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In the Supreme Court of Florida

FILED
MAY 22 1985
CLERK, SUPREME COURT
By ____ Chief Deputy Clerk

Shell Oil Company,	)	Case Nos. 66,240
Petitioner,	)	66,254
v.	)	
Department of Revenue,	)	
Respondent.	)	

On Review from the District Court of Appeal, First District

Petitioner's Reply Brief

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I.

FLORIDA IS PROHIBITED FROM IMPOSING A TAX ON INCOME DERIVED FROM THE PRODUCTION OF CRUDE OIL AND NATURAL GAS ON PROPERTY OF THE UNITED STATES DENOMINATED AS THE OUTER CONTINENTAL SHELF

Surely the Court must be confused after reading the department's Answer Brief and finding in it no common ground with Shell's discussion of the question certified. The Court has every right to be perplexed, for the department has declined to controvert anything of substance which Shell has argued. Rather, the department has attempted to shift the ground on which the issue rests. Under these circumstances, this reply brief can best serve the Court by trying to explain why the parties' briefs do not meet.

To begin, we call to the Court's attention those points which Shell had developed in its Initial Brief and which the department's brief has neither contravened nor even mentioned. Silence under these circumstances must be taken to mean that the department accepts these points as accurate, and as valid premises for the Court's disposition of this appeal.

1. The legislative history of the OCS Lands Act reflects congressional policy to prevent any assertion of state tax power in respect to the Outer Continental Shelf, and Congress considered and intended to bar state income taxation specifically. See Shell's Initial Brief at pages 21-29.

2. State income taxation, or any other direct or indirect form of state tax exaction with respect to the Outer Continental Shelf, will burden the cost of federal leases. The effect of taxation is to decrease the net return to the federal government from leased undersea lands, and this effect is precisely and explicitly contrary to expressed congressional policy. That policy has been affirmed in court decisions. See Shell's Initial Brief at pages 18 and 30, and the department's Answer Brief at pages 13-14.

3. Federal law and policy is controlling in this area by reason of federal constitutional doctrines, federal law, and the Florida income tax code's acknowledgment of federal supremacy. See Shell's Initial Brief at pages 15-21, 29-30.

4. The dollar amount of Shell's exclusion from income of its production income on crude oil transfers is accurate. That is, Shell's method for computing the crude oil transfers portion of production income from the Outer Continental Shelf, as described in its Initial Brief on page 9, is accurate for purposes of this case in that it reflects a standard and accepted method for calculating a sales equivalent.

Given this uncontested framework in which to decide this case, the Court can more easily identify and evaluate what the department has done to re-focus the Court's attention. Basically, the department has endeavored to recast the issue in

terms of "when" income has been earned, rather than answering the focal issue of "where" it has been earned as the OCS Lands Act requires.[1] To shift the Court's attention, the department attempts to tie together in some loose fashion four separate propositions, no one of which either meets Shell's contentions or contradicts the controlling federal imperative.

(a) The department's first and main thrust is to talk about the issue in this case as if it were one of timing, or the "realization" of income. See, for example, Answer Brief at page 14. Where sales of refined petroleum products take place is irrelevant, however, if the State of Florida may not under any circumstances reduce federal lease revenues from Outer Continental Shelf lands by tax levies. By repeating over and over the rubrics relevent to putting earned income into neat twelve-month pigeonholes, such as "realization is determined by sales" and "the Florida code adopts the federal concept of realization", the department stresses the wrong point. These timing-of-income doctrines present no basis for the state to tax an item or category of income which is constitutionally beyond its reach. This Court simply may not,

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[1]Shell's preliminary statement to the Court identified the difference between the two as the key to this proceeding. See Shell's Initial Brief at pages 1-2.

as the department urges, ignore the effect of attempted state taxation on these sovereign federal resources.

On the basis of the department's reasoning, Florida could tax a sale of property by a partnership of individuals despite the prohibition on personal income taxation in Article VII, Section 5 of the Florida Constitution. That, of course, is prohibited by Section 220.02(1), Florida Statutes. But the same contention could be made that, simply because income is "realized" by the partnership (not, individuals) at the time of sale, the tax is not burdening natural persons. In short, while realization is relevant for computational code purposes, it is no guide to evaluating limitations imposed by the constitution on the jurisdictional reach of the state in tax matters.[2]

(b) Next, the department offers the thesis that it is in any event not attempting to tax income "on" the Outer Continental Shelf. See Answer Brief at pages 12, 14 and 18. It asserts, rather, that it merely seeks to tax sales occurring in Florida and the several other states. But the point ignored in this discussion is the critical one: the governing federal

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[2]The department's inability or willingness to recognize the constitutional issue at the crux of this case is reflected in its misguided discussion of discretionary income exclusions, such as Section 220.13 of the income tax code. See Answer Brief at page 22. As Shell has noted, there is a world of difference between the exclusions permitted by legislative fiat for policy reasons, and those required by a constitutional imperative. See Shell's Initial Brief at pages 13-16.

statute is not locational in nature, or designed merely to limit the states from imposing severance type-taxes on this federal domain.[3] Several senators and congressmen attempted to confine the law that way, but they were not successful. See Shell's Initial Brief at pages 24-29. As a result, the statute says as clearly as Congress knows how that states may not apply any of their tax laws "to" OCS lands. The choice of "to" rather than "on" was no accident. That terminology reflects lengthy debates, and it incorporates resulting congressional policy against <u>any</u> form of levy which would impact on the revenues from federal leases.[4] All this is clearly explained by the legislative history of the OCS Lands Act, which we again note the department has not challenged. In essence, the department would have this Court pare back the OCS Land Act prohibition to locational taxes, notwithstanding that Congress has decided otherwise.

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[3]The district court was led by the department to believe that the OCS Lands Act had this narrow focus. The Court compared an income tax with a sales tax, apparently based on the department's location fixation. See Shell's Initial Brief at page 31, fn. 19.

[4]Cases cited by the department which emphasize congessional concern for federal leases illustrate precisely the point which Shell urges. See <u>Union Oil Co. of California v. Morton</u>, 512 F.2d 743 (9th Cir. 1975) and <u>United States v. Maine</u>, 420 U.S. 515, 95 S.Ct. 1155, 43 L.Ed.2d 363 (1975), cited in the department's Answer Brief on pages 13-14.

(c) The third thesis which runs through the response of the department links provisions of the Florida income tax code which adopt a "piggy-back" approach to the federal tax law, with federal code provisions themselves. The conclusion drawn by this thesis is that piggy-backed federal law accords no exclusion to production income from the Outer Continental Shelf, and therefore Florida accords none either. This argument makes less sense than the others asserted.

Florida law does indeed piggy-back the federal tax law for income determination purposes. And, admittedly, federal law does not exclude production income from the Outer Continental Shelf. This reason is abundantly clear. The OCS Lands Act is aimed only at the authority of states to exercise tax sovereignty. It does not address the federal government's own income determinations. Thus, federal taxation is absolutely irrelevant here, whether or not a state has chosen to piggy-back federal tax law for income definition purposes.

Put another way, the issue before the Court is whether any state can do with its tax law what Congress has said it may not with respect to the Outer Continental Shelf. Congress has prohibited states from increasing the tax burdens of federal lessees with respect to activities on the Outer Continental Shelf, directly or indirectly, to prevent an erosion of net federal revenues from undersea federal resources. It matters not in the least that state law provisions for <u>other</u> income

determination issues have been geared to generalized federal income tax concepts. Significantly, for all its reliance on the Florida code, the department never mentions the declaration in Section 220.02(5), that the Florida legislature has no intention of taxing items of income declared beyond its reach by federal statute or by the federal constitution.

(d) Finally, the department suggests that the record does not support Shell's arguments. Rather, it states that Shell had no arms-length sales of crude oil or natural gas to third parties, so that all of Shell's production income from the Outer Continental Shelf is "artificially" created. This is also irrelevant if the tax limitation of federal law is to be given effect, and we note again that the department finds no fault with the method of exclusion which Shell used to reflect production income from the Outer Continental Shelf.

Nonetheless, Shell suggests that the record in fact belies the department's assertion, and that the department's record distortion may not be accidental. The department's argument depends on the Court's believing that Shell has created a wholly artificial exclusion from income, as a departure from traditional federal concepts of "realization." But all items of income which Shell has excluded are <u>not</u> transfers; some crude oil and all natural gas was sold at arms

length to third parties on the platform.[5] These sales produced the classic form of realization. Inasmuch as the department offers no legal way to distinguish these sales from Shell's OCS platform transfers, it would seem that its distortion of the record may only be an effort to bootstrap the facts to an assumed legal conclusion.

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[5]Shell's answers to question 29 of the department's initial interrogatory to Shell (R. Vol. I, p. 52), which is not controverted, provide the record on this point.

> 29. (a) Does Plaintiff sell any of the products from its OCS production operations to purchasers not affiliated with Plaintiff in sales which take place outside the 50 states and District of Columbia?
>
> Yes, the Plaintiff sells some of its oil and gas production to independent purchasers on the OCS, which is outside the 50 states and district of Columbia.
>
> (b) Where are these sales made (i.e., at the wellhead, in foreign ports)?
>
> They are made at or near the offshore wellhead.
>
> (c) What percentage of Plaintiff's total OCS production (in barrels, cubic feet, etc.) was sold in the sales described in interrogatory 29(a) for each year in controversy?

1972	1973	1974	1975
17.5%	21.4%	22.5%	19.2%

II.

THE ISSUE OF INTANGIBLE DRILLING COSTS IS NOT PROPERLY BEFORE THE COURT, AND THE DECISION OF THE DISTRICT COURT DOES NOT CONFLICT WITH ANY FLORIDA APPELLATE DECISION

The department brings to the Court in parts II and III of its Answer Brief a challenge to Shell's inclusion of intangible drilling costs ("IDCs") in the apportionment formula. This issue is not properly before the Court. The reason it is not involves highly important policy reasons affecting not just this case but the entire operation of the judicial system. In any event, there is no constitutional requisite of an express and direct conflict of decisions. Shell suggests, however, that the policy issue in this instance transcends the absence of a jurisdictional conflict.

The department's assertion of its statutory argument on the IDC issue plunges the Court into this issue: when in the course of litigation will courts preclude the assertion of new theories of law on appeal which were available throughout the litigation from well-established law? In this case, the department's theory of law on the IDC issue was raised for the first time in its request for rehearing from the district court's appellate decision on the merits.

The decision of the district court from which the department seeks "conflict" review is that the Court refused to consider an issue raised for the first time on appeal in a

petition for rehearing. This Court has long held that this form of belated theorizing will not be allowed. In fact, there is no precedent on that proposition to the contrary. Thus, there is no conflict of decisions.

The district court's opinion accurately reflects the chronology of this litigation, and as to these facts the department asserts no disagreement. Shell's treatment of IDCs in the apportionment formula of its tax return was challenged by the department on audit, in administrative proceedings, in circuit court, and then in the district court of appeal, solely on the basis of the department's disagreement as to the proper interpretation of its own governing rule -- Rule 12C-1.15(4)(b)5, Florida Administrative Code. In the administrative proceeding, in the circuit court after a hearing, and in the district court after briefs and oral argument, decisions were rendered on the IDC issue based on the meaning and applicability of the Rule. Thereafter, and for the first time in its petition for rehearing, the department asserted an entirely new theory, based on a previously un-identified provision of the income tax code which had been a part of the code from its enactment in 1971.

The threshold question which faced the district court at that juncture was: assuming the newly-asserted interpretation of this statutory provision would change the outcome of the case (a matter never conceded or argued by Shell

because of the posture in which it popped up as an issue), is it appropriate to allow the department to argue the issue under these circumstances? In this case, not only was the statute available for reference all along and the agency asserting it presumptively more familiar with the income tax code than any taxpayer, but that agency had promulgated the governing Rule on which it had travelled and in so doing specifically did not identify this statute as relevant (as the Administrative Procedure Act requires).

Faced with this situation, the district court quite properly relied on precedent and policy to hold that the department was precluded from raising a new interpretation of the pre-existing statute, to contradict its own Rule, at that stage of the litigation. In essence, the court held that the department must turn square corners not only with taxpayers, but with the courts. Shell suggests the district court was eminently correct in so ruling, and that precedent fully supports its action. For that reason, the district court's rejection of the department's post-decision theory of law should be sustained here, either by denying review of the issue or by direct affirmation of the district court's decision on this point.

All decisions on this point in Florida hold that parties may not raise issues for the first time in a rehearing petition on appeal. The integrity of the judicial system, and

its utility to parties in litigation as a reliable process for resolving disputes, is destroyed by the new-theory-on-rehearing ploy. Delmonico v. State, 155 So.2d 368, 369 (Fla. 1963); Nelson v. Selden Cypress Door Co., 78 Fla. 203, 83 So. 286 (1919); Sarmiento v. State, 371 So.2d 1047, 1052-53 (Fla. 3d DCA 1979), approved on other grounds, 397 So.2d 643 (Fla. 1981); Cartee v. Florida Department of Health and Rehabilitative Services, 354 So.2d 81, 83 (Fla. 1st DCA 1977); Price Wise Buying Group v. Nuzum, 343 So.2d 115, 117 (Fla. 1st DCA 1977).

The latter two cases were situations, as was the situation here, in which a state agency wanted a "win" at any cost after being told it had lost on the issue originally presented on appeal. Nuzum moreover, just like this case, involved an old statute newly-asserted on rehearing.

The cases identified by the department as supporting its standing to raise the new issue do not involve a new legal theory asserted for the first time on rehearing. In Barnett Bank of Jacksonville v. Jacksonville National Bank, 457 So.2d 535 (Fla. 1st DCA 1984) (litigation incidentally between two private parties and not the rule-promulgating agency), the court merely held that a trial court should have taken judicial notice of a clearly applicable statute. The statute was not dredged up on rehearing for the first time. Similarly, Bedenbaugh v. Adams, 88 So.2d 765 (Fla. 1956), was not a

presentation on rehearing. Rather, a clear directive in a statute became the decisional point when the Court itself discovered the governing statute and applied it to the issue on direct appeal. Every other case identified by the department in its Answer Brief at pages 28-29 is equally off the mark, as none involves the "first-time-on-rehearing" problem.

Shell respectfully suggests that the district court's decision on the IDC issue,[6] holding that new matters may not be raised for the first time on appeal, does not conflict with any Florida precedent so as to give the Court "express and direct" conflict jurisdiction. More significantly, the district court's decision reflects sound judicial policy to which this Court should continue to adhere. The IDC issue raised by the department is not properly before the Court for consideration.

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[6] Shell Oil Co. v. Department of Revenue, 461 So.2d 959, 962-63 (Fla. 1st DCA 1984).

III.

INTANGIBLE DRILLING COSTS ARE PROPERLY INCLUDED IN THE PROPERTY FACTOR OF THE APPORTIONMENT FORMULA

1. The department's rule requires that these costs be included in the property factor.

The district court's original decision on IDCs [7] should be sustained if the Court elects to reach that issue. The district court held that Shell's inclusion of drilling and development costs in the property factor of the apportionment formula is consistent with Rule 12C-1.15(4)(b)5 as promulgated by the department. That Rule states in relevant part:

> 5. Valuation of Owned Property. Property owned by the taxpayer shall be valued at its original cost. As a general rule "original cost" is deemed to be the basis of the property for federal income tax purposes (prior to any federal adjustments) at the time of acquisition by the taxpayer and adjusted by subsequent capital additions or improvements thereto and partial disposition thereof, by reason of sale, exchange or abandonment, etc.

The basis of the Rule is Section 214.71(1)(a), Florida Statutes, which states that real property owned by a taxpayer "shall be valued at original cost."

Through its administrative proceeding and the courts below, the department had asserted that IDCs were not "property" as defined in the statute and the department's

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[7] 461 So.2d at 959.

Rule. In this Court, the department has totally abandoned that basis for argument. Not once in its brief on this issue has the department asserted a construction of its Rule different from the one approved by the district court. Plainly, the department must be deemed to have abandoned its contention that inclusion is improper under its Rule. The district court's construction of the department's Rule, therefore, that inclusion _is_ proper under the Rule, should be affirmed.

The department has audited this taxpayer and in essence said: our Rule prevents you from treating your IDCs as "property," and we want more tax. The taxpayer challenged that position in court, where the department asserted its expertise, its understanding, and its intent in formulating the Rule. The department failed to convince either the trial court or the appellate court that its rationale was sound. The department now asks this Court to sanction the additional tax _without_ the Rule.

Shell respectfully suggests that the Court deem the department's challenge to the district court's construction of the Rule as abandoned for purposes of this proceeding, and that the district court's decision on this issue be affirmed. The sole issue remaining, then, is whether Section 220.42(1) overrides the Rule so as to govern the excludability of IDCs (if the Court chooses to allow the department to argue its interpretation of the statute). Before addressing that issue,

however, it is important to develop for the Court a more complete understanding of the nature of IDCs, and to explain the rationale for their historic treatment as property in the apportionment formulae of the several states.

2. Intangible drilling costs are property for apportionment purposes

The department's substantive treatment of IDCs reflects at best confusion, and at worst a statutory sleight-of-hand with respect to the differences between income determinations under the income tax code (Chapter 220) and the apportionment criteria in part IV of Chapter 214. The two are so different, and are so specifically treated as different by the laws defining them, that it is easier to track the statutes and their purpose than it is to respond directly to the department's brief.

Calculating a taxpayer's state income tax liability is essentially a two step process.

1) The taxpayer's taxable income is first determined in the manner required by chapter 220, the income tax code;

2) The taxpayer's taxable income is then apportioned among the various states in which the taxpayer's income-producing activities occurred, in the manner required by chapter 214 of the laws of Florida.

The issue before the Court centers on the second step of the process: how properly and fairly to apportion among

various states the income earned by a multistate corporation. In 1957, a committee was formed to draft the Uniform Division of Income for Tax Purposes Act (UDITPA) in order to resolve this problem on a national basis. That committee, and the resulting Act, adopted the familiar three factor formula which is used by most states, including Florida, for the apportionment of income (and other taxes) to a particular taxing jurisdiction. The use of the three factor formula as a fair and proper method of apportioning income has been ratified time and time again by the United States Supreme Court.[8]

The components of the three factor formula are sales, payroll, and property. Under Chapter 214, a taxpayer's Florida sales, payroll and property are compared to the taxpayer's total U.S. sales, payroll and property, in order to derive a percentage. That percentage is then mechanically multiplied against the taxpayer's taxable income, to arrive at the amount of taxable income deemed to be earned in Florida by the taxpayer.

The three factor formula is designed to obtain an approximation that is reasonably related to the activities conducted within the taxing state. Thus, each component of the

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[8]See Container Corp. v. California Franchise Tax Board, 463 U.S. 159, 103 S.Ct. 2933, 77 L.Ed.2d 545 (1983); ASARCO Inc. v. Idaho State Tax Commission, 458 U.S. 307, 102 S.Ct. 3103, 73 L.Ed.2d 787 (1982).

formula in its unique way gauges the income-generating opportunities provided by the state. "Sales" are included because sales measure the extent to which the corporation avails itself of the marketplace provided by the state. "Payroll" measures the contribution of the taxing state's labor force to the generation of income. And the property factor, by reflecting the taxpayer's relative investment in the state, provides a reasonable indicator of the assets in the taxing state which contribute to the taxpayer's income-generating activities.

In this case, only the property factor of the formula is at issue. The total amount of taxable income has been correctly determined (under step 1 above), and is not in issue. Since only the question of how properly and fairly to apportion the amount of taxable income is at issue (under step 2 above), the question boils down to:

> Whether the value of property included in the property factor of the Uniform Division of Income for Tax Purposes Act, the Act itself being adopted in Florida as chapter 214, includes intangible drilling costs?

Section 214.71(1)(a) says that real and tangible property shall be valued "at original cost." The department has taken the position that original cost, as defined in chapter 214 and its regulation, does not include costs which have been "expensed" on the tax return of a taxpayer for purposes of computing taxable income. By taking this position, the department confuses the purpose of apportionment (and its property

ingredient under step 2) with the determination of income under step 1. One has nothing to do with the other.

For purposes of apportioning taxable income, Florida has chosen to follow the provisions of UDITPA, as the department's brief notes. The distinctive purpose of apportionment established by UDITPA was succinctly described in Pierce, The Uniform Division of Income for State Tax Purposes, 35 Taxes 747 (1957):

> "At the outset it should be made clear that the uniform act makes two significant basic assumptions that should not be overlooked. First, it assumes that the state has jurisdiction to levy the particular tax. Second, the uniform act assumes that the existing state legislation has defined the base of the tax and that the only remaining problem is the amount of the base that should be assigned to the particular taxing jurisdiction. Thus, the statute does not deal with the problem of ascertaining the items used in computing income or the allowable items of expense.
>
> The proposal does not provide for the tax or the tax base; it merely provides for an equitable means of apportioning and allocating the income to individual states when the taxpayer is engaged in business in more than one state." (emphasis added).

The rationale for adopting original cost as the measure of value for property is traceable to the committee of the National Conference of Commissioners on Uniform State Laws, which developed UDITPA provisions in 1956 and 1957. The committee chairman was George Powell. At the July 9, 1957, hearings, the rationale for using original cost to value property was specifically raised and discussed by Mr. Powell:

> MR. BUERGER: I am not too familiar with the general purposes of the details of this Act. I am curious about the first sentence of Section 11 [Property owned by the taxpayer is valued at its original cost.] which apparently does not take into consideration depreciation. Is there any particular reason behind that?
>
> MR. POWELL: Yes. First, the purpose of this Act, as we must remember, is not to determine the amount of the tax but just the distribution of the tax among the several states. The basis of distribution is determined by these factors. Each one of the taxing statutes of the various states undoubtedly has provision for depreciation and general deduction from gross income to arrive at the taxable net. We find that there is a great disparity among corporations as to the extent to which they have old properties, new properties and the like, and it was nearly impossible to arrive at a basis which was mutually acceptable, and the original cost seemed to be more generally acceptable than any other basis. If we said "cost after depreciation" we then get into the <u>fast write-off situations</u> and a great many things, and <u>original cost as reflected on the books</u> of every corporation is something readily arrived at, and throughout here we have tried to keep the accounting required by the corporation or by the taxpayer to a minimum.
> (Underlining added).

The drafters of UDITPA sought to avoid any method that would involve the use of disparate rates of depreciation or amortization in the apportionment formula. "Fast write-off situations" were singled out as those particularly sought to be avoided. Original cost was selected as more acceptable than any other basis for the purpose of reflecting the value of a corporation's property. The department's position, contrary to

the purpose of the formula itself, actually makes inclusion of IDCs in the property factor turn on whether IDCs are written off slowly or all at once.

Incidentally, the department does not dispute the fact that IDCs are part of an oil well's original cost, so as to fall within the ambit of the statute. Instead, it arbitrarily has chosen to disallow that element of original cost as part of the property factor on the ground that Shell expensed the IDCs under IRC Section 263(c). There is no faster write-off than expensing a cost in the year in which it is incurred. Thus, comparing a taxpayer which expenses IDCs with one which does not accords precisely the disparate treatment sought to be avoided by the drafters of UDITPA--*i.e.*, different cost recovery methods yield different property factor values for identical investments in the same types of property. If the drafters sought to avoid disparity between taxpayers whose property would have been depreciated over, say, ten years and six years, respectively, it follows that the disparities generated by a ten year vs. three year depreciation period, or the disparities generated by a ten year depreciation period vs. an immediate write-off, are the types that were designated to be avoided.

As noted above, even though measures of value other than original cost were considered, original cost was the measure of value decided upon. It was found to be more in line

with the purpose of UDITPA, which is to apportion taxable income rather than compute taxable income. And it was considered to be the most acceptable and most easily computed measure of value since original cost is always reflected in a company's financial records. With its use, similar investments would reflect similar values, because original cost would not be subject to adjustments peculiar only to a particular taxpayer.

The error of the department's position is exacerbated by the provisions of the Tax Equity and Fiscal Responsibility Act (TEFRA) enacted in 1982. Section 204 of TEFRA added section 291 to the Internal Revenue Code to provide for a 15% reduction in certain corporate tax preference items. Among those items are IDCs which are otherwise allowed to be expensed under Section 263(c). The effect of Section 291(b), under the department's position, is that 15% of the IDCs would be included in the property factor and 85% of the IDCs (assuming the taxpayer elects to expense the remaining 85% of the IDCs) would be excluded from the property factor. This bizarre result highlights the fact that the denial of a deduction for 15% of IDCs for federal tax purposes does not make IDCs any more or less a part of the original cost of an oil or gas well; it merely affects the time at which that original cost may be deducted in the computation of taxable income.

Despite occasional attempts to vary the values to be included in the property factor, state courts have uniformly

resisted such efforts and steadfastly held that the value of property used in a business is a measure which will carry out the purpose of the apportionment formula--to apportion taxable income fairly and not to determine taxable income. For example, in McDonnell Douglas Corp. v. California Franchise Tax Board, 69 Cal.2d 506, 72 Cal. Rptr. 465, 446 P.2d 313 (1968), the California Supreme Court resisted the efforts of the California Franchise Tax Board to dilute the taxpayer's property factor through exclusion of certain non-owned property from the property factor. In McDonnell, a majority of taxpayer's manufacturing activities took place in plant facilities owned not by the taxpayer, but by the U.S. government. The taxpayer included such plant facilities in its property factor. In holding that the non-owned plant facilities should be included in the property factor, the court noted that "In the apportionment of a unitary business the formula used must give adequate weight to the essential elements responsible for the earning of the income." 446 P.2d at 314.

In Department of Revenue v. Amoco Production Co., 676 P.2d 595 (Alaska 1984), the Alaska Supreme Court resisted the efforts of the taxpayer to dilute the property factor through exclusion of non-producing oil and gas leases from the property

factor.[9] Arguing that non-producing leases did not generate income, the taxpayer contended the leases were for this reason properly excludable from the property factor. The court held otherwise and included non-producing leases in the property factor:

> "The economic theory underlying the [apportionment] formula is that the dollar value of the unitary business capital investments, labor costs, and sales within the state, when compared to the business' total capital investments, labor costs and sales everywhere will roughly reflect the fraction of total income that is attributable to the business' in-state activities. These property, payroll and sales factors are merely indicative of the business income producing capabilities."
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> "The exploration and development of what later turn out to be unproductive oil and gas wells is a necessary and integral part of Amoco's eventual discovery and exploration of productive oil and gas wells. 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

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[9] "Non-producing leases" are leases which do not contain producing oil and gas wells, for one of several reasons: (1) no exploration has taken place to date; (2) exploration has taken place and oil and gas has been located, but transportation facilities, etc. are still being constructed; or (3) exploration is taking place but no commercial deposits of oil and gas have been located to date.

> business activities that lead up to Amoco's ability to derive oil and gas income." 676 P.2d at 599-600.

And see Continental Oil Co. v. Reily, 235 La. 511, 104 So.2d 633 (1958), where the Louisiana Supreme Court held that it was irrelevant that the taxpayer had expensed IDC costs. The court said these items constituted part of the original cost of oil and gas wells, and as such clearly constituted an asset subject to the Louisiana franchise tax on capital. 104 So.2d at 635.

The purpose of the property factor is to apportion taxable income in accordance with the income earning capabilities of the enterprise, not to determine taxable income. Intangible drilling costs--being a part of the original costs incurred by the taxpayer to drill an oil and gas well--must be included in the property factor, for clearly such costs are an essential element of original cost ultimately responsible for the earning of income, and are a necessary and integral part of the ability to derive income. They should be reflected in any formula which apportions income if that formula is to operate as it was intended--fairly among the several states.

In an article entitled Proposed Multistate Tax Commission Ruling on Intangible Drilling Costs Under Article IV of the Multistate Tax Compact, 10 The Urban Lawyer 236 (1978), Eugene F. Corrigan, Executive Director of the Multistate Tax Commission, stated:

". . . . the fact significant for our purposes here, is that intangible drilling and development costs all represent long-range investments by oil and gas producers for the production of oil and gas which lead to the production of income. Furthermore, the overriding purpose of the property factor of the UDITPA apportionment formula contained in Article IV of the Compact is to assign income in part to where property is employed by the taxpayer for the production of income. Consistent with this purpose . . . fairness and logic dictate that they be treated as tangible personal or real property for property factor purposes. Otherwise, long-range investments for the production of oil and gas would be ignored under the property factor . . . we conclude that such costs . . . are tangible personal and/or real property for property factor apportionment purposes. Furthermore, it is immaterial whether these costs have in fact been capitalized or expensed for federal income tax purposes. (Underlining added.)

For purposes of determining taxable income, the decision whether a particular cost should be "capitalized" or "expensed" is solely a function of time.[10] That is, an expenditure for an item which will generally have a useful life

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[10]Whether a particular cost is capitalized or expensed, the total cost is eventually allowed as a deduction from a taxpayer's gross income for the purposes of determining the taxpayer's taxable income. The significance of capitalizing a cost is that the deduction is spread out over a number of years. With capitalization, only a portion of the total cost incurred is utilized each year as a deduction. Expensing the cost, on the other hand, results in the total cost of an item being deducted in the year the cost is incurred. See generally Commissioner v. Idaho Power Co., 418 U.S. 1, 94 S.Ct. 2757, 41 L.Ed.2d 535 (1974).

beyond one year is capitalized (e.g., a truck), while an expenditure for an item which will have a useful life of one year or less is expensed (e.g., a monthly rental payment for the use of a building, or machinery, etc.). However, for apportionment purposes, it is clearly immaterial whether an asset is capitalized or expensed.

Rental payments are clearly expensed for the purpose of determining taxable income. Yet they are specifically includible in the property factor of the UDITPA (and Florida's) apportionment formula. See Section 214.71(1)(a), Florida Statutes. Clearly, if the test for inclusion in the apportionment formula turned on whether a particular item has or has not been expensed for purposes of determining taxable income, then rental payments which clearly are not capitalized items should be excluded from the property factor. However, that is not the case. The primary test for inclusion in the property factor--as envisioned by the authors of UDITPA--was whether or not the item in question contributed to the generation of income. IDCs clearly meet that test.

As a further illustration, consider a fifty story office building, or a large manufacturing complex, which has a useful life longer in duration than one year. In constructing the office building or manufacturing complex, costs for labor, fuel, repairs, hauling, and supplies are incurred and properly

treated as part of the original capitalized cost. Commissioner v. Idaho Power Co., 418 U.S. at 13. Being a component of original cost, these costs are also quite properly included in the UDITPA property factor.

In drilling an oil or gas well, a taxpayer also incurs costs for labor, fuel, repairs, hauling and supplies. These costs are termed intangible drilling costs and are clearly a part of the original cost of drilling an oil and gas well. Treas. Reg. § 1.612-4. That regulation specifically notes that the choice of the term "intangible" is strictly for convenience.

The question naturally arises: if it is proper to treat the costs of labor, fuel, repairs, hauling and supplies as part of the original cost when associated with an office building or a manufacturing complex (and thence as part of the property factor), why is it not proper to treat these identical costs, when incurred in association with the drilling of an oil and gas well, as part of original cost (and as a component of the property factor)? The answer is obvious, as the district court below has held.

The department argues as a generalization that for purposes of determining taxable income, Shell's IDCs were expensed. Of course, that fact is accurate, for under federal tax law a taxpayer has the option of either expensing or

capitalizing IDCs. See IRC § 263(c).[11] But the conclusion drawn by the department does not follow from its generalized premise, for the entire discussion of expensing versus capitalizing is irrelevant. The purpose of the property factor is to apportion taxable income, not to determine taxable income. For purposes of determining taxable income, Florida has chosen as a matter of tax policy to allow IDCs (as well as rental costs discussed above) to be expensed. For purposes of apportioning taxable income, however, the Florida legislature has chosen to include original costs in the property factor. IDCs clearly are part of the original cost of an oil and gas well, as are the identical costs when incurred in constructing a fifty story office building.

In Commissioner v. Idaho Power, the Court said:

> "There can be little question that other construction-related expense items, such as

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[11]For financial book purposes, these costs are required to be capitalized. For UDITPA apportionment purposes, the financial book records and not tax records are to be utilized for determining the property factor. See generally the statement by Mr. Powell, supra, and the Commissioners' notes to UDITPA, Section 11, which say:

> The use of original cost obviates any differences due to varying methods of depreciation, and has the advantage that the basic figure is readily ascertainable from the taxpayer's books. No method of valuing the property would probably be universally acceptable. 7A ULA, Uniform Division of Income for Tax Purposes Act, § 11, Commissioners' Note (1978). (Emphasis added.)

> tools, materials, and wages paid construction workers, are to be treated as part of the cost of acquisition of a capital asset . . . . [W]hen wages are paid in connection with the construction or acquisition of a capital asset, they must be capitalized . . . ." 418 U.S. at 13.

It is only by virtue of the exception provided by Section 263(c) that expenses such as those discussed in Idaho Power may be deducted in the year in which they are paid or incurred, rather than amortized over the life of the capital asset acquired or constructed. And see F.H.E. Oil Co. v. Commissioner, 147 F.2d 1002 (5th Cir. 1945). For other cases reaching the same conclusion, see A.T. Jergins Trust v. Commissioner, 22 B.T.A. 551, rev'd on other grounds, 61 F.2d 92 (9th Cir. 1932), rev'd sub nom., Burnet v. A.J. Jergins Trust, 288 U.S. 508, 53 S.Ct. 439, 77 L.Ed.2d 925 (1933) (1931); Ziegler v. Commissioner, 23 B.T.A. 1091 (1931); Burnet v. P-M-K Petroleum 24 B.T.A. 360 (1931); United States v. Dakota-Montana Oil, 288 U.S. 459, 53 S.Ct. 435, 77 L.Ed. 893 (1933); Hunt v. Commissioner, 135 F.2d 697 (5th Cir. 1943); Continental Oil Co. v. Reily, 235 La. 511, 104 So.2d 633 (1958).

If, as the department insists, IDCs are costs that are not inherently capital in nature, then there is absolutely no reason for the federal tax code to contain a provision which authorizes the taxpayer to expense those costs. Barring a provision such as Section 263 mandating that particular items are to be treated as capital costs, all costs incurred by a

taxpayer in his business would simply be expensed. No costs would ever be capitalized. The fact that a statutory option was necessary clearly indicates IDCs are in fact capital in nature.

In summary of this analysis, Shell suggests that the Department's position is totally contrary to the history and purpose of the apportionment law. The drafters of the uniform law chose a three factor formula to apportion a multistate company's income to various taxing jurisdictions, and they designed the property factor to reflect the relative amount of business activity carried on in those jurisdictions. Original cost was chosen as the measure of property value for clearly stated reasons, the most important of which was to avoid disparities among taxpayers because of fast write-off situations.

The uniform law was adopted by the Florida legislature. The department now seeks to generate a disparity among taxpayers based on the fastest form of fast write-off. In that regard, the department's position runs contrary to the decisions of courts which have uniformly rejected any construction of UDITPA that departs from the dominant purpose for the inclusion in the property factor of the original value of the property used by a business enterprise in the conduct of its business. Moreover, the department's position is at odds with the measure of value used for other types of property

identical to oil and gas wells, such as buildings and manufacturing facilities. In short, there is no support for the department's position in the history of the law, the purpose of the law, the interpretation of the law, or by analogy to identical costs incurred in the construction of other types of property.

3. Section 220.42(1) does not pertain to the property factor.

The district court has held that the department's Rule directs taxpayers to put IDCs in the property factor of the apportionment formula. This Rule is the department's authoritative interpretation of the term "original cost" in the property factor for apportionment formula matters under Chapter 214, Florida Statutes. That chapter prescribes the mechanisms for assigning a fair portion of a taxpayer's income to Florida.

The department now argues that an income tax code provision, Section 220.42(1), Florida Statutes, compels the exclusion of these items from the property factor. In relevant part, that section of the income tax code states:

> 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 . . . . (emphasis added)

There are several reasons why Section 220.42(1) has no bearing on this controversy.

Section 220.42(1) appears in Chapter 220, the code which prescribes what is and what is not "income" (step 1

above). Shell used its federal accounting method for determining its Florida income by expensing rather than capitalizing IDCs. The department does not assert that Shell improperly reported or computed its income under Chapter 220.

In apportioning its income to Florida, Shell followed the formulary treatment in Chapter 214, which weights sales, property and payroll. As discussed above, Shell treated IDCs as part of the original cost of the "property" included in the formula. It is easily demonstrated that apportionment involves issues which are in most ways absolutely unrelated to income determinations, and that Section 220.42(1) only deals with a taxpayer's "method of accounting" for income determinations.

Sales, as an example, are the major element in Florida's apportionment formula, composing 50%. Yet they have no foundation in the taxpayer's accounting method for federal tax purposes. How and where a sale occurs for purposes of the sales factor of the formula, see Section 214.71(3), Florida Statutes, is not related to whether the taxpayer is on a cash basis, an accrual basis, or a hybrid method of accounting for its income. The method of accounting merely provides a uniform way in which to prepare an annual (or 52/53 week) report of earnings or loss. It is a tool for timing, and nothing more. Weighting mechanisms for assigning a fair portion of that income to any state involve non-accounting matters. The point can be illustrated in many different ways.

1. "Property", as a concept for apportionment purposes, stands apart from any "method of accounting." See Section 214.71(1)(a), Florida Statutes, and Rule 12C-1.15(4)(b)6, which direct that rent payments are an item of "property" to be included at eight times net annual rent. This computation, obviously, is not related to a taxpayer's method of accounting for its income on an annual basis.

2. One can ask, rhetorically, where in an airline, railroad or pipeline company's "method of accounting" there is any reference to or use of "revenue miles". The answer, of course, is nowhere. Yet that term is the sole and exclusive apportionment tool in Chapter 214 for determining Florida's share of the earnings of these corporate taxpayers. See Section 214.72(2), Florida Statutes.

These illustrations show that the apportionment formula of Chapter 214 does not, cannot, and has not been correlated with the methods of accounting which taxpayers use to measure profit or loss. The formula serves a wholly different function in the scheme of state income taxation.

By asking to assert Section 220.42(1) for the first time on rehearing below, the department was able to gloss over the differing functions of apportionment and income determination. Had the issue been properly joined, Shell could have pointed out that the statutes themselves, in plain terms, made clear that Section 220.42(1) does <u>not</u> govern apportionment considerations under Chapter 214.

Section 220.42(1) states in its opening phrase: "For purposes of this code." "This code", of course, is Chapter 220, the income tax code. While the department recognizes the statutes's self-imposed limiting reach (Answer Brief at page 41), it hints that the code includes apportionment matters because it touches that subject in Section 220.15. That section, however, is not the source of apportionment criteria. The identification and definition of factors for formulary apportionment appear in Part IV of Chapter 214. Section 220.15 of the income tax code merely makes modifications not relevant to this case "for the purpose of applying [Part IV] to this code." To accept the department's shallow suggestion that Section 220.15 picks up and incorporates wholesale all of the provisions of Chapter 214 is really asking the Court both to negate the language of Section 220.15, and then to rewrite the statute.

As if the point were not otherwise clear enough, Section 220.53 of the income tax code declares that the tax imposed by the code is "subject to" Chapter 214; not the other way around. Consequently, the provisions of Chapter 214, and any interpretative rules thereunder, necessarily prevail over anything in the income tax code.

For these reasons, Section 220.42(1) of the income tax code is irrelevant to any definition of "property" vis-a-vis apportionability. Section 220.42(1) does not countermand or

override Chapter 214. Rather, the provisions of Chapter 214 dominate, and the tax imposed in Chapter 220 is "subject to" Chapter 214 determinations.

CONCLUSION

The department has endeavored to tax Shell on production income derived from the Outer Continental Shelf, in contravention of federal law and policy. The basis for this attempt ignores federal imperatives by focusing on the timing device of realization of income for federal and state income tax purposes. Unchallenged, however, is the congressional determination that state income taxes, as well as state sales, severance or other locational taxes, may not burden the cost of federal resources under the sea which are leased to Shell and others. The department's attempt to tax Shell contravenes the congressional ban on state authority to tax in this manner.

Issues may not be raised for the first time on appeal in a petition for rehearing. The district court properly rejected the department's attempt to theorize anew at that late stage of this proceeding. That decision of the district court is proper, and it does not conflict with any Florida appellate decision. The issue brought by the department on cross-petition is improperly before the Court and should not be considered.

Intangible drilling costs are property for apportionment purposes, to be valued under Florida law at original cost. Shell's election to expense these costs for income determination purposes has no bearing on their inclusion in the property factor of the apportionment formula for apportionment purposes. Section 220.42(1) of the income tax code, relating to a taxpayer's method of accounting, likewise has no bearing on apportionability under chapter 214, Florida Statutes.

CERTIFICATE OF SERVICE

I certify that true and correct copies of this reply brief were mailed on May 20, 1985, to Joseph C. Mellichamp, III, Esq., Assistant Attorney General, The Capitol, Tallahassee, Florida 32301, and to Sharon A. Zahner, Assistant General Counsel, Department of Revenue, Carlton Building, Tallahassee, Florida 32301.

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