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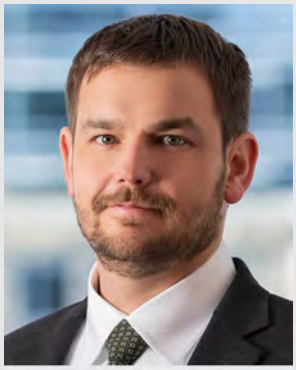

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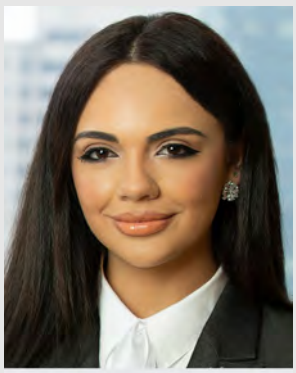

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In this installment of A Pinch of SALT, the authors examine the application of statutory construction principles to conflicts involving allocation and apportionment statutes.

Introduction

Courts have formulated more than a dozen legal canons of statutory construction specific to tax.[1] This article examines the application of statutory construction principles to conflicts involving allocation and apportionment statutes. Because an income tax must contain an allocation and apportionment regime to comply with the due process and commerce clauses of the U.S. Constitution, these regimes should be treated as imposition statutes and not exemptions or deductions.

Origin of the Competing Canons

There are long-standing canons of statutory construction that favor taxpayers,[2] and they are certain to be with us for the long haul.[3] An early example of an application of these principles is the 1842 opinion by Justice Joseph Story in *Wigglesworth*, in which he explained:

> [It is] a general rule in the interpretation of all statutes, levying taxes or duties upon subjects or citizens, not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operation so as to embrace matters, not specifically pointed out, although standing upon a close analogy. In

[1] Steve R. Johnson, "The Canon That Tax Penalties Should Be Strictly Construed," 3 *Nev. L.J.* 495-496 (2003) (listing canons of construction particular to tax).

[2] *See Eidman v. Martinez*, 184 U.S. 578, 583 (1902) (describing it as "an old and familiar rule of the English courts").

[3] *See* Peter A. Lowy and Juan F. Vasquez Jr., "Interpreting Tax Statutes: When Are Statutory Presumptions Justified?" 4 *Hous. Bus. & Tax L.J.* 389, 393 (2004) ("Courts rarely, if ever, squarely confront presumptions, because litigants rarely build an argument around a presumption; that is they rarely frame the issue in terms of whether a statutory provision should be construed broadly or narrowly. Doing so would risk creating the perception that the litigant needs a favorable presumption to win.").

> every case, therefore, of doubt, such statutes are construed most strongly against the government, and in favor of the subjects or citizens, because burdens are not to be imposed, nor presumed to be imposed, beyond what the statutes expressly and clearly import.[4]

A nearly identical statement of this rule was applied by the Supreme Court in *Gould*, interpreting the newly enacted federal income tax of 1913.[5] And for many years thereafter, explained former U.S. Solicitor General Erwin Griswold, "this passage was calculated to put terror into a Government lawyer's heart."[6] Although now somewhat limited in its application for federal income tax purposes,[7] the general rule requiring construction in favor of taxpayers is deeply rooted in the common law of the states and has been since the 19th century.[8]

In the 1930s, during times of great financial need, federal courts developed a competing tax canon of statutory construction. In 1934 the Supreme Court held in *New Colonial Ice* that "the power to tax income . . . is plain and extends to the gross income. Whether and to what extent deductions shall be allowed *depends upon legislative grace*; and only as there is clear provision therefor can any particular deduction be allowed."[9] Referenced by the Court less than a decade later in 1943 as "the now familiar"[10] canon of strict construction,[11] lower courts extended it to "exemptions"[12] from tax, "exclusions"[13] from income, and tax credits,[14] finding that they are also matters of "legislative grace" strictly construed in favor of the taxing authority under *New Colonial Ice*.

Despite being the subject of much scholarly debate,[15] state courts have largely adopted this principle of "legislative grace," strictly construing statutory deductions, exemptions, and exclusions against taxpayers while continuing to construe tax "imposition" statutes in favor of the taxpayer.[16] Some state courts have struggled, however, with the application of these competing canons of construction to state tax allocation and apportionment statutes, such as codifications of the Uniform Division of Income for Tax Purposes Act.

Principles Favoring the Taxpayer

A large number of courts (at least 17, and likely more) have construed ambiguous allocation or apportionment statutes *in favor of* the taxpayer.[17] Some of these courts have reasoned that apportionment laws — which determine what portion of the tax base is attributable to the

[4] *United States v. Wigglesworth*, 28 F. Cas. 595, 596-597 (C.C.D. Mass. 1842) (emphasis added).

[5] *Gould v. Gould*, 245 U.S. 151 (1917).

[6] Erwin Griswold, "An Argument Against the Doctrine That Deductions Should Be Narrowly Construed as a Matter of Legislative Grace," 56 *Harv. L. Rev.* 1142 (1943).

[7] *See Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429 (1955) (explaining that the expansive definition of gross income was used by "Congress to exert in this field 'the full measure of its taxing power'").

[8] *See generally* Thomas M. Cooley, *A Treatise on the Law of Taxation: Including the Law of Local Assessments*, 200-202 (1876) (describing then-contemporary law); Norman J. Singer and J.D. Shambie Singer, *Statutes and Statutory Construction*, section 66:1 (1891) (providing that "the rule is firmly established" and citing a long list of state cases).

[9] *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934) (emphasis added); *see also INDOPCO Inc. v. Commissioner*, 503 U.S. 79, 84 (1992).

[10] *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943) (emphasis added).

[11] *Equitable Life Assurance Society v. Commissioner*, 321 U.S. 560, 564 (1944); *see also* Michelle M. Kwon, "Custom-Tailored Law: When Statutory Interpretation Meets the Internal Revenue Code," 97 *Neb. L. Rev.* 1118, 1138 (2019).

[12] *See, e.g.*, *Slough v. Commissioner*, 147 F.2d 836, 839 (6th Cir. 1945); *Keasbey & Mattison Co. v. Rothensies*, 133 F.2d 894, 898 (3d Cir. 1943); *Commissioner v. Trustees of Lumber Investment Association*, 100 F.2d 18, 29 (7th Cir. 1938); and *Nelson v. Commissioner*, 30 T.C. 1151, 1154 (1958).

[13] *Mostowy v. United States*, 966 F.2d 668, 671 (Fed. Cir. 1992); *Kirk v. Commissioner*, 425 F.2d 492, 494 (D.C. Cir. 1970); *but see Hochman v. Commissioner*, 51 T.C.M. 311 (T.C. 1986).

[14] *James F. Waters Inc. v. Commissioner*, 160 F.2d 596, 598 (9th Cir. 1947) ("It is well settled that where statutes create special relief, credits, or the like, such concessions are matters of legislative grace.").

[15] *See, e.g.*, Antonin Scalia and Bryan A. Garner, *Reading Law: The Interpretation of Legal Texts*, 359-363 (2012); Griswold, *supra* note 6; Lowy and Vasquez, *supra* note 3.

[16] *See* Singer and Singer, *supra* note 8.

[17] *See, e.g.*, *Synthes USA HQ Inc. v. Commonwealth*, 289 A.3d 846, 855 (Pa. 2023); *NuStar Energy L.P. v. Hegar*, 683 S.W.3d 831, 837 (Tex. App. 2023); *Honigman Miller Schwartz & Cohn LLP v. City of Detroit*, 505 Mich. 284, 291 n.3 (Mich. 2020); *Target Brands Inc. v. Department of Revenue*, No. 2015CV33831 (Colo. Dist. Ct. Jan. 27, 2017); *Harris Corp. v. Arizona Department of Revenue*, 233 Ariz. 377, 384 (Ariz. Ct. App. 2013); *BellSouth Advertising & Publishing Corp. v. Chumley*, 308 S.W.3d 350, 362 (Tenn. Ct. App. 2009); *Microsoft Corp. v. Franchise Tax Board*, 39 Cal. 4th 750, 759 (Cal. 2006); *Nadler v. Commissioner*, No. 7736-R (Minn. T.C. Apr. 21, 2006); *Amerada Hess Corp. v. State ex rel. Commissioner*, 2005 N.D. 155, P19 (N.D. 2005); *Lenox Inc. v. Tolson*, 353 N.C. 659, 664 (N.C. 2001); *Upjohn Co. v. Rylander*, 38 S.W.3d 600 (Tex. App. 2000); *Polaroid Corp. v. Offerman*, 349 N.C. 290, 297 (N.C. 1998); *Ex parte Uniroyal Tire Co.*, 779 So. 2d 227, 231 (Ala. 2000); *Foodways National Inc. v. Crystal*, 232 Conn. 325, 334 (Conn. 1995); *Kelly-Springfield Tire Co. v. Bajorski*, 228 Conn. 137, 144 (Conn. 1993); *Altray Co. v. Groppo*, 619 A.2d 443 (Conn. 1993); *Langley v. Administrative Hearing Commission*, 649 S.W.2d 216 (Mo. 1983); *Goldberg v. State Tax Commission*, 639 S.W.2d 796, 802 (Mo. 1982); *Block Inc. v. City of Atlanta*, Case No. 2022CV368115 (Fulton Cnty. Super. Ct., May 23, 2024).

taxing state — are tax imposition statutes. They have found that unlike deductions, exemptions, and exclusions, apportionment is not a "benefit" given to taxpayers through "legislative grace," but rather a constitutional requirement.

For example, in *Kelly-Springfield Tire*, the Connecticut Supreme Court found that "the apportionment of net income . . . reflect[s] constraints on the state's taxing power that derive from constraints imposed by the commerce and the due process clauses of the federal constitution."[18] The court further noted that, "viewed from this perspective, any ambiguities in the applicability of the statutes in light of the available factual record must be construed in favor of the taxpayers and against the commissioner."[19] Critical to its analysis, the court reasoned:

> The apportionment statute, although itself not a taxing statute, provides the criteria and formulae for determining net income subject to the state's corporation tax. Because [it] is an integral component of this state's tax imposition scheme . . . it cannot properly be characterized as a statute providing a taxpayer exemption.[20]

A Texas court of appeals decision is another example of a determination that allocation and apportionment statutes should be treated as imposition statutes. In *Upjohn*, the court explained that whether a statute embodies "an imposition of tax or an exemption from tax determines who bears the burden of proving its application."[21] The court recognized that deductions and exemptions are narrowly construed as they "are matters of legislative grace,"[22] but it ruled that apportionment formulas determine "the part of the base that is properly attributable to the State" and should therefore be considered "imposition type items" that are "strictly construed against the Comptroller."[23]

Courts have also construed allocation provisions, distinguishing between business and nonbusiness income, in favor of the taxpayer.[24]

Principles Favoring Tax Administrators

Other courts have found that allocation or apportionment provisions are matters of legislative grace, construed against the taxpayer. For example, in a case predating the four-prong test articulated in *Complete Auto*,[25] the Pennsylvania Supreme Court held that "as to domestic corporations . . . the ability to allocate and apportion is a matter of legislative grace similar to a deduction."[26] According to the court, "as to foreign corporations the apportionment and allocation is constitutionally required because the Commonwealth may not tax assets of foreign corporations beyond its jurisdiction. As to domestic corporations . . . the legislative grant is not constitutionally compelled."[27] Thus, based on its premise that apportionment was not constitutionally required for domestic corporations, the court found that apportionment was an act of legislative grace, giving preference to the government's interpretation.[28]

A California court of appeal recently found that a sourcing rule applicable to nonresidents is characterized as an "exemption" from tax. In *J.P. Morgan Trust*,[29] the nonresident taxpayers argued that income derived from the sale of intangible property was governed by a statute stating that "income of nonresidents from stocks, bonds, notes, or other intangible personal property is not income from sources within this state unless the property has acquired a business situs in this state."[30] The court recognized that to "the extent a tax statute is unclear, it should be construed to favor the taxpayer," but that "laws creating tax exemptions must be strictly construed against the

[18] *Kelly-Springfield Tire*, 228 Conn. at 144.
[19] *See id.* at 143.
[20] *See id.*
[21] *Upjohn*, 38 S.W.3d 600.
[22] *See id.*
[23] *Id.*
[24] *See, e.g.*, *Nadler*, No. 7736-R.
[25] *Complete Auto Transit Inc. v. Brady*, 430 U.S. 274 (1977).
[26] *Commonwealth v. Greenville Steel Car Co.*, 469 Pa. 444, 448 (1976).
[27] *See id.*
[28] *See id.*
[29] *J.P. Morgan Trust Co. of Delaware v. Franchise Tax Board*, 79 Cal. App. 5th 245 (Cal. Ct. App. 2022).
[30] *Id.* at 273-274 (quoting Cal. Rev. & Tax. Code section 17952).

taxpayer."[31] Applying this formulation, the court found that the statute must be construed against the taxpayer because the taxpayer "seeks to exempt itself from taxation under that scheme."[32]

Courts have also relied on the general rule of placing the *burden of proof* on a taxpayer to find that allocation or apportionment rules are construed against them. In *Comcast Holdings*, for example, the Tennessee Court of Appeals acknowledged that under Tennessee law, ambiguities in statutes imposing taxes must be resolved in favor of the taxpayer.[33] Nonetheless, and undermining its rule of statutory construction, the court did not construe the statute in the taxpayer's favor because "when a taxpayer challenges a tax assessment issued by the Department, the court must presume the assessment to be correct."[34]

Similarly, in *Public Service Co. of New Mexico*,[35] the court found that "there is a presumption in favor of taxation and therefore statutes such as UDITPA are construed to effectuate such a presumption."[36] Also, in *Gannett Satellite*,[37] the taxpayer argued that the statutory language must be strictly construed in the light most favorable to the taxpayer. Again, the court sided with the government, finding that the "*exemption* for nonbusiness income" must be construed "most favorably in favor of the state" and against the taxpayer.[38] To reach this conclusion, the court relied on *National Holdings*[39] and its rationale that the "taxpayer bears *the burden* of establishing that income is nonbusiness income."[40]

Construction in Favor of the Taxpayer Is Required for Allocation and Apportionment Laws

We believe that ambiguities in allocation and apportionment statutes must be resolved in favor of the taxpayer. The U.S. Constitution requires "fair apportionment," and a state providing allocation and apportionment statutes is complying with that constitutional mandate. In *Complete Auto*, the Supreme Court held that taxes must be "fairly apportioned" under the commerce clause.[41] A tax must also satisfy two requirements under the due process clause: (1) a "minimal connection" between the interstate activities and the taxing state; and (2) a rational relationship between the income attributed to the state and the intrastate values of the enterprise.[42] While states have latitude in determining the specifics of allocation and apportionment, these laws are neither gifts from the legislature nor acts of legislative grace.[43]

Further, contrary to the Pennsylvania Supreme Court's decision in *Greenville*, the requirement to apportion income applies equally to in-state corporations (domiciled or headquartered in a state) and out-of-state corporations — and thus, again, is not an act of legislative grace. In *Wynne*, the U.S. Supreme Court found that in-state residents engaging in interstate commerce were protected by the commerce clause.[44] Following *Wynne*, it is clear that state and local taxes imposed on those engaging in interstate commerce must be fairly apportioned irrespective of the status of a taxpayer as a resident or nonresident, domestic or foreign.

Notably, the court in *J.P. Morgan Trust* incorrectly characterized a sourcing rule for nonresidents as an "exemption" from tax. A

[31] *Id.*

[32] *Id.*

[33] *Comcast Holdings Corp. v. Tennessee Department of Revenue*, No. M2017-02250-COA-R3-CV (Tenn. Ct. App. Apr. 25, 2019).

[34] *Id.* (internal citations omitted).

[35] *Public Service Co. of New Mexico v. New Mexico Taxation and Revenue Department*, 141 N.M. 520 (N.M. Ct. App. 2007).

[36] *Id.* at 529.

[37] *Gannett Satellite Information Network Inc. v. Montana Department of Revenue*, Cause No. BDV 2007-514 (Mont. 1st Jud. Dist. Ct. 2007) (emphasis added).

[38] *Id.* (emphasis added).

[39] *National Holdings Inc. v. Zehnder*, 874 N.E.2d 91 (Ill. App. Ct. 2007).

[40] *Id.* (emphasis added).

[41] *Complete Auto*, 430 U.S. at 279.

[42] *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 279 (1978) (citing *Hans Rees' Sons Inc. v. North Carolina ex rel. Maxwell*, 283 U.S. 123, 135 (1931); and *Norfolk & Western Railway Co. v. Missouri State Tax Commission*, 390 U.S. 317, 326 (1968)).

[43] *See Hochman v. Commissioner*, 51 T.C.M. 311 (T.C. 1986) ("Although *deductions* are a matter of legislative grace, to be bestowed or withheld by Congress . . . gross income still does not include the return of capital. The latter is an exclusion from gross receipts, and its allowance is not a matter of legislative grace, but rather a matter of determining the true gross income which constitutionally may be taxed.").

[44] *Comptroller of the Treasury of Maryland v. Wynne*, 575 U.S. 542, 555 (2015).

sourcing rule, which is a component of an apportionment regime, cannot be viewed as an exemption or exclusion because of the requirement to apportion income under the commerce clause and due process clause.

Finally, the approaches of the Tennessee Court of Appeals in *Comcast Holdings*, the New Mexico Court of Appeals in *Public Service Co. of New Mexico*, and the Montana First Judicial District Court in *Gannett Satellite* are based on a fundamental misunderstanding of the difference between a burden of proof and a rule of statutory construction. As discussed above, each of these courts mistakenly found that a presumption in favor of a tax agency's assessment or imposition — which does place the burden of proof on a taxpayer — overrides a requirement to construe ambiguous language in tax imposition statutes in favor of a taxpayer.[45] Not only would this "override" effectively eliminate the rule of construction in favor of taxpayers, but a burden of proof and a rule of construction are different legal requirements. The burden of proof in a case concerns which party must establish the facts required by the law, whereas a rule of construction concerns interpreting what the law is.[46] Thus, a statute placing the burden of proof on a taxpayer should not change the rule of statutory construction that is applied in a given case.

Conclusion

Because allocation and apportionment laws are required by the U.S. Constitution, these laws are not acts of legislative grace. They are tax imposition statutes. Accordingly, allocation and apportionment rules — such as those in UDITPA and similar state statutes — should be construed in favor of the taxpayer and against the government. Thankfully, based on our research, most modern-day state courts that have encountered these issues have come to the right result.[47] ■

[45] *Comcast Holdings*, No. M2017-02250-COA-R3-CV.

[46] *See Farr v. County of Nevada*, 187 Cal. App. 4th 669, 682 (Cal. Ct. App. 2010); *Alcoa Inc. v. United States*, 406 F. Supp. 2d 580, 582 (W.D. Pa. 2005) ("In a tax refund suit, the taxpayer has the burden of proof as to the taxpayer's claim. . . . When the IRS assesses a tax, a rebuttable presumption arises that the assessment is correct. . . . 'This presumption is a procedural device that places the burden of producing evidence to rebut the presumption on the taxpayer.'"); *Key Air Inc. v. Commissioner*, 294 Conn. 225, 241, 983 A.2d 1 (Conn. 2009) (explaining that the presumption of strict construction in favor of the taxpayer does not apply when statute is not ambiguous); *see also, e.g.*, *Texaco-Cities Service Pipeline Co. v. McGaw*, 182 Ill. 2d 262, 272-273 (Ill. 1998) ("Having arrived at the meaning of the statute, we now apply the functional test to the facts of this case, and conclude that Texaco-Cities has failed in its burden of proving that the gain from the sale of its pipeline assets was nonbusiness income.").

[47] *See supra* note 17.