IN THE SUPREME COURT OF THE STATE OF IDAHO

UNION PACIFIC CORPORATION, Plaintiff-Respondent, v. IDAHO STATE TAX COMMISSION Defendant-Appellant.	)	No. 25876

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BRIEF AMICUS CURIAE OF MULTISTATE TAX COMMISSION IN SUPPORT OF DEFENDANT-APPELLANT, IDAHO STATE TAX COMMISSION

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Appeal from the District Court of the Fourth Judicial District
For Ada County, Honorable D. Duff McKee, District Judge

Eugene A. Ritti
Richard G. Smith
Hawley Troxell Ennis & Hawley LLP
P. O. Box 1617
Boise, ID 83701-1617
Attorneys for Plaintiff-Respondent

Geoffrey L. Thorpe
Deputy Attorney General
Idaho State Tax Commission
P.O. Box 36
Boise, ID 83722-1050
Attorney for Defendant-Appellant

Paull Mines, General Counsel
Frank D. Katz, Deputy Gen. Counsel
444 No. Capitol St., N.W., Suite 425
Washington, D.C. 20001-1538
(202) 624-8699
Attorneys for *Amicus Curiae*,
Multistate Tax Commission

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STATEMENT OF THE CASE

The Idaho State Tax Commission contests Union Pacific's treatment of dividend income from its interest in a joint venture that mines, processes and sells Union Pacific's trona from Union Pacific's land. The Tax Commission contends this income is unitary "business income" properly included in apportionable base income.

Union Pacific is a textbook example of a unitary business. It came into existence with two synergistically related and clearly defined lines of business—building and operating a railroad and developing the enormous Land Grants simultaneously gifted to Union Pacific by Congress to help pay for the founding and upkeep of the railroad. The existence of the railroad substantially increased the value of the adjacent lands Congress granted the railroads because of the ready access the railroad provided. And the existence of the Land Grant substantially increased the value of the railroad because businesses developed there have provided custom to the railroad in transporting their products.

Union Pacific has fully developed this symbiotic relation over many years. It has continually entered into various business relationships to exploit the mineral wealth of the Land Grant. In some cases, it invested none of its capital, just leased the mineral rights for royalties. Union Pacific has always agreed that the royalties from this mineral development constitute apportionable unitary business income as it derives from the regular course of Union Pacific's business—managing, developing, and profiting from Union Pacific's natural resources.

But Union Pacific has also understood that more money can be made from its mineral wealth than simply from selling the minerals in the ground. Those who extract, process and sell the minerals create additional wealth from those minerals and profit from the additional investment. Union Pacific followed that model with its subsidiary Union Pacific Resources, Inc (UPR). Because UPR is wholly owned by Union Pacific and furthers the unitary business of Union Pacific, no one has questioned that it is unitary with Union Pacific and that its income as well as property, payroll and sales are properly included in Union Pacific's unitary income and apportionment factors respectively.

In the current case, Union Pacific sought to develop its own trona mineral holdings. It wanted to do more than merely lease the mineral rights. It wanted to invest some of its capital toward that development, with the full understanding and expectation that there would be financial rewards not only from selling the minerals in the ground, but also from extracting, processing and selling the ore. Having no experience with trona mining, Union Pacific followed the prudent course of entering into a joint venture with a company that had such experience. That joint venture, Rhone Poulenc of Wyoming, Inc. (RPW), operated the trona mining undertaking. As hoped and anticipated, the joint venture was successful, not only earning Union Pacific royalties RPW paid for the trona extracted—which royalties Union Pacific concedes are unitary and apportionable business income—but also earning a profit from the mining, processing, and selling of the trona. It is Union Pacific's share of those profits, paid to it as dividends from RPW, that are at issue.

Your *Amicus Curiae* Multistate Tax Commission (MTC) has a particular interest as we describe in the next section in encouraging uniform application of state income tax laws. Our focus in this *amicus* brief is on uniform application of the "business income" definition of the Uniform Division of Income for Tax Purposes Act (UDIPTA), chiefly with reference to the so-called functional test.

INTEREST OF *AMICUS CURIAE*, MULTISTATE TAX COMMISSION

Amicus MTC files this brief in support of the Idaho State Tax Commission. The MTC's prime concern is to foster uniformity in taxation of multistate businesses to prevent multiple or duplicative taxation. Multiple or duplicative taxation has the potential to subvert the sovereignty of the States to require interstate commerce to pay its fair share, but only its fair share, of state taxes.

The MTC 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"), an interstate compact proposed to the States in 1966 by the National Association of Attorneys General and the National Legislative Council. The MTC was formed to respond to the immediate need for substantial reform in state taxation of interstate commerce in order to preserve recognized tax sovereignty the States enjoy with respect to interstate (and now foreign) commerce. The 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.

[COMPACT, art. I, *supra*.]

The COMPACT became effective in 1967 when the required minimum number of States had adopted it. *See* IDAHO CODE § 63-3701. Now, twenty-one States (including the District of Columbia) have adopted the COMPACT through the enactment of legislation that makes the COMPACT a part of their respective state statutory law. Two States have joined as sovereignty members, a class of membership that entitles the States to full consultative membership without having enacted the COMPACT into the State's statutory law. Nineteen additional States have expressed their commitment to the goals of the MTC without statutory enactment of the COMPACT by joining as associate member States.[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).

Central to the mission of the MTC 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"). The MTC 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 MTC Allocation and Apportionment Regulations, STATE &

[1]The current full members are the States of Alabama, Alaska, Arkansas, California, Colorado, District of Columbia, Hawaii, Idaho, Kansas, Maine, Minnesota, Missouri, Michigan, Montana, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah, and Washington. The two sovereignty members are the States of Florida and Wyoming. 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.

LOCAL TAXES: ALL ST. TAX GUIDE ¶630 *et seq.*, p. 604 (RIA 1995); IDAPA 35.01.01.320 *et seq.*

While the past accomplishments of the MTC evidence the sincerity of the commitment of the MTC's party States to uniformity in state income taxation of interstate commerce, the need for increased uniformity in state income taxation of interstate (and foreign) commerce has not lessened from the time of the MTC's founding. The modern economy is becoming less centered on local business and more organized around interstate and international commerce. In light of the criticisms of Congress, see pp. 8-10, below, and the U.S. Supreme Court's concern about multiple taxation that can arise from a lack of uniform division of income rules, *Allied-Signal Inc.* v. *Director, Div. of Taxation*, 504 U.S. 768, 777-778 (1992) (severe multiple taxation has drastic consequences for national economy), States must remain vigilant to avoid significant deviations in taxing approaches. Any State that applies its income tax to interstate commerce should be concerned with fair apportionment, state tax uniformity and ease of compliance. Adequate concern in these areas will assure that an enterprise engaged in interstate business will be subjected to tax on no more than one hundred percent of its income and will not be faced with an unreasonable compliance burden.

ARGUMENT

I. HISTORY DEMONSTRATES THAT THE STATES ADOPTED UDITPA'S DIVISION OF INCOME RULES TO PROMOTE UNIFORMITY AND THEREBY RESPOND TO INTENSE CRITICISM OF STATE INCOME TAX SOVEREIGNTY WITH RESPECT TO INTERSTATE COMMERCE.

To place the importance of uniform application of the division of income rules into proper perspective a review of some history is necessary. This history discloses the forces that demanded more state tax uniformity. The demand for uniformity resulted in the formation of the MTC and undoubtedly contributed to Idaho's 1965 adoption of its version of UDITPA. IDAHO CODE §63-3027.

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.

The modern era that raised the challenge of state taxation of interstate commerce began in 1959. *Northwestern States Portland Cement Co.* v. *Minnesota*, 358 U.S. 450 (1959), 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.

The controversy rose 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. 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 PUB. LAW 86-272's temporary status, 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., Pt. I, at 9 (1964). In discharge of the mandate, Congress formed the Willis Committee (so named for the chair of what actually was a Special Subcommittee of the House Judiciary Committee). 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 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 States realistically to exercise their sovereignty to impose income tax on interstate commerce. 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 were generally 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. Politically, 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. Corrigan, *A Final Review*, 1989 MULTISTATE TAX COMM'N REV. 1, 23. Moreover, aspects of the proposed solution were also distasteful to some interstate businesses. *Id.*

The need for the States to solve their own problems prompted several States to adopt the COMPACT and form the MTC. From the foregoing discussion, it is apparent that the purposes of the COMPACT, *see* p. 4, 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 Idaho in the mid-1960s, since UDITPA division of income rules were adopted by the Idaho legislature in 1965. Idaho Code §63-3027.

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

A. How Formula Apportionment Works In General.

Most States employ formula apportionment to divide income that results from a taxable business that is conducted in more than a single State. Formula apportionment uses evidence of the relative degree of business activities in the taxing States to make this division. The relative amounts of payroll, property, and sales are used to determine the amount of business activities in the States. By averaging these factors an apportionment fraction (decimally expressed) for each taxing State is determined. The apportionment fraction is then applied against the income of the interstate business that is subject to apportionment (the apportionable base) to determine how much of the interstate business' income is subject to tax in the taxing State.

Formula apportionment does not employ complex separate accounting to establish the situs of the individual items of income that make-up the entirety of apportionable income. The assumption of formula apportionment is that by applying the factors of the entire multistate business to the entirety of the apportionable income of that business, a reasonable approximation of the source of that income can be made. Formula apportionment thus avoids significant complexity, *Allied-Signal*, 504 U.S. at 778, and potential taxpayer manipulation. *See Barclays Bank PLC* v. *Franchise Tax Bd.*, 512 U.S. 298, 305 (1994).

An obvious key step to establishing the proper division of multistate income by formula is determining the apportionable base, *i.e.*, determining which items of income of the multistate business are subject to apportionment. The UDITPA divides the income of a multistate business into "business income" and "nonbusiness income" to determine what constitutes apportionable income. This dichotomy is employed by more States than any other system. States employing the UDITPA concept of business income do so either by formal adoption of the uniform act or substantial incorporation of the provisions of the uniform act without formally enacting the uniform act (or both as in Idaho). Either type of State may properly be designated as a "UDITPA State." The conclusion that an item of income is business income means that the income is included in the apportionable base and divided among the states in which a company does business. The conclusion that an item of income is nonbusiness income means that it is allocated under specific allocation rules for that type of income. UDITPA §§ 4 and 9; IDAHO CODE § 63-3027(e) and (i). Thus "apportionment" and "allocation" carry technical connotations under UDIPTA. Business income is "apportioned" among the States in which a company conducts its unitary business. Nonbusiness income is "allocated" to a single State, usually to the corporate domicile of the business.

In addition to the UDITPA States, a significant number of other States purport to require apportionment of all income of the multistate business. In some of these States, certain limited types of income are nevertheless specifically allocated regardless of whether this income is related to the operation of the multistate business. These "full apportionment" States do not use the business and nonbusiness income model of UDITPA.

Full apportionment is not what it appears, however. The U.S. Constitution, as interpreted by the U.S. Supreme Court, allows apportionment of the income of a nondomiciliary company, only if the income relates to a business that is partly conducted in the State. *Allied-Signal*, 504 U.S. at 778. This restriction, known as the unitary business principle, emanates from the Due Process and Commerce Clause of the United States Constitution and applies to *all States*. The unitary business principle recognizes the synergy inherent in an on-going business that frequently cannot be captured by isolating only that portion of the business conducted in a single State. *See Allied-Signal*, 504 U.S. at 778-780 for a discussion of the development of the unitary business principle.

Thus, in both UDITPA States and full apportionment States, the U.S. Constitution bars apportionment of income that does not arise from a unitary business, part of which is conducted in the taxing States. This black letter rule is the source of the oft quoted statement in *Mobil Oil Corp.* v. *Commissioner*, 445 U.S. 425, 439 (1980), that "the linchpin of apportionability in the field of state income taxation is the unitary-business principle." As *Allied-Signal* itself demonstrates, a State is entitled to apportion only that income which is unitary with the business that a nondomiciliary company is conducting in the State. If a single company has two or more separate unitary businesses, some which are not conducted in the taxing State, or if the non-domiciliary company has income derived from a passive investment, the taxing State cannot include that income in the apportionable base. States are limited to apportioning and taxing the income that is derived of the unitary business being conducted within the taxing State.

Thus, whether Union Pacific's dividend income from RPW earned from operating the trona mine on Union Pacific's Land Grant is includable in the apportionable base involves two issues. First, a statutory issue—is this "business income" within the UDITPA definition?—and second, a constitutional issue—does this income meet the unitary business standard? We will focus our discussion on the statutory issue because of MTC's role in preserving and promoting UDITPA.

B. A Uniform And Consistent Understanding Of What Constitutes Apportionable Income Among The States Is Necessary To Avoid Increased Potential For Duplicative Taxation.

The classification of an item of income as either apportionable or allocable impacts whether the item is placed in the apportionable base or is allocated to, and taxed by, a specific State. This means that without a common understanding as to apportionable income, the same item of income might be allocated to one state while apportioned to another State. In this sense, the classification of an item of income is a central provision in the division of income among the States, because uniform classification goes to the heart of avoiding duplicative taxation.

To illustrate this point, consider a multistate business that is subject to tax in two States. If one State (because of its understanding of apportionable business 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 apportionable business 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 allocated entirely to the second State and the second State required the item of loss to be apportioned, the company will have enjoyed only a portion of loss. In either case, duplicative taxation will have occurred.

III. AS A MATTER OF STRAIGHT STATUTORY CONSTRUCTION UDITPA'S DEFINITION OF BUSINESS INCOME, AS WELL AS IDAHO'S, CONTAINS TWO, INDEPENDENT TESTS FOR ESTABLISHING THAT AN ITEM OF INCOME IS APPORTIONABLE BUSINESS INCOME.

The UDITPA definition of business income reads as follows:

> "Business income" means *income arising from transactions and activity in the regular course of the taxpayer's trade or business* and includes <u>income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations</u>.

This definition describes two separate types of income. The first, the italicized portion, is income from activities in the regular course of a company's business, such as receipts from the everyday sale of widgets. It is generally referred to as the "transactional" test. The second type, the underlined portion, is income from the tangibles and intangibles used to operate the business, such as from the sale of the old machine that made the widgets or from investments that ensure the supply of materials or that develop a business segment. It is generally referred to as the "functional" test. See generally Tax Mgmt. Multistate Tax Portfolio, *Income Taxes: The Distinction Between Business and Nonbusiness Income* ¶ 1140.04.C.2, p.21*ff* (1996) (hereafter "*Business and Nonbusiness Income*").

A. <u>Idaho's Definition Of Business Income Is For All Practical Purposes Identical To UDITPA's.</u>

Idaho's modification of the UDITPA definition of the term "business income" is not a deviation of any significance. The changes effected are the substitution of the word "or" for the word "and", the addition of "or necessary" and a second sentence. These changes are reflected in following quotation that uses brackets to differentiate the two forms of the definition:

> "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, [UDITPA: and] [Idaho: or] disposition of the property constitute integral [Idaho: or necessary] parts of the taxpayer's regular trade or business operations. [Idaho: Gains or losses and dividend and interest income from stock and securities of any foreign or domestic corporation shall be presumed to be income from intangible property, the acquisition, management, or disposition of which constitute an integral part of the taxpayer's trade or business; such presumption may only be overcome by clear and convincing evidence to the contrary.]

Classification of an item of income under either form of the definition will be the same. Idaho's use of the disjunctive "or" ensures Idaho's definition of income is at least as expansive as UDITPA's definition. But in reality, that "or" merely expresses the true meaning of the word "and" in UDITPA's definition. The conjunctive "and" is often used to express both a conjunctive and a disjunctive sense. SUTHERLAND STAT. CONSTR. § 21.14, pp. 129-130 (5th Ed, 1992).

To read UDITPA's "and" only in the conjunctive sense would mean that before income from dealings in property could be classified as business income, the property giving rise to the income must have been acquired, managed *and disposed of*. This understanding would prevent income from dealings in property to be apportionable under the second independent clause—the functional test—where the property had not yet been disposed of. Yet if income from property arises through the management of the property not yet disposed of and the management of that property is in furtherance of the multistate unitary business, part of which is conducted in the taxing State, that item of income is properly apportionable income of the unitary business.

Finally, the additional sentence only underlines the existence of the functional test.

B. The Business Income Definition Contains Two Separate And Independent Tests Of What Constitutes Business Income.

There has been some debate whether the business income definition contains two tests or only one. Taxpayers have challenged the existence of a separate functional test and a few courts have found there to be only one test. See the discussion of those cases, *infra*, at pp. 22-26. Although the court below appeared to accept both definitions, it did not tarry to make the point. We think the point is worth making—in fact, it is important to do so explicitly in order to maintain uniformity in the interpretation of UDITPA's business income definition. Deviation from the two-test interpretation has become increasingly rare and isolated as we discuss below. Legislative response to the few court decisions against the functional test has generally been to return to the uniformity of the two test standard.

The clearest path to understanding a statute is to construe its plain meaning from the words used. This approach in construction with regard to the definition of business income supports the existence of the two independent tests for classifying income as apportionable.

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The first thing to note is that the first sentence of the definition is a compound sentence with two independent clauses. The common subject to these two independent clauses is "business income," the actual term being defined. Thus, the grammatically correct reading of the statute is as follows:

> "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and ["business income"] includes income from tangible and intangible property if the acquisition, management, or disposition of the property constitute integral or necessary parts of the corporation's regular trade or business operations.

To read "includes" as giving examples of the first independent clause, and not as an addition and separate definition of business income, is to read the words "and includes" as "including." But the definition does not read, "'Business income' means income arising from transactions and activity in the regular course of the corporation's trade or business ~~and includes~~, including * * *."

Beyond this simple observation, it is puzzling how some courts have read into the *second* independent clause a requirement that the transaction giving rise to the item of income must occur in the regular course of the taxpayer's business of the taxpayer. That understanding is certainly the requirement of the *first* independent clause but not of the second, when the clauses are read independently, as grammatically they must be.

The first independent clause requires the income to arise in the ordinary course. The second independent clause requires the acquisition, management, or disposition of the property giving rise to the income to be integral or necessary to the regular trade or business operations. Another way to restate the second independent clause in simpler language is that business income includes income from dealings in property when the actions taken with respect to the property were integral or necessary to the taxpayer's multistate unitary business. "Integral or necessary" in this sense means necessary to the regular trade or business *operations*, *i.e.*, the multistate unitary business. The management actions over the property that give rise to the income do not have to be actions that frequently occur. Rather the management actions have to be a normal part of how the regular trade or business operations are accomplished. The two independent clauses of the business income definition state something largely different from one another.

IV. UNIFORMITY IN THE APPLICATION OF DIVISION OF INCOME RULES SUPPORTS THE INTERPRETATION THAT UDITPA'S DEFINITION OF BUSINESS INCOME CONTAINS A SECOND ALTERNATIVE TEST.

Simple statutory construction should be sufficient to support the determination that the second independent clause of the business income definition states a separate alternative test of apportionability. Yet if the Court believes that the matter is not entirely clear, your *Amicus* asks that the Court in reaching its determination in this case consider the goal of uniformity that is essential to preserving state income tax jurisdiction with respect to interstate and foreign commerce. Uniformity is important, because as previously noted, inconsistent approaches to determining apportionable income can result in duplicative taxation. See p. 15.

Reference to the goal of uniformity in the Court's interpretation of Idaho's division of income rules is appropriate, since uniformity appears to have been Idaho's motivation when it adopted its version of UDITPA effective in 1965.

Of the States that may be classified as UDITPA States, see p. 12, almost all interpret the business income concept as having two separate, alternative tests. That the UDITPA States hold this understanding can be determined by (i) court decision, *e.g., Simpson Timber Co.* v. *Dept. of Revenue,* 326 Ore. 370, 953 P.2d 366 (1998); *Polaroid Corp. v. Offerman,* 507 S.E.2d 284 (N.C. 1998); (ii) administrative decision, *e.g., Ruling 94-0709 ITC* (March 11, 1996) in *Quarterly Summary of Revenue Rulings and Administrative Decisions. Indiana Department of Revenue, Legal Division, Tax Appeals Section, April, 1996* (Apr. 01, 1996), In. Tax Rptr. (CCH) ¶400-216; or (iii) adoption of the MTC's recommended apportionment regulation, MTC Reg. IV.1.(c).2 (1973), reprinted in *Business and Nonbusiness Income,* Worksheet 4, p. 6403, that has been identified as a statement of the functional test. *Id.* at ¶ 1140.06.D.1., p. 45. The MTC regulation, which has been adopted by almost all UDITPA States, including Idaho as IDAPA 35.01.01.345.04, classifies income arising from the sale and exchange of assets based upon whether the asset was used in the taxpayer's business. And to your *Amicus'* knowledge, only the UDITPA States of Iowa, Kansas, and Tennessee have rejected the existence of the functional test in published appellate cases. Yet even the apparent limited view of the functional test by these States is something less than what it seems.

Iowa is represented as rejecting the functional test by its decision in *Phillips Petroleum Co.* v. *Dept. of Revenue & Finance*, 511 N.W.2d 698 (Iowa 1993). Yet in the earlier case of *Super Valu Stores, Inc.* v. *Dept. of Revenue & Finance*, 479 N.W.2d 255 (Iowa 1991), a case that was not noted in *Phillips*, the Iowa Supreme Court held that a large gain realized by the sale of stock in a subsidiary that was a part of the unitary business of the taxpayer was apportionable business income. *Super Valu* is a curious result for a State that indicates it does not recognize a functional test. In any event, shortly after *Phillips*, the Iowa legislature amended its business income statute. The amendment extended business income to income from the sale of property, if the property while owned by the taxpayer was operationally related to the taxpayer's trade or business carried on in Iowa. The amendment also provides that business income extends to gain or loss resulting from the sale, exchange, or other disposition of stock in another corporation if the activities of the other corporation were operationally related to the taxpayer's trade or business carried on in Iowa while the stock was owned by the taxpayer. This amendment to IOWA CODE § 422.32(2), added by 1995 Iowa Acts Ch. 141, § 1, firmly places Iowa in the functional test camp.

A similar legislative reaction followed Tennessee case law rejecting the functional test, *e.g., Federated Stores Realty, Inc.* v. *Huddleston*, 852 S.W.2d 206 (Tenn. 1992) and *Federated Stores Realty, Inc.* v. *Huddleston*, 852 S.W.2d 215 (Tenn. 1993) (rehearing). Soon after these decisions, the Tennessee legislature umended its "business earnings" statute to provide apportionable income extended :o income from property where the use of the property constitutes an integral part ɔf the taxpayer's regular trade or business operations. The legislature also declared that earnings that arise from the conduct of the trade or trades or business operations of a taxpayer are apportionable. TENN. CODE ANN. § 67-4-804(a)(1), as amended by 1993 Tenn. Pub. Acts Ch. 282, §§ 1 and 2.

The legislature of Kansas reacted differently to its case. *Appeal of Chief Industries, Inc.*, 255 Kan. 640, 875 P.2d 278 (1994). Nonetheless, the legislative reaction in Kansas certainly reflects discomfort with leaving unamended its business income definition, KAN. STAT. ANN. § 79-3271, without a functional test. Kansas now provides the multistate taxpayer with a ten year election to treat income from dealings in property as apportionable. 1996 KAN. SESS. LAWS Ch. 264, § 1. This amendment provides a taxpayer with a mechanism to avoid potential multiple taxation that might have occurred with Kansas allocating income to it and other States apportioning the same income.

It has been asserted that other States in addition to Kansas, Iowa, and Tennessee do not recognize a second functional test. We do not believe that a thorough analysis of the law in those States supports that assertion.

First, we do not view a decision that rests on the transactional test as a rejection of the functional test. *Atlantic Richfield Co.* v. *Colorado*, 198 Colo. 413, 601 P.2d 628 (1979). *Atlantic Richfield* simply avoided determining whether there was a functional test because the income in dispute met the transactional test. Indeed, we understand from our contact with Colorado, a party State of the MTC, that the tax administrator in that State applies the functional test in administering the Colorado income tax and does not view Colorado as having rejected the functional test. See 2000 MULTISTATE CORPORATE TAX GUIDE, *Introduction*, p. I-v, *Tax Base: Business v. Nonbusiness Income*, p. I-623 (Colorado self describes its business income concept as the same as the MTC's).

Second, cases that bar apportionment on the basis of constitutional due process restrictions cannot be cited as an indication that the State does not apply the functional test. As noted previously, the U.S. Constitution has its own rule—the unitary business principle—that operates to limit when income is apportionable. See pp. 13-14. A constitutional finding of nonapportionability is a strong suggestion that the functional test of UDITPA could not be met. Thus, a case like *Sperry & Hutchinson Co.* v. *Dept. of Revenue*, 270 Ore. 329, 527 P.2d 729 (1974), which construed its state statutory requirements as "minor variations on the concept of 'unitary business,'" does not reject the functional test. Indeed, the Oregon Supreme Court expressly applied the functional test and stated that part of the income in dispute did not meet that test. *See also Simpson Timber, supra.*

Third, cases relying on the U.S. Supreme Court's rejection of the so called "business purpose" test are essentially applying the constitutional unitary business concept. *Pledger* v. *Getty Oil Exploration Co.*, 309 Ark. 257, 831 S.W.2d

121 (1992). The business purpose test reflects that at one time certain States argued that *any* asset that was held by a corporate taxpayer could give rise to apportionable income. The U.S. Supreme Court labeled this test the "corporate purpose" test in *ASARCO Inc.* v. *Idaho State Tax Comm'n*, 458 U.S. 307 (1982), and rejected it because property giving rise to apportionable income had to be related to the unitary business being conducted in the taxing State beyond mere financial gain from a passive investment. *Id.*; *Allied-Signal, supra.* The rejection of the corporate purpose test is not, therefore, a rejection of the functional test of the business income definition. Indeed, since the functional test requires the acquisition, management, and disposition of the property to be integral parts to the taxpayer's regular trade or business operations, the functional test and the U.S. Constitution are essentially requiring the very same connection.

Fourth, New Mexico applies its "use" test in addition to the transactional test. *Kewanee Industries, Inc.* v. *Secretary*, 114 N.M. 784, 845 P.2d 1238 (1993). The use test acts in the same fashion as the functional test. As we understand application of the use test, New Mexico endeavors to determine whether the transaction giving rise to apportionable income was in furtherance of the unitary business beyond mere financial betterment of a passive investment. We do not understand that classification of income as apportionable under the use test depends upon the use of the income generated in the unitary business; rather use of the income generated in the unitary business is *evidence* that the extraordinary transaction that gave rise to the income being used, a sale-leaseback in *Kewanee*, was completed to further the unitary business. Thus, the use test is a variation of the unitary business principle, which we noted in the preceding point, is totally consistent with the functional test. Moreover, the 1999 New Mexico legislature amended NMSA 1978 § 7-4-2 in NEW MEXICO LAWS 1999, Chapter 47, Section 7 to explicitly include the functional test.

Fifth, true liquidation cases are in a category by themselves. Reliance on liquidation cases to establish the absence of a functional test is misplaced. Notwithstanding the sometimes broad language used in liquidation cases, in reality, these cases are saying that the liquidation was not integral to the regular trade or business operations but in termination of it. Application of liquidation cases to this matter is inappropriate in any event. We are dealing here with dividend earnings from capital invested literally in "operating" Union Pacific's unitary business of developing its Land Grant mineral resources. We are not dealing with capital gains from liquidating an investment.

V. PROMOTION OF UNIFORMITY IS AN APPROPRIATE GOAL IN ITSELF AND IN THE CONTEXT OF BUSINESS (APPORTIONABLE) INCOME UNIFORMITY SERVES TO ENSURE FUNDAMENTAL FAIRNESS AMONG ALL BUSINESS TAXPAYERS.

Hopefully, the discussion of the importance of uniformity to the continued exercise of state taxation with respect to interstate and foreign commerce has adequately demonstrated the relevance of the MTC's uniformity work to Idaho and to this case. As to any supposed "revenue" motivation of the MTC, we note that the concept of apportionable business income is neutral. Neutrality in this sense means that there is no way to anticipate at the time a State adopts uniform principles governing the classification of business income of *all taxpayers* whether the rules will favor a particular taxpayer or the state tax administrator in any future circumstance. Facts peculiar to each taxpayer's own circumstances will determine whether apportionment or allocation is more favorable. These circumstances include whether the taxpayer is commercially domiciled in the taxing State, whether the item in issue is income or loss, and what the applicable tax rates and apportionment factors are in the competing States.

Neutrality of the uniform rule for determining business income is also evident from the fact that taxpayers whose tax liability has been satisfactorily reduced under the uniform rule adopted by a taxing State will have no motivation for giving notice of that fact to either the state tax administrator or the courts. State tax administrators and the courts hear only from those few taxpayers whose unique circumstances provide the motivation for challenging the uniform understanding of what constitutes business income. A Court proposing to grant relief to a single taxpayer by adopting a new understanding of business income must be mindful, therefore, of the consequences its announced principles will have on the many taxpayers from which it does not hear. New business income understandings have the potential to upset settled expectations.

In light of these observations, the MTC's defense of a uniform understanding of business income does not reflect considerations of the amount of revenue to be raised, but rather of fundamental fairness in the distribution of the tax burden among all business enterprises. The MTC's participation in this case is a manifestation of sensitivity to the important role uniformity plays in ensuring fairness of state taxation of multistate businesses. The application of the separate income tax systems of each State to interstate commerce is not a matter of individual state preference. In truth, state income taxation of interstate commerce must be a multistate affair. It is uniformity that promotes fairness and avoids the imposition of restrictions on state taxation that could potentially diminish the State's tax base. In addition, when States fail to use uniform approaches to income apportionment, they risk burdening some multistate taxpayers with the potential, unfair burden of duplicative taxation. If as a result States lose their ability to tax interstate commerce fairly, the burden of those lost revenues are likely to fall at least in part on the captive, in-state taxpayers who do not enjoy the tax planning potential that arises from operating a business on a multistate basis. Therefore, uniformity in the critical features of the division of income rules, such as the determination of business income, is fundamental to the fair and balanced taxation of all businesses, be they in-state or multistate taxpayers.

CONCLUSION

For the foregoing reasons, *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 separate and alternative test for apportionable income.

Respectfully submitted this 21st day of April 2000.

MULTISTATE TAX COMMISSION

By ______________________
Paull Mines, General Counsel
Frank D. Katz, Deputy General Counsel
444 North Capitol Street, N.W. Suite 425
Washington, D.C. 20001-1538
(202) 624-8699
Attorneys for *Amicus Curiae*,
Multistate Tax Commission

CERTIFICATE OF SERVICE

I, Frank D. Katz, attorney for the Multistate Tax Commission, do certify that I have served the foregoing Brief *Amicus Curiae* of Multistate Tax Commission in Support of Defendant-Appellant, Idaho State Tax Commission by depositing the same in the United States Mail, postage prepaid and addressed to the following:

Eugene A. Ritti
Richard G. Smith
HAWLEY TROXELL ENNIS &
HAWLEY LLP
P. O. Box 1617
Boise, ID 83701-1617

Geoffrey L. Thorpe
Deputy Attorney General
STATE TAX COMMISSION
P.O. Box 36
Boise, ID 83722-1050

This the 21 day of April, 2000.

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