FILED
01/16/2019
Bowen Greenwood
CLERK OF THE SUPREME COURT
STATE OF MONTANA
Case Number: DA 18-0541

IN THE SUPREME COURT OF THE STATE OF MONTANA
No. DA 18-0541

EXXON MOBIL CORPORATION,

Petitioner/Appellant,

v.

MONTANA DEPARTMENT OF REVENUE,

Respondent/Appellee.

AMICUS BRIEF OF COUNCIL ON STATE TAXATION

TERRY B.COSGROVE
MURRY WARHANK
Jackson, Murdo & Grant, P.C.
203 North Ewing Street
Helena, MT 59601-4240
Telephone: (406) 442-1300
Email: tcosgrove@jmgm.com
mwarhank@jmgm.com

Attorneys for Petitioner/Appellant

BRIANNE C. MCCLAFFERTY
FRANS A. ANDERSSON
Holland & Hart
401 N. 31st Street, Suite 1500
P.O. Box 639
Billings, MT 59103-0639
Telephone: (406) 252-2166
bcmcclafferty@hollandhart.com
faandersson@hollandhart.com

Attorneys for Amicus Council on State Taxation

BRENDAN R. BEATTY
DEREK R. BELL
Special Assistant Attorneys General
Montana Dept. of Revenue
Legal Services Office
125 N. Roberts
P.O. Box 770
Helena, MT 59604-7701

Attorneys for Respondent/Appellee

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I. INTEREST OF AMICUS

The Council On State Taxation ("COST") is a nonprofit trade association based in Washington, D.C. Its membership is comprised of approximately 550 of the largest multistate corporations engaged in interstate and international business and represents industries doing business in every state across the country. Its objective is to preserve and promote the equitable, non-discriminatory state and local taxation of multijurisdictional business entities. In furtherance of its objective, COST previously has participated as amicus in numerous significant federal and state tax cases over the past 40 years.

COST is interested in this case because of its potential impact on taxpayers' ability to rely on clear and fair tax laws. The Montana Department of Revenue's (the "Department") interpretation of § 15-31-325, MCA, in this case is contrary to the plain language of the statute and the relevant statutory history. Adopting the Department's interpretation of § 15-31-325, MCA would create substantial uncertainty for COST's members who conduct business in Montana, as these members seek and rely upon fair and consistent application of the State's statutory and regulatory tax provisions.[1] Further, the level of this uncertainty could likely infringe on a taxpayer's ability to exercise its statutory right to choose between the

[1] *See, e.g.*, *Mut. Sav. Life Ins. Co. v. United States*, 488 F.2d 1142, 1145-46 (5th Cir. 1974) ("A taxpayer has the right to rely upon the Government's Regulations and their published illustrations. Treasury Regulations having the force and effect of law are binding on tax officials, as well as taxpayers.")

different filing methods in Montana (e.g., whether to make a water's edge election). If the District Court's decision is upheld, § 15-31-325, MCA, would be applied to result in businesses incorporated in the United States being taxed more heavily than similarly situated foreign incorporated businesses. The disparate treatment of these two groups unfairly penalizes companies for incorporating subsidiaries in Montana – a result the Montana Legislature did not intend when enacting the statute.

II. STATEMENT OF THE ISSUE

Whether the District Court erred when it held that § 15-31-325(5), MCA does not specifically exclude 100% of the actual dividends paid by affiliated corporations, commonly referred to as "80/20 Companies," that are incorporated in the United States, but are excluded from the Montana water's edge combined group pursuant to § 15-31-322(1)(a), MCA because 20% or less of their payroll and property are assignable to locations inside the United States?

III. SUMMARY OF THE ARGUMENT

The District Court erred in adopting the Department's interpretation and application of § 15-31-325(5), MCA. The Department has interpreted Montana's water's edge provision to not exclude 100% of the dividends actually received from 80/20 Companies by members of the Montana water's edge[2] combined group.

[2] Multinational corporations, such as Exxon Mobil Corporation, may elect to file Montana tax returns by including domestic corporations but excluding certain foreign activities in computing

The Department's interpretation of the statute is wrong for the reasons set forth in the taxpayer's brief. *Amicus* agrees that the Department's statutory construction is flawed. In addition, the Department's interpretation of § 15-31-325, MCA results in the double inclusion of income, which the federal government has avoided when taxing earnings and profits of controlled foreign corporations.

Further, the national, and state tax policy in effect when Montana adopted its water's edge election[3] is inconsistent with the Department's and District Court's interpretation and implementation of § 15-31-325, MCA. The history, policies and politics at play when § 15-31-325, MCA was enacted are relevant considerations for this Court and support the plain language reading advanced by the taxpayer in its brief. In issuing its order upholding the Department's determination that Exxon Mobil is entitled to an 80% deduction of the dividends received from Exxon Mobil's 80/20 companies, rather than 100% exclusion, the Court did not address the clear intent of the Montana Legislature evidenced by the legislative history of the water's edge statutes. This Court should.

Montana tax obligations. The election is referred to as the "water's edge election." The "water's edge" combined reporting was adopted in Montana in 1987 as an alternative to world-wide combined reporting. *See* Order on Petition for Interlocutory Adjudication.

[3] Amicus also adopts by reference Exxon Mobil Corporation's Statement of the Case and Statement of the Facts.

IV. ARGUMENT

A. Dividends Paid From 80/20 Companies Are Excluded from Income Based on The Plain Language of § 15-31-325, MCA Which Is Further Supported By the Federal Government's Treatment of Earnings and Profits of Controlled Foreign Corporations.

The Department's interpretation of § 15-31-325(5), MCA is unreasonable and must be rejected based on a plain reading of the statute. Further, the Department's interpretation of that provision results in the double inclusion of income. When addressing earnings and profits of controlled foreign corporations, the federal government chose to avoid double inclusion of income. The state should follow suit.

1. The Plain Language of the Statute Excludes from Income Dividends Paid from 80/20 Companies.

Amicus concurs with Petitioner that when subsection (5) is read in conjunction with the rest of § 15-31-325, actual dividends from an 80/20 company must be excluded from the group's income and only a portion of the after-tax net income of such a company is included in the corporate tax base. Section 15-31-325, MCA provides for the "[t]reatment of dividends." It explains, in subsection (2) that "[t]he after-tax net income of United States corporations excluded from eligibility as affiliated corporations under 15-31-322(1) and possession of corporations described in section 931 through 934 and 936 of the Internal Revenue Code are considered dividends received from corporations incorporated outside the United States." The statute then states, in subsection (5) that "[d]eemed

distributions, as set forth in section 78 of the Internal Revenue Code, and corresponding amounts with respect to dividends considered received under subsection (2) of this section must be excluded from the income of the water's-edge combined group."

Subsection (2)'s reference to "United States corporations excluded from eligibility as affiliated corporations under 15-31-322(1)" addresses the after-tax net income of 80/20 companies. For such 80/20 companies, the after-tax net income is treated as a dividend paid by a non-U.S. company. § 15-31-325(2), MCA. Subsection (5) specifically references subsection (2) when it excludes "corresponding amounts with respect to dividends considered received under subsection (2) of this section" from "the income of the water's-edge combined group." When the reference to subsection (2) is considered in conjunction with subsection (5), it is apparent that actual dividends paid by an 80/20 company must be excluded when they are paid. In addition, the reliance by the Department (and holding by the District Court) that subsection (4) provides a basis for the inclusion of 20% of the actual dividends paid by an 80/20 company in the Montana corporate tax base is misplaced. Subsection (4) provides that "[e]ighty percent of all dividends apportionable under this section must be *excluded* from income subject to apportionment." § 15-31-325(4), MCA (emphasis added).

The Department maintains that subsection (4) implies that, because 80% of dividends under § 15-31-325 are excluded from tax, the remaining 20% must necessarily be taxed. This interpretation is wrong. First, as discussed above, another provision (subsection (5)) in § 15-31-325, MCA excludes the remaining 20% of dividends from an 80/20 company from taxation. Second, subsection (4) is not an income "inclusion" provision, as the Department asserts. Rather it is an "exclusion" provision—*excluding* 80% of the "deemed" dividends (*e.g*., after-tax income) of an 80/20 company taxable under subsection (2) and 80% of the actual dividends of a foreign corporation taxable under subsection (1).

A tax exclusion provision, such as subsection (4), is hardly the basis for the affirmative *imposition* of tax. "In interpreting statutes levying taxes, it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt, they are construed most strongly against the government and in favor of the citizen." *In re Wilson's Estate*, 102 Mont. 178, 194-195 (1936). If the Department were right, subsection (4) would need to include language affirmatively imposing taxation upon dividends. The language as drafted excludes such dividends from taxation.

2. The Federal Government's Treatment of Earnings and Profits of Controlled Foreign Corporations Supports the Appellant's Interpretation of § 15-31-325, MCA.

The Department's reading of these provisions results in a double inclusion of income. Pursuant to the Department's erroneous reading, a portion of the same income would be included in Montana taxable income under both subsection (2) of § 15-31-325, MCA when the after-tax net income of the includable corporation is included as a deemed dividend; and, again, when an actual dividend is paid. This double inclusion of the same income runs counter to the sound tax policy considerations developed by the American Institute of Certified Public Accountants.[4] These principles, as set forth in *Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals*, promote certainty, fairness, transparency, and ease of administration and compliance in tax legislation. Effectuating sound tax policy reinforces taxpayers' confidence in the voluntary compliance system, which is based on clear, transparent rules and the expectation that both the taxing agency and taxpayers will respect them. *See, e.g.*, *Mut. Sav. Life Ins. Co. v. United States*, 488 F.2d 1142, 1145-46 (5th Cir. 1974). ("A taxpayer has the right to rely upon the Government's Regulations and their

[4] American Institute of Certified Public Accountants, Guiding Principles of Good Tax Policy: A Framework for Evaluating Tax Proposals (March 2001) (issued by the Tax Division of the American Institute of Certified Public Accountants making recommendations that certain principles guide proposals for tax legislation).

published illustrations. Treasury Regulations having the force and effect of law are binding on tax officials, as well as taxpayers.").[5]

The Petitioner's interpretation of §15-31-325(5), MCA is consistent with how the federal government treats the earnings and profits of controlled foreign corporations ("CFC") that already have been included in the gross income of certain U.S. shareholders and have been subjected to U.S. income taxation pursuant to I.R.C. sections 951 through 965, commonly referred to as the federal "Subpart F" rules. For federal income tax purposes, Section 959 of Subpart F of the Internal Revenue Code prevents double taxation of the earnings and profits of CFCs by excluding actual distributions of previously taxed income ("PTI") from the gross income of certain U.S. shareholders that previously have been taxed. Section 15-31-325(3), MCA provides that amounts included under the federal Subpart F rules are considered dividends paid by foreign corporations. Accordingly, Subpart F income is included in Montana apportionable income and subject to the 80% exclusion pursuant to §15-31-325(4), MCA. Actual distributions with respect to Subpart F income, however, are not included in Montana apportionable income when paid, because the federal PTI provisions do not treat actual distributions of Subpart F income as dividends. Because there is no

[5] Clear statutory guidance is particularly important for multi-jurisdictional taxpayers that are required to know and follow the laws of dozens of states, and sometimes local jurisdictions.

federal PTI equivalent with respect to 80/20 income included in the Montana corporate income tax base by Subsection (2) of § 15-31-325, MCA and, therefore, no federal provisions to which Montana could conform, presumably, it was necessary for the Legislature to include a specific exclusion for actual distributions from 80/20 Companies under subsection (5).

This Court should avoid an interpretation that results in the inclusion of both 20% of the 80/20 companies' after-tax net income and 20% of the actual dividends paid by the 80/20 companies.

B. The Department's Interpretation of the Water's Edge Provision is Inconsistent with National and State Tax Policy in Effect When Montana Adopted the Legislation.

Tax policies, at the national, state and local level, have evolved significantly over the last 50 years. *Amicus*, as a preeminent state and local tax policy organization, has been involved in that evolution alongside the states. As the world has become smaller over the course of the last 50 years through globalization, the issue of how to tax worldwide income emerged.[6] The evolution of how to tax this income and the context in which Montana adopted its current

[6] Report to Fiftieth State Legislature of Montana, HB 703, p.1 ("It is very easy for a Montana corporation that does all of its business in Montana to determine how much of its income is taxable in Montana (100%)." But, "[w]hen these same corporations do business all over the world and are part of much larger corporations, it presents an almost impossible task for business to determine and for our tax commission to exactly audit what is Montana taxable income.").

water's edge provisions is helpful in understanding the Legislature's intent for § 15-31-325, MCA.

Montana, like all states, can only tax income earned within its state boundaries. *Moorman Mfg. Co. v.* Bair, 437 U.S. 267, 272-273 ("no tax may be imposed unless there is some minimal connection between those activities and the taxing state" and "the income attributed to the State for tax purposes must be rationally related to 'values connected with the taxing State'). This simple principle is complicated when a corporation's business within Montana is dependent on or contributes to its business outside of Montana. Report to Fiftieth State Legislature of Montana, HB 703, p. 1-2. To determine how much of a corporation's income can be attributable to Montana, the State uses (and has used) a method of dividing income among states using factors of profitability: property, payroll and sales. *Id.*; *see Montana Dept. of Revenue v. American Smelting & Refining Co.*, 173 Mont. 316, 328, 567 P.2d 901, 908 (Mont. 1977) (determining that six wholly owned subsidiaries must be included in corporation's computation of apportionable net income."). For example, a corporation could compare its payroll in Montana to the balance of the locations where the corporation does business and apply the percentage to total income in order to estimate income taxable in Montana. Report to Fiftieth State Legislature of Montana, HB 703, p. 1-2.

The apportionment process is further complicated when a taxpayer's business in Montana (or another state employing the unitary approach) is dependent on or contributes to its business outside of the state. Report to Fiftieth State Legislature of Montana, HB 703, p. 2. Montana's default (since 1974) has been to use the worldwide income of a business (and its affiliates) to determine the taxpayer's income apportionable to Montana. ARM 42.26.204. The unitary approach looks at the entire corporate enterprise (including the parent and all subsidiaries that are unitary with the parent) as a single unit, or a "unitary business." Report to Fiftieth State Legislature of Montana, HB 703, p. 2-3. A taxpayer is engaged in a unitary business when "the operation of the business within the state is dependent upon or contributory to the operation of the business outside the state or if the units of the business within and without the state are closely allied and not capable of separate maintenance as independent businesses." § 15-31-301, MCA. A unitary business group[7] files a "combined report" whereby the "entire apportionable income" of such business group is apportioned. ARM 42.26.204.

Prior to the enactment of the statute subject to this dispute (§ 15-31-325, MCA), taxing worldwide income had become a "sensitive issue" with the U.S.

[7] The unitary business group consists of the corporation, all unitary affiliates in which the corporation owns (directly or indirectly) more than a 50% interest, and all affiliates that own more than 50% interest in the corporation. ARM 42.26.204; § 15-31-321, MCA.

Government and foreign corporations. Report to Fiftieth State Legislature of Montana, HB 703, p. 3. Foreign governments threatened to tax income of U.S. corporations earned outside of its borders[8] and legal challenges to a state's unitary business principle and formula apportionment were not uncommon. *See Container Corp. of Am. v. Fran. Tax Bd.* ("*Container*"), 463 U.S. 159, 163 (1983) (noting that various aspects of state taxation systems that employed the unitary approach and required worldwide reporting had "provoked repeated constitutional litigation").

In 1983, the U.S. Supreme Court decided *Container*, upholding California's imposition of worldwide combined reporting on a domestic parent and its foreign subsidiaries. *Id*. In that challenge, Container Corp., a Delaware corporation headquartered in Illinois and doing business in California and elsewhere, claimed that the application of California's state taxation scheme violated the Due Process and Commerce Clauses of the Federal Constitution. *Id* at 163-64. California was employing the "unitary business" principle and used a formula apportioning the income of a deemed unitary business within and outside of the State.[9] *Id*. at 170. The United States Supreme Court determined that California's use of the three-

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[8] The British Parliament passed legislation enabling the British Treasury to retaliate against U.S. corporations in response to the worldwide unitary tax regimes. *See* 7 Sec. 54, Finance Act 1985, reprinted in New Clause 27, 1985 Finance Bill, 1355 Parl. Deb., H.C. 1014 (1985). See Robert D. Wallingford, British Retaliation Against the California Unitary Tax: The Needed Impetus for a Federal Solution, 8 J. Comparative Bus. & Cap. Market L.345-371 (1986).

[9] California applied the "three-factor" formula, which is based, in equal parts, on the proportion of a unitary business' total payroll, property, and sales that are located in the State.

factor formula to apportion the income of the unitary business consisting of Container Corp. and its foreign subsidiaries was fair. *Id*. at 184-85.

Following that decision, President Ronald Reagan, spurred by pressure from the U.S. business and international community in opposition to worldwide combined reporting, convened the Worldwide Unitary Taxation Working Group (the "Working Group"). As described in the introduction to the Working Group's final report, "[i]n the wake of the *Container* decision, members of the business community and major trading partners of the United States renewed their objections to the worldwide unitary tax method and urged the Administration to: (1) file a memorandum with the Supreme Court as amicus curiae in support of a rehearing in the Container case; and (2) support federal legislation that would limit or prohibit worldwide unitary taxation."[10] In response to those concerns, President Reagan established a working group composed of representatives from the federal government, state governments and the business community charged with producing recommendations…that [would] be conducive to harmonious international economic relations, while also respecting the fiscal rights and privileges of the individual states."[11]

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[10] See Dept. of the Treasury, The Final Report of the Worldwide Unitary Taxation Working Group, Aug. 1984, at 1, *available at* https://www.cost.org/globalassets/cost/state-tax-resources-pdf-pages/other-state-tax-studies-articles-reports/worldwide-unitary-taxation-working-group-final-report.pdf
[11] *Id*. at 3-4.

In August of 1984, after ten months of meetings and analysis, the Working Group issued its final report. The government and business representatives did not agree on a number of specific legislative solutions aimed at addressing the taxation of 80/20 companies and foreign-source dividends, but instead agreed "on a set of principles that should guide the formulation of state tax policy." These principles consisted of the following:

> Principle One: Water's edge unitary combination for both U.S. and foreign based companies.
>
> Principle Two: Increased federal administrative assistance and cooperation with the states to promote full taxpayer disclosure and accountability; and
>
> Principle Three: Competitive balance for U.S. multinationals, foreign multinationals, and purely domestic businesses. [12]

These principles support the conclusion that if a state chooses to include a portion of foreign dividends or the income of 80/20 companies in the corporate income tax base, it should do so only in a manner that does not discriminate between domestic and foreign corporations. This principle also was expressed by Supreme Court in *Container*, when it explained that any apportionment formula must not result in discrimination against interstate or foreign commerce. *Container*, 463 U.S. at 170.

When the states did not adhere to the principles promoted by the Working Group, the Treasury in 1985, proposed legislation that would preempt the state's

[12] *Id*. at 5-6.

ability to tax on a worldwide basis. *See* Walter Hellerstein, Designing the Limits of Formulary Income Attribution Regimes, 2014 STT 36-62 (2014). The legislation initiative was sidelined to give states remaining on the worldwide unitary system the opportunity to take legislative action themselves. Report to Fiftieth State Legislature of Montana, HB 703, p. 3.

As a result, Montana took legislative action. The Taxation Committee of the 50th Legislative Session of the Montana House of Representatives met on February 19, 1987 to discuss House Bill No. 703 ("HB 703") which became what is now the water's edge provisions in dispute in this case. *Id*. HB 703 was intended to "allow Montana to be competitive with other states" and "lure large corporations to the state, build the tax base, and provide jobs" by treating all corporations on the same basis. Minutes of the Meeting of the Taxation Committee, 5th Legislative Session, House of Representatives, February 19, 1987, p. 9-10.

It was in the aftermath of the Working Group's final report and the U.S. Treasury's proposed legislation that Montana's Legislature enacted its water's edge election legislation and § 15-31-325, MCA. The statute's words—chosen by the Montana Legislature—should be considered in the context of this historic backdrop. Based on the principles in the Working Group's final report, and the circumstances under which Montana provided an alternative to its worldwide

regime, it is evident that the water's edge provisions in Montana are intended to result in one level of tax – 20% (initially 15%) of the net income of 80/20 companies and 20% (initially 15%) of the dividends of foreign corporations.

The inclusion of a portion of both the operating income from and dividends paid by 80/20 companies in the corporate income tax base is completely inconsistent with the Working Group principles set forth above – namely that a "competitive balance" be maintained for "U.S. multinationals, foreign multinationals, and purely domestic business."[13] If the Department's statutory interpretation is upheld, it would tax foreign operating companies incorporated in the United States (80/20 companies) more than those companies that are incorporated outside of the United States. This is because the Department has included both deemed and actually received dividends in apportionable income.[14] The Department's reading treats two similarly situated taxpayers (organizations that incorporated subsidiaries in the U.S. and those that did not) differently, providing a more favorable result to those organizations without U.S.-incorporated subsidiaries. Thus, the Department's reading provides a disadvantage for 80/20 companies solely because they are incorporated in the United States.

[13] Dept. of the Treasury, The Final Report of the Worldwide Unitary Taxation Working Group, Aug. 1984, at 10.
[14] *See* Petitioner's Reply Brief at 11 for example.

Whether such privilege is sound tax policy is a question for the Legislature, not the Judiciary. And, conveniently, in this case, the Legislature clearly has answered the question. The Department's interpretation cannot be reconciled with the Legislature's intention to fairly tax foreign commerce in the same fashion, to "keep[] Montana competitive" and to ensure a competitive balance between foreign corporations, U.S. corporations with foreign subsidiaries, and domestic corporations. Report to Fiftieth State Legislature of Montana, HB 703, p. 6; Minutes of the Meeting of the Taxation Committee, 5th Legislative Session, House of Representatives, February 19, 1987, p. 9-10. As such, this Court should reject the Department's interpretation and reverse the District Court.

V. CONCLUSION

For the foregoing reasons, the Court should reverse the District Court's decision. As set forth in the taxpayer's brief, the plain reading of § 15-31-325(5), specifically excludes the taxation of actual dividends paid by 80/20 companies. This plain reading is supported by the circumstances under which the waters' edge provision was enacted and the intent expressed by the Montana Legislature.

Dated this 16th day of January, 2019.

Respectfully submitted,

<u>/s/ Brianne C. McClafferty</u>

Counsel for Amicus Council on State Taxation

CERTIFICATE OF COMPLIANCE

The undersigned, Brianne C. McClafferty, certifies that the foregoing complies with the requirements of Rule 7.1(d)(2). The lines in this document are double spaced, except for footnotes and quoted and indented material, and the document is proportionately spaced with typeface consisting of fourteen characters per inch. The total word count is 3,906, excluding caption, table of contents, table of authorities and certificate of compliance. The undersigned relies on the word count of the word processing system used to prepare this document.

/s/ Brianne C. McClafferty

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CERTIFICATE OF SERVICE

I, Brianne McClafferty, hereby certify that I have served true and accurate copies of the foregoing Brief - Amicus to the following on 01-16-2019:

Terrence B. Cosgrove (Attorney)
203 North Ewing Street
Helena MT 59601
Representing: Exxon Mobil Corporation
Service Method: eService

Brendan R. Beatty (Attorney)
P.O. Box 7701
Helena MT 59624
Representing: Revenue, Department of
Service Method: eService

Derek R. Bell (Attorney)
125 North Roberts
PO Box 7701
Helena MT 59604
Representing: Revenue, Department of
Service Method: eService

Murry Warhank (Attorney)
203 North Ewing Street
Helena MT 59601
Representing: Exxon Mobil Corporation
Service Method: eService

Electronically Signed By: Brianne McClafferty
Dated: 01-16-2019