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In the Supreme Court of Florida

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SID J. WHITE
JUN 14 1985
CLERK, SUPREME COURT
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Shell Oil Company,

Petitioner,

v.

Case Nos. 66,240
66,254

Department of Revenue,

Respondent.

______________________________/

On Review from the District Court of Appeal, First District

Respondent's Cross-Reply Brief

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ARGUMENT
POINT II

WHETHER THE SUPREME COURT SHOULD EXERCISE ITS DISCRETIONARY JURISDICTION TO REVIEW THE CHALLENGED DECISION OF THE DISTRICT COURT BECAUSE THE DECISION EXPRESSLY AND DIRECTLY CONFLICTS WITH DECISIONS OF THIS COURT.

The Department urged that the District Court overlook Section 220.42(1), F.S., which legislatively mandated that, for the purpose of Chapter 220, the taxpayers method of accounting shall be the same as the taxpayers method of accounting for federal tax purposes.

The Department's reference to the statute in its Motion for Rehearing and Clarification in the District Court did not constitute a "new interpretation" of a pre-existing statute, which contradicted its own rule, as is suggested by Shell. What it involved was the calling to the attention of the District Court a statute which controlled an issue before the court, not a new issue. Although the statute in question was not called to the trial court's attention, nevertheless it is the law of this state and is evident by the District Court's decision on rehearing in this matter, that it is controlling on the issue of the treatment of IDC's by Shell.

Since court's of this state take judicial cognizance of all public statutes, the Department submits that the District Court had no alternative but to consider Section 220.42(1), F.S. in resolving the issues before it. To do otherwise, as the majority opinion did, conflicts with not only the cases which were cited in the Department's Answer Brief, but likewise conflicts with the decisions cited by Shell of Bedenbaugh v. Adams, 88 So.2d 765

(Fla. 1956) and Barnett Bank v. Jacksonville Nat. Bank, 457 So.2d 535 (Fla. App. 1 Dist. 1984). The other cases cited by Shell have no application to circumstances in the instant case.

The District Court in its opinion held that even though Section 220.42(1), F.S., might well have controlled on the issue of the treatment of IDC's by Shell, it was going to ignore such controlling statutory law, because the statute was not cited in the trial court and was not cited until rehearing.

In order to make such a ruling, the District Court expressly and directly conflicted with the prior rulings of this court, which clearly hold that the court's of this state will take judicial cognizancae of all statutes, and that since such statutes are the law of this state, the court has no alternative but to follow them. The District Court's attempt to side step the issue, by saying that the issue in the case was framed upon the interpretation of Rule 12C-1.15(4)(b)5, F.A.C., has a hollow ring when considered in conjunction with the separate concurring and dissenting opinion. Judge Wentworth observed that the consideration of Section 220.42(1), F.S. dictates a construction of Rule 12C-1.15(4)(b)5, F.A.C. which requires that Shell's method of accounting for federal income tax purposes, by which it deducted intangible drilling costs from gross income and precluded capitalizalization thereafter, determines the method of accounting by which the property factor shall be computed in the apportionment formula under the Florida Code. This is the construction that has been urged by the Department.

This is not a case of an immaterial issue. The consideration of Section 220.42(1), F.S., when interpreting Rule

12C-1.15(4)(b)5, F.A.C., is not only material, but to do as the District Court did, is prejudiced to the Department's administration of Ch. 220, F.S. Likewise, to apply the rationale of the District Court ignores the very material legislative intent and directive set forth in Section 220.42, F.S., that for the purpose of the Florida Code, a taxpayer's method of accounting shall be the same as such taxpayers method of accounting for federal income tax purposes.

POINT III

WHETHER SECTION 220.42(1), F.S., PRECLUDES SHELL FROM CLASSIFYING IDC'S AS DEDUCTIBLE EXPENSES IN ITS FEDERAL INCOME TAX RETURN (THUS AFFECTING A REDUCTION IN TAXABLE INCOME FOR THE YEARS IN WHICH THE EXPENSES ARE INCURRED), WHILE AT THE SAME TIME CLASSIFYING THEM AS CAPITAL ASSETS (TREATED AS PART OF THE COSTS OF ACQUISITION OF AN OIL WELL), FOR FLORIDA CORPORATE TAX PURPOSES.

The exact question presented here by Shell has arisen in two states which have enacted or paralleled the provisions of the Uniform Division of Income for Tax Purposes Act, UDITPA. In both California and Oregon taxpayers have challenged the exclusion of IDC's from the property factor of the apportionment formula. The decisions in both states held that the tax administrators had acted properly by excluding the IDC's from the property factor. Both cases involved taxpayers who had, as Shell has, expensed the IDC's for federal income tax purposes.

The Florida Statutes "track" UDITPA. The result is that the valuation of property at its "original cost" and the definition of "original cost" as contained in Florida rules, and the counterparts in California and Oregon, are identical.

In Appeal of Pauley Petroleum Inc., 400-101 California Tax Reports, CCH, 1982 (attached), IDC's were expensed for federal income tax purposes, and the taxpayer attempted, like Shell, to include them in the property factor of the apportionment formula. Property in California's property factor is valued at its "original cost" which is defined in the California Administrative Code in the same manner as "original cost" is defined in the Florida Administrative Code. The California State Board of Equalization concluded that the taxpayer's election to expense or capitalize IDC's for federal income tax purposes establishes the nature of the IDC's for state apportionment purposes. Therefore if the taxpayer had elected to expense the IDC's then the basis of the property would be excluded from the value of the property. On the other hand, if the taxpayer had capitalized the IDC's, then the basis of the property would be affected and the IDC's would be included in the original cost of the property. The board further concluded that the manner in which the IDC costs were treated for financial accounting purposes was irrelevant in determining whether they were includable in the property factor of California's apportionment formula.

Also in Atlantic Richfield Co. v. Department of Revenue, 9 Oregon Tax Rep. 451 (1984) (on Appeal to the Oregon Supreme Court) on substantially identical facts and law, the court concluded that the rule defining original cost to exclude IDC's expensed for federal income tax purposes was a reasonable interpretation of the statute. And since the court found that

only one member of the Multi-state Tax Commission which have uniformly adopted UDITPA, Alaska, includes IDC's in the computation of the property factor, it found that the exclusion of IDC's contributed to the goal espoused by UDITPA and the legislative intent for uniformity in the apportionment of business income.

Therefore on identical facts as presented here by Shell, the decisions in two states, who have adopted substantially identical laws as Florida, have held that IDC expensed for federal income tax purposes are excludable from the property factor.

Shell begins its reply brief by suggesting that the Department has abandoned its contention that inclusion of IDC's is improper under Rule 12C-1.15(4)(b)5. The Department has not so abandoned its reliance on its rule. Doubtless the District Court, at least in principal, agrees. The Department's position is expressed in both the District Court's majority opinion and in its dissent on the Motion for Rehearing. The majority stated:

> There is merit in the department's position that the statute (Section 220.42(1)) would indicate that IDC's should be treated the same in the apportionment formula as in Shell's federal income tax returns. We may speculate that had this statute been urged in the court below, in support of the department's interpretation of its rule, the trial judge's decision might well have been favorable to the department on this issue.

Shell Oil Co. v. Department of Revenue, 461 So.2d 959, 962 (Fla. 1 DCA, 1984)

Furthermore the dissent stated:

> I agree with denial of appellant's motion for rehearing but would grant cross-appellant's motion and reinstate the Department's determination of Shell's property factor in the apportionment formula. Section 220.42(1), Florida Statutes, requires that for Florida income tax purposes Shell's

> "method of accounting shall be the same as such taxpayer's method of accounting for federal income tax purposes." I would conclude upon reconsideration that this statutory language dictates a construction of Rule 12C-1.15(4)(b)5, F.A.R., to require that Shell's method of accounting for federal income tax purposes, by which it deducted intangible drilling costs from gross income and precluded capitalization thereafter, determines the method of accounting by which the property factor shall be computed in the apportionment formula under the Florida code. Supra at p. 963.

It is the Department's position that the proper interpretation of Rule 12C-1.15(4)(b)(5) F.A.C. and Section 220.42(1), F.S. does not allow for the inclusion in the property factor of the apportionment formula of Shell's IDC's which had been expensed for federal income tax purposes. The majority opinion above indicated the possibility of a decision in favor of the Department had the statute been brought to the attention of the trial court. Further the dissent would have included in its deliberations the statute which the Circuit Court overlooked and would overturn the lower courts decision. The Department's determination of Shell's property factor was correct and should be upheld.

Shell argues that the value of property should be taken from financial accounting records which may be different from the "original cost" used for federal income tax purposes. It suggests that this method would avoid the effect of disparate rates of depreciation or amortization upon recovery of capitalized property values. However it is clear from the statute and the rule that the intent of the legislature was to

include in the property factor the original cost used for federal income tax purposes.

Furthermore Shell suggests that the legislature was shortsighted if it intended to include in the property factor only that which was considered as "property" for federal income tax purposes. Shell contends that recent changes in the Internal Revenue Code would complicate the determination of the property factor. However subsequent changes in the Internal Revenue Code cannot retroactively impact legislative intent. Doubtless the legislature has responded to this complicating change. Section 220.13(1)(b)(6) as created in Ch. 84-549 Laws of Florida is a clear statement to Shell of how valuations are to be made currently for apportionment factor purposes. It states:

> Further, all valuations made for apportionment factor purposes shall be made on a basis consistent with the taxpayer's method of accounting for federal income tax purposes.

Shell cites McDonnell Douglas Corp. v. California Franchise Tax Board, 446 P.2d 313 (1968), Department of Revenue v. Amoco Production Co., 676 P.2d 595 (Alaska 1984) and Continental Oil Co. v. Reily, 104 So.2d 633 (1958), and contends that state courts have held that the value of property used in a business is the measure which will carry out the purpose of the apportionment formula. In McDonnell the California Franchise Tax Board attempted to exclude from the property factor certain properties used by McDonnell but owned by the U.S. Government. The court held the taxpayer in this case had shown that the formula used by the board was arbitrary and reached an unreasonable result. However McDonnell can be distinguished on several bases.

First in Shell there is no question that the property is owned by Shell; rather the question is how it is to be valued. In McDonnell the property was used but owned by another and no rent was paid as is usual in such circumstances.

Further the inequity in McDonnell stems from the fact the taxpayer owned counterpart property in other states and only the facility owned by the U.S. government located in California was excluded. In the absence of rental payments the exclusion of the government owned property created an imbalance. This lead to the conclusion by the court that the result reached was unreasonable in the case, but it did not lead the court to conclude that the Board's method was always unreasonable. Indeed the court pointed out that under another set of circumstances (such as the payment of rent) the use of the same method by the Board would not reach an unreasonable result. In McDonnell the unreasonable result was reached because the non-owned property which was excluded because rents were not paid was not located equally in each of the three oil-producing states involved. In Shell the IDC's wherever located were excluded from the valuation of the property for Florida apportionment purposes.

The exclusion of the IDC's is similar to the set of circumstances which the court pointed out would not reach an unreasonable result. It is similar because IDC's are almost uniformly expensed; therefore, the risk of distortion of the property factor among oil-producing states is negligible. And the risk of distortion between oil producing and non-producing states is also not great because IDC's do not constitute a significant part of the property factor numerators in oil

producing states.

Neither did the issue in Amoco involve IDC's. The issue there was whether non-producing gas and oil leases were included in the property factor of the apportionment formula because they were property rented and used. The court noted that the purpose of the apportionment formula was to measure the income producing activity of a corporation within and without the state and stated:

> To say that only property values associated with oil and gas leases which are known to contain recoverable quantities of oil and gas should be included within the property factor is to ignore the actual business activities that lead up to Amoco's ability to derive oil and gas income. 676 P.2d at p. 600.

The court also pointed out that the state's statutes provided for the relative value of non producing leases by the use of alternatives in the normal inclusion of eight times the rental costs in the property factor. Therefore the state had resolved any inequities that could arise from the inclusion in the apportionment formula of non-producing gas and oil leases.

In Continental a franchise tax wholly different from that of Florida, was assessed on the value of the capital assets of the corporation. The capital assets included only the IDC's and not the value of a producing well as a value could be determined for the IDC's but could not be for a producing well. Further the collector had acted within specific statutory authority in revising the information contained in the report on the value of capital assets.

Shell presents Eugene F. Corrigans opinion that IDC's should be included in the property factor. Proposed Multistate Tax

Commission Ruling on Intangible Drilling Costs under Article IV of the Multistate Tax Compact, 10 Urban Lawyer 236 (1978). This article represents his opinion which post dates the years in question. While the article refers to proposed regulations, to date the Multistate Tax Commission has not uttered any regulation embracing Corrigans conclusion. Further in the Atlantic Richfield case supra, the court found that, except for Alaska, all other states embracing UDIPTA (which include all Multistate Tax Compact members) follow an opposite practice and in fact exclude IDC. Furthermore Steven S. Bronson in an article in the same publication comes to the exact opposite conclusion. Treatment of Expensed Intangible Drilling and Development Costs for Purposes of the Property Factor of the Multi-State Tax Commission's Apportionment Formula, 10 Urban Lawyer 224 (1978).

Shell's comparison between IDC's and rent is clearly misplaced. Stating the relevant portion of Section 214.71(1), F.S. resolves the issue:

> 214.71 Apportionment; general method.
>
> (1) The property factor is a fraction the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the taxable year or period and the denominator of which is the average value of such property owned or rented and used everywhere.
> (a) Real and tangible personal property owned by the taxpayer shall be valued at original cost. Real and tangible personal property rented by the taxpayer shall be valued at 8 times the net annual rental rate paid by the taxpayer less any annual rental rate received from subrentals.

The property factor is to include "the taxpayers real and tangible personal property owned or rented and used". Rental expense is used as a means of determining the value of the property that the taxpayer rents and uses. The statute uses 8 times the rental expense as a mechanical means for uniformly computing the value of property which a taxpayer rents and uses but does not own. Rents, per se, are not expenses included in the property factor. They are only used as a means of valuing non-owned property. Capitalized royalties on the other hand are included in the property factor. If Shell had not elected to expense the IDC's the IDC's would have been included in the property factor as are capitilized royalties. This is true because Shell would have included them in "original cost" of each well for both federal and Florida purposes.

Further, because oil companies have a special election to expense IDC's, Shell should not compare the exclusion of its IDC's to the inclusion of intangibles in property valuations of taxpayers who do not have the special advantage of currently deducting intangible costs related to other assets in the determination of "original costs" for federal purposes. In any such comparison one can only speculate what taxpayers in other industries might elect if the federal law permitted them the special advantage given to oil companies.

Shell's reference to Commissioner v. Idaho Power Co., 418 US 1 (1974) is wholly irrelevant because the issue there was whether an expense has been properly characterized in the federal return as an asset (property) or as an expense. Shell properly chose to treat the IDC's as current expenses in its federal return.

Florida is bound by that election under Shell's federal method of accounting to give the same character to the IDC's for the determination of the income base and for apportionment purposes.

Lastly, Shell contends that Section 220.42(1), F.S., has no bearing on the controversy. Shell quotes however only part of that section. If stated in whole its relevance becomes clear.

> 220.42 Methods of accounting.
>
> (1) For purposes of this code, a taxpayer's method of accounting shall be the same as such taxpayer's method of accounting for federal income tax purposes, except as provided in subsection (3). If no method of accounting has been regularly used by a taxpayer, net income for purposes of this code shall be computed by such method as in the opinion of the department fairly reflects income.

The determination of net income pursuant to Section 220.12, F.S., requires that adjusted federal income be apportioned under Section 220.15, F.S. The amounts included in the apportionment formula then become inextricably tied to the computation of net income. All doubt as to the legislative intent to use federal determination for apportionment purposes is eliminated by the repetition of the term net income in Section 220.43(2), F.S.

For both federal and Florida tax purposes Shell has elected not to treat IDC's as property. The Department concedes that for financial accounting purposes the IDC's are capital assets but urges that this is irrelevant. The only insistence that the Department makes is that Shell use the same method for Florida purposes as it has for federal income tax purposes in determining the value of its property. Had Shell elected to capitalize the IDC's there would have been no controversy.

CONCLUSION

The Department, based upon the foregoing, respectfully request this Court to answer the question certified in the negative, as did the District Court. Further, the Department requests that this Court reverse the District Court on the issue concerning Shell's entitlement to include IDC's in the property factor in the apportionment formula, and remand that issue to the District Court with directions to enter an order consistent with §220.42(1), and the Department's treatment of Shell's IDC's.

Respectfully submitted,

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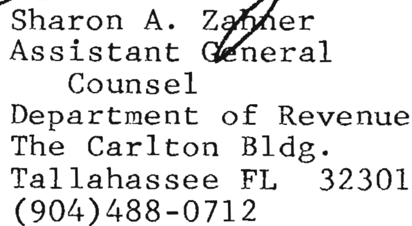

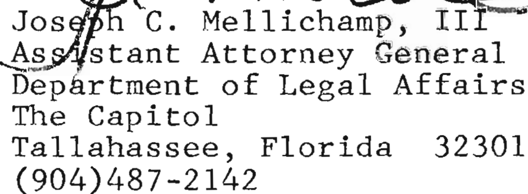

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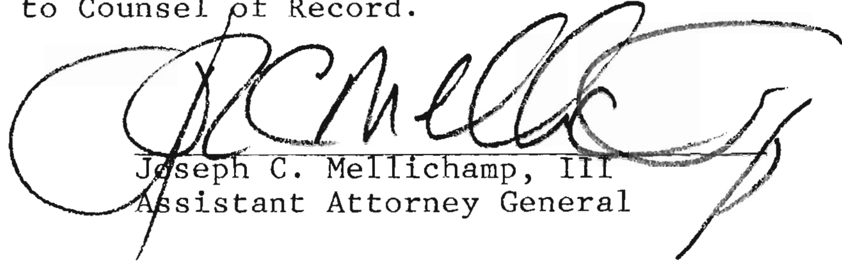
CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the foregoing Cross-Reply Brief has been furnished by mail this 14th day of June, 1985, to Counsel of Record.



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