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Continental Telephone Company of Utah v. State Tax Commission of Utah : Brief of Appellant

Utah Supreme Court

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Unknown.

IN THE SUPREME COURT OF THE STATE OF UTAH

CONTINENTAL TELEPHONE COMPANY OF UTAH,
Plaintiff,

vs.

STATE TAX COMMISSION OF UTAH,
Defendant.

Two Cases
No. 13842
and
No. 13843

BRIEF OF PLAINTIFF

On Writ of Review to the State Tax Commission of Utah

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IN THE SUPREME COURT OF THE STATE OF UTAH

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BRIEF OF PLAINTIFF

NATURE OF THE CASES

These are consolidated cases arising on petitions for review by this Court of a decision of the State Tax Commission assessing additional corporation franchise taxes.

DISPOSITION OF THE CASES IN THE TAX COMMISSION

The Tax Commission's Decision No. 288 partially disallowed deductions made by the taxpayers, in the computation of Utah corporation franchise taxes, for federal income taxes paid.

RELIEF SOUGHT ON REVIEW

Plaintiff seeks reversal of the Commission's decision.

STATEMENT OF THE FACTS

The taxpayers in the cases before the Court are The Midland Telephone Company and Utah Telephone

Company (formerly Bear River Telephone Company), two public utility corporations. During the tax years in question, 1965 through 1970, the two were separate corporations having the same parent, Continental Telephone Corporation, which owned 100% of the stock of Midland and more than 99% of the stock of Utah.[1]

Both taxpayers provide telephone service in rural areas. Midland's main office is at Moab, in Grand County, and Utah has its headquarters at Tremonton, Box Elder County. About 95% of Midland's service area, plant and business is within the state, and the correctness of its allocation of the proportion of its income to this state as reported in its Utah return was not questioned at the tax audits and was not involved at the Tax Commission hearing (Finding 2; R. 12). The certificated service area of Utah is wholly within this state, and thus all of its income is Utah income which was so reported on its Utah corporation franchise tax return.

Each taxpayer, as a public utility, holds a certificate of convenience and necessity describing the area within which it provides telephone service to the public. Each is subject to the regulatory supervision of the Public Service Commision in respect to its rates, its allowable revenues and expenses, its investment in plant, its financing, and other like matters. The accounting records of each company are required to be kept in the manner prescribed by the Public Service Commission, and are

[1]Both cases bear the same name here because, after the tax years in question, Midland merged into Utah and the surviving corporation took the present corporate name of Continental Telephone Company of Utah, the present plaintiff. In this brief, the taxpayer corporations are referred to separately, so as to conform with the manner in which the tax returns were filed and audited, and with the record made at the Commission hearing.

maintained in such a way that the information required for regulation may be obtained (Finding 2; R. 12).

Each taxpayer files its Utah corporation franchise tax return with the Tax Commission as a separate corporation.

Continental, the parent corporation, has a number of subsidiaries other than Midland and Utah. Most of these are operating telephone utilities like the two Utah companies but some are non-utility companies (Tr. 31). The number of Continental subsidiaries varied, during the tax years involved, but averaged in the range of about 130 companies (Tr. 31). These affiliates of the Continental system do business in 42 states and a few foreign countries (R. 12).

Exhibits 2 through 7 are the corporation franchise tax returns filed by Utah with the Tax Commission. Exhibits 11 through 16 are the returns filed by Midland. In the computation of its taxable income, each made the usual deduction from gross income of an amount for its federal income taxes for that year. It is this deduction which is the disputed item in the present proceeding. The hearing thus was concerned principally with the process by which the federal income taxes were computed and paid.

Midland and Utah join with the other subsidiaries of Continental in the filing of a consolidated federal income tax return (R. 13, ¶15). The parties stipulated that "[t]he steps involved in the computation, payment and inter-system accounting of the consolidated federal tax of the Continental group for each of the years in question were taken as required or permitted under the federal laws and regulations" (Exhibit 1, ¶7). Details of the process are summarized in the stipulation (Exhibit 1, ¶7(a)-7(f) and the closing agreement between Continental and the Internal Revenue Service (Exhibit 18), and are amplified and explained in the testimony and cross examination of the witness Gunter, Continental's chief tax officer (Tr. 30-35, 47-51).

The consolidated federal tax return of Continental and the subsidiaries is prepared on a "separate company" basis (Tr. 31-2). Continental acts as agent for each member of the consolidated group, in accordance with the federal regulations. On behalf of each member, it files a declaration of estimated taxes at the beginning of the tax year, remits quarterly payments, files the consolidated return, pays the tax at the end of the tax year, and otherwise represents the members of the consolidated group in dealings with the Internal Revenue Service. Each of the members, including Midland and Utah, computes its declaration of estimated federal taxes separately at the beginning of the tax year and remits its quarterly payment to Continental, which forwards the consolidated payment to the IRS (Tr. 35). At the close of the year, the federal taxable income is computed by each subsidiary for itself, as a separate corporation (Tr. 32). The figures are then sent to the parent and consolidated in the federal return. Preparation of the consolidated return involves the combining of the separately computed net taxable incomes of each subsidiary. As explained by Mr. Gunter, this step also requires a verification that certain of the deductions separately taken by the members do not in the aggregate exceed the limitations also imposed upon a consolidated group (Tr. 32). The consolidated return then is filed with the IRS by the parent with its payment on behalf of the members of the indicated federal tax. The remittances of all members of the group are made by actual transfers of funds and are not merely accounting entries (Tr. 35).

In the tax years involved here, the net amount due the IRS under the consolidated return is less than the sum of all the tax payments remitted separately to the parent by the income-producing members of the group. The difference arises because a few subsidiaries incurred operating losses. The consolidated incomes thus totalled less than the incomes reported by the profit-producing members.

The record details the handling of the funds reflecting the difference between the tax payments received by Continental and the consolidated tax remitted by it to the federal government. Each loss-incurring subsidiary receives from Continental the amount it would otherwise receive from the IRS by way of refund if it had filed its federal return separately (Tr. 35-36). In a few instances, a loss-incurring subsidiary does not immediately receive a refund (as where, in the example stated by the witness, a newly acquired subsidiary incurs a loss but lacks "enough experience" with Continental to justify a loss carry-forward. In such a case, no refund is available from the parent until in future quarters the earnings experience of the subsidiary supports a refund; the parent then remits the refund to the subsidiary as would be the case were that subsidiary a separately filing corporation (Tr. 36-37).

The Continental witness, Gunter, an experienced tax accountant with responsibility for the supervision of the Continental system's returns, testified that the Continental system in the long run pays no less and no more Federal tax whether the tax returns are computed separately or computed on a consolidated basis; however, when a consolidated return is utilized, the members of the system realize a benefit by reason of the quicker availability of funds (Tr. 44-45).

During the Tax Commission's audit of the Utah corporation franchise tax returns of Midland and Utah, the auditor requested and the taxpayers supplied the figures showing Continental's consolidated federal income and taxes for all subsidiaries. The staff then proposed the deficiencies which are the subject of these cases. The staff computation would partly disallow the federal tax deductions taken, by reducing the deduction in the proportion that the taxpayer's federal tax bears to the federal tax of the consolidated system. The staff theory is that, as the Continental system paid a lesser federal tax because of the losses of some subsidiaries, the difference is allocable among the income-producing subsidiaries to cut down their federal "taxes paid" deduction in their state tax returns. (For an example of an audit computation, with staff explanation, see Exhibit 15, Midland's 1969 return, into which the audit has been stapled.)

For hearing purposes the cases of Utah and Midland were consolidated by the Commission and a formal hearing was held July 6, 1972. At the hearing, the parties submitted an agreed statement of facts (Exhibit

1) and stipulated that the arithmetic involved in the staff's deficiency computations would not be disputed and that the proceedings taken and filing made by the taxpayers and by the Auditing Division were regular and correct. The staff offered testimony and exhibits, as did the taxpayers. The Commission issued its Decision on October 9, 1974, sustaining the staff-proposed deficiencies in every respect.

ARGUMENT

POINT 1.

THE DEDUCTIONS TAKEN BY MIDLAND AND UTAH FOR FEDERAL TAXES PAID ARE DIRECTLY AND EXPRESSLY AUTHORIZED BY SECTION 59-13-7, UCA 1953.

In their computations of their Utah corporation franchise taxes, Midland and Utah deducted their respective federal income taxes, computed on the separate company basis explained above and delivered to the parent company for remittance to the federal government. The Commission's partial disallowance of the deduction limits the taxpayers to a proportionate share of the Continental federal income tax due on the consolidated return. It is only this lesser amount, it is said by the Commission, that the two Utah companies "actually" paid. This part of the taxpayers' brief shows that the deduction is authorized by the applicable statute and that the Commission's action was unlawful because contrary to the statute.

The "taxes paid or accrued" deduction is authorized by Section 59-13-7(3), UCA 1953, which provides:

> In computing net income there shall be allowed as deductions:
>
> * * *
>
> Taxes Paid.
>
> (3) Taxes paid or accrued within the taxable year, except —
>
> (a) Taxes imposed by this chapter; and,
>
> (b) Taxes assessed against local benefits of a kind tending to increase the value of the property assessed; provided, that so much of taxes as are properly allocable to maintenance or interest charges may be deducted.

A Kansas case, *Cities Service Gas Company v. McDonald,* 204 Kan. 705, 466 P2d 277 (1970), is squarely in point. In that case, upon facts similar to those here, the court construed a statute like ours to mean that the subsidiary may deduct in full the amount of its separately computed federal income tax payment made to its parent, which in turn made refund-type payments to those subsidiaries reporting losses. The holding of the case is that the profitable subsidiary actually incurred and paid its federal tax and may therefore deduct it on the state return. The Kansas court stated (466 P2d, at 283):

> Under the procedure followed here, the parent company acted simply as a clearing house in collecting tax monies from those of its subsidiaries having taxable income and in refunding and paying out to its loss subsidiaries the amounts to which they were entitled by reason of their loss credits having been utilized in the consolidated return. No gain actually resulted to the parent. Just the same, a tax liability was incurred and paid by Gas Company. Its tax liability was reported and

> paid to the parent company, and the consolidated return reflected that tax liability in the same amount as had an individual return been filed. As already pointed out, there was no tax saving to either the parent or Gas Company as a result of Gas Company being included in the consolidated return.

The case before this court is even stronger than the *Cities Service* case, in that in the Kansas case the consolidated group reported an overall loss so that no federal tax was paid on the consolidated return; in the present case a federal tax was paid.

The *Cities Service* case followed and reaffirmed an earlier decision, *Northern Natural Gas Processing Co. v. McCoy,* 197 Kan. 740, 421 P2d 190 (1967). The *Northern* case also held that the subsidiary is authorized to deduct its federal income tax liability, computed on a separate return basis and actually paid to its parent, notwithstanding a lesser federal tax on a consolidated return.

A recent decision of the Iowa Board of Tax Review, *Massey-Ferguson Credit Corporation v. Briggs, Director of Revenue,* (Decision No. 48, July 8, 1974; slip opinion not yet published), on similar facts, reached the same conclusion. The Iowa Tax Board stated:

> "In support of this position [i.e., deductibility] the Board favorably considers the language of the Supreme Court of Kansas in the case of Cities Service Gas Company vs. McDonald, 466 P2d 277. In this case the Court is considering a factual situation much like the one at hand and a Kansas statute similar to our own statute.

Although the Tax Commission's decision does not explicitly so state, it appears based on a Louisiana decision, *Trunkline Gas Co. v. Collector of Revenue* (La. App. 1965) 182 So.2d 674, which describes an allocation procedure like that followed in the staff audits of Midland and Utah. *Trunkline Gas* is not in point. The distinction between that case and this one lies in the governing statutes and regulations. In Louisiana, the court had before it a statute specifically authorizing the Collector to make regulations so as to effect such allocations in cases of federal consolidated returns, and such regulations had been promulgated and followed. No such statute and no such regulations apply in the present case. The Kansas court in the *Cities Service* case considered, and explicitly rejected, the *Trunkline* decision on this basis (466 P2d, at 281).

The record, and the statutory language and the cited authorities, compel the conclusion that Midland and Utah actually paid their respective federal taxes and are entitled to the deductions taken. The federal tax payments were effected by transfers of actual funds. The taxes of these taxpayers were remitted to the IRS by the taxpayers' agent. Neither taxpayer paid a lesser or greater federal tax than would have been due had no consolidated return been filed and each had filed its federal return separately.

The Commission's Finding 7 (last sentence; R. 13) states: "The taxes Midland and Utah deducted on their Utah returns were in a larger amount than were actually paid to the Federal Government." This of course is not the finding of a fact but is rather the conclusionary determination of the basic legal problem of the case. The idea that not all of the computed federal taxes were "actually" paid comes from Finding 6 (R. 13) in which the Commission purports to find that the parent company "benefited" by the consolidated returns, since some subsidiaries had losses which could be used to offset the gains of others which could not be utilized separately by the loss subsidiaries.

The Commission's reasoning is wrong in two respects: First, it is wholly immaterial to the correct computation of a Utah tax that a loss incurred by another on business due elsewhere in this country would benefit another corporation having nothing to do with Utah. This is the reasoning of the Kansas and Iowa cases. Secondly, the Commission is factually wrong.

It is true that Continental's accounting officer testified that in a few situations a loss-incurring subsidiary may not immediately receive its tax refund from Continental in the normal way, as where the loss subsidiary's membership in the system is new, so that "experience" (i.e., recognition of income) is lacking to demonstrate earnings capability (Tr. 36-37). The witness stated that the subsidiary receives the refund in the future, when justified: ". . . as we get experience, they get the money" (Tr. 37). The Commission has assumed that Continental may simply keep the potential refund if the necessary "experience" does not materialize. In actuality, it does not work that way. Continental's separate-company computation forbids it. Indeed, the basic purpose of forbidding the refund to a newly acquired loss subsidiary is to foreclose a holding company from trafficking in loss-incurring subsidiaries for the purpose of availing itself of another company's tax loss. The matter is discussed in Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* (3d Ed. 1971), pp 15-69 et seq. The whole point, which the Commission ignores, is that if a new loss subsidiary's lack of experience prevents its loss from generating a tax refund to the subsidiary, then on the identical principle that loss may not be availed of by the parent. This is the very purpose of the regulation. The hidden "benefit" to Continental imagined by the Commission thus is not only not there: the whole exercise arises out of a federal regulation whose exact purpose is to foreclose any such benefit.

Further, in any case where a loss may be deducted by the group, the basis of the stock of the loss affiliate in the parent's hands is reduced to the extent the loss is "availed of" by the group (Bittker & Eustice, op. cit., p. 15-64).

At the bottom of the Commission's decision is the idea that there is some hidden benefit for Continental in the filing of a consolidated return which in some way works to the proportionate benefit of these Utah subsidiaries. This idea is without any support in the record.

Moreover, the Tax Commission has ignored the regulatory way of life to which these taxpayers are subject. The items making up Midland's revenues and expenses, and its relationship with its parent, are recorded in accordance with accounting rules whose very purpose is to assure that that corporation's earnings may be measured, and measured separately. The process is continuously monitored by a regulatory agency charged by law with that function, and such oversight is backed up by independent audits and reports to lenders. There is no way, given the facts of life for a regulated utility, that benefits of the sort imagined by the Tax Commission could be availed of by these small telephone companies.

The reasons for choosing to file a consolidated federal return are the reasons stated in the record. There is a quicker availability of funds. This lessens borrowing costs.

The suitability of a separate-company consolidated federal tax return, for a regulated public utility, is obvious. It is essential to the nature of a utility that its revenues, operating expenses, plant investments and its profits, be correctly allocated to and recorded for the entity which generates them. That is true of its state and federal tax expenses. A utility cannot otherwise be accurately managed or correctly regulated by the responsible public authorities.

The Tax Commission's determination that Midland and Utah did not "actually" pay the federal taxes they deducted is wrong. Such taxes were actually remitted to the taxpayer's agent and by the agent remitted to the IRS for their account. Equally important, the economic realities fully demonstrate an actual payment.

POINT 2.

THE DECISION OF THE TAX COMMISSION IS ERRONEOUS INSOFAR AS IT IS BASED UPON

(a) AN ALLOCATION PURPORTEDLY MADE UNDER SECTION 59-13-17;

(b) THIS COURT'S DECISION IN THE KENNECOTT CASE; OR

(c) REGULATION 13.

POINT 2(a)

THE DECISION OF THE TAX COMMISSION IS ERRONEOUS INSOFAR AS IT IS BASED UPON AN ALLOCATION PURPORTEDLY MADE UNDER SECTION 59-13-17.

Conclusion of Law No. 2 (R. 16) recites that the Tax Commission is authorized by Sec. 59-13-17 to distribute, apportion or allocate gross income or deductions between and among affiliated corporations if it determines that to be necessary in order to prevent evasion of taxes or clearly to reflect income. The language of the statute is:

> Allocation of income and deductions between several corporations controlled by same interests.—In any case of two or more corporations (whether or not organized or doing business in this state, and whether or not affiliated) owned or controlled directly or indirectly by the same interest, the tax commission is authorized to distribute, apportion or allocate gross income or deductions between or among such corporations, if it determines that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such corporations.

The statute affords no basis for the Commission's decision. Legally, Conclusion 2 is a nullity. The Commission merely mentioned the statute's existence. There is no finding or determination whatever that its application is necessary to prevent evasion of taxes by Midland or Utah, or clearly to reflect the income of Midland or Utah. Such a determination of course could not be made in the face of this record, which demonstrates that neither Midland nor Utah paid a greater or lesser tax under the consolidated return than it would have paid had it filed its federal return separately.

Section 59-13-17 is taken almost word for word from a parallel federal statute, 26 USCA, §482. In a recent decision the United States Supreme Court stated that §482 is ". . . designed to prevent 'artificial shifting, milking, or distorting of the true net income of commonly controlled enterprises.' " *Commissioner v. First Security Bank of Utah,* 405 US 394, 31 L.Ed.2d 318, 92 S.Ct. 1085 (1972), citing Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders,* p. 15-21.

No shifting, milking or distorting of true income is present here. As was shown under Point 1, the basic and intended effect of the separate-company consolidated return method followed by Continental is to reflect items of income and tax expense with exactness for the subsidiary corporation which generates the income resulting in the tax. Being a system comprised of regulated utilities, Continental could do little else even if it sought to do so. The present case is not a case of affiliated taxpayers attempting to move income or deduction items to a more favorable jurisdiction, which is what Section 59-13-17 is aimed at. Rather, the case is the opposite; it is an effort of the Utah taxing authority to avail itself of a loss situation arising in some other jurisdiction with which this state and these Utah taxpayers have no proper concern.

POINT 2(b)

THE DECISION OF THE TAX COMMISSION IS ERRONEOUS INSOFAR AS IT IS BASED UPON THE *KENNECOTT* CASE.

Conclusion No. 3 recites:

> The case of Kennecott Copper Corporation v. State Tax Commission, reported at 27 U.2d 119, 493 P.2d 632 (1972), applies to this matter for all tax years in question and allows the Tax Commission alternate methods other than statutory formulas of calculating and allocating taxpayers' income equitably to reflect fairly the extent of taxpayers' business activity in the State of Utah; and recognizes the application of state tax regulation to the allocation of the federal income tax deduction.

Midland and Utah submit that the *Kennecott* case has no application here. *Kennecott* differs factually, in a substantial way. Basically, that case involved difficult questions as to the allocation to this state of the correct share of income generated from the multi-state operations of a number of affiliated corporations doing business in Utah and in many other states. The Kennecott group of affiliated companies which did business in Utah filed a Utah consolidated franchise tax return. These corporations, and additional affiliated corporations which had no contact with Utah, filed a consolidated federal return. In that context this Court's decision was that the Commission had made lawful allocations of the incomes of the various affiliated companies for purposes of the Utah corporation franchise tax. In the same context the *Kennecott* case also upholds the Commission's allocation of the "taxes paid or accrued" deduction, stating (493 P.2d, at 636):

> Kennecott further contends that the Commission erred in its allocation of deductible federal income tax to the Utah affiliated group. This matter was handled in accordance with the regulations of the Commission rather than federal regulations. Kennecott was bound by the regulations of the Commission and we perceive no error in its application.

It is clear from the opinion as a whole that the overall problem of the case is the application of the allocation power to assign income items and expense items as among the various affiliates, in the complicated fact situation before the Court. The taxpayer was a group of companies filing a Utah consolidated return which was a different group from the larger group of affiliates filing the federal consolidated return. The regulations referred to by the Court as binding on Kennecott were those which became binding when the Kennecott affiliated corporations in Utah elected to file a Utah consolidated return.

In the present case, none of this is present. All income involved is Utah income. Midland and Utah filed separate Utah returns. There is no problem of income allocations among various companies filing a Utah consolidated return and no related problem of the allocation of the federal tax deduction related to the income. The *Kennecott* decision supplies no support for the Tax Commission's action in this case.

POINT 2(c)

THE DECISION OF THE TAX COMMISSION IS ERRONEOUS INSOFAR AS IT IS BASED UPON REGULATION 13.

In its Conclusions of Law 4 and 5, the Commission recites reliance upon Utah Corporation Franchise Tax Regulation 13 as a basis for its decision. Conclusion 5 says that Regulation 13 applies to all tax years involved, and Conclusion 4 says that Regulation 13 limits these taxpayers to the deduction of their proportionate share of the federal tax actually paid by the parent.

This part of the brief shows that the Commission is wrong in both conclusions. It is further shown that Regulation 13 could not, by construction or amendment, lawfully be extended to these taxpayers.

The Commission's findings of fact rely upon and quote three paragraphs of Regulation 13 (Finding 13; R. 15):

> Deductible Federal Income Taxes and Refunds Thereof — Allocation of Federal Income Taxes.
>
> 1. Federal Tax Deduction to be Reduced by Credits. The amount of federal income tax which may be deducted against total corporate income for Utah income or franchise tax purposes is the amount of the federal tax after all credits such as investment tax credits (current and carryover), foreign tax credits, etc., have been deducted.
>
> 2. Cash Basis Taxpayer. (a) In the case of a taxpayer reporting on the cash basis, the amount of federal income taxes actually paid during the taxable period is allowable as a deduction, whether such taxes represent the preceding year's tax or

additional tax for prior years. Refunds of federal taxes must be reported as income in the year received or offset against payments made in that year and the net amount only of the payments deducted.

3. Accrual Basis Taxpayer. (a) In the case of an accrual basis taxpayer, the amount of federal income tax to be allowed as a deduction in arriving at the total corporate net income for Utah fanchise tax purposes is normally limited to the amount of the actual federal income tax liability in connection with its federal return for the same period.

The regulation is lengthier than the brief portion extracted in the Commission's findings. As presently effective, Regulation 13 is reprinted in the Appendix to this brief. Particular attention is invited to the unnumbered paragraph, following paragraph 13.3.(a). This is a new provision, effective for tax years beginning on or after January 1, 1973. The new paragraph describes the situation of taxpayers like Midland and Utah. In contrast, the paragraphs quoted by the Commission say only that the federal tax deduction must reflect tax credits (¶1); that cash basis taxpayers deduct the federal tax paid in the same year (¶2(a)); and that accrual basis taxpayers deduct federal taxes accrued during the same year (¶2(b)). Plainly, the quoted paragraphs have nothing to do with the problem involved in this case, and Regulation 13 as effective for the tax years in question did not apply to Midland and Utah. Equally plainly, the Tax Commission thought so too. That is why it attempted to promulgate the new paragraph to be effective for subsequent years.

On basic principles, and so far as concerns Midland and Utah and taxpayers situated like them, Regulation 13 cannot be extended or amended so as to achieve what the Tax Commission wishes. This is so because the statute which permits the deduction of federal taxes paid or accrued provides otherwise. The Commission lacks power to rewrite that statute. Midland and Utah paid their federal taxes and are entitled to the statutory deduction.

Moreover, the Tax Commission lacks authority to make a regulation governing the "taxes paid or accrued" deduction. The power to promulgate regulations is that which comes from legislation. A canvass of the tax laws shows that the grants of this power are specific. Where the legislature intends that an area of taxation be governed by regulations which are more detailed than the statute, that area is specifically stated and the authority is delegated.

The best illustration of the point is in the statute involved in this case, Section 59-13-7, the allowable-deductions provision. As to some deductions there is an express grant of authority to prescribe regulations (subsection (8), depletion; subsection (10), casual sales of realty).

The same pattern is apparent throughout Title 59. Power is delegated, in Section 59-5-46(2), to prescribe procedural regulations governing the conduct of Commission's business in assessment of property tax matters. Section 59-13-23(2) extends a regulation-making power in cases of Utah consolidated returns.

The conclusion is plain. There is no delegation of a like power in respect to the "taxes paid or accrued" deduction allowed under subsection (3). The Commission. having power to make substantive regulations only where such power is delegated, has no power to make a regulation governing the "taxes paid or accrued" deduction. Regulation 13 cannot be extended to that subject matter, by amendment or interpretation.

This is not to say that the Tax Commission lacks authority to reach, and to collect the proper tax, in those fanchise tax cases which should be reached as a matter of correct principle and fairness. Not all corporate taxpayers elect to file a consolidated return and make the appropriate election to file their return and keep their accounts on a separate-company basis. A corporate taxpayer which files a consolidated federal return on a different basis, and whose federal tax is distorted, can be reached and an appropriate allocation made, under a properly drawn regulation. Further, the Tax Commission has ample further power under the allocation statute (Section 53-19-17) to make proper allocations of income or deduction items on a case-by-case basis where a taxpayer has, innocently or otherwise, adopted a federal return procedure which shifts or distorts income or deductions. This power extends to any group of affiliated companies, whether the members file separately or on a consolidated basis.

That, however, is not this case. Midland and Utah paid their federal tax, as a matter of both form and substance. They may deduct it on their franchise tax return because the statute says they may. Regulation 13 does not apply to them and could not be made to do so.

CONCLUSION

For the foregoing reasons, the Tax Commission's decision should be reversed.

Respectfully submitted,

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APPENDIX

CORPORATION FRANCHISE TAX REGULATION NO. 13

Subject: Deductible Federal Income Taxes and Refunds Thereof — Allocation of Federal Income Taxes.

13.1. Federal Tax Deduction to be Reduced by Credits. — The amount of federal income tax which may be deducted against total corporate income for Utah income or franchise tax purposes is the amount of the federal tax after all credits such as investment tax credits (current and carryover), foreign tax credits, etc., have been deducted.

13.2.(a). Cash Basis Taxpayer. — In the case of a taxpayer reporting on the cash basis, the amount of federal income taxes actually paid during the taxable period is allowable as a deduction, whether such taxes represent the preceding year's tax or additional tax for prior years. Refunds of federal taxes must be reported as income in the year received or offset against payments made in that year and the net amount only of the payments deducted.

13.2.(b). The Tax Commission will permit a corporation reporting on the cash basis to deduct federal income tax on the accrual basis if an election is made upon filing its first return. If the corporation claims the accrued federal tax on the first return, it shall be considered as an election. Once the election is made the corporation may change the basis of federal tax deduction only with permission of the Tax Commission.

13.2.(c). The Tax Commission may grant permission, upon request from the Taxpayer, to change the deduction of federal income tax from the cash to the accrual basis. If permission is granted, the taxpayer may effect the change to the accrual basis of claiming the federal tax deduction for any taxable year within the statutory limitation period by filing of such amended returns or recomputations as may be required.

13.2.(d). The federal tax deduction on the return for the year for which an election or a change is permitted under Regulation 13.2.(b) or Regulation 13.2.(c) above shall be limited to the amount of federal tax actually due on the federal return for that year, and the rules relative to the accrual basis taxpayer will apply to that and all subsequent returns.

13.3.(a). Accrual Basis Taxpayer. — In the case of an accrual basis taxpayer, the amount of federal income tax to be allowed as a deduction in arriving at the total corporate net income for Utah franchise tax purposes is normally limited to the amount of the actual federal income tax liability in connection with its federal return for the same period.

In case the corporation was included in a consolidated return for federal income tax purposes, the amount of federal income tax to be allowed as a deduction in arriving at the net income of the corporation shall be limited to its proportionate share of the actual federal income tax due with the federal consolidated return for the same period. The proration of the allowable federal tax must be made only to profit-producing corporations included in the consolidated return. (See Reg. 13.4. for information concerning further assignments.)

13.3.(b). Additional federal income tax for prior years is ordinarily a part of the tax liability accrued for such prior years and must be claimed for corporation franchise tax purposes by filing amended returns and/or recomputations of net income for the year or years for which the additional federal taxes were determined to be due. The amended returns and/or recomputations must take into account all federal adjustments to net income to the extent applicable to the state return.

13.3.(c). In the case of a contested federal tax liability, the additional federal tax is deductible on the return for the year in which the taxpayer's liability to pay is finally determined, unless paid prior to that time (whether or not under protest and whether or not action to recover is instituted), in which case the deduction for the contested tax must be taken on the return for the year in which paid.

The mere payment of a tax under protest, even though followed by an action to recover, does not constitute a contested tax liability, and the additional tax paid under such circumstances must be treated as outlined in Reg. 13.3.(b) above.

Recovery of a tax paid under any of the circumstances set forth in this section must be reported as income in the year received.

13.3.(d). Refunds or credits of federal income taxes must normally be included in income for Utah corporation franchise tax purposes in the year of receipt. The Commission recognizes some exceptions as outlined below:

13.3.(d).(1). Ordinary overpayments and over-assessments whether determined by the taxpayer subsequent to the filing of the federal return or determined by the Internal Revenue Service upon examining the return may, if the Tax Commission so requires or approves, be related to the year in which the original tax was allowable as a deduction. If such earlier year is closed by the statute of limitation, however, the refund or credit must be included in income in the year received or credit allowed.

13.3.(d).(2). In case of refunds resulting from renegotiation of contracts with the federal government, the net amount due the government; i.e., the gross amount of the renegotiation less the reduction in federal taxes resulting therefrom, must be applied to reduce the income for the year or years to which the renegotiation applied. The taxpayer, prior to the expiration of the statute of limitations of the year or years to which the renegotiation applies, should file a claim for refund based on the net amount refundable to the government.

13.3.(d).(3). Refunds due to accelerated amortization, together with the accelerated amortization deductions thetmselves, must be related to the year to which the accelerated amortization deductions apply for federal tax purposes.

13.3.(d).(4). Refunds resulting from operating loss carry-backs, investment credit carry-backs, unused excess profits tax credits, and similar items are includible in income for Utah corporation franchise tax purposes in the year in which such refunds are legally accrued, provided such right to receive the refund is not subject to some future contingency such as the outcome of litigation.

13.4.(a). Assignment of Federal Income Taexs. — An assignment of a portion of the total allowable federal income tax deduction on the Utah corporation franchise tax return may be required for certain purposes, such as arriving at:

(1) Income less "related expense" which is subject to specific allocation under the statute,

(2) Net income from various properties in depletion computations, and

(3) Separate accounting determinations of net income when authorized by the Utah State Tax Commission.

13.4.(b). In general, the assignment of federal income taxes shall be made only to those segments of net income subject to federal income tax and shall be made on the basis of net income before federal taxes. Due consideration must be given to segments of net income subject to special federal tax treatment, such as domestic and foreign dividends, capital gains, etc.

13.4.(c). Federal income tax assignments are to be made to profit-producing items or divisions only. Each profit-producing item or division must be assigned its proportonate share of the total allowable federal tax deduction based on the ratio that the income of such profit-producing item or division bears to the total of all profit-producing items or divisions. Regardless of the mechanics used, the total of the federal tax assignments made against the profit-producing items or divisions, regardless of where located or whether or not subject to state income or franchise taxes, may not exceed the total corporate federal tax liability for the particular year involved (in case of an accrual basis taxpayer), or the total amount paid (in the case of a cash basis taxpayer).

The Utah State Tax Commission does not recognize, for Utah corporation franchise tax purposes, the so-called "tax savings" resulting from loss items. "Red-figure" allocations of federal income taxes will not be accepted. Loss items or divisions must not be assigned any federal income tax either positive or negative. Loss items or divisions shall be appropriately treated in effective tax rate determinations so as to produce assignments of federal income tax which are consonant with the requirements set forth herein.

Effective for taxable years beginning on or after January 1, 1973.