Court Finds Deposit of Nonconventional Fuel Tax Credits In The Environmental Protection Fund Constitutional

The Michigan Court of Appeals has upheld the constitutionality of Section 503(4) of the Natural Resources and Environmental Protection Act (NREPA), which authorizes the Michigan Department of Natural Resources (MDNR) to enter into contracts for the sale of the economic share of royalty interests the State of Michigan holds in hydrocarbons produced from devonian or antrim shale (i.e., oil shale) that qualifies for the federal nonconventional fuel tax credit under Section 29 of the Internal Revenue Code (IRC). Under NREPA § 503(4)(a), the net proceeds of the funds the State receives from the sale of the economic share of royalty interests allocable to the nonconventional fuel tax credit are deposited in the Environment Protection Fund.

Facts

A number of Michigan environmental and conservation organizations and private citizens (collectively, the Citizens) argued that the deposit of these funds in the Environment Protection Fund violated Article 9, Section 35 of the Michigan Constitution, which directs that "bonuses, rentals, delayed rentals, and royalties collected or reserved by the state under provisions of leases for the extraction of nonrenewable resources from state owned lands" be deposited in the Natural Resources Trust Fund, and brought suit against the Michigan Department of Treasury to compel the Treasurer to deposit the funds in the Natural Resources Trust Fund. The trial court held that NREPA § 503(4)(a) violated this constitutional direction and the State appealed the trial court's decision.

Congress enacted the nonconventional fuel tax credit in order to encourage taxpayers to develop nonconventional fuel resources, such as oil shale and tar sands, by allowing taxpayers who own an interest in facilities that produce fuels from such resources to claim a tax credit of $3 per quantity of fuel produced equal to one barrel of oil. Given that a tax credit is available only to a taxpayer, i.e., not the State of Michigan, the State would not normally be able to claim the nonconventional fuels tax credit even though the State owns properties and facilities that produce nonconventional fuels. Thus, the Legislature enacted NREPA § 503(4) to establish a mechanism through which the State could take advantage of the nonconventional fuels tax credit and obtain funds which would not otherwise be available to the State.

Motor City Four, LLP (Motor City) agreed to pay the State $33,903,483.46 under a secured nonrecourse promissory note in exchange for the sale or assignment of the State's royalty interests to Motor City. The Citizens asserted that that these monies should have been deposited in the Natural Resources Trust Fund under Article 9, Section 35, not the Environment Protection Fund as NREPA § 503(4)(a) directs. That is, the Citizens argued that the revenues produced under NREPA § 503(4) constituted "bonuses, rentals, delayed rentals, and royalties" under Article 9, Section 35 and that deposit of the revenues in the Environment Protection Fund pursuant to NREPA § 503(4)(a) violated the Constitution.

Court's Decision

In beginning its analysis of the constitutionality of NREPA § 503, the Court of Appeals noted that statutes are presumed to be constitutional and that the Court has a duty to construe the

statute as constitutional unless it is clearly unconstitutional. "To make a successful facial challenge to the constitutionality of a statute, the challenger must establish that *no circumstances exist under which the statute would be valid*." Slip op. at 4 (emphasis in original). The Court analyzed the meanings of "bonuses," "rentals," "delayed rentals," and "royalties" as used in Article 9, Section 35, finding that each term has a clear and unambiguous meaning. The Court held that all of the terms were terms of art and technical terms which should be given their special meanings, but none of the terms described the payments that Motor City was making to the State:

> A "lease bonus is the 'cash consideration paid by the lessee for the execution of an oil and gas lease by the landowner . . . . Bonus is usually figured on a per acre basis.'" Here the money derived from tax credits that Motor City conveyed to the state was neither consideration for a lease nor calculated on a per acre basis. Moreover, as [the State] points out, [the Citizens] have not averred (for seemingly obvious reasons) that the credit is a rental or delayed payment.

Slip op. at 5 (citations omitted).

The Court next analyzed whether the tax credits qualified as "royalties." Relying on two dictionary definitions of the term, the Court stated that a "royalty" has the following characteristics: "(1) it is a payment; (2) in the form of either the product itself or proceeds from the sale of the product; and (3) made in consideration for the use of the property." *Id*. The Court held that the tax credit has none of these characteristics:

> First, a tax credit to a taxpayer is not a payment. Rather a tax credit "is a direct reduction of the tax due. A credit arises . . . because of a provision in the law . . . ." Second, [the Citizens] might argue that even if the credit due to Motor City was not an affirmative payment, Motor City's transfer of funds back to the state *was* a payment, qualifying the transfer as a royalty. The transfer of funds back to the state was not in the form of the product or its proceeds, however. Rather the transfer of money from Motor City to the state was made in consideration for whatever tax benefits might accrue to Motor City pursuant to this transaction. Indeed, even assuming that the promissory note to the state was calculated based on an estimate of the tax credits that Motor City could recover, and the amount of the tax credits was calculated according to the amount of gas produced, the tax credits do not constitute production payments, sale proceeds, or royalties. We find no authority requiring that these distinct sources of funding be lumped into one category. And third, Motor City never actually used the state's land, but instead acquired an ownership interest in royalties derived from extracting natural gas from the land, and all royalty payments were transferred back to (or, in

> effect, remained with) the state in the form of a production payment.

Slip op. at 5 - 6 (citation omitted, emphasis omitted).

The payment Motor City made to the State was calculated based on the estimated tax credit that Motor City would be entitled to receive under the nonconventional fuels tax credit, "*not* from the sale of the product extracted from state property." Slip op. at 6. The Court observed that Motor City granted back to the State all royalty interests in the property and, therefore, the royalty payments remained with the State. Thus, because the money paid to the State by Motor City represented the value of the tax credits it would receive as a result of the agreement with the State, and the royalty interests would remain with the State, nothing in the transaction deprived the Natural Resources Trust Fund of monies it would have otherwise received before the enactment of NREPA § 503(4)(a). The Court held that NREPA § 503(4)(a) "does not violate [Article 9, Section 35] by placing into the environmental protection fund the otherwise unavailable *proceeds* arising out of the transfer of the state's royalty interest to a third party who can, unlike the state, generate additional income merely by holding the interest." *Id*. The Court noted that the Natural Resources Trust Fund would be in the same position whether or not NREPA § 503(4)(a) was ever enacted.

Article 9, Section 35 was ratified as an amendment to the Michigan Constitution by the Michigan voters in 1984. The Citizens argued that the voters who ratified Article 9, Section 35 likely understood that all revenue derived from leases of state land for the extraction of nonrenewable resources would be deposited in the Natural Resources Trust Fund. The Citizens claimed that the Article 9, Section 35 came about in response to several "raids" on the Natural Resources Trust Fund where monies were diverted from the fund to pay for other programs. Elevating the Natural Resources Trust Fund to Constitutional Status was intended to protect the Fund from such "raids" in the future. The Court explained that, even accepting these explanations as true, the Citizens did not demonstrate how the transaction at issue qualified as a "raid," because the monies involved would not have existed absent the enactment of IRC § 29 and NREPA § 503(4). That is, existing funds were not diverted, nor were monies removed, from the Natural Resources Trust Fund. Instead, this case concerned where newly created revenue should be deposited. Thus, the Court held that the motivations underlying Article 9, Section 35 were not offended by NREPA § 503(4).

Based on the above rationale, the Court held that the Citizens were not able to overcome the presumption of constitutionality afforded to NREPA § 503(4) and reversed the trial court's finding of unconstitutionality.

***Michigan United Conservation Club v. Dept. of Treasury*,** Mich. Ct. App., No. 208429 (Dec. 10, 1999).

This article was prepared by Brian J. Negele, a partner in our Environmental Department, and previously appeared in the April, 2000 edition of the Michigan Environmental Compliance Update, a monthly newsletter prepared by the Environmental Department and published by M. Lee Smith Publishers.