IN THE OREGON TAX COURT
MAGISTRATE DIVISION
Corporate Excise Tax

MIAMI CORPORATION,	)	
	)	
Plaintiff,	)	TC-MD 021295C
	)	
v.	)	
	)	
DEPARTMENT OF REVENUE,	)	
State of Oregon,	)	
	)	
Defendant.	)	**DECISION**

This matter is before the court on Plaintiff's appeal of corporate excise tax assessments under the statutory apportionment formula for the years 1997, 1998, and 1999. Richard A. Hanson, McDermott Will & Emery, Illinois, and Robert T. Manicke, Stoel Rives LLP, Portland, argued the cause for Plaintiff. Marilyn J. Harbur, Assistant Attorney General, Salem, argued the cause for Defendant Department of Revenue. For ease of reference the parties will be referred to as "taxpayer" and "the department."

At trial, testimony was presented for taxpayer by Richard Hogan (Hogan), Executive Vice President of Miami Corporation; Michael Friedrichs (Friedrichs), Vice President Taxes for Miami Corporation; and Allan Foutch (Foutch), Manager of taxpayer's Oregon Tree Farm. Joe DiNicola (DiNicola), Auditor, Oregon Department of Revenue, testified for the department.

I. STATEMENT OF FACTS

Both parties included proposed findings of fact with their post-trial briefs, but stipulated facts were not entered into the record. (*See* Ptf's Post-Trial Brief at 2-11; *see* Def's Post-Trial Brief at 2-11.) No documentation of the interactions of taxpayer's Oregon operations and corporate management or day-to-day business transactions was provided to the court, other than minutes of the meetings of taxpayer's board of directors. Due to the detail required in analyzing

the issues before the court, the court finds the following general facts, and provides additional detailed findings of fact under the appropriate subsections.

Miami Corporation (taxpayer), a Delaware corporation headquartered in Chicago, Illinois, was organized in 1917 for the purpose of overseeing the investments of the Deering family. In 1922, taxpayer was reorganized and its assets divided into two departments, the Securities Department and the Real Estate Department. Concurrent with that reorganization, two classes of stock were issued, Class A and Class B. (Joint Ex 1 at 2.) Those individuals holding Class A stock were entitled to the income and assets of the Securities Department; those holding Class B stock were entitled to the income and assets of the Real Estate Department. (Hogan's Test at Trial, Tr 22-23: Joint Ex 1 at 3-6.) In 1998, taxpayer formed one wholly owned subsidiary, Dade Ventures, LLC, a Delaware limited liability company organized to "avoid complications regarding state income tax reporting" over its investments in ING Realty Partners, LP. As a result of forming Dade Ventures, LLC, taxpayer began filing federal and state consolidated tax returns in 1998. (Def's Post-Trial Brief at 13.)

During the tax years in question, taxpayer conducted business in four states. Its Real Estate Department managed timberlands in Florida, a tree farm in Oregon, and lands and associated oil and gas reserves in Louisiana; its Securities Department managed its securities portfolio from the corporate head office in Illinois. Taxpayer's securities portfolio includes the securities of its Securities Department in Illinois as well as securities held as part of the Real Estate Department. (*See* Hogan's Test at Trial, Tr at 64 .) The securities portfolio managed in Illinois and the oil and gas reserves in Louisiana represent the greatest part of taxpayer's income-producing assets. (*See* Ptf's Post Trial Brief at 10-11.)

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Taxpayer's Oregon Tree Farm is run by qualified employees situated within the state who manage the harvesting and reforestation phases of the timber operation and deal directly with the necessary independent contractors, consultants, advisors, and government agencies. (Foutch's Test at Trial, Tr at 107-111.) Friedrichs, who works in taxpayer's Chicago corporate office, is the appointed liaison between taxpayer's board of directors and the Oregon Tree Farm and signs the initial timber harvest contracts for the Oregon Tree Farm. (Friedrichs' Test at Trial, Tr at 151; Foutch's Test at Trial, Tr at 104-06.) Taxpayer's board of directors ratifies Oregon Tree Farm transactions of $100,000 and greater. (Hogan's Test at Trial, Tr at 82.) Foutch, the Oregon Tree Farm manager, has authority to write checks up to the amount of $20,000. (Foutch's Test at Trial, Tr at 130-31.)

II. TAXPAYER'S ARGUMENT

Taxpayer's primary argument is that the Oregon Tree Farm is a trade or business that is separate from its operations in other states and, because the three requirements for application of the apportionment formula are not met, its tax should be determined using separate accounting. (Ptf's Post-Trial Brief at 12.) It states that the first factor, centralized management, is not demonstrated because Foutch bears sole responsibility for the management of the Oregon Tree Farm, other Miami Corporation employees and officers do not have the requisite experience or training, and its board of directors is not notified of transactions involving the Oregon Tree Farm until after they have been completed. (*Id.* at 12, 16.) Taxpayer quotes *Container Corporation v. Franchise Tax Board*, 463 US 159, 180 n 19, 103 S Ct 2933, 77 L Ed 2d 545 (1983) as providing

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the distinction between centralized and decentralized management: "The difference lies in whether the management role that the parent does play is grounded in its own **operational expertise** and its overall **operational** strategy" (emphasis added by Ptf). (Ptf's Post-Trial Brief at 16.)

The second factor, centralized functions that lead to economies of scale, is also absent, argues taxpayer, because the Oregon Tree Farm does its own accounting using a separate system, completes its own timber and local tax returns, and conducts its own employee evaluations. (*Id*. at 17.) Taxpayer's central office in Chicago provides the Oregon Tree Farm with management of "insurance, pensions, unemployment taxes and payroll," but taxpayer argues that the economies of scale provided by those functions are *de minimis* because of "the limited number of employees in the company." (*Id*.) Further, taxpayer emphasizes, because all centralized services provided to the Oregon Tree Farm occur beyond Oregon's borders, they "cannot serve as the basis for additional tax in this case." (*Id*.)

Finally, taxpayer argues that the third factor, functional integration, is not present because there are "no intercompany sales, no common purchasing, no common marketing or any other intercompany transactions of the type typically found in a single trade or business." (*Id*.)

However, in the event the court finds taxpayer's business activities do satisfy the three factors, taxpayer argues that the statutory apportionment formula is inappropriate because its application produces an unconstitutional result. (*Id.* at 18.) Taxpayer points to an Illinois Appellate Court decision (*Miami Corporation v. Department of Revenue*, 571 NE 2d 800 (1991)) and quotes professors Jerome Hellerstein and Walter Hellerstein, who state that "such a formula would not be suited to taxpayers other than those engaged in manufacturing or conducting mercantile businesses." (Ptf's Post-Trial Brief at 18, quoting Jerome Hellerstein and Walter

Hellerstein, *State and Local Taxation*, Sixth Ed (1997) at 498, 642-43 (emphasis omitted).) Taxpayer finds unconstitutionality in the application of the formula because the property factor includes only tangible property, because the payroll factor does not take into account the use of independent contractors, and because the sales factor does not include the sale of securities. (Ptf's Post-Trial Brief at 19.) It finds distortion to be self-evident because the formula increases taxpayer's tax from $300,000 to almost $2,400,000, and in the fact that the "formula attributes approximately $41,000,000 of taxable net income to the Oregon Tree Farm," despite gross receipts of $17,000,000, during the tax years in question. (*Id.*)

In its submissions to the court, taxpayer demonstrated that in the statutory apportionment formula, as applied by the department, the property factor for its Oregon holdings is approximately 60 percent, which does not take into account that the corporation's two major income producing assets are located in Illinois and Louisiana. (Ptf's Ex 1 at 11.) Further, taxpayer contends that the sales factor is flawed because it reflects gross receipts for sale of Oregon timber, but only net income from the other three states in which it operates, resulting in distortion in the application of the formula. (Ptf's Post Trial Brief at 19.) Finally, taxpayer contends that the payroll factor is flawed because it excludes independent contractors, although they represent the greatest labor segment in its Louisiana operations. (*Id.*)

Based upon the unconstitutionality of the application of the statutory formula, taxpayer argues that it is entitled to use separate accounting under the provisions of ORS 314.670(1)[1] because "virtually all of Miami Corporation's income and expenses can be definitively assigned to one of the four businesses." (*Id.* at 20-21.) Taxpayer cites an Alaskan case for the proposition

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[1] All references to the Oregon Revised Statutes (ORS) are to 1997, unless noted otherwise. No substantive changes were made to the statutes cited herein by the 1997 legislature. Amendments made by the 1999 legislature and effective January 1, 1999 are discussed where applicable.

that separate accounting is the appropriate means of "sourcing" income from oil and gas reserves, such as those taxpayer holds in the state of Louisiana. (*Id*. at 21-22, citing *Atlantic Richfield Company v. State of Alaska*, 705 P2d 418, 426-27 (1985).) Further, taxpayer states that it has paid tax to other states on all income earned in those other states, thus the application of Oregon's apportionment formula results in double taxation, contrary to the primary purpose of the Uniform Distribution of Income for Tax Purposes Act (UDITPA). (Ptf's Post-Trial Brief at 21.)

Finally, taxpayer states that the department's proposed alteration to the formula is "completely inadequate" because it gives equal weight to tangible and intangible property of vastly different cost bases, does not reflect the Louisiana oil and gas reserves, and does not address its concerns regarding the payroll and sales factors. (*Id*. at 22-23.)

III. THE DEPARTMENT'S ARGUMENT

The department asserts that taxpayer is "a passive holding company engaged in a single unitary business" and that taxpayer "demonstrates the qualities of a common executive force, economies of scale and functional integration." (Pft's Ex 1 at 4.) It states that because taxpayer does business within the State of Oregon, it must pay excise tax under ORS 317.070, and that because taxpayer does business outside the State of Oregon as well, its business income must be apportioned under ORS 314.605 to 314.675, unless it qualifies for relief under ORS 314.670 due to an unconstitutional result from apportionment. (Def's Post-Trial Brief at 14.)

The department takes issue with taxpayer's characterization of the Oregon Tree Farm as a trade or business separate from Miami Corporation itself, pointing out that the Oregon Tree Farm is not a registered legal entity, whereas Miami Corporation is. (*Id*. at 14 n 3.) Because Miami Corporation alone is registered, the department argues, taxpayer's discussion of the three

requirements necessary for a finding of a single trade or business is moot, as there is no question that Miami Corporation is a single legal entity that does business in Oregon. (*Id.* at 14-15, 20 n 7.) As a result, citing *Twentieth Century-Fox Film Corp. v. Dept. of Rev.*, 299 Or 220, 700 P2d 1035 (1985), the department sees the only issue before the court to be whether the three-factor formula, applied as a whole, fairly taxes taxpayer's business income. (Def's Post-Trial Brief at 16-17, 20.) The department maintains that taxpayer's business income is fairly taxed by the formula. (*See id.* at 15-17.)

Although it believes taxpayer's corporate structure automatically constitutes a unitary business, and that discussion of the three-factor formula is unnecessary, to be safe the department individually addresses taxpayer's contentions regarding each of the three factors that comprise a single trade or business. (*Id.* at 17-20.) In response to taxpayer's argument that the payroll factor is skewed because of taxpayer's use of independent contractors rather than employees in Louisiana, the department points out that taxpayer uses independent contractors in Oregon and Florida as well – and that the usual job duties of officers employed in Illinois include travel to and time spent in other states, although that value is not apportioned to those other states. (*Id.* at 18.) In response to taxpayer's argument that the property factor weights the formula unfairly because taxpayer's oil and gas reserves are included at a cost incurred decades ago rather than at their greatly increased market value, the department states that all property is included only at book value, excluding decades of increases in market value for its Oregon and Florida timberlands. (*Id.*) In response to taxpayer's assertion that the exclusion of its securities portfolio makes application of the property factor unfair, the department argues that because taxpayer is not a financial institution, management of its securities portfolio is "not a business activity," because taxpayer is not licensed to manage investments for the public. (*Id.* at 18-19.) The

purpose of the property factor, it argues, is to apportion real and personal tangible property, not intangible property. (*See id.* at 19.) Neither, argues the department, are the securities themselves new sales income and includible as such under the sales factor. (*Id.*)

In the event that the court finds the three-factor formula does not fairly apportion taxpayer's income, the department proposes a modification to that formula – the addition of a fourth factor for intangible property so that taxpayer's securities portfolio is weighted equally with the traditional property factor. (*Id.* at 23.) The result would be a weighting of 50 percent for the sales factor, 25 percent for payroll, and 12.5 percent for each of tangible and intangible property. (*Id.*)

Finally, in the event that the court finds taxpayer's discussion of the factors proving a single trade or business relevant, the department states that all three factors – centralized management, economies of scale, and functional integration – are demonstrated by taxpayer, because taxpayer's administration is carried out by its board of directors and an executive management team located in Chicago, which directly or indirectly control all revenues, expenses, and capital resources in the management of its securities, venture capital investments, and natural resource operations in Oregon, Louisiana, and Florida. (*Id.* at 15.) It cites ORS 317.705(3)(a), which provides that a "single trade or business" means an enterprise in which there exists "a sharing or exchange of value," as demonstrated by the three factors. (*Id.* at 13.)

IV. ISSUES PRESENTED

The issues presented are whether taxpayer's Oregon timber operations and the corporation itself comprise a unitary business that can be taxed under Oregon's statutory apportionment formula. If not, the Oregon Tree Farm would pay an excise tax on its Oregon taxable income. ORS 317.070. If taxpayer is engaged in a single unitary business enterprise, the

court must determine whether application of the three-factor statutory apportionment formula is appropriate or whether the departure provisions found in ORS 314.670 should be employed. As part of that process the court will review the department's application of the formula to taxpayer's business activities. Finally, the court must determine whether taxpayer is entitled to costs and reasonable attorney fees under ORS 182.090(1).

V. ANALYSIS

A. *Oregon's Law Regarding Taxation of Corporations*

The State of Oregon imposes an excise tax on corporations operating within its borders. ORS 317.070 provides as follows:

> "Every centrally assessed corporation, the property of which is assessed by the Department of Revenue under ORS 308.505 to 308.665 and every mercantile, manufacturing and business corporation doing or authorized to do business within this state, except as provided in ORS 317.080 and 317.090, shall annually pay to this state, for the privilege of carrying on or doing business by it within this state**, an excise tax according to or measured by its Oregon taxable income**, to be computed in the manner provided by this chapter, at the rates provided in ORS 317.061."

(Emphasis added). "Excise tax" is defined as "a tax measured by or according to net income." ORS 317.010(5). "Oregon taxable income" is defined as "taxable income, less the deduction allowed under ORS 317.476 [net losses of prior years]." ORS 317.010(8).

However, for corporations operating both within Oregon and out-of-state, Oregon codified UDITPA. ORS 314.605(1); *see generally* ORS 314.605 to 314.675. The concept driving UDITPA is that the in-state earnings of "unitary" businesses operating across state lines are more accurately represented by apportionment of the business's entire income than by geographical or transactional accounting methods, which do not recognize enhancement to the value of in-state operations resulting from such things as national market presence or

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management functions provided from outside Oregon's borders. *See Container Corp.*, 463 US at 164-65. Oregon's purpose in adopting UDITPA was to ensure uniform taxation of businesses that operate in more than one state. ORS 314.605(2). ORS 314.615 provides, in relevant part:

> "Any taxpayer having income from business activity which is taxable both within and without this state, other than activity as a financial organization or public utility or the rendering of purely personal services by an individual, **shall allocate and apportion the net income of the taxpayer** as provided in ORS 314.605 to 314.675."

(Emphasis added). Notably, the formula in ORS 314.615 allocates and apportions the net income of the taxpayer, rather than applying an excise tax "according to or measured by" its Oregon taxable income, as provided in ORS 317.070. Allocation and apportionment is an approximation meant to capture the benefits gained from the interdependence and integration inherent in a unitary business that operates in more than one state. The "formula assumes a direct relationship between the extent of the business activity within the state and the income earned by that business within the state." *Lee v. Dept. of Rev.*, 14 OTR 460, 464 (1998) (finding a partnership of S corporations to be a unitary business and application of the apportionment formula constitutional despite inconsistency in cost basis of properties, payroll costs, and materials costs). As a result, for corporations found to be unitary businesses, that are doing business both within and without Oregon's borders, Oregon's statutes measure business activity rather than net income – by considering sales, payroll, and property.[2]

However, not all corporations doing business on both sides of Oregon's borders are unitary businesses. Whether a corporation is a unitary business is determined under standards set

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[2] Taxpayer in its briefings repeatedly refers to the disparity between the income it earned within Oregon during the years in question and the tax it has been assessed. However, as the court in *Twentieth Century-Fox* stated, "it must be established that statutory apportionment does not adequately represent business activity, not merely that it does not adequately reflect income earned in the state." *Twentieth Century-Fox*, 299 Or at 233 (citation omitted).

by statute. A corporation will be assessed tax as a unitary business if it is "a corporation or group of corporations engaged in business activities that constitute a single trade or business." ORS 317.705(2). A "single trade or business" is defined as:

> "a business enterprise in which there exists directly or indirectly between the members or parts of the enterprise a sharing or exchange of value as demonstrated by:
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> "(A) Centralized management or a common executive force;
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> "(B) Centralized administrative services or functions resulting in economies of scale; and
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> "(C) Flow of goods, capital resources or services demonstrating functional integration."

ORS 317.705(3)(a). Thus, the primary question in taxation of a corporation operating both within and without Oregon is whether the corporation's in-state operations are unitary with its out-of-state operations, so that the corporation is benefitting from interdependence and integration. In the case at hand, the wording of ORS 317.705(2) makes clear that the consideration of whether a business is unitary applies to both single corporations and groups of corporations, rendering moot the department's contention that the analysis need not be applied to taxpayer, a single corporation. *See also* OAR 150-317.705(3)(a).[3]

B. *Are Taxpayer and the Oregon Tree Farm a Unitary Business?*

In the case at hand, taxpayer is a single corporation doing business in four states – Oregon, Illinois, Florida, and Louisiana. As pointed out by the department, taxpayer's Oregon Tree Farm is not registered with the Oregon Secretary of State as a separate entity. (Def's Post-Trial Brief at 14 n 3.) Taxpayer's sole subsidiary, Dade Ventures, LLC, is not at issue, although its formation predicated taxpayer's filing of federal and state consolidated tax returns in 1998 and

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[3] All references to the Oregon Administrative Rules (OAR) are to 1997, unless otherwise noted.

likely was the action that prompted the department to initiate apportionment. (*See* Def's Post-Trial Brief at 13.) Whether taxpayer qualifies as a single trade or business depends upon whether its interaction with the Oregon Tree Farm satisfies the three factors identified in ORS 317.705(3)(a).

1. *Factor: Centralized Management or Common Executive Force*

In the *Lee* case cited above, the court found that the partnership in question was a single operating entity because the stipulated facts indicated that it was a "single-operating entity" and engaged in "a single line of business throughout its divisions on a uniform basis." *Lee*, 14 OTR at 462. However, the court stated that, even if it had been stipulated that the various divisions of the partnership were separate businesses, the court would have found the partnership to be a unitary business because centralized management was present – as the partnership had one set of officers who "undoubtedly provide policy and direction, set standards and require levels of performance." *Id.* at 462-63. The court stated that it found centralized management present even though the partnership delegated "a large degree of decisional responsibility" to its divisional managers, each division operated "autonomously in its own market," each division had a different gross-profit margin, and each divisional manager made decisions regarding "employment, job selection, bidding, scheduling and [the] ordering of materials and supplies." *Id.* at 462.

Taxpayer's conduct of its business in the case at hand is analogous, although taxpayer's business is more diversified than the partnership in *Lee*. As in *Lee*, divisional manager Foutch has a large degree of decisional responsibility. According to testimony, Foutch hires temporary staff and does personnel evaluations (Foutch's Test at Trial, Tr at 115); deals with government agencies (Foutch's Test at Trial, Tr at 111); assesses opportunities to purchase timberlands as

they arise (Hogan's Test at Trial, Tr at 36); and negotiates and signs contracts for sales of logs, site preparation, replanting logged areas, and road maintenance (Foutch's Test at Trial, Tr at 108-10). In fact, Hogan, taxpayer's Executive Vice President in Chicago, stated that Foutch has been given "complete authority." (Hogan's Test at Trial, Tr at 42-43.)

However, taxpayer has centralized upper management and a common executive force; the board and all corporate officers work from the Chicago office. Taxpayer's board of directors, like the partners in *Lee*, provides policy and direction, sets standards, and requires levels of performance. Although he visits Oregon only once a year, Friedrichs, who is Vice President Taxes and works out of Chicago, "oversees some of the activities in the Oregon Tree Farm" and testified that he spends about five percent of his time on Oregon Tree Farm matters. (Foutch's Test at Trial, Tr at 115-16; Hogan's Test at Trial, Tr at 41; Friedrichs' Test at Trial, Tr at 152.) As the Chicago "liaison" for Oregon, Friedrichs' role is to keep the president "informed as to operations" in that geographic area. (Friedrichs' Test at Trial, Tr at 165.) Foutch, the Oregon manager, develops a budget and annual business plan, but then presents them to the board of directors for approval before implementation. (Foutch's Test at Trial, Tr at 130-31.) There is frequent communication between Oregon and Illinois. Friedrichs and Foutch speak "once or twice a week" and Friedrichs testified that "[Foutch] is very good at writing memorandums; he's very good at keeping me informed." (Foutch's Test at Trial, Tr at 116; Friedrichs' Test at Trial, Tr at 152.) Foutch stated: "Generally I keep [Friedrichs] informed of what things are going on so he's aware." (Foutch's Test at Trial, Tr at 132.) Further, although Foutch stated that the board of directors never disagrees with him about anything of major importance, he also testified that at one point it denied his proposal to purchase a tractor, requiring him to wait until the following year to make that purchase. (Foutch's Test at Trial, Tr at 141-42.) The level of

contact demonstrated by the above establishes that taxpayer's officers and directors actively oversee the operations of the Oregon Tree Farm.

Further, in taxpayer's 'Corporate Philosophy – Miami Corporation's Oregon Tree Farm,' adopted in 1995, Oregon Tree Farm management is given "primary responsibility in meeting the corporate philosophy." (Ptf's Ex 9 at 1; Joint Ex 13 at 1; Joint Ex 16A at 2.) It is charged with identifying and implementing forestry applications, identifying markets, and providing "clear, up-to-date information to Miami management and Board in a timely manner so they can make well-informed decisions regarding operations." (*Id.*) As Hogan testified at trial:

> "The way our board operates, they've given us broad policy guidelines and expect us to act in accordance with those, and we have a responsibility, A, to follow those general guidelines; but, B, to also report back to them so that they can then monitor and assess our performance in connection or regard to those guidelines."

(Hogan's Test at Trial, Tr at 83.) Thus, like the partnership in the *Lee* case, taxpayer has delegated a large degree of decisional responsibility to its divisional managers, but provides policy and direction, sets standards, and requires levels of performance from the Oregon Tree Farm, demonstrating centralized management. It also keeps up to date with division operations and scrutinizes their decisions. The common executive force is self evident.

In *Maytag Corp. v. Dept. of Rev.*, 12 OTR 502 (1993), this court found that the income of two subsidiaries was properly included in the apportionment of the taxpayer's income because they "serve[d] an operational function rather than an investment function."[4] *Id.* at 510. Using language from United States Supreme Court cases, the court stated that although the taxpayer's

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[4] In its Post-Trial Brief, taxpayer points out that the *Maytag* decision was written when an earlier version of the OAR was in effect, in which a finding of any one of the three statutory requirements was sufficient to demonstrate a unitary business. (Ptf's Post-Trial Brief at 15-16 n 2.) That is true; however, that court noted that the Oregon legislature met in 1984 in special session and repealed ORS 314.363 – adopting a new definition of a unitary group, which required that all three factors be met – in response to the United States Supreme Court holding in *Container Corporation*. *Maytag*, 12 OTR at 505-06. Despite an ambiguous discussion of functional integration, the court found that the taxpayer in *Maytag* met the definition of a unitary business. On points other than its discussion of functional integration, the *Maytag* court's analysis remains worthy of consideration here.

management was not "extensive day-to-day operation management," it was also not mere "oversight of an investment," which would have prevented a finding of centralized management. *Id.* at 508; *see Container Corp.*, 463 US at 180; *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 US 768, 781, 112 S Ct 2251, 119 L Ed 2d 533 (1992). As the parent corporation in *Maytag* stated, its officers were not involved in day-to-day operations, but rather practiced "management by objectives" and granted its divisions "substantial freedom in their operations." *Maytag,* 12 OTR at 508.

In the case at hand, more than oversight of an investment is again apparent. Although Foutch negotiates and signs some contracts, he cannot sign the initial contracts to cut or sell timber; those are signed in Chicago by Friedrichs. (*See* Foutch's Test at Trial, Tr at 104-06.) Foutch can only sign addenda to the initial contracts. Moreover, although the initial contracts submitted to the court (that are signed by Friedrichs) were 7 and 10 pages in length, the addenda were one-page letters allowing a logging company to continue cutting during the current year, with adjustments for price and location.[5] Foutch's authority does not extend to contracting with a new logging company, or beyond the calendar year, as is shown by the fact that when taxpayer wished to extend its contractual relationship with Fall Creek Logging, Inc. from 1998 to 1999, it extended that relationship with a new contract signed by Friedrichs, not an addendum signed by Foutch. (*See* Joint Ex 16 at 31.)

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[5] Joint Exhibit 16 includes three addenda signed by Foutch. The first extends an initial contract signed by Friedrichs on January 15, 1997, reflecting a change in the price of timber and allowing Gahlsdorf Logging, Inc. to cut timber in a different locale. The second and third addenda are the same, extending initial contracts signed by Friedrichs on January 15, 1998, and January 6, 1999, respectively, setting price changes and allowing Fall Creek Logging, Inc. to cut in additional locations.

Foutch testified that only 10 to 15 percent of the volume of timber cut during the year is covered by the initial contracts and ratified by the board of directors. (*See* Foutch's Test at Trial, Tr at 107.) However, that means that at least 10 to 15 percent of the Oregon Tree Farm's transactions are beyond Foutch's unilateral authority. In addition, the board of directors ratifies any Oregon Tree Farm transactions involving amounts of $100,000 or greater, an amount likely to encompass the purchase of any new tracts of timberland.[6] (Hogan's Test at Trial, Tr at 81-82.) As Friedrichs testified, the money for land acquisitions in Oregon comes from Chicago "because we are one corporation." (Friedrichs' Test at Trial, Tr at 180.)

Taxpayer argues that its board of directors is not "advised" of Oregon Tree Farm transactions until after they are completed. (Ptf's Post-Trial Brief at 12.) "Ratification," however, when used in reference to the signing of contracts, is defined as "binding adoption of an act already completed but either not done in a way that originally produced a legal obligation or done by a third party having at the time no authority to act as the person's agent." *Black's Law Dictionary* 1268-69 (7th ed 1999). Regardless of which eventuality is true here, the fact that the board of directors routinely ratifies contracts for its Oregon Tree Farm demonstrates its involvement on an operational level. (*See generally* Joint Ex 14 at 25-26, 78-79, 134-35, 160-62.) Examples of such contracts are provided in Joint Exhibit 16, dated January 15, 1997, January 15, 1998, and January 6, 1999. (Joint Ex 16 at 1, 11, 22.) The contracts identify Miami Corporation as "Owner," not the Oregon Tree Farm, and delegate duties and responsibilities that occur onsite to "Owner's representative."[7] (*Id.* at 1-7, 11-18, 22-30.) All three contracts are

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[6] Hogan also testified: "If we had done a transaction even below the $100,000, most likely that would also be shown in the resolution just to make sure that there's a complete and full reporting back to the board." (Hogan's Test at Trial, Tr at 83.)

[7] The 1997 contract does not identify "Owner's representative" by name, but all three contracts require that any notice or communications with Owner be given to "Manager, Miami Oregon Tree Farm." (Joint Ex 16 at 1, 19, 30.) The 1998 and 1999 contracts identify Allan Foutch as Owner's representative. (*Id.* at 11, 22.)

signed by Friedrichs and state: "IN WITNESS WHEREOF, the parties hereto have executed this agreement in duplicate as of the day and year first hereinabove written." (*Id.* at 7, 20, 31.) Both due to its practice of routinely ratifying Oregon Tree Farm contracts, and as is demonstrated by the wording of those contracts, taxpayer's involvement with the Oregon Tree Farm is more than oversight of an investment.

Taxpayer points out that, unlike the parent corporation in *Maytag*, it does not practice "daily cash sweeps." *See Maytag*, 12 OTR at 508. (Ptf's Post-Trial Brief at 17.) However, the timber business is more likely to generate periodic lump sums than daily revenue, and checks for Oregon Tree Farm earnings are sent to Chicago after verification against sales, rather than being deposited in the Oregon Tree Farm bank account. (Foutch's Test at Trial, Tr at 133-34.) Further, the Oregon account is an imprest account, one that taxpayer's management in Chicago replenishes up to $100,000 – after verifying Oregon Tree Farm's expenditures – on a bi-weekly basis. (Hogan's Test at Trial, Tr at 75; Foutch's Test at Trial, Tr at 132-33.) Foutch's independent check-writing ability is limited to $20,000.[8] (Foutch's Test at Trial, Tr at 130-31.) As in the *Maytag* case, that demonstrates less than extensive day-to-day operational management, but more than oversight of an investment.

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[8] Although not stated specifically at trial or offered in evidence, presumably Friedrichs signs those checks for amounts greater than $20,000. Neither was evidence received as to what checks from the Oregon Tree Farm imprest account are written for; however, regarding taxpayer's division in Louisiana, Hogan testified that its imprest account is used to "pay rent, [] buy copier paper, coffee for their coffee machine." (Hogan's Test at Trial, Tr at 75.)

Minutes from the board of directors' meetings show that the board of directors approves actions regarding the Oregon Tree Farm as those of taxpayer's executive officers.[9] Moreover, pursuant to the written philosophy of the Oregon Tree Farm, its management is directed to "[p]rovide clear, up-to-date information to Miami management and Board in a timely manner **so they can make well-informed decisions regarding operations"** (emphasis added). (Ptf's Ex 9 at 1; Joint Ex 13 at 1; Joint Ex 16A at 2.) In the *Container Corporation* quotation cited by taxpayer in its Post-Trial Brief, the Supreme Court stated that it had already made clear in previous cases that "occasional oversight" would not support a unitary business finding, while "mere decentralization of day-to-day management responsibility" would not defeat one. *Container Corp.*, 463 US at 180 n 19 (citations omitted). (Ptf's Post-Trial Brief at 16.) The Court concluded: "The difference lies in whether the management role that the parent does play is grounded in its own operational expertise and its overall operational strategy." (*Id.*) Here, the board of directors' record of its actions declares it to be the acting party (authority) in Oregon Tree Farm contracts, and the Oregon Tree Farm corporate philosophy states that taxpayer's board of directors makes operational decisions. Taxpayer's oversight of its Oregon Tree Farm is extensive, as shown by the regular communication and travel between Oregon and Illinois, Foutch's spending and contract execution limitations, and location of liaisons and the executive force in Illinois. Under the standard established in *Container Corporation*, and this court's

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[9] The following is an example:

> "RESOLVED, That **the action of the Executive Officers of Miami Corporation**, in entering into a Logging Contract * * * for the harvesting and delivery of designated young growth timber on certain lands in Oregon owned by Miami Corporation * * * **is hereby in all respects approved, ratified and confirmed."**

(Joint Ex 14 at 78) (emphasis added).

findings in both *Lee* and *Maytag*, centralized management and a common executive force is demonstrated by taxpayer's board of directors and the supervisory role performed by Friedrichs.

2. *Factor: Economies of Scale*

The second factor required for a demonstration of single trade or business is "centralized administrative services or functions resulting in economies of scale." ORS 317.705(3)(a)(B). In *Maytag*, this court found economies of scale present "primarily in administration rather than operation." *Maytag*, 12 OTR at 509. It stated:

> "Since [taxpayer's subsidiaries] were not functionally integrated, there were no economies of scale realized from such practices as centralized purchasing or coordinated distribution and sales. Rather the benefits [taxpayer's subsidiaries] realized were in lower overhead costs for such items as insurance, human resources, pension administration, rental cars, legal fees and internal audits. * * * [The subsidiaries] had financing available on an as-needed basis. * * * [T]he diversified products and markets strengthened [the parent company] overall."

Id.

As in *Maytag*, taxpayer in the case at hand benefits from economies of scale through its centralized administrative services. Friedrichs' title is "Vice President Taxes"; he testified that he is personally responsible for staying abreast of changing tax laws in the areas of oil and gas operations and timber. (Friedrichs' Test at Trial, Tr at 170-71; Joint Ex 17 at 47.) Although Foutch prepares state timber tax returns for the Oregon Tree Farm, and verifies that Oregon property tax bills are correct, Friedrichs prepares and signs the federal and state "income" tax returns, as well as taking care of "any type of tax problem." (Friedrichs' Test at Trial, Tr at 154, 163, 164, 171.) For example, when the department audited taxpayer's Oregon corporate

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excise tax return, Friedrichs facilitated the audit and provided the auditor with the necessary information, in Chicago. (Friedrichs Test at Trial, Tr at 159.) As stated by Friedrichs:

> "[A]s Counsel said this morning, this is one corporation. I can't really go ahead and say that this division or this operation over here, you go do your own tax return. So I have to know what all of these operations are doing."

(Friedrichs' Test at Trial, Tr at 171.)

Further, administrative functions such as payroll, pension, and insurance benefits for employees are all provided by taxpayer's management team in Chicago. Payroll for Oregon Tree Farm employees is handled by Jan Coventry, Office Manager in Chicago. (Hogan's Test at Trial, Tr at 53; *see also* Foutch's Test at Trial, Tr at 134.) Employee expenses, such as reimbursement for travel, are handled in Chicago. (Hogan's Test at Trial, Tr at 54.) Pension plans are administered by Hogan, from Chicago, and cover all employees. (Hogan's Test at Trial, Tr at 54-55.) Insurance for all employees and properties is handled by one employee, Barbara Goering, from the Chicago office. (Hogan's Test at Trial, Tr at 54; *see also* Foutch's Test at Trial, Tr at 134.)

Taxpayer argues that the separate accounting system used by the Oregon Tree Farm demonstrates that economies of scale are not present in the area of accounting services. (Ptf's Post-Trial Brief at 17.) However, accounting clerks in Chicago subsequently transfer the data into taxpayer's general ledger – transactions such as reimbursement of the imprest account, invoices, sales receipts, and any expenditures over $20,000. (Friedrichs' Test at Trial, Tr at 153.) The testimony suggests that the Oregon Tree Farm is tracking expenses. The court finds that the accounting functions performed by the Oregon Tree Farm are minimal, while true accounting services are being performed in Illinois.

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In *F.W. Woolworth Co. v. Taxation and Revenue Dept.*, 458 US 354, 102 S Ct 3128, 73 L Ed 2d 819 (1982), the Supreme Court found that the subsidiaries in question were not part of a unitary business, and found no economies of scale. *Id.* at 366-68. The Court stated:

> "Importantly, the Department's hearing examiner found that Woolworth had 'no department or section, as such, devoted to overseeing the foreign subsidiary operations.' Neither the parent corporation nor any of the subsidiaries consolidates its tax return with any of the other companies. The tax manager for Woolworth stated that he did not review the subsidiaries' tax returns or consult with them on decisions affecting taxes. There was no 'policy of the parent that all of the managers of all the operations get together periodically to discuss the overall Woolworth operations.'"

Id. at 367-68 (citations omitted). Unlike the taxpayer in *Woolworth*, in the case at hand taxpayer has delegated Friedrichs, an executive officer, to oversee the Oregon Tree Farm (Hogan's Test at Trial, Tr at 41; Friedrichs' Test at Trial, Tr at 165); the tax returns for the Oregon Tree Farm are prepared and signed by Friedrichs in Chicago (Friedrichs' Test at Trial, Tr at 154, 163, 164, 171); Foutch travels to Chicago each year (Hogan's Test at Trial, Tr at 41; Foutch's Test at Trial, Tr at 115-16); and Friedrichs travels to Oregon each year (Friedrichs' Test at Trial, Tr at 151-52). There is no question of whether to consolidate the Oregon Tree Farm tax return with taxpayer's as the two are a single corporation.

In sum, unlike the taxpayer in *Woolworth*, economies of scale are apparent in taxpayer's appointment of Friedrichs as a liaison for the Oregon Tree Farm, centralization of services such as tax preparation, and routine meetings between its board of directors and the Oregon Tree Farm manager, Foutch. And, like the subsidiaries in *Maytag*, the Oregon Tree Farm benefits from economies of scale through taxpayer's centralized administrative services in the form of payroll, pensions, insurance, and legal services. Further, although no testimony was elicited on that point, like the subsidiaries in the *Maytag* case, taxpayer's Oregon Tree Farm benefits from having the financing capabilities of a much larger corporation available on an as-needed basis,

and taxpayer benefits from its diversification into the timber industry and market. Taxpayer exhibits centralized administrative services resulting in economies of scale.

3. *Factor: Functional Integration*

The third and final factor required for a finding that taxpayer is a single trade or business is the "[f]low of goods, capital resources or services demonstrating functional integration." ORS 317.705(3)(a)(C).

Taxpayer asserts that there is no functional integration between Miami Corporation and the Oregon Tree Farm because there are "no intercompany sales, no common purchasing, no common marketing or any other intercompany transactions of the type typically found in a single trade or business." (Ptf's Post-Trial Brief at 17.) The department contends that functional integration was apparent in that "there's a significant flow of value from the parent company's financial resources" (DiNicola's Test at Trial, Tr at 207); common payroll tax and insurance (DiNicola's Test at Trial, Tr at 206-07); common pension and profit-sharing plans (DiNicola's Test at Trial, Tr at 206); and guaranteed payments to the ING partnership on behalf of its subsidiary, Dade Ventures, LLC (DiNicola's Test at Trial, Tr at 206). The court agrees.

As stated above, in *Woolworth* the Supreme Court found that the subsidiaries in question were not part of a unitary business. It also found "little functional integration." *Woolworth*, 458 US at 364. The Court distinguished between Woolworth's operations and companies that locate, process, and market a resource, or companies that earn a unitary stream of income from internal transfers of raw materials, but did not find that indicative of the taxpayer failing the unitary business test. *Id.* at 364-65, citing *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 US 207, 100 S Ct 2109, 65 L Ed 2d 66 (1980); *Mobil Oil Co. v. Comm. of Taxes of Vermont*, 445 US 425, 100 S Ct 1223, 63 L Ed 2d 510 (1980). The Court did state specifically why it

found no functional integration between Woolworth and its foreign subsidiaries: (1) each subsidiary had its own accounting department and financial staff; (2) despite Woolworth being a retail operation, there was no central purchasing, manufacturing, or warehousing of merchandise; (3) Woolworth provided no training for personnel; and (4) each subsidiary was responsible for finding its own financing from outside sources. *Woolworth*, 458 US at 365-66.

Here, unlike the taxpayer in *Woolworth*, the functions of accounting and tax return preparation are integrated between taxpayer and the Oregon Tree Farm, under the management of Friedrichs and Hogan. (Friedrichs' Test at Trial, Tr at 171.) Financing for the Oregon Tree Farm comes from taxpayer, both in terms of the imprest account replenished by management in Chicago, and the flow of monies for purchases that cost more than $100,000 (*e.g.*, land and heavy equipment). (*See* Foutch's Test at Trial, Tr at 132; Friedrichs' Test at Trial, Tr at 153.) Further, Oregon Tree Farm earnings are remitted to Chicago, free to be distributed to any of its divisions. (Foutch's Test at Trial, Tr at 133-34.) Like the *Woolworth* case, there is nothing in the record that shows training is provided for Oregon personnel, but the Oregon Tree Farm's corporate philosophy lists specific expectations that taxpayer's board of directors has for Oregon Tree Farm personnel, again demonstrating integration. (*See* Ptf's Ex 9 at 1; Joint Ex 13 at 1; Joint Ex 16A at 2.)

In the *Lee* case, the court noted a flow of goods, capital resources, and services. Functional integration was found due to "capital and credit; purchases of fuel; centralized management of payroll, pension, taxes, customer payments, and trade accounts; and centralized purchasing and accounting." *Lee*, 14 OTR at 462. Here, there is a flow of capital resources and services. In *Maytag*, the court did not find functional integration, in part because the taxpayer's subsidiaries could "hire and fire their own employees, set salaries, vacations, retirement benefits

and essentially operate as separate businesses."[10] *Maytag*, 12 OTR at 509. Here, the Oregon Tree Farm does not operate as a separate business. The court finds that, like the *Lee* case and unlike the *Woolworth* and *Maytag* cases, taxpayer's Oregon Tree Farm does benefit from integrated functions, particularly in the areas of personnel, finance, and accounting.

Because functional integration is apparent between taxpayer and its Oregon Tree Farm, the third factor required for a finding of "single trade or business" under ORS 317.705(3)(a)(A)-(C) is also met. Because all three factors have been established, the court finds that taxpayer is a single trade or business and subject to apportionment, under ORS 314.605 to 314.675. As a result, for Oregon tax purposes, because taxpayer is doing business both within and without Oregon's borders, Oregon's statutes require measurement of its business activity rather than its Oregon net income, under the apportionment method – provided that method is constitutional in application.

C. *Is Application of the Statutory Formula Fair and Constitutional?*

Taxpayer argues that application of Oregon's statutory apportionment formula is unfair and unconstitutional. (Ptf's Post-Trial Brief at 13-14.) It asserts that the formula apportions income to the Oregon Tree Farm "out of all proportion to the income generated by Miami Corporation's business activities in Oregon." (*Id.* at 13.) That distortion, taxpayer states, is readily apparent in that the formula increases taxpayer's Oregon tax eightfold and, during the tax years at issue, "attributes approximately $41,000,000 in taxable net income to [the] Oregon Tree Farm" although the actual gross receipts were close to $17,000,000. (*Id.* at 19.) Citing

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[10] In addition the *Maytag* court listed characteristics common to companies that manufacture and market electronic products, a category applicable to both the *Maytag* parent company and its subsidiaries.

ORS 314.670, taxpayer asserts that if application of the apportionment formula does not fairly represent a taxpayer's income in Oregon, the taxpayer is entitled to use separate accounting. (*Id.* at 20.)

ORS 314.670 allows departure from the standard three-factor apportionment formula in certain situations. The law in effect for 1997 and 1998 required a finding of unfairness and unconstitutionality. The law in effect for 1999 merely required a finding of unfairness.[11] The court will therefore address those time periods separately.

1. *Tax Years 1997 and 1998*

The version of the statute in effect for tax years 1997 and 1998 provides:

> "If the application of the allocation and apportionment provisions of ORS 314.605 to 314.675 do not fairly represent the extent of the taxpayer's business activity in this state, and result in the violation of the taxpayer's rights under the Constitution of this state or of the United States, the taxpayer may petition for and the Department of Revenue may permit, or the department may require, in respect to all or any part of the taxpayer's business activity:
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> "(1) Separate accounting;
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> "(2) The exclusion of any one or more of the factors;
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> "(3) The inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
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> "(4) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."

ORS 314.670. There is a strong preference for apportionment. *See* OAR 150-314.615-(D) (mandating apportionment for unitary businesses with activities both within and without the state).

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[11] Effective January 1, 1999, and thus applicable to tax year 1999, the statute was amended to remove the clause "and result in the violation of the taxpayer's rights under the Constitution of this state or of the United States." Or Laws 1999, ch 144, §§ 9, 10. Although OAR 150-314.670 remained in effect without amendment until it was repealed on December 31, 1999, it does not affect the court's holding here.

Under ORS 305.427, taxpayer bears the burden of proof and, hence, must prove that application of the apportionment formula "do[es] not fairly represent the extent of the taxpayer's business activity in this state, and result[s] in the violation of the taxpayer's [constitutional] rights." ORS 314.670. *See also Lee*, 14 OTR at 464. The court's discussion for tax years 1997 and 1998 is limited to the question of whether application of the formula violates taxpayer's constitutional rights because without that finding alternative methods are not available under the statute. For the reasons set forth below, the court concludes that the allocation and apportionment provisions of ORS 314.605 to 314.675 do not violate taxpayer's constitutional rights.

That apportionment results in a greater tax than separate geographical accounting does not demonstrate unconstitutionality *per se*. In the *Maytag* case, this court stated that it was the legislature's intention, both before and after the 1983 special session, to tax corporations to the maximum extent allowable without violating the Due Process Clause of the Fourteenth Amendment of the United States Constitution. *Maytag*, 12 OTR at 506; *see also Lee*, 14 OTR at 463. Generally, application of UDITPA will result in the highest tax, but it is nonetheless the appropriate method unless the taxpayer proves the violation of constitutional rights. *Lee*, 14 OTR at 463.

The Oregon Supreme Court addressed the constitutionality of the apportionment formula in its decision in *Pennzoil Co. v. Dept. of Rev.*, 332 Or 542, 33 P3d 314 (2001) (upholding Tax Court's ruling that proceeds from tortious interference with contract suit were properly included as unitary business income). In that case, *inter alia*, the taxpayer argued that the Due Process and Commerce clauses of the United States Constitution prohibited Oregon from taxing the proceeds of the lawsuit settlement and that the manner in which its income was apportioned under

ORS 314.670 "grossly and unconstitutionally distort[ed] Pennzoil's activity in Oregon." *Id.* at 546. The taxpayer asserted that application of the formula was *per se* unconstitutional because it resulted in a tax liability that was approximately 844 percent greater than it would have been under separate accounting. *Id.* at 550. Like taxpayer in the case at hand, the taxpayer in *Pennzoil* cited *Hans Rees' Sons, Inc. v. North Carolina ex rel Maxwell*, 283 US 123, 51 S Ct 385, 75 L Ed 879 (1931), as holding that the state's apportionment formula "operated unreasonably and arbitrarily" because it attributed to the state "a percentage of income out of all appropriate proportion to business transacted" within the state. *Pennzoil*, 332 Or at 550 n 4; *see Hans Rees' Sons*, 283 US at 135. (Ptf's Opening Statement at Trial.)

The court in *Pennzoil* held that the Due Process and Commerce clauses were not violated and that application of the apportionment formula, resulting in more than an 800 percent increase in tax liability, was not unconstitutional, because "if Oregon could sever a single capital transaction from unitary business income simply because apportionment of that income would result in distortion, then there would be little point in maintaining the unitary business principle." *Pennzoil*, 332 Or at 551. It stated that *Hans Rees' Sons* is of limited precedential value because Oregon, like most states, now has a multifactor apportionment formula. *Id.* at 550 n 4. Further, the court stated that the difficulty in applying separate accounting accurately was the very reason for the adoption of apportionment and the unitary business principle. *Id.* at 551. Hence, under the precedent set by *Pennzoil*, the fact that the formula increases taxpayer's Oregon tax eightfold and attributes more than double the amount of taxable net income to its Oregon Tree Farm is not indicative of the *per se* unconstitutionality of the apportionment formula. (*See* Ptf's Post-Trial Brief at 19.)

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In *Mobil Oil Corporation v. Com'r of Taxes of Vermont,* 445 US 425, 100 S Ct 1223, 63 L Ed 2d 510 (1980), the United States Supreme Court considered the constitutional limits on a nondomiciliary state's taxation of an international corporation's income, providing a historical analysis of the extent of the states' rights to tax interstate corporations under the Due Process Clause. *Id.* at 427, 436-42. Although the Court narrowed its analysis and holding in the *Mobil Oil* case to whether income earned by investment in foreign affiliates or subsidiaries was constitutionally precluded from state taxation, its discussion of the requirements of the Due Process Clause is applicable to the case at hand. *See Mobil Oil*, 445 US at 434-35.

The taxpayer in *Mobil Oil* conducted but a small part of its business within the taxing state, and the figures representing its in-state sales, payroll, and property were but a tiny portion of the corporation's total sales, payroll, and property. *Id.* at 428-29. However, the Court found no violation of the Due Process or Commerce clauses. *Id.* at 449. The Court held that for a state to tax income generated in interstate commerce, there must be a "'minimal connection' between the interstate activities and the taxing State, and a rational relationship between the income attributed to the State and the intrastate values of the enterprise." *Id.* at 436-37 (citations omitted) (internal quotations omitted). The Court stated that nexus is sufficient if the corporation has availed itself of the "substantial privilege of carrying on business" within the state. *Id.* at 437. Further, in addressing Mobil Oil's contention that dividends it had earned from foreign sources should not be taxable by Vermont, the Court stated:

> "The argument that the source of the income precludes its taxability runs contrary to precedent. In the past, apportionability often has been challenged by the contention that income earned in one State may not be taxed in another if the source of the income may be ascertained by separate geographical accounting. The Court has rejected that contention so long as the intrastate and extrastate activities formed part of a single unitary business. In these circumstances, the Court has noted that separate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income

> resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.' Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required."

Mobil Oil, 445 US at 438 (citations omitted).

In the case at hand, taxpayer has availed itself of the privilege of operating in Oregon, establishing nexus sufficient to satisfy the Due Process Clause. In addition, as in *Mobil Oil*, the fact that separate geographical accounting demonstrates that only a small portion of taxpayer's sales, payroll, and property resulted from its operations in Oregon is not dispositive of unconstitutional taxation. Although taxpayer argues that Oregon should not be able to tax value added to its Oregon Tree Farm by "centralized services and financing" provided by its officers and directors in Illinois, and that its Oregon operations add no value to the rest of the company (Ptf's Post-Trial Brief at 17), as stated in *Mobil Oil,* separate accounting is inferior to apportionment as a means of portraying an interstate corporation because it fails to account for contributions to income resulting from functional integration, centralization of management, and economies of scale – factors of profitability that arise from the operation of a unitary business. *Mobil Oil*, 445 US at 438. (*See* Foutch's Test at Trial, Tr at 133-34.)

In its Post-Trial Reply Brief, taxpayer points out that the department's witness did not identify specific contributions by the Oregon operations to other Miami Corporation operations, the presence of which would support application of the apportionment method rather than separate accounting. (Ptf's Post-Trial Reply Brief, at 3-4; *see* DiNicola's Test at Trial, Tr at 214-15.) Taxpayer states that "[a]ny flow of value between Miami Corporation's other businesses and the Oregon Tree Farm flows **to** Oregon, not **from** Oregon" (emphasis in original). (Ptf's Post-Trial Brief at 13.) However, the direct deposit of Oregon Tree Farm earnings in

Chicago is a patent flow of value from taxpayer's Oregon operations to its out-of-state operations. Moreover, the test is whether there are contributions to the income of the divisions or subsidiaries resulting from the three factors, and not whether there are contributions to taxpayer's out-of-state operations. *Maytag*, 12 OTR at 507 (quoting *Woolworth*, 458 US at 364).

In *Container Corporation*, the Supreme Court upheld the state supreme court's determination that the corporation was a unitary business, finding that the two factors most indicative of the corporation's unity with its subsidiaries were the flow of capital resources from the taxpayer to its subsidiaries through loans and loan guarantees, and the managerial role the taxpayer played in its subsidiaries' affairs. *Container Corp.* at 173, 180 n 19. The Court developed further the constraints placed upon a state's use of the apportionment method by the constitutional requirements behind due process and interstate commerce. In addition to nexus and the requirement that there be "a rational relationship between the income attributed to the State and the intrastate values of the enterprise" (*id.* at 165-66 (citations omitted)), the Court stated that there must be some "concrete" connection between the unitary business's in-state and out-of-state activities – a requirement that is demonstrated if

> "there be some sharing or exchange of value not capable of precise identification or measurement – beyond the mere flow of funds arising out of a passive investment or a distinct business operation – which renders formula apportionment a reasonable method of taxation."

Id. at 166 (citations omitted). In the case at hand, the managerial oversight provided by taxpayer's board of directors and Friedrichs belies any possible claim that the Oregon Tree Farm is a passive investment. Although it could be argued that the Oregon Tree Farm is a distinct business operation, the court rejects that characterization. Sharing and exchange of value is

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exhibited by the commingling of funds between taxpayer's central office and its Oregon division, its centralized management in Chicago, and the provision of administrative services by its central office in Chicago.

Taxpayer argues that because it already paid tax on its earnings in Florida, Louisiana, and Illinois to those states, it is being unconstitutionally double taxed by Oregon's application of its apportionment formula. (Ptf's Post-Trial Brief at 21.) In *Container Corporation*, the Supreme Court stated that the constitution required fairness and that, to be fair, a state's apportionment formula must have "internal consistency," so that if the formula were "applied in every jurisdiction, it would result in no more than all of the unitary business'[s] income being taxed," and "external consistency" in that the factors used in the formula "must actually reflect a reasonable sense of how income is generated." *Container Corp.*, 463 US at 169. However, the Court mitigated those strong statements by then stating that "[t]he Constitution does not invalidat[e] an apportionment formula whenever it *may* result in taxation of some income that did not have its source in the taxing State," and that a taxpayer would have to prove "by clear and cogent evidence that the income attributed to the State is in fact out of all appropriate proportions to the business transacted * * * in that State." *Id.* at 169-70 (citing *Moorman Mfg. Co. v. Bair*, 437 US 267, 98 S Ct 2340, 57 L Ed 2d 197 (1978); *Hans Rees' Sons*, 283 US at 135 (internal quotations omitted) (emphasis in original).

In the case at hand, taxpayer has not demonstrated that if Oregon's formula were applied in every jurisdiction, more than all taxpayer's income would be taxed. Further, taxpayer has alleged double taxation, but has not provided evidence that Oregon's apportionment formula has resulted in double taxation. *See Container Corp.*, 463 US at 169. As the Court stated in *Container Corporation*, even a stipulation that tax had been paid to other taxing bodies would not be sufficient to prove double taxation because it is "entirely possible that deductions,

exemptions, or adjustments in those returns eliminated whatever overlap in taxable income resulted" from the taxing state's action. *Id.*, at 187 n 22. Moreover, the fact the taxpayer paid taxes to the other three states on all of the income earned in those states does not automatically demonstrate double taxation, because the formula measures **business activity** within and without the state and applies the resulting ratio to taxpayer's total income to **approximate** its income earned from Oregon business activities.

As in *Mobil Oil*, taxpayer has availed itself of the privilege of carrying on business within the taxing state, establishing nexus. As in the *Pennzoil* case, the fact that application of the apportionment formula results in a greater than 800 percent increase in tax liability is not indicative of unconstitutionality *per se*. Under *Container Corporation*, taxpayer's unsupported allegation of double taxation is insufficient to prove unconstitutionality of the apportionment formula. Therefore, the court finds that Oregon's apportionment formula, as applied to taxpayer, violates neither the Due Process Clause nor the Commerce Clause, hence is not unconstitutional.[12] This ends the court's inquiry for the 1997 and 1998 tax years.

2. *Tax Year 1999*

As indicated above, the 1999 legislature amended ORS 314.670 by removing the phrase "and result in the violation of the taxpayer's rights under the Constitution of this state or the United States." It made that amendment effective as of January 1, 1999. Thus, for tax year 1999, only a finding of unfairness is necessary to invoke the departure provisions in ORS 314.670.

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[12] Taxpayer also argued that application of the apportionment formula is unconstitutional because it was designed for manufacturing and mercantile businesses only, citing a passage from a case book written by professors Jerome and Walter Hellerstein, and that there are better methods for allocating the income of other businesses, according to the principal author of UDITPA, William Pierce. (Ptf's Post-Trial Brief at 18-19.) However, such policy considerations are for the legislature; the court's task is to apply existing law.

In *Twentieth Century-Fox*, the Oregon Supreme Court stated that formula apportionment "typically produces fair taxation in that it fairly approximates the portion of taxpayer's business activity that was conducted in Oregon." *Twentieth Century-Fox*, 299 Or at 224. Nonetheless, the court found application of the statutory apportionment formula unfair because the sales factor accurately reflected Oregon receipts, the taxpayer had the lowest possible payroll factor (at zero), and the property factor substantially under-represented the taxpayer's business activity in Oregon. *Id.* at 235-36. Unfairness from application of the formula as a whole occurred because no factor compensated for the substantial under-representation by the property factor. The reason the standard property factor was unfair was because it only captured the cost of the reels of film shipped to Oregon and projected onscreen in public theaters; that cost did not reflect the substantial value connected with the film negatives stored in California, without which the reels of film (the positive images printed from the negatives) could not be produced. Thus, the department succeeded in modifying the property factor to account for the proportionate value of the film negatives in California. *Id.*

Using the analysis employed by the court in *Twentieth Century-Fox*, the court begins by looking at taxpayer's business activity in Oregon. Taxpayer owns timberlands in Oregon. During each of the years at issue taxpayer harvested timber through the use of independent contractors. The Oregon timberlands are managed by employees in Oregon, with oversight provided by officers and directors in Illinois. Taxpayer also owns and manages a securities portfolio in Illinois, land with associated oil and gas reserves in Louisiana, and timberlands in Florida. Revenues come primarily from the sale of securities in Illinois and royalties from the extraction of oil and gas in Louisiana, both of which are intangibles – and secondarily from the sale of timber in Oregon and Florida.

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Turning to the fairness of the formula, the court finds insufficient evidence to support taxpayer's assertion that the payroll factor is flawed, because independent contractors are used in Oregon as well as Louisiana and apportionment is only an approximation of business activity. *See* ORS 314.660 (defining payroll as compensation); OAR 150-314.660(1) (4) (excluding payments to independent contractors from the payroll factor). Moreover, taxpayer's officers and employees stationed in Illinois provide the Oregon Tree Farm with services, but their pay is not reflected in Oregon payroll; rather, it is represented in the denominator. As for the sales factor, the court finds no distortion once it is adjusted to include gross receipts rather than net gain, as discussed below. Because neither the payroll nor sales factor underweights taxpayer's business activity in Oregon, those factors will not offset any overweighting of the property factor. *See Twentieth Century-Fox*, 299 Or at 234-35.

Taxpayer argues that the property factor is flawed because it excludes intangible property, such as its securities portfolio and oil and gas reserves in Louisiana – its two largest assets. (Ptf's Post-Trial Brief at 19.) The court agrees. According to testimony and evidentiary submissions, the Oregon property factor is greater than 60 percent and the cost basis of its tangible property (including capitalized rent, as required by the statute) was $19,426,127 in 1999. Thus, the cost basis for Oregon property (tangible) was approximately $12 million. However, the 1999 cost basis of its securities portfolio (intangibles), which is outside of Oregon, was $295,530,134. It is clear from those numbers that the vast majority of taxpayer's total property value was attributable to its intangible assets outside the state, yet under the formula, the majority of taxpayer's "property" appears to be in Oregon. Accordingly, the property factor in Oregon's standard apportionment formula, which includes only tangible property, is "woefully inadequate" to represent taxpayer's business activity in Oregon. *See Twentieth Century-Fox*, 299 at 236.

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Thus, an adjustment is required for tax year 1999. The court finds that the formula should be adjusted to include intangibles in the property factor.[13]

The court is aware that simply adding intangibles to the property factor goes significantly farther than the department's alternative method, which it felt would be reasonable if and only if the court concluded that the standard three-factor formula did not fairly approximate taxpayer's Oregon business activity. (Def's Post-Trial Brief at 11, 23.) The department's alternative is "to add a fourth factor for intangible property to include the securities portfolio, giving it equal weighting along with the traditional property factor. This would result in the following formula: 50% sales factor, 25% payroll, 12.5% tangible property, 12.5% intangible property." (*Id.* at 23.) That modest concession is woefully inadequate because taxpayer's total property, tangible and intangible, in Oregon and elsewhere, had a cost basis of $314,956,261 for 1999, while its tangible property had a cost basis of $19,426,127. (Ptf's Post-Trial Brief at 10.) Equally weighting the two paints a considerably different picture than adding the intangible property to the tangible. That is because there is apparently no intangible property in Oregon and thus the numerator of the intangible property factor would be zero, rendering that whole factor zero. Conversely, adding intangibles to tangibles in a single property factor greatly increases the denominator, thereby reducing the Oregon property factor from roughly 60 percent to 4 percent. The latter approach provides a more accurate representation of the relative value of taxpayer's

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[13] Inclusion of intangibles in the property factor was approved by the Oregon Supreme Court in *Crocker Equipment Leasing, Inc. v. Dept. of Rev.*, 314 Or 122 (1992), where the court found that "exclusion of intangibles from the property factor increases that factor about 16 times * * * ." *Id.* at 132. Here, exclusion of intangibles from the property factor also increases that factor about 16 times.

Oregon property versus all property. Given that the majority of its property assets and revenue comes from intangibles, the court finds it is unfair to exclude intangibles.[14]

D. *The Department's Error in its Application of the Sales Factor*

As a general rule, the sales factor is comprised of gross receipts. *See* ORS 314.665(1) (providing that "total sales" go into the numerator and denominator); *see* ORS 314.610(7) (defining "sales" as gross receipts). ORS 314.665(6) addresses the sale of intangibles, including securities. The statute was amended in 1999, and made effective for "tax years beginning on or after January 1, 1999." Or Laws 1999, ch 143, §§ 8, 10. Prior to the amendment, under ORS 314.665(6)(a), gross receipts from the sale of securities were excluded from the sales factor "unless those receipts [were] derived from the taxpayer's primary business activity."[15] The amendment in 1999 addressed the sale of intangible assets (including securities) "**not** derived from the primary business activity of the taxpayer but included in the taxpayer's business

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[14] Under the department's proposal, taxpayer's tangible property factor goes from approximately 60 percent to 30 percent. That number is based upon representations that the Oregon property factor is greater than 60 percent and the department's proposal to reduce the weight given to that factor from 25 percent to 12.5 percent, effectively cutting the factor in half. Additionally, because the parties agree that the numerator in the intangible property factor would be zero, that factor adds nothing to the equation (0/$295,530,134 = 0). However, combining tangible and intangible property results in a denominator of $314,956,261 ($295,530,134 for intangible property + $19,426,127 for tangible property) and a numerator of approximately $11.7 million (60% of $19,426,127). (*See* Ptf's Post-Trial Brief at 10.) The resulting property factor would be roughly 3.7 percent.

[15] The statute applicable to tax years 1997 and 1998 provided in relevant part:

"(6) For purposes of this section, 'sales' excludes:

"(a) gross receipts arising from the sale * * * of intangible assets, including * * * securities, unless those receipts are derived from the taxpayer's primary business activity.

ORS 314.665. This portion of the law was identical in the 1995 and 1997 editions of the ORS.

income." Or Laws 1999, ch 143, § 8; *see also* ORS 314.665(6)(b) (1999) (emphasis added). Only the "net gain" from the sale of such assets is included in the sales factor.[16] Thus, after the 1999 amendment, some portion of the transaction is reported – regardless of whether the sale is or is not part of the taxpayer's primary business activity – whereas prior to the change, gross receipts were either in or out depending upon the nature of the transaction.

During trial, the department acknowledged that it was including the net gain, rather than gross receipts, from the sale of taxpayer's securities outside Oregon. (DiNicola's Test at Trial, Tr at 234-35.) The court concludes that gross receipts should be included in the sales factor. Taxpayer's corporation is divided into two divisions – the Real Estate Department and the Securities Department. (Ptf's Post-Trial Brief at 4; Def's Post-Trial Brief at 2.) The corporation was organized in 1917 for the purpose of overseeing the investments of the Deering family. (Hogan's Test at Trial, Tr at 22.) As such, taxpayer is a private investment company – investing in timber, land bearing oil and gas reserves, and securities. Taxpayer regularly sells or exchanges securities – a primary function of its Securities Department in Chicago. Accordingly, receipts from those sales "are derived from the taxpayer's primary business activity." ORS 314.665(6)(a).[17]

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[16] The statute after the 1999 amendment provides:

"(6) For purposes of this section, 'sales'

"(a) Excludes gross receipts arising from the sale * * * of intangible assets, including * * * securities, unless those receipts are derived from the taxpayer's primary business activity.

"(b) Includes **net gain** from the sale * * * of intangible assets not derived from the primary business activity of the taxpayer but included in the taxpayer's business income."

1999 Or Laws, ch 143, § 8; *see also* ORS 314.665 (1999) (emphasis added).

[17] That statutory requirement, found in subsection (6)(a), remained unchanged during the tax years in question.

Nor can the department limit the inclusion to net gain under the provisions of OAR 150-314.280-(N), because that rule was promulgated to interpret ORS 314.280, the statute that governs the allocation of the income of financial organizations and public utilities.[18] Taxpayer does not meet the definition of a financial institution, hence is not subject to the provisions of ORS 314.280.[19]

The court concludes that the department erred in including taxpayer's net gain rather than gross receipts from its sale of intangibles, including securities.

E. *Is an Award of Attorney Fees Appropriate?*

In its Complaint, taxpayer asked for attorney fees and costs under ORS 182.090(1), on the basis that the department acted with no reasonable basis in fact or law. (*See* Compl at 9.) ORS 182.090(1) provides as follows:

> "In any civil judicial proceeding involving as adverse parties a state agency, as defined in ORS 291.002, and a petitioner, the court shall award the petitioner reasonable attorney fees and reasonable expenses **if the court finds in favor of the petitioner and also finds that the state agency acted without a reasonable basis in fact or in law."**

(Emphasis added.) Although taxpayer has achieved at least a partial victory, the court finds that the department did not act without a reasonable basis in fact or in law.

IV. CONCLUSION

The court finds that taxpayer is a corporation operating both within and without Oregon, as a unitary business, and is subject to application of the statutory apportionment formula to

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[18] ORS 314.615 provides: "Any taxpayer having income from business activity which is taxable both within and without this state, other than activity as a financial organization or public utility or the rendering of purely personal services by an individual, shall allocate and apportion the net income of the taxpayer as provided in ORS 314.605 to 314.675. Taxpayers engaged in activities as a financial organization or public utility shall report their income as provided in ORS 314.280 and 314.675." *See also U.S. Bancorp v. Dept. of Rev.*, 337 Or 625, 629, 103 P3d 85 (Dec 16, 2004).

[19] ORS 314.610(4) lists financial service companies that provide services to the public, such as industrial banks, safe deposit companies, investment companies, and insurance companies.

determine its tax liability for tax years 1997, 1998, and 1999. As taxpayer has not demonstrated that the formula is unconstitutional as applied, the court finds that application of an alternative method is not mandatory for tax years 1997 and 1998. However, for tax year 1999, the court finds that the formula as a whole requires adjustment to operate fairly; accordingly, for that year the property factor shall include intangibles. Further, regarding all three tax years, the court holds that the department erred by including net gain rather than gross receipts in the sales factor for taxpayer's sale of intangible assets, including securities. That error must be rectified by including gross receipts in the sales factor. Now, therefore,

IT IS THE DECISION OF THIS COURT that taxpayer is a unitary business, having met the three statutory requirements, and as such is subject to the statutory apportionment formula;

IT IS FURTHER DECIDED that application of the statutory apportionment formula to taxpayer is not unconstitutional, making consideration of an alternative method for tax years 1997 and 1998 unnecessary;

IT IS FURTHER DECIDED that, for tax year 1999, application of the statutory apportionment formula is unfair, requiring application of an alternative method for that year;

IT IS FURTHER DECIDED that to rectify the unfairness for 1999, the property factor shall be modified to include intangibles;

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IT IS FURTHER DECIDED that the department erred in including net gain rather than gross receipts in the sales factor for taxpayer's sale of intangibles, and that the sales factor shall be modified to include gross receipts; and

IT IS FURTHER DECIDED that each party shall bear its own attorney fees and costs.

Dated this _____ day of February 2005.

DAN ROBINSON
MAGISTRATE

IF YOU WANT TO APPEAL THIS DECISION, FILE A COMPLAINT IN THE REGULAR DIVISION OF THE OREGON TAX COURT, BY *MAILING* TO: 1163 STATE STREET, SALEM, OR 97301-2563; OR BY *HAND DELIVERY* TO: FOURTH FLOOR, 1241 STATE STREET, SALEM, OR. YOUR COMPLAINT MUST BE SUBMITTED WITHIN 60 DAYS AFTER THE DATE OF THE DECISION OR THIS DECISION BECOMES FINAL AND CANNOT BE CHANGED.

THIS DOCUMENT WAS SIGNED BY MAGISTRATE DAN ROBINSON FEBRUARY 17, 2005. THE COURT FILED AND ENTERED THIS DOCUMENT FEBRUARY 17, 2005.