COURT OF APPEAL OF THE STATE OF CALIFORNIA

THIRD APPELLATE DISTRICT

HOECHST CELANESE CORPORATION,	)	
	)	
Plaintiff-Appellant,	)	
	)	
v.	)	NO. C030702
	)	
FRANCHISE TAX BOARD, **an agency of the State of California**,	)	
	)	
	)	
Defendant-Appellee.	)	

Sacramento County Superior Court No. 96AS01954
The Honorable William M. Gallagher, Judge

BRIEF *AMICUS CURIAE* OF MULTISTATE TAX COMMISSION IN SUPPORT OF DEFENDANT-APPELLEE, FRANCHISE TAX BOARD

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INTEREST OF *AMICUS CURIAE*, MULTISTATE TAX COMMISSION

Amicus Curiae, Multistate Tax Commission ("Commission"), files this brief in support of Defendant-Appellee Franchise Tax Board. The Commission agrees with the Board's argument that the overwhelming prevailing view among those jurisdictions that have a position is that the business income definition (the California version of which is set forth in Rev. & Tax. Code § 25120(a)) includes two tests, including a functional test. The functional test treats the fact that an event associated with income is unusual or extraordinary as irrelevant. Respondent's Brief ("R.B.") 30-35. Commission files this brief solely because of the importance it attaches to uniform construction of the law.

The Commission is the administrative agency of the Multistate Tax Compact, Multistate Tax Compact, STATE AND LOCAL TAXES: ALL ST. TAX GUIDE ¶701 *et seq.* (RIA 1995) ("Compact"). The Commission has

forty one members, full, sovereignty and associate.[1] The U.S. Supreme Court upheld the validity of the Compact in *United States Steel Corp.* v. *Multistate Tax Comm'n*, 434 U.S. 452 (1978). California enacted the Compact in 1974, Stats. 1974, c. 93. The substantive provisions of Compact are found at Rev. & Tax. Code § 38006.

The purposes of the Compact, which became effective in 1967 when the required minimum number of States had adopted it, include "proper determination of state and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases," "[promotion of] uniformity," and "avoid[ance of] duplicative taxation." Compact, art. I.

Central to the existence of the Commission is the promotion of uniformity in the approach of the States' taxation of interstate and foreign commerce. Thus, Article IV of the Compact incorporates almost word for word the Uniform Division of Income for Tax Purposes Act, 7A UNIFORM LAWS ANNOTATED 331 (WEST 1985) ("UDITPA"). California enacted UDITPA in 1966, Stats. 1966, c.2. The provisions of UDITPA are found at Rev. & Tax. Code § 25120 *et seq.*

The Commission has also promulgated recommended regulations that interpret UDITPA for possible use by the States. These recommended regulations promote uniformity in the day-to-day administration of state income taxation of interstate commerce. See Commission Allocation and Apportionment Regulations, STATE & LOCAL TAXES: ALL ST. TAX GUIDE

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[1]In addition to the State of California, the current full members are the States of Alabama, Alaska, Arkansas, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Maine, Minnesota, Missouri, Michigan, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah, and Washington. The one sovereignty member is the State of Florida. The associate members are the States of Arizona, Connecticut, Georgia, Illinois, Kentucky, Louisiana, Maryland, Massachusetts, Mississippi, New Hampshire, New Jersey, North Carolina, Ohio, Oklahoma, Pennsylvania, South Carolina, Tennessee, West Virginia, and Wisconsin.

¶630 *et seq.*, p. 604 (RIA 1995). California has adopted the substance of these regulations. The regulations are interspersed in the division of income regulations found at 18 California Code Reg. 25120 *et seq.*

The Uniform Act provides that it shall be interpreted so as to "effectuate its general purpose to make uniform the law of those states that enact it." Rev. & Tax. Code § 25138. Uniformity of interpretation furthers the purposes of the Uniform Act and the Compact; lack of uniformity frustrates that purpose.

As Respondent Franchise Tax Board points out, virtually all states whose position can be determined acknowledge the existence of the functional test, and essentially all of these states view the unusual or extraordinary character of an event with which income is associated as irrelevant under the functional test. R.B. 30-35. Commission respectfully submits that a decision by California that conflicts with the prevailing view will pose a significant obstacle to the achievement of the purposes for the Uniform Act and the Compact. This is especially true given the fact that jurisprudence developed in California is the source of much of the language of the definition.

Against the backdrop of desired uniformity, Plaintiff-Appellant Hoechst Celanese advocates a distinctly minority view of business income that fails to interpret UDITPA's definition of business income properly. Hoechst Celanese maintains that an event that is extraordinary in the history of a business, which Hoechst Celanese characterizes its pension reversion as, cannot give rise to business (apportionable) income within the meaning of Rev. & Tax. Code § 25120(a), a provision identical to section 1(a) of UDITPA and art. IV.1.(a) of the Compact.

For reasons set forth below, your *Amicus* urges this Court to exercise caution in embracing a minority view of business income, a core provision of UDITPA's division of income rules. Deviation from a uniform

understanding would significantly upset the goal of both UDITPA and the Compact (by its incorporation of UDITPA in art. IV.) to avoid duplicative taxation and ensure full apportionment. See William J. Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 TAXES 747, 748 (1957) (problems UDITPA addressed).

ARGUMENT

I. UDITPA CONTAINS TWO ALTERNATIVE AND INDEPENDENT TESTS FOR DETERMINING BUSINESS INCOME AND THE PENSION REVERSION IS PROPERLY CLASSIFIED AS BUSINESS INCOME IN THIS CASE.

Defendant-Appellee Franchise Tax Board, using history, statutory interpretation, prior administrative practice, legislative intent, precedent from other jurisdictions, and the policy of state income tax uniformity, articulates the basis for concluding that business income is classified under UDITPA by two separate and independent tests. Defendant-Appellee Franchise Tax Board further explains why the application of these tests results in the classification of the pension reversion in this case as business income and why in making the classification the characterization of an event as unusual or extraordinary is irrelevant under the functional test. There is no need to repeat those observations that are incorporated here.

II. STATE INCOME TAX UNIFORMITY IS A VALUE WORTH PRESERVING IN OUR FEDERAL SYSTEM OF GOVERNMENT TO THE MAXIMUM EXTENT THAT IS REASONABLY POSSIBLE.

The modern era of state income tax uniformity began with the approval of UDITPA in 1957 by the National Conference of Commissioners on Uniform State Laws and the American Bar Association. *Historical Note*, Uniform Division of Income for Tax Purposes Act, 7A UNIFORM LAWS ANNOTATED 331 (WEST 1985). The push for increased state tax uniformity continued through the deliberations of the Willis Committee that were critical of diverse state income tax rules for the division of income, see pp.

7-8, below, and the eventual adoption of the Multistate Tax Compact in 1967. Roy E.Crawford & Russell D. Uzes, *Income Taxes: The Distinction Between Business and Nonbusiness Income* 4, TAX MGMT. MULTISTATE (BNA 1996). The effort to promote state tax uniformity, however imperfect in the real world, continues today with the operation of the Multistate Tax Commission, the administrative arm of the Multistate Tax Compact. Your *amicus* now shows that State tax uniformity as a value of our federal form of government is worth preserving to the maximum extent that is reasonably possible.

1. *UDITPA Seeks To Lessen Compliance Complexity And Costs And To Support Full Apportionability.*

The approval of UDITPA by the National Conference of Commissioners on Uniform State Laws and the American Bar Association was an inevitable development of the U.S. Supreme Court's increased recognition that States could elect to require interstate commerce to pay its fair share of state taxes. The drafters of UDITPA sought to address the problem of the incredibly diverse and complex systems of state income taxes that existed in the late 1950s. William J. Pierce, *The Uniform Division of Income for State Tax Purposes*, 35 TAXES 747, 748 (1957). These divergent systems of taxation caused enormous compliance complexities and burdens. *Id.* And the differences also created a lack of full apportionability.[2] *Id.*

[2]Full apportionability encompasses a problem UDITPA addressed, as described by Professor Pierce, the principal drafter of UDITPA. UDITPA sought a uniform system for the division of multijurisdictional income that avoids duplicative taxation and that ensures that the income is attributed to some jurisdiction, whether or not that jurisdiction taxes the income. UDITPA's division of income rules attribute income to a jurisdiction through its rules of apportionment, §§ 9-17, and allocation. §§ 4-8. Full apportionability is not to be confused with full taxability that is the goal of neither UDITPA nor the Multistate Tax Compact.

2. *The States Adopted UDITPA's Division Of Income Rules To Promote Needed Uniformity And Thereby Respond To Intense Criticism Of State Income Tax Sovereignty With Respect To Interstate Commerce.*

States are an important component of our federal system of government. "Our Federalism" presupposes two separate sovereigns, the Federal Government and the States, each with their own sphere of responsibility. The right of taxation is an essential part of sovereignty. A sovereign without the authority to raise revenues is a sovereign without power to discharge its governmental functions. The continuous challenge faced by the States in this environment is the preservation of taxing authority over interstate and foreign commerce without unreasonably interfering with that commerce.

Examination of state taxation of interstate commerce began in earnest following the Supreme Court's 1959 decision in *Northwestern States Portland Cement Co.* v. *Minnesota*, 358 U.S. 450 (1959). *Northwestern States* recognized for the first time that States had the sovereignty to impose an income tax on a nondomiciliary business engaged exclusively in interstate commerce. The justification for recognizing the authority of States to charge a "fair share" of taxes from interstate business was and remains that interstate business benefits from the ordered society provided by the States. *Northwestern States Portland Cement*, *supra*, 358 U.S. at 461-462. Notwithstanding the rationale, the interstate business community viewed *Northwestern States Portland Cement* with alarm.

Controversy arose because of the perceived compliance burden that would fall on interstate business due to its now being made subject to the full income tax jurisdiction of the States. (Compliance burdens remained high in 1959 and the early to mid-1960s, because few States had moved to adopt UDITPA. John S. Warren, *Income Taxes: Principles of Formulary Apportionment* 1, TAX MGMT. MULTISTATE (BNA 1995).) The controversy

was intense enough to prompt Congress within little more than six months following *Northwestern States Portland Cement*, to enact on an "interim basis" PUB. LAW 86-272, 73 STAT. 555 (1959), codified in part at 15 U.S.C. §381*ff*. (net income tax may not be applied where out-of-state company's contacts with taxing state are limited to prescribed safe harbor).

Consistent with the temporary status of PUB. LAW 86-272, Title II of PUB. LAW 86-272 mandated a congressional review of state income taxes as applied to interstate commerce. Subsequent legislation expanded this mandated study to include all forms of state and local taxation affecting interstate commerce. H.R. REP. NO. 1480, 88th Cong., 2nd Sess., at 9 (1964). In discharge of the mandate, the Willis Committee (so named for the chair of what actually was a Special Subcommittee of the House Judiciary Committee) was formed. The Committee conducted extensive hearings as a part of its exhaustive review of state taxes as applied to interstate commerce. Consistent with the controversy that greeted *Northwestern States Portland Cement*, the Willis Committee found many practical impediments to applying state taxes to interstate commerce. With respect to the application of state income taxes to interstate commerce the Committee observed:

> While each of the State laws contains its own inner logic, the aggregate of these laws—comprising the system confronting the interstate taxpayer—defies reason. Indeed, so varied are the provisions concerning jurisdiction, division of income, and tax base, that it is rare to find a statement which is true of all income tax States.

H.R. REP. NO. 952, 89th Cong., 1st Sess., Pt. VI, at 1143 (1965).

The Willis Committee made extensive recommendations for federal legislation to preempt and regulate the application of state taxes to interstate commerce, including state income taxes. *Id.* at 1139*ff*. The recommendations for state income taxes sought, among other things, more uniformity in the rules for the division of income among the States and in

the starting point used to compute the state income tax base. These recommendations and other recommendations attempted to address numerous problems that flowed from a substantial lack of uniformity that resulted in complexity, uncertainty, compliance burden, administrative challenge, and overtaxation and undertaxation.

The States welcomed the recognition *Northwestern States Portland Cement* provided for their income taxing authority over interstate commerce. The enactment of PUB. LAW 86-272 and the recommendations of the Willis Committee that became the subject of separate hearings, *Interstate Taxation Act: Hearings on H.R. 11798 and Companion Bills Before Special Subcomm. on State Taxation of Interstate Commerce of the House Comm. on the Judiciary*, 89th Cong., 2d Sess. (1966), forced the States also to recognize a practical problem—state income taxes were not then well framed to be applied to interstate business. State income taxes required reform, especially in the development of substantial uniformity, in order for the recognized state income tax sovereignty over interstate commerce to be realistically exercised. The States could not ignore the immediate need for reform of state income taxes, because Congress stood ready to enact the reform itself through federal legislation that would preempt and regulate these and other state taxes.

The States generally were unwilling to accept a congressionally mandated solution, preferring instead for the States to devise a state solution to the state problems. Otherwise, legislative enactment and regulation of significant aspects of state taxes would be removed from the state legislatures to the Congress and the federal bureaucracy. Institutionally, this shift in responsibility was unacceptable, because Congress and the Federal Government lacked any consequent responsibility for the delivery of governmental (state) services that would be impacted by federal regulation of state income and other taxes. In addition, the States

did not favor several aspects of the proposed federal solution. Gene Corrigan, *A Final Review*, 1989 MULTISTATE TAX COMM'N REV. 1, 23. It may also be noted that some of the aspects of the proposed solution were distasteful to some of interstate business also. Warren, *Income Tax: Principles of Formulary Apportionment* at 1, above.

The need for the States to solve their own problems prompted several States to adopt the Compact and form the Commission. From the foregoing discussion, it is apparent that the purposes of the Compact, see p. 2, were intended to and do respond directly to the criticism the Willis Committee leveled at the then existing state tax systems. Undoubtedly, the same forces of reform were present in California in the mid-1960s, since the UDITPA-based division of income rules were adopted by the California legislature to be effective on July 1, 1966, Stats. 1966, c. 2., a period that falls within the center of the controversy.

III. A UNIFORM UNDERSTANDING AMONG THE STATES AS TO THE MEANING OF BUSINESS (APPORTIONABLE) INCOME IS CENTRAL TO THE AVOIDANCE OF DUPLICATIVE TAXATION.

Defendant-Appellee Franchise Tax Board fully describes the operation of UDITPA's formula apportionment and how the concept of business income interacts with that formula. It suffices to note after this description that the concept of business income is central to proper division of multijurisdictional income, because it is only business income that is actually subject to UDITPA's formula apportionment. Rev. & Tax. Code § 25128(a), UDITPA § 9, Compact art. IV.9. Nonbusiness income is subject to allocation (attribution to a specific jurisdiction and not divided by formula). Rev. & Tax. Code § 25123, UDITPA § 4, Compact art. IV.4.

The centrality of business income to the division of income rules means that inconsistent understandings of the concept give rise to the potential for duplicative taxation, one of the problems the adoption of UDITPA sought

to eliminate.[3] Pierce, *Uniform Division of Income for State Tax Purposes* at 748, above. Duplicative taxation was also an objectionable characteristic of non-uniform state income taxation that the Willis Committee identified. H.R. Rep. 1480 at 389, above. To illustrate the potential for duplicative taxation, consider a multistate business that is subject to tax in two States. If one State (because of its understanding of business (apportionable) income) requires the taxpayer to allocate 100% of an item of income to it as the place of the business' commercial domicile and the other State (because of its differing understanding of business (apportionable) income) requires the same item of income to be apportioned at least in part to it, then more than 100% of the same item of income in the aggregate will have been taxed. Similarly, if the same multistate company had an item of loss that the first State required to be apportioned and the second State required the item of loss to be allocated entirely to the first State, the company will have enjoyed only a portion of loss. In either case, duplicative taxation will have occurred.

CONCLUSION

In the interest of continuing state income tax uniformity that is sought through the application of UDITPA and the Mulitstate Tax Compact, *Amicus Curiae*, the Multistate Tax Commission, respectfully suggests that the Court should clearly adopt an interpretation of the business income definition in UDITPA that recognizes the second independent clause to be a

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[3]A non-uniform understanding of business income can also give rise to a lack of full apportionment, a problem that also was identified by the drafters of UDITPA. William J. Pierce, *Uniform Division of Income for State Tax Purposes*, 35 TAXES 747, 748 (1957). Because taxpayers generally would not view a lack of full apportionment, *i.e.*, the presence of taxable income that is not attributable to any State, a burden on interstate commerce, this brief does not focus on this problem that admittedly impacts the overall fairness of state income tax systems to all taxpayers and not to a specific taxpayer. See H.R. Rep. 1480 at 389, above.

separate and alternative test for apportionable income. Your *amicus* makes this request well knowing that the current condition of state income tax uniformity is not perfect. Yet the concept of business income comes as about as close to a uniform concept as anything.[4] Maintaining the line on business income means that States have taken seriously the need to employ *uniform* division of income rules if they are to defend successfully state tax sovereignty against federal regulation and preemption.

Respectfully submitted this 31th day of March 1999.

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[4]In addition to the UDITPA States identified by Defendant-Appellee Franchise Tax Board, R.B. at part V.A., there are other States that employ the same concept. *E.g.*, N.C. GEN. STAT. § 105.130.4(a)(1).