BEVERIDGE & DIAMOND PC

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MEMORANDUM

FROM: Beveridge & Diamond, P.C.
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RE: Analysis of an Alternative to H.R. 6--the Severance Tax Option

I. SUMMARY

On January 18, 2007, the House of Representative passed H.R. 6, the principal purpose of which is to coerce lessees of certain Outer Continental Shelf ("OCS") leases in the Gulf of Mexico issued in 1998 and 1999 with between 17.5 and 87.5 million barrels of oil equivalent in royalty relief to amend their leases to include a price threshold applicable to that royalty relief. With price thresholds, at current market price levels these lessees would be required to pay billions of dollars in royalties on oil and gas production that currently is exempt from that obligation. In a March 9, 2007 memorandum, we concluded that H.R. 6 suffers from serious legal defects and would likely be struck down by a court on breach of contract, takings, equal protection, bill of attainder, and due process grounds ("March 9 Memorandum")[1].

The Senate currently is considering an alternative to H.R. 6 in the form of a severance tax that primarily singles out 1998/1999 lessees and requires them to pay billions of dollars in taxes on oil and gas production that other Gulf of Mexico lessees are not required to pay. The severance tax would recoup on a dollar-for-dollar basis the royalty relief to which the 1998/1999 lessees are entitled under the terms of their leases. Therefore, this alternative proposal has the same discriminatory and punitive effects as H.R. 6, and suffers from the same legal defects.

[1] Cross-references included herein refer to "Attachment A" to the March 9 Memorandum.

The proposed alternative to H.R. 6 would impose a severance tax at a rate of 13 percent on the production of oil and gas from all OCS Gulf of Mexico leases. A tax credit up to the amount of the tax due would be provided on a lease-by-lease basis in the amount of federal royalties paid on the lease. For most lessees, the severance tax proposal would have little to no effect because their royalties would offset the tax. However, the 1998/1999 leases, which are exempt from paying royalties on oil and gas production, would not qualify for the tax credit and would be required to pay the full tax. Therefore, the severance tax proposal effectively would nullify the royalty relief provided in the 1998/1999 leases by making those lessees pay an equivalent amount in tax. A few other Gulf of Mexico lessees currently entitled to royalty relief would be similarly affected.

The fact that the alternative to H.R. 6 is structured as a tax, rather than a royalty payment or fee, has no bearing on the legal analysis. In Puerto Rico v. Russell & Co., 315 U.S. 610 (1942), the Supreme Court struck down a law imposing a tax on a select group which, pursuant to contracts with the government, had been exempted from contributing to the development of an irrigation system. According to the Court, the law was adopted with the impermissible purpose of recouping costs lost by the government because it failed to provide for such fees in the contracts. Similarly, in Centex Corp. v. United States, 395 F.3d 1283, 1310 (Fed. Cir. 2005), the Federal Circuit Court of Appeals held that Congress breached contracts by imposing a tax "targeted" at "reappropriat[ing] the profits that the plaintiffs expected" from the contracts simply because the government thought "the contract was improvident." The court also stated that the government cannot use "its taxing power to appropriate back benefits that it has given up pursuant to contract."

Further, the severance tax proposal is a retroactive statute because it would take rights vested in the 1998/1999 lessees. A retroactive tax that is "harsh and oppressive" or "arbitrary and capricious" violates the Due Process and Takings Clauses of the Fifth Amendment. Welch v. Henry, 305 U.S. 134, 147 (1938); Nichols v. Coolidge, 274 U.S. 531, 542 - 43 (1927). The analysis courts apply to a retroactive tax is essentially the same as the analysis applied to any piece of economic legislation, like H.R. 6, and therefore, like H.R. 6, the severance tax proposal violates due process and constitutes an unconstitutional taking. The severance tax proposal is particularly harsh on many of the 1998/1999 lessees because they acquired their leases through assignment from a prior lessee. Because of the royalty relief included in the lease, these bona fide purchasers paid a premium to acquire their lease interests. Requiring these lessees to pay the severance tax effectively makes them pay a cost they already paid once to avoid.

Finally, courts apply the same analysis under the Equal Protection Clause -- whether a legitimate purpose exists that rationally furthers the burden imposed -- to tax laws as they do to other economic legislation. NationsBank of Texas v. United States, 44 Fed. Cl. 661, 666 - 67 (1999). Like H.R. 6, the severance tax proposal does not meet this standard, and thus, violates the Equal Protection Clause.

Because the purpose and effect of the severance tax proposal are indistinguishable from the mandatory "conservation of resources" fees under H.R. 6, it violates the 1998/1999 lessees' contractual and constitutional rights to the same extent. Congress' reliance on its authority to tax will not shield it from legal challenge on those grounds. The Supreme Court and other federal courts have consistently held that Congress has no greater authority to breach contracts, take property, or violate other constitutional rights merely because it is acting pursuant to its authority to tax. A full analysis of the legal issues presented by the severance tax proposal follows.

II. INTRODUCTION

The March 9 Memorandum provides an extensive analysis of the legal issues presented by H.R. 6, passed by the House of Representatives on January 18, 2007 and currently under consideration in the Senate. A copy of the March 9 Memorandum is attached. We now address whether the severance tax alternative to H.R. 6 under consideration by the Senate presents the same legal deficiencies. We conclude that it does.

A. Summary of the March 9 Legal Analysis of H.R. 6

As explained in the March 9 Memorandum, the principal purpose of H.R. 6 is to coerce lessees of federal Outer Continental Shelf ("OCS") leases in the Gulf of Mexico that were issued in 1998 and 1999 pursuant to the Deep Water Royalty Relief Act, Pub. L. No. 104-58 ("DWRRA")[2] to amend their leases to include a so-called "price threshold."[3] The effect of

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[2] The DWRRA was enacted in 1995 and imposed new requirements for leasing under the Outer Continental Shelf Lands Act, 43 U.S.C. §§ 1331-1356a ("OCSLA"). Under Section 304 of the DWRRA, the Minerals Management Service ("MMS"), the agency within the Department of the Interior responsible for leasing on the OCS, was directed to provide royalty relief for deep water leases (water depths in excess of 200 meters) issued in certain portions of the Gulf of Mexico in lease sales for five years, 1996-2000. The amount of royalty relief varied from 17.5 to 87.5 million barrels of oil equivalent depending on water depth. Neither Section 304 of the DWRRA nor the MMS regulations implementing that statute required a "price threshold" that would suspend the royalty relief in calendar years when average market prices for oil or gas exceed a prescribed level. MMS included a price threshold provision as an addendum to DWRRA leases issued in 1996, 1997, and 2000 but did not include price thresholds in the 1998/1999 leases. Therefore, under the applicable statutes, regulations and lease terms, the 1998/1999 lessees only begin to pay royalties on oil and gas production from their leases once the applicable royalty suspension volume is exhausted. Another provision of the DWRRA, Section 302, also provided an opportunity for royalty relief for certain leases issued before the DWRRA's enactment. Section 302 had an express price threshold provision applicable only to royalty relief authorized under that section (in contrast to Section 304 which included no price threshold).

[3] In 2005 dollars, the price thresholds required under H.R. 6 are $34.92/barrel for oil and $4.36/million Btu for gas, and are adjusted annually for inflation. Current market prices substantially exceed these thresholds.

including the price thresholds is that, at current price levels, these lessees would be required to pay royalties on oil and gas production that now is exempt from that obligation.[4]

Under H.R. 6, any lessee who fails to amend all of its 1998/1999[5] leases to include the price threshold, or fails to agree to pay a "conservation of resources fee"[6] on all production from those leases in calendar years when average market prices exceed the price thresholds, would be barred from future Gulf of Mexico OCS lease sales. These lessees also would be prohibited in the future from acquiring any existing OCS leases. In any event, for 1998/1999 lessees that do not amend their leases to include price thresholds, payment of the conservation of resources fee under section 204(b)(2) of H.R. 6 is mandatory.

The March 9 Memorandum explains the various legal issues that H.R. 6 presents, including:

Breach of contract -- Recent court decisions clearly establish that new lease obligations imposed by legislation enacted after the lease is issued and not expressly contemplated therein, like those imposed in Section 204 of H.R. 6, constitute a material breach of contract.

Unlawful taking -- The DWRRA royalty suspension volumes effectively convey to the lessee the royalty interest usually held by the lessor, until the royalty suspension volumes are exhausted. H.R. 6 results in a taking of this entire property interest from the lessee without just compensation in violation of the Fifth Amendment to the U.S. Constitution;

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[4] The effect of including the price threshold in a lease or paying the fee would be to deprive each lessee of tens or hundreds of millions of dollars of royalty relief that it is entitled to under the DWRRA and the terms of its lease.

[5] Reference in this memorandum to "1998/1999" leases is only a reference to those Gulf of Mexico OCS leases issued during those years pursuant to the DWRRA.

[6] The fee is set in H.R. 6 at $9.00 per barrel of oil or $1.25 per million Btu of natural gas in 2005 dollars.

Equal protection -- Requiring only the class of 1998/1999 lessees to pay additional royalties/fees or be deprived of participation in OCS lease sales, when there is no legitimate government interest furthered by such restriction, amounts to discrimination and a denial of equal protection under the Fifth Amendment;

Bill of attainder -- Singling out and punishing a select, "easily ascertainable" number of lessees who have committed no offense and caused no harm raises concerns that H.R. 6 may qualify as a bill of attainder in violation of the Constitution; and

Due process concerns -- Laws like H.R. 6 with retroactive effect are disfavored, and in this situation amount to a violation of the lessees' due process rights under the Fifth Amendment.[7]

B. The Severance Tax Alternative to H.R. 6

We now apply the legal principles analyzed in the March 9 Memorandum to the severance tax proposal under consideration in the Senate. The Senate bill is also entitled H.R. 6, and thus to avoid confusion with the bill passed by the House also entitled H.R. 6, we will refer to the House bill as H.R. 6 and the Senate bill as the Tax Option.

The Tax Option begins with the imposition of a severance tax under section 5896(a) "equal to 13 percent of the removal price of any taxable crude oil or natural gas removed from the premises during any taxable period." The Tax Option further provides that:

[7] On April 16, 2007, the Congressional Research Service issued a report analyzing the legal issues raised by H.R. 6. The Report is deficient in its legal analysis for many reasons. Most importantly, the Report completely overlooks the fact that H.R. 6 imposes a mandatory conservation of resources fee on production. This significant misunderstanding of the bill undermines several of the Report's legal arguments in support of H.R. 6. Moreover, while the Report generally establishes the correct constitutional and legal framework for its selected issues, it omits several important aspects of these doctrines and applies the relevant standards incorrectly. Nothing in the Report would cause us to change our analysis of the legal defects presented in H.R. 6.

> [t]here shall be allowed as a credit against the tax imposed by subsection (a) with respect to the production of any taxable crude oil or natural gas an amount equal to the aggregate amount of royalties paid under Federal law with respect to such production.

Section 5896(b)(1). The aggregate amount of the tax credits for any period cannot exceed the tax. Section 5896(b)(2).

This Tax Option would have different effects depending on the lease royalty rate and whether the Gulf Of Mexico OCS lease was subject to royalty relief with a price threshold. For typical OCS leases with a royalty rate of either 16.67 percent or 12.5 percent and no royalty relief, the lessee would pay either no severance tax or .5 percent, respectively. Therefore, for the vast majority of OCS leases, the tax is either entirely, or almost entirely, offset by the royalties paid on lease production. In contrast, a 1998/1999 DWRRA lease with a 12.5 percent royalty rate, but that is subject to royalty relief with no price threshold (and, therefore, has no royalty payment to deduct from the severance tax), would pay the full 13 percent severance tax until the royalty suspension volume for the lease is exhausted. Other leases with royalty relief, such as leases in shallow water that qualify for deep gas royalty relief, also would pay the full 13 percent severance tax in any year when prices are below the price threshold applicable under that regulatory program (which is higher than the DWRRA price threshold for gas).

We believe the Tax Option is subject to the same legal defects as H.R. 6. Under the DWRRA and the terms of their leases, the 1998/1999 lessees are entitled to pay no royalty on production until they reach their respective royalty suspension volumes. Like H.R. 6, the Tax Option deprives the lessees of their right to production free of royalty, except that Congress now would be using its taxing authority. Once you peel away the veneer, it is plain that under the guise of imposing a severance tax on all Gulf of Mexico OCS lessees, the obvious purpose and effect of the Tax Option is to recoup for the Treasury the royalties that the 1998/1999 lessees

(and a few other lessees) are not required to pay under the terms of applicable law, MMS regulations, and their lease terms.[8]

III. LEGAL ANALYSIS OF THE TAX OPTION

The Tax Option appears to rely on the principle that Congress' authority to impose taxes has been construed to be very broad, United States v. Ptasynski, 462 U.S. 74, 79 (1983), and therefore, Congress may be able to achieve through the tax process what it cannot lawfully achieve through H.R. 6. Before addressing that question, we first compare the effects of the Tax Option and H.R. 6 on 1998/1999 lessees.

A. The Tax Option Has the Same Effect as H.R. 6

The Tax Option begins with a proposed severance tax "equal to 13 percent of the removal price of any taxable crude oil or natural gas removed from the premises during any taxable period." Section 5896(a). The operative language is the next subsection, which allows a credit against the tax in an amount equal to the royalties paid with respect to such production. Section 5896(b)(1). It is the structure of the credit that places the discriminatory and punitive burden of the severance tax on the 1998/1999 lessees, and on a limited group of other lessees with royalty relief.

The vast majority of OCS lessees have leases with a royalty rate of 16.67 percent and no royalty relief. Therefore, the royalty these lessees pay on production exceeds 13 percent and will offset completely the severance tax. These lessees will pay no severance tax under the Tax Option.

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[8] The severance tax option also presents a number of practical implementation issues that are problematic. For example, the Tax Option would require the IRS to establish valuation procedures for oil and gas production that may be different from the long-standing MMS regulations governing valuation of production. This memorandum, however, will not address this and other practical implementation problems.

The other large category of OCS lessees has leases with a 12.5 percent royalty rate. Most of these leases have no royalty relief provision at all. Some, like the 1996, 1997, and 2000 DWRRA leases, have royalty relief provisions but contain price thresholds that are below current market prices. When the lessees in this category pay royalty it will offset all but a fraction, .5 percent, of the severance tax.[9] Therefore, with some possible limited exceptions, the two largest categories of Gulf of Mexico OCS lessees will pay either no tax or a *de minimis* tax.

The impact of the Tax Option is markedly different for the 1998/1999 lessees. Because their leases provide for royalty relief as prescribed in DWRRA Section 304, but include no price thresholds, these lessees will pay no royalty on production until they reach their royalty suspension volume, ranging from 17.5 to 87.5 million barrels of oil equivalent. The value of the royalty suspension at today's oil and gas prices ranges from approximately $125 million to $625 million for each lease. Because these lessees would have no royalty payments to offset against the severance tax, they would pay the full 13 percent severance tax until they exhaust their royalty suspension volumes and start paying royalties. The effect is that the Treasury would recoup on a dollar-for-dollar basis the very amount of royalty relief these lessees are entitled to receive. The tax therefore is functionally equivalent to requiring the 1998/1999 lessees to pay royalties or fees on their royalty suspension volumes.[10]

[9] Several of the 1996, 1997, and 2000 DWRRA lessees have challenged MMS' authority to include the price threshold provisions in their leases. Pursuant to MMS' standard procedures, most of these lessees are not paying the disputed royalties while these challenges are pending.

[10] Those 1998/1999 lessees who recently agreed to amend their leases and include price thresholds are affected differently. Because they will pay royalty on their production, the impact of the Tax Option is the same as for other 12.5 percent royalty rate leases--their net tax payment will be .5 percent.

Other Gulf of Mexico OCS lessees who currently receive royalty relief would be affected by the Tax Option similarly to the 1998/1999 lessees. For example, there currently are several lessees who receive royalty relief for drilling deep gas wells in the shallower waters of the OCS less than 200 meters deep. This royalty relief is authorized under MMS regulations and by some of the lease terms. While there is an applicable price threshold, that threshold is much higher than the thresholds applicable to DWRRA leases or proposed in H.R. 6. Therefore, these lessees currently are producing gas and paying no royalty until they reach their royalty suspension volume. Like the 1998/1999 lessees, these lessees would have no royalty offset against the severance tax. The Tax Option would make these lessees pay the full 13 percent severance tax, effectively making them pay royalty on production that otherwise would be royalty-free, same as the 1998/1999 lessees.[11]

It is plain that, notwithstanding statements by Senator Bingaman and others to the contrary, the Tax Option is not uniformly applicable to all Gulf of Mexico OCS lessees. On the contrary, many OCS lessees will pay no severance tax; another large group will pay only a .5 percent severance tax; and the 1998/1999 lessees will pay the full 13 percent which discriminates against that group of lessees to the same extent as H.R. 6. Whether it is paying the conservation of resources fee (that may be even higher than a royalty) or including price thresholds in a lease to avoid the bar from future leasing under H.R. 6, or paying severance taxes that other OCS lessees are not required to pay under the Tax Option, the practical result is identical -- the 1998/1999 lessees will pay the equivalent of the royalty on the production that currently is

[11] Not many leases will qualify for deep gas royalty relief and the potential dollar value of that relief does not compare to the 1998/1999 lessees' projected royalty relief. Therefore, while these leases are treated similarly to the 1998/1999 leases, recouping the royalty relief granted to the latter group is the focus of the Tax Option.

royalty-free under the terms of applicable law, regulations and lease terms. Therefore, like H.R. 6, the Tax Option is unquestionably targeted at the 1998/1999 lessees.

B. The Tax Option Has the Same Legal Deficiencies as H.R. 6

In the March 9 Memorandum we examined whether Congress could lawfully use its authority to require the 1998/1999 lessees to pay billions of dollars in royalties or fees on oil and gas production currently exempt from royalty. We concluded that Congress could not lawfully accomplish that result. In the preceding section we explain that the practical effect of the Tax Option on the 1998/1999 lessees is the same as H.R. 6. Therefore, the next inquiry is whether the proposed severance tax similarly would breach the 1998/1999 lease contracts, take property without just compensation, and discriminate against and punish a defined class of OCS lessees who have done nothing wrong. As we explain below, the Supreme Court and other federal courts have concluded in several cases with facts analogous to those presented here that Congress cannot use its taxing authority to: (1) deprive the 1998/1999 lessees of their contractual right to royalty-free production; (2) take the 1998/1999 lessees' property right in the royalty interest in violation of the Fifth Amendment to the Constitution; or (3) discriminate against and punish these lessees in violation of their rights to equal protection and due process by imposing a tax other similarly situated lessees are not required to bear.

1. The Tax Option would breach the 1998/1999 lease contracts

In the March 9 Memorandum we concluded that H.R. 6 constitutes a breach of contract under the Supreme Court's analysis in Mobil Oil Exploration & Producing SE, Inc. v. United States, 530 U.S. 604 (2000), and the Court of Federal Claims' recent application of Mobil Oil in Amber Resources v. United States, 68 Fed. Cl. 535 (2005). Both cases held that Congress cannot impose a post-lease issuance requirement on an OCS lease that materially alters the terms

of the lease. The mandatory fees and additional royalty obligations that H.R. 6 would impose on the 1998/1999 lessees constitutes such a material alteration of the leases. We also concluded that H.R. 6 will deprive the 1998/1999 lessees of one of the benefits of their bargain, *i.e.*, royalty relief without price thresholds, and therefore, the application of new fees under H.R. 6 will breach the implied covenant of good faith and fair dealing.

The Tax Option suffers from the same defects as H.R. 6. Though Congress' power to tax is broad, federal courts will strike down tax legislation that deprives a party of a benefit it previously contracted for or otherwise interferes with contractual rights. For example, in Puerto Rico v. Russell & Co., 315 U.S. 610 (1942), the plaintiff entered into contracts with Puerto Rico. To aid the development of an irrigation system, the contracts suspended certain water rights possessed by the plaintiff during the life of the contracts and assured delivery of a specific amount of water as the fair equivalent of the rights suspended. Id. at 611 - 12. Several years later, the Puerto Rican legislature passed an act imposing a special tax on all those who, like the plaintiff, had contracted for the receipt of water, to help fund the maintenance cost of the system. Id. at 613. The Supreme Court found that (i) the act proposing the special tax was adopted "with the evident purpose of recouping a portion of [the maintenance cost] from the [plaintiff] and others with whom it had made contracts," and (ii) the "history of the legislation shows that the proposed exaction was not a general tax but was an effort to collect ... a portion of the expense of maintaining [the] system, whereas the contracts exempted them from contributing to such cost," and therefore, there was "a clear violation of the obligation of the contracts." Id. at 619.

Similarly, in Centex Corp. v. United States, 395 F.3d 1283, 1287 (Fed. Cir. 2005), the United States sought to mitigate the savings & loan crisis of the 1980s by providing incentives to healthy financial institutions to take over troubled thrifts. Plaintiffs did so, entering into a

contract with the United States to acquire four thrifts in exchange for various considerations, including tax benefits. Id. at 1288. Several years later, Congress enacted the "Guarini amendment," which abrogated the tax benefits that had been a major inducement to plaintiffs to acquire the thrifts. Id. at 1289. Plaintiffs brought suit, alleging that the Guarini amendment constituted a breach of their contract with the United States to acquire the thrifts. Id. The trial court entered summary judgment in favor of plaintiffs, finding that the Guarini amendment breached the United States' implied duty of good faith and fair dealing, and awarded damages slightly over $28 million.

On appeal, the Federal Circuit, in affirming the trial court, held that Congress breached private contracts when it enacted a tax law "targeted" at "reappropriat[ing] the profits that the plaintiffs expected" from the contracts simply because the government thought "the contract was improvident." Id. at 1310. The government cannot use "its taxing power to appropriate back benefits that it has given up pursuant to contract." Id. The Federal Circuit further explained that the amendment "was specifically addressed to a small number of transactions," "Congress was keenly aware of the tax benefits that the acquiring institutions were offered," and the amendment "was not part of a broader change to the Tax Code affecting taxpayers generally, but had its sole impact on particular contracts that Congress regarded as unduly favorable to the acquiring institutions." Id. at 1306. The court went on to explain that "the government's assertion that a contract cannot preclude Congress from changing the tax laws does not fairly characterize the issue we are called on to decide, [which is] whether the government is liable in damages for breach of the contract when Congress enacts specifically targeted legislation that appropriates a portion of the benefits previously available to the contractor." Id. at 1309.

In the Federal Circuit's decision, the court presented a hypothetical to illustrate its holding that is strikingly similar to the impact of the Tax Option on the 1998/1999 lessees.[12] For all the reasons the court plainly articulated in response to the hypothetical, the court would find the Tax Option equally unlawful.

The royalty relief offered in 1998/1999 leases without price thresholds unquestionably was a major inducement to the lessees to enter into these contracts. As explained above, the Tax Option is not a general tax but is plainly targeted at abrogating the important lease provisions granting royalty relief. Based on recent case law, there seems to be little doubt that a court would conclude that the Tax Option breaches the 1998/1999 leases.

The analysis in a June 14, 2007 memorandum from a legislative attorney with the Congressional Research Service ("CRS Memorandum")[13] to the Senate Committee on Energy

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[12] "Suppose the government contracts with a shipbuilder to construct an aircraft carrier for a fixed price. If, after the contract is completed, Department of Defense officials decided that the contract was improvident in that the government paid too much, they cannot simply reduce the amount of the payment without being in obvious breach of the contract. The case is no different if it is Congress that decides the contract was unduly generous to the contractor; again, Congress plainly cannot enact legislation reducing the amount of the payment to the contractor without causing a breach of the contract. The case would not be different if Congress took the same step but packaged it in the form of a change in the Internal Revenue Code. Thus, a 'windfall profits' tax imposed on the particular shipbuilding contractor in connection with the aircraft carrier contract would be as much a breach of the contract as a simple refusal to pay the agreed-upon amount or the enactment of legislation prohibiting the Department of Defense from making the agreed-upon payment. Nor should it make any difference if Congress achieved the same reduction in the benefits to which the contractor was entitled under the contract by enacting a targeted statute that reduced the particular shipbuilding contractor's right to deduct certain business expenses in connection with the contract. To the extent the government's argument relies on the fact that Congress effected the reduction in the benefits of the contract in this case (and thus reduced the cost of the contract to the government) by the indirect means of denying the contractor a tax benefit to which the contractor had previously been entitled, we reject that argument as being based on a distinction in form, not substance." Id. at 1310.

[13] We note that, unlike the April 14 CRS Report discussed *supra*, this is not a formal report issued by CRS. Rather, it is only a memorandum that responds to a letter from Senator

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and Natural Resources does not support a difference conclusion. Indeed, in many respects the CRS Memorandum affirms our own analysis of the breach of contract issues.

The CRS Memorandum questions "whether the sovereign acts doctrine would be available to the United States as a defense to a breach of contract action under these circumstances." CRS Memorandum at 2. The CRS Memorandum correctly identifies the doctrine, which provides that "[w]hatever acts the government may do ... so long as they be public and general, cannot be deemed specially to alter, modify, obstruct, or violate the particular contracts into which it enters with private persons." Id. at 2, quoting United States v. Winstar Corp., 518 U.S. 839, 891 (1996). However, as the CRS Memorandum effectively concedes, it is well understood that "the sovereign acts doctrine does not apply to 'legislation targeting a class of contracts to which [the government] is a party.'" Centex at 1307, citing Winstar at 898 n. 45 (quoting Resolution Trust Corp. v. Fed. Sav. & Loan Ins. Corp., 25 F.3d 1493, 1501 (10th Cir. 1994)).

While the CRS Memorandum recognizes that the purported reason for the tax is to fund "green energy tax initiatives," the use of the revenues collected is not the controlling factor in the sovereign acts doctrine analysis. Rather, the proper inquiry is whether the tax is generally imposed or is targeted at a specific group, particularly where the intent of the legislation appears to be directed at recovering concessions made by the Government with that group. In that regard, the CRS Memorandum concedes that the Tax Option is unquestionably targeted at the 1998/1999 lessees. CRS Memorandum at 2 - 3 ("Undercutting this stated congressional purpose of funding energy tax initiatives are (1) congressional hearings and a year-and-a-half of

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(Continued …)
Bingaman outlining the basic elements of the Tax Option and acknowledges from the outset that the "analysis is brief and tentative."

statements from Members expressing indignation at the Department of the Interior for having allowed these no-price-threshold leases in 1998 and 1999, and (2) the question why, if new revenue is the sole motivation for the severance tax proposal, it does not apply to *all* oil and gas leaseholders at the same effective rate."). CRS even concedes that "the best case in support of the legal soundness of the Bingaman proposal [Yankee Atomic Electric Co. v. United States, 112 F.3d 1569 (Fed. Cir. 1997)] can also be distinguished" because the tax legislation at issue there was not specifically targeted at the government's contracting partners. CRS Memorandum at 3; see also Centex, 395 F.3d at 1308. Therefore, because the Tax Option is targeted at the 1998/1999 lessees, the sovereign acts doctrine is unavailable here to protect the United States from liability for breach of contract.

2. The Tax Option effects an unconstitutional taking of the lessees' property interest in the royalty and fails due process

In the March 9 Memorandum, we explained that because H.R. 6 would reach back and retroactively take away vested rights in the 1998/1999 leases, namely the royalty interest up to the suspension volumes, H.R. 6 would have to pass a rational basis due process review. Because H.R. 6 identifies no harm attributable to the 1998/1999 leases that would warrant and rationally relate to the measures it proposes, H.R. 6 likely fails due process review. We also explained that the DWRRA granted royalty suspension volumes, the practical effect of which was to convey the royalty interest in the first 17.5 million to 87.5 million barrels of oil equivalent, depending on the water depth, to the 1998/1999 lessees. We further explained that this royalty interest was a protected property interest and that H.R. 6 would take that interest away in its entirety, which (1) would constitute an unconstitutional, *per se* taking under the Supreme Court's decision in Lucas v. South Carolina Coastal Council, 505 U.S. 1003 (1992), or (2) would likely be construed as a

taking under the balancing test set forth by the Supreme Court in Penn Central Transp. Co. v. New York City, 438 U.S. 104 (1978).

The fact that Congress would wield its tax authority via the Tax Option makes no difference to the foregoing analyses. Because the Tax Option seeks to take the same vested rights (*i.e.* the 1998/1999 lessees' royalty interest up to the amount of the suspension volumes) that were at issue in H.R. 6 by requiring the 1998/1999 lessees to pay a tax that is the equivalent of the royalty saved, the Tax Option is a retroactive statute. Fernandez-Vargas v. Gonzales, 126 S. Ct. 2422, 2428 (2006) ("The modern law thus follows Justice Story's definition of a retroactive statute, as 'tak[ing] away or impair[ing] vested rights acquired under existing laws.'"). A retroactive tax is unconstitutional if its application is so "harsh and oppressive" as to violate due process. Welch v. Henry, 305 U.S. 134, 147 (1938). This "harsh and oppressive" test does not differ from the test of constitutionality applicable to economic legislation generally; namely, that such legislation is constitutional unless Congress has acted in an arbitrary and irrational way. Pension Benefit Guaranty Corp. v. R.R. Gray & Co., 467 U.S. 717, 733 (1984). In short, the retroactive application of the statute must be justified by a rational purpose. Id. at 730. Further, as noted by the Supreme Court, "these antiretroactivity concerns are most pressing in cases involving new provisions affecting contractual or property rights, matters in which predictability and stability are of prime importance." Republic of Austria v. Altmann, 541 U.S. 677, 693 (2004). Like H.R. 6, the Tax Option identifies no harm attributable to the 1998/1999 leases that would warrant and rationally relate to the measures it proposes, and therefore, it fails due process review.

Further, it is well settled that a retroactive tax constitutes a taking if the retroactive feature makes it "so arbitrary and capricious as to amount to confiscation," Nichols v. Coolidge,

274 U.S. 531, 542 - 43 (1927), or if the retroactive reach extends temporally beyond "short and limited periods required by the practicalities of producing national legislation," United States v. Darusmont, 449 U.S. 292, 296 - 97 (1981). Courts evaluate whether a retroactive tax is a taking using the Penn Central test. See, e.g., Quarty v. United States, 170 F.3d 961, 969 (9th Cir. 1999). Applying that test here, the economic impact of the Tax Option will be severe. The 1998/1999 lessees would be required to pay billions of dollars to the Treasury they otherwise would not have had to pay. Further, the Tax Option would interfere greatly with the 1998/1999 lessees' investment-backed expectations. This factor is often analyzed under a two-step approach: (1) does the owner have actual investment-backed expectations, and (2) were those expectations reasonable. Cienega Gardens v. United States, 331 F.3d 1319, 1345 (Fed. Cir. 2003). Here, the DWRAA gave the 1998/1999 lessees the royalty interest in specified amounts of produced oil and gas, and the expectations were reasonable because the DWRAA did not impose price thresholds; MMS did not promulgate a regulatory price threshold; and price thresholds in other leases were addendums and not part of the boilerplate language of the leases. Finally, the Tax Option singles out 1998/1999 lessees as having to pay the tax. In short, the Tax Option would constitute a taking.

The CRS Memorandum also addresses whether the Tax Option would constitute a taking. Importantly, the Memorandum makes a critical concession, acknowledging that the 1998/1999 lessees' "right to pay no royalties irrespective of the price of oil and gas [is] 'property' under the Takings Clause." CRS Memorandum at 4. As we explain in the March 9 Memorandum, legislation that would deprive the 1998/1999 lessees fully of their property right in royalty free production is a *per se* taking to be analyzed under the Supreme Court's decision in Lucas. Like H.R. 6, the Tax Option effects a complete taking of this property interest, and thus it too would

likely be considered a *per se* taking under the Lucas standard. A court would therefore likely need not reach the three-factor Penn Central balancing test. However, even if a court were to consider the Tax Option under the Penn Central test, as discussed above the balance of the factors would weigh in the 1998/1999 lessees' favor.

3. The Tax Option denies the 1998/1999 lessees' right to equal protection

We previously determined that H.R. 6 likely ran afoul of the Equal Protection Clause of the Fifth Amendment since only 1998/1999 lessees were forced to renegotiate their leases or pay a fee on production. We found that the group of affected lessees was easily ascertainable and that any legitimate purpose stated in the statute did not justify and was not rationally furthered by a burden specially imposed only on the 1998/1999 lessees. Likewise, that analysis remains valid here. In judging whether tax laws violate the Equal Protection Clause, courts apply the same standard as they do to other economic legislation. NationsBank of Texas v. United States, 44 Fed. Cl. 661, 666 - 67 (1999) ("in cases that do not affect a fundamental right and where the subject class is not one for whom the law gives special protection, laws that affect a particular class of persons more harshly than others will be struck unless the government can espouse a rational relationship to a legitimate governmental goal."). While this standard is especially deferential in the context of classifications made by complex tax laws, Nordlinger v. Hahn, 505 U.S. 1, 11 (1992), here the Tax Option is not such a law. Further, like H.R. 6, the Tax Option does not appear to have a legitimate purpose that justifies or rationally furthers the burden imposed on the 1998/1999 lessees. Accordingly, like H.R. 6, the Tax Option likely violates the Equal Protection Clause.

The impact of both H.R. 6 and the Tax Option is particularly harsh on many of the current 1998/1999 lessees who were not the original lessees. This large group acquired its

1998/1999 lease interests through private purchase and unquestionably paid a premium to acquire OCS leases with no royalty obligation for the prescribed royalty suspension volume. The Tax Option would "punish" these lessees by effectively making them pay a cost that they already paid once to avoid. Thus, they are burdened even more severely by the Tax Option than the other 1998/1999 lessees who are original lease owners.

IV. CONCLUSION

Since the House of Representative passed H.R. 6 in January, doubt has surrounded the legality of that bill. The Tax Option represents an effort to use one of Congress' most potent constitutional authorities to achieve the same purpose as H.R. 6. Congress' sovereign authority to impose the tax is not in question, and while the power to tax is broad, federal courts have consistently recognized that even this authority cannot be used by the Government to deprive parties of their contractual or constitutional rights without subjecting the United States to liability. Therefore, like H.R. 6, the Tax Option cannot deprive the 1998/1999 lessees of their right to royalty relief to the full extent of the suspension volumes granted under their leases.