No. 47,050

AMOCO PRODUCTION COMPANY, Formerly PAN AMERICAN PETROLEUM CORPORATION, *Appellant*, v. HAROLD A. ARMOLD, Director of Taxation for the State of Kansas, [as successor to JAMES T. McDONALD, Director of Revenue for the State of Kansas], *Appellee*.

SYLLABUS BY THE COURT

1. ADMINISTRATIVE AGENCY—*Power to Adopt Rules and Regulations—Power Must Be Within Authority Conferred.* The power of an administrative agency to adopt rules and regulations is administrative in nature, not legislative, and to be valid administrative regulations must be within the authority conferred. An administrative regulation which goes beyond or conflicts with legislative authorization is void.
2. TAXATION—*Administrative in Character—Court Will Not Substitute Its Judgment.* Matters of assessment and taxation are administrative in character and not judicial. A court will not substitute its judgment for that of an administrative agency in matters other than law or essentially judicial matters.
3. SAME—*Method of Allocating Income—Administrative Duty.* The determination of proper methods of allocating income of a multistate corporation for purposes of assessing state income tax is an administrative duty cast upon the state taxing agency and is to be performed by it.
4. STATUTES—*Interpretation a Question of Law.* The interpretation of a statute is a question of law and it is the function of a court to interpret a statute to give it the effect intended by the legislature.
5. SAME—*Administrative Ruling Erroneous—Construction of Statute for the Courts.* While the administrative interpretation of a statute should be given consideration and weight it does not follow that a court will adhere to the administrative ruling where the statute is clear and the administrative ruling is erroneous. The final construction of a statute rests within the courts.
6. TAXATION—*Review of Method of Allocation—Administrative Determination Based Upon Erroneous Interpretation of Statutes.* On judicial review of an order of the Director of Revenue requiring a particular method of allocation, a court will not substitute its judgment for that of the Director and determine that a particular method shall be applied to reflect income justly allocable to the state and, thus, make an independent finding, but it is the function of a court to set aside an administrative determination that is based upon an erroneous interpretation of relative statutes.
7. SAME — *Challenging Order of Director — Requiring Separate Accounting Method—Erroneous Regulation—Erroneous Interpretation of Uniform Act.* In an action challenging an order of the Director of Taxation requiring the appellant taxpayer, a multistate corporation, to apportion its net business income under a method of "separate accounting," the record is examined, pertinent provisions of the Uniform Division of Income for Tax Purposes Act (K. S. A. and K. S. A. 1973 Supp. 79-3271, *et seq.*) are construed and it is *held:* The trial court's judgment voiding the effect of an erroneous regulation promulgated by the Director of Revenue is affirmed. The trial court's judgment affirming the decision of the State Board of Tax Appeals is reversed and set aside for the reason that the decision referred to is based upon an erroneous interpretation of certain provisions of the Uniform Act, as more fully set forth in the opinion.

Appeal from Seward district court; KEATON G. DUCKWORTH, judge. Opinion filed January 26, 1974. Affirmed in part, reversed in part and remanded with directions.

Ellis D. Bever and *William Cobb*, both of Wichita, argued the cause, and *William E. Jetter*, of Chicago, Illinois, was with them on the brief for the appellant.

O. F. Baldwin, of Topeka, argued the cause, and *William L. Harris, Jr.*, of Topeka, was with him on the brief for the appellee.

The opinion of the court was delivered by

KAUL, J.: This litigation stems from a requirement by the Director of Taxation that appellant, pursuant to provisions of the Uniform Division of Income for Tax Purposes Act (K. S. A. and K. S. A. 1973 Supp. 79-3271, *et seq.*) employ the "separate accounting" method rather than allocating and apportioning its multistate net income under the so-called "three-factor" formula method (K. S. A. 79-3279 to 79-3287, incl.) for the taxable years 1968 and 1969. The "separate accounting" method is sometimes referred to as the "direct" or "segregated" method of accounting. For convenience and brevity, appellant will hereafter be referred to as Amoco; appellee as Director; the Kansas Board of Tax Appeals as the Board; The Uniform Division of Income for Tax Purposes Act as the Uniform Act; and the "three-factor" formula apportionment method as the formula. The Director's assessment made on the "separate accounting" method was sustained by the Board and the order of the Board was affirmed by the trial court. This appeal ensued.

On appeal Amoco contends the Board and the Director failed to recognize that the Uniform Act changed the general rule for allocating and apportioning business income of a multistate business from the former rule generally requiring "separate accounting" to one requiring use of the "three-factor" formula prescribed by 79-3279 of the Uniform Act. Amoco further asserts that in this regard the trial court, in affirming the Board's order, committed reversible error in failing to properly interpret and apply the Uni-

form Act. Amoco further contends that the evidence does not support the Board's conclusion that "separate accounting" fairly represents the extent of its business activity in Kansas; and that the Board's order is arbitrary and capricious because it is based upon an invalid procedural rule and a legal standard for measuring business activities within the state which had been repealed by the adoption of the Uniform Act in 1963. Amoco also claims the trial court erred in determining that the nature of Amoco's business precluded it from utilizing the formula method in allocating its business income.

Amoco asks that the judgment of the trial court be reversed and the case remanded to the Director for redetermination of its Kansas income tax liability in accordance with apportionment provisions of the Uniform Act.

Amoco is a Deleware corporation with its principal office in Tulsa, Oklahoma. It was authorized to do business in Kansas prior to the effective date of the Kansas income tax in 1933. Its principal business is the production, processing and sale of oil, gas and related products. It is the wholly owned domestic subsidiary of Standard Oil Company of Indiana and provides the principal source of crude oil for its parent and affiliated corporations. During the taxable years in question, Amoco was engaged in exploring for and producing oil and gas in twenty-one states. Its general operating office is located in Tulsa, Oklahoma. During the taxable years, Amoco's activities in Kansas consisted of production, exploration, purchasing oil and gas from other producers and reselling such products for use within and without the state. It also owned interests in three gas processing plants located in Kansas. An exhibit, reproduced in the record, reflects Federal and Kansas taxable income or losses during the years 1933 through 1969. It discloses that during the early years Amoco's Kansas operations resulted in losses.

Since 1933 Amoco has employed "separate" or "segregated" accounting in rendering its income tax returns, although on several occasions it attempted, unsuccessfully, to employ the formula method. In 1959 Amoco filed its return and reported its income on the formula method authorized by G. S. 1949, 79-3218, which was in effect at the time. The Director rejected the filing and required Amoco to compute its income tax by use of the "direct" or "separate" accounting method, also authorized by G. S. 1949, 79-3217. On appeal the Director's requirement was sustained by

the Board of Tax Appeals and thereafter by the district court of Seward County. G. S. 1949, 79-3217 and G. S. 1961 Supp. 79-3218 were repealed in 1963 (L. 1963, Ch. 485, Sec. 24) by the adoption of the Uniform Act. Amoco filed its return for 1963 on the "three-factor" formula then provided by K. S. A. 79-3271, *et seq.* The return was rejected and Amoco was again required to report its income by the "separate accounting" method on the grounds that "separate accounting" clearly reflected its Kansas business activities; and on the further ground that Amoco had not obtained the Director's permission to change its method of accounting. Amoco complied and continued to compute its Kansas income tax on "separate accounting" through 1967, although it claims the returns for those years were filed under duress. For the years in question —1968 and 1969—returns were made on the formula method, but at the request of the Director, Amoco also filed unsigned returns based upon "separate accounting." On these unsigned "separate accounting" returns the deficiencies in dispute were assessed. There is no dispute concerning the accuracy of figures in either the "separate accounting" or formula method returns. Formula apportionment allocated a composite fractional 2.78 percent of Amoco's total net taxable income to Kansas for the year 1968 and 2.71 percent for the year 1969; whereas "separate accounting" attributed to Kansas approximately 23 percent of total net income for each of the two years.

The record on appeal discloses that the evidence before the trial court consisted generally of the transcript of proceedings before the Board, its order therein, the testimony of three witnesses called by Amoco and documentary evidence consisting of tax returns reflecting the use of both methods for the years in question, various statistical schedules and correspondence between Amoco and officials of the Director's office.

The Uniform Act was approved by the National Conference of Commissioners on Uniform State Laws and by the House of Delegates of the American Bar Association in 1957 (Vol. 7 Uniform Laws Annotated, p. 365). Professor William J. Pierce, of the University of Michigan Law School, a member of the National Conference, was the draftsman. In a treatise analyzing the provisions of the Act appearing in Vol. 35, "TAXES" The Tax Magazine (October 1957), commencing at page 747, Professor Pierce states that its basic purpose should be the simplification of computing state taxes and that, "the Act, if adopted in every state having a net income tax or

a tax measured by net income, would assure that 100 percent of income, and no more or no less would be taxed." The Uniform Act was first adopted by Alaska in 1960, followed by Arkansas in 1961, and Kansas in 1963. At the time this action was tried it had been adopted in substantially its original form in twenty-three states.

K. S. A. 79-3272 of the Uniform Act mandates that any taxpayer (with certain exceptions not pertinent herein) having income from business activity taxable both within and without this state shall allocate and apportion his net income as provided in the Act.

The "three-factor" formula is set out in K. S. A. 79-3279 which reads:

"All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three."

The three factors are defined in the following section of the Act. K. S. A. 79-3280 defines the property factor in this fashion:

"The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the tax period and the denominator of which is the average value of all the taxpayer's real and tangible personal property owned or rented and used during the tax period."

K. S. A. 79-3281 and 79-3283 prescribe rules for the valuation of owned and rented property and the averaging of the values thereof.

The "payroll factor" is defined in K. S. A. 79-3283:

"The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the tax period by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the tax period."

The "sale factor" is defined in K. S. A. 79-3285:

"The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period."

The provisions of the Uniform Act most critical to this litigation appear in K. S. A. 1973 Supp. 79-3288 which read in pertinent part:

"If the allocation and apportionment provisions of this act do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the secretary of revenue may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

"(*a*) Separate accounting;

"(*b*) the exclusion of any one or more of the factors;

"(*c*) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or

"(*d*) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income; or . . ."

This section of the Act is frequently referred to as the "relief" provision (Vol. 1972 Utah Law Review, p. 607; and Vol. 15 University of California Los Angeles Law Review [1967], [Keesling and Warren], Corporate Taxation, pp. 156. *171*).

After requiring Amoco to file its returns based on "separate accounting" the Director held a hearing on the matter on July 15, 1971. On August 2 the Director filed an assessment for the years in question based on "separate accounting" stating that Amoco had reported its income in previous years on "separate accounting" and did not petition the Director for permission to change. The Director made an affirmative finding that "separate accounting," as provided in 79-3288, fairly represented the extent of taxpayer's business activities in the state, but he made no negative findings concerning formula apportionment nor did he specify reasons why it did not fairly represent business activities in the state.

In its order sustaining the Director's requirement of "separate accounting," the Board found in pertinent part:

"6. That the appellant operated in 34 states in 1968 and in 35 states in 1969, and that they used the direct method of accounting in reporting their income to the majority of said states. In addition, the appellant filed its income tax return in the state of its principal business activity namely Oklahoma, upon the direct or segregated method of accounting.

"7. That the appellant can and has for many years determined its income tax liability by direct accounting according to state lines.

"8. That the appellant has never contended that the direct accounting method has caused it to pay tax on more than 100% of its income or that it does not clearly reflect its business activity within the State of Kansas.

"9. That contrary to the figures shown in the appellants (*sic*) statement of facts, the figures revealed on the appellants (*sic*) amended tax returns indicate that the appellant derived approximately 24% of its total taxable income in the State of Kansas in each of the years 1968 and 1969."

In finding No. 10 the Board delineated the issues to be considered in this manner:

"10. . . .

"a. Does K. S. A. 79-3288 authorize the Kansas Director of Revenue to require direct or separate accounting if such method clearly reflects the appellants (*sic*) Kansas income from business transacted or derived from sources within the State of Kansas?

"b. If the Director of Revenue of the State of Kansas orders a taxpayer to use the separate or direct accounting method in computing its Kansas taxable income and said accounting method clearly reflects the income from business

is evidence that apportionment does not fairly represent the extent of its business activities in this state. As tending to bear on this point the majority points out that during 1968 and 1969 twenty-one states in which Amoco was doing business had income tax and of these only thirteen had adopted the Uniform Act. However, we were advised upon oral argument that now all but two have adopted the Act or turned to the apportionment method.

In summary, it is my opinion that the record contains no substantial evidence either to sustain the director's order assessing additional taxes based on the separate accounting method, or to support the conclusions reached by the board of tax appeals and by the district court to the effect that the director acted reasonably and within statutory requirements. Our rule has been, and I trust still is, that a finding which is not based on substantial competent evidence is not sufficient to support a judgment. (*J. R. Watkins Co. v. Waldo*, 117 Kan. 250, 255, 230 Pac. 1051; *Potts v. McDonald*, 146 Kan. 366, 369, 69 P. 2d 685.)

Since, in my opinion, the judgment of the court below lacks substantial evidentiary support, I respectfully submit it should be reversed, not that another bite at the cherry may be taken, but that judgment might be entered in favor of the prevailing party.

FATZER, C. J., joins in the foregoing dissent.

FATZER, C. J., dissenting: I join in Justice Fontron's dissent; however, I wish to make an additional comment. Conflicting apportionment and allocation methods utilized in taxing multistate business are the most severe ailment of state taxation policies. The theory of apportionment by formula is that certain elements of a business will fairly reflect the measure of tax allocable to a state. Accordingly, the formula method has been recognized as a practical approach in the taxation of multistate business. (*Gen. Motors v. District of Columbia*, 380 U. S. 553, 14 L. Ed. 2d 68, 85 S. Ct. 1156; *Harvester Co. v. Evatt*, 329 U. S. 416, 91 L. Ed. 390, 67 S. Ct. 444; Subcommittee on State Taxation of Interstate Commerce of the House Committee on the Judiciary, "State Taxation of Interstate Commerce," H. Rept. No. 1480, 88th Cong., 2d Sess., Vols. 1 and 2 [June 15, 1964], H. Rept. No. 565, 89th Cong. 1st Sess., Vol. 3 [June 30, 1965].)

It is my opinion that a multistate business is entitled to apportionment and allocation regardless of whether the power of taxation has

been exercised by another state. This is the fundamental premise of the Uniform Act. The purpose of the Act is uniform apportionment and allocation of business income, and not to insure all income of a multistate business will be taxed. (K. S. A. 79-3289.) Tax liability is to be computed on the basis of business activity, and a comparison between formula allocation and separate accounting to ascertain the higher tax, is not within the scheme of the Uniform Act.

Whether the apportionment formula correctly depicts a multistate business' activity in this state is dependent upon the facts of each particular case. A taxpayer's return when filed in accordance with applicable statutes speaks for itself. The party seeking to invoke the alternate taxing methods set out in K. S. A. 1973 Supp. 79-3288 has the burden of proof. In the instant case, the director failed to offer any evidence which would warrant the use of separate accounting.

Finally, in conjunction with apportioning the taxable income of a multistate business is the apportionment of any losses of that business. (*Bass, Etc., Ltd. v. Tax Comm.*, 266 U. S. 271, 69 L. Ed. 282, 45 S. Ct. 82.) I submit, continued diversity by the states in taxing multistate business will result in federal legislation establishing a mandatory method for apportionment and allocation of income.

Accordingly, I join with Justice Fontron in concluding this case should be reversed and that judgment be entered in favor of the taxpayer on the basis of the record presented.

FONTRON, J., joins in the foregoing dissent.

Perhaps, we could take the various figures from the exhibits and testimony and arrive at the conclusion the formula method, in this particular case, does not fairly represent the extent of business activities in this state and that "separate accounting" or formula modified by one or more of the various modifications authorized by 79-3288 does operate to fairly represent business activities, but to do that would be to perform a duty laid upon the Director and one that we are without authority to perform.

In view of our interpretation of the pertinent provisions of the Uniform Act, the present posture of this case forecloses final disposition of the matter on this appeal. The matter must be remanded for a redetermination by the Director on the premise that formula is the prescribed method of apportionment and a determination otherwise is to be made on a standard of measurement that extent of business activities within the state is the test rather than solely business income. The Director's discretion afforded by the Uniform Act is not to choose between "separate accounting" and the formula method, as contemplated by K. A. R. 92-12-53. A departure from formula apportionment necessitates, in the first instance, a negative finding by the Director that such method does not fairly represent the extent of the taxpayer's business activities. If, under the guidelines pronounced herein, the Director, for valid reasons, determines that formula apportionment does not fairly represent the extent of business activities within the state, he may require in his discretion, if reasonable, any of the variations enumerated in 79-3288 that would effectuate an equitable allocation of income. The Director's discretion, in this regard, is not limited to merely substituting "separate accounting" as indicated by K. A. R. 92-12-53.

The trial court's judgment reversing the Board's order that a taxpayer is required under K. A. R. 92-12-53 to petition for a change in accounting methods as set forth in conclusion of law No. 2 is affirmed. In all other respects the judgment is reversed and the cause remanded with directions to remand the matter to the Director for redetermination in accordance with the provisions of the Uniform Act and consistent with the views expressed herein.

It is so ordered.

FONTRON, J., dissenting: I respectfully suggest that under rules

of appellant procedure to which this court has long adhered, the instant case should be reversed, period.

The Uniform Division of Income for Tax Purposes Act, K. S. A. 79-3271 to 79-3293, was adopted by the Kansas Legislature in 1963 "to provide for uniform allocation and apportionment of the state income taxes of any taxpayer doing a multi-state business." (*Western Natural Gas Co. v. McDonald,* 202 Kan. 98, 99, 446 P. 2d 781.) According to an article by Keesling and Warren, California's Uniform Division of Income for Tax Purposes Act, appearing in 15 UCLA Law Review 156, the Uniform Act was both drafted and sponsored by the National Conference of Commissioners on Uniform Laws, to promote uniformity in allocation practices among the states which impose taxes on or measured by income of corporations, and to relieve the pressure for congressional legislation in that field. (See, also, dissenting opinion of Chief Justice Callister in *Kennecott Copper Corp. v. State Tax Com'n,* 27 Utah 2d 119, 493 P. 2d 632.) It was no doubt in furtherance of such worthy objectives that the legislature enacted § 19 of the Act, now K. S. A. 79-3289, which reads as follows:

> "This act shall be so construed as to effectuate its general purpose to make uniform the law of those states which enact it."

Adoption of the Uniform Act effected a philosophical change in the method of computing the taxable income of multi-state taxpayers. Whereas, under the former statute, G. S. 1949, 79-3217, use of the direct allocation or separate accounting method was the general rule, under the provisions of the Uniform Act, the apportionment or three-factor method became the prescribed method of allocating income, and any other system, including the separate accounting method, became the exception. The burden of proving an exception warranting the use of one of the alternative methods spelled out in K. S. A. 1973 Supp. 79-3288, that is, where the apportionment provisions of the Act do not fairly represent the extent of taxpayer's business activity in this state, rests upon the party who would invoke the exception. This, I believe, is the sense of the following proviso to 79-3288:

> ". . . That the burden of proof of any contrivance to evade taxes under this act shall rest upon the director of taxation or secretary of revenue."

In the case of *Donald M. Drake Co. v. Dept. of Rev.,* 263 Or. 26, 32, 500 P. 2d 1041, the Supreme Court of Oregon said that the use of any method other than apportionment should be exceptional and the party who seeks to invoke the exception has the burden of proof.