

11-18-2014

## *Cloud Peak Energy v. Montana Department of Revenue: Defining the Market Value of Coal in Non-Arm's-length Transactions*

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### Recommended Citation

Adam Wade, Oral Argument Preview, *Cloud Peak Energy v. Montana Department of Revenue: Defining the Market Value of Coal in Non-Arm's-length Transactions*, 75 Mont. L. Rev. Online 84, [https://scholarship.law.umt.edu/mlr\\_online/vol75/iss1/16](https://scholarship.law.umt.edu/mlr_online/vol75/iss1/16).

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***Cloud Peak Energy v. Montana Department of Revenue; Defining the  
Market Value of Coal in Non-Arm's-length Transactions***

**Adam Wade**

No. DA 14-0057

Montana Supreme Court

Oral Argument: Tuesday, November 25, 2014, at 9:30 a.m. in the Courtroom of the Montana Supreme Court, Joseph P. Mazurek Justice Building, Helena, Montana.

I. QUESTION PRESENTED

Is the market value of coal sold under non-arm's-length ("NAL") agreements best determined (i) through a comparison of arm's-length sales agreements negotiated during the same time period or (ii) by comparing actual coal sale prices from the time of the coal's extraction from the earth?

II. FACTUAL AND PROCEDURAL BACKGROUND<sup>1</sup>

The Plaintiff and Appellee, Cloud Peak Energy ("CPE"), operates a coal-mining business known as Spring Creek Coal, LLC, in Big Horn County, Montana. In July 2008, the Montana Department of Revenue ("Department") audited CPE's coal-production taxes for the period 2005–2007. After completing the audit, the Department provided proposed adjustments to CPE's coal-production taxes and the parties resolved several, but not all, of the identified audit issues.

One of the remaining audit issues concerned the value of coal that CPE sold in NAL agreements to its affiliated business entities "Venture Fuels" and "Northern Coal Transportation Company." Coal is often sold below market value in NAL agreements, but Montana's coal-production tax is based on coal's present market value, which is not always reflected in NAL agreements. To account for this reality and ensure proper valuations for tax purposes, both Montana and federal law provide mechanisms to impute the value of coal sold below market value in NAL agreements.

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<sup>1</sup> The facts presented in this section are drawn from two documents: (1) Opening Br. of Appellant/Cross-Appellee State of Montana, Department of Revenue, *Cloud Peak Energy Resources, LLC v. Mont. Dept. of Revenue* at \*\*3–6 (Mont. April 17, 2014) (No. DA 14-0057) (hereinafter Opening Br. of Appellant); and (2) Opening Br. of Appellee/Cross-Appellant Cloud Peak Energy Resources, LLC, *Cloud Peak Energy Resources, LLC v. Mont. Dept. of Revenue* at \*\*2–9 (Mont. June 13, 2014) (No. DA 14-0057) (hereinafter Opening Br. of Appellee).

For federal royalty purposes, CPE determines the market value of its NAL coal sales pursuant to a federal settlement agreement between CPE's predecessor (Kennecott) and the Federal Mineral Management Service. Per the express terms of the agreement, the market valuation method outlined in the agreement only applies for federal royalty purposes. Following this federal royalty valuation method to compute coal's current market value, CPE compares each NAL agreement with the company's average arm's-length transaction prices for the given month. If the NAL sale price is lower than the average arm's-length price, CPE imputes revenue income equal to the arm's-length average. CPE does not make a downward adjustment if the NAL sale price is higher than the average arm's-length price. Following this valuation method, CPE deducted the previously mentioned federal royalties on its Montana Coal Production Tax Returns to reduce its Montana tax liability.

On March 13, 2012, the Department issued a deficiency assessment for the additional taxes due from the below-market NAL sales. The Department adopted CPE's market value calculation from the federal settlement agreement, but CPE pointed to the express terms of the agreement and argued said agreement should not be used to approximate market values for Montana tax purposes.

Before the Department issued a Final Agency Decision, CPE filed a complaint in Montana's First Judicial District seeking a declaratory judgment that the Department erred in relying on CPE's Federal Settlement to assess additional Montana coal taxes.

The Department considered the position outlined in CPE's complaint and conducted a market study to impute the value of the NAL coal sales instead of relying on CPE's calculations. The Department's methodology in imputing the NAL coal sale values for state tax purposes was very similar to the method found in CPE's Federal Settlement. This application of the federal settlement agreement resulted in an additional \$3,369,713 of tax burden for CPE.

Judge Sherlock of the First Judicial District granted summary judgment to the Department on the issue of determination of additional revenue; and granted summary judgment to CPE on the issue of the Department's decision to include certain additives in its calculation of the sale price. Both parties appealed.

### III. ARGUMENTS FROM THE PARTIES' BRIEFS

#### A. *The Montana Department of Revenue's argument on appeal:*

1. For Montana tax purposes, the imputed value of the coal sold in CPE's NAL agreements should be the coal's market value at the time

it is extracted from the earth and prepared for shipment.<sup>2</sup> The Department argues that “Montana Coal Production taxes attach when the coal is ‘produced,’” meaning extracted from the earth.<sup>3</sup> Therefore, the Department correctly imputed the market value of CPE’s NAL agreements by comparing average values of similar arm’s-length sales during the same time period. The Department notes CPE uses this exact formulation to impute NAL sale values for federal royalty purposes and argues the market value should be the same for both federal and state purposes.

2. The District Court misinterpreted Montana law and erroneously concluded the value of CPE’s NAL agreements should be determined using the market value of contemporaneously negotiated arm’s-length sales.<sup>4</sup> The District Court misinterpreted the definition of “time of sale” as contemplated in *Decker Coal Company v. Department of Revenue*<sup>5</sup> because Montana Coal Production taxes are determined from the “price of coal extracted and prepared for shipment.”<sup>6</sup> Under Montana statute,<sup>7</sup> the Department is required to determine the value of NAL agreements “at the time of sale” rather than the time of negotiation because negotiations often occur long before “the NAL coal in question [is] extracted.”<sup>8</sup> The Department concludes the Legislature clearly intended to tax the production of coal at the time of extraction; therefore, the District Court’s erroneous interpretation of Montana law should be reversed.

#### *B. Plaintiff and Appellee CPE’s argument on appeal:*

1. CPE argues the District Court properly imputed the value of NAL coal sales by using similar arm’s-length contracts negotiated during the same time period. CPE argues the Department’s valuation methodology is flawed because it (1) does not take prevailing market conditions into account at the time of the NAL agreement, (2) produces anomalous results, and (3) yields “widely divergent ‘market’ prices for coal sold under the same contract.” As noted by the Montana Supreme Court in *Decker*, NAL valuations require comparisons of arm’s-length contracts “*negotiated in the same time frame*” as the instant agreement.<sup>9</sup> CPE argues valuations relying on other time periods may produce anomalous results than can “nearly double” the price of similar arm’s-

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<sup>2</sup> Opening Br. of Appellant, *supra* n. 1, at \*15.

<sup>3</sup> *Id.* at \*9 (citing Mont Code Ann. §§ 15–23–701; 15–35–103; 15–38–103 (2013)).

<sup>4</sup> *Id.* at \*15.

<sup>5</sup> 2 P.3d 245 (Mont. 2000).

<sup>6</sup> Opening Br. of Appellant, *supra* n. 1, at \*9 (citing Mont Code Ann. §§ 15–23–701; 15–35–103; 15–38–103, *Decker*, 2 P.3d at 257).

<sup>7</sup> Mont. Code Ann. § 15–35–107.

<sup>8</sup> Opening Br. of Appellant, *supra* n. 1, at \*\*9, 13 (citing *Decker*, 2 P.3d at 252).

<sup>9</sup> Opening Br. of Appellee, *supra* n. 1, at \*\*18–19 (citing *Decker*, 2 P.3d at 250).

length transactions.<sup>10</sup> The introduction of such an unpredictable valuation methodology will lead to “widely divergent” NAL prices that do not accurately reflect coal’s fair market value for tax purposes and will lead to improper price fluctuations in otherwise identical purchase contracts.<sup>11</sup>

2. CPE argues the Department’s valuation methodology has significant practical ramifications that yield “artificially high and artificially low” revenues for tax purposes.<sup>12</sup> Here, CPE’s imputed revenue from 2005–2007 “greatly exceeds the revenues CPE ‘could have’ received from arm’s-length sales.”<sup>13</sup> Equally problematic, the Department’s valuations that occur in periods of economic decline will understate revenues and deprive Montana of significant amounts of coal taxes in applicable NAL sales.<sup>14</sup>

3. In response to the Department’s reliance upon a federal settlement agreement to calculate federal royalties, CPE argues the agreement does not apply to the instant case because the express terms of the agreement preclude “application of its terms to Montana Coal Taxes.”<sup>15</sup>

4. In its cross appeal, CPE argues the District Court erred in applying Montana statute<sup>16</sup> to coal mined *before* June 30, 2009 because the statute is strictly limited to “coal mined *after* June 30, 2009.”<sup>17</sup> The statutory provision defines “prepared for shipment” for coal mined *after* June 30, 2009. CPE argues the Department improperly applied this definition to “impose taxes on [coal] additives for the time period 2005–2007.”<sup>18</sup>

#### IV. ANALYSIS

This case presents an interesting question that will likely provide definitive guidance outlining the procedure required to impute revenue in future NAL coal sale agreements. The most important issue in this case concerns the timing of NAL coal sale price valuations. The Department favors a system that compares actual contemporaneous sale prices<sup>19</sup> while CPE favors one that compares prices negotiated in contemporaneous arm’s-length sales contracts.<sup>20</sup> While these methods may seem extremely similar, this case illustrates the radically different tax consequences that can result from the two different approaches. In

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<sup>10</sup> *Id.* at \*20.

<sup>11</sup> *Id.* at \*\*19–20.

<sup>12</sup> *Id.* at \*\*26–31.

<sup>13</sup> *Id.* at \*20.

<sup>14</sup> *Id.* at \*12.

<sup>15</sup> Opening Br. of Appellee, *supra* n. 1, at \*32.

<sup>16</sup> Mont. Code Ann. § 15–35–107.

<sup>17</sup> Opening Br. of Appellee, *supra* n. 1, at \*37.

<sup>18</sup> *Id.* at \*36.

<sup>19</sup> Opening Br. of Appellant, *supra* n. 1, at \*\*8–9.

<sup>20</sup> Opening Br. of Appellee, *supra* n. 1, at \*\*17–19.

addition to the immediate tax burden at issue, this case also presents important policy considerations that must be carefully weighed by the Court.<sup>21</sup> Specifically, the Court must weigh the significant short-term loss of tax revenue presented by CPE's disputed tax burden against the potentially problematic precedent created if the Court adopts the Department's valuation method.

While the Department's argument has obvious merits, CPE presents a compelling argument identifying a potential flaw in the Department's valuation methodology. CPE correctly argues NAL coal sales are the result of previously negotiated agreements that often occur months, if not years before the actual sale.<sup>22</sup> While parties may attempt to predict future market prices and factor these predictions into their agreements, these attempts are simply conjecture until present-day market conditions reveal the actual market price. Because of this reality, the Department's reliance upon current sale prices actually utilizes dated prices that merely reflect market values in past negotiations. As noted by CPE, these dated prices may not accurately reflect coal's current market value, which may result in both overstated and understated tax burdens.<sup>23</sup> If the Court finds merit in CPE's claim, these inaccuracies have no place in Montana tax law and the Court should be hesitant to create problematic precedent that will lead to inaccurate applications in future cases. Uniform application and predictable results are crucial requirements in tax law and any action that may introduce uncertainty should be treated with utmost caution.

Lower Court: Lewis and Clark County Cause No. BDV2012-239, Honorable Jeffery M. Sherlock, District Court Judge of the First Judicial District, Lewis and Clark County.

Attorneys for the Petitioner: Brendan R. Beatty and Courtney Jenkins, Special Assistant Attorneys General, Montana Department of Revenue.

Attorneys for the Respondent: Robert L. Sterup and Kyle Anne Gray, Holland & Hart L.L.P., Billings, Montana.

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<sup>21</sup> See Mont. Code Ann. § 15-35-101 for a statement of the policy behind the Coal Severance Tax (distinguishing coal from metal minerals as well as from petroleum for tax purposes; seeking a tax that is a "constant percentage" of the price of coal; seeking to stabilize tax revenue from coal; and simplifying the "structure of coal taxation").

<sup>22</sup> Opening Br. of Appellee, *supra* n. 1, at \*\*24-25.

<sup>23</sup> Opening Br. of Appellee, *supra* n. 1, at \*22.