COLO. HIGH COURT SHOULD AFFIRM EXISTING TAX REPORTING REGIME

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On April 9, the Colorado Supreme Court heard argument in two similar state income tax cases, Agilent Technologies Inc. v. Department of Revenue,[1] and Oracle Corp. v. Department of Revenue.[2] Both cases present the question of how Colorado's "water's edge" statutory provision applies to companies with no property or payroll. The cases also involve Colorado's general anti-abuse provision, which affords the Colorado Department of Revenue the discretion, in some circumstances, to allocate gross income and deductions among commonly-controlled corporations to avoid abuse and to clearly reflect income. Finally, the cases address the fundamental issue of whether taxpayers are entitled to rely on express provisions of state statutes and regulations — both of which, in these instances, support the lower courts' conclusions in favor of the taxpayers.

Legislative History

Based on the sound reasoning of the decisions below, rulings in favor of the taxpayers in these cases seem likely.

Colorado, like many states, is a unitary combined reporting state. This means that certain groups of related corporations are required to file a single, aggregate Colorado state income tax return, essentially as if they were a single entity. Such a return is often referred to as a "combined return" or a "combined report."

Unlike the statutes in other unitary combined reporting states, the Colorado statute provides that the corporations to be included in a combined report are those that satisfy specific ownership requirements and a six-part test related to activities occurring between the corporations.

However, the Colorado General Assembly included in this framework a special rule for an otherwise includable corporation if 80% or more of such corporation's property and payroll (determined on the basis of the average of the corporation's property and payroll factors under Colorado's version of the Multistate Tax Commission apportionment rules generally applicable to tax years beginning before 2009) is assigned to locations outside the United States. Under this rule, these corporations cannot be included in a Colorado unitary combined report even if they otherwise meet the ownership and six-part tests.

The department also promulgated a regulation over 20 years ago expressly excluding from a combined report those corporations with neither property nor payroll factors. Not surprisingly, the taxpayers had both relied on the regulation in excluding respective holding companies from combined reports. The department was therefore forced to argue against the language of its own regulation in the litigation below and on appeal.

Even more remarkably, prior to promulgating this regulation, the department had issued a regulation essentially stating the opposite, that is, that corporations with neither property nor payroll factors had to be included in a unitary combined return. The department made the change to the current regulation in the mid-1990s, upon being advised by the Office of Legislative Legal Services that its original regulation, requiring inclusion, did not comply with the governing statutes.

Factual Background

The Agilent and Oracle cases present similar facts. Agilent is a multinational corporation that does business in Colorado and files Colorado corporation income tax returns. It has a holding company that, in turn, uses the Agilent name and owns several affiliates that operate outside the United States. The holding company does not have any business activities of its own, does not own real or tangible personal property and does not have any employees. Nor does it engage in activities in Colorado, and it is not subject to Colorado tax. But the Colorado Department of Revenue sought to tax the holding company's income by forcing Agilent to include the holding company, along with its income, in Agilent's Colorado combined income tax return.

Similarly, Oracle is the parent corporation of a group of subsidiaries operating in the United States and elsewhere and includes several of its subsidiaries in its Colorado combined income tax return. Like Agilent, Oracle has a holding company that uses Oracle's name but has no real or tangible personal property or payroll in the United States. The holding company's only asset is stock of a foreign operating subsidiary. The Colorado Department of Revenue sought to require Oracle to include its holding company, and income, in the Colorado combined return or to disregard the holding company and treat the gain as Oracle's income.

Lower Courts' Decisions

In both cases, the trial courts and the Colorado Court of Appeals rejected the Department of Revenue's positions and held that the applicable income tax statute and corresponding regulation preclude corporations that have neither property nor payroll factors from being included in Colorado combined reports. The lower courts also concluded that the department could not rely on the state's corporate anti-abuse provision.

Supreme Court Arguments

The department successfully petitioned for certiorari review by the Colorado Supreme Court in both cases. In its briefs and in oral argument, the department principally argued, as it did in the lower courts, that a company with neither a property factor nor a payroll factor should not be treated as a corporation that has predominately foreign property and payroll. Rather, according to the department, a holding company with no foreign property, payroll or operations must, by definition, conduct its business inside the United States, should not be subject to the "water's edge" provision, and is includible.

These positions, however, are directly undermined by the language of the statute and regulation and should be rejected by the Supreme Court.

The department further argued that the lower courts' analyses would lead to absurd and illogical results because a purely domestic holding company and its subsidiaries could not be included in the Colorado unitary combined report of the holding company's parent (although the holding company's subsidiaries could possibly form a separate unitary combined group required to file a Colorado unitary combined report of its own).

The department also argued for application of the anti-abuse provision — an issue the court addressed in much of its questioning, asking the department what standard it was requesting the court to adopt and how any broad standard of "abuse" could be prevented from swallowing the general rule set forth in the income tax statute.

Based on the court's questioning, several justices appeared troubled by the idea of granting the department unchecked discretion to undo a taxpayer's reporting decisions under the guise of avoiding some undefined notion of "abuse."

In response, the taxpayers primarily relied on the language of the statute and regulation, both of which indicate that holding companies with neither property factors nor payroll factors cannot be included in a unitary combined report. The policy underlying this argument cannot be overstated: taxpayers must be allowed to base tax planning decisions on the guidance provided in applicable statutes and regulations.

They also argued that, even if a holding company were excluded from a combined report, chains both above and below it could still be included in Colorado combined reports if they satisfied the Colorado unitary tests. And, they argued, because the holding companies were formed for legitimate, nontax reasons, the anti-abuse provision does not apply.

Finally, the department flagged for the court the concern that rulings in favor of the taxpayers could result in a significant reduction of tax revenue going forward — to the tune of "hundreds of millions of tax dollars" — and that any corporation can avoid Colorado income tax by "flipping a switch." What the department fails to realize is that the exclusion of entities without property and payroll factors is a two-way street.

Exclusion could either increase or decrease Colorado income tax from combined reports. If the company in question had losses, then excluding it from a combined report could increase income for the combined group. At the same time, if the excluded company had income, then excluding it from a combined report could decrease the income for the combined group. Thus, if the Colorado Supreme Court were to rule in favor of the taxpayers, the result could very well be tax neutral for the state.

Legislative Response

Simultaneously with the arguments in the Supreme Court, the Colorado General Assembly (or at least one bill-sponsoring member) has joined the fight. State Sen. Pete Lee introduced a bill on April 2 referencing the Court of Appeals' decisions in Agilent and Oracle and attempting to undo them.

In what appears to be a last-minute effort to save the department from additional adverse decisions in these cases, Senate Bill 19-233[3] attempts to clarify that only corporations with property and payroll located outside the United States are excluded from combined reports and states that the legislature never intended the provision to exclude holding companies from combined reports due to lack of property and payroll.

The bill was presented to the Senate Finance Committee on April 16, after which it was laid over for a future committee vote. Thus, the committee may schedule additional testimony, submit the measure for a vote or postpone it indefinitely (in the latter case, likely effectively killing it). The Colorado General Assembly is scheduled to adjourn on May 3.

Although difficult to predict, the Supreme Court is expected to issue decisions later this year.

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Disclosure: The authors submitted amicus filings in both cases on behalf of the Council on State Taxation in support of the taxpayers.

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[1] Agilent Technologies Inc. v. Department of Revenue, 2017 COA 137.

[2] Oracle Corp. v. Department of Revenue, 2017 COA 152.

[3] Colorado SB 19-233.