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Western Contracting Corporation, An Iowa Corporation v. State Tax Commission : Plaintiff's Brief

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IN THE SUPREME COURT OF THE STATE OF UTAH

WESTERN CONTRACTING CORPORATION, a [redacted] corporation,
Plaintiff,

vs.

STATE TAX COMMISSION,
Defendant.

No. 10322

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PLAINTIFF'S BRIEF

Original Proceeding for Review of Decision of State Tax Commission

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STATEMENT OF KIND OF CASE

This is an original proceeding pursuant to Section 59-13-46 Utah Code Annotated 1953 for review of a decision of the State Tax Commission approving a deficiency assessment in plaintiff-taxpayer's corporation franchise tax for the calendar year 1962.

DISPOSITION BY STATE TAX COMMISSION

The Tax Commission, on the basis of a stipulation of facts, exhibits, and memoranda submitted by counsel for plaintiff and the Commission, approved a deficiency assessment as proposed by the Commission's auditing division. The effect of the approval was to apply a "segregated accounting method" in such a way that plaintiff's tax assessment was based upon a "constructive" income that greatly exceeded its total net income for the year in question.

RELIEF SOUGHT ON APPEAL

Plaintiff seeks reversal of the decision of the Tax Commission and remand of the case to the Commission with directions that it assess plaintiff's franchise tax in such a manner that (1) the taxable income will not exceed the net income, and (2) the assessment will not exceed an amount based upon allocation to Utah of "the proportion of net income fairly and equitably attributable to the state."

STATEMENT OF FACTS

Western Contracting Corporation, plaintiff, is an Iowa corporation which, since its incorporation in 1917, has had its principal place of business in Sioux City, Iowa. It has been qualified to do business in Utah and has filed Utah tax returns since August 8, 1955.

In 1958, plaintiff commenced a stripping contract for Kennecott Copper Corporation in Bingham Canyon, Utah. A second stage of the stripping contract was commenced in 1960, and completed in 1961. Income from a third stage, commenced in 1961 and completed in 1962, is the subject of this proceeding.

During 1962, the company also engaged in major constructing activities such as bridge construction, dredging, and stripping in the states of Louisiana, New Jersey, Pennsylvania, California, Iowa, Wisconsin, and South Dakota.

In compliance with the provisions of subsection 4 of Regulation 8, Corporation Franchise Tax Act, issued by the State Tax Commission, and dealing with exceptions to the statutory method of allocation of net income, the plaintiff filed its Utah franchise tax return for calendar 1962 using the segregated accounting method, and allocated equivalent federal income taxes of $905,-443.46 against the net income before federal income taxes allocated to Utah by this method ($1,741,237.43), resulting in net income for Utah corporation franchise tax purposes of $835,793.97. Plaintiff has regularly filed its federal income tax returns using the "completed contract" basis of accounting and has used the same method of accounting for filing its Utah state franchise tax returns. The auditing division has proposed an additional assessment of franchise taxes for calendar 1962 in the amount of $32,913.39 plus interest, based primarily on the disallowance of a substantial portion of the claimed deduction for federal income taxes.

Plaintiff reported in 1962 net income before federal income taxes of $555,088.31, and paid federal income taxes of $183,215.11, resulting in total net income from operations in that year of $371,873.20. The proposed assessment would create net income assignable to Utah of $1,626,985.92. Details of the gross receipts, deductions, and elements of the allocation factors and specific allocation items set forth in the statutory formula are itemized in the Stipulation of Facts found on pages 9 through 15 of the Transcript of Record.

ARGUMENT

I

INCOME ALLOCATED TO UTAH FOR CORPORATION FRANCHISE TAX PURPOSES MAY NOT EXCEED THE TOTAL NET INCOME OF THE CORPORATION.

Section 59-13-3 Utah Code Annotated 1953 provides for a corporation franchise tax as follows:

> " . . . equal to 4 per cent of its *net income* for the preceding taxable year computed and allocated to this state in the manner hereinafter provided, or 1/20 of 1 per cent of the fair value during the next preceding taxable year of its tangible property in this state, whichever is greater; but in no case shall the tax be less than $10." (Emphasis added.)

For corporations doing business in more than one state, 59-13-20 provides for the determination of net income in the state of Utah for the purpose of establishing the basis for the imposition of the franchise tax.

> "The portion of net income assignable to business done within this state, and which shall be the basis and measure of the tax imposed by this chapter, may be determined by an allocation upon the basis of the following rules: . . ."

After certain specific allocations of interest, dividends, and gains from the sale or exchange of capital assets, subsection 5 of section 59-13-20 provides:

> "If the bank or other corporation carries on no business outside this state, the whole of the remainder of net income may be allocated to this state."

Subsection 6 sets forth the basic allocation formula whereby income from a multi-state corporation is to be allocated to the individual states. In these quotations, the words "net income" are used repeatedly, indicating the intent of the legislature that the franchise tax is to be based on the net income of the corporation and that specialized rules in apportioning or allocating such income where necessary still deal with the same basic concept.

It is not necessary to look outside the statute to find the meaning of "net income." Section 59-13-6 defines it:

> "Net income" means the gross income computed under section 59-13-5, less the deductions allowed by section 59-13-7."

Gross income is defined in section 59-13-5, with certain items excluded from gross income for purposes of the franchise tax computation. Similarly, section 59-13-7 sets forth specified deductions from gross income in computing net income. Not all expenses of business operations are deductions from gross income as defined in the Utah statutes. In applying these various definition statutes, including particular items of gross income and deducting specific items from gross income, we derive a statutory concept of "net income" which in turn is the basis for the application of the corporate franchise tax and for the allocation of income for corporations doing business in more than one state. Any allocation of income or tax on income is limited to the amount of such income derived pursuant to the statute. Even subsection 8 of section 59-13-20, which gives the Tax Commission power to allocate to the state of Utah income of the taxpayer apart from the general apportionment statute, provides:

> "If in the judgment of the Tax Commission the application of the foregoing rules does not allocate to this state a proportion of *net income* fairly and equitably attributable to this state, it may with such information as it may be able to obtain make such allocation as is fairly calculated to assign to this state the portion of income reasonably attributable to the business done within this state and to avoid subjecting the taxpayer to double taxation." (Emphasis added.)

The intent of the legislature is clear: the corporate franchise tax is to be based upon "net income" as defined in the statute, subject to the minimum taxes and an alternative tax based upon tangible property in the state. Any method of allocation derived by the Commission under its powers in subsection 8 of section 59-13-20 or in its regulations interpreting this section are subject to the overall limitation of net income. To hold otherwise would subject some "gross" income to tax rather than "net" income as required.

Plaintiff's net income after federal income taxes for the calendar year 1962 amounted to $371,872.20. In accordance with the regulations of the State Tax Commission, plaintiff reported its income in Utah for the year using segregated accounting and after making some allocation assumptions concerning this income, at $835,793.97. This reported amount exceeds 200 per cent of the total net income of plaintiff for the calendar year 1962. The proposed deficiency assessment by the State Tax Commission assigns net income in the amount of $1,626,985.92 to business done in Utah, an amount which exceeds four times the total net income reported by the corporation for the year. The effect of the proposed allocation used by the State Tax Commission is to depart from the allocation of net income as defined in the statute, and instead to allocate gross income found in Utah after the deduction of only specified deductions in Utah.

This Court, in the case of *New Park Mining Company v. State Tax Commission*, 113 Utah 410, 196 P.2d 485 (1948), in an attempt to interpret the allowance for depletion, held:

> "Mining corporations must deduct federal income and excess profit taxes, before calculating the depletion allowance to which they are entitled in computing their corporate franchise taxes under a statute providing that allowance for depletion shall be one-third of 'net income' from property during the taxable year."

This depletion deduction is authorized specifically in section 59-13-7, Utah Code Annotated 1953, which provides for this deduction for depletion pursuant to rules and regulations prescribed by the State Tax Commission. Regulation No. 12 of the State Tax Commission sets forth the rule for the depletion deduction, and establishes an alternative deduction based on cost or "33 1/3 per cent of the net income of the taxpayer from the property during the taxable year computed without allowance for depletion." The same regulation later defines net income as follows:

> "Net income from the property must be computed by deducting from gross income from the property all deductions allowed by statute in computing taxable net income (excluding the allowance for depletion) to the extent that they are applicable to the property. The requisite deduction shall include overhead and operating expenses, development costs to extent claimed or allowed as a deduction on the return, depreciation, taxes, including federal income taxes, losses sustained, etc."

It is clear, therefore, that both the Tax Commission and the legislature have decided that the term "net income" as used in certain of the sections of the chapter dealing with corporate franchise taxes refers to defined "net income"—gross income from items taxable in Utah less specified deductions.

This term has also been defined in many cases in many jurisdictions. The following are typical:

> "A tax may be imposed only upon 'net income' which is defined as the gross income of the taxpayer, less the deductions and exemptions allowed by law." *Morley v. Remmel,* 221 S.W. 2d 51; 215 Ark. 434.
>
> "Net income, or earnings, are the products of a business, deducting the expenses only." *Jones & Nimick Mfg. Co. v. Commonwealth,* 69 Pa. 137.
>
> "Net income means profit, and profit is derived, in any business in which capital is lost or depleted, only after the expenses of conducting the business are paid, and return is made of the capital invested which is gone." *Carter v. Phillips,* 212 Pac. 747, 88 Okla. 202 (1923).
>
> "Necessarily, net income for tax purposes is a conception of the income tax statute, and amount arrived at is ascertained by deducting from gross amount of income received by taxpayer from all sources, the specified deductions allowed to it by statute, even though for corporate purposes only, net income may be arrived at by the deduction of entries and accounts not permissible for taxation purposes." *American Can Co. v. Bowers,* 35 F.2d 832 (1929).
>
> "The words 'net income' being used in their common and usual meaning mean the income remaining after the deduction of all charges,

outlay, loss, etc." *People ex rel. Standard Oil Company of New York v. Law*, 200 N.Y.S. 72, 205 App. Div. 531.

> "The state legislature in taxing net income cannot exclude as deductions from gross income such items as ordinary and necessary expenses of doing business, including salaries, rentals, interest, losses, and bad debts." *Cook v. Walters Dry Goods Co.*, 206 S.W.2d 742, 212 Ark. 485.

An attempt by the State Tax Commission to tax more than net income of the corporation, as being properly allocable to Utah, violates the commerce clause, Article I, Section 8, Clause 3, of the Federal Constitution. In the case of *Gwin, White & Prince v. Henneford*, 305 U.S. 434, 83 L.Ed. 272, 59 S.Ct. 325 (1938), the United States Supreme Court in interpreting a state tax said:

> "The present tax, though nominally local, thus in its practical operation discriminates against interstate commerce, since it imposes upon it, merely because interstate commerce is being done, *the risk of a multiple burden to which local commerce is not exposed.*" (Emphasis added.)

In that case, the court said that the *application* of the statute discriminated against interstate commerce. The same would appear to be true in the case of the Utah Corporation Franchise Tax Act. If the State Tax Commission interprets it in such a way that a company doing business in interstate commerce can be forced to pay a greater tax under that interpretation of the Act than a corporation doing business solely within the State of Utah, the taxing statute discriminates against interstate commerce. Such a result is obvious in the case in point. If plaintiff were a Utah corporation, it would pay tax only on its total net income. It is inequitable to require plaintiff to pay tax under the Utah Franchise Tax provisions on any amount in excess of net income simply because the corporation is doing business in interstate commerce.

In a Pennsylvania case where the starting point for allocation is net income, not as determined by state statute, but as returned to and ascertained by the federal government, a company had an overall net loss on its federal return, but it had a net gain in Pennsylvania. In denying the Commonwealth the authority to tax gain, the court said:

> "We are unable to comprehend how a net loss can be construed as net income. The tax is levied on each dollar of net income, not on each dollar of net loss. If we are correct in this hypothesis, there is no net income as defined . . . to be allocated and apportioned . . . in which event no tax is due for the period involved."

The court went on to say:

> "The Act imposes no tax on a net loss, and when there is a net loss there is no net income to be allocated or apportioned." *Commonwealth v. Columbia Steel & Shafting Co.*, 83 D & C 326, 62 Dauph 1 (Pa. Common Pleas, 1952).

Where a legislature has intended a different result, the statute has clearly said so. For example, in the case of *Edward Hines Lumber Co. v. Galloway,* 175 Ore. 524, 154 P.2d 539 (1944), the Oregon Supreme Court said in connection with this question:

> "Is it essential that a corporation which does business both within and without this state . . . had a net over-all income before the defendants are authorized to assess against it the corporation excise tax . . . or will it suffice if the corporation's Oregon business yielded a net income; . . ."

In answering this question, the court said:

> "Manifestly, when the legislature wrote our statute, it could have embraced either the proposition submitted by the plaintiffs or the one for which the defendants contend; that is, it could have made the Act provide that no corporation doing business both within and without Oregon should be liable for a tax unless its total operations resulted in a net income; or it could have provided that all corporations should be subject to the tax if their Oregon business yielded a net return regardless of the results achieved in other states. Obviously, one or the other proposition was embraced by the legislature. A choice was necessarily made. In determining which was chosen, we must of course look to the statute. Hence, the first of the two issues calls for nothing more than statutory construction."

The court then analyzed the statutory provisions and decided that the Oregon tax base was net income from within Oregon. The most pertinent statutory words were found to be:

> "The determination of net income shall be based upon the business done within the state."

The Utah statute does not define net income for Utah franchise tax purposes in the same way that the Oregon statute defined it for Oregon purposes. Rather, our statute clearly indicates that the net income of the taxpayer everywhere is to be assignable to business done within the state, based on a statutory formula, subject to a modification of that statutory formula in unusual cases, but still dealing with "the portion of net income" as a limiting factor.

It follows that the maximum amount of net income that could be allocated to Utah under any formula devised by the State Tax Commission in the event that the statutory formula does not equitably allocate the correct amount of income to Utah, is $371,873.20, the total net income of plaintiff for the calendar year 1962. Any holding to the contrary is in direct conflict with the terms of the statute, the normal meaning of the term net income, and the requirement of the statute that the taxpayer is not to be subjected to double taxation.

II

PLAINTIFF IS ENTITLED TO USE THE STATUTORY ALLOCATION FORMULA IN CALCULATING THE AMOUNT OF INCOME SUBJECT TO TAX IN THE STATE OF UTAH.

Section 59-13-20 of the Utah Code Annotated 1953 sets forth the procedure to be followed in determining the net income allocated to the State of Utah. This section begins:

> "The portion of *net income* assignable to business done within this state, and which shall be the basis and measure of the tax imposed by this chapter, may be determined by an allocation upon the basis of the following rules: . . ." (Emphasis added.)

Following subsections provide for the specific allocation of certain items such as interest, dividends, and gains from the sale or exchange of a capital asset. Subsection 6 sets forth the allocation formula to be used for taxpayers doing business in more than one state, as follows:

> "(6) If the bank or other corporation carries on any business outside this state, the said remainder may be divided into three equal parts:
>
> "(a) Of one third, such portion shall be attributed to business carried on within this state as shall be found by multiplying said third by a fraction whose numerator is the value of the corporation's tangible property situated within this state and whose denominator is the value of all the corporation's tangible property wherever situated.
>
> "(b) Of another third, such portion shall be attributed to business carried on within this state as shall be found by multiplying said thir[d] by a fraction whose numerator is the total amoun[t] expended by the corporation for wages, salarie[s] commissions or other compensation to its em[-] ployees and assignable to this state and whos[e] denominator is the total expenditures of the co[r-]

poration for wages, salaries, commissions, or other compensation to all of its employees.

"(c) Of the remaining third, such portion shall be attributed to business carried on within this state as shall be found by multiplying said third by a fraction whose numerator is the amount of the corporation's gross receipts from business assignable to this state, and whose denominator is the amount of the corporation's gross receipts from all its business.

"(d) The amount assignable to this state of expenditures of the corporation for wages, salaries, commissions or other compensation to its employees shall be such expenditures for the taxable year as represent the compensation of employees not chiefly situated at, connected with or sent out from, premises for the transaction of business owned or rented by the corporation outside this state.

"(e) The amount of the corporation's gross receipts from business assignable to this state shall be the amount of its gross receipts for the taxable year from

"(1st) Sales, except those negotiated or effected in behalf of the corporation by agents or agencies chiefly situated at, connected with or sent out from premises for the transaction of business owned or rented by the corporation outside this state, and sales otherwise determined by the tax commission to be attributable to the business conducted on such premises,

"(2nd) Rentals or royalties from property situated, or from the use of patents, within this state.

"(f) The value of the corporation's tangible property for the purpose of this section shall be the average value of such property during the taxable year."

Subsection 8 of this statute provides:

> "If in the judgment of the tax commission the application of the foregoing rules does not allocate to this state the proportion of net income fairly and equitably attributable to this state, it may with such information as it may be able to obtain make such allocation as is fairly calculated to assign to this state the portion of net income reasonably attributable to the business done within this state and to avoid subjecting the taxpayer to double taxation."

The legislature must have intended the allocation formula, combined with the specific allocations of particular items, to be the normal method by which multistate corporations would pay a tax to the State of Utah on a proportionate share of their income. It is only in the event that the application of the general formula does not allocate to this state the proportion of net income fairly and equitably attributable to the state that the Tax Commission has the power to depart from the formula.

This Court has considered this subsection in two cases germane to our discussion. Justice Wolfe, concurring in part and dissenting in part, in the case of *California Packing Corporation v. State Tax Commission*, 97 Utah 367, 93 P.2d 463 (1939), made the following statement:

> "The very reading of subsection 8 precludes any other construction (referring to the departure from the allocation rules when that is required to be fair to either the state or the taxpayer). In determining the portion of net income assignable to business done within this state, the Commission 'may' use a rule set out in the main opinion. This does not mean that the Commission may ignore the rules and choose its own. 'May' has the meaning of 'should,' i.e., should follow the rules unless the rules fail to accomplish the overarching purpose as revealed by subsection 8. It is only in case an application of the rules as laid down fails to allocate to this state the proportion of net income fairly and equitably attributable to this state, or on the other hand, where the rules would subject the taxpayer to so-called double taxation that the Commission may depart from them."

The same approach was used in the case of *Kennecott Copper Company, et al. v. State Tax Commission*, 118 Utah 140, 221 P.2d 857 (1950), in which Justice Pratt made the following comment:

> "We have decided that the Commission 'should' follow the legislative formula, *unless* it fails to accomplish the purpose of the formula. With such a foundation upon which to act, *neither the Commission nor this court should reject the formula because of the laborious task possibly attendent upon its application.*" (Emphasis added.)

Thus it is clear that the legislature intended that, except in most unuusal cases, the statutory formula set forth in subsections 1 through 7, inclusive, should be applied, and that consistent with such legislative intent this court has held that subsection 8 should be applied only in most unusual cases.

The Court has gone further and said that even if subsection 8 is applied, any formula so devised must be equitable to the taxpayer and to all others similarly situated. A taxpayer conducting a unitary business such as this plaintiff, operating in several states, should be subject to tax only on a reasonably allocable portion of such income in any of the individual states. The statutory formula was designed to accomplish this purpose.

The Commission, pursuant to the authority of subsection 8, has adopted Regulation No. 8. Subsection 4 of that Regulation reads as follows:

> "Exceptions to statutory method. It is the policy of the Tax Commission, based upon court interpretations of the statute, *to require that the method set forth in the statute be used for the assignment of net income within and without this state.*" (Emphasis added.)

This subsection of the Regulation goes on to outline the Tax Commission's authority to modify this statutory formula and pursuant to this power makes the following provision:

> "The segregated accounting method is generally required in the case of mining companies, contractors, ranch and farm corporations, and may be required in the case of certain financial

institutions or other corporations upon audit and review of the returns filed, if necessary to produce a reasonable result."

The intent of the legislature in using the statutory formula to determine the amount of income that should be assigned to Utah where corporations are "doing business" both in and outside Utah, is set forth by the Commission in the same subsection 4 of Regulation 8:

> "There is a strong presumption that the application of the statutory method of assigning net income will produce a reasonable allocation of net income within and without this state, and it must be used in all cases except those in which the Tax Commission has determined that an exception should be made. It should be emphasized that the statutory method may produce an income assignment substantially different from that produced by some other method (such as segregated accounting), but that fact alone is not sufficient to justify an exception. It must be shown that the factors of the formula when applied to the particular business at hand could not be expected to produce a reasonable allocation because of a variance from normal situations with respect to property, wages, and salaries, receipts, rents, interests, dividends, etc., sufficient to invalidate the assumption of a reasonable allocation."

There is no reason why the formula should not be applied to determine the amount of income assignable to Utah from its operations in Utah. The application of the formula does fairly and equitably apportion net income to Utah, and the burden of proof in overcoming the presumption is not met by the Commission when it arbitrarily holds that contractors must depart from the formula.

The problem of taxing income from multi-state operations is a complicated one. All states have recognized this problem, and have developed apportionment formulas in order to tax the income from these corporations so that they would bear a fair share of the cost of government in the various states in which they did business. A substantial majority of these states have adopted a three-factor apportionment formula similar to the one set forth in the Utah statute. The states of California, Idaho, Arizona, and Oregon have adopted a formula using substantially the same three factors to determine the amount of net income properly assignable to an individual state from these multi-state corporations. In the application of these allocation formulas it has become important to determine whether the business of the multi-state corporation is unitary or nonunitary in nature, in that the statutory allocation formulas are generally applicable to the unitary type business, whereas the nonunitary businesses lend themselves appropriately to allocation by the use of separate accounting methods. The Utah State Tax Commission has apparently decided that contractors and certain other types of businesses are "nonunitary" in nature and therefore should file their returns on the basis of separate accounting.

Plaintiff carries on a unitary type business, even though many of the activities necessary in the performance of the particular contract in question were performed entirely within the state of Utah. The factors supporting this contention are as follows:

Plaintiff's only permanent office is in Sioux City, Iowa. Temporary offices are opened in connection with each major project at the job sites. The executive, administrative, and financial offices of the corporation are in Sioux City. There the President and other principal officers have their offices, the Board of Directors regularly holds its meetings, and all of the general company personnel, including the chief engineer, the chief accountant, and managers of the various departments (such as highway construction, heavy construction, marine construction, special projects, materials production, and equipment) are located.

Plaintiff hires people on a permanent basis from the Sioux City area, including project managers, project accountants, project engineers, construction superintendents, and master mechanics. These employees move from project to project and sometimes are transferred before a project is completed. The only people hired by plaintiff at a project are laborers and some clerical help.

Plaintiff's property and equipment are maintained in Sioux City. Equipment is purchased by the manager of the equipment department and is transferred from job to job. When a project is commenced, the project manager is given a control list of suppliers by the executive personnel from whom he can acquire major items to be used at the project. Repair parts and minor supplies are purchased locally. Major purchases, such as dynamite, for many of the construction jobs are made or specifically approved at the offices in Sioux City.

Each project maintains a separate set of books for that project and prepares and forwards to the home office weekly and monthly reports. The project payroll is prepared at the job site. Depreciation and overhead costs are applied to the monthly and weekly reports in Sioux City, and the financial statements of the corporation are prepared at the general accounting offices. All receipts from the various projects are processed through Sioux City. The banking functions are all handled by the home office. Payroll checks are prepared locally and signed locally. All invoices are matched against purchase orders at the individual project offices, where the checks in payment of those invoices are prepared. These checks, together with the approved invoices, are forwarded to the main offices of the company, where they are signed by the chief accountant. The chief accountant periodically transfers money to the local bank accounts from the general account of the company in order to cover the local payroll checks on each project.

All permanent records in connection with the payrolls on the individual projects are maintained in Sioux City and the quarterly payroll reports to the various governmental organizations are prepared there.

A permanent staff of approximately forty-five persons is maintained at the Sioux City offices. The individual project managers are called there regularly to review progress on individual jobs. All bidding, major supply purchasing, and equipment purchases are handled from the head office. All important decisions in connection with the individual projects, including modifications on these projects, are cleared with Sioux City. The functions handled by the individual project managers could be classified as ministerial in nature, with all of the managerial functions performed by personnel at the headquarters of the company.

Plaintiff contends, based on the above factors, that it is unitary in nature and therefore the allocation formula should be applied to its total net income for the purpose of determining the fair and equitable portion of such net income that should be taxed in the state of Utah.

The United States Supreme Court in interpreting a statute that is very similar to the Utah statute clearly set forth the rule in connection with the use of an apportionment formula. In ***Butler Bros v. McColgan,*** 315 U.S. 501, 86 L.Ed. 991, 62 S.Ct. 701 (1942), the court said, quoting from ***Hans Rees Sons v. North*** *Carolina*, 283 U.S. 123, 75 L.Ed. 904, 51 S.Ct. 385 (1931):

> "The enterprise of a corporation which manufactures and sells its manufactured products is ordinarily a unitary business and *all the factors in that enterprise are essential to the realization of profits.*" (Emphasis added.)

The court went on to say that by the same token, the state of California could treat the appellant's business in that case as a unitary one, and justified its ruling on the following **factors:**

> "There is unity of ownership and management. The operation of the central buying division alone demonstrates that functionally the various branches are closely integrated."

In that case, the appellant operated branch wholesale distributing houses in several states, including one at San Francisco, California. Each of these branches maintained a stock of goods, served a separate territory, had its own sales force, handled its own sales, and all solicitations, credit and collection arrangements in connection therewith, and kept its own books of account. All the purchases made for the various wholesale distributing houses were made through a central buying division, the goods ordered being shipped by the manufacturer directly to the houses for which they were ordered. The cost of the goods and the transportation charges were entered on the books of the house which received the goods. No charges were made against that particular house for the benefit of any of the houses by reason of the centralized purchasing. The actual cost of operating the centralized buying division was allocated among the houses. The greater part of the appellant's other operating expenses was incurred directly and exclusively at the respective houses. Certain items benefiting all of the distributing houses were paid by the appellant and allocated to them. Included in such expenses were executive salaries, certain accounting expenses, the cost of operating the central buying division, and the central advertising division. Except for these common expenses, each house was operated independently of each other house. The California house, keeping its books using generally accepted accounting principles, and after allocation of common expenses, reported a loss of approximately $82,000, while the total profit for all of the houses was approximately $1,150,000. The court continued:

> "We cannot say that property, payroll, and sales are inappropriate ingredients of an apportionment formula. We agree with the Supreme Court of California that these factors may properly be deemed to reflect 'the relative contribution of the activities in the various states to the production of the total unitary income' so as to allocate to California its just proportion of the profits earned by appellant from his unitary business."

Similar factors were used in *Crawford Mfg. Co. v. State Commission of Revenue and Taxation,* 180 Kan. 352, 304 P.2d 504 (1956), wherein the Supreme Court of Kansas held:

> "A multi-state business is a unitary business for income tax purposes when the operations conducted in one state benefit and are benefited by the operations conducted in another state or states. If its various parts are interdependent and of mutual benefit so as to form one integral business rather than several business entities, it is unitary. . . .

> "The essential test to be applied is whether or not the operation of the portion of the business within the state is dependent upon or contributory to the operation of the business outside the state. If there is such relationship, the business is unitary."

The functions performed by the management and general office personnel of plaintiff are considerably more involved than those in the *Butler Bros.* case, *supra*, and it appears therefore that under the factors considered by the U. S. Supreme Court, plaintiff's operation is clearly a unitary business, and that therefore the formula for determining the portion of income allocable to Utah should be followed in this case. All of the activities of the corporation, both within and without the state of Utah, contributed to the realization of profits by the corporation.

III

THE STATE TAX COMMISSION ERRED IN REFUSING TO ALLOW THE DEDUCTION OF FEDERAL INCOME TAXES ON A SEPARATE ACCOUNTING BASIS.

In the event this Court finds that the net income limitation is inapplicable to the operations of plaintiff in Utah for the calendar year 1962, and that the plaintiff is not entitled to use the statutory formula to determine the amount of income to be allocated to Utah, and further decides that the petitioner must file its returns using the separate or segregated accounting method, a deduction for federal income taxes computed on an equivalent basis is a part of such segregated accounting.

Segregated accounting means that the taxpayer is keeping a separate set of records for the determination of net income from business done within a particular division of a business. This means that the taxpayer accounts for gross revenues and deductions on an individual state or unit basis rather than by total amounts for the operations of the company. Separate accounting is ordinarily appropriate for businesses of a non-unitary nature and has been applied to an oil business doing all production, manufacturing and refining outside the taxing state, particularly where local sales outlets were charged at the market price of products received from the outside producers and refiners, to disconnected railroad lines in different states and to world-wide operations.

The purpose of independent unit, or segregated accounting is not to raise additional revenue but to prevent the imposition of an unconstitutional tax; separate accounting (particularly without legislative sanction) cannot be forced on a taxpayer without his consent. Ordinarily, separate accounting is claimed by certain taxpayers in order to prevent taxing a disproportionate part of income regardless of the type of company or income, if not geared or related to taxable privilege or incident.

This is just contrary to the situation with plaintiff in this case. The plaintiff's gross profit arising from its contract operations in Utah exceeded its gross profits in other states. If the Commission has power to force contractors to file their returns using a segregated accounting method, this indicates that the Commission wants a separate determination of the amount of income earned in Utah. The logical result of such a determination is that all income and expenses directly attributable to Utah should be accounted for in Utah, and those costs that are general throughout the company should be allocated to Utah on some reasonable basis. The basis of allocation used by the plaintiff is not in question in this proceeding with the exception that the amount of the deduction for federal income taxes deducted by plaintiff is in conflict with Regulation No. 13 issued by the State Tax Commission. In that regulation, the Commission takes the position that it 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 are not accepted. Loss items or divisions must not be assigned any federal income tax either positive or negative. In effect, the Commission is saying that only those items that produce a profit should have any federal income tax deduction allocated against them, and that those items that produce a loss have no effect on federal income taxes. This result is absurd. Federal income taxes are paid on the basis of the net income of the taxpaying unit, not on the net income of any individual components of that unit. Those divisions or portions of the unit that have a loss for the period have the effect of reducing the taxes paid by the profit-making divisions of the taxpaying unit. To say that only the divisions of the taxpaying unit that contribute a profit to the organization affected the federal income tax in any given taxable period is simply not in agreement with the facts of the taxing statute. Regulation No. 13 therefore is contrary to a proper determination of net income using the segregated accounting method and is not consistent with the Commission's express desire to use segregated accounting in connection with contractors.

The use of segregated accounting means that all income and expense items should be specifically determined for the particular business done in the State of Utah, and this should logically result in a separate determination of federal income taxes for that particular unit. Federal income taxes are the single most expensive item of cost that most businesses incur, and to say that net income can be determined by using a federal income tax deduction which has been reduced because of losses in other states has the effect of taxing only "net income before federal income taxes" earned in the State of Utah pursuant to the segregated accounting method.

Section 59-13-7, subsection 3, provides specifically, "Taxes paid or accrued within the taxable year" are deductions in the determination of net income. It is an accepted accounting procedure to use the so-called "red figure" method of determining federal income taxes where apportionments are necessary between departments, divisions, or operating units of a particular taxpayer. The American Institute of Certified Public Accountants, in its Accounting Research Bulletin No. 43, pages 87 to 92, deals with this subject as it relates to the proper allocation of income tax to a corporation that is deducting for tax purposes accelerated depreciation or amortization, or where there is any other substantial difference between income per books and income per tax return. The Institute position in this matter is that the financial statements of any given period should show as a deduction the income tax properly paid, based upon generally accepted accounting principles, without regard to the amount actually set up as the tax liability based on the tax returns filed. The most popular elementary accounting textbook, Finney & Miller's Sixth Edition, in its chapter on departmental operations, page 369, clearly indicates that a department that has a loss should have a negative tax figure assigned to it for the purpose of determining the true net income or loss from that particular department. All accountants who prepare certified financial statements use the theory of tax allocation in making adjustments for taxes where the statements based on good accounting principles differ from the statements filed for tax purposes. Either a prepaid tax account or a tax liability account is set up to account for the difference between the amounts paid to the taxing authorities and the amount properly accrued based upon the reportable income of a company for other than tax purposes.

"Segregated" means *segregated,* and it is not within the authority of the Tax Commission in its allocation of net income, "as is fairly calculated to assign to this state the portion of net income reasonably attributable to the business done within this state and to avoid subjecting the taxpayer to double taxation," for it to attempt to force the determination of gross income and specific expenses in Utah using the segregated accounting method and then rely upon the total federal income taxes paid by the corporation based on its total operations for the purpose of determining the amount of the deduction for federal income taxes. If the Commission wants a separate determination of net income in Utah, then the amount deductible for federal income taxes in Utah should be the amount based upon the income before taxes determined separately in the State of Utah rather than the amount of taxes paid based on the total net income, including loss operations in other operating divisions of the company.

The calculation of the amount of such taxes is a relatively simple matter. The net income before taxes allocated to Utah is simply multiplied by the applicable tax rates of the federal income tax law for the year in question. The plaintiff filed its return on this basis and deducted federal taxes of $905,443.46. The Tax Commission seems to be in a position of saying, "Since you had more net income in the state of Utah than for the total operations of the company, we will depart from the allocation formula, but because the losses in other states contributed to a reduction in federal income taxes we will limit your deduction for federal income tax purposes to the amount paid on net income after deducting those losses."

Even the Commission appears to recognize the necessity of matching income within the state of Utah, that created federal income tax, against such taxes, when it finds in its conclusion of law, No. 4:

> "The taxpayer is entitled to deduct no more than the portion of federal taxes paid *which pertains or relates to income from its Utah operations* against its Utah income for Utah franchise tax purposes." (Emphasis added.)

The amount of federal taxes pertaining or relating to income from Utah operations is substantially in excess of the total federal taxes paid based on net income from operations in all states. If the Tax Commission can base the tax on a "constructive net income," it should have no difficulty in determining a "constructive" federal tax on that income.

IV

THE PURPORTED CONTRACT OR AGREEMENT TO FILE UTAH CORPORATION FRANCHISE TAX RETURNS USING THE SEGREGATED ACCOUNTING METHOD IS NOT BINDING UPON PLAINTIFF.

Methods of accounting and the accounting periods to be followed by franchise taxpayers are set forth in 59-13-15 Utah Code Annotated 1953:

> "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) and in accordance with the method of accounting regularly employed in keeping the books of said taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the tax commission does clearly reflect the income."

The Tax Commission is authorized, if at all, to require a taxpayer to enter into an agreement by which taxpayer gives up some rights in order for the taxpayer to receive permission to use its regular method of accounting employed on its books, only when such method of accounting does not clearly reflect the income of the taxpayer. This burden of showing that such method does not clearly reflect income is on the Tax Commission and would be extremely difficult to sustain in that the federal tax regulations and generally accepted accounting principles both permit the use of the completed contract method of accounting as an accepted method. See Accounting Research Bulletin, No. 45, American Institute of Certified Public Accountants (October, 1955).

The Tax Commission's use of such an agreement (pages 17 and 18 of the Transcript of Record) is based upon its concern that a contractor reporting on the completed contract method might complete a contract in Utah and withdraw from Utah without paying any corporation franchise tax on the amount of net income earned on such contract. The agreement requires, therefore, that if taxpayer reports its income on the completed contract basis it agrees to waive the statute of limitations and agrees to certain other covenants in consideration of the Tax Commission's agreement to accept the filing of corporation franchise tax returns using the completed contract method of accounting. Such agreement recites that the Commission requires the filing of corporation franchise tax returns using the accrual or percentage of contract completion basis and a separate accounting basis. The Tax Commission does not have the authority to require the use of this accrual or percentage of completion method of accounting, and it is questionable whether it has the authority to require the use of separate accounting by a taxpayer whose regularly employed accounting method "clearly reflects the income" of the taxpayer. Plaintiff signed the purported agreement on October 25, 1962, under the assumption that such an agreement was within the power of the Tax Commission and with the desire to comply with the rules and regulations set forth by such Tax Commission. The agreement provides that plaintiff would report all income received or earned as a result of its operations in Utah on its corporation franchise tax returns. The agreement did not commit the plaintiff to file its returns using the separate method of accounting. The comment "all income derived from its Utah contracts completed while it is qualified as a corporation in Utah," however, does indicate that the Commission intended the separate accounting method to apply here. Plaintiff contends that the contract is not binding in that the State Tax Commission does not have the power to enter into this type of an agreement and that there was no consideration for the agreement because the plaintiff was entitled to file its returns using the method of accounting consistently employed by it without the Commission's permission.

> "Unless there is ratification by the State, the State is not bound by a contract made by its agents without authority conferred on them by statute or by the Constitution." 81 C.J.S., States, p. 1087.

This statement appears to set forth the general rule in connection with the powers of officers of a state. Such officers have only the powers expressly granted to them by statute, and there appears to be no express authority in the Utah statutes authorizing the Commission to enter into the type of agreement involved in this case. Certain commissions functioning as part of the state government have been given specific power. In *Campbell Building Company v. State Road Commission,* 95 Utah 242, 70 P.2d 857 (1937), this court said:

> "The statute empowers the State Road Commission to bind the state by written contracts and it is only on such written contract that it may be sued. The state cannot be held for the acts of

> its engineer beyond the powers conferred by law or the written contract."

Interpreting the powers of the State Tax Commission, this court said in *Logan City v. Allen,* 86 Utah 375, 44 P.2d 1085 (1935):

> "As a general rule, the taxing officers of the state, county, or municipal corporation, may not compromise or release claims for taxes legally assessed unless empowered to do so by statute."

The statute setting forth the general powers and duties of the Tax Commission, 59-5-46 Utah Code Annotated 1953, authorizes the Commission to prescribe regulations and rules, and to exercise supervision over the administration of the tax laws. In this connection, the Commission is to exercise all powers necessary in the performance of its duties, but there is nothing which expressly authorizes the Commission to make contracts with taxpayers concerning their method of accounting or modifying the statutory requirements in connection with the filing of Utah corporation franchise tax returns. If the use of the completed contract accounting method were not a generally accepted method of accounting, or if such method did not clearly reflect the income of the taxpayer, it is possible that the Comsion's power might include entering into an agreement to accept the method of accounting used by the taxpayer in consideration of the taxpayer agreeing to certain conditions prescribed by the Commission. Even conceding such power, the particular agreement in question is void for lack of consideration in that the

Commission covenanted only to accept the filing of corporation franchise tax returns on a completed contract basis, which method was within the express provisions of the statute. The Commission's permission to use an accounting method in lieu of a method it could not force the use of is not consideration and the contract is therefore void and of no effect, and does not preclude the taxpayer from asserting its rights to file its tax return under a method differing from that of the separate accounting method implied in the agreement.

The contract is also void in that it is against public policy to deprive a taxpayer of the express right to judicial review on the question of the reasonableness of the accounting system which the taxpayer is required to use. Section 59-13-46, Utah Code Annotated 1953 provides for review by this court of decisions of the State Tax Commission on questions involving the franchise tax. Encompassed within this right to judicial review would be the determination of the reasonableness of the accounting method and the Commission should not be able to restrict the scope of review by contracts purporting to bind the taxpayer to a particular method of accounting.

CONCLUSION

The findings of fact and conclusions of law of the State Tax Commission of Utah are clearly erroneous to the extent they hold that plaintiff does not conduct a unitary business, and that any allocation of net income to Utah for corporation franchise tax purposes is not limited to the total net income of the plaintiff from its total operations. To the extent that separate accounting is a valid method of determining net income allocated to Utah, "equivalent" federal income taxes are a proper deduction in establishing such net income as a basis for franchise taxes.

The State Tax Commission has failed to establish the necessity of departing from the statutory allocation formula so plaintiff is entitled to use this formula in determining its net income properly allocable to Utah for franchise tax purposes.

In the alternative, if this court finds that departure from the statutory allocation formula is justified, plaintiff cannot be taxed on any amount exceeding its overall net income from its operations within and without the state.

Further in the alternative, if allocated net income can exceed total net income of the plaintiff, a deduction for federal income taxes on an "equivalent" basis is required for a correct separate accounting determination of net income.

The deficiency assessed by the State Tax Commission should be cancelled and this case remanded to the Commission for determination of franchise taxes due pursuant to the opinion of the Court.

Respectfully submitted,

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