

18-56

TAX TYPE: CORPORATE FRANCHISE TAX

TAX YEAR: 3/1/2008 – 2/29/2016

DATE SIGNED: 6/25/2019

COMMISSIONERS: J. VALENTINE, M. CRAGUN, R. ROCKWELL, L. WALTERS

GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

<p>TAXPAYER,</p> <p style="text-align: center;">Petitioner,</p> <p>v.</p> <p>AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION,</p> <p style="text-align: center;">Respondent.</p>	<p style="text-align: center;">INITIAL HEARING ORDER</p> <p>Appeal No. 18-56</p> <p>Account No. #####</p> <p>Tax Type: Corporate Franchise Tax</p> <p>Audit Period: 3/1/2008 – 2/29/2016</p> <p>Judge: Phan</p>
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Presiding:

Jane Phan, Administrative Law Judge

Appearances:

For Petitioner: REPRESENTATIVE-1 FOR TAXPAYER, Vice President Tax,
TAXPAYER
REPRESENTATIVE-2 FOR TAXPAYER, Senior Manager Tax,
TAXPAYER

For Respondent: REPRESENTATIVE FOR RESPONDENT, Assistant Attorney
General
RESPONDENT-1, Manager, Corporate Franchise Auditing
RESPONDENT-2, Senior Auditor

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission on February 26, 2019 for an Initial Hearing in accordance with Utah Code §59-1-502.5. Petitioner (“Taxpayer”) had filed an appeal under Utah Code §59-1-501 of a corporate franchise tax audit deficiency which was issued by Respondent (“Division”) by Statutory Notice dated December 12, 2017. The Statutory Notice indicated an audit deficiency for the period of March 1, 2008 through February 29, 2016 in the amount of \$\$\$\$ and interest accrued thereon as of the notice date of \$\$\$\$\$, for a total of \$\$\$\$\$. Prior to the hearing, on June 5, 2018, after further review and discussion, the Division issued a

preliminary draft that increased the amount to \$\$\$\$\$, but correcting for the state tax add back amount, the difference was a balance of \$\$\$\$\$ which was the amount contested by the Taxpayer as of the Initial Hearing. Interest will continue to accrue on any unpaid balance.

APPLICABLE LAW

Utah law requires filing a water's edge combined return at Utah Code Subsection 59-7-402(1) (2016)¹ as follows:

Except as provided in Section 59-7-403, if any corporation listed in Subsection 59-7-101(36)(a) is doing business in Utah, the unitary group shall file a water's edge combined report.

Calculation of unadjusted income for combined reporting is set out at Utah Code Sec. 59-7-404 as follows:

- (1) A group filing a combined report under Section 59-7-402 or 59-7-403 shall calculate unadjusted income of the combined group by:
 - (a) computing unadjusted income on a separate return basis;
 - (b) combining income or loss of the members included in the combined report; and
 - (c) making appropriate eliminations and adjustments between members included in the combined report.
- (2) For purposes of this section, if an entity does not calculate federal taxable income, then unadjusted income shall be calculated based on the applicable federal tax laws.

Utah Code Sec. 59-7-101(2016) provides specific definitions for the Corporate Franchise and Income Taxes Chapter of the Utah Tax Code. Subsection 59-7-101(29) defines "unadjusted income" as follows:

"Unadjusted income" means federal taxable income as determined on a separate return basis before intercompany eliminations as determined by the Internal Revenue Code, before the net operating loss deduction and special deductions for dividends received.

Subsection 59-7-101(30) defines "unitary group" as follows:

- (a) "Unitary group" means a group of corporations that: (i) are related through common ownership; and (ii) by a preponderance of the evidence as determined by a court of competent jurisdiction or the commission, are economically interdependent with one another as demonstrated by the following factors: (A) centralized management; (B) functional integration; and (C) economies of scale.

¹ For ease of reference, this decision cites to the 2016 version of the Utah Code for substantive law provisions. The parties did not argue that there had been revisions during the audit period that affected the outcome of this appeal.

Subsection 59-7-101(36) defines “Water’s edge combined report” as follows:

- (a) “Water’s edge combined report” means a report combining the income and activities of:
 - (i) all members of a unitary group that are:
 - (A) corporations organized or incorporated in the United States, including those corporations qualifying for the Puerto Rico and Possession Tax Credit as provided in Section 936, Internal Revenue Code, in accordance with Subsection (36)(b); and
 - (B) corporations organized or incorporated outside of the United States meeting the threshold level of business activity; and
 - (ii) an affiliated group electing to file a water’s edge combined report under Subsection 59-7-402(2).

Subsection 59-7-101(28) defines “threshold level of business activity” as follows:

“Threshold level of business activity” means business activity in the United States equal to or greater than 20% of the corporation’s total business activity as determined under Section 59-7-401.

Section 1504(d) of the Internal Revenue Code provides as follows:

In the case of a domestic corporation owning or controlling, directly or indirectly, 100 percent of the capital stock (exclusive of directors’ qualifying shares) of a corporation organized under the laws of a contiguous foreign country and maintained solely for the purpose of complying with the laws of such country as to title and operation of property, such foreign corporation may, at the option of the domestic corporation, be treated for the purpose of this subtitle as a domestic corporation.

Utah Code §59-1-1417(1) provides for burden of proof and statutory construction as follows:

- (1) In a proceeding before the commission, the burden of proof is on the petitioner except for . . .
- 2) Regardless of whether a taxpayer has paid or remitted a tax, fee or charge, the commission or a court considering a case involving the tax, fee, or charge shall:
 - (a) construe a statute imposing the tax, fee, or charge strictly in favor of the taxpayer; and
 - (b) construe a statute providing an exemption from or credit against the tax, fee or charge strictly against the taxpayer.

Utah Admin. Rule R865-6F-14 provides:

- (1) It is the policy of the commission, in matters involving the determination of income for Utah corporation franchise purposes, to follow as closely as possible federal requirements with respect to the same matters. In some instances the federal and state statutes differ, and as a result the federal rulings, regulations, and decisions may not be followed. Furthermore, in

some instances, the commission may disagree with the federal determinations and does not consider them controlling for Utah corporation franchise purposes.

DISCUSSION

The facts proffered by the parties at the Initial Hearing and in their prehearing briefs were not substantially in dispute and the issue is a legal question that appears to be a matter of first impression before the Tax Commission as neither party was able to cite to a prior Tax Commission decision or a Utah court decision directly on point.²

The Taxpayer, TAXPAYER, files as part of a consolidated group for federal income tax purposes, under the parent corporation CORPORATION-1 (“CORPORATION-1”). CORPORATION-2 (“CORPORATION-2”) is incorporated and organized under the laws of FOREIGN COUNTRY. CORPORATION-3 (“CORPORATION-3”) is organized under the laws of FOREIGN COUNTRY. Neither CORPORATION-2 nor CORPORATION-3 operated in the United States or in Utah or have employees, property, or revenue that can be sourced to the United States or Utah. Neither conducts business in the United States or Utah. However, CORPORATION-2 and CORPORATION-3 are included in the Taxpayer’s federal consolidated group under an I.R.C. §1504(d) election and the income from CORPORATION-2 and CORPORATION-3 is included in their U.S. federal income. The Taxpayer and others of the related entities in the consolidated group conduct business in Utah. The Taxpayer has not made an election under Utah Code Subsections 59-7-403(1) to file a worldwide combined report in Utah. The amount of the audit deficiency at issue is from the Division’s inclusion of the income and activity from CORPORATION-2 and CORPORATION-3 in the Taxpayer’s “unadjusted income.”

The Taxpayer argues that CORPORATION-2 and CORPORATION-3 do not meet the “threshold level of business activity” to be included in the water’s edge combined report. They point out that Utah Code Subsection 59-7-402(1) requires the unitary group to file the water’s edge combined report. However, Utah Code Subsection 59-7-101(36) defines “water’s edge combined report” to be a report that combines “the income and activities of” all members of the unitary group that are either U.S. corporations, or corporations organized or incorporated outside

² The Division pointed to a Minnesota Supreme Court decision, *Ashland Inc. and Affiliates v. Comm’r of Rev.*, 899 N.W.2d 812 (2017), in which the Minnesota Supreme Court held that where the taxpayer had elected to have the income from its foreign subsidiary included in its federal income, that income was properly included in the Minnesota return. However, the Division noted that there was a difference in Minnesota law. Both Minnesota and Utah followed water’s edge combined reporting that includes only the domestic members of the unitary group in the combined report, but Minnesota incorporates federal elections made by the taxpayer in its definition of net income.

of the U.S. that meet the “threshold level of business activity.” It is the Taxpayer’s argument that CORPORATION-2 and CORPORATION-3 do not meet the “threshold level of business activity.” Utah Code Sec. 59-7-101(28) defines “threshold level of business activity” to be “activity in the United States equal to or greater than 20% of the corporation’s total business activity.” The Taxpayer proffers that this 20% threshold was not met and that was not contested by the Division.

The issue to address in this appeal is whether CORPORATION-2 and CORPORATION-3 should be included in the Taxpayer’s water’s edge combined report. The Division issued the audit including the income from CORPORATION-2 and CORPORATION-3 in its calculation of the “unadjusted income” required for the water’s edge combined return. The Division points out that the Taxpayer had made the election to treat CORPORATION-2 and CORPORATION-3 as U.S. domestic corporations for federal filing purposes by making that election under I.R.C. §1504(d) and the Taxpayer included them in the consolidated federal return. Since the Taxpayer elected to treat them that way for federal filing purposes, it was the Division’s argument that CORPORATION-2 and CORPORATION-3 should also be treated as domestic corporations for Utah filing purposes.

The Division points out that a water’s edge combined report is based on “unadjusted income.” Utah Code Subsection 59-7-101(29) defines “unadjusted income” as “federal taxable income as determined on a separate return basis” with some intercompany eliminations and other deductions. Utah Code Sec. 59-7-404 sets out how “unadjusted income” is calculated. The Taxpayer acknowledged it was a member of a unitary group and did not dispute that CORPORATION-2 and CORPORATION-3 were part of the unitary group. Utah uses Line 28 of the federal return as the starting point for determining Utah corporate franchise and income tax. Utah Code Subsection 59-7-101(29) mirrors the language of Line 28 to define unadjusted income. The Taxpayer’s federal Line 28 amount, which is the summation of all the companies included in the federal return, includes the income of CORPORATION-2 and CORPORATION-3.

The Division acknowledges that Utah Code is silent on the Utah treatment of a federal IRC §1504(d) election. The Division argues that as a result, the general rule of following as close as possible the federal requirements should be applied. The Division points to Utah Admin. Rule R865-6F-14.³ The Division also points out that once the income from the foreign companies is included in the federal taxable income, there is no provision in Utah law to pull it back out when

³ The Division acknowledges that the rule indicates there may be differences between state and federal statutes, but argues this language references those areas of the Utah Code dealing with combined reporting that explicitly require different treatment at the state level.

computing the Utah “unadjusted income.” Because the “unadjusted income” starts with the federal taxable income and because the Taxpayer had made the election pursuant to I.R.C. §1504(d) to treat CORPORATION-2 and CORPORATION-3 as domestic corporations for federal filing purposes, it was the Division’s position that the CORPORATION-2 and CORPORATION-3 income should also be included in the state tax return.

After reviewing the arguments of the parties, the Commission must first consider that the issue before it is a matter of interpreting a tax imposition statute, one of imposing a tax on a water’s edge combined return. Under Utah Code Subsection 59-1-1417(2) the Commission shall construe a statute imposing a tax strictly in favor of the taxpayer. Utah Code Subsection 59-7-101(36) makes it clear that the income and activity from the corporations organized or incorporated outside the U.S. is only included in the “water’s edge combined report” if the foreign corporation meets the “threshold level of business activity.” Based on the undisputed proffer at the Initial Hearing, CORPORATION-2 and CORPORATION-3 do not meet the threshold level. Under these provisions, which are specific to when income from foreign corporations is to be included, the income from CORPORATION-2 and CORPORATION-3 would not be included in the water’s edge combined report.

When applying these provisions of law to the facts in this case, it does appear that the provisions indicating that foreign corporations are not included in the “water’s edge combined report” if they do not meet the threshold level is in conflict with the definition of “unadjusted income” at Utah Code Subsection 59-7-101(29), when there is a federal IRC §1504(d) election. There are no statutory provisions that dictate what happens to the income from the foreign entities that do not meet the threshold, but are included because of this election. The Division has pointed to Utah Admin. Rule R865-6F-14 for the position that Utah should “follow as closely as possible federal requirements with respect to the same matters” but that rule also states, “In some instances the federal and state statutes differ, and as a result the federal rulings, regulations, and decisions may not be followed.” Both parties are offering a plausible interpretation of the current statutory framework. However, the more specific provision of law regarding whether income from a foreign entity should be included is Utah Code Subsection 59-7-101(36) and that would exclude the income at issue.⁴ This provision is to be strictly construed in favor of the Taxpayer under Utah Code Subsection 59-1-1417(2), because this is a matter of tax imposition. The Commission should find that it was proper for the Taxpayer to exclude the income and activity from

⁴ In interpreting statutory provisions, the Utah Supreme Court has indicated that a “more specific statute governs instead of a more general statute.” *Jensen v. IHC Hospitals Inc.*, 944 P.2d 327, 331 (1997). See also *Hall v. Utah State Department of Corrections*, 24 P.3d 958 (Utah 2001).

CORPORATION-2 and CORPORATION-3 on its Utah water's edge combined return for the audit period at issue.

Jane Phan
Administrative Law Judge

DECISION AND ORDER

Based on the foregoing, the Commission finds for the Taxpayer on the issue presented at the Initial Hearing, that the income and activity from CORPORATION-2 and CORPORATION-3 should not be included in the Taxpayer's "unadjusted income" for purposes of its "water's edge combined report." The audit of additional corporate franchise tax and interest for the period of March 1, 2008 through February 29, 2016, should be adjusted accordingly. It is so ordered.

This decision does not limit a party's right to a Formal Hearing. However, this Decision and Order will become the Final Decision and Order of the Commission unless any party to this case files a written request within thirty (30) days of the date of this decision to proceed to a Formal Hearing. Such a request shall be mailed, or emailed, to the address listed below and must include the Petitioner's name, address, and appeal number:

Utah State Tax Commission
Appeals Division
210 North 1950 West
Salt Lake City, Utah 84134

or emailed to:
taxappeals@utah.gov

Failure to request a Formal Hearing will preclude any further appeal rights in this matter.

DATED this _____ day of _____, 2019.

John L. Valentine
Commission Chair

Michael J. Cragun
Commissioner

Rebecca L. Rockwell
Commissioner

Lawrence C. Walters
Commissioner

Notice of Payment Requirement: Any balance due as a result of this order must be paid within thirty (30) days of the date of this order, or a late payment penalty could be applied.