No. 87-894

In The

Supreme Court of the United States

October Term, 1987

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SHELL OIL COMPANY,

Appellant,

v.

THE IOWA DEPARTMENT OF REVENUE,

Appellee.

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On Appeal from the Supreme Court of Iowa

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BRIEF OF MULTISTATE TAX COMMISSION AS AMICUS CURIAE IN SUPPORT OF APPELLEE

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QUESTION PRESENTED

Whether the Outer Continental Shelf Lands Act precludes the State of Iowa from imposing a tax upon that portion of a unitary net income base which is reasonably attributable to the taxpayer's income producing activities in Iowa.

PARTIES TO THE PROCEEDING

The parties to the proceeding are Shell Oil Company and the Iowa Department of Revenue.

CONSENT

The parties have given their consent pursuant to Rule 36.2 of the Supreme Court Rules to the filing of this Amicus Curiae brief. Copies of the letters of consent are on file with the Clerk of the Court.

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STATEMENT OF INTEREST OF AMICUS CURIAE MULTISTATE TAX COMMISSION

The Multistate Tax Commission (MTC) is the official administrative agency of the Multistate Tax Compact (Compact) entered into by 18 states[1] and the District of

1 Alaska, Arkansas, California, Colorado, Hawaii, Idaho, Kansas, Minnesota, Missouri, Michigan, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington.

Columbia as full members and by 10 states[2] as associate members.

The Commission and its member states are concerned with the contention of the Appellant, a corporation which conducts business in many states, that the Court should allow Appellant to carve out of its apportionable business income base that income which Appellant claims is attributable to a specific geographical location.

The stated purposes of the Compact are to:

1. Facilitate proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes.

2. Promote uniformity or compatibility in significant components of tax systems.

3. Facilitate taxpayer convenience and compliance in the filing of tax returns and in other phases of tax administration.

4. Avoid duplicative taxation.

The Commission is vitally interested in assisting the states in preserving their rights to protect their tax bases and to apply their taxes fairly to that portion of every corporate taxpayer's income which is reasonably attributable to the taxpayer's activities within the state.

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2 Alabama, Arizona, Georgia, Louisiana, Maryland, Massachusetts, New Jersey, Ohio, Pennsylvania and Tennessee.

STATEMENT OF THE CASE

The Multistate Tax Commission accepts the Statement of the Case as set forth in the Brief for the Appellee, the Iowa Department of Revenue.

SUMMARY OF ARGUMENT

I. SHELL, WHILE PURPORTING TO BASE ITS CLAIM ON A FEDERAL STATUTE, IS REALLY ATTACKING FORMULARY APPORTIONMENT; IT SHOULD NOT BE ALLOWED TO SUCCEED IN THAT EFFORT.

Shell purports to accept the validity of the apportionment formula which Iowa uses to determine what amount of Shell's total income is attributable to Iowa for income tax purposes. Yet it attacks the results of that formulary approach on the basis of a claim that it violates a federal statute. Nor does Shell attack the reasonableness of the formulary apportionment results. In thereby conceding that no Due Process or Interstate Commerce Issue lies in the case, Shell really concedes the invalidity of its so-called statutory claim.

II. THE COURT SHOULD REJECT SHELL'S ATTEMPT TO INSULATE IOWA INCOME FROM FAIR TAXATION.

Shell seeks to overthrow the results of formulary apportionment on the basis of its own self-serving application of a method to which it refers as "separate accounting" but which really is nothing more than an income apportionment method that has been tailored to serve Shell's purposes. It should be rejected.

III. THE OUTER CONTINENTAL SHELF LANDS ACT (OCSLA) IS IRRELEVANT TO THE DETERMINATION OF THE AMOUNT OF SHELL'S NET INCOME THAT IS REASONABLY ATTRIBUTABLE TO IOWA.

Iowa's formula seeks to arrive at a portion of Shell's total income that is reasonably attributable to Iowa. It is not, and need not be, concerned with the specific location of any portions of non-Iowa income.

IV. THE COURT SHOULD END THE PRACTICE OF ACCORDING "SEPARATE ACCOUNTING" THE DIGNITY OF AN ACCOUNTING TERM.

The term "separate accounting" is not an accounting term. It is an income attribution term which had arisen in the field of state taxation. But its widespread use in the income attribution context has often caused it to be treated as if it were an accounting term. The entire field of income attribution would be well-served if the Court would take the opportunity in this case to eliminate "accounting" from the income attribution vocabulary. That would help to eliminate much litigation which otherwise can be expected to arise out of false respect for a non-accounting term masking as an accounting term.

V. THE POSITIONS OF IOWA AND FLORIDA ARE COMPATIBLE; NEITHER SEEKS TO TAX ANY PORTIONS OF SHELL'S INCOME THAT IS NOT REASONABLY ATTRIBUTABLE TO ACTIVITIES CARRIED ON WITHIN ITS BORDERS.

Both Iowa and Florida apply a formula to determine the amount of income that is reasonably attributable to activities carried on within their borders. Florida accomplishes the purpose in a two-step procedure. It actually uses the Iowa formula in the first step. If it also applied the Iowa formula in the second step, the result would be the same as if it had applied Iowa's single-stop approach. In applying its own formula in the second step, Florida simply exercises its constitutional prerogative to use a formula of its own choosing.

VI. THE COURT SHOULD REJECT THE INTENDED EFFECTS OF SHELL'S OUT-OF-CONTEXT QUOTATIONS AND MISLEADING IMPLICATIONS.

Shell's incomplete quotes produce misleading impressions. They lack merit and confuse facts; and they imply that this Court and congressional leaders have taken positions which they have not taken.

ARGUMENT

I. SHELL, WHILE PURPORTING TO BASE ITS CLAIM ON A FEDERAL STATUTE, IS REALLY ATTACKING FORMULARY APPORTIONMENT; IT SHOULD NOT BE ALLOWED TO SUCCEED IN THAT EFFORT.

Shell bases its claim herein on the allegations: 1) that Iowa's apportionment formula attributes to Iowa income that Shell maintains was earned on the Outer Continental

Shelf (OCS); and 2) that that constitutes a violation of the Outer Continental Shelf Lands Act (OCSLA), 43 U.S.C. Sec. 1331 et seq.

Yet, it does not challenge the validity of Iowa's apportionment formula.[3] The philosophical underpinning of formulary apportionment is that it determines the amount of a taxpayer's income that is attributable to the state applying the formula. Therefore, in attacking the results of the formula, Shell is attacking the validity of the formula in the case at hand. It would not be improper to attack the results of the formula by seeking to demonstrate that they are unreasonable[4] or grossly distorted in effect[5], thereby seeking the protection of the Due Process and Interstate Commerce clauses. Shell has chosen not to do that. Rather, it attacks the formula indirectly by reference to the federal statute. In doing so, it generally attacks formulary apportionment, a concept which has always had the blessing of the Court. Shell should not be allowed to succeed in this attempt.

In failing to challenge the validity of the formula and the reasonableness of the result, Shell really concedes that Iowa is taxing only income that is properly attributable to Iowa and that is, by definition, not income earned elsewhere. Therefore, the claimed statutory basis for its complaint is facially defective and should be rejected.

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3 It could hardly do so in view of the fact that the Court upheld the validity of that formula in *Moorman Manufacturing Co. v. Bair,* 437 U.S. 267 (1978).

4 *Base, Ratcliff, & Gretton, Ltd. v. State Tax Commission,* 226 U.S. 271, 283.

5 *Norfolk & Western Railway Co. v. Missouri State Tax Commission,* 390 U.S. 317, 326 (1968).

Even as to the import of the statute, Shell asks the Court to accept a ridiculous conclusion. It would have the Court think, from the legislative history of OCSLA that the non-coastal states, in supporting congressional efforts to eliminate the jurisdiction and power of the coastal states over the OCS, sought to deprive themselves of the right to tax income which is attributable to activities within their borders. Such a contention is laughable. The representatives of the non-coastal states were simply protecting the rights of their own states to share, through the Federal Government, in the riches of the OCS. They were doing so by depriving the coastal states of jurisdiction and control over the OCS. Certainly, the last thing in their minds was that they should or would thereby restrict the authority of their own states to tax income attributable to activities within their own borders.

II. THE COURT SHOULD REJECT SHELL'S ATTEMPT TO INSULATE IOWA INCOME FROM FAIR TAXATION.

Shell claims to be able, by the use of its special attribution method, which it calls "separate accounting", to determine specific income that it claims to have been earned solely on the OCS. Its position flies in the face of the position which the Court has taken for the past sixty-eight years, starting with *Underwood*[6] and continu-

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6 *Underwood Typewriter Co. v. Chamberlain,* 254 U.S. 113 (1920).

ing on through the most recent case on the subject, *Container*[7], that it is impossible to source income to specific geographical locations; and that the results of the application by a state of formulary apportionment, of which the unitary business principle is the linchpin[8], must prevail unless the taxpayer can prove by clear and cogent evidence that extraterritorial values are being taxed[9], that there is no "rational relationship between the income attributed to the state and the intrastate values of the enterprise,"[10] or that the results are unfair[11], or unreasonable[12], or "out of all appropriate proportions to the business transacted . . . in that state."[13] Shell has not even sought to shoulder that burden of proof in this case, but simply relies on a so-called "separate accounting" method to attack the fundamental underpinnings of the unitary business principle.

But Shell does not really seek to apply even "separate accounting as that term has come to be used

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7 *Container Corp. of America v. Franchise Tax Board,* 463 U.S. 159 (1983).

8 *Mobil Oil Corp. v. Commissioner of Taxes of Vermont,* 445 U.S. 425, 439 (1980).

9 *Container, supra* at 164.

10 *Exxon Corp. v. Dept. of Revenue of Wisconsin,* 447 U.S. 207, 219-220 (1980).

11 *Container, supra* at 169.

12 *Bass, Ratcliff, supra* at 283 (1924).

13 *Container, supra* at 170, quoting from *Hans Rees' Sons, Inc. v. North Carolina,* 283 U.S. 123, 135 (1931).

in the field of state taxation. It really seeks to apply a method which has even less validity than does "separate accounting." Even though the method has been termed throughout the briefs in this case as "separate accounting," it is really the specific income attribution method. It purports to attribute specific portions of the taxpayer's overall net income to specific locations, and to do so accurately. Shell's reliance upon the method, by whatever name it is designated, conflicts with the position which the Court has long taken on the subject. In 1920, the Court commented upon "the impossibility of allocating specifically the profits earned by the processes conducted" by a business within the borders of a state.[14] It did so in ruling against an attack on formulary apportionment. It has never ruled otherwise. Indeed, formulary apportionment has withstood every challenge that taxpayers have directed at it in Supreme Court litigation since *Underwood.*

III. THE OUTER CONTINENTAL SHELF LANDS ACT (OCSLA) IS IRRELEVANT TO THE DETERMINATION OF THE AMOUNT OF SHELL'S NET INCOME THAT IS REASONABLY ATTRIBUTABLE TO IOWA.

The method proposed by the taxpayer here is not preferable to formulary apportionment as applied by Iowa in determining the amount of Shell's total income which is reasonably attributable to Iowa. That formula does not concern itself with where in the world any non-Iowa income was earned. Such a concern is irrelevant to the reasonableness of the Iowa result. Therefore, whether

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14 *Underwood, supra* at 121.

or not any of such income was or was not earned on the OCS is likewise irrelevant to the question of whether the income which the formula attributes to Iowa is reasonable. It must follow, then, that the OCSLA itself is irrelevant to any question as to what portion of Shell's income is properly attributable to Iowa. Since the taxpayer has not questioned the reasonableness of Iowa's formulary result and has offered no proof whatsoever that that result is not reasonable, the Court should simply rule that Iowa is not precluded by the OCSLA from taxing that portion of Shell's total unitary net income which is reasonably attributable to Iowa as determined by Iowa's application of formulary apportionment to that income.

IV. THE COURT SHOULD END THE PRACTICE OF ACCORDING "SEPARATE ACCOUNTING" THE DIGNITY OF AN ACCOUNTING TERM.

The entire field of interstate taxation, starting with the unitary business principle, is plagued by misunderstanding. Much of it traces to efforts to apply scientific exactness to the field of income attribution, which is by its very nature, impervious to exactness. [15]

In applying the unitary business principle in the context of corporate income taxation, the Court has always kept before it the simple question of whether the state was making a reasonable effort to effect a fair division of the income of a multistate taxpayer. Thus, the question has always been that of whether the effort has re-

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15 *Ibid.*

sulted in an attribution of income to the state in a manner which produced a fair and reasonable result.[16]

Toward this end, the Court has always carefully avoided blessing any particular method as the preferred method.[17] In *Container,* the Court noted that variations on the theme of unitary apportionment can be acceptable so long as those variations "are logically consistent with the underlying principles motivating the unitary approach."[18] Those principles may be summed up to be that the end result must be fair and reasonable. The mere fact that the use of some other approach, such as separate income attribution (formerly, we hope, called "separate accounting"), might produce a different result is irrelevant. Adherence to the principles is the standard against which any result will be measured.

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16 "Fair and reasonable" is a distillation of the Court's comments in various decisions, e.g.: "[A]n apportionment formula must, under both the Due Process and Commerce Clauses, be fair . . .," *Container, supra* at 169; "the Due Process Clause . . . [requires] . . . a rational relationship between the income attributed to the State and the intrastate values of the enterprise," *Mobil, supra* at 436-7; there must be a "rational relationship between the income attributed to the State and the intrastate values of the enterprise," *ibid;* the tax must be "fairly apportioned" and it must be "fairly related" to services rendered by the state, *Exxon, supra* at 228; the state must tax only its "fair share" of the taxpayer's income, *ibid* at 219; the tax must be "reasonably related to the activities conducted within the taxing State," *Moorman, supra* at 273; "[i]t is not shown in the present case . . . that [the method used] has produced an unreasonable result," *Bass, Ratcliff, supra* at 283; the income being taxed must be "reasonably atrributable" to in-state activities so that the taxpayer shoulders "its fair share of the burden of taxation," *Underwood, supra* at 121.

17 See *Container, supra* at 171.

18 *Ibid* at 167.

The problems that have been attributed to the unitary business principle trace largely to two things: 1) the ignoring of its fundamental purpose, which is to apportion all income that is related to the totality of the business in question, regardless of the form in which that business is conducted[19]; and 2) confusion as to the meaning of terms. Therefore, Amicus will here seek to clarify at least some aspects of the unitary business principle, as seen by the MTC, by defining terms and discussing them.

SPECIFIC INCOME ATTRIBUTION, in the stead of "Specific Accounting" or of a form of "separate accounting": means the tracing of gross income and related expenses to specific locations, thereby assigning the resulting net income specifically to those locations. It involves the attribution of net income on the basis of sourcing rules[20] as opposed to the attribution of net income on the basis of formulary apportionment . A taxpayer's attempt to use the concept to attribute income among its various locations was rejected by the Court in *Butler Bros. v. McColgan.*[21] The Court referred to the system used there as "separate accounting" and has continued to use that term over the years in reference to what we here propose to call specific income attribution.[22]

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19 ". . . the form of business organization may have nothing to do with the underlying unity of diversity of business enterprise." *Mobil, supra* at 440 (1980).

20 Sourcing rules may be based on the location of activities or properties or on the domicile of the entity.

21 315 U.S. 501 (1942).

22 It is common to attribute non-business income specifically. Thus, for example, UDITPA specifically attributes non-business net rental income from real estate to the state in which the property is located.

SEPARATE ENTITY INCOME ATTRIBUTION, in the stead of "Separate Accounting": Means a method of attributing the income of a taxpayer corporation among the various jurisdictions in which it conducts its business. It is a method which uses the books and records of the corporation to determine the income to which formulary apportionment applies in order to achieve its income attribution purpose. Since the books and records of a corporation invariably reflect only its own separate activities, the term "sparate entity accounting" has often been used interchangeably with the term "separate accounting." But neither constitutes the applying of accounting principles and neither necessarily produces accurate income attribution results.

The development of unitary combination and the ultimate confirmation of its validity by the Court in *Container*[23], have given rise to the above indicated definition of separate entity income attribution ("separate accounting") in the context of an alternative to unitary combination. Thus, unitary combination is defined as the application of the unitary business principle to two or more corporations engaged in the same unitary business; by contrast, separate entity income attribution limits its horizons to a single corporation.

In the briefs in the instant case as well as in the other pending case of *Shell Oil Co. v. Florida Department of Revenue*[24], the parties use the term "separate accounting." This reflects the imprecise nomenclature which has evolved. Both Iowa and Florida apply separate entity ac-

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23 *Supra.*

24 No. 86-1593.

counting in that neither state looks beyond the single corporate entity to determine a taxpayer's taxable income, i.e. neither state applies unitary combination. What the parties are really describing is specific income attribution, since they are referring to a specific item of income, namely that income which Shell claims to have had its source on the Outer Continental Shelf. No separate entity accounting applies here since the same corporation, Shell, is conducting activities both in Iowa and on the OCS. Formulary apportionment is, therefore, the proper method by which to determine what portion of that corporation's income is attributable to Iowa.

Shell seeks to attribute a portion of its income by means of what it calls "separate accounting" but which is nothing more than specific income attribution. In applying the method, Shell purports to trace specific gross income and specific related expenses to a specific location, the OCS, thereby assigning specific net income to the OCS. (We will not here duplicate the excellent discussion, in Iowa's brief, of the inconsistent manner in which Shell has sought to do this; that very inconsistency on the part of Shell constitutes a demonstration in itself of the impossibility of accurately attributing net income to specific locations.) In "skewing [facts] to resolve all doubts"[25] in its favor, Shell simply ignores expenses which it might have been expected to attribute to the OCS had it really believed in the system which it purports to use.

The Court has, from time to time, used other terms which have included the word "accounting." It has re-

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25 The "skewing" wordage is derived from *Container, supra,* at page 183, in which the Court referred to a "separate accounting analysis" which had been involved in *Hans Rees' Sons,* supra.

ferred to "formal geographical or transactional accounting" in *Container*[26], to "separate geographical accounting" in *Mobil*[27] and in *Exxon*[28] and to "separate functional accounting" in *Exxon.*[29] Amicus submits that the substitution of the word "attribution" would be preferable in every such instance; and that the elimination of the word "formal" is equally desirable. "Formal," as so used, implies that the method being applied is one that reflects generally accepted (i.e. "formal") accounting principles. In fact, the method does nothing of the kind.

The "separate accounting" which Shell prefers here is nothing more than one of the various "internal accounting techniques [which a company may use and which] are not binding on a State for tax purposes"[30]. The Court has always rejected such techniques when proffered as alternatives to formulary apportionment. But taxpayers refuse to believe it because of their mystical confidence in the efficacy of the word "accounting" to tip the scales in their direction. The Court might well relieve them of their misconception if it would resort to the use of income attribution language in the stead of "accounting" language in referring to the concepts in question.

UNITARY BUSINESS: Means a business the activities of whose elements (members, in the case of a multi-corporate structure) are so functionally integrated as to

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26 *Supra* at 164.

27 *Supra* at 438.

28 *Supra* at 215.

29 *Ibid* at 218, 223, 225 and 226.

30 *Ibid* at page 221.

be engaged in a single economic enterprise. Questions as to whether those elements are unitary will generally arise when the elements consist of separate legal entitles, e.g., separate corporations.

A corporation may be engaged in two or more discrete unitary businesses, thereby having two classifications of income within the single corporate structure. In such instances, it may be appropriate to apply the specific income attribution concept to determine what portion of the corporation's total income is attributable to each of the businesses and then to apply formulary apportionment to each of those businesses in order to determine how much of the income of each should be attributed to the states in which the corporation does business. In applying apportionment under such circumstances, it is necessary to attribute property, payroll and sales specifically to each of the discrete businesses.

Although this does not happen often[31], the states are experiencing increasing numbers of instances in which a question arises as to whether a taxpayer consisting of a single corporation is engaged in more than one discrete business.[32]

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31 In *Exxon, supra,* the taxpayer, a single corporation, attempted to separate its exploration, production and refining functions, which were all performed out-of-state, from its marketing function, part of which was performed in-state. The Court rejected the attempt.

32 See, for example, *Silent Hoist & Crane, Inc. v. Director of Taxation,* 100 N.J. 1, 494 A.2d 775 (1985), in which a corporation failed to convince the New Jersey Supreme Court that its various multidivisional activities were not unitary. And see Proposed California Diverse Business regulation

(Continued on following page)

Historically, a prerequisite to qualification as a unitary business has been common ownership or control, either directly or indirectly, of more than fifty percent of the voting stock of related corporations. In *ASARCO, Inc. v. Idaho State Tax Commission*[33], the Court held that ownership of more than fifty percent of the voting stock was not sufficient where there was no control. This has left open the question as to whether control provides a sufficient ownership basis even if ownership amounts to fifty percent or less.

Unities of operation[34] and of use[35] will always be pres-

(Continued from previous page)

25120(b), the first sentence of which reads: "A corporation subject to taxation may be engaged in more than one 'trade or business'." MTC Review, December 1987. But see *Appeal of P and M Lumber Products, Inc.,* Calif. St. Bd. of Equal., June 27, 1984 CCH 400-902, P-H 13, 112-W, in which the Board held that there were insufficient unitary ties between a lumber business division and a cattle business division of a single corporation to sustain a contention by the taxpayer that it conducted only a single unitary business. See also *Appeal of Mole-Richardson Company,* Calif. St. Bd. of Equal., October 26, 1983, CCH 400-652, P-H 13, 109-H, in which the Board held that a closely-held corporation was operating a number of separate enterprises.

33 458 U.S. 307 (1982).

34 Unity of operation means unity of staff administrative service functions, such as centralized purchasing, advertising, accounting, personnel policies and management, which further the integration of operations of the entities in question. See *Edison California Stores v. McColgan,* 183 P.2d 16, 20 (1947).

35 Unity of use involves unity of line functions, such as a centralized executive force and a centralized system of operation, all of which contribute to the functional integration of the activities of the entities in question. See *Edison California Stores, supra* at 20. Intercompany sales can also be indicators of unity of use, although the absence of such sales does not necessarily mean that such unity does not exist. See *Container, supra* at 176.

ent when functional integration exists among the related corporations.[36] So will the elements of dependency and contribution, in that the various entities will derive mutual benefits from their business relationships with each other as members of the unitary business.[37] In such cases, substantial flows of value[38] will be taking place. In sum, the unitary business will be benefitting from "functional integration, centralization of management, and economies of scale."[39]

UNITARY COMBINATION: Means the procedure under which unitary apportionment is applied. It involves the preparation of a so-called "combined report" in which the activities (e.g., property, payroll and sales) of a group of corporations that are engaged in a unitary business are taken into account to arrive at a formulary percentage. That percentage is then applied to the entire income of the unitary group to determine the amount of income that should be attributable to a state for corporate tax purposes.

UNITARY BUSINESS INCOME: Means all income derived by the unitary business from the conducting of its business activities. Such income is apportionable income. It includes dividends from investments made to further the purposes of the unitary business, e.g., to ensure a market for its goods or services, to ensure a source of raw ma-

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36 The so-called "three-unities" test of ownership, operation and use was established in *Butler Bros. v. McColgan, supra.*

37 The so-called "contribution or dependency" test traces to *Edison California Stores, supra.*

38 See *Container, supra* at 178.

39 *Ibid, supra* at 179.

terials, and/or to ensure availability of transportation, when needed, for its products. It includes interest received on short-term investments of money being held for purposes of the unitary business, e.g., for expansion of its facilities, for purchases of raw materials at anticipated advantageous market prices, for research and development. Amicus contends that such income includes royalty income from patents, copyrights and trademarks developed and/or owned by the unitary business in connection with the operation of that business; and that in none of these instances need the source of the income be engaged in the unitary business with the taxpayer as a prerequisite to that income's being included in the taxpayer's apportionable business income.[40]

The determination of the amount of the taxpayer's apportionable net business income is made by reference to the activities of the entity which is the source of the dividends, interest or royalties. Of course, some income may be received from a corporation which, were it not for a lack of unity of ownership, would be unitarily combinable with the taxpayer. Such income is clearly unitary income to the taxpayer. Had unity of ownership existed along with unities of operation and use so that functional integration existed and combination could have been applied,

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40 Attempts are often made to separate out from apportionable business income that income that has been received from intangibles, the rationale being that that income is derived from some outside source, e.g., dividends received from an unrelated corporation or interest received on debentures issued by an unrelated corporation. But Amicus contends that this is an erroneous approach, and that one should look only to the questions of why the investments were made and how they enhance the operation of the taxpayer's business.

that corporation's income would have been combined into the apportionable net business income base of the entire unitary business. Amicus contends that the mere absence of unity of ownership does not change the unitary nature of income received from that corporation by the parent even though that income now comes to the parent in the form of dividends.[41]

NONBUSINESS INCOME: Means all income other than unitary business income.[42]

CONSOLIDATION: Means the determination of the tax liability of the taxpayer by combining the activities of all commonly owned, whether directly or indirectly, corporations to determine the apportionment percentage of the group and then applying the resultant in-state percentage to the total income of the group. It differs from unitary combination in that it is based solely upon ownership without regard to whether the corporations are engaged in a unitary business. (For federal income tax purposes, the percentage of common ownership that is required is 80%. A consolidated federal income tax report does not, therefore, include unitary corporations that are more than 50% but less than 80% commonly owned.) Consolidation affords the taxpayer the advantage of being able to offset losses in some corporations against profits in others. Due Process considerations dictate that, absent a unitary relationship as evidenced by functional integration among the commonly owned corporations that are included in the consolidated report, a state cannot constitu-

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41 Many states now exempt a large percentage of such dividends from taxation, however.

42 See Section 1.(e) of the Uniform Division of Income for Tax Purposes Act (UDITPA).

tionally require consolidation. It can, though, give the taxpayer the option to use consolidation.[43]

V. THE POSITIONS OF IOWA AND FLORIDA ARE COMPATIBLE; NEITHER SEEKS TO TAX ANY PORTION OF SHELL'S INCOME THAT IS NOT REASONABLY ATTRIBUTABLE TO ACTIVITIES CARRIED ON WITHIN ITS BORDERS.

Since the same taxpayer, Shell, has pending before the Court another case which involves the same type of claim against Florida[44] with respect to its alleged OCS income as is at issue herein, it is important that there be no misunderstanding here as to the possible effect of the decision in this case on the Court's subsequent decision in the Florida case. The two states arrive at substantially similar results by routes that are substantially similar.

Iowa applies its single factor formula to the worldwide income of Shell to determine what portion of that income is attributable to Iowa.

Florida applies the same single factor formula to the worldwide income of Shell to determine what portion of that income is attributable to the fifty states of the United States. It then applies its own three-factor formula to

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43 Arkansas affords the taxpayer this option, allowing the application of the formula to consolidated federal taxable income. Oklahoma allows the taxpayer the option to apply the formula to only those members of the federal consolidated group which have property, payroll and/or sales in the state. Hawaii gives the taxpayer the option of applying the formula to only those members of its unitary business which have a taxable nexus within the state.

44 *Shell Oil Company v. Department of Revenue, State of Florida*, No. 86-1593.

the latter fifty-state income to determine what portion of it is attributable to Florida. If it used the Iowa formula in the latter exercise, the result would be identical to that reached by Iowa.[45]

Assume, for example, that one per cent of Shell's total sales are made into each of the fifty states. Iowa's formula would attribute one per cent of Shell's income to Iowa. Florida would use the same formula to determine that 50% of Shell's income is attributable to the fifty states. If it used Iowa's formula in the second step, it would now determine that one fiftieth of the fifty-state income was attributable to Florida, which would also be one per cent.

At the second step, Florida takes into account two other activities in addition to those of sales. It takes the route which the states more commonly apply[46] by using a three-factor formula which includes property and payroll as well as sales. The Florida formula, like those of eight other states,[47] consists of a 50% sales factor, a 25% property factor and a 25% payroll factor. If one per cent of Shell's total property and one per cent of its total payroll were in Florida, then the result would still be the

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45 Of course, Florida has the right to use its own formula to achieve a reasonable result. ". . . the Court has refused to impose strict constitutional restraints on a State's selection of a particular formula." *Moorman, supra* at 273.

46 All income tax states except Iowa make available to the taxpayer a three-factor formula consisting of property, payroll and sales. The weighting of the factors varies somewhat among the states.

47 Connecticut, Illinois, Kentucky, Massachusetts, New York, Ohio, West Virginia and Wisconsin. See Multistate Tax Commission Review, June 1987, page 11, footnote 4.

same; and one per cent of Shell's total income would be attributable to Florida just as would be the case if it used the Iowa formula throughout. If its property and payroll percentages were smaller, then a smaller percentage of Shell's total payroll would be attributable to Florida; if they were greater, then the greater attribution would be constitutionally valid so long as the result was not unfair,[48] unreasonable,[49] or grossly distorted.[50]

The result is that, in initially applying the single (sales) factor formula to all of Shell's income, both states include all of Shell's sales, including any that may be made on the OCS, in the denominator of the sales factor; and that neither of the states includes any of the OCS sales in the numerator of that factor.[51]

Shell would have the Court think otherwise. It claims that "under Iowa's reading of the OCSLA each of these jurisdictions [i.e. the states that use formulary apportionment] would be free to tax Shell's OCS income by including it in the apportionable base." (Shell brief at 8.) In fact, if every state followed either Iowa's or Florida's practice, no OCS income would be taxed. Thus, the formulas have the required internal consistency required by this Court.[52] In the example given above, only 50%

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48 *Container, supra* at 164.

49 *Bass, Ratcliff, supra* at 283.

50 *Norfolk and Western Railway Co., supra* at 326.

51 Neither does Florida include any non-Florida sales in the numerator of the sales factor of its three-factor formula in the second stage of its calculation.

52 See *Container, supra* at 169.

of Shell's income would be attributed among all of the states; any OCS income would fall into the category of income that had been formularily excluded from taxation by any state, i.e. the other 50%. Thus, Shell is inaccurate again when it says (Shell brief at 15) that Iowa's position would allow the states collectively to do what it concedes that no state can do individually. As shown in the example, each state could tax only its 1%, and the group of states could tax only 50% of Shell's worldwide income; the remaining 50% would be excluded from taxation by any state.

VI. THE COURT SHOULD REJECT THE INTENDED EFFECTS OF SHELL'S OUT-OF-CONTEXT QUOTATIONS AND MISLEADING IMPLICATIONS.

Shell quotes Exxon out of context, saying (Shell brief at 23) that "it is clear, as this Court has recognized, that apportionment 'subject[s] to taxation * * * income derived from the extraction of oil and gas located outside the State'." The full sentence reads, "The second issue is whether the Due Process Clause permits a State to subject to taxation under its statutory apportionment formula income derived from the extraction of oil and gas located outside the State which is used by the refining department of the taxpayer, or whether the State is required to allocate such income to the situs state."[53] The "recognition" that Shell represents does not exist. This Court simply rejected Exxon's contention that separate accounting was preferable to formulary apportionment as a means of obtaining "a rough approximation of the in-

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53 *Exxon, supra* at 210.

come that is reasonably related to the activities conducted within the taxing State.''[54]

Shell quotes *Moorman* out of context by extracting only part of a sentence from that decision. The full sentence is: ''Yet even were we to assume that the Illinois activities made some contribution to the profitability of the Iowa sales, appellant's claim that the Constitution invalidates an apportionment formula whenever it may result in taxation of some income that did not have its source in the taxing State is incorrect.''[55] That is a far cry from any recognition by the Court that, as Shell claims, ''apportionment 'may result in taxation of some income that did not have its source in the taxing State'.'' (Shell brief at 23).

In reference to n. 1 of J. Hellerstein, State Taxation, at p. 478, Shell correctly quotes a Florida case cited in that note that ''[i]n * * * apportionment, the taxpayer's normal or business income is mathematically divided among the various jurisdictions in which it does business to determine the measure of local tax.'' (Shell brief at 23.) But, contrary to Shell's implication, the Iowa formula does exactly that, attributing outside of Iowa, and therefore potentially to the OCS, any income not reasonably attributed to Iowa by the formula.

Shell justifies its contention that Iowa is taxing some of its OCS income by the fact that the result is an increase in Shell's tax to Iowa over the separate accounting approach. (Shell brief at 24.) But, of course, the

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54 *Ibid* at 223, quoting from *Moorman, supra* at 120.

55 See *Moorman, supra* at 272.

opposite would be the case were Iowa in a start-up situation which, over a period of start-up years on the OCS, might well result in a lesser tax liability to Iowa as the result of the application of the Iowa formula to Shell's total income which the huge start-up expenses would normally reduce during those years. It is not without significance that no other oil company has, to our knowledge, filed a brief in this case. That is tacit recognition of the fact that they are likely to incur future start-up expenses on the OCS and that they do not want those expenses to be excluded from the determination of their apportionable income base for the formulary apportionment purposes of the various states. Their concern is appropriate from both a practical and a legal perspective. The proper application of the apportionment formula dictates that all of the corporation's income and activities, including any on the OCS, be taken into account by every state in the determining of the net income base to which that state applies its apportionment formula and in determining the denominators of the factors in that formula.

Neither Iowa nor Florida is exercising any sovereignty over the OCS in applying formulary apportionment to Shell's income, Shell's contention to the contrary notwithstanding (Shell brief at 25). Neither state goes near the OCS. It does not know and cannot know how much or which of Shell's income comes from the OCS; neither does nor can Shell know. Nor does either state care about the source of any of Shell's income that may be attributable to locations outside its borders. It cares about only that portion of Shell's total income that is reasonably attributable to activities within its borders. Therefore, neither state is applying its taxation laws to the OCS nor exercising any jurisdiction over the OCS.

It is only political and taxing jurisdiction that is precluded by OCSLA. Representative Boggs made that clear when, during congressional debate, he said that the law "strikes out any participation by the States in the taxing of these resources."[56] Resources are capable of being located specifically, unlike the net income of a multistate or multinational corporation like Shell. A tax on those resources would clearly violate the statute. Neither Iowa nor Florida seeks to apply such a tax. Each seeks to tax only that portion of Shell's total income which is reasonally attributable to activities within the state's own borders. It should be allowed to continue to do so without concern for Shell's spurious OCS contentions.

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56 99 Cong. Rec. at 2572.

CONCLUSION

Shell's references to an irrelevant Federal Act, OCSLA, and to an incorrectly named non-accounting term should not blind the Court to the effect which Shell seeks to accomplish here, namely the emascalating of formulary apportionment and the overturning of nearly seventy years of consistent rulings by the Court. The decision of the Iowa Supreme Court should be affirmed.

Respectfully submitted,

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