

February 2021

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### Recommended Citation

John A. Carver, Jr., Intergovernmental Relations and Energy Taxation, 58 Denv. L.J. 141 (1980).

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# INTERGOVERNMENTAL RELATIONS AND ENERGY TAXATION

JOHN A. CARVER, JR.\*

An evaluation of the impact of taxation on energy markets has to be concerned with the federal system, under which the federal sovereignty and the state sovereignties<sup>1</sup> each adopt their own taxing philosophies and taxing structures. Since there are not fifty different statewide energy markets, and since political tradition and legal precedent favor continuance of the existing arrangement, it is desirable to illustrate how the system works in selected situations. An effective analysis of national energy policies requires an understanding of energy taxation.

This article will examine those constitutional provisions limiting taxing power as well as those which furnish a basis for federal preemption or federal dominance.<sup>2</sup> Additionally, it will consider the "in-lieu-of-tax" aspects of

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A version of this paper was prepared for the Committee on Energy Taxation of the National Research Council. The views expressed are those of the author, however, and should not be interpreted to represent the views of the Committee, the National Research Council, or the National Academy of Sciences.

1. This classification includes the fifty states, the District of Columbia, and the territories.

2. The federal government's power to tax is derived from art. I, § 8, cl. 1 of the United States Constitution, which confers on Congress the power to tax. In commenting on the scope of this power, the Supreme Court, speaking through Mr. Justice Chase, remarked: "[T]he power of Congress to tax is a very extensive power. It is given in the Constitution, with only one exception, and only two qualifications. Congress cannot tax exports, and it must impose direct taxes by the rule of apportionment [U.S. CONST. art. I, § 2, cl. 3 and § 9, cl. 4] and indirect taxes by the rule of uniformity [U.S. CONST. art. I, § 8, cl. 1]. Thus limited, and thus only, it reaches every subject, and may be exercised at discretion." *License Tax Cases*, 72 U.S. (5 Wall.) 462, 471 (1866).

State limitations on the power to tax are more circumscribed. Since *McCulloch v. Maryland*, 17 U.S. (4 Wheat.) 316 (1819), where the Supreme Court held that a state could not tax a federal bank, the well-established rule, based on the Supremacy Clause, has been that a state cannot levy a property tax on federal property. *See, e.g., Van Brocklin v. Tennessee*, 117 U.S. 151 (1886). An exception to this rule arises if Congress expressly permits such taxation. *Id.* at 175.

It was not until 1871, however, that state immunity from federal taxation was recognized in *Collector v. Day*, 78 U.S. (11 Wall.) 113 (1871) (holding that the salary of a state judge was immune from the national income tax). Under the doctrine of intergovernmental immunity, first enunciated in *McCulloch*, limitations are imposed upon both the federal and state governments with respect to their power to tax each other. *See* note 12 *infra* and accompanying text.

A further limitation on state taxing power is found under the Commerce Clause, U.S. CONST. art. I, § 8, cl. 3, which vests Congress with the exclusive power to regulate interstate and foreign commerce. *Pennsylvania v. West Virginia*, 262 U.S. 553, 596 (1923). No state may levy a tax which imposes an unreasonable burden on interstate commerce. *Id.* at 596. State taxing power is also limited under the Import-Export Clause, U.S. CONST. art. I, § 10, cl. 2, which specifies that no state can levy any imports or duties on imports or exports without congressional approval, unless it is absolutely necessary to carry out the state's inspection laws. In regard to sales taxes, Congress, by statute, can prohibit the states from levying sales taxes on the federal government. *Carson v. Roan-Anderson Co.*, 342 U.S. 232 (1952). This power is not dependent

provisions for the sharing of revenues from energy mineral production. The tax-like effects of federal and state mineral leasing policies are also treated in this article, as are seemingly remote relationships which affect energy markets in a tax-like way, such as utility regulatory policies, state water laws, and federal programs for regional development. The effect of state mineral taxing policies upon mineral production and energy resource development is also a subject of discussion. And, finally, brief attention is given to the forces encouraging states to conform their administration and compliance systems to those of the federal government to facilitate collection and enforcement.

## I. CONSTITUTIONAL LIMITATIONS

### A. *Intergovernmental Immunity*

Both the states and the federal government own property or operate enterprises which, if owned or operated privately, would be subject to the taxing power of the other sovereignty. The property may consist of energy minerals reserved by the governmental body upon sale of the surface estate, or it may consist of real property owned by the governmental body, which contains energy minerals.<sup>3</sup> Similarly, the states and the federal government engage independently in various energy-related activities. States either authorize their municipal corporations to engage in the generation, distribution, and sale of electricity or natural gas,<sup>4</sup> or, by general legislation or specific charter, they authorize municipal districts to perform such functions. New York sells power through the Power Authority of the State of New York;<sup>5</sup> Nebraska's entire electric utility system is a public system;<sup>6</sup> Washington has many municipal utility districts (Public Utility Districts or PUD's);<sup>7</sup> and Oregon has a comparable scheme.<sup>8</sup> The federal government has numerous government-owned and operated utility facilities on its military bases

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on the nature of the activity exempted from taxation. *Federal Land Bank v. Bismarck Lumber Co.*, 314 U.S. 95 (1941).

3. Of the 2.2 billion acres of land within the United States, 755.3 million acres are owned by the federal government. *Preface to PUBLIC LAND LAW REVIEW COMMISSION, ONE THIRD OF THE NATION'S LAND AT X* (1970). The federal government also holds reserved mineral interests in 62 million acres of land where the surface is in non-federal ownership. *Id.* at 137. It has been customary for Congress to grant public lands to states for a variety of purposes. Beginning with a grant to Ohio of one section of each township for schools, states created from public lands have received grants of public lands consisting of one, two, and four sections of each township to use for such purposes. The size of the grant depended upon the date of admission. Alaska, the last state to join the union, was admitted with a gross grant of 102.5 million acres, which the state was free to select. In addition to the school grants, generally held in trust, the typical admission act provided for specific grants to assist in such purposes as building a capitol or a penitentiary. *See, e.g.*, Colorado Enabling Act, §§ 7-10, 1 COLO. REV. STAT. 43, 45-46 (1973), which granted sections 16 and 36 for school purposes, 50 sections for public buildings, 50 sections for a penitentiary, and 72 sections for a university. Mineral lands were excepted, but this depended on classification as of the date of selection, and the selected lands are in fact rich in minerals. Texas is a special case, since its "public" land was that of a sovereign nation and was retained by Texas upon admission. *See note 80 infra.*

4. *See, e.g.*, COLO. CONST. art. XX, § 1 (1902, amended 1974); COLO. REV. STAT. §§ 31-32-105, -201(1) (1973).

5. N.Y. PUB. AUTH. LAW. §§ 1000-1015 (McKinney 1970 & Supp. 1979).

6. NEB. REV. STAT. §§ 70-501 to -515, 70-601 to -680, & 70-801 to -808 (1976).

7. WASH. REV. CODE ANN. §§ 54.04 010-180 (1962 & Supp. 1978).

8. OR. REV. STAT. §§ 261.005-.730 (1977).

and on some Indian reservations.<sup>9</sup> The Tennessee Valley Authority<sup>10</sup> and the Bonneville Power Administration<sup>11</sup> are the best examples of federally-operated energy facilities.

The generalized rule that a state cannot constitutionally levy a tax directly against the government of the United States and that the federal government cannot constitutionally levy a tax directly against the state<sup>12</sup> does not answer all questions. If Congress taps a source of revenue that is not uniquely capable of being earned only by a state, the federal government may constitutionally levy a tax although it incidentally affects a state.<sup>13</sup> The government may, of course, legislatively choose not to tax state activities it constitutionally might tax.<sup>14</sup> It is virtually impossible to find a federal activity not constitutionally immune from state taxation, but a state may employ other indirect tactics to collect revenue. The situation of the Tennessee Valley Authority (TVA) is instructive. Under its enabling statute, the TVA is exempt from state taxation but is authorized to make payments in lieu of taxes on its power facilities.<sup>15</sup> It has acquired uranium reserves in Wyoming but has been denied necessary operating permits by Wyoming unless it agrees that its production may be taxed under the state's laws. The controversy seems about to be resolved by an agreement between the Chairman of TVA and the Governor of Wyoming, which provides that the Authority will take action, possibly by transfer of title to a trustee, to make its production subject to Wyoming severance taxes.<sup>16</sup> Additionally, the states can and do successfully levy taxes on the business activity of removing and selling minerals from lands leased from the federal government. These excise or severance taxes are measured by the value of the minerals removed.<sup>17</sup>

There was a time, even after the passage of the sixteenth amendment in 1913, when the salaries of state officials and the income from state bonds were deemed constitutionally protected from federal income taxes.<sup>18</sup> The continued exemption of municipal bond interest is probably not a constitu-

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9. See 10 U.S.C. §§ 2481(a), 3012(b)(4) (1976); 25 U.S.C. § 15 (1976).

10. 16 U.S.C. § 831 (1976).

11. *Id.* § 832. The Bonneville Power Administration is now administered by the Department of Energy under the Department of Energy Organization Act, Pub. L. No. 95-91, 91 Stat. 965 (1977) (codified at 42 U.S.C. §§ 7101-7352 (Supp. 1978)). The Bonneville Power Administration was formerly administered by the Department of the Interior. 16 U.S.C. § 832(a) (1976).

12. See *New York v. United States*, 326 U.S. 572, 576 (1946). For a discussion of the history of intergovernmental immunity from taxation, see G. GUNTHER, *CONSTITUTIONAL LAW* 373-85 (1975); J. NOWAK, R. ROTUNDA, & J. YOUNG, *CONSTITUTIONAL LAW* 367-70 (1978).

13. *New York v. United States*, 326 U.S. 572, 582 (1946).

14. *Id.*

15. 16 U.S.C. § 831 (1976).

16. Interview with Deputy General Counsel, TVA (Apr. 15, 1980). The agreement between TVA and Wyoming, dated April 2, 1980, is on file in the governor's office in Cheyenne and at TVA headquarters.

17. See, e.g., *Montana coal severance tax*, MONT. REV. CODES ANN. §§ 15-35-101 to -111 (1979). Not only can states levy severance taxes for the removal of minerals, but the Tenth Circuit Court of Appeals has recently held that an Indian tribe can impose a severance tax on nontribal members for the removal of oil and gas from the reservation. *Merrion v. Jicarillo Apache Tribe*, 617 F.2d 537 (10th Cir. 1980).

18. See, e.g., *Evans v. Gore*, 253 U.S. 245 (1920).

tional requisite, but it is statutory<sup>19</sup> as are many existing tax exemptions. Being legislative creations, they are subject to elimination by statute.

Tax exemption and tax immunity are alike in their effects on energy markets. Specific statutory exemptions, such as percentage depletion<sup>20</sup> or expensing of intangible drilling costs,<sup>21</sup> are, however, definitionally easier to change than those which are traditional but nonstatutory.<sup>22</sup>

#### B. *The Commerce Clause and the Equal Protection Clause*

The Commerce Clause<sup>23</sup> and the Equal Protection Clause<sup>24</sup> of the Constitution are the principal bases for attacks on state taxes which add to the cost of producing, transporting, converting, or selling energy.<sup>25</sup> If there is no statutory mandate or policy, the question of what does or does not burden interstate commerce, or what is or is not equally protective of the rights of citizens, is a matter for judicial consideration.<sup>26</sup> The courts have increasingly been called upon to resolve these constitutional issues.

Louisiana's First Use Tax<sup>27</sup> is presently under attack in the Supreme Court of the United States<sup>28</sup> as an unconstitutional burden on interstate commerce. The tax is imposed on natural gas brought to shore in Louisiana from the federal domain offshore and destined for markets beyond Louisiana, principally the northeastern industrial states. The impact of such a tax—in this case, seven cents per thousand cubic feet—<sup>29</sup> would, under normal ratemaking practices of utility commissions, be passed on directly to consumers. The challenge has been raised by a group of consuming states, and the Federal Energy Regulatory Commission has intervened as a party plaintiff.

The Supreme Court of Montana recently rejected the contention of a group of utility companies that Montana's thirty percent severance tax on coal violated the Commerce Clause.<sup>30</sup> The Montana court also rejected the contention that the tax was impermissible under the Supremacy Clause as frustrating *national* policy<sup>31</sup> and particularly the Mineral Lands Leasing Act of 1920.<sup>32</sup> Still another comparable challenge to a state's energy tax re-

19. I.R.C. § 103(a)(1).

20. *Id.* § 613.

21. *Id.* § 615 (repealed 1976).

22. *See generally* S. Blackstone, *Mineral Severance Taxes in the Western States: An Economic and Legal Analysis of State Tax Policies* (Nov. 26, 1979) (dissertation submitted to the Colorado School of Mines).

23. U.S. CONST. art. I, § 8, cl. 3.

24. *Id.* amend. XIV, § 1.

25. S. Blackstone, *supra* note 22, at 137-53.

26. For a discussion of the problems inherent in determining what constitutes a burden on interstate commerce and a review of the Supreme Court's struggle to draw the line between a permissible and impermissible state tax, see G. GUNTHER, *supra* note 12, at 354-56.

27. LA. REV. STAT. ANN. §§ 47:1301-1307 (West Supp. 1979).

28. *Maryland v. Louisiana*, 47 U.S.L.W. 3813 (1979). The Federal Energy Regulatory Commission (FERC) has submitted an amicus curiae brief in this litigation. FERC also challenges the Louisiana tax.

29. LA. REV. STAT. ANN. § 47:1303(B) (West Supp. 1979).

30. *Commonwealth Edison Co. v. Montana*, No. 14982 (Mont. July 17, 1980).

31. *Id.*

32. *Id.*

ceived a different treatment by the United States Supreme Court. New Mexico's Electrical Energy Tax<sup>33</sup> was levied on electrical energy exported from the state. In lieu of resolving the constitutional controversy, the Court held instead that Congress, in passing the Tax Reform Act of 1976, had expressly forbidden the tax in question.<sup>34</sup>

One recent severance tax has been declared unconstitutional as a burden on interstate commerce.<sup>35</sup> Ohio imposed a tax on the severance of coal mined in the state. The tax rate increased as the sulphur content of the coal decreased.<sup>36</sup> Because most Ohio coal is high in sulphur, the Ohio coal was favored over competing low sulphur coal in the Ohio utility market.<sup>37</sup> Consequently, the severance tax was held to fall short of the evenhanded treatment demanded by the Commerce Clause.<sup>38</sup>

Connecticut has recently imposed a two percent tax on the sale of all petroleum-based products distributed by companies with refining capabilities.<sup>39</sup> New York is considering a similar tax to help subsidize its mass transit system.<sup>40</sup> A California proposition to levy a ten percent tax on the profits of all energy companies except utilities was defeated in June.<sup>41</sup> Each of these taxes will, in all probability, be challenged on equal protection or commerce clause grounds by the entities affected.

## II. ADJUSTMENTS RELATED TO TAX IMMUNITY AND TAX EXEMPTIONS: "IN-LIEU-OF-TAX" PROVISIONS

The federal government's dominating position as owner of land and underlying or reserved mineral resources has been considered burdensome by the states. Therefore, numerous laws enacted since at least 1907 have required the federal government to share with the states proceeds realized from the management or disposition of such resources.<sup>42</sup> These revenues displace the need to rely on the stock of private resources as the base for raising revenues.

The Land Ordinance of 1785 provided that the land areas ceded by the states then operating under the Articles of Confederation would be owned by the national government.<sup>43</sup> The Ordinance created a capital stock which helped to make the federal government viable. Further, it established a precedent so that when future states were created, the federal government

33. N.M. STAT. ANN. §§ 7-18-3, 7-9-80(B)-(C) (1978).

34. *Arizona Pub. Serv. Co. v. Snead*, 441 U.S. 141 (1979).

35. *Dayton Power & Light Co. v. Lindley*, 58 Ohio St. 2d 465, 391 N.E.2d 716 (1979).

36. OHIO REV. CODE ANN. § 5751.02(A) (Page Supp. 1978).

37. *Dayton Power & Light Co. v. Lindley*, 58 Ohio St. 2d 465, 474, 391 N.E.2d 716, 721 (1979).

38. *Id.* at 474, 391 N.E.2d at 721.

39. *Wall St. J.*, Apr. 16, 1980, at 13, col. 1.

40. *Id.*

41. Proposition 11 was submitted to the voters on June 3, 1980.

42. PUBLIC LAND LAW REVIEW COMMISSION, *supra* note 3, at 235. For a breakdown of all the programs and payments see 2 EBS MGMT. CONSULTANTS, INC., REVENUE SHARING AND PAYMENTS IN LIEU OF TAXES ON THE PUBLIC LAND (1968).

43. *See generally* P. GATES, HISTORY OF PUBLIC LAND LAW DEVELOPMENT 59-74 (1968). The Land Ordinance of 1785 is reprinted in DOCUMENTS OF AMERICAN HISTORY 123-24 (7th ed. H. Commager ed. 1963).

would not automatically lose jurisdiction over its lands in the newly created states.<sup>44</sup> Additionally, the Property Clause<sup>45</sup> of the United States Constitution gave Congress a special role with respect to public domain lands by vesting it with the exclusive right to control and dispose of such lands without interference from the states.<sup>46</sup>

This public land has caused an imbalance between the so-called public land states and the rest of the nation. The attendant controversies sharply divide the East and the West.<sup>47</sup> The East fought to get land grants in the western territories to match those made to new states and was successful when the Morrill Act was passed.<sup>48</sup> This Act gave scrip instead of land to the eastern states for sale to third parties.<sup>49</sup> The revenue produced was then used to build agricultural and mechanical arts colleges.<sup>50</sup>

Under the federal mineral leasing acts, fifty percent of the lease revenues derived by the federal government are paid to the states where the minerals are located.<sup>51</sup> Congress has augmented this provision by a program of in-lieu-of-taxes payments based upon the relative percentage of federal lands in the states. Thus, the states benefit from national park, wildlife refuge, and non-commercial forest and forage acreages as well from the commercial proceeds of mineral, forage, and timber disposition.<sup>52</sup>

The nontaxable status of federal minerals is probably a part of the motivation for a program of federal loans to states and political subdivisions designed to relieve social or economic impacts occasioned by the development of federal minerals in such states.<sup>53</sup> The loans are treated as advances against the states' expected revenues from the federal sharing program for the subsequent ten years;<sup>54</sup> they bear interest equivalent to the lowest interest rate paid on tax exempt bonds of the borrowing state within the preceding calendar year.<sup>55</sup> When the loan program was created in 1976, the interest rate adopted was three percent per annum.<sup>56</sup>

### III. LEASING POLICIES: ECONOMIC RENT

The federal government and the state governments can and do expect part of their return from the disposition of energy minerals as rent. The return is typically derived from a combination of land rentals at a fixed per-acre basis, royalties at a fixed percentage rate, and lease bonuses received in

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44. See generally P. GATES, *supra* note 43, at 59-74.

45. U.S. CONST. art. IV, § 3, cl. 2.

46. *Kleppe v. New Mexico*, 426 U.S. 529, 539-43 (1976).

47. See generally PUBLIC LAND LAW REVIEW COMMISSION, *supra* note 3, at 243-45.

48. P. GATES, *supra* note 43, at 22-23 (1968).

49. *Id.* at 22.

50. *Id.* For example, Cornell University traces its origin to one of these "land grants," which New York sold to the founder of the university.

51. 30 U.S.C. § 191 (1976).

52. 31 U.S.C. §§ 1601-1607 (1976).

53. 43 U.S.C. § 1747(1) (Supp. 1978).

54. *Id.* § 1747(2).

55. *Id.* § 1747(5).

56. Federal Land Policy and Management Act of 1976, Pub. L. No. 94-579, tit. III, § 317(c)(1), 90 Stat. 2771 (1976).

a competitive or auction system.<sup>57</sup> Variants include bidding on the royalty which the bidder is willing to pay and sequential bidding. A complicating factor is that the federal government operates (or was operating until a moratorium was declared in February 1980)<sup>58</sup> a lottery system<sup>59</sup> for the disposition of acreage not classified within a known geologic structure of a producing field. The lottery has been highly productive of revenue, independently of the ultimate productivity of the parcels offered. Additionally, the tracts so disposed of are subject to the usual fixed rentals and fixed royalty provisions.<sup>60</sup>

The sheer volume of the federal government's mineral ownership<sup>61</sup> makes the question of leasing policies extremely sensitive. The timing and the form of sales tend to dictate the size of the bids. Spacing the sales too closely together tends to reduce the size of the bids, at least in theory.<sup>62</sup> Royalty bidding involves risks to the government which bureaucrats find difficult to justify if the leased acreage turns out to be dry.<sup>63</sup> A front-end bonus on a dry hole creates no such problem.<sup>64</sup>

Policy considerations are numerous, and the choices are not easy to make. For example, it is not completely clear that the government's policy is or ought to be the maximization of the present value of the economic rent derivable from government-owned minerals.<sup>65</sup> In the past, management policies have been manipulated to keep the price of the federally-owned production down, thus tending to depress the price realized on the private or state produced oil or gas.<sup>66</sup> However, the statute permitting production to resume on acreage set apart in naval petroleum reserves provides for maximization of the government's return by an auction of the produced oil.<sup>67</sup> Recent sales of oil from naval petroleum reserves have yielded prices in excess of the OPEC prices.<sup>68</sup>

A policy to maximize return to the federal government, given the sharing statutes referred to above,<sup>69</sup> might tend to enrich the states in which the minerals are located. A particularly striking illustration of this enrichment is

57. See, e.g., 30 U.S.C. § 223 (1976). See also PUBLIC LAND LAW REVIEW COMMISSION, *supra* note 3, at 124.

58. Secretary of the Interior, Order No. 3049, Feb. 29, 1980.

59. 30 U.S.C. § 226(c) (1976); 43 C.F.R. §§ 3112.1-1 to .5-2 (1979).

60. 30 U.S.C. § 226(c)-(d) (1976).

61. The federal government's mineral ownership encompasses the mineral resources underlying the one-fourth of the land area of the United States administered by the Department of the Interior, the resources beneath extensive areas of the public lands that are administered by other federal agencies, and those underlying approximately 125,000 square miles of land in private ownership. U.S. DEP'T OF THE INTERIOR, MINING AND MINERALS POLICY 3 (1979).

62. See generally S. McDONALD, THE LEASING OF FEDERAL LANDS FOR FOSSIL FUELS PRODUCTION 77-81, 95-101 (1979).

63. *Id.* at 98-99.

64. *Id.* at 95-98.

65. For the view that the federal government has not adopted such policies but that it should see S. McDONALD, *supra* note 62, at 24-46.

66. In 1967, the Interior Department threatened to exclude federal leases from prorationing by state conservation authorities if the major oil companies did not roll back an increase in gasoline prices. N.Y. Times, Feb. 21, 1967, § 1, at 1, col. 4.

67. 10 U.S.C. § 7430(b) (1976).

68. EN. L. SERV. (CCH) 4 (Feb. 7, 1980).

69. See notes 51-52 *supra*.

found in the Minerals Leasing Act, which provides that Alaska may receive ninety percent of the revenues from federal lease sales.<sup>70</sup>

The federal government may dominate markets through ownership of substantial shares of such natural resources as softwood timber or offshore oil and gas. Not only market dominance, however, but land use, environmental, and other statutes affect energy prices in confusing and contradictory ways. The Wilderness Act,<sup>71</sup> and various subsequent statutes<sup>72</sup> authorize withholding lands from mineral exploitation until their potential as wilderness areas has been evaluated. The Coastal Zone Management Act of 1972<sup>73</sup> can similarly affect energy markets by constraining port or conversion facilities. And, much mineral-rich land is "checkerboarded" as a result of the railroad grant statutes,<sup>74</sup> which gave the odd-numbered sections in each township to the grantee and effectively blocked access to any public land without permission from the "checkerboarded" private owner.<sup>75</sup> Conversely, the federal government has blocked much private development of coal because the federal government has denied access to its "checkerboarded" lands.<sup>76</sup>

The states do not share in the proceeds of the most prolific oil and gas producing area, the federal domain offshore.<sup>77</sup> It may be argued, however, that the Submerged Lands Act,<sup>78</sup> in allotting to the states the three-mile or three-league band (depending on the traditional legal regime in effect at statehood) nearest the shore, put the coastal states in a favored position comparable to that enjoyed by the western states when they received land grants upon achieving statehood.<sup>79</sup> Where the state patrimony is substantial, as, for example, in state-owned areas offshore, in what would have been public land if Texas had not enjoyed a period of sovereignty,<sup>80</sup> and in Alaska, which received a large land grant upon its admission to the Union,<sup>81</sup> the states can coordinate their leasing policies with their taxing policies. The

70. 30 U.S.C. § 191 (1976).

71. 16 U.S.C. §§ 1131-1136 (1976).

72. *See, e.g.*, Federal Land Policy and Management Act, § 603(c), 43 U.S.C. § 1782(c) (1976).

73. 16 U.S.C. §§ 1451-1464 (1976).

74. *See, e.g.*, Pacific Railroad and Telegraph Line Act, ch. 120, 12 Stat. 489 (1862). *See also* P. GATES, *supra* note 43, at 364-79.

75. *See* *Leo Sheep Co. v. United States*, 440 U.S. 668 (1979) (review of the genesis of the checkerboard pattern).

76. *See Foster v. United States*, 607 F.2d 943 (Ct. Cl. 1979), which held that the federal government had condemned a privately reserved mineral estate by denying access. *See also* *Coronado Oil Co. v. Grieves*, 603 P.2d 406 (Wyo. 1979) (condemnation of private property by private oil company).

77. *See generally* PUBLIC LAND LAW REVIEW COMMISSION, *supra* note 3, at 187-95. For a discussion of the management of our federal offshore resources, see R. Krueger, *Management of Energy Resources on Federal Lands*, 2 Energy Law Service §§ 11A.23-.33 (1978). For an analysis of the 1978 Amendments to the Outer Continental Shelf Lands Act, see Krueger & Singer, *An Analysis of the Outer Continental Shelf Lands Act Amendments of 1978*, 19 NAT. RESOURCES J. 909 (1979).

78. 43 U.S.C. §§ 1301-1303, 1311-1315 (1976).

79. *See* note 3 *supra*.

80. *See* P. GATES, *supra* note 43, at 80-83.

81. Upon becoming a state, Alaska was granted 102,550,000 acres of public lands and 400,000 acres of national forest lands. Act of July 7, 1958, Pub. L. No. 85-508, §§ 6a-6b, 72 Stat. 339 (1958).

exemption of state royalty interests from the windfall profit tax<sup>82</sup> will have a multi-billion dollar tax expenditure effect from the federal government to several of the states.<sup>83</sup>

It has been argued that leasing policies might well be different for coal, which is abundant, and for oil and gas, which are not.<sup>84</sup> A conscious policy of making coal available from federal lands at lesser royalty rates could create additional opportunities for states to increase severance taxes.

#### IV. OTHER RELATIONSHIPS WHICH HAVE A TAX-LIKE EFFECT ON ENERGY MARKETS

##### A. Regionalism

The tax-exempt status of TVA and the Bonneville Power Administration has been previously mentioned.<sup>85</sup> The resource policies espoused in these two laws were based on the use of natural or regional rather than strictly political boundaries for the allocation of benefits. The pattern started in 1902, when the Reclamation Act of 1902<sup>86</sup> created a reclamation fund, which was initially earmarked for water projects in the states west of the 100th meridian. This regional pattern was continued under the Minerals Leasing Act which directs that forty percent of the revenues received from the disposition of public lands under this Act and under the Geothermal Steam Act of 1970<sup>87</sup> be deposited into the reclamation fund.<sup>88</sup>

The federal purposes included a public ownership preference. The output of federally constructed hydroelectric projects was made preferentially available to states, municipalities, and other public and cooperative bodies.<sup>89</sup> The resultant rates were "yardsticks" against which the investor-owned competitors had to compete. A special kind of regional preference developed when industries capable of adjusting their own loads to peaks in the loads of the preference customers signed long-term contracts and made huge investments in such energy-intensive industrial operations as aluminum

82. See I.R.C. § 4994(a). An equivalent exemption applies to Indian-owned oil. See *id.* § 4994(d).

83. Proposals were made during the debates on the windfall profit tax to make this oil taxable.

84. For example, the oil and gas of the outer continental shelf is under exclusive federal dominion, and the timing of leases is based upon a variety of considerations, the majority of which appear to be aimed at maximizing the income to the federal government. Coal leasing, on the other hand, is constrained by the checkerboard pattern of federal land ownership and the relative abundance of non-federal coal. McDonald recommends increasing the rate of leasing for offshore oil and gas but decreasing the rate of leasing federal coal to assure the receipt of a fair market value for coal lands and also to assure the efficient development of the nation's total coal deposits in the order of their rent-yielding capacity. See S. McDONALD, *supra* note 62, at 87-94.

85. See notes 10-16 *supra* and accompanying text.

86. Pub. L. No. 161, 32 Stat. 388 (1902). The successor Act is codified at 43 U.S.C. § 391 (1976). See also *id.* § 522 (1976).

87. 30 U.S.C. §§ 1001-1025 (1976).

88. *Id.* § 191.

89. For such a preference in relicensing proceedings, see Federal Power Act, 16 U.S.C. §§ 791a-825 (1976).

smelting. This caused a major part of the nation's aluminum smelting industry to locate near the inexpensive power in the Pacific Northwest.

The demands of preference customers in the Bonneville Power Administration marketing area in the Pacific Northwest can no longer be met from federal hydroelectric projects. The base loads now are increasingly being met with nuclear and fossil-fired plants so that the hydro capacity can be shifted to its more valuable peaking use.<sup>90</sup> As a result, the price gap between the energy supplied by the government and that furnished from investor-owned utilities, although still wide, is narrowing. Furthermore, a legislative proposal sponsored by the congressional delegations from the region would broaden the authority of the Bonneville Power Agency to contract with investor-owned utilities to supply bulk power to them from federal plants powered by fossil fuels and to issue bonds for this purpose.<sup>91</sup> The bill is widely supported as a way of assuring the region a continued advantage in energy prices.

Regionalism is the hallmark of the electric power system in this country. The utility systems, both public and private, have formed a National Electric Reliability Council, which is composed of nine regional reliability councils. The system is principally autonomous, although the authority of the Federal Energy Regulatory Commission to order interconnections has been expanded.<sup>92</sup> Physical interconnections are supplemented by contractual agreements for the interchange of economy and emergency energy. With one exception—that being in Texas—these pools and councils ignore state boundaries. They permit reductions in costs and savings of petroleum fuels by calling on the least costly power source first and disregarding the ownership of particular generating stations.

Problems exist, however. Wisconsin, for example, has ruled that out-of-state utilities cannot own an interest in an in-state generating plant.<sup>93</sup> And, California's public utilities commission has indicated that a California utility desiring to construct a plant in another state would need, in addition to the certificate in that state, a California license.<sup>94</sup>

Another kind of regionalism is evident in the western section of the nation. There the energy producing states formed a loose association originally known as the Western Interstate Nuclear Board. In September 1977, the organization became the Western Interstate Energy Board.<sup>95</sup> As previously

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90. See generally BONNEVILLE POWER ADMINISTRATION, U.S. DEP'T OF ENERGY, NOTICE OF PROPOSED POLICY AND FORMULA TO GUIDE ALLOCATION OF FIRM ELECTRIC ENERGY AND SYSTEM RESERVE ENERGY FROM THE FEDERAL COLUMBIA RIVER POWER SYSTEM, 44 Fed. Reg. 57,824 (1979) [hereinafter cited as BPA POLICY REPORT].

91. S. 885, 96th Cong., 1st Sess., 125 CONG. REC. S 3996 (daily ed. Apr. 5, 1979). See also S. REP. NO. 96-272, 96th Cong., 1st Sess. (1979) (to accompany S. 885); H.R. 6677, 96th Cong., 2d Sess., 126 CONG. REC. H 1502 (daily ed. Mar. 3, 1980).

92. Public Utility Regulatory Policies Act of 1978, Pub. L. No. 95-617, 92 Stat. 3117 (1978), adding section 210 to Federal Power Act (codified in 16 U.S.C. § 824i (Supp. II 1978)).

93. Application of Northern States Power for a Certificate, No. CA-5447, Feb. 24, 1978.

94. In the Matter of the Participation of Southern California Edison Company and San Diego Gas & Electric Company in the Proposed Kaiparowits Electric Generation Plant, No. 88005, Calif. PUC, Oct. 18, 1977, [1974-79] UTIL. L. REP. (CCH) ¶ 22,511.

95. [1977-1978] Annual Report of the Western Interstate Energy Board 3-4.

noted,<sup>96</sup> a group of consuming states have brought an action in the United States Supreme Court to invalidate the Louisiana First Use Tax. It is evident that lines are being drawn between the energy-producing and energy-consuming states.

### B. *Water Policy and Energy*

It is well recognized that sources of energy to displace both imported oil and polluting coal could be furnished from the rivers of the West. Such a use would be at the expense of the agricultural economy to which the waters are presently committed under a property system known as "prior appropriation." Under this system, a property right can be created by the application of water to a beneficial use; the right is superior to those established later, but junior to those established earlier.<sup>97</sup>

The rights are transferable, and the markets now existing for them are administered differently in each of the western states adhering to the doctrine.<sup>98</sup> In a simplified example, the owner of a water right connected with a hydroelectric generating station might be limited by the nature of the water right to operating the dam at less than its rated capacity in low water years in order to meet the demands of downstream owners of senior water rights. However, absent legislative constraints within the particular state, a power company could purchase water rights either with or without land if the value of the additional power justified it. When the cost of the electricity acquired in this way (without new investment and without fuel costs) is compared with the price of that generated by new plants burning oil, it is apparent that even productive farm land might be retired to facilitate an energy policy designed to reduce reliance on oil.

The federal government affirmatively encourages the installation of generators at existing dam sites in the Northeast, where much of the production is oil-fired. There, however, the water rights system operates differently than it does in the arid West. In the West, much of the electric power produced from water projects goes to metropolitan centers remote from the mountainous regions where the water falls and is stored, and where the earlier water rights support the local economies. The political pressures to maintain the agricultural economy based on these early water rights are very strong.

Similar analyses can be made with respect to other kinds of energy projects. In theory, the sponsor of a project to make a slurry of coal and to transport it by pipeline to a generating station can assemble the required water by purchasing existing rights alone or by purchasing the lands on which they are used and retiring the lands from agricultural production. The economics of the project might justify the purchase of substantial amounts of agricultural land.

States use their police power to frustrate energy projects requiring

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96. See note 28 *supra*.

97. See generally F. TRELEASE, WATER LAW 32-45, 92-99 (3d ed. 1979).

98. Compare COLO. REV. STAT. §§ 37-92-101 to -602 (1973 & Supp. 1979) with MONT. REV. CODES ANN. §§ 85-1-201 to -224 (1979).

water. In Montana, for example, the legislature has said that using water for slurry projects is not a "beneficial use."<sup>99</sup> Thus, the energy entrepreneur is precluded from appropriating water initially and possibly from buying existing water rights. The constitutionality of this type of statute has not yet been adjudicated. Colorado, as another example, specifically forbids the export of "Colorado" water.<sup>100</sup>

The federal government's ownership of land in the public land states,<sup>101</sup> is the basis for an assertion made by the Solicitor of the Department of the Interior on June 25, 1979, that the federal government's rights to waters needed to make full use of its own lands are superior to most of the state-administered water rights perfected under state law.<sup>102</sup> This is an extension of the judicially recognized doctrine of "implied reservation" of water used by the United States when it created Indian reservations, wildlife refuges, national forests, and national parks; the water retained must be sufficient to meet the needs of the federal preserve. The priority of the government's right is established as of the date the land is reserved for federal purposes.<sup>103</sup>

The Solicitor's opinion caused great consternation in the West, for it cast a cloud on the existing property system. The threat was considered most real in connection with the development of coal and oil shale on public lands. Obviously, the federal government could realize a greater return from leasing these water demanding projects if it could use its sovereign claims to assure the supply of water necessary to complete them, without having to pay for the value of the water rights "taken" by the process.

### C. *Utility Regulatory Policies*

It is traditional for each state to review applications for the construction of utility facilities against the public convenience and the need for such facilities in the state. Where the facility is designed to serve the needs of the residents of other states, a state can tax the plant's value. Under its police power, it can also control pollution and regulate the siting process.<sup>104</sup>

California requires utilities seeking to locate a plant in another state to secure a California certificate for the plant.<sup>105</sup> Many applications for new facilities are being resisted on the basis of an insufficient need for the plant's

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99. MONT. REV. CODES ANN. § 85-2-104(2) (1979).

100. COLO. REV. STAT. § 37-81-101 (Supp. 1979).

101. See note 3 *supra*.

102. 86 Interior Dec. 553, 564 (June 25, 1979).

103. *Arizona v. California*, 373 U.S. 546 (1963).

104. Under the Tax Reform Act of 1976, however, a state may not impose a tax on the generation or transmission of electricity which discriminates against out-of-state consumers or sellers. 15 U.S.C. § 391 (1976). Discrimination is defined as any tax which results in a greater burden on interstate commerce than on intrastate commerce. *Id.* See *Arizona Pub. Serv. Co. v. Sneed*, 441 U.S. 141 (1979), where the Supreme Court held a New Mexico tax on exported electrical energy invalid under 15 U.S.C. § 391 (1976). In *Arizona* the Court also recognized that generating electricity could result in environmental and other problems for the generating state; it found no indication under § 391 that Congress intended to prohibit the states from taxing the generation of electricity to pay for solutions to these problems. 441 U.S. at 150-51. But the Court warned that the interstate and the intrastate customers would have to be taxed equally. *Id.* at 151.

105. See note 94 *supra*.

output in the particular state. Thus, the potential is created for acceptance of a more expensive alternative site in a different state.

It may be necessary for federal preemptive legislation to break through future impasses to assure conformance with national energy policies, such as the policy to displace oil-fired electric generation with coal-fired generation. From the revenue standpoint of states such as Montana or Wyoming, which are rich in coal resources, utility regulatory policies could be manipulated to assure cheaper power for the state's own requirements. For example, Wyoming power plants generate several times as much power as Wyoming customers consume, thereby assuring Wyoming residents of whatever advantage there might be in scale. But, Wyoming also might condition the granting of its certificates on the acceptance of valuation divisions charging a disproportionate share of facilities' costs to the out-of-state customers. At some point this would be subject to an equal protection or commerce clause objection in the courts,<sup>106</sup> but the process is so amorphous that such an attack would not be brought until the process was flagrantly abused.

Oregon has enacted legislation enabling its domestic and rural power consumers to take advantage of the preference provisions in the Bonneville legislation.<sup>107</sup> If other states in the Columbia Basin follow suit, California could be deprived of the use of the two major high voltage entities between the Pacific Northwest and Southwest because no excess power will be available for export.<sup>108</sup>

#### V. EFFECT OF STATE MINERAL TAX POLICIES ON MINERAL PRODUCTION AND ENERGY RESOURCE DEVELOPMENT

Differentials traceable to the federal system or to state constitutional principles involving tax immunity patterned after the federal system are compounded by the variety and complexity of mineral tax policies among the states.<sup>109</sup> Energy production is taxed through income taxes, property taxes, severance taxes, and production taxes.<sup>110</sup>

It is virtually impossible to derive data on the effect of these taxes on mineral production and energy resource development because they cannot be analyzed in isolation. For example, even though an income tax compares favorably with many other kinds of taxes on the mineral industry because it is based on profitability, and it is neutral with respect to ore cut-off grades or the classification of reserves,<sup>111</sup> state-to-state comparisons are hampered because some states do not have income taxes;<sup>112</sup> other states have substantially different rates due to the deductibility or nondeductibility of federal

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106. A similar argument might be raised with respect to proposals in Delaware and Georgia to restrict the sale of shares of lower-cost electric generating facilities to out-of-state utilities. *See* *Electrical Week*, Mar. 3, 1980, at 1.

107. 1977 Or. Laws ch. 888, §§ 1-44, *reprinted in* OR. REV. STAT. § 262.115 (1977) (note).

108. *See generally* BPA POLICY REPORT, *supra* note 90.

109. S. Blackstone, *supra* note 22, at 99-119.

110. *Id.* at 11.

111. *Id.*

112. Wyoming and South Dakota, for example, do not impose personal or corporate income taxes. *Id.* at 99.

income taxes.<sup>113</sup> Similarly, the use of income tax deductions to encourage mineral development, a practice which is common in the federal system,<sup>114</sup> varies from state to state, making it difficult to analyze state tax policies with any degree of accuracy. The same generalizations can be made concerning property taxes. In addition to differentials among states in the methodology for property tax valuation, there may be considerable variance within a state owing to the autonomy of the assessors.

Severance taxes have the most easily identifiable effects on the economics of mineral production.<sup>115</sup> Unit severance taxes differ from ad valorem severance taxes.<sup>116</sup> A severance tax based on the net proceeds has effects similar to an income tax.<sup>117</sup> Severance taxes are also naturally nonneutral in regard to resource allocation because mineral prices are increased in relation to other prices to the extent that forward shifting is possible.<sup>118</sup> Most relevant to this inquiry, however, is not their characteristic of nonneutrality but their imposition on sources of energy as a means for exporting the tax to consuming states. Also important, from an intergovernmental relations standpoint, is the shift of the severance tax from a role of internalizing external costs to revenue-raising.

The following chart showing the pattern of mineral taxes in the selected western states is instructive.<sup>119</sup>

## VI. ADMINISTRATION, COMPLIANCE AND INTERACTION

Studies have dealt with the steps states have taken to conform their income tax statutes with the federal scheme to facilitate administration and compliance.<sup>120</sup> The program of deductions and credits for conservation expenditures, now written into federal law, has been rapidly copied at the state level.<sup>121</sup> In the area of credits for gasohol, the states have moved ahead of the federal government.<sup>122</sup> To the extent that it amounts to a subsidy,<sup>123</sup>

113. *Id.* at 11.

114. *See, e.g.*, I.R.C. § 611.

115. S. Blackstone, *supra* note 22, at 14-16. For a comparison of the effects of severance taxes with those of income and property taxes, see *id.* at 11-14.

116. *Id.* at 15. A unit severance tax is a flat rate per unit of production, and an ad valorem severance tax is a percentage value of production. The unit tax tends to discriminate against low-grade ores while the ad valorem severance tax discriminates more against ores with high mining costs (assuming quality is held constant). The burden of the unit tax decreases with price increases and increases with price decreases, whereas the burden of the ad valorem tax varies with product prices. *Id.*

117. *Id.*

118. Steele, *Natural Resource Taxation: Resource Allocation and Distribution Implications*, in *EXTRACTIVE RESOURCES AND TAXATION* 247 (M. Gaffney ed. 1967).

119. S. Blackstone, *supra* note 22, at 100.

120. *See, e.g.*, Stolz & Purdy, *Federal Collection of State Individual Income Taxes*, 1977 DUKE L.J. 59.

121. H.B. 1264, 52d Colo. Gen. Assembly, 2d Sess. (1980) (to be codified in COLO. REV. STAT. § 39-22-128).

122. *See, e.g.*, NEB. REV. STAT. §§ 66-821 to -841 (Supp. 1979).

123. For a qualitative analysis of federal subsidies involving energy see U.S. DEP'T OF ENERGY, *SELECTED FEDERAL TAX AND NON-TAX SUBSIDIES FOR ENERGY USE AND PRODUCTION* 1 (1980).

Table 22  
Summary Comparison of State Tax Structures:  
Income, Sales, Property, & Severance Taxes (FY 1976)

	Colorado	Montana	New Mexico	N. Dakota	S. Dakota	Utah	Wyoming
<b>Total Tax Revenue (\$000)</b>	1,212,097	330,256	761,076	309,589	223,601	605,981	289,484
<b>Income Taxes</b>							
<b>Personal</b>							
Yield (\$000)	375,341	123,621	43,992	69,171	None	188,894	None
% Total	31%	37%	6%	22%	-0-	31%	-0-
<b>Corporate</b>							
Rate <sup>(1)</sup>	5%	6.75%	3%	7%	None <sup>(2)</sup>	4%	None
Yield (\$000)	88,203	29,239	37,608	20,921	-0-	29,440	-0-
% Total	7%	9%	5%	7%	-0-	5%	-0-
Combined % Total	33%	46%	11%	29%	-0-	35%	-0-
<b>General Sales &amp; Use Taxes<sup>(3)</sup></b>							
Rate	3%	None	3.75%	3%	4%	4%	3%
Yield (\$000)	424,403	-0-	328,804	97,471	114,895	259,230	115,969
% Total	35%	-0-	43%	31%	51%	62%	60%
<b>General Property Taxes</b>							
Yield (\$000)	2,607	16,329	19,851	2,625	-0-	106	17,589
% Total	0.2%	5%	3%	1%	-0-	0.03%	6%
<b>Severance Taxes</b>							
Yield (\$000)	6,212 <sup>(3)</sup>	44,667	137,277	18,619	872	8,926	65,021
% Total	0.5%	13%	10%	6%	0.4%	1.5%	23%

(1) Maximum rate

(2) Corporate income tax only on banks and financial institutions

(3) Does not include selective sales taxes, e.g. gasoline, tobacco

(4) Data revised by input from Colorado Dept. of Revenue

Sources: Commerce Clearing House, Inc., "State Tax Guide" (1976, as updated).  
U.S. Dept. of Commerce, Bureau of Census, "State Government Tax Collections in 1978" (1979).

the combination of federal and state tax exemptions or credits has been calculated to be a substantial subsidy.<sup>124</sup>

The windfall profit tax<sup>125</sup> illustrates another important aspect of inter-governmental relations. To the extent that the tax allows the payment of state taxes on production as a cost, states will be able to tax oil enterprises without affecting the cost of production. There is likely to be political pressure in each state to take advantage of this "free" revenue.

As structured, the new law continues a shadow price control system to serve as the beginning or measuring point of that part of the realization of a producer that is "windfall" and subject to the tax.<sup>126</sup> The displaced price control system was complex, and prior to the enactment of the windfall profit tax the program was administered by the Department of Energy.<sup>127</sup> The compliance and enforcement process now will move to the Internal Revenue Service.<sup>128</sup> Consequently, the transactional costs, particularly to small producers, will probably increase.

#### CONCLUSION

It is evident that the utmost care must attend any effort to generalize about federal-state relationships, uniformity among the states or even within a particular state, taxes or tax-like effects on energy mineral production, or energy conversion. The beginning of reform, assuming reform is needed at all, is comprehension of the existing situation which is staggering in its complexity. The energy market has previously adjusted to the labyrinthine federal system and presumably will adjust to it in the future, although it will suffer the costs associated with uncertainty. The problem of coordinating the interests of the so-called consuming states and the producing states is not new; many cases have dealt with it in the past.<sup>129</sup>

The complexities of policy development in a federal structure are illustrated in energy policy development. The federal government's leasing policies are not integrated with its taxing policies and probably will not be. The conflicting objectives and the overlapping jurisdictional considerations impede the effort to construct a national policy. Taxes and tax-like effects of leasing and sales of public lands and resources must be understood if any progress is to be made.

The federal government faces no practical constitutional obstacle in passing legislation that would eliminate or tend to eliminate some of the situations previously identified. The Commerce Clause and other constitutional provisions support legislation like that introduced to put a cap on the

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124. R. Crow, *The Effect of Use Taxes and Conservation Oriented Tax Incentives on Energy Markets* (1980) (unpublished paper on file with Professor Carver).

125. *Crude Oil Windfall Profit Tax Act of 1980*, I.R.C. §§ 4986-4998.

126. *Id.* § 4988(a).

127. S. REP. NO. 96-394, 96th Cong., 2d Sess. 66, *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 1073.

128. *Id.* at 68, *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 1075.

129. *See, e.g.*, *FPC v. Louisiana Power & Light Co.*, 406 U.S. 621 (1972); *FPC v. Transcontinental Gas Pipe Line Corp.*, 365 U.S. 1 (1961).

states' severance taxes.<sup>130</sup> Moreover, the federal government could legislatively invalidate Louisiana's First Use Tax.<sup>131</sup> It could also remove the exemption of municipal bond interest from federal individual income tax liability. Federal income tax deductions for state gasoline tax payments have already been eliminated.<sup>132</sup>

The likelihood that any or all of these things will happen is slim, but it may be growing. Clearly, the federal government cannot permit frustration of its energy programs—a frustration which is all too possible.

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130. *See* S. 1778, 96th Cong., 1st Sess., 125 CONG. REC. S 13,017 (daily ed. Sept. 19, 1979) (limits state severance taxes on energy resources produced from Indian lands or lands owned by the United States to 12-1/2%). On Aug. 5, 1980, the National Governor's Conference adopted a resolution endorsing the right of coal-producing states to impose "reasonable" coal severance taxes. INGAA Washington Report, No. 974, at 9 (Aug. 8, 1980).

131. Congress could invalidate the Louisiana First Use Tax by the same process that it used to invalidate the New Mexico Electrical Energy Tax, that is, by passing legislation that would expressly prohibit such a tax. *See* note 104 *supra*.

132. *See* I.R.C. § 164.

