1965

Bennett Association v. Utah State Tax Commission : Brief of Petitioner

IN THE SUPREME
OF THE STATE

BENNETT ASSOCIATION,

—vs.—

UTAH STATE TAX

BRIEF OF

WRIT OF CERTIORARI TO
OF THE UTAH

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IN THE SUPREME COURT OF THE STATE OF UTAH

BENNETT ASSOCIATION,
Petitioner,

— vs. —

UTAH STATE TAX COMMISSION,
Respondent.

Case No. 10682

BRIEF OF PETITIONER

NATURE OF CASE

This case involves the legality of the respondent's assertion of a corporate franchise tax deficiency against the petitioner.

DISPOSITION OF THE CASE BELOW

The petitioner's petition for redetermination of the Notice of Tax Deficiency was heard February 9, 1966, and was denied by respondent on June 13, 1966.

NATURE OF RELIEF SOUGHT ON APPEAL

By this appeal petitioner seeks a reversal of the June 13, 1966, decision of respondent.

STATEMENT OF FACTS

The facts in the controversy were settled by written stipulation of the parties, and references in support of the material facts will cite the appropriate page of the stipulation (Stip. ....).

The petitioner is a Massachusetts business trust which has been treated as a taxable corporation at all times since adoption of the Utah Corporate Franchise Tax Act (Stip. 1). Petitioner during the periods involved owned more than ninety-five per cent of the outstanding capital stock of the Bennett Leasing Company, a Utah corporation, of Utah Auto Rentals, dba National Car Rentals of Utah, a Utah corporation, and of Bennett's, a Utah corporation (Stip. 1).

In 1963, petitioner caused inquiry to be made regarding merging Bennett's into petitioner. Petitioner was advised that this could not be accomplished in a feasible manner for federal income tax purposes, but that Bennett's could be dissolved and liquidated into its parent (petitioner), in a tax free manner, under Section 332 of the Internal Revenue Code and under the provisions of Section 59-13-23, Utah Code Annotated 1953, and pursuant to Article 34 of Regulation 4 pertaining to consolidated returns of affiliated corporations during a consolidated return period, without recognition of taxable gain to petitioner under the Utah Corporate Franchise Tax Act (Stip. 2).

Thereafter, in order to become eligible to file a consolidated return, Bennett Leasing Company, Utah Auto

Rentals, Bennett's and petitioner requested and obtained approval from the Utah State Tax Commission and the United States Treasury Department to change their method of accounting (Stip. 3). This resulted in all the named corporations and petitioner utilizing the accrual method of accounting on a calendar year period, commencing January 1, 1964 (Stip. 5).

On March 31, 1964, Bennett's, in complete redemption and cancellation of all its outstanding capital stock, made a liquidating distribution of all its assets to petitioner and minority shareholders. Prior to March 31, 1964, Bennett's carried on its business as usual, and ever since that date the business has continued to be operated, uninterrupted and unchanged, by petitioner with the assets it received pursuant to said liquidating distribution (Stip. 4).

On or before April 15, 1965, petitioner filed a Utah Consolidated Corporate Franchise Tax Return for the calendar year 1964, including therein income of Utah Auto Rentals, Bennett Leasing Company, and all income earned by petitioner for said year, including income earned from the continuation of the business of Bennett's, after liquidation and dissolution of Bennett's on March 31, 1964 (Stip. 1 and 2).

In preparation of the consolidated return for the calendar year 1964, the petitioner's accountant inadvertently failed to include the income of Bennett's for the first three months of 1964, and also similarly failed to include "Form 22," a consent from Bennett's to the filing of said return (Stip. 4).

Subsequently petitioner attempted to file with the Utah State Tax Commission (respondent) an amended consolidated return, tendering in conjunction therewith a check for additional tax, the purpose of which was to include the income of the business of Bennett's from January 1, 1964, through March 31, 1964 (Stip 4 and 5).

On August 31, 1965, the respondent asserted a tax deficiency for the period ended December 31, 1964, against petitioner in the amount of $70,559.44, plus interest. The deficiency was based on the fair market value of the liquidating distribution from Bennett's to petitioner in the amount of $1,766,362.80 (Stip. 2).

STATEMENT OF ARGUMENT

POINT I.

GAIN IN THE LIQUIDATING DISTRIBUTION FROM BENNETT'S TO PETITIONER IS NOT RECOGNIZABLE BY REASON OF ARTICLE 34 OF REGULATION 4, SINCE

A. PETITIONER AND BENNETT'S WERE MEMBERS OF AN AFFILIATED GROUP, AND

B. THE DISTRIBUTION FROM BENNETT'S TO PETITIONER IN CANCELLATION OF BENNETT'S STOCK WAS MADE DURING A "CONSOLIDATED RETURN PERIOD."

POINT II.

PROMULGATION OF ARTICLE 34 OF REGULATION 4 WAS CLEARLY AUTHORIZED BY STATUTE AND IS VALID AND BINDING UPON THE RESPONDENT.

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RESPONDENT'S AMENDMENT OF REGULATION 4 CLEARLY DEMONSTRATES THAT THE RELIEF SOUGHT SHOULD BE GRANTED TO THE PETITIONER.

ARGUMENT

POINT I.

GAIN IN THE LIQUIDATING DISTRIBUTION FROM BENNETT'S TO PETITIONER IS NOT RECOGNIZABLE BY REASON OF ARTICLE 34 OF REGULATION 4, SINCE

A. PETITIONER AND BENNETT'S WERE MEMBERS OF AN AFFILIATED GROUP.

Article 34 of Regulation 4 provides:

> "(a) During consolidated return period. — Gain or loss shall not be recognized upon a distribution during a consolidated return period, by a member of an affiliated group to another member of such group, in cancellation or redemption of all or any portion of its stock; and any such distribution shall be considered an intercompany transaction."

The issue in this appeal centers upon and revolves about the above quoted regulation. Everything petitioner did or inadverently did not do relates to this regulation.

Section 59-13-23, Utah Code Annotated, defines an "affiliated group" as follows:

> "Sec. 59-13-23. * * * (4) As used in this section an 'affiliated group' means two or more cor-

porations connected through stock ownership with a common parent corporation, if —

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

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

The liquidating distribution was from Bennett's to petitioner, and it occurred at a time when petitioner owned more than ninety-five per cent of the stock of three subsidiaries, one of which was Bennett's. These are the stipulated facts, and it is likewise stipulated that petitioner and its subsidiaries, including Bennett's, were members of an "affiliated group," and such is conceded by respondent in its Decision opinion at paragraph 2, Conclusions of Law.

B. THE DISTRIBUTION FROM BENNETT'S TO PETITIONER IN CANCELLATION OF BENNETT'S STOCK WAS MADE DURING A "CONSOLIDATED RETURN PERIOD."

Article 1, subsection (c) of Regulation 4 states the following definition:

"(c) Consolidated return period. — The term 'consolidated return period' means any taxable year for which a consolidated return is made or is required."

As stated in (a) of Article 34, Regulation 4, in order to avoid recognition of gain or loss on the distribution from a subsidiary to a parent, the distribution must be made "during a consolidated return period" and this term is defined by subsection (c) as "any taxable year for which a consolidated return is made or required." In reference to separate or consolidated returns of affiliated corporations, the statutory law of Utah provides:

> "Sec. 59-13-23. * * * (1) An affiliated group of bank and/or other corporations shall, subject to the provisions of this section, have the privilege of making a consolidated return for any taxable year in lieu of separate returns. The making of a consolidated return shall be upon the condition that all the corporations which have been members of the affiliated group at any time during the taxable year for which the return is made consent to all the regulations under subsection (2) of this section prescribed prior to the making of such return; and the making of a consolidated return shall be considered as such consent. In the case of a bank or other corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such bank and/or other corporation for such part of the year as it is a member of the affiliated group.

As previously stated, by its own decision the respondent at paragraph (2), Conclusions of Law, concluded that "Petitioner and its subsidiaries, including Bennett's, a Utah corporation, were members of an 'affiliated group, as that term is defined by Section 59-12-23 (4), Utah Code Annotated 1953, *at the time the liquidating distribution in question was made to petitioner.*" (Emphasis added)

The statute above set forth clearly states that in the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group. Yet, despite the plain meaning of the statute, respondent ruled that because of dissolution Bennett's owed neither a franchise tax nor a franchise tax return for the year 1964, and thus could not join in a consolidated return, and that 1964 was not a taxable year for Bennett's.

Not only does respondent's decision violate the plain meaning of the statute but it also violates respondent's own regulation, namely, Article 12(e), Regulation 4, which provides:

> "(e) Signatures in case subsidiary has left group. — It will be observed that form 22 is required even though the member (because of a dissolution or sale of stock or otherwise) has ceased during the consolidated return period to be a member of the group. Accordingly, it may be advisable for the corporation filing the consolidated return to obtain the signature to the form prior to the time the corporation ceases to be a member of the group."

A casual reading of respondent's Regulation 4 will disclose other instances in which it is plain that "members of an affiliated group" embraces such members as become or cease to be members at any time. And of course this is correct because where a consolidated return is filed, it is filed for a group and not for separate entities. For instance, Article 31, Regulation 4, provides:

"(a) Definition. — Except as otherwise provided in these regulations, the consolidated net income of the affiliated group, which makes or is required to make a consolidated return for any taxable year, shall be the aggregate of the gross income of each of the members of such group less the aggregate of the allowable deductions of each of such members, except that gain or loss will not be recognized on transactions between members of the group (referred to in these regulations as 'intercompany transactions')."

Likewise, Article 32 of Regulation 4, provides:

"If a corporation, during the taxable year of the group, becomes a member or ceases to be a member of an affiliated group which makes or is required to make a consolidated return for such year, the income of such corporation to be included in the consolidated return shall be computed on the basis of its income as shown by its books (subject to the elimination of items exempt from taxation and the addition of items not allowable as deductions in computing net income) if the accounts are so kept that the income for the period during which it is a member of the group can be clearly and accurately determined."

The consolidated return was made, and by statute the making of such is deemed consent to the respondent's regulations. By Article 15, Regulation 4, it is provided that the parent corporation for all purposes in respect of the tax for the taxable year for which a consolidated return is made or required, shall be the agent of each corporation which during any part of such period was a member of the affiliated group.

Article 30 of Regulation 4, provides "in the case of an affiliated group which makes, or is required to make, a

consolidated return for any taxable year, the tax liability of each corporation for the period during such year that it was a member of such group shall be computed upon the basis of a consolidated return."

Petitioner filed a consolidated corporate franchise tax return for the period January 1, 1964, through December 31, 1964, and this return reflected the gross income of two of petitioner's subsidiaries, namely, Utah Auto Rentals and Bennett Leasing Company, and it also reflected all income of petitioner for said period. The consolidated return also included income earned from the continuation of the business of Bennett's after liquidation and dissolution of Bennett's on March 31, 1964, but inadvertently neglected to include the income earned by Bennett's from January 1, 1964, to and including March 31, 1964.

Respondent holds, at sub-paragraphs numbered 3, 4, and 5 of its decision, that Bennett's could not join in a consolidated return since, as stated in paragraph No. 3, it was a corporation which owed no individual return for the taxable year 1964, and, as stated in paragraph No. 4, because of its dissolution Bennett's owed neither a franchise tax nor a franchise tax return, and therefore could not join in a consolidated return for the taxable year 1964, and, at paragraph 5, the year 1964 was not a taxable year for Bennett's and therefore the liquidating distribution was not made during a consolidated return period in which Bennett's was included.

Petitioner submits that the statute itself and the regulations promulgated thereunder do not permit such

an interpretation. Clearly, any subsidiary corporation which is a member of an affiliated group for only a portion of a year is not deprived of its status as a member of the affiliated group and the subsequent right to join in a consolidated return. Indeed, since the taxable entity is the group, and not the separate constituent members thereof, if a consolidated return is filed, the statute and the regulations require the subsidiary to join in such a return, Sec. 59-13-23 U.C.A. 1953, Reg. 4, Art. 12 (e); and require the subsidiary's income to be included in such a return for that portion of the year during which it was a "member of the affiliated group." Sec. 59-13-23 U.C.A. 1953; Reg. 4, Art. 32.

The consolidated return, of course, covered the year 1964, and thus 1964 was the group's "consolidated return period," and it was during this "consolidated return period" that Bennett's distributed its assets to petitioner in cancellation of Bennett's stock. This is the precise intercompany transaction which Article 34 of Regulation 4 referred to when it stated that there will be no gain or loss recognized upon such a distribution.

POINT II.

PROMULGATION OF ARTICLE 34 OF REGULATION 4 WAS CLEARLY AUTHORIZED BY STATUTE AND IS VALID AND BINDING UPON THE RESPONDENT.

Petitioner recognizes that its position depends upon the validity of Article 34 of Regulation 4.

Since this is a regulation promulgated by respondent, inquiry must first be directed to respondent's au-

thority. This court in *Utah Hotel Company* v. *Industrial Commission*, 151 P. 2d 467, 107 Ut. 24 (1944), said:

> "We deem it essential to a clear understanding of the problems implicit in this matter to note at the outset that regulations of administrative tribunals are not all birds of a feather. A failure to note this fact will inevitably lead to hazy thinking and erroneous concepts. The weight which should be given to a prior administrative regulation will to a large extent be dependent upon the type of regulation involved. Regulations may be promulgated pursuant to a specific delegation of legislative power. In prescribing such regulations, the administrative tribunal, within designated limits, may actually be making the law or prescribing what the law shall be. In prescribing such a regulation the tribunal in effect legislates within the boundaries marked out for its action by legislative enactment. On the other hand, the administrative tribunal may, by adopting a given regulation, only purport to interpret what the legislature meant by its statutory language. Such a regulation is nothing but an administrative opinion as to what the statute under construction means. See Von-Baur, 'Federal Administrative Law,' p. 487, sec. 489, wherein it is stated that the interpretive regulation is nothing more 'substantial than an administrative construction or interpretation of a general term in a statute — that is, an administrative guess at a judicial question.' "
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> * * *
>
> "An administrative interpretation out of harmony and contrary to the express provisions of a statute cannot be given weight. To do so would in effect amend the statute. Construction may not be substituted for legislation. United States v. Mis-

souri Pac. R. Co., 278 U.S. 269, 49 S. Ct. 133, 73 L. Ed. 322.

* * *

"In Alvord's article in 40 Col. L. Rev. 252, the distinction is clearly drawn. He notes that the issue is not one of nomenclature, but is far more fundamental. The article points out that 'Legislative Regulations' are prescribed pursuant to a specific delegation of Legislative power. They purport to prescribe for the future a rule of general application. They have the force and effect of law. On the other hand 'Interpretive Regulations' are merely the administrator's construction of a statute."

The authority for the regulation, of course, is the statute, and this provides:

"Sec. 59-13-23. * * * (2) The tax commission shall prescribe such regulations as it may deem necessary in order that the tax liability of an affiliated group of banks and/or corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, may be determined, computed, assessed, collected and adjusted in such manner as clearly to reflect the income and to prevent avoidance of tax liability."

The Utah statute was copied virtually intact from the 1928 Internal Revenue Code under which the Commissioner of Internal Revenue was granted broad powers to prescribe regulations "in order that the tax liability of an affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation may be determined, computed, assessed, collected and adjusted

in such manner as clearly to reflect the income and to prevent avoidance of tax liability." Revenue Act of May 29, 1928, § 141 (b), 26 U.S.C. § 2141 (1928).

Pursuant to the 1928 Act, the Commissioner adopted regulations, and in the case of *Charles Ilfeld Co.* v. *Hernandez*, 292 U.S. 62, 78 L.Ed. 1127, 54 S. Ct. 596 (1934), the U. S. Supreme Court passed upon the validity of the regulations adopted. At issue were the provisions of Article 37 (a) of Regulation 75 which provided that *gains or losses* shall not be recognized upon a distribution during a consolidated return period by one member to another in cancellation or redemption of its stock, "and any such distribution shall be considered an intercompany transaction." In that case the petitioner was the parent corporation which owned all the stock of two other corporations for a number of years. In 1929 both subsidiary corporations were dissolved. Thereafter petitioner sought a refund on the basis that losses to petitioner from its investments in the subsidiaries should have been deducted. The Supreme Court said:

> "The Revenue Act of [May 29], 1928, U.S.C. Title 26, § 2141, and Regulation 75 made under § 141(b) govern. Section 141(a) gives to groups of affiliated corporations the privilege of making consolidated returns, in lieu of separate ones, for 1929 or in subsequent years upon condition that all members consent to the regulations prescribed prior to the return. And, in view of the many difficult problems arising in the administration of earlier provisions authorizing consolidated returns, *the Congress deemed it desirable to delegate by § 141(b) the power to 'prescribe regulations legislative in character.'* Senate Report No. 960, 70th

> Cong., 1st Sess., p. 15. That subsection authorizes the commissioner, with the approval of the Secretary, to make such regulations as he may deem necessary in order that the tax liability of an affiliated group and of each member 'may be determined, computed, assessed, collected, and adjusted in such manner as clearly to reflect the income and to prevent avoidance of tax liability.' " (Emphasis added)

The Supreme Court upheld the validity of the regulations as governing this situation and no loss deduction was allowed. The Commissioner's Regulations were also adopted virtually intact by the State of Utah in 1931, and are applicable at all times material to this matter. The provisions of the Federal Regulations referred to in the cited case are identical to the provisions of Article 34(a), Regulation 4 at issue in this case. In *Ilfeld* the Supreme Court held that the losses were intercompany transactions that should not be recognized even though, under other provisions of the law, they would have been recognized. Similarly, petitioner's gains are intercompany transactions that should not be recognized even though under other provisions of the law they would have been recognized. In other words, the delegation of the power to prescribe regulations was proper and Regulation 4 is valid and binding on respondent.

POINT III.

RESPONDENT'S AMENDMENT OF REGULATION 4 CLEARLY DEMONSTRATES THAT THE RELIEF SOUGHT SHOULD BE GRANTED TO THE PETITIONER.

Bennett's was liquidated into petitioner on March 31, 1964, and the hearing herein before respondent was held in February, 1966. It seems fair to assert that this was the causative event which led respondent, in May, 1966, to drastically change Regulation 4, since the decision herein was not handed down by respondent until June, 1966. Regulation 4, prior to change, had been in existence and unchanged for some thirty-five years.

The changes promulgated resulted in the elimination from Regulation 4 of provisions entitled "Definitions, Dissolutions, Basis of Property and Inventories," and there are additional and changed interpretations which are startling.

Regulation 4 as presently constituted is not long and should be read in its entirety. However, petitioner would like to direct this Court's attention to some of the judicial and legislative reversals that occurred in respondent's thinking. Regulation 4, Article 1, General Provisions, was amended to add the following:

> "A consolidated return may not be filed unless the group includes at least two qualified subsidiaries and a parent corporation. A consolidated return may not include (1) a corporation for which no return would be required for the period if filing on a separate basis. . . ."

A totally new Article 8 has been added, which reads as follows:

> "8. Dissolution of a Member of the Affiliated Group. Activity of corporations which have ceased to be members of the group due to dissolu-

tion or withdrawal from this state during the taxable year is not to be included in the consolidated return of the group and such corporation is not required to file a return for the year, the tax for the period having been paid with the return filed for the previous year. In the case of a dissolution gain or loss on the distribution of assets in exchange for stock may not be treated as 'intercompany transactions' but must be computed in accordance with provisions of Section 59-13-14 (2) Utah Code Annotated 1953. In the event that a member leaves the affiliated group for any reason and there remains less than three members in the group, the privilege of filing a consolidated return ceases and separate returns will be required from all corporations required to file returns."

Section 59-13-14-(2) UCA 1953, deals with Distributions in Liquidation and states that the gain to the distributee shall be the excess of the amount realized over the basis. This excess is, of course, taxable under that section.

Article 12 states:

"12. Consolidated Net Income. Consolidated net income shall be the aggregate of the gross income of each of the includable corporations less the aggregate of the allowable deductions of each of such corporations, except that gain or loss will not be recognized on intercompany transactions, other than provided elsewhere in this Regulation."

And the last sentence of Article 13 provides:

"* * * Transactions with an excluded subsidiary shall not be considered intercompany transactions during a consolidated return period."

As has been heretofore noted, definitions of terms used have been totally eliminated in the current Regulation 4. Thus some difficulties may arise as to what is an "intercompany transaction" in Article 12, and what is an "excluded subsidiary" in Article 13.

However, at least one proposition is abundantly clear, and that is that Regulation 4, Article 8, was rewritten to strike at petitioner's situation. This present Article 8 of Regulation 4 is a complete reversal of and diametrically opposed to respondent's prior Article 34(a) of Regulation 4, which stated that gain or loss would not be recognized, during a consolidated return period, upon a transfer by a member of an affiliated group to another member of such group in cancellation or redemption of all or any portion of its stock.

Petitioner considers this to be a direct repudiation of the Statute itself, inasmuch as Sec. 59-13-23 (1) U.C.A. 1953 provides ". . . In the case of a . . . corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such . . . corporation for such part of the year as it is a member of the affiliated group."

Respondent thus finds itself in the anomalous position of asserting and deciding that under Regulation 4, prior to its amendment in 1966, it was plain that a dissolving corporation could not join in a consolidated return covering the year of dissolution, and yet, even though so asserting and deciding, respondent deemed it advisable to change completely the "gain or loss" con-

sequences and necessary to spell out specifically that a corporation upon dissolution cannot join in a consolidated return covering the year of dissolution. Of course, the subject of the amendment was the precise issue that is involved in this case, and the actions of respondent in issuing the vastly new Regulation 4 in May of 1966 would seem to confirm that it, too, recognizes the validity of petitioner's position. By deleting Article 34(a), and promulgating Article 8, in the present Regulation 4, respondent must have recognized that its former regulations meant exactly what this petitioner is here contending they did mean.

Had this petitioner in 1963 been confronted with the regulations as presently amended, it would certainly have been on notice that, if such regulations were valid, a dissolving corporation could not be a member of an affiliated group and thus would not be entitled to file a consolidated return.

Petitioner contends, however, that the Legislature and the respondent have made it clear, as shown by this brief and the statute and regulations cited herein, that a consolidated return could be filed even though one of the members of the affiliated group was dissolved during the taxable year, and, if such a return were filed, that the income of any such corporation must be included in the return.

To follow respondent's argument to its logical conclusion would have required Bennett's, in dissolution, to transfer all of its assets, with the exception of an insig-

nificant asset such as one can of paint or one paint brush, to petitioner in the year 1964. Thereafter Bennett's should have kept its charter alive and distributed the remaining can of paint or paint brush in 1965 and then dissolved. This, according to respondent's argument, would permit Bennett's to file a consolidated return with Petitioner and the other subsidiaries for 1964 and the 1964 intercompany transaction would not have been taxed. The Statutes, the Regulations and common sense did not require such a maneuver.

CONCLUSION

It is submitted that the decision of Respondent should be reversed.

Respectfully submitted,

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