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

Utah Supreme Court

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IN THE

SUPREME COURT

OF THE

STATE OF UTAH

CONTINENTAL TELEPHONE COMPANY OF UTAH,
Appellants,

vs.

STATE TAX COMMISSION OF UTAH,
Respondent.

Civil Nos. 13843 and 13842

BRIEF OF RESPONDENT

Appeal from an Order of the State Tax Commission of Utah

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RELIEF SOUGHT ON REVIEW

Respondent, State Tax Commission of Utah, seeks affirmation of its decision, holding that appellants were not entitled to certain deductions of Federal taxes on their Utah corporate franchise tax returns for tax years 1965 through 1970, inclusive, and, as such, appellants must pay additional corporate franchise taxes.

STATEMENT OF FACTS

References to the transcript of proceedings before the State Tax Commission are designated (TR) with page number following. References to the remaining Record on Appeal are designated (R) with the page number following. References to exhibits are designated (E) with the exhibit number following. References to Appellants' Brief are designated (AB) with page number following.

The general facts set forth in Appellants' Brief provide adequate background information; however, additional clarification of the facts is necessary. This dispute questions the amount of Federal taxes that may be lawfully deducted on a Utah corporate tax return to arrive at taxable income by a business after it has joined together with other businesses to file a consolidated Federal tax return. Midland Telephone Company and Utah Telephone Company (hereinafter referred to jointly as "taxpayers") claim the proper amount to be deducted is a separately calculated amount. Respondent, Tax Commission, claims the only legally deductible amount is each company's proportionate share of the Federal tax liability *actually paid* based on a ratio of the company's taxable income to the total taxable income of all companies on a consolidated basis. Taxpayers do not remit Federal income taxes directly to the Federal Government representing their Federal tax liability each year. Said taxes are estimated at the beginning of the tax year, and quarterly payments are sent to Continental Telephone Company (hereinafter "Continental"), the parent corporation. (R-7) (AB-4) (TR-35) The computation of the Federal corporate tax liability in any given year is, as follows:

(a) The separate taxable income of taxpayers is computed excluding deferred inter-company transactions, net operating loss carry-over, capital gains and losses, Section 1231 transactions, charitable contributions, and Western Hemisphere Trade Corporation deductions.

(b) The items excluded are consolidated, and their sum is deducted from the consolidated, taxable income of the Continental group as a whole.

(c) Allegedly each member then prepares its own separate, recomputed tax liability and remits the amount of its taxes to Continental.

(d) Continental then remits directly to the IRS the amount of estimated, consolidated tax in quarterly installments. For any given year, the total of funds directly remitted to Continental by taxpayers normally exceeds the tax due on the consolidated return, partly by reason of the availability of the operating loss deduction of the loss-incurring members of the group. (R-8,9)

(e) When any current operating loss is utilized, Continental remits funds to that member to the extent of the tax effect of the loss, which could have been carried back to prior years under the Internal Revenue Code of 1954. The effect of any remaining, unused portion of net operating loss is offset as to that member in the future and, thereafter, Continental remits funds to such member at the then current rate.

(f) Continental credits each member of the group for the appropriate amount of its investment credit earned. (R-8,9) (Investment credit is a direct reduction of taxes in an amount not exceeding seven percent of the cost of certain tangible, personal property acquired during the year.)

In the computation by taxpayers of its Utah corporate franchise tax for each of the years in question, each deducted Federal taxes in an amount computed by multiplying its taxable income, separately computed, by the then current Federal income tax rate, less the appropriate amount of Federal income tax credit earned, and deducted said amount on its Utah corporation franchise tax return. (R-9) Rather than take an amount of Federal income tax deduction on the Utah corporation franchise tax return that would have been assigned ratably to each of the companies based upon a ratio that the Federal taxable income of each profit-producing company in the group bears to the total taxable income of all profit-producing companies, taxpayers computed their tax deduction separately and aside from the consolidated computation. (R-13) Respondent, Tax Commission, found that by reason of the separate audits prepared and performed by the Tax Commission's auditing staff, the following corporate franchise tax deficiencies were assessed:

UTAH TELEPHONE COMPANY

1 Year	2 Proportionate Share of Fed. Tax Liab. *1	3 Fed. Tax Deducted on Utah Return	4 Over or (Under Deducted) Difference	5 Assessed Utah Tax Deficiency (Refund)	6 Source *2
1965	$35,415.52	$57,219.54	21,804.02	$1,308.24	E-No. 2
1966	27,205.00	48,979.00	21,774.00	1,306.44	E-No. 3
1967	9,777.00	8,375.00	(1,402.00)	($85.20)	E-No. 4
1968	-0-			None	E-No. 5
1969	15,749.00			369.84	E-No. 6
1970	40,921.00	26,750.00	(14,171.00)	($850.26)	E-No. 7

MIDLAND TELEPHONE COMPANY

1 Year	2 Proportionate Share of Fed. Tax Liab. *1	3 Fed. Tax Deducted on Utah Return	4 Over or (Under Deducted) Difference	5 Assessed Utah Tax Deficiency (Refund)	6 Source *2
1965	46,000.00	91,250.00	45,250.00	2,577.91	E-No. 11
1966	44,259.00	75,572.00	31,313,00	1,758.60	E-No. 12
1967	45,322.00	90,491.00	45,169.00	2,560.40	E-No. 14
1968	26,157.00	86,288.00	60,131.00	3,372.48	E-No. 14
1969	24,802.00	54,573.00	29,771.00	1,688.28	E-No. 15
1970	-0-	-0-		-0-	E-No. 16

*1 - Formula — $\frac{\text{Taxpayer Taxable Income}}{\text{Total Consolidated Taxable Income}} \times$ Actual Fed. Taxes Pd. by Consolidated Group = Amount in Col. 1

(See Note 1 and 2)

Note *1 All of the figures contained in Column 2 above were taken as a ratio of the taxable income of the separate taxpayer to the total taxable income of all corporations in the consolidated group to arrive at a percentage figure. This percentage figure times the Federal income tax liability of the total consolidated group actually paid to the Federal Government resulted in the separate taxpayer's share of Federal income tax liability, according to the respondent's staff audits. This is the figure shown in Column 2 above. Note *2 All of the above information was taken from Schedule 2 of the State Tax Commission's staff audit report, "Computation of Tax", found in each of the above exhibits before this court, respectively.

Counsel for appellant, Continental, in a letter dated October 3, 1969 (Exhibit No. 9), stated on page two of said letter, the following in the Recitation of Facts in petitioning for redetermination of the tax liability:

> "In each of the years 1965, 1966, 1967, some other Continental subsidiaries sustained operating losses and the Federal tax paid by the consolidated group accordingly was less than the sum of the Federal taxes which would have been paid had each profit-making subsidiary filed its Federal return separately."

On page three of the same Exhibit 9, counsel for petitioner also states:

> "The apparent lessening of the consolidated Federal tax liability is the reflection of the remittances to the loss companies of the amounts otherwise available by way of loss carry-back or carry forward to other taxable years." (See AB-10, 11, 12, 13, and 15)

All tax audits performed by the Utah State Tax Commission's staff were on due and proper notice given to taxpayers and in all cases proper and timely requests and notices for hearings have been filed. Mr. Gunther, the chief tax accountant for Continental, testified (TR-36, 37) in response to a question of whether, in any given tax year the total of the Federal income taxes for all the subsidiaries computed separately, less all of the refunds given by Continental to the loss subsidiaries, is the same figure as the amount remitted to the Federal Goverment as "no". This is due to Continental constantly acquiring companies, and situations where a subsidiary has a loss in the current year that cannot be carried back. That loss is held and, ultimately, transferred to the subsidiary in the form of cash. (TR-37) Mr. Gunther testified (TR-48-50) that, if a subsidiary corporation of Continental suffered a loss in the first year of existence and could not legally take advantage of said loss for Federal income tax purposes, the Continental Telephone group would utilize said loss, and the Continental group would have the availability of those tax refund dollars for at least one-to-five years, interest free. (TR-51) Apparently, by filing a consolidated return, inter-company profits from deferred inter-company transactions are eliminated. (TR-51) Mr. Gunther testified that by utilization of Continental's consolidated method, in most cases a greater amount of Federal tax is assigned to both Midland Telephone and Utah Telephone Company than would have been assigned if Regulation 13 of the Utah State Tax Commission had been followed. (TR-51) Mr. Gunther testified that Regulation 13 was not followed on the basis that it should apply only to businesses' income earned in more than one state. (TR-52) The basic savings in a consolidated tax return result from current utilization of net operating losses, elimination of dividends, and from the elimination of inter-company profits. (TR-53-54)

No evidence was presented reconciling the amount claimed by taxpayers on each of the tax years, respectively, to the total amount of Federal tax liability actually paid to the Federal Government, showing the amounts actually assigned to and paid by other subsidiary companies not in the State of Utah. No evidence was presented regarding the amount that taxpayers delivered quarterly to Continental in relation to the amount actually assessed as a separate company taxable income. Nor are facts presented regarding the amount of state taxes estimated and deducted on the Federal return.

ARGUMENT

POINT I

THE UTAH STATE TAX COMMISSION HAS AUTHORITY UNDER UTAH LAW TO ADOPT RULES AND REGULATIONS PERTAINING TO THE PRESENT DISPUTE AND HAS, IN FACT, LEGALLY ADOPTED REGULATION 13 APPLICABLE TO THE PRESENT SITUATION.

Appellants have brought into dispute the question of whether the Utah State Tax Commission is authorized to adopt rules and regulations pertaining to the question of deductibility of Federal income taxes for state corporate franchise tax purposes. Appellants take the position that the Utah State Tax Commission may not adopt such rules and regulations. (AB-10, 20, 21, 22)

The Constitution of the State of Utah, in Article XIII, Section 11, provides, in part:

> "...The State Tax Commission shall administer and supervise the tax laws of the State. ...The State Tax Commission and the County Boards of Equalization shall each have such other powers as may be prescribed by the Legislature."

Pursuant to the constitutionally created authority of the Utah State Tax Commission, additional powers are set forth in Utah Code Annotated, Section 59-5-46 (1953), as follows:

> "The powers and duties of the state tax commission are as follows:
>
> * * *
>
> (2) To prescribe rules and regulations not in conflict with the Constitution and laws of this state for its own government and the transaction of its business.
>
> (3) To prescribe such rules and regulations as it may deem necessary, not in conflict with the Constitution and laws of the state, to govern county boards and officers in the performance of any duty in connection with assessment, equalization and collection of general taxes.
>
> * * *
>
> (23) To perform such further duties as may be imposed upon it by law, and exercise all powers necessary in the performance of its duties."

The present action constitutes a dispute regarding the allocation and apportionment of Federal income taxes deducted by taxpayers on their Utah corporate franchise tax returns in an amount of Federal taxes proportionally different than was actually paid by their parent corporation which filed a consolidated Federal income tax return on behalf of all subsidiaries. Utah Code Annotated, Section 59-13-23 (1953) provides, in part, as follows:

"Consolidated returns.—
By Affiliated Group.

(1) An affiliated group of banks and/or other corporations shall, subject to the provisions of this section, have the privilege of making a consolidated return for any taxable year in lieu of separate returns. . . .

Rules and Regulations.

(2) The tax commission shall prescribe such regulations as it may deem necessary in order that the tax liability of an affiliated group of banks and/or corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be determined, computed, assessed, collected and adjusted in such manner as clearly to reflect the income and to prevent avoidance of tax liability.

(3) (Omitted as not applicable.)

'Affiliated Group' Defined.

(4) As used in this section an 'affiliated group' means two or more corporations connected through stock ownership with a common parent corporation, if—

(a) At least ninety-five percent of the stock of each of the banks and/or corporations (except the common parent corporation) is owned directly by one or more of the other banks and/or corporations; and,

(b) The common parent corporation owns directly at least ninety-five percent of the stock of at least one of the other corporations. As used in this subsection the term 'stock' does not include nonvoting stock which is limited and perferred as to dividends.''

Taxpayers make no contention that they are not a member of an affiliated group as defined in the above-cited statutes. Appellants do contend that the above subsection (2) of Utah Code Annotated, Section 59-13-23, does not apply to the present situation on the ground that taxpayers did not file a consolidated Utah corporate franchise tax return. The statute authorizes the Tax Commission to prescribe such regulations for ''of each corporation in the group, both during and after the period of affiliation . . . .'' Certainly, after the period of affiliation, a corporation would not be filing a consolidated Utah income tax return; hence, the above-subsection (2) reaches all situations dealing with an affiliated group of corporations, as defined.

Utah Code Annotated, Section 59-13-17 (1953), provides:

> ''Allocation of income and deductions between several corporations controlled by same interest. — 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 interests, 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 such corporations.''

Utah law provides that tax statutes should be construed to effectuate their purposes as representative of the intent of the Legislature.

Appellants state in their own Brief:

> "Further, the Tax Commission had 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." (AB-21)

Utah statutes further provide:

> "Rules of construction as to words and phrases. —Words and phrases are to be construed according to the context and the approved usage of the language; but technical words and phrases, and such others as have acquired a peculiar and appropriate meaning in law, or are defined by statute, are to be construed according to such peculiar and appropriate meaning or definition." (Utah Code Annotated, Section 68-3-11 (1953))

Where there is doubt respecting true meaning of certain words, the words should be read in light of conditions and necessities which they are intended to meet and objects sought to be attained thereby. (*United States Smelting, Refining & Milling Co. v. Utah Power & Light Co.*, 58 U. 168, 197 P. 902 (1921)) The Utah Legislature intended to cover all situations dealing with consolidated returns and affiliated groups and statutorily authorized the Utah State Tax Commission to adopt such rules and regulations as it may deem necessary in order to properly determine, compute, assess, collect and adjust the income tax of each member of said group to clearly reflect income and to prevent the avoidance of tax liability.

Regarding the adoption of rules and regulations by an administrative body of the State of Utah, this court, in *Utah Hotel Company v. Industrial Commission,* 107 Utah 24, 151 P. 2d 467 (1944), stated, in dictum, that:

> "In *Manhattan General Equipment Co. v. Commissioner of Internal Revenue*, 297 U.S. 129, 56 S. Ct. 397, 400, 80 L.Ed. 528, the Court held that an administrative regulation which was contrary to the statutory provision was a nullity. In so holding, the Court said:
>
> 'The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law . . .dut the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity . . . .'' (107 Utah 24, 32)

The Court further stated:

> "We deem it essential to a clear understanding of the problems implicit in this matter to note at the outset that regulations of administrative tribunals are not all birds of a feather. A failure to note this fact will inevitably lead to hazy thinking and erroneous concepts. The weight which should be given to a prior administrative regulation will to a large extent be dependent upon the type of regulation involved. Regulations may be promulgated pursuant to a specific delegation of legislative power. In prescribing such regulations, the administrative tribunal, within designated limits, may actually be making the law or prescribing what the law shall be. In prescribing such a regulation the tribunal in effect legislates within the boundaries marked out for its action by

> legislative enactment. On the other hand, the administrative tribunal may, by adopting a given regulation, only purport to interpret what the legislature meant by its statutory language. Such a regulation is nothing but an administrative opinion as to what the statute under construction means." (At page 31)

Pursuant to the above statute, authorizing the State Tax Commission to apportion or allocate gross income between affiliated corporations to properly reflect income and prevent evasion of taxes, and the other statutory authority cited above, the Utah State Tax Commission adopted Corporate Franchise Tax Regulation, No. 13 (Exhibit No. 17). This regulation is directed specifically to the problem of deducting an amount on the state corporate tax return of Federal taxes different from an amount representing that corporation's proportionate share of Federal income taxes actually paid and was intended to govern all deductions of Federal income taxes for Utah corporate taxation.

Utah Code Annotated, Section 59-13-7 (1953), provided certain deductions from gross income to compute net income, and these include:

> (3) Taxes paid or accrued within the taxable year, except—(exceptions not applicable in this case).

One Utah case has specifically dealt with the above Utah statute which was formerly Utah Code Annotated, Section 80-13-8 (3) (1943), granting a "taxes paid" deduction and stated:

> "...The former statute defines net income as 'gross income . . .less the deduction allowed by section 80-13-8.' The latter enumerates the various items to be deducted from gross income to determine net income. In making the argument plaintiffs had either overlooked or wholly ignored subsection (3) of section 80-13-8. That subsection provides in language which could hardly be made more clear, and certainly cannot

> be said to be ambiguous or uncertain, that taxes 'paid or accrued within the taxable year' are one of the items to be deducted from gross income in order to determine net income." *(New Park Mining Company v. State Tax Commission*, 113 Utah 410, 413, 196 P.2d 485 (1948))

Appellants contend in their Brief (AB-20) that Utah Code Annotated, Section 59-13-7 (3), regarding "taxes-paid deduction in computing net income," does not specifically refer to or grant the State Tax Commission authority to make rules and regulations. In support of this contention, appellant notes that other subsections, most notably 8 and 10, expressly provide authorization for rules and regulations. Appellants then argue the doctrine of *expressio unius est exclusio alterius*. This doctrine has never been applied to the tax laws in the State of Utah. The mere expression of an item in one part of the statute does not exclude its application in another part of the same statute.

Based on the facts and exhibits before the Utah State Tax Commission, as hereinabove more specifically set forth, the Tax Commission concluded that Utah Code Annotated, Section 59-13-17 (1953), was applicable and necessary to clearly reflect income. The Utah State Tax Commission set forth in Finding of Fact, Paragraph 14 (R-15), that the failure to apply the Utah State Corporate Franchise Tax Regulation, No. 13, would cost the State of Utah revenue, since a greater amount of Federal tax liability deduction was taken by taxpayers on their separate state corporate franchise tax returns than was actually paid to the Federal Government on the basis of apportioning taxpayers' share of Federal tax liability. The apportioned figure is a ratio of the taxable income of the separate taxpayer to the total taxable income of all corporations in the consolidated group times the Federal income tax liability of the total group. Hence, Utah income was not properly reflected; and the assessed deficiencies and overpayments are set forth in the Exhibits 2 through 7 and 11 through 16.

Substantial benefits were given the parent corporation and each member of the consolidated group. Some ten specific advantages are set forth in a tax treatise: *75 Commerce Clearing House, Standard Federal Tax Reporter*, Vol. 7, Paragraph 4903.17, at Page 58560-58561. Some of these advantages include offsetting of operating losses of one company against the profits of another; the distribution of intercompany dividends without the recognition of taxable income (this advantage will be eliminated in 1975); the avoidance of tax on other intercompany distributions; the use by the consolidated group of the excess of one member's foreign tax credit over its limitation on that credit; the use by the group of the excess of one member's investment credit over its investment credit limitation, and no recapture of earlier years' investment credits where there is an early disposition to another group member. Many advantages result from taking deductions as a group that are not otherwise legally available to the separate companies due to limitations and restrictions.

The adoption of Regulation 13 was in accordance with Utah law and applied specifically to taxpayers, together with the Utah statutes requiring a proper allocation of Federal income tax deductions on the corporate franchise tax return.

POINT II

CORPORATE FRANCHISE TAX REGULATION, NO. 13, APPLIES DIRECTLY TO THE PRESENT SITUATION AND HAS BEEN RECOGNIZED AS APPLICABLE TO SIMILAR SITUATIONS BY THE UTAH SUPREME COURT.

Corporate Franchise Tax Regulation, No. 13, deals directly with deductable Federal income taxes and the allocation of the same. (E-17) The Corporate Franchise Tax Regulation, No. 13, set forth in the Appendix to Appellant's Brief, is *not* the regulation in effect under the present fact situation during the taxable years in question and should be disregarded. (AB-Appendix) (See Exhibit 17) In particular, the second paragraph in Section 13.3 (a) is not found in the Regulation 13 applicable to this situation. Appellant's argument (AB-19) that the addition to the regulation, to be effective for tax years after January 1, 1973, as indicative of the Tax Commission's own admission of lack of regulative support for its position in this matter, is untenable. This argument is irrelevant and bears similarity to the "subsequent repairs" reason for nonadmissibility of evidence under the Utah Rules of Evidence 51. There are other minor word changes in appellant's Regulation 13 that should be disregarded. The correct regulation is Exhibit 17.

The applicable portions of Corporate Franchise Tax Regulation, No. 13, effective for all taxable years beginning after October 31, 1964, are, as follows:

> "4. Allocation of federal income taxes. . . .(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.

(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 proportionate 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 the case of an accural 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." (Emphasis added.)

The above-cited sections of Regulation 13 are most applicable to appellants' fact situation. Sections of Regulation 13 cited in the Conclusions of Law deal specifically with the requirements that the taxes be "actually paid." In the case of *Kennecott Copper Corporation v. State Tax Commission of Utah*, 27 Utah 2d 119, 125, 493 P.2d 632 (1972), this Court, in considering the same question regarding the deductibility of Federal income taxes by an affiliated group of corporations, held that Regulation 13 as applied by the State Tax Commission was binding upon Kennecott and gave rise to no error in its application. The exact same method of apportioning and allocating the Federal income tax deduction in the *Kennecott* case which was approved by this Court was applied in the present situation to taxpayers. The *Kennecott* case, cited above, is a judicial recognition by this Court of the applicability of respondent's Corporate Franchise Tax Regulation, No. 13, to similar situations and to the taxpayers involved herein.

The Federal regulations regarding affiliated corporations filing Federal consolidated income tax returns provide four basic allocation methods, as follows:

1. A taxable income method. (See Treas. Reg., Section 1.1552-1 (a) (1).)

2. The separate return liability method. (See Treas. Reg., Section 1.1552-1 (a) (2).)

3. The tax increase allocation method. (See Treas. Re., Section 1.1552-1 (a) (3).)

4. Discretionary method. (See Treas. Reg., Section 1.1552-1 (a) (4).)

All taxpayers filing a Federal consolidated income tax return must utilize one of the above-basic methods. However, in addition to these basic methods, certain qualifying groups may also further allocate Federal taxes as provided by Treas. Reg., Section 1.1502-33 (d) (2).

Such further allocation is grounded upon the fact that when affiliated corporations join together for the purpose of filing a consolidated tax return, it is generally agreed between them that profit members will compensate loss members in amounts necessary to reflect the fact that the profit members tax would have been greater if a loss member had not joined in the consolidation. These tax-compensating or excess payments made by a profit to a loss member are treated by the treasury as either a dividend or capital contribution, depending upon whether the payment is made from a profit parent to a loss subsidiary, a profit subisidiary to a loss parent, or between subsidiaries themselves. Likewise, taxes are reduced by moving in and out of different percentage tax brackets, in general.

As a result, the member making such a payment is not entitled to a tax deduction, and the member receiving the payment may be taxed on the amounts so received. The treasury department has provided that corporations qualifying under Regulation Section 1.1502-33 (d) (2) may treat these tax-compensating payments as a deductible tax payment, both to the profit member making the payment and to the loss member receiving it. The resulting tax effect is obvious.

The Utah Regulation 13 specifically prohibits the "red-figure" allocation contemplated by Federal Regulation, Section 1.1502-33(d), and thereby specifically evidences that the Tax Commission has adopted an allocation method contrary to that contemplated by the Federal regulation. In no manner does the Federal regulation attempt to regulate the deductibility of Federal income taxes paid for purposes of a state corporate franchise tax return.

Utah Corporate Franchise Tax Regulation, No. 13, was intended to specifically apply to the present fact situation and was, in fact, applied by the staff of the Tax Commission in assessing additional deficiencies against taxpayers. Taxpayers testified that

Regulation 13 was not appplied by them in their calculation of Federal income taxes to be deducted on their state corporate franchise tax return. (TR-52) This resulted in considerable loss of revenue to the State of Utah and a substantial distortion of the true taxable income of taxpayers for each of the tax years in question. Continental derives substantial benefit by following the procedure adopted under Federal regulations. Any amounts received from profit corporations were dividends to the parent and any amounts transferred to loss corporations were a capital contribution. This changes the investment base and the value of the Continental group, which, apparently, is regulated by various state Public Service Commissions. It is noteworthy, however, that the various Public Service Commissions do not necessarily regulate the various members of the Continental consolidated group to verify and render tax compliance audits.

POINT III

TAXPAYERS' POSITION SHOULD BE REJECTED, AND THE AMOUNT ALLOWABLE AS A DEDUCTION FOR STATE INCOME TAX PURPOSES SHOULD BE EACH AFFILIATED CORPORATION'S PROPORTIONATE SHARE OF THE ACTUAL FEDERAL CORPORATION TAX LIABILITY PAID TO THE FEDERAL GOVERNMENT.

There appears to be no Utah cases specifically resolving the question of what constitutes the proper deduction of Federal taxes for state income tax purposes under the present fact situation. Appellants contend that a separate company calculation paid to a parent corporation, which parent thereafter makes a total consolidated group calculation and delivers the taxes directly to the

Federal Government, allegedly resulting in cash refunds to loss companies and no refunds to profit-making companies, should be adopted since lawful under Federal agreements and regulations. The Tax Commission contends that, to properly reflect income in Utah, the proportionate share of the actual Federal tax liability is the only amount to be allowed as a deduction to arrive at the state corporate franchise tax liability under Utah statutes and Regulation 13. Strangely enough, both the taxpayers and the Utah State Tax Commission can cite a case out of other jurisdictions which is on point, factually, yet reaching opposite results.

Taxpayers cite the Kansas Supreme Court case of *Cities Service Gas Company v. McDonald,* 204 Kans. 705, 466 P.2d 277 (1970), (cited AB-8,9,10), wherein the Kansas Court held that a subsidiary taxpayer, in computing its net income for state income tax purposes, was entitled to take a deduction for Federal income tax paid, accrued or incurred, based on its computation of what it owed the Federal Government on a separate return basis, even though it had joined with other wholly-owned subsidiaries of the parent company in filing a consolidated Federal income tax return showing no tax due, where a parent company does not retain monies received from said subsidiary, but, instead, distributed them along with monies received from other subsidiaries. The Kansas case attempted to differentiate the *Trunkline* case to be cited hereinafter by the Tax Commission on the basis the *Trunkline* case had a specific regulation governing the amount of deduction of Federal income taxes on a state corporate tax return. Apparently, the Kansas case relied upon the reasoning that there was not tax savings to either the parent or the subsidiary company as a result of being included in the consolidated return. (At page 283) Respondent has previously shown substantial tax savings to the parent and subsidiaries. The *Cities Service* case cited by appellants is no longer the law in Kansas. Immediately after the Court's decision, the Kansas Legislature repealed the law granting a deduction for Federal taxes paid. No corporation in Kansas may now deduct any Federal income taxes paid to arrive at a corporate taxable income. (See K.S.A. 1974 Supp. 79-32, 138 (c) (ii) (effective July 1, 1972)) The Kansas Legislature effectively overruled the *Cities Service* case.

Respondent, Utah Tax Commission, cites the case of *Trunkline Gas Company v. Collector of Revenue*, 182 So. 2d 674, aff'd, 184 So. 2d 25 (1965), wherein the Louisiana Court held that the payment by the parent company of Federal income taxes on a consolidated return, which accounts for and includes net income of some affiliates, including *Trunkline Gas*, as well as operating losses of other affiliates, all wholly-owned by the parent company, is not payment in fact of Federal income taxes within the contemplation and intentment of LSA-RS 47:55 and 47:241, as to entitle the Trunkline Gas Company to full credit deduction of the Federal income tax attributable to Louisiana derived income, which it computes to be due the Federal Government as though it were paying this tax on the basis of a separate tax return. (At page 679) Apparently, the Louisiana Court based its decision on the statute requiring payment in fact. It should be noted that the statute providing for the deduction of Federal taxes in Louisiana is the same, word-for-word, as the statute in question in Utah. (See Utah Code Annotated, Section 59-13-7 (3) (1953)) Utah's regulation governing the situation is not worded exactly the same but is intended to and does cover the same situation. Appellants only differentiate their case *(Cities Service)* from the respondent's by saying Utah has no statutes or regulations governing the situation. Utah has statutes and regulations specifically covering the situation, and, further, appellants were aware of these regulations and statutes. (TR-52) In addition to the statutes, regulations, and cases cited by respondent, what policy considerations for the State of Utah should govern the adoption of one position as opposed to the other? The Tax Commission would suggest that the following policy reasons for its position as determinative that the amount of Federal tax deduction should be the proportionate amount actually paid:

(1) The State of Utah is deprived of vital revenues based on Federal tax loopholes that large, corporate taxpayers may take advantage of due to affiliation with corporations having no business or other interests with the State of Utah, but of which local, smaller competitors may not take advantage.

(2) The Utah Legislature should determine who is entitled to a greater reduction in their taxable income, and the Legislature should set the guidelines if affiliated companies are to get tax relief.

(3) The Utah Tax Commission has no authority or ability to audit corporations not doing business in the State of Utah to determine whether the amount contributed by the Utah taxpayers was reasonable in light of the total Federal tax liability.

(4) The Utah taxing authorities have no control over the parent corporation to compel it to assess its subsidiaries only in an amount equal to their tax liability.

(5) The State of Utah should not be required to subsidize the elimination of intercompany profits and transactions between affiliated groups by granting relief from Utah taxes.

(6) The payment of the corporate franchise tax is for the privilege of exercising a franchise with all corporate benefits within the State of Utah, based upon a percentage of taxable income. The reduction of the franchise fee necessarily discriminates against intra-state domestic corporations.

(7) Adoption of appellants' recommendation necessarily ties the State of Utah to everchanging Federal tax regulations in the area of filing consolidated returns and may result in undesirable revenue loss and other adverse effects to the State of Utah should the government change its Federal tax laws for fiscal or other reasons. Again, local regulation is pushed back up to a Federal level.

Based upon the facts hereinabove set forth, showing the discrepancies in amounts paid and apportioned, Continental and taxpayers derive a special benefit not otherwise obtainable under Utah law. The Utah State Tax Commission has the authority to make rules and regulations to properly reflect income. The Utah Code provides that the State Tax Commission may allocate and apportion income and deductions in a manner to prevent the evasion of taxes and properly reflect their taxable income. The additional assessments made by the staff of the Utah State Tax Commission were not arbitrary nor capricious, but were made in accordance with Utah law and regulations and were within the statutory realm of authority granted to respondent, State Tax Commission. Based upon the above-cited policy reasons, the case law and statutes, appellants' method of calculating a deduction for Federal state income taxes should be rejected.

CONCLUSION

State Tax Commission's previous decision assessing the above-stated deficiencies against Midland Telephone Company and Utah Telephone Company as set forth in the Facts, together with interest at six percent until paid, should be affirmed.

Respectfully submitted,

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