

1965

Western Contracting Corporation, An Iowa Corporation v. State Tax Commission : Brief of Defendant

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IN THE SUPREME COURT OF THE STATE OF UTAH

WESTERN CONTRACTING
CORPORATION, a Corporation,
Plaintiff,

— vs. —

STATE TAX COMMISSION
OF UTAH,

Defendant.

Case
No. 10322

APR 8 - 1965

FILED

BRIEF OF DEFENDANT

Clerk, Supreme Court, Utah

UPON WRIT OF CERTIORARI TO REVIEW AN
ORDER OF THE STATE TAX COMMISSION
OF UTAH

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IN THE SUPREME COURT OF THE STATE OF UTAH

WESTERN CONTRACTING
CORPORATION, a Corporation,
Plaintiff,

— vs. —

STATE TAX COMMISSION
OF UTAH,

Defendant.

} Case
No. 10322

BRIEF OF DEFENDANT

STATEMENT OF THE NATURE OF THE CASE

This case involves a corporation franchise tax deficiency assessment proposed against the Western Contracting Corporation by the defendant for the year 1962, in the total amount of \$32,913.59.

DISPOSITION BEFORE THE STATE TAX COMMISSION

A formal hearing was held before a lawfully constituted quorum of the State Tax Commission on September 21, 1964, upon petition and notice as required by law. As a result of this hearing, the commission sustained the aforementioned deficiency, thereby imposing liability for the tax upon the plaintiff.

RELIEF SOUGHT ON REVIEW

Plaintiff seeks reversal of the decision of the tax commission and remand with directions as to the manner and basis of assessment.

STATEMENT OF FACTS

Western Contracting Corporation, the plaintiff, is an Iowa corporation duly qualified to transact business in the State of Utah. The plaintiff is engaged in the construction business as a general contractor and engages in such projects as dredging rivers, building bridges and constructing airport facilities. In Utah plaintiff strips overburden or earth from the Kennecott Copper Company's Bingham Mine.

During the year 1962 plaintiff performed general contracting work in eight different states. Severe losses resulted from some of the foreign state projects. Most of the losses resulted from dredging operations requiring specialized equipment in order to perform the particular project involved.

Project revenues and costs relating to specific contracts or projects closed in 1962 and the resulting net profit or loss are set forth in the following tables:

CONTRACTS CLOSED DURING YEAR

	Project Revenue	Direct Cost
Union-Lincoln		
County	\$9,014,197.87	\$7,295,903.22
Kennecott Stripping-		
Stage III	6,144,875.00	3,788,784.62

Lake St. Clair		
Dredging	3,074,773.52	1,654,262.52
Erie Harbor Dredging	1,307,740.18	834,484.54
Ashland Harbor		
Dredging	768,814.60	616,513.66
Stapleton Air Field...	3,529,804.85	3,376,262.23
Delaware River		
Dredging	1,976,958.50	2,170,581.54
Mississippi Gulf		
Dredging	1,573,000.00	3,006,491.34
Hudson River		
Dredging	1,418,994.50	1,739,547.38
Floyd River Bridges..	440,520.51	401,882.39

CONTRACTS CLOSED DURING YEAR

	Allocated Administrative Expenses	Net Profit
Union-Lincoln		
County	\$1,285,123.74	\$ 433,170.91
Kennecott Stripping-		
Stage III	614,608.24	1,741,237.43
Lake St. Clair		
Dredging	291,022.27	1,129,488.73
Erie Harbor		
Dredging	146,605.20	326,650.44
Ashland Harbor		
Dredging	108,531.61	43,769.33
Stapleton Air Field..	593,860.47	(440,317.85)
Delaware River		
Dredging	381,611.15	(575,234.19)

Mississippi Gulf		
Dredging	528,653.98	(1,962,145.32)
Hudson River		
Dredging	305,901.60	(626,454.48)
Floyd River Bridges	70,458.02	(31,819.90)

If the net income from its Utah contract is excluded, plaintiff received \$23,104,804.53 in total project revenue on jobs or projects closed in 1962. Total project costs and allocated administrative expenses on all projects closed in 1962, excluding the Kennecott project, were \$24,806,696.86, resulting in an over-all net loss on projects closed in 1962 of \$1,702,892.33, if the Kennecott project is excluded.

As reflected above, the gross project revenue or receipts to plaintiff from its Utah operations from contracts completed in 1962 were \$6,144,875.00. It was stipulated that on a segregated accounting basis, after deducting applicable expenses, that the net profit before federal taxes to be allocated to the Utah contract is the sum of \$1,741,237.43.

Section 59-13-22, U.C.A. 1953, together with Section 59-13-15, U.C.A. 1953, requires the filing of franchise tax returns on an accrual or percentage of completion basis. However, the nature of the accounting procedure used in connection with contracts of more than one year's duration, such as the taxpayer's Kennecott contract, is such that the contract costs to be set off against contract receipts cannot be conveniently ascertained until completion of the contract. Because of this fact, it is difficult

for plaintiff to file returns on a percentage of completion basis.

In addition the plaintiff's records are maintained on a completed contract basis and its federal tax returns are prepared on such a basis.

To alleviate the burden of annual payment on corporations so maintaining their records, the tax commission adopted a policy in 1944 requiring segregated accounting for contractors. As part of this administrative policy, income of all contractors was required to be computed and reported on a percentage of job completion or complete accrual basis. This requirement has been adhered to unless a contractor requests otherwise and agrees to file on a completed contract basis, using segregated accounting. This policy was subsequently promulgated as Corporation Franchise Tax Regulation No. 8 by the commission (R. 87).

In 1962 the plaintiff expressed its willingness to comply with the regulation of the commission and formally agreed to report its income on a completed contract and segregated accounting business basis (R. 17-18).

The plaintiff thereafter filed its Utah franchise tax return for 1962 using the segregated accounting method. It allocated a net income of \$1,741,237.43 to Utah from its stripping contract with Kennecott Copper Corporation. Plaintiff's total income before federal taxes for the year 1962 was \$555,088.31. After deducting investment

credit of \$86,071.71 it paid federal income taxes in the amount of \$183,215.11 resulting in a total net income to plaintiff of \$371,873.20 after federal taxes.

For Utah franchise tax purposes, however, the plaintiff allocated the computed sum of \$905,443.46 in federal taxes against the actual income from the Utah job. Thus, while it only *paid* \$183,215.11 in actual federal taxes, it claims the right to deduct the federal taxes it would owe if doing business in Utah alone after an income of \$1,741,237.43.

The auditing division proposed an additional assessment of \$32,913.59 based primarily on the disallowance of most of the federal income taxes deducted on the return.

The plaintiff now claims that its Utah income should be taxed pursuant to the allocation formula set forth in Section 59-13-20, U.C.A. 1953, and not on a segregated accounting basis. It further contends that the commission's right to tax its segregated income is limited to its "net income" as defined by statute. It is also argued that if the commission determines that segregated accounting is proper, a projected federal income tax deduction must be allowed.

ARGUMENT

POINT I

THE PLAINTIFF'S UTAH INCOME IS SEPARABLE FROM ITS FOREIGN INCOME AND MAY BE TAXED IN ITS ENTIRETY BY THIS STATE.

The Utah franchise tax is a privilege tax on the right to do business in this state measured by net income. Income derived from business done outside the state cannot be included in the tax. *American Investment Corp. v. State Tax Commission*, 101 Utah 189, 120 P. 2d 331; *J. M. & M. S. Browning Co. v. State Tax Commission*, 107 Utah 457, 154 P. 2d 993. In other words the value of the franchise for tax purposes is based on income attributable to business done within this state. Such franchise or privilege is taxed at a rate of 4 per cent of the corporation's net income "allocated to this state . . ." 59-13-3, U.C.A. 1953 (emphasis supplied).

The tax is imposed upon the portion of a multi-state corporation's net income assignable or allocable to business done within this state. See 59-13-20, U.C.A. 1953. This statute provides for an allocation formula designed to determine the portion of the taxpayer's business taxable by this state. The section further provides:

"(8) *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.” (Emphasis supplied.)

Thus the manifest intention of the Utah Legislature is to impose the franchise tax upon that portion of corporate net income attributable to business done within this state.

It is clear that no state may tax any subject over which it has no jurisdiction. However, it is equally well established that a state may tax that portion of a multi-state corporation's income which is derived from sources or activities within its boundaries. *Shaffer v. Carter*, 252 U.S. 37, 40 S. Ct. 221, 64 L. Ed. 445; *United States Glue Co. v. Town of Oak Creek*, 247 U.S. 321, 38 S. Ct. 499, 62 L. Ed. 1135.

No state may impose a tax which burdens interstate commerce. *Gwen, White & Prince v. Henneford*, 305 U.S. 434, 59 S. Ct. 325, 83 L. Ed. 272. Double taxation may create an unfair burden on interstate commerce violative of the commerce clause. *Adams Manufacturing Co. v. Storen*, 304 U.S. 307, 58 S. Ct. 913, 82 L. Ed. 1365

While the taxpayer herein does not claim constitutional violations, these constitutional provisions explain the reason for Utah legislative insistence that only income attributable to Utah business activities be taxed. The absence of some apportionment rule can lead to constitutional objections. Therefore, where the source of income crosses state lines, some rule of apportionment

must be used by taxing authorities lest a tax on unapportioned multi-state income be declared invalid. Such a formula for apportionment is provided by 59-13-20(6), U.C.A. 1953.

In the present case the income sought to be taxed does not cross state lines. It is entirely attributable to the taxpayer's activities in Utah.

"Such income, under the principles stated, could be segregated and taxed in its entirety by the state. . . . The same, it would follow, is true of income derived from personal services wholly performed within the state. It is only the income derived from a source which crosses state lines, such as business operations extending into more than one state, to which the rule of apportionment must be applied." *Allocation of Income in State Taxation*, Altman & Keesling, C.C.H. 1946. See also *Indiana v. Ingram-Richardson Mfg. Co.*, 313 U.S. 252, 61 S. Ct. 866, 85 L. Ed. 1313.

If the use of an otherwise permissible formula produces an obviously unreasonable result, and it is possible to show with fair accuracy by separate accounting the income attributable to a state, application of the formula is not required. *Hans Rees Sons Inc. v. North Carolina*, 283 U.S. 123, 51 S. Ct. 385, 75 L. Ed. 904.

Even though the income of a business is derived partly from within and partly from without a taxing state, an allocation to that state of a portion of the total income, as the basis for computing state income tax, is not ordinarily proper where the business transacted

within the state is separable from that transacted outside the state. The business within the taxing state has been held to be separable, so as to make an allocation improper, in a number of cases. See Annotation 130 A.L.R. 1205.

These cases include those of *Piedmont & Am. R. Co. v. Query*, 56 F. 2d 172, where a South Carolina corporation owned two entirely disconnected railroad lines, one in South Carolina and the other in North Carolina. The corporation paid income tax to South Carolina on the entire net income of the South Carolina line but paid no tax on the income of the North Carolina line. South Carolina taxing authorities attempted to use an apportionment formula to reach income from the foreign line, and the federal court held for the railroad on the ground that income from the interstate business of the two lines was readily separable and that the allocation statute was not intended to apply to such a situation. The court said:

“We do not think that a proper construction of the statute requires that the formula be applied in such a case. The whole spirit of the act negatives the intention to tax income earned beyond the limits of the state, which would result from applying the formula to a case such as this.”

The case of *Fisher v. Standard Oil Co.*, 12 F. 2d 744, involved a foreign corporation doing business in North Dakota by selling petroleum products which it produced and refined wholly outside the state. There, also, North Dakota taxing authorities attempted to allocate the cor-

poration's business under a formula so as to reach out-of-state business activity. The court there said:

“The theories of allocation can have no place in the inquiry, if net income within the state stands on its own footing unmixed with outside business. . . . We think it cannot be doubted that the products as brought into this state had an easily ascertainable wholesale market price. We think appellee's business within the state is easily separable from its other business by charging it with the wholesale price of products which it sells in North Dakota. That would put it on an equality there with those who sell and do not produce and refine.”

Another similar case was that of *Standard Oil Co. v. Thoresen*, 29 F. 2d 708, which involved the same corporation but a later North Dakota statute which provided for the allocation to the state of such portion of the corporation's total income as its tangible property in business bore to its total tangible property in business outside the state. The state thereupon contended that the corporation's business should be regarded as a unit in the production, refining, distribution and marketing of oil. But the court refused to accept the state's position.

In the case of *Standard Oil Co. v. Wisconsin Tax Commission*, 197 Wis. 630, 223 N.W. 85, a foreign corporation was engaged in the business of producing, refining, transporting, and marketing petroleum products. Its property in Wisconsin consisted largely of tanks in filling stations, and the corporation did no producing or refining in the state. The Wisconsin income tax statute pro-

vided that "persons engaged in business within and without the state" should "be taxed only on such income as is derived from business transacted and property located within the state," that "the amount of such income apportionable to Wisconsin may be determined by an allocation and separate accounting thereof, when, in the judgment of the tax commission, that method will reasonably reflect the income properly assignable to this state," but that otherwise such income should be determined by allocating to Wisconsin a portion of the total income based upon a formula. The tax commission assessed the tax computed by the use of the allocation formula, but the corporation contended that its income should be ascertained by the allocation and separate accounting method by which the Wisconsin business was charged at the market price with all products received by it. The court sustained the corporation's contention and said:

"There are some operations which from their very nature produce an income which cannot be properly allocated by separate accounting methods, instances of which are the telegraph, telephone, and express companies. They stand ready to serve whosoever may apply for service and the entire operation constitutes a unit of service. That is not the case with the manufacturing and sales business, particularly so when the accounts are so kept as to be readily separable . . . We perceive no reason why under the facts of this case, the profits derived from the sales operations should not be ascertained insofar as plaintiff is concerned as they would be if the sales operations were conducted by a separate corporate entity."

Most state tax statutes provided a method or formula for allocating interstate income of a multi-state business. Such allocation is appropriate only where the business within the state is not separable. However, these statutes usually do not require the utilization of an allocation formula where the statutory method would operate inequitably or fails to achieve its purpose under the circumstances. (For cases and statutes see 130 A.L.R. 1207 — Annotation State Income Tax on Business in Other States.)

So, in *Union Pacific Railroad Co. v. State Tax Commission*, 145 Kan. 715, 68 P. 2d 1, a statute provided that in case allocation according to the statutory method was impractical or inequitable, so as to work an undue hardship upon the taxpayer, or in case the factors necessary for an allocation according to the statutory method could not be ascertained from the taxpayer's records, the taxpayer should, subject to the approval of the tax commission, allocate a fair part of its total income to the state by some other method. This case further held that the determination of whether or not the statutory method of allocation should be used is ordinarily an administrative duty of the officers charged with the administration of the tax laws. A district court should not be allowed to substitute its judgment for that of the tax commission and make an independent determination of the proper method of allocation of income.

The case of *Montgomery Ward & Co. v. State Tax Commission*, 151 Kan. 159, 98 P. 2d 143, involved a for-

eign corporation operating over 500 retail stores, a part of which were located in Kansas. All merchandise sold in the Kansas stores were bought through the corporation's offices outside the state, and the business of the stores was administered and supervised through that office. A net income for the Kansas stores was arrived at by deducting from all their gross receipts expenses directly connected with the Kansas business and a pro-rata share of the cost of purchasing, handling, and supervisory activities carried on outside the state. The Kansas Tax Commission attempted to impose a tax on this entire "net income," but the corporation on its returns made an allocation of this income between Kansas and the states in which the purchasing and supervisory activities were carried on.

The court pointed out that the taxpayer's Kansas income was segregated by direct accounting in that case, so that there was no question of allocation of its total income within and without the state, and both the statute providing a specific method of allocation and that providing for the use of some other method where the statutory method was impractical or inequitable were inapplicable. The court held the taxpayer entitled to a judicial review of the commission's refusal to permit an allocation of its Kansas income, where its method of accounting was shown on its returns.

The Utah case of *Kennecott Copper Co. v. State Tax Commission*, 18 Utah 140, 221 P. 2d 857, appears to be controlling. There the taxpayer engaged in certain

mining activities in the State of Utah. Mill concentrates were shipped outside the state for processing and the refined products sold outside the state by a wholly owned subsidiary of the taxpayer.

A separate accounting system was maintained for the Utah Copper division, but the franchise tax for the years prior to the controversy had been based on a special allocation formula obtained by agreement between the parties. Kennecott thereafter attempted to change its reporting and determine the net income assignable to the state by pooling income from all of its divisions and then applying the formula prescribed by the statute. It asserted that it was an "indivisible" or unitary business. See 118 Utah, pp. 143, 147. The tax commission refused to allow the change. The court said:

"We see no good reason for reversing the State Tax Commission on this ruling and see many practical difficulties had a different method been permitted. In some instances the actual net income to be allocated to business transacted in this state cannot be fixed with certainty so the legislature set up one method and then clothed the Commission with the power to permit selection of another method if it would more accurately reflect the true net income . . . Kennecott's books are kept on the basis used by the Commission in determining the deficiency and must of necessity be so kept . . . The franchise tax reports filed . . . were based on the prescribed system aside from certain contested items [and] they suggest a fair and equitable means of determining the tax liability. . . . To use the method [requested by the taxpayer] might introduce variable factors, some impossible to ascertainment. . . . In addition it might unjustly

discriminate against this state or the taxpayer in that the tax assessed might bear no reasonable relationship to . . . the amount of business done in this state." 118 Utah, p. 149.

The court concluded:

"The problem that concerns us here is not that the Commission seeks to force the taxpayer to a non-statutory basis. On the contrary, the Commission has permitted the taxpayer to file on a basis selected by it which the taxpayer seeks to change because the amount of tax has become onerous. Such a request may be entirely legitimate but when as here there are factors which cannot be determined with any degree of satisfaction, the request is made some six years after the tax has accrued and the only reason assigned is that the change may substantially reduce the tax liability, the showing is not sufficient to convince us that the Commission was arbitrary and capricious in denying the request." Ibid, p. 151.

It appears therefore that resort to the formula established by Section 59-13-20(6), U.C.A. 1953, is improper unless the income sought to be taxed by the State of Utah is attributable to two or more states. This is because a precise allocation of income may not be possible in such instances.

Many types of income, however, *can* be specifically allocated or determined without resort to a formula. In such cases the taxing state is justified in disregarding the formula and proceeding to tax the actual or real income attributable to business done or income derived from sources within its borders.

Theories of allocation have no place in determining income tax on a corporation if net income within a state can be distinguished from outside business. *Fisher v. Standard Oil* (8 Cir.) 12 F. 2d 744.

If the taxpayer's business within the state is separable from his other business outside the state, no allocation under the income tax statutes is necessary in order to determine the amount of tax to be paid. 85 C.J.S., *Taxation*, § 1103; *Mexican Petroleum Corp. of Georgia v. Head*, 64 Ga. App. 529, 13 S.E. 2d 887; *Magnolio Petroleum Co. v. Oklahoma Tax Comm.*, 121 P. 2d 1008, 190 Okla. 172; *Texas Co. v. Cooper*, 107 So. 2d 676, 236 La. 380; *McWilliams Dredging Co. v. McKeigney*, 227 Miss. 730, 86 So. 2d 672, app. dismissed, 352 U.S. 807, 77 S. Ct. 57, 1 L. Ed. 2d 38.

Separate accounting on a completed job basis is a precise record of income attributable to a state.¹ It is a complete record of sales, costs and expenses resulting from business done within the state. In the present case the taxpayer's business activities are clearly separable and subject to separate accounting. The plaintiff kept its books and records of its Utah contract separate from those of its other business activities. It filed its Utah franchise tax returns on a segregated accounting basis.

As the portion of plaintiff's income attributable to its Utah activities is clearly reflected in its records and tax returns, such income is taxable without reference

¹ A complete discussion of separate accounting as related to the allocation of business income is found in *Allocation of Income in State Taxation*, Altman & Keesling, pp. 89-97, 1946 C.C.H.

to the formula provided by Section 59-13-20(6), U.C.A. 1953. Only where income cannot be ascertained should the allocation formula be used.

POINT II

THE TAXPAYER DOES NOT CONDUCT A UNITARY BUSINESS.

The taxpayer contends that it is a unitary business and therefore is not capable of specifically accounting for its income. This contention is in direct conflict with the 1962 agreement signed by the taxpayer. It also contradicts the returns and records of the taxpayer which are maintained and filed on a segregated basis.

A business is unitary "if business done in any state benefits the business done elsewhere and is benefited by the business done elsewhere because of the distribution of processes and operations, centralized management, increased buying power, volume reduction of manufacturing cost, or other factors of the business as a unit. Altman & Keesling, *Allocation of Income in State Taxation*, p. 38. If the business is of such character, income apportionment by formula may be required except where the result is obviously unreasonable in a particular case. *Butler Bros. v. McColgan*, 315 U.S. 501, 62 S. Ct. 701.

The Utah Franchise Tax Statutes provide for the taxation of foreign corporations doing business in this state. The extent of Utah's power to tax is limited to income from sources within the state. Where income of a corporation is derived from sources partly within and

partly without a taxing state and where the business is unitary in the sense that business transacted within the state is not separable from that transacted outside the state, taxation of the income of such a corporation is controlled by the Commerce Clause of the Federal Constitution. In this situation most state statutes provide for an allocation to the taxing state of a portion of the total income of such a business. Such statutes are constitutional. *Shaffer v. Carter*, 252 U.S. 37, 40 S. Ct. 221, 64 L. Ed. 445; *Travis v. Yale & T. Mfg. Co.*, 252 U.S. 60, 40 S. Ct. 228, 54 L. Ed. 460.

Such statutes generally provide methods or formulae for allocating to the taxing state a share of the total income of a multi-state business where the business in the state is not separable. Often they permit the use of alternate methods if inequities result from a statutory formula. *Matson Nav. Co. v. State Board of Equalization*, 297 U.S. 441, 56 S. Ct. 553, 80 L. Ed. 791.

These allocation statutes are intended to prevent double taxation resulting from the imposition of state taxes upon income crossing state lines. But even where income of a business is derived partly from within and partly from without a taxing state, formula allocation of income is not proper where the business transacted within the state is separable from that transacted without. *Fisher v. Standard Oil Co.*, (C.C.A. 8th) 12 F. 2d 744.

It is well established that the unitary nature of a business is dependent upon the manner in which the

business is conducted. *Crawford Manufacturing Co. v. State Commission of Revenue and Taxation*, 180 Kan. 352, 304 P. 2d 504. In that case the court concluded that the question of the unitary nature of a business was a mixed question of law and fact properly within the jurisdiction of the fact-finding state commission. The court, however, cited *Altman & Keesling, Allocation of Income in State Taxation*, 1946, p. 100, as follows:

“The authorities, we believe, preponderate in holding that the direct or separate accounting method may not be properly employed to determine the amount of income earned in the particular state where it was derived from a unitary business. Instead, the factor formula should be employed, thus giving weight to the different factors responsible for earning the income so as to apportion it from the entire business among the states in which it was earned.”

The taxpayer herein seeks to utilize a claim of unitary business operations to avoid the separate reporting of its Utah business activities. The rule stated above does not apply, however.

“... Where the business within the state is truly separate and distinct from the business without the state, this segregation can be made fairly, easily and accurately, and, accordingly, the separate accounting method may properly be used. Where, however, the business within the state is not a separate business but is an integral part of a unitary business carried on within and without the state, difficulties will be encountered both in the segregation of the gross income attributable to the state and in the segregation of the expenses attributable to the state and in the segregation of the expenses attributable thereto. . . . Op. cit, p. 90.

Even a finding that a business is unitary, however, has been held not to preclude state taxation of various aspects of its intrastate activity.

In the case of *Hans Rees' Sons v. North Carolina*, 283 U.S. 123, 51 S. Ct. 385, 75 L. Ed. 879, the taxpayer was engaged in the business of tanning, manufacturing and selling leather products. The principal manufacturing and supply house was located in North Carolina. Sales were made throughout the United States, and the question of a proper apportionment formula was at issue. The court said:

“The difficulty of making an exact apportionment is apparent, and hence, when the state has adopted a method not intrinsically arbitrary, it will be sustained until proof is offered of an unreasonable and arbitrary application in particular cases. But the fact that the corporate enterprise is a unitary one, in the sense that the ultimate gain is derived from the entire business, does not mean that for the purpose of taxation the activities which are conducted in different jurisdictions are to be regarded as ‘component parts of a single unit’ so that the entire net income may be taxed in one state regardless of the extent to which it may be derived from the conduct of the enterprise in another state.” 283 U. S. p. 133.

A recent Louisiana case involved a claimed unitary business under a fact situation not wholly dissimilar to the instant matter. In *Texas Co. v. Cooper*, 236 La. 380, 107 So. 2d 676, the Texas Company, conducting operations on a world-wide scale, produced crude oil in Louisi-

ana. Its oil refineries and asphalt plants were operated outside that state, but a significant portion of its crude oil production was in Louisiana. The State Collector of Revenue required the taxpayer to report his income by a separate accounting method, which was contested by the taxpayer, who argued that the statutory apportionment formula method should be used. The taxpayer argued that the collector did not possess the statutory power to require its income to be determined by a separate accounting method, and that if such attempts were made, the federal constitution was offended. Louisiana statutes defined the manner in which the net income earned by a foreign corporation from sources within the state was to be determined and prescribed two methods of determining the amount of income tax to be paid to the state. They were a separate accounting method and an apportionment method. The statute provided :

“Where the collector finds that the use of the apportionment method by the taxpayer produces a manifestly unfair result and that the separate accounting method would more equitably determine the amount of net income derived from sources in Louisiana, he may require that the separate accounting method be used in such case.”
L. S. A. - R. S. 42:244.

The Texas Company produced about 30,000,000 barrels of crude oil in Louisiana, which was co-mingled with company-produced oil and sold either to purchasers in Louisiana or transported out of the state to company refineries. The company filed its 1950 income tax returns and paid its tax for that year by the apportionment

method, which resulted in a tax of \$58,336.35. The collector calculated a tax deficiency in the amount of \$468,398.49, which in large measure was based on his separate accounting theory. The taxpayer argued that it was impossible and inequitable to attribute any direct profit to its Louisiana production operations, since, due to the unitary nature of its world-wide operations, each stage of the product's progress from production through refining to distribution to ultimate marketing was so interdependent that only the final gain or loss could be considered realized without identification of a particular process as the source of any part of eventual profit or loss. The court, adopting the trial court's decision, stated:

“In the first place, counsel for plaintiff has not favored the court with any judicial decree holding that corporations engaged in the petroleum industry are unitary in character. To the contrary . . . the collector cites the following cases which in each instance upheld the taxpayer's (oil company) contention to the effect that company operations similar to those of the present taxpayer were not so unitary in nature that the company was precluded from using the separate accounting method to determine intrastate profits as against the taxing authority's attempts to utilize the apportionment method of fixing the taxpayer's share of income attributable to the taxing states respectively: *Magnolia Petroleum Co. v. Oklahoma Tax Commission*, 1941, 190 Okla. 172, 121 P. 2d 1008; *Standard Oil Co. v. Wisconsin Tax Commission*, 1929, 197 Wis. 632, 23 N.W. 85; *Standard Oil Co., Indiana v. Thoresen, Tax Commissioner, etc.*, 8th Cir., 1928, 29 F. 2d 708; *Fisher v. Standard Oil Co.*, 8th Cir., 1926, 12 F. 2d 744, *Ibid*, p. 681 and footnote therein.”

The court continued:

“... Louisiana, having the right to collect a tax imposed on net income, has the right to determine what that right is in relation to the business transacted within the state if that can be done fairly and equitably even though the net income by that separate accounting method is more than what would be the state's aliquot portion of the earnings based on the statutory formula of apportionment of the nation wide operations.”

“* * *

“The fact that the plaintiff can make a unit accounting of every step of its operations from the moment the crude oil comes to the surface until the sale of the refined product in all parts of the world convinces me that if there is a profit in the oil above the cost of production or purchase in Louisiana the margin of profit can be determined by an expert accountant as of the moment the oil leaves the state. An example of a unitary business where it would seem to be impossible to make a separate accounting of income within the boundaries of a state would be an express company, a telephone or telegraph company, in which the whole operation ‘constitutes but a single plan, made so by the very character and necessities of the business.’ ”

“* * *

“Plaintiff contends that it is not possible from an accounting standpoint to determine the net income from its transactions in Louisiana by the separate accounting method. Not only does plaintiff actually use that method in those states where it wants to use it, but it appears to me that in Louisiana in order to find the arithmetical ratios which constitute the statutory formula used in the apportionment method, it is absolutely necessary to keep an account of and show the separate values

and amounts of the property, payrolls and sales of this plaintiff's business transacted in Louisiana, which are fundamental steps and basic information for a separate accounting. It is inconsistent to say that a separate accounting cannot be made when the apportionment formula cannot be known without a separation of the principal items of the Louisiana transaction used in determining net income."

The court then cited Altman & Keesling, *Allocation of Income in State Taxation* (2d ed. 1950), as follows:

"Thus, in this field, as in many other fields, the ideal cannot be obtained. Something less than perfection must suffice."

The court continued:

"I see no reason why the separate accounting method applied to the oil gathering operation should not be as accurate as plain bookkeeping can and should be. While there is no testimony on the subject I can perceive more difficulty or inaccuracy when the separate method is applied to sales of the refined products brought into the state. . . ."

Altman & Keesling's book, *Allocation of Income in State Taxation* (2d ed. 1950), was cited as follows:

"Where the business within a state is truly separate and distinct from the business without the state this segregation can be made fairly, easily and accurately, and, accordingly, the separate accounting method may properly be used."

The court continued:

"Where the business within the state is not separate, but is an integral part of a unitary busi-

ness carried on within and without the state, difficulties will be encountered in determining the income and expenses attributable to the state, and the principal objection to the apportionment method is that it is apt to be arbitrary and to represent merely the opinion of the taxpayer, which may be biased. Therefore, if the Texas Company business is a unit from beginning to end and the Louisiana transactions cannot be separated to determine the net income from them, then that is all there is to this case and judgment would have to be for plaintiff as prayed for. The evidence in this case convinces me that a separate accounting of the Louisiana operations can properly be applied to determine the Louisiana net income. It is done by this plaintiff in other states where its operations are exactly the same as here and the collector has demonstrated that it can and should be done in Louisiana.”

The court made reference to a requirement imposing upon the collector the burden of showing that the apportionment method produced “a manifestly unfair result.” The court said:

“The term ‘manifestly unfair result’ has an obvious meaning in the context of its statutory setting . . . [This] demonstrates to us the legislative intent that the ‘manifestly unfair result’ referred to is a manifestly inaccurate representation through the apportionment method of income derived from within Louisiana, so that the separate accounting method more equitably determines the amount of the net income attributable to Louisiana operations.

“This standard is applicable both to the taxpayer and to the collector.”

The court concluded:

“The apportionment method produces a manifestly unfair result, and the separate accounting method more equitably determines the income derived from Louisiana sources, not because the tax liability is greater by the latter method, but because the separate accounting method assigns a value properly attributable to the Louisiana production operations of the taxpayer by including within the measure of the tax the value of the oil produced by such production operations, whereas the apportionment formula in computing state tax liability does not take into account the value of such operations insofar as singularly attributable to this state wherein are produced approximately 30,000,000 of the 100,000,000 barrels of oil which constitute the world-wide production of the taxpayer.

“A domestic producer identically situated with the appellant which sold its product at the market value would report a net income based upon the gross price or value of the oil produced, less the expenses of production. The separate accounting method requires the taxpayer to determine its net profit from Louisiana production operations on the same basis. Ibid. p. 690.”

The 1956 case of *McWilliams Dredging Co. v. McKeigny*, 227 Miss. 730, 86 So. 2d 672, app. dismissed, 352 U.S. 807, 77 S. Ct. 57, 1 L. Ed. 38, is directly controlling. There, the taxpayer, an Illinois corporation, was engaged in the performance of dredging contracts. Certain projects were performed entirely within the State of Mississippi. In addition it conducted crossing repairs between Mississippi and Louisiana and had other projects in Illinois,

Louisiana and Texas. It reported income from these projects to Mississippi under an apportionment formula. The Mississippi Tax Commission set up schedules basing a proposed tax assessment upon receipts from the dredging contracts in Mississippi less certain prorated contract costs. The Commission justified its method of assessment in the following words: "It is believed we can prove that you, of necessity, must determine the probable cost of any contract performed at any time in order to bid. Having done so, it would be the height of folly not to maintain an accounting system which would tell you whether or not you had erred in arriving at your bid . . ."

The taxpayer contended that its business was a unitary operation in that its component parts were so closely connected and necessary to each other that the business could not be divided into separate units for state income tax purposes and that therefore the Commission's assessment was improper.

The court after citing the applicable statute and regulations said:

"Our law unquestionably favors the specific accounting by foreign corporations. . . . It has been well said that 'theories of allocation have no place in determining income tax on corporations, if net income within the state can be distinguished from outside business.' *Magnolia Petroleum Co. v. Oklahoma Tax Comm.*, 190 Okla. 172, 121 P. 2d 1008, 1011."

The court continued:

“In the case here the tax commission did not seek to have a formula upheld. It contended that specific accounting should and could be made. It rejected the company’s formula. Consequently the burden was on the company to show that its extra-territorial values were being taxed or affected. It cannot complain unless it can show that the Commission’s method was arbitrary and unreasonable. *Bass, Ratcliff & Gretton, Ltd. v. State Tax Commission*, 266 U.S. 271, 45 S. Ct. 82, 59 L. Ed. 282.

“As has been stated, the formula, upon which the Company based its returns, was applicable to manufacturing. But by no stretch of the imagination could dredging fall into the category of manufacturing.

“The Company maintained that its operations were so unitary that it was impossible, from its books, to account specifically on its Mississippi contracts. Yet, by its books, it had no difficulty in so accounting to the State of Louisiana for its income in that state.

“In bidding on a contract, it was of course necessary for the Company to anticipate and take into consideration all proper expenses and costs in advance in making its bid so that it could insure a profit. If this could be fairly done with reasonable certainty, assuredly the Company could keep up with its receipts and expenses, and reasonably determine, and have reflected in its books, the profit or loss on each particular contract. The auditors of the Tax Commission experienced no insurmountable difficulty in ascertaining from the books of the Company its receipts from each project together with expenses properly chargeable thereto.

“One serious trouble about the manner in which the Company kept its books was that, although a substantial profit was shown on all the contracts wholly or partly performed in Mississippi, yet, by insisting that it had the right to charge to the Mississippi projects an unreasonable amount of the so-called “idle shop account,” it attempted to cancel out a large part of its Mississippi income. Since it had a number of other projects, the Company was not entitled to attribute to its Mississippi contracts an undue proportion of this account.

“The fact that such an over-all return on the Company’s business, so far as federal income is concerned, might be proper or acceptable for that purpose is no reason why it should be applicable insofar as state income is concerned. If the laws or conditions in this state were perhaps more conducive to the earnings of profits than elsewhere, nevertheless this should not have the effect of penalizing this State by taking the income earned here to replenish the Company’s coffers which had been exhausted by loss from profligate or improvident contracts elsewhere.”

There is little or no justification in the record for the facts asserted for the first time by plaintiff on pages 21 to 23 of its brief. As such they are not properly before the court and must be disregarded in the determination of this matter. *Brandley v. Lewis*, 97 Utah 217, 92 P. 2d 338.

In this regard Section 59-13-46, U.C.A. 1953, provides in part:

“Upon the hearing [in the Supreme Court] no new or additional evidence may be introduced,

but the cause shall be heard upon the record before the tax commission as certified by it . . .”

Under a statute very similar to 59-13-46, U.C.A. 1953, this court was faced with an attempt to supplement the factual record in the case of *Ferguson v. Industrial Commission*, 63 Utah 112, 221 Pac. 1099. It was there stated:

“This court has frequently held that in certorari proceedings the record certified up by the tribunal to whom the writ is directed imports absolute verity, and cannot be contradicted or supported by extrinsic evidence.” 63 Utah 112, 114.

However, even if such facts were present and uncontested, the cases of *McWilliams Dredging Co. v. McKeigney*, 227 Miss. 730, 86 So. 2d 672, and *Texas Co. v. Cooper*, 236 La. 380, 107 So. 2d 676, would appear to control.

Plaintiff has cited no cases holding that corporations engaged in the construction business in several states are unitary in nature. The *McWilliams Dredging Co.* case, *supra*, holds they are not. The only justification for adopting the plaintiff's claim that it is a unitary business entitled to use the apportionment formula is if actual net income resulting to plaintiff from its Utah operations cannot be determined.

That plaintiff incurs overhead expense in the overall administration of its business does not convert it into a unitary business. The tax commission has allowed a deduction for a portion of such expense.

The fact remains that the plaintiff actually segregates and separately accounts for its Utah income. It is absolutely necessary to the well-being of plaintiff's business that the separate values and amounts of property, payrolls, sales and income in Utah be kept.

Not only does the plaintiff actually segregate and separately account for its Utah income, but the Utah apportionment formula requires a similar segregation and separation. The formula should not obscure the underlying purpose of the Utah Franchise Tax Act, i.e., to equate the value of the franchise to the net income derived from Utah business operations.

POINT III

THE TAXPAYER IS ENTITLED TO DEDUCT NO MORE THAN THE PORTION OF FEDERAL TAXES PAID WHICH PERTAINS TO INCOME FROM ITS UTAH OPERATIONS AGAINST ITS UTAH INCOME FOR FRANCHISE TAX PURPOSES.

The taxpayer claims that should the Court find the statutory formula inapplicable to its operations so as to require the reporting of gross income from Utah alone, then it should be entitled to a deduction of projected federal taxes which it would have paid had it only reported the Utah income.

It seems perfectly clear that the plaintiff can claim no more deductions than those actually *paid*. Deductions are exemptions from taxation and where taxation is the

rule exemption is the exception. Any statutes purporting to establish exemptions from taxation must be strictly construed against the taxpayer.

The statutes in question provide as follows:

59-13-3. "Every . . . corporation, . . . for the privilege of exercising its corporate franchise or the privilege of doing business in the state, shall annually pay to the state a tax equal to four per cent of its net income for the preceding taxable year computed and allocated to this state in the manner hereinafter provided, . . ."

59-13-5(1). "'Gross income' includes gains, profits and income derived from services, of whatever kind in whatever form paid, or from trades, businesses, commerce or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends or securities or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."

59-13-7. "In computing net income there shall be allowed as deductions:

"* * *

"Taxes Paid.

"(3) Taxes *paid* or accrued within the taxable year, . . ." (emphasis supplied.)

Thus it appears that to accept the taxpayer's position involves granting a greater deduction than that allowed by the statute.

The tax commission, on the other hand, takes the position that the statutory deduction must be apportioned,

in case of multi-state taxpayers, in accordance with the relationship of income within the State of Utah as compared to income outside the state. The question arises, therefore, as to what deduction exactly the statute does allow.

The commission has promulgated a regulation, No. 13, which was in effect during the period in controversy, which provides in part:

“Allocation of Federal Income Taxes.

“(a) An assignment of a portion of the total allowable federal income tax deduction on the Utah corporation franchise return may be required for certain purposes, such as arriving at:

- (1) Income less ‘related expense’ which is subject to specific allocation under the statute,
- (2) Net income from various properties in depletion computations, and
- (3) Separate accounting determinations of net income when authorized by the Utah State Tax Commission under the provisions of sub-section (8) of section 59-13-20 of the statute.

“(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 case of an accrual basis taxpayer), or the total amount paid (in the case of a cash basis taxpayer).

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

Generally, it has been assumed that an allocable² portion of the federal taxes of a multi-state corporation should be deducted from gross income in order to arrive at usable "net income" under Utah law. See *New Park Mining Co. v. State Tax Commission*, 113 Utah 410, 196 P. 2d 485; *Kennecott Copper Co. v. State Tax Comm.*, 118 Utah 140, 221 P. 2d 857.

To adopt the view advocated by the petitioner or even to allow the entire amount of federal taxes paid by a multi-state taxpayer as a deduction against Utah net income is to overturn the pattern of tax compliance established by the *New Park Mining* and *Kennecott* cases and to promote new controversy and litigation. This should not be done unless the tax commission's position is untenable.

Research has disclosed few cases where this matter has arisen in other jurisdictions under similar statutory provisions.

Under a Kansas statute similar to our own a multi-state corporation was held entitled to deduct from income allocable to that state an applicable portion of taxes paid to the United States. The State Tax Commission had ruled that the taxpayer was entitled to no deduction. Apparently, no claim was made that the taxpayer was

² Only an allocated portion of federal taxes was involved in the *Kennecott Copper* case. See p. 10 of the defendant's brief, which indicates that federal taxes of Kennecott were allocated to Utah, and p. 6 of defendant's reply brief to plaintiff's petition for rehearing, which quotes Commission instructions then in force limiting federal tax deductions to those applicable property in Utah.

entitled to the entire deduction. *Union Pac. R. Co. v. State Tax Commission*, 145 Kan. 715, 68 P. 2d 1.

The deductions allowed to a business which extends into several states may be confined by statutes to those expenses, losses, etc., which are related to income derived from sources within the taxing state, where only such income is subject to tax.

In the case of *Buick Motor Co. v. Milwaukee*, 48 F. 2d 801, affirming 43 F. 2d 385, cert. den., 284 U.S. 655, 52 S. Ct. 34, 76 L. Ed. 556, the taxpayer corporation sold automobiles and parts manufactured by the General Motors Company and was owned by the latter company. The court held the corporation subject to a Wisconsin income tax on the income from sales made through its Wisconsin branch and further approved the practice of the Wisconsin Tax Commission regarding the apportionment of the deduction on account of federal income tax. In this case the General Motors Company and its subsidiaries made a consolidated federal return, but the Wisconsin Tax Commission allowed a deduction from the Wisconsin tax of the proportion of the consolidated federal tax as was attributable to Wisconsin business. The company contended that it should be allowed to deduct the same amount on account of federal income tax as an independent dealer would have been entitled to deduct, but this claim was rejected.

The Kansas income tax of a corporation engaged in an interstate business was computed on the basis of an

allocation to that state of a portion of the corporation's total income, in *Union Pacific Railroad Co. v. State Tax Commission*, 145 Kan. 715, 68 P. 2d 1. There, the statute provided for an allocation where a direct allocation was impractical. The court held that the mere fact that the corporation received interest on invested funds which had no taxable situs in Kansas and so were excluded from the total income, a portion of which was allocated to that state, did not make the interest paid by it on mortgages on property in Kansas and elsewhere a related expense, but that an allocable portion of the interest paid was deductible.

The tax commission's position is best justified by the underlying purpose of the Franchise Tax Act. In order that allocation can reach its final aim of *net income* to be assigned to the State of Utah it is first necessary to assign items of deduction to items of gross income and to allocate resulting net income or else to apportion items of deduction separately. This is what the tax commission has done by separately determining income and thereafter apportioning deduction items. The result is *true net income* to Utah which our statutes manifestly intend to tax. To allow *all* federal taxes paid by the petitioner as a deduction is to not allocate or tax *true net income* to the petitioner in this state.

Deductions should be subject to the same geographical limitations as the gross income included. If only income derived from sources within this state is taxable, and this is the rule established by *American Investment*

Co. v. State Tax Commission, 101 Utah 189, 120 P. 2d 331, 337, then only items arising within the state should be allowed as deductions if true net income is to be ascertained. See Altman & Keesling, *Allocation of Income in State Taxation*, p. 177.

This argument is summarized by Altman & Keesling in their book, *Allocation of Income in State Taxation*, p. 186, as follows:

“...[T]he portion of federal income taxes which may be deducted is determined in most states on the basis of net income . . . where net income is used, the net income used is that of the year covered by the federal tax for which deduction is sought. The determination is made by applying to the entire amount of federal taxes on income a fraction, the numerator of which is the net income within the scope of the estate tax and the denominator of which is the net income shown by the federal returns.”

As Tax Commission Regulation No. 13 achieves substantially the same result and as the purpose of the Franchise Tax Act is to tax net income attributable to Utah, it would appear proper to disallow any deduction which would tend to distort reportable true net income. No double taxation results from a refusal to allow a deduction greater than that actually attributable to Utah income.

POINT IV

THE QUESTION OF THE VALIDITY OF THE
AGREEMENT TO FILE ON A COMPLETED
CONTRACT BASIS USING SEGREGATED

ACCOUNTING IS NOT PROPERLY BEFORE THE COURT.

The question of the validity of the agreement (R. 17-18) between the taxpayer and the tax commission was not raised before the tax commission in the proceeding below.

It has long been the law of this state that legal questions cannot be raised for the first time on appeal. See *Salt Lake Investment Co. v. Fox*, 37 Utah 334, 108 Pac. 1132; *In Re Jones Estate*, 99 Utah 373, 104 P. 2d 210; *Radley v. Smith*, 6 Utah 2d 314, 313 P. 2d 465; *Chief Consolidated Mining Co. v. Industrial Commission*, 78 Utah 447, 4 P. 2d 1083.

Thus the question of whether or not this agreement is binding on the plaintiff has no bearing upon the issues presented herein.

Plaintiff's contention in this regard is based primarily upon a claim that the tax commission has no power to enter into written agreements with taxpayers. This question is also not before the court.

It must be noted that authorities cited in plaintiff's brief on this point do not involve the present problem where a taxpayer seeks to rescind an agreement which has been relied upon by the state.

It has been held that agreements between taxpayers and a state to pay taxes for which the taxpayer otherwise might not have been liable are enforceable if supported

by sufficient consideration. *Commonwealth ex rel. Dept. of Justice v. Socony Vacuum Oil Co.*, 347 Pa. 410, 32 A. 2d 631.

The contract in question involved the tax commission's release of a right to require filing and payment on a percentage of completion basis in exchange for the taxpayer's promise to file and pay on a completed contract basis. The practical benefits of this agreement to the taxpayer are apparent in that it is only required to subject its Utah income to taxation when ascertained and received.

If the taxpayer desires to avoid the agreement, it would seem better to merely serve notice of the tax commission that it wants to report on the percentage of completion or complete accrual basis. To change the basis of reporting income after returns are filed is to invite tax avoidance and create administrative hardship. It should not be allowed without compelling reasons therefor.

POINT V

THE ALLOCATION FORMULA PROVIDED BY SECTION 59-13-20, U.C.A. 1953, DOES NOT ALLOCATE INCOME FAIRLY AND EQUITABLY IN THE CASE OF CONTRACTORS.

The formula established in Section 59-13-20, U.C.A. 1953, allocates income to the State of Utah on the basis of a three factor formula. After certain specific treatments for capital gains or losses, rents, interest, and

dividends, income attributable to the Utah activities of a multi-state corporation is determined on the basis of (1) tangible property, (2) salaries, wages and commissions, and (3) sales.

The application of this formula contemplates a unitary business operation within and without the State of Utah, the operations of which are so interdependent and related that income from the Utah portion alone cannot be ascertained. The percentage resulting from the formula is then representative of the amount of business done in any state.

However, because of the wide possibility of variance of the formula factors, together with the unrelated nature of separate contract projects, the formula does not result in a reasonable or true determination of income in the case of contractors.

In the tangible property fraction if all or most of the equipment is rented on one contract but owned by the corporation on another, in the formula for this particular fraction no income would be assigned to the contract which had the rented equipment but would all be assigned to the contract where the equipment was owned, regardless of the earnings of each contract.

In the wage fraction, on one contract the labor may all be subcontracted and the corporation have little or no payroll for its own employee, and on another the personnel may all be employees of the corporation. The income, of course, would then be weighted or allocated to

the contract which used company employees and not to the one which used subcontractors.

And in the sales fraction, sales, under Section 59-13-20(6)(c) are assigned to the office out of which the taxpayer negotiates such sales. In the case of a contracting corporation the sale or negotiation of a particular contract may or may not be accomplished in the same state as the actual performance of such contract. In plaintiff's case the sale or negotiation of the contract with Kennecott was out of the office located in Sioux City, Iowa and therefore under the formula would not be assigned to Utah.

From a hypothetical application of the above three examples of the formula factors it can be seen that a very profitable contract (such as the one with Kennecott) could result in little or no net income allocated to this state if the corporation owned no property or equipment (rented), paid no wages or salaries (subcontractors), and assigned no sales (location of office) to Utah.

For these reasons the tax commission has established special regulations governing the allocation of income to contractors. The plaintiff filed its returns on the basis of segregated accounting pursuant to its agreement with the tax commission in tacit recognition of the inequities resulting, to state and taxpayer alike, from a strict application of the formula.

The deficiency assessment against plaintiff is based almost entirely upon the allocation of federal income tax

to taxpayer's various profit items or income divisions in and out of Utah as required by Corporation Franchise Tax Regulation No. 13.

This regulation requires federal income tax to be assigned against profit producing items or divisions only. Section 59-13-7(3), U.C.A. 1953, allows as a deduction against gross income "taxes paid or accrued within the taxable year."

However, the plaintiff in filing its franchise tax return assigned what was termed "federal income tax" as an expense against its Utah income in the amount of 52 per cent of its Utah net income before tax. In other words, it assigned \$905,443.46 "federal income tax" to its Utah net income, while the actual accrued federal income tax liability as computed in its federal return, after investment credit, was \$183,215.11.

Thus, while plaintiff only *paid* \$183,215.11 actual federal taxes, it claims the right to deduct federal taxes it would owe if it received \$1,741,237.43 in income and did business in Utah alone.

The statute requires actual figures to be used in allocating direct income, direct expenses and indirect expenses. Actual figures should also be used in assigning federal taxes. Regulation 13 contemplates an assignment of the actual federal tax to each profit item *only to the extent it is subject to federal tax*. As a result loss items are not assigned any federal tax.

If federal taxes are assigned against such loss items, extreme inequities result to the taxing authority. This can best be illustrated by the following two hypothetical examples which would *not* be allowed by Regulation 13:

	Within Utah	Outside Utah	Total
Net contract profit before fed. tax	\$2,000,000.00	\$(1,000,000.00)	\$1,000,000.00
Fed. tax @ 52% (expense)	* 1,000,000.00	(500,000.00)	* 500,000.00
Net taxable income	\$1,000,000.00	\$(500,000.00)	\$ 500,000.00
* (Actual federal tax only \$500,000.00. Utah assigned \$1,000,000.00 fed tax.)			

If the plaintiff's position is carried to the extreme, the following could occur:

	Within Utah	Outside Utah	Total
Net contract profit before fed. tax.....	\$2,000,000.00	\$(2,000,000.00)	-0-
Fed. tax @ 52% (approx.)	1,000,000.00	(1,000,000.00)	* -0-
Net taxable income..	\$1,000,000.00	(1,000,000.00)	-0-
* Actual federal income tax -0-, yet Utah assigned \$1,000,000.00 federal tax expense.			

In the foregoing example Utah would be allocated more than total net income, just as in fact plaintiff allocated more net income to Utah on its 1962 return than its total for that year.

It is apparent from these examples that Utah income can be reduced by a nonexistent federal tax lia-

bility if plaintiff prevails herein. Such a result clearly does not allocate to this state the proportion of net income fairly and equitably attributable to the state and furnishes sufficient justification for the commission to disregard the formula and make an allocation of income under Section 59-13-20(8), U.C.A. 1953.

CONCLUSION

The apportionment formula established by Section 59-13-20, U.C.A. 1953, produces manifestly unfair results in this case. Plaintiff's income must be separately determined in order that it may be subjected to a proper tax liability.

In any determination of this liability it is income resulting from businesses transacted within the state which is the measure of the value of plaintiff's franchise. Deductions from this income are allowable only to the extent authorized by law.

For these reasons the tax commission urges that its decision be upheld.

Respectfully submitted,

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