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Continental Telephone Company of Utah v. Utah Tax Commission : Reply Brief

Utah Supreme Court

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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

REPLY BRIEF OF PLAINTIFF

On Writ of Review to the State Tax Commission of Utah

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TABLE OF CONTENTS

Page

PRELIMINARY STATEMENT 1

STATEMENT OF THE FACTS 1

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. 5

POINT 2(a). THE DECISION OF THE TAX COMMISSION IS ERRONEOUS INSOFAR AS IT IS BASED UPON AN ALLOCATION PURPORTEDLY MADE UNDER SECTION 59-13-7. 7

POINT 2(b). THE DECISION OF THE TAX COMMISSION IS ERRONEOUS INSOFAR AS IT IS BASED ON THE *KENNECOTT* CASE. 8

POINT 2(c). THE DECISION OF THE TAX COMMISSION IS ERRONEOUS INSOFAR AS IT IS BASED UPON REGULATION 13. 8

POINT 3. THE TAX COMMISSION'S DECISION IS NOT SUPPORTED BY MATTERS NEWLY RAISED HERE. 12

CONCLUSION 18

CASES CITED

Basin Flying Service v. Public Service Commission, ... U. ...., 531 P2d 1303 (1975) 12

Cities Service Gas Company v. McDonald, 204 Kan. 705, 466 P.2d 277 (1970) 5

Kennecott Copper Corporation v. State Tax Commission, 27 U.2d 119, 493 P.2d 632 (1972) 8, 11

Massey-Ferguson Credit Corporation v. Briggs, Director of Revenue (Decision No. 48, Iowa Tax Board, 7/8/74) 5

Northern Natural Gas Processing Co. v. McCoy, 197 Kan. 740, 421 P.2d 190 (1967) 5

TABLE OF CONTENTS—Continued

Page

Trunkline Gas Co. v. Collector of Revenue, (La. App. 1965) 182 So.2d 674 ....5, 6

AUTHORITIES CITED

7 CCH, Standard Federal Reporter, ¶4903.17 13

STATUTES AND REGULATIONS

Utah Constitution, Article XIII, §11 10

Utah Code Annotated 1953:
- Section 59-5-46 10
- Section 59-13-7 5
- Section 59-13-7(3) 3
- Section 59-13-17 ....7, 10, 15
- Section 59-13-23(2) 10

Utah Corporation Franchise Tax Regulations:
- Regulation No. 13 ....7, 8, 9, 10, 11, 12, 13

Louisiana Revised Statutes: §47:241 6

Louisiana Regulation: ITR 55.2 6

Rule 51, Utah Rules of Evidence 9

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REPLY BRIEF OF PLAINTIFF

PRELIMINARY STATEMENT

This brief replies to the matters raised in the Tax Commission brief. The format is that of plaintiff's earlier brief, except that a new Point 3 has been added as to matters presented here by the Commission for the first time. In the discussion which follows, both taxpayers, The Midland Telephone Company and Utah Telephone Company, are for brevity and convenience referred to together as "Midland."

STATEMENT OF THE FACTS

The Tax Commission's description of the process by which Midland's federal tax was computed suggests an overall impression that the first step is the combining by the parent of the subsidiaries' incomes and expenses into a consolidated income figure, and that Midland's separate taxable income is thereafter artificially computed.

Any such impression is incorrect. The Commission's brief says (p. 2) that some of Midland's deductions are excluded initially and deducted after the consolidation. The brief then states (see step (c), p. 2) that "allegedly" each member "then" prepares its own separate, "recomputed" tax liability. The words in quotation marks are added in the Commission's brief and do not appear in the agreed statement (R 8).

In fact, the process operates in the reverse order and is the opposite in substance. Midland's separate computation of its federal tax is the basic, first step (Tr. 30, 32). It is that tax which Midland actually pays to the Internal Revenue Service. The items supposedly excluded from the first step are in fact included and deducted in the initial computation. The Midland witness testified, referring to contributions as an example of such a deduction (Tr. 32): "But it does not mean by any stretch of the imagination that that company does not get to deduct its contributions, it does so." Confusion about the so-called excluded items appears initially in the record (cf. ¶7(a) with ¶7(c); R 8), since such items must also be kept account of for another purpose, that of assuring that the deduction of these items does not exceed an overall limitation imposed upon the federal consolidated return. The quoted testimony was later submitted to clarify the process.

The point of the foregoing is this: the computation process that all Continental subsidiaries (including Midland) must follow is the separate-company procedure. This fact is basic to this case. As the Midland witness stated (Tr. 34):

> "And because of one thing, our closing agreement with the Internal Revenue Service which does not give us an option of doing it any way other than on a separate company basis and two, the various and sundry public utility commissions which also do not give us an option of how we account for these things, we use a separate company calculation."

The single legal problem of this litigation emerges from these central facts, testified to and uncontradicted: Midland first computes its federal taxes separately (Tr. 31, 32). It delivers that tax, by a transfer of actual funds, to its parent. Midland's parent is its sole agent for federal taxation purposes. The parent prepares and files the consolidated return of the entire Continental system and sends in the indicated consolidated tax. If a subsidiary incurs a loss, and if that loss lessens consolidated income, the loss subsidiary gets a refund from Continental in the amount of the tax effect of its loss (R 35). Such refund would be the same had that subsidiary filed its federal return separately (R 36). Neither Midland, nor the Continental system as a system, pays a greater or lesser or different federal tax over the long run by reason of the system's choice of filing a federal consolidated return (R 44-45).

The Utah corporation franchise tax return of Midland is filed by it directly and separately. The taxes-paid deduction taken by Midland in that computation is Midland's separately computed and actually paid federal tax.

The Tax Commission's assignment method is described at pp. 4-5 of its brief. That theory would limit Midland's allowable deduction to a figure arrived at by determining the ratio that Midland's income bears to the incomes of all the profit-making subsidiaries, multiplied by the federal tax of the consolidated group. The practical effect is seen most clearly in a simplified example:

> Assume that the Continental system consists of three operating utility subsidiaries: Midland, having income of $1,000 from Utah operations; a Montana corporation, having income of $1,000 from Montana; and an Alaska corporation, having a $1,000 loss upon Alaska operations. Assume a 50% federal tax rate.
>
> The federal tax result would be: Midland would remit its separate-company tax of $500 to the parent. Montana would remit a $500 tax to the parent. On the consolidated income of $1,000 ($1,000 plus $1,000 minus $1,000) the consolidated tax is $500. Alaska would receive a $500 tax refund from the parent. The parent's books would net out at zero.
>
> As to the Utah franchise tax, on these facts, the Commission's assignment theory would allow Midland a deduction of $250 on its Utah franchise tax return. The deduction would be computed as the ratio of Midland's income to the incomes of Midland and Montana, multiplied by the consolidated tax (1,000 ÷ 2,000 x 500 = 250).

The Commission's method asserts that Alaska's operating loss "saved" $500 of federal tax. Midland is assigned what the Commission says is a proper portion of the "savings." The Commission seeks to lay hold upon this Alaska item and to move it to Utah even though it reflects business done solely in Alaska. The Commission would not, it may be observed, seek to move any of the Alaska operating loss to Utah for purposes of measuring Midland's franchise tax income. The fact of Alaska's federal tax refund is ignored.

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.

The Tax Commission response to Midland's first point appears in Point III of its brief, p. 20, et seq).

The applicable statute, Sec. 59-13-7(3), authorizes the franchise taxpayer to deduct "taxes paid or accrued." As concerns the application of such a statute to cases like this, Midland cited three cases directly supporting its position, *Cities Service Gas Co. v. McDonald,* 204 Kan. 705, 466 P2d 277 (1970); *Northern Natural Gas Processing Co. v. McCoy,* 197 Kan. 740, 241 P2d 190 (1967); and *Massey-Ferguson Credit Corporation v. Briggs,* (Decision No. 48, Iowa Tax Board, 7/8/74). The Commission's response is limited to the observation (p. 22) that by subsequent legislation, "The Kansas legislature effectively overruled the *Cities Service* case." This is exactly Midland's point. The Utah statute authorizes the deduction Midland took. If the law of Utah is to be altered, the legislature is the appropriate agent of government to effect the change.

There is no authority contrary to Midland's position. The case relied upon by the Commission, *Trunkline Gas Co. v. Collector of Revenue* (La. App. 1965), 182 So2d

674, is not in point. The Commission's description of the holding is not correct. The Commission omits any mention of the statute, R.S. 47:241, and regulation, ITR 55.2, on which the decision is based. The statute directs an apportionment of the federal income tax deduction and explicitly empowers the Collector to make rules and regulations to do so. The Kansas court declined to follow *Trunkline,* as Kansas had no such statute and no such regulation. The Utah situation is the same as that in Kansas.

Moreover, the Lousiana allocation method upheld in the *Trunkline* decision differs fundamentally from that sought to be imposed here by the Utah Commission. The Louisiana regulation does not ignore the tax refund payments, as the Utah Commission would seek to do; instead, such payments are taken into account in the computation. The last sentence of the governing regulation, as quoted in the decision (182 So.2d, at 678), so provides.[1] To be accurate about the matter, *Trunkline* is contrary to the position taken by the Utah Commission.

The Commission's brief attempts a showing (pp. 15, 19), that "[s]ubstantial benefits were given the members of the consolidated group by the filing of Continental's consolidated federal return." Except for the matter of the offsetting of losses against gains, none of these had been mentioned in the Commission's findings. The Com-

[1]"For this purpose, the amount of Federal income tax paid by a corporation shall be deemed to be the sum of payments it makes to the Federal Government and payments it makes to any other corporation of the consolidated group in discharge of the tax obligation arising from the consolidation, minus the sum of any payments it receives from the Federal Government and the sum of any payments it receives from any other corporation in the consolidated group in discharge of the tax obligation arising from the consolidation."

mission's theory of "benefits" is accordingly discussed in Point 3 of this brief.

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.

The statute referred to in the heading authorizes the Commission to apportion or allocate income or deductions among affiliated corporations, whether or not they do business in Utah, if the Commission determines that such an allocation is necessary to prevent evasion of taxes or clearly to reflect income.

Midland's first brief argued that the Commission did not make the factual determination necessary to the application of the statute. The Commission response (p. 14) is to claim that such a determination was made in Finding of Fact No. 14 by the recital that unless the audit deficiency were sustained, it ". . . would cost the State of Utah revenue." It is submitted that a mention of this simplistic truism is not a "determination" of the kind intended by Sec. 59-13-17. The Commission did not make the factual determination necessary to call the statute into operation nor did it even purport to do so. Given the record, as a matter of law it could not.

The Tax Commission brief also suggests (p. 10) that Sec. 59-13-17 is a statutory delegation of Commission power to promulgate Regulation 13. That problem is discussed in Point 2(c) below.

POINT 2(b)

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

The Commission's discussion of the *Kennecott* case (*Kennecott Copper Corporation v. State Tax Commission,* 27 U2d 119, 493 P2d 632 (1972)) goes basically to its claim that the decision upholds Regulation 13. This idea is discussed in Point 2(c).

It is sufficient for the present point of the argument to note the error of the Commission's statement (p. 18) that: "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." By the necessities of the situation, the Commission cannot be right about that. The factual differences between the two cases are so marked that the apportioning procedures were necessarily very different. From the standpoint of a judicial precedent, *Kennecott* does not support the Commission argument.

POINT 2(c)

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

Most of the Commission's brief is given over to an effort to save Regulation 13, and to justify its application to Midland during tax years 1965 through 1970.

Two legal obstacles face the Commission in this effort: First, as in effect during those tax years the regulation did not by its own terms apply to a case of this kind. Second, the Commission lacks power to make it applicable, by amendment or construction.

Regulation 13 was revised, after Midland's hearing, by the addition of the new paragraph shown in the initial brief. That the old regulation did not apply appears clearly from a reading of sections relied upon by the Commission in its Findings.[2] Those address subjects wholly different from what is involved in this case. The Commission's re-write of Regulation 13, effective for 1973 and tax years thereafter, shows the correctness of Midland's reading of the old regulation. The Commission's response (p. 16) to this argument is that it bears similarity to the "subsequent repairs" evidentiary rule (Rule 51, Rules of Evidence, which says that evidence of subsequent repair measures is not admissable to prove prior culpability or negligence). The assumed analogy does not exist. It is obvious that that Commission revised

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[2]The Commission's Finding of Fact No. 12 reads in full as follows:
"12. Utah Corporation Franchise Tax Regulation 13 provides:

Deductible Federal Income Taxes and Refunds Thereof — Allocation of Federal Income Taxes. 1. Federal Tax Deductions 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 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."

Regulation 13 to make it say what it had not said before the revision.

Viewed strictly, it may be enough to decide this case, so far as concerns Regulation 13, to conclude that the old regulation, effective during the tax years at issue, does not apply. On this view, Midland's further showing that the Commission has no authority to make the 1973 amendment would be superfluous.

This argument is advanced, however, in response to the Commission's position that the 1973 addition only restates what the regulation always said.

The Commission asserts power to make the new regulation on a number of theories:

(a) General power is said to be delegated in Art. XIII, §11 of the Constitution, and by Section 59-5-46. These delegate only as to procedural matters.

(b) The Commission claims authority in Section 59-13-23(2). That statute empowers the Commission to make substantive regulations governing affiliated groups which file consolidated returns for Utah corporation franchise tax purposes. A regulation based thereon has valid authority for consolidated Utah return matters, but it cannot apply here. Midland did not file a Utah consolidated return.

(c) The Commission asserts that regulation-making power comes from the allocation authority granted by Section 59-13-17 governing the allocation of income deductions between several corporations controlled by the same interests. By its own provisions, the statute does not operate until after the Commission ". . . determines that such distribution, apportionment or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of such corporations." No such claim was made here, no evidence to that effect was adduced and no related findings made. That statute provides for the examination of claimed distortions and provides the state a remedy; it does not grant or imply a power to legislate.

(d) The Commission asserts that the *Kennecott* case holds that Regulation 13 is valid and that it applies to situations like Midland's. *Kennecott* does not so hold. That case involved a multi-state group of companies reporting Utah income and non-Utah income, and filing a consolidated corporation franchise tax return with the Commission for Utah tax purposes. This court stated that the Kennecott consolidated group "bound" its members to the Utah regulations (493 P2d, at 636) by filing a Utah consolidated return. The case does not support any inference that it is within the Commission's statutory power to write or re-write a new provision into Regulaton 13 applicable to Midland which did not so file.

Midland's brief made the point that the pattern of the tax statutes, which extend substantive rule-making power in some tax areas, and withhhold it in others (including the taxes-paid deduction area), shows the absence of delegated authority in the case of Rule 13. The Commission's response (p. 14) assumes that Midland has made an *expressio unius* argument, and claims that for some reason that rule is not valid in tax matters. Midland's point is more fundamental. The applicable rule is a matter of basic governmental law. This

Court said in *Basin Flying Service v. Public Service Commission,* .... U. ...., 531 P2d 1303 (1975), in connection with powers of the Public Service Commission, that (531 P2d 1303, at 1305):

> In harmony with this it is well established that a regulatory body such as the Public Service Commission, which is created by and derives its powers and duties from statute, has no inherent regulatory powers, but only those which are expressly granted, or which are clearly implied as necessary to the discharge of the duties and responsibilities imposed upon it [citations omitted].

That rule applies here with like force.

POINT 3

THE TAX COMMISSION'S DECISION IS NOT SUPPORTED BY MATTERS NEWLY RAISED HERE.

This part of Midland's brief discusses theories and arguments that were neither presented to the Commission nor reflected in its findings and conclusions, but are urged here for the first time.

(a) At pages 16-17 of its brief, and at page 19, the Commission quotes from, and now relies upon, Sec. 4 of Regulation 13.

Sec. 4 concerns itself with assignments of the federal income tax deduction among the various items or divisions of a taxpayer. The references are to "items" and "divisions" of one taxpayer's overall business and is applicable to multi-state operations of that business. There is no reference to separate but affiliated corporations, and thus in the present case there is no subject matter to which Sec. 4 can apply. The Commission was right the first time to omit Sec. 4, and this afterthought does not help its position.

(b) The Commission's brief attempts a showing (p. 15) that "[s]ubstantial benefits were given the parent corporation and each member of the consolidated group" by the filing of a consolidated federal return, mentioning some ten listed in 7 CCH, Standard Federal Tax Reporter, ¶4903.17. Another purported benefit is mentioned on p. 19: ". . . taxes are reduced by moving in and out of different percentage tax brackets, in general."

The Commission's findings refer only to one such claimed benefit. Finding of Fact 6 mentions an assumed benefit in the offsetting of operational losses against profits. (In the example given in the statement of facts of this brief, this would be the offsetting of the Alaska loss against the incomes of Midland and Montana.) That is the "benefit" on which the Commission based its decision. The other matters are merely afterthoughts, not considered at the time the decision appealed from was made.

Moreover, the point is immaterial. The federal tax laws levy the tax provided for; the local taxing authorities make other levies; the franchise tax law provides that all these may be deducted. If some "benefit" in the other taxes lessens their impact, then the franchise taxes-paid deduction is lessened and the franchise tax increases.

The Commission's list of assumed benefits includes the claim (p. 19) that on a consolidated return "taxes are reduced by moving in and out of different percentage tax brackets." The Commission was speaking only generally, as the record and testimony show that no such factor is or could be present in this case (Tr. 57-58).

In its Point II (p. 18) the Commission lists the four methods provided in federal regulations for the computation of a consolidated return: (1) a taxable income method; (2) a separate return method; (3) a tax increase allocation method; and (4) discretionary methods. The basic fact in this case is that Midland's federal return was computed on the separate-return basis. The federal closing agreement with the IRS so provides, and that method is also imposed by the regulatory commissions. The further basic fact is that the separate-return method forecloses the benefits the Commission now brings up.

(c) The Tax Commission brief suggests seven policy reasons for its position, which are said to be "determinative." So far as these are accurately labeled "policy reasons" they are of course presented in the wrong forum. So far as they constitute argumentation they are replied to below, in the order appearing in the Commission's brief (pp. 23-24).

(1) It is said that unless the Commission prevails, the State is "deprived of vital revenues based on federal tax loopholes" that "large, corporate taxpayers" may take advantage of by reason of their affiliations with out-of-state interests, but of which "local, smaller competitors" may not take advantage.

The rhetoric need not be responded to. That aside, the point is empty of real content. No federal loophole was taken advantage of by Midland, as the record demonstrates. As concerns the notion that Midland is given advantage over smaller competitors, it can be noted that Midland is a regulated monoply and is without a competitor of any size; apart from that, not many telephone companies are more "local" than Midland, or "smaller."

(2) We are told by the Commission that it is the Utah Legislature which should determine who is entitled to a greater reduction in their taxable income, and that it is the legislature which should set the guidelines if affiliated companies are to get tax relief.

Midland would agree with this.

(3) The Commission states that it lacks authority or ability to audit corporations not doing business in Utah to determine whether the amount contributed by the Utah taxpayer was reasonable in light of the total federal tax liability.

The argument is incorrect. Section 59-13-17 provides otherwise and this case demonstrates otherwise.

(4) The Commission complains that 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.

It is accurate to say that the Commission has no such control or power of compulsion. Nor should it. If what is meant is that the Commission may not, for franchise tax purposes, disallow an excessive "assessment," then the statement is simply wrong.

(5) We are told that the State of Utah should not be required to subsidize the elimination of inter-company profits and transactions between affiliated groups by granting relief from Utah taxes.

This platitude has nothing to do with the present case.

If it is the Commission's notion that Midland or Continental have found a way to do away with federal taxes on inter-company transactions, then the Commission is wrong. The treatment of profits upon Continental's inter-company transactions, for federal income tax purposes, was shown the Commission and is before the Court as reflected in testimony and in the closing agreement with the Internal Revenue Service (Exhibit 16). That agreement does not "eliminate" the profit or the tax on these transactions but defers them (or takes account of them in increments) over the life of the plant item. As the Midland witness stated, the profit is attributed to the operating utility. The benefit obtained by deferring the tax is that the borrowing costs of the utilities are lessened. This of course raises income, and this raises the franchise tax. The Commission is arguing with itself.

(6) The Commission tells us that the corporation franchise tax is upon the privilege of exercising a franchise with all corporate benefits within the state, based upon the percentage of taxable income, and that the reduction of the franchise fee necessarily discriminates against intra-state domestic corporations.

The short answer is that no "reduction" is present. Midland's deduction for federal taxes paid was the same as it would have been if no federal consolidated return had been filed. The Commission has assumed its answer before commencing any analysis of the problem. Indeed, it is the Commission which seeks to bring in outside factors to vary Midland's taxable Utah income because of occurrences outside this state.

(7) As a final item, the Commission argues that "Adoption of appellant's recommendation necessarily ties the State of Utah to everchanging Federal tax regulations in the area of consolidated returns and may result in undesirable revenue loss and other adverse effects to the State of Utah should the government change its fedral tax laws for fiscal or other reasons. Again, local regulations are pushed back up to a federal level."

The argument is a legislative argument. It may be observed that during all of the history of the Utah income tax, upon persons and upon corporations, we have all been accustomed to deducting the taxes levied by other tax-laying authorities. If the tax collector wishes this fundamental pattern changed, it has chosen the wrong forum in which to make the effort.

Midland cannot forebear the observation that the Commission's arguments and its "policy" presentation bespeak a preoccupation with matters other than the one before the Court. Midland's case is its own case. Midland is a taxpayer which, because of the separate-company accounting method laid out for it and because of its intensely regulated way of life as a public utility, does not present a case of the kind the Commission affects to be concerned about. It is time for a decision of the Court that the Commission is and has been wrong about this case, on its merits.

CONCLUSION

Tax Commission Decision No. 288 is incorrect and should be reversed.

Respectfully submitted,

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