motion to dismiss as if it were one for summary judgment.²⁰ The case did not involve any factual questions but instead presented an application of legal rules; therefore, the Court did not need to examine the record and could “simply determine whether the Counties were entitled to judgment as a matter of law.”²¹

The Taxpayers argued that their complaint supported an illegal exaction claim.²² The Counties argued that the Taxpayers’ claim was really an issue with how the tax was assessed and that the claim was improperly raised.²³ The Court recognized that article 16, section 13 of the Arkansas Constitution granted citizens the right to bring an illegal exaction claim.²⁴ “An illegal exaction is defined as any exaction that is either not authorized by law or is contrary to law.”²⁵ Citizens can bring one of two illegal exactions claims: a “public funds” case, where the citizens are claiming the public funds are being used in an unauthorized way, or an “illegal-tax” case, where the citizens claim the tax itself is illegal.²⁶ Here, the Taxpayers are pursuing an “illegal-tax” claim.²⁷ However, the legality of an ad valorem tax on gas was not disputed by the Taxpayers.²⁸

The Arkansas Constitution and Arkansas statutes authorize property taxes to be levied on all personal and real property.²⁹ The taxes are to be assessed, collected, and distributed by the county assessors, collectors, and treasurers.³⁰ “Assessors must determine the value of both personal property and real estate.”³¹ Prior case law has determined that mineral interests are included as tangible real property,³² and, according to the Arkansas Constitution, county assessors determine the value of the applied to the deposits for equality and uniformity.³³ Following legislative guidance, the value of the gas while still in the ground is zero, while it is assessed a value for tax purposes once it is produced or sold.³⁴

20. *Id.*, __ S.W.3d __ (citing to Koch v. Adams, 2010 Ark. 131, 361 S.W.3d 817).
21. *Id.* at 6–7, __ S.W.3d __.
22. *Id.* at 7, __ S.W.3d __.
23. *Id.*, __ S.W.3d __.
24. *May*, 2012 Ark. 7, at 7, __ S.W.3d __.
25. *Id.*, __ S.W.3d __.
26. *Id.*, __ S.W.3d __.
27. *Id.*, __ S.W.3d __.
28. *Id.* at 8, __ S.W.3d __.
29. *Id.*, __ S.W.3d __.
30. *May*, 2012 Ark. 7, at 8, __ S.W.3d __ (citing to ARK. CODE ANN. § 14-14-904(b)(1)).
31. *Id.*, __ S.W.3d __.
32. *Id.* at 8–9, __ S.W.3d __ (citing to Sorkin v. Myers, 216 Ark. 908, 227 S.W.2d 958 (1950)); *see also* ARK. CODE ANN. § 26-26-1110 (Repl. 1997 & Supp. 2011).
33. *Id.* at 9, __ S.W.3d __ (citing to ARK. CONST. art. 16, § 5(a)).
34. *Id.*, __ S.W.3d __.

The Court found that the Taxpayers' argument was that the assessment timing was the issue and not that the tax itself was illegal.³⁵ As such, the Court noted that it had stuck to established precedent that an illegal exaction claim will not stand if the taxes themselves are not illegal,³⁶ likening the present case to a factually similar case from the year before.³⁷ Though the Taxpayers tried to argue that, through the assessment, the tax was transformed into a tax on intangible personal property or an income tax, the Court noted that the Taxpayers themselves conceded that their income was not used in the assessment formula.³⁸ The Taxpayers also argued that the tax was duplicative because it was also subject to a severance tax, the Court rejected that argument by finding that the legislature had explicitly authorized the applicability of both taxes.³⁹

Finally, the Court rejected the Taxpayers' Equal Protection violation claim because they had not shown they were similarly situated to landowners with nonproducing mineral interests.⁴⁰ Additionally, the Court found that the argument was really against the manner of assessment, as the Taxpayers took issue with the valuation of their gas versus the valuation of the landowners with nonproducing mineral interests.⁴¹ Therefore, the Court found that the Taxpayers had not met the burden necessary for proving an illegal exaction claim.⁴² The Court noted that the Taxpayers should follow the proper course of appealing an assessment pursuant to statute before appealing to the courts⁴³ and affirmed the circuit court's order.⁴⁴

With its decision in *May v. Akers-Lang*, the Supreme Court of Arkansas reiterated the idea that an illegal exaction claim cannot be brought unless it is argued that the tax itself is illegal. Due to the increase in mineral rights drilling around the state, it is likely that this issue will continue to see litigation by Taxpayers challenging the tax and the manner of assessment.

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35. *Id.*, __ S.W.3d __.

36. *May*, 2012 Ark. 7, at 9–10, __ S.W.3d __ (citing to *Hambay v. Williams*, 373 Ark. 532, 535, 285 S.W.3d 239, 241–42 (2008)).

37. *Id.* at 10, __ S.W.3d __ (citing to *Comcast of Little Rock, Inc. v. Bradshaw*, 2011 Ark. 431, at 12, __ S.W.3d __ where Comcast was found to be arguing not the validity of the tax but the assessment of it.).

38. *Id.*, __ S.W.3d __.

39. *Id.* at 10–11, __ S.W.3d __ (citing to ARK. CODE ANN. § 26-58-109 (Repl. 2008)).

40. *Id.* at 11, __ S.W.3d __ (citing to *Arkansas Beverage Retailers Ass'n v. Langley*, 2009 Ark. 187, 305 S.W.3d 427 (2009)).

41. *Id.*, __ S.W.3d __.

42. *May*, 2012 Ark. 7, at 11–12, __ S.W.3d __.

43. *Id.* at 12, __ S.W.3d __ (citing to ARK. CODE ANN. § 26-27-317).

44. *Id.* at 12, __ S.W.3d __.