IN THE
SUPREME COURT
STATE OF MISSOURI

No. 85181

T-3, INC.,
Appellant,

v.

DIRECTOR OF REVENUE, STATE OF MISSOURI,
Respondent.

ON PETITION FOR REVIEW
FROM THE MISSOURI ADMINISTRATIVE HEARING COMMISSION
THE HONORABLE KAREN A. WINN, COMMISSIONER

REPLY BRIEF FOR APPELLANT

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ARGUMENT

I. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN UPHOLDING THE ASSESSMENT BECAUSE, UNDER SECTIONS 621.189 AND 621.193, THAT DECISION IS NOT AUTHORIZED BY LAW OR SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE IN THAT SECTION 147.010 DOES NOT ALLOW THE DIRECTOR TO IMPOSE THE MISSOURI FRANCHISE TAX ON T-3'S PROPERTY AND ASSETS EMPLOYED IN BUSINESS OUTSIDE OF MISSOURI.

A. Section 147.010 Requires T-3 to Apportion its Missouri Franchise Tax Base

Section 147.010.1[1] provides that corporations employing "part of their outstanding shares in business in another state or country" "***shall***"[2] pay their Missouri franchise tax on a part of their "shares and surplus" determined by the location of their "property and assets employed" in business. Among other things, T-3 owns shares of mutual funds and municipal bonds. Some of those municipalities and mutual funds used T-3's capital entirely outside of Missouri. Therefore, T-3 apportioned out the value of those assets from its franchise tax base. The Director argues that T-3 must include all of its assets in its franchise tax base, even those assets that are not employed in Missouri, because ***T-3*** is not

[1] All statutory citations are to the Revised Statutes of Missouri of 2000, as amended, unless otherwise noted.

[2] Emphasis added here and throughout, unless otherwise noted.

paying franchise tax to any other states on the value of its assets employed outside of Missouri (Dir. Br. 15). This Court should reject the Director's argument just as it did over fifty years ago in *Union Electric Company v. Morris*, 222 S.W.2d 767 (Mo. 1949) and forty years ago in *Household Finance Corporation v. Robertson*, 364 S.W.2d 595 (Mo. banc 1963).

In *Union Electric*, this Court concluded that the value of shares of stock that Union Electric held in Illinois subsidiaries were not to be included in Union Electric's franchise tax base because the stock represented Union Electric's interest in the subsidiaries and those subsidiaries had no assets in Missouri and did no business in Missouri. It was obviously unimportant whether Union Electric filed franchise tax returns in Illinois because that fact was not mentioned in the opinion. Rightly, this Court's focus was not on what other states did not tax. Rather, this Court's focus was on what ***Missouri*** taxed. Recognizing that Missouri imposed the franchise tax upon the use of assets in Missouri, the Court concluded that Union Electric's capital was not used in Missouri because the Illinois corporations' assets that the shares represented were not used in Missouri:

> "While respondent's capital was invested in the shares of stock and while the shares of stock were owned and held by respondent a domestic corporation in this state, ***the capital so invested and evidenced by such shares of stock was not employed in business in this state, but was employed where the property and business of the two foreign corporations was located.***" *Id.* at 770.

Accordingly, this Court held that by using capital in business outside of Missouri, a corporation "employs" part of its shares in business outside of Missouri:

> "Reading and considering the statute as a whole and giving effect to its several provisions, we must hold that respondent does in fact employ part of its outstanding shares in business in another state; that the amount evidenced by the market value of the shares of stock held in the two Illinois corporations is not 'property and assets in this state,' ***nor are such shares of stock 'property and assets in this state'*** within the meaning of those words as used in the statute; that such property and assets were ***not 'employed in this state'***; and that the market value of such shares of stock should not have been included in the tax base for computing the amount of respondent's corporate franchise tax for said years." *Id.* at 772.

Thus, contrary to the Director's claim (Dir. Br. 13), the word "employed" is not read out of the statute. Simply, a corporation employs its shares outside of Missouri when its capital and assets are employed outside of Missouri.

The Director cannot and does not dispute the holding of *Union Electric.* Instead, she attempts to distinguish it. First, she takes one sentence of *dicta* out of context to argue that this Court should reach a different decision in this case (Dir. Br. 15). In *Union Electric*, this Court stated:

> "There is no suggestion that the shares of stock in question were used in respondent's business, or that it was in the business of buying and

> selling stocks. On the other hand, it is admitted that respondent is 'engaged as a public utility corporation in the business of generating, transmitting, distributing and selling electric energy and steam in the state of Missouri' and that respondent owns the shares of stock of the two Illinois corporations."

The Director incorrectly assumes that had Union Electric been in the business of buying and selling stocks, this Court would have included the value of the stock in the subsidiaries in Union Electric's Missouri tax base. The holding of *Union Electric* would have been the same. Tax statutes are construed in favor of the taxpayer, not against it.[3] The Court concluded that the value of the stock that Union Electric held was not to be included in the Missouri tax base because the assets that stock represented were not used in business in Missouri. That is the basis for the decision and that basis applies to T-3. Section 147.010 taxes corporations doing business in Missouri, but the amount of tax is a function of the extent of the use of the franchise in Missouri and, under the statute, that use is determined by use of assets and property in Missouri. *See Union Electric*, 222 S.W.2d at 770. The cited *dicta* does not alter the result for T-3. Had T-3 owned outright the assets of the corporations whose stock it held through the mutual funds, instead of through shares of stock, the Director would agree that T-3 was not employing those assets in Missouri. T-3's

[3] Section 147.010.1, as a tax statute, must ***plainly confer*** the right to tax T-3's assets. *See United Air Lines, Inc. v. State Tax Commission*, 377 S.W.2d 444, 448, (Mo. banc 1964).

shares merely constitute evidence of the property and assets that are employed entirely outside of Missouri.

Furthermore, this Court came to the same result in *Household Finance*. There, the Court determined that the taxpayer's shares of stock in its subsidiaries, like T-3's shares of the mutual funds, were not to be included in the franchise tax base. Likewise, the Court concluded that the taxpayer's loans to its subsidiaries, like T-3's loans to municipalities represented by the municipal bonds, were not to be included in the tax base. This Court found the tax statute simply did not impose the tax on assets of other than the taxpayer, and the loans and shares of stock represented someone else's assets:

> "Neither the earlier act nor [section] 147.010 contains any wording whatever whereby if fairly may be said the Legislature intended that either the cash paid by plaintiff to its subsidiaries operating in Missouri in return for the stock delivered to plaintiff at the time of their incorporation, or the money advanced them by plaintiff, as shown by the admitted facts, should be included in the computation of the amount of franchise taxes owed by plaintiff to the State of Missouri. "The language used in that statute … imposes a corporate franchise tax … ***solely*** upon that portion of its property and assets [employed] in this state bears to all its property and assets wherever located. When plaintiff paid its seven subsidiaries the $560,000.00 for their capital stock and thereafter advanced them money, the purchase price of the capital stock and the money became assets of the subsidiaries[.]

Household Finance, 364 S.W.2d at 606-07.

The plain language of Section 147.010 and the cases construing it clearly support appellant's construction of the law.

B. The Director's Construction Leads to Multiple Taxation.

The Director's construction leads to multiple taxation of the same assets. The very language of Section 147.010 is designed to limit the Missouri franchise tax base to assets used in business in Missouri. Obviously, that language also is designed to exclude from the Missouri tax base assets that are used in business in other states. One obvious purpose of that exclusion is to prevent multiple taxation. Multiple taxation can violate the commerce clause of the United States Constitution. *See Goldberg v. Sweet*, 488 U.S. 252, 261 (1989) (to be internally consistent, a tax must be structured so that multiple taxation would not result if every state imposed an identical tax).

The assets of a corporation can obviously be included in the tax base in the jurisdictions where the corporation uses them in its business. Under the Director's theory, those assets can also be included (through inclusion of shares representing the value of those assets) in Missouri's tax base if the corporation's shareholders (or their shareholders' shareholders) do business in Missouri. Thus, regardless of whether such assets have already been included in a state's tax base, the Director contends that Missouri should tax the value of shares representing those assets. This can not have been the reasonable expectation of the Missouri General Assembly. Had it been, there would have been no requirement to apportion the franchise tax base. Also, had that been the

expectation of the Missouri General Assembly, it certainly would have legislatively overruled *Union Electric* at some point in the last fifty years.

The Director claims that her construction does not result in double taxation, but her arguments are unavailing (Dir. Br. 15). First, she claims that the record fails to show whether any of the mutual funds in which T-3 invests pay any franchise tax by citing one jurisdiction that imposes its franchise tax on a different tax base than Missouri. This Court does not ordinarily construe Missouri law in such a way that will lead to or cause multiple taxation even if the construction does not lead to double taxation for all types of income. The Director offers no explanation for how multiple taxation can be avoided under her theory. Instead, she claims that because T-3 is not ***directly*** double taxed, there could be no double taxation. When the corporations whose shares T-3 holds pay tax on their assets, T-3, and the corporations' other shareholders, bear the incidence of that taxation. Finally, the Director argues that some of T-3's investments are in municipal bonds that represent assets held by entities that are generally not subject to franchise tax. While true, that is hardly support for the Director's argument. The assets that the municipalities purchased with T-3's capital are not used in business in Missouri (at least for those bonds that T-3 attempts to exclude). The fact that some states elect not to include municipalities under their franchise tax is not evidence of the General Assembly's intent to tax those assets in Missouri.

C. The Commission's Decision

1. Interstate Offices and Franchise Tax Returns

The Director concedes that there is no requirement under Section 147.010 that a taxpayer have physical offices outside of Missouri or file franchise taxes in other states to

apportion the Missouri franchise tax base (Dir. Br. 17). Nonetheless, she asserts that these facts are relevant to show whether a taxpayer employs shares outside of Missouri. That is not what this Court held over fifty years ago in *Union Electric.* A corporation's shares are employed outside of Missouri if its assets are used in business outside of Missouri ("we must hold that respondent does in fact employ part of its outstanding shares in business in another state; that the amount evidenced by the market value of the shares of stock held in the two Illinois corporations is not 'property and assets in this state'"). *Union Electric*, 222 S.W.2d at 772. The pieces of paper evidencing ownership of the Illinois corporations were not Union Electric's assets employed in business. They represented the assets that were employed in business, and those assets were employed in business in Illinois, which was free to subject the underlying assets to its franchise taxes.

The Commission attempted to distinguish *Union Electric* on the theory that *Union Electric* applied only to the value of stock in ***wholly-owned*** subsidiaries. But even the Director concedes that percentage of ownership is a "red herring" (Dir. Br. 20). The Commission theorized that because Union Electric owned the subsidiaries, the Court must have determined that Union Electric's "degree of control" was a factor in taxation. The Director argues that the "degree of control" is determinative since the Missouri corporation would be viewed as employing its shares in business outside of Missouri if it indirectly controls the subsidiaries' use of assets outside of Missouri (Dir. Br. 20). Neither Section 147.010, nor any case construing it, supports that assertion. Had that been the *Union Electric* Court's basis, it certainly would have said so.

2. Municipal Bonds

The Director argues that because T-3 made its investments in Missouri, it matters not that the capital is employed outside of Missouri. The Director apparently confuses the holding of *Household Finance Corporation v. Robertson*, 364 S.W.2d 595 (Mo. banc 1963), in an effort to support her claim. *Household Finance* dealt primarily with three issues. First, it concluded that cash the taxpayer held in Illinois banks was nevertheless employed in business in Missouri because that is where it was used in business. *Id*. 364 S.W.2d at 603. Second, it concluded that the Missouri franchise tax base of the parent should not include the value of stock held in its subsidiaries because when the parent paid for the shares of the subsidiaries, "the purchase price of the capital stock and the money became assets of the subsidiaries and these identical assets were thereafter employed by the subsidiaries in Missouri, not by plaintiff[.]" *Id*. 364 S.W.2d at 607. And third, it concluded that money the taxpayer loaned to its subsidiaries, like the money loaned to the municipalities, was not an asset of the taxpayer and not includable in the franchise tax base. Those holdings clearly support T-3, and not just at "first blush" as the Director claims.

Here, T-3's investments in non-Missouri entities were like the shares of stock in *Union Electric* and *Household Finance* (stock holdings) or like the loans in *Household Finance* (bond holdings). The assets those investments represented were used in business outside of Missouri by other than T-3. The assets were the things purchased with the capital; the assets were not the capital investments. The Director argues that because the bonds are held in Missouri, they are includable in the tax base. That claim is not supported by Section 147.010 or the cases construing it. Under *Household Finance*, the situs of the

municipal bonds is irrelevant in determining whether such assets should be included in T-3's Missouri franchise tax base. T-3 could not evade Missouri franchise tax by placing the physical Missouri municipal bonds in a safety deposit box in East St. Louis, Illinois. As this court stated in *Household Finance:* "[t]he language used in the statute … imposes a corporate franchise tax … ***solely*** upon that portion of its property and assets [employed] in this state bears to all its property and assets wherever located." *Id*. 364 S.W.2d at 607. T-3's possession of non-Missouri bonds in Missouri does not constitute evidence that the capital underlying the investment was employed in business in Missouri.

3. Mutual Funds

The Director's discussion of 12 CSR 10-9.200(1)(C) is a red herring. T-3 does not assert that it should be permitted to deduct from its Missouri franchise tax base because it has invested in subsidiaries. Rather, T-3's investments in those non-Missouri entities are excluded from the tax base because the assets represented by that capital are not used in business in Missouri.

In summary, because T-3 employs part of its assets in business outside of Missouri, it is required under Section 147.010 to apportion its Missouri franchise tax base.

II. THE ADMINISTRATIVE HEARING COMMISSION ERRED IN UPHOLDING THE ASSESSMENT BECAUSE, UNDER SECTIONS 621.189 AND 621.193, THAT DECISION IS NOT AUTHORIZED BY LAW OR SUPPORTED BY COMPETENT AND SUBSTANTIAL EVIDENCE IN THAT THE ALTERNATE METHOD OF APPORTIONMENT USED BY T-3 FAIRLY REFLECTS ITS ASSETS USED IN BUSINESS IN MISSOURI, IN THAT THE REGULATION'S METHOD OF APPORTIONMENT DOES NOT FAIRLY APPORTION ALL "ASSETS AND PROPERTY" OF T-3.

A. The Director's Regulation does not Prohibit Apportionment

The version of the regulation in effect during the Tax Periods is Exhibit X to the Stipulation of Facts and is attached to the Director's brief at A 20-21.[4] Regulation 15 CSR 30-150.170(2)(E) provides that a company required to apportion its tax base "shall calculate the percentage of its assets attributable to Missouri on lines 3a through 3d and 4" of the return form. Copies of T-3's returns attached as Exhibit A to the Stipulation of Facts show that a taxpayer is to list Missouri accounts receivable, inventories or land and fixed assets in column A, and list all accounts receivable, inventories or land and fixed assets in column B. The two columns are then totaled on line 3d. Column A, line 3d, is then divided by column B, line 3d, to determine a ratio that is listed on line 4 as "MISSOURI

[4] T-3 is at a loss to understand why the Director would attach a subsequent version of the regulation to her brief (Dir. Br., A-19), since it obviously does not apply. The subsequent version now requires "written approval" to use an alternative formula.

PERCENTAGE FOR APPORTIONMENT." The "ASSETS APPORTIONED TO MISSOURI" is the product of adjusted total assets from line 2c and the apportionment ratio from line 4. In short, if the ratio is zero, there is no Missouri tax base and no Missouri tax because zero multiplied by anything is zero. It is thus hard to fathom how, under the words of the regulation and the Secretary's tax forms, the Director can conclude that a corporation having nothing to report in either column A or column B, and has a "zero figure" for its "apportionment calculation" (Dir. Br. 23), must pay tax on ***all*** of its assets. Since the numerator is zero, the apportionment ratio is literally zero and the tax base is zero. Oddly, it is the taxpayer's alternative apportionment formula that leads to the payment of Missouri franchise tax.

The above literal application of the regulation demonstrates exactly why an alternative formula was required for T-3. The Director does not dispute that the regulation allows the use of an alternative formula. The issue is whether, on review, the Director's disallowance of the alternative formula was supported by law. Clearly it was not.

Section 147.010 provides that apportionment of the tax base is grounded on "property and assets." In her regulation, the Secretary took it upon herself to reduce the statute to three kinds of assets: accounts receivable, inventories or land and fixed assets. Because the Secretary's list is not all-inclusive, the regulation allows for an alternative formula. The regular formula is unfair when corporations do not have accounts receivable, inventories or land and fixed assets. It is unfair to the Director because under a literal application of the formula a taxpayer doing business in Missouri can escape taxation. It is

unfair to the taxpayer if one applies the regulation as the Director does, namely that 0/0=100 %.

Therefore, Section 147.010 requires apportionment of "property and assets." When a corporation's "property and assets" are not "accounts receivable, inventories or land and fixed assets," an alternative apportionment formula is the only possibility for fairness.

B. The Alternative Method of Apportionment Fairly Reflects T-3's Assets Employed in Missouri.

In its opening brief, T-3 demonstrated that the alternative method of apportionment fairly reflects T-3's assets and that the Director's regular formula in the regulation does not. The Director's response is that T-3 has not shown "good cause" for using an alternative formula. She ***assumes*** that T-3 does not employ part of its shares outside of Missouri because the *Union Electric* decision allegedly does not apply to the facts of this case (Dir. Br. 25-26). She makes no argument that T-3's apportionment formula is unfair to either party in the event her construction of *Union Electric* is incorrect. Indeed, in this case, the alternate method of apportionment benefits the Director as compared with a literal application of the regulation. Also, if T-3 had just one small receivable outside of Missouri, the regular apportionment formula would attribute no assets to the Missouri tax base and that could be unfair to the Director as well.

The Director argues that T-3 is unlike *Union Electric*, because T-3 conducts a unitary business.[5] Even if Section 147.010 imposed the franchise tax on a unitary basis, which it does not, the Director has no basis to argue, and cites not facts to support her argument, that Union Electric did not conduct a unitary business. The franchise tax is imposed on property and assets used in Missouri. Neither the stock in *Union Electric* nor T-3's stock and bonds represent assets used in Missouri. Likewise, there is nothing in the regulation that restricts alternative apportionment methods to non-unitary businesses, and the Director provides absolutely no authority for why that would be relevant.

The Director argues that *Household Finance* is relevant, but her basis for so arguing is unclear (Dir. Br. 23-24). The case does not disclose whether any regulation set forth franchise tax reporting formulas. What we do know is that the taxpayer tried to exclude capital (cash) from its tax base even though it used that capital in Missouri. The State Tax Commission used the ratio of receivables and "tangible assets" to determine what part of the cash should be included in the Missouri tax base. 364 S.W.2d at 598. There was no dispute over the formula. The Court did not "uphold the apportionment method used by the State Tax Commission" (Dir. Br. 23), at least in the sense that the formula was at issue and upheld. Indeed, the citation the Director makes to that case, 364 S.W.2d at 603, shows that the apportionment formula was not at issue:

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[5] By applying the theory of "unitary business" in this case, the Director is effectively trying to apply income tax rules rather than anything in the franchise tax statute, rules or regulations.

> "Plaintiff makes no showing that the method by which the [Tax] Commission made that determination was inherently arbitrary or unreasonable; nor does plaintiff undertake to show or contend that the amount of cash as thus determined by the [Tax] Commission was in excess of the amount of cash actually employed by plaintiff in Missouri. To the contrary, plaintiff's petition, after correctly alleging the method by which the [Tax] Commission determined the cash allocable to Missouri in computing the tax due … challenged the legality of that method only on the ground that [section] 147.010 did not authorize the inclusion of assets located outside Missouri."

In summary, the Director mixes some of her Point I arguments into Point II, but makes no credible case that T-3's alternative method of apportionment is not fair and accurate or that the regulation's regular formula is, under the circumstances, fair and accurate to anybody.

CONCLUSION

For all of the foregoing reasons, T-3 properly completed its Missouri franchise tax returns for the Tax Periods. Accordingly, this Court should reverse the Commission with instructions to enter an Order that T-3 has no additional Missouri franchise tax liability for the Tax Periods.

Respectfully Submitted,

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CERTIFICATE OF SERVICE

I hereby certify that two true and accurate copies of the foregoing, as well as a labeled disk containing the same, were mailed first class, postage prepaid or hand-delivered this _____ day of September 2003, to Victorine R. Mahon, Assistant Attorney General, Missouri Attorney General's Office, P.O. Box 899, Jefferson City 65102.

_____

CERTIFICATE REQUIRED BY SPECIAL RULE 1(C)

I hereby certify that the foregoing brief includes the information required by Supreme Court Rule 55.03 and complies with the limitations contained in Supreme Court Special Rule 1(b). The foregoing brief contains 4,233 words.

The undersigned further certifies that the disk simultaneously filed with the briefs filed with this Court under Supreme Court Rule 84.05(a) has been scanned for viruses and is virus-free.

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