STATE OF ALASKA
DEPARTMENT OF ADMINISTRATION
OFFICE OF TAX APPEALS
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BEFORE THE OFFICE OF TAX APPEALS

STATE OF ALASKA

IN THE MATTER OF:	Case No. OTA-2003-01
Magella Healthcare Corporation	Decision and Order Granting Summary Judgment to Taxpayer
Corporate Income Tax Tax Periods: 1998, 1999, 2000	

Introduction.

In this case Magella Healthcare Corporation, parent of Alaska Neonatology Associates, Inc. ("ANA'), challenges use of the standard three-factor apportionment formula to determine the Alaska net income of the combined group of health care corporations that includes ANA. Magella contends that the Department of Revenue (Department or DOR) erred in rejecting factor relief under AS 43.10.010 (Art. IV, Section 18) (Section 18) because applying the standard three-factor apportionment formula does not fairly represent the extent of the taxpayer's business activities in Alaska. Alternatively, Magella argues that if DOR is not required to grant factor relief under Section 18, then separate accounting is required because application of the standard three factor apportionment formula to the unusual facts of the taxpayer's business results in unconstitutional distortion of Magella's Alaska taxable income.

On February 5, 2003 Magella filed a timely appeal in the Office of Tax Appeals from the Department's informal conference decision (ICD) dated January 7, 2003, which denied Magella's claim for factor relief under Section 18 for 1998, 1999 and 2000 and refund of corporate income taxes. Briefing on cross motions for summary judgment was completed November 7, 2003. Oral argument on the summary judgment motions was heard on November 21, 2003 in Juneau. Magella and DOR agree that there are no disputed material facts and that disposition by summary judgment is appropriate.

Robert Mahon and Gregg Barton represented the taxpayer, Magella Healthcare Corporation. Michael Barnhill, Assistant Attorney General and Tim Cottongim, Appeals Officer, represented DOR.

Facts.

The parties filed a Partial Stipulation of Facts dated June 19, 2003, consisting of 47 numbered paragraphs of agreed facts, and four exhibits, which are copies of Magella's practice management agreements with non-subsidiary medical practices in other states. The stipulated facts are adopted and incorporated here. In addition, in support of its motion for summary judgment, Magella submitted two affidavits by Lee Ann Steinberg, corporate director of taxation for ANA and Magella. For the purpose of these cross-motions for summary judgment the facts stated in the affidavits are taken as true because DOR did not dispute them or ask to cross-examine Ms. Steinberg.

Magella is the parent corporation of Alaska Neonatology Associates, Inc. (ANA). ANA is in the business of providing medical care to high-risk infants at Providence and Alaska Regional hospitals in Anchorage. ANA employs Physicians and support staff to provide those medical services. Magella, which was incorporated in Delaware and has its headquarters in Texas, provides administrative, management, and consulting services to ANA and other medical practices that it owns or controls.

Magella acquired the stock of ANA in April 1998. In 1999 Magella acquired neonatology practices in Missouri and Idaho and those practices, like ANA, became corporate subsidiaries of Magella. However, in other states, including California, Texas, Nevada, Iowa and Indiana, Magella was unable to directly own medical practices because of state law restrictions on the practice of medicine. In those states, Magella entered into practice management agreements that allowed Magella to effectively control the medical practices and realize the net revenue from those practices without violating state law restrictions on the practice of medicine.

During the tax years at issue, 1998, 1999 and 2000, Magella owned three entities, including ANA, which performed medical services in Alaska, Missouri, and Idaho. Only ANA conducted business in Alaska. During this period Magella had practice management agreements with three entities that performed medical services in Texas, California, Nevada, Iowa, and Indiana.

Magella's practice management agreements (PMAs) with it non-subsidiary medical practices in Texas, California,Nevada, Iowa and Indiana, had 40 year terms and were not terminable except in cases of gross negligence, fraud, or felonious acts by Magella. The PMAs provided Magella with a fee equal to the net earnings of the non-subsidiary medical practices. The PMAs gave Magella authority over all operations of the non-subsidiary medical practices, except for the provision of medical services by the physicians to their clients. Magella was entitled under the PMAs to establish guidelines and procedures for selecting, employing, and terminating physicians and medical personnel. Magella also had the unilateral right to sell or transfer its interest in the non-subsidiary practices under the PMAs.

Magella's audited financial statements during the tax periods at issue included both its subsidiary medical practices and its non-subsidiary medical practices because, under generally accepted accounting principles, Magella held a "controlling financial interest" under the practice management agreements in the non-subsidiary practices. (Second Affidavit of Lee Ann Steinberg.) The Financial Accounting Standard Board (FASB) recognizes that pervasive control exercised by a parent over a non-subsidiary medical practice through a practice management agreement is the equivalent of a controlling ownership interest which requires consolidation for financial reporting purposes. (Ex E).

The business of ANA was substantially the same before and after Magella acquired it in April 1998. Before 1998 and after, ANA was engaged in the business of providing neonatal and perinatal medical care to high-risk infants at Providence and Alaska Regional hospitals in Anchorage. ANA's physicians provided care for high-risk deliveries, emergency room care for infants, and consultation for the newborn nursery. Upon acquisition, Magella took over the administrative functions of ANA but ANA's business activities, including numbers of physicians and staff, patient-days per year, and gross revenue did not change significantly.

For the three years prior to Magella's acquisition ANA's Alaska taxable income was $43,607 in 1995; $1,157 for 1996; and $47,623 for 1997.

ANA calculates its taxable income on a separate reporting basis for the tax years at issue as follows: $1,181,944 in 1998; $453,682 in 1999; and $1,474,169 in 2000. The Department does not dispute the accuracy of these calculations.

For the short year of the acquisition (from April 6-December 31, 1998) and the next two years, ANA's Alaska taxable income, determined by application of the standard three factor apportionment methodology under the Department's Informal Conference Decision, is $3,152,177 in 1998; $3,3099,951 in 1999; and $2,990,410 in 2000.

ANA's Alaska apportioned income is 297% higher over the three-year period than ANA's income calculated on a separate reporting basis. The percentage increase is: 266.7% in 1998; 683.3 % in 1999; and 202.9 % in 2000; for a total increase of 297% over the three-year tax period.

The standard three-factor apportionment formula, as applied by DOR in this case, includes the net income paid to Magella from its non-subsidiary medical practices in the total combined income of the group but excludes the property, payroll and sales of the non-subsidiary practices in calculating the fraction of the total income apportioned to Alaska.

After Magella's acquisition of ANA, Magella filed its 1998 Alaska return on a combined basis, including Magella and ANA. Magella initially filed its 1999 Alaska return on a combined basis, including Magella, ANA and its corporate subsidiaries in Missouri and Idaho. In March 1991 Magella filed amended returns for 1998 and 1999 on a separate reporting basis and requested a refund of its overpayment of corporate income tax under combined reporting. The Department denied Magella's refund requests for 1998 and 1999. Magella filed its 2000 return on a separate company basis, including only ANA.

> 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.

AS 43.19.010 (Multistate Tax Compact, Art. IV,§18).

The Department contends that the taxpayer must establish that application of the statutory three-factor apportionment formula results in an unconstitutional distortion in Alaska income to be entitled to factor relief under Section 18. According to the Department, if the taxpayer establishes unfair representation of the taxpayer's business activities but falls short of showing a constitutional violation, the Department may exercise its discretion to deny factor relief if it can articulate some rational basis for using the standard apportionment formula. The Department relies on *Gulf Oil Corp. v. State, Dep't of Revenue*, 755 P.372 (Alaska 1988) as support for its position.

The Department's argument that the taxpayer must prove an unconstitutional distortion to get factor relief under Section 18 is flawed. The Department misreads both the statute and the *Gulf Oil* decision, and ignores persuasive precedent from other states that have construed Section 18 of the Multistate Tax Compact.

Turning first to the statute, the Department's position is inconsistent with the statutory language. Section 18, by its plain language, provides for relief if the statutory apportionment provisions "do not fairly represent the extent of the taxpayer's business activities in this state."

In addition, Section 18 provides that an action to modify the standard apportionment formula to effectuate equitable apportionment of a taxpayer's income may be initiated by either a taxpayer or the Department. The statutory phrase "the taxpayer may petition for, or the Department may require" authorizes the Department to require some modification to the standard formula in particular cases by audit and assessment or regulation. It does not, as the Department suggests, say that the department may deny a taxpayer's petition for relief if the taxpayer shows that the standard formula results in unfair representation of the taxpayer's Alaska business activities. And, nothing in the statute suggests that the standard for factor relief differs depending on whether it is the taxpayer or the Department that seeks to modify the statutory formula in a particular case.

In *Gulf Oil* the Alaska Supreme Court described Section 18 as "the discretion clause". *Id.* At 386. The Court also noted that the deferential standard of appellate review applied:

> Since the discretion clause allows, but does not require, the DOR to grant relief, we review the DOR's decision using the "arbitrary, unreasonable, or...abuse of discretion" standard. See, Rose v. Commercial Fisheries Entry Comm'n, 647 P. 2d 154, 161 (Alaska 1982).

755 P. 2d at 381, n. 23.

Although *Gulf Oil* lends support to the argument that the Department has some discretion in granting or denying deny factor relief under Section 18, *Gulf Oil* does not hold that the taxpayer must prove a constitutional violation to trigger the Section 18 relief provision. To the contrary, the Court analyzed as separate issues the Taxpayer's claim for relief under Section 18 and its claim that application of the apportionment formula was unconstitutional.

The Court first addressed Section 18 and considered whether the taxpayer had shown that the statutory methodology of valuing Gulf's dry oil wells in Alaska at cost in determining the property factor resulted in an unfair representation of Gulf's Alaska activity. After reviewing the evidence, the Court concluded that Gulf had not proven that application of the apportionment formula without modification resulted in unfair representation of Gulf's oil exploration and leasing activity in Alaska. The Court also concluded that the alternatives proposed by the taxpayer for determining Gulf's Alaska income were flawed and no less arbitrary than the statutory method. For these reasons, the Court affirmed the Department's denial of Section 18 factor relief.

After concluding that Gulf had failed to prove that it was entitled to relief under Section 18, the Court separately analyzed the "constitutional dimension" of Gulf's claims. Citing *Container Corp .v. Franchise Tax Bd.*, 463 U.S. 159, 170 U.S. (1983), the Court held that to establish a constitutional violation, the taxpayer must 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,' or has "led to a grossly distorted result.' " *Gulf Oil,* 755 P. 2d 372 at 383-384,386. The Court concluded that Gulf had failed to carry its "high burden" of proof to establish a constitutional violation.

Implicit in the *Gulf Oil* is the conclusion that unfairness under Section 18 is not synonymous with unconstitutional and that a taxpayer (or the department) can invoke Section 18 to obtain factor relief without establishing a constitutional violation. Other state courts that have considered the issue have reached the same conclusion. *Twentieth Century-Fox Film Corp. v. Department of Revenue*, 700 P2d 1035 (Or. 1985); *Crocker Equip. Leasing, Inc. v. Department of Revenue*, 838 P.2d 552, 557 (Or. 1992); *Montana Dept. of Revenue v. United Parcel Service, Inc.*, 830 P.2d 1259 (Mt. 1992).

Although *Gulf Oil* did not specifically address the question of what burden of proof the taxpayer must meet to obtain factor relief under Section 18, it stands to reason that the hurdle is not as high as the burden of proving a constitutional violation. Magella contends (and concedes) that as a taxpayer requesting factor relief under Section 18 it bears the burden of proving by a preponderance of the evidence that use of the statutory apportionment formula does not fairly represent the extent of its business activity in Alaska. I agree.

The preponderance of evidence standard applies here for the following reasons. First, the statute governing tax appeals heard by the Office of Tax Appeals provides that the preponderance of evidence standard applies in resolving questions of fact unless a different standard is set by law. AS 43.05.435. Second, other states that have considered the question have held that the taxpayer must prove entitlement to Section 18 relief by a preponderance of the evidence. *Crocker Equip. Leasing, Inc. v. Department of Revenue*, 838 P.2d 552, 557 (Or. 1992).

C. The Three Factor Apportionment Formula Does Not Fairly Represent the Extent of the Taxpayer's Business Activities in Alaska.

Through a series of cases involving Section 18 of the Multistate Tax Compact, the Supreme Court of Oregon has thoroughly analyzed the requirements for Section 18 relief and has developed a framework for analyzing alternative apportionment methods. First, the party invoking Section 18 must demonstrate, by a preponderance of the evidence, that the statutory formula as a whole does not fairly represent the extent of the taxpayer's business activity in this state. Second, the requesting party must establish that its alternative method of allocating income is reasonable. Reasonableness in this context has three components: the method of apportioning income must reflect the economic reality of the taxpayer's business activity; must result in not more or less than 100 percent of the taxpayer's income being subject to tax, if applied uniformly; and must not foster lack of uniformity among taxing jurisdictions. *Crocker Equip. Leasing, Inc. v. Dept. of Revenue*, 838 P.2d 552, 557-558 (Or. 1992); *Twentieth Century-Fox Film v. Dept. of Revenue*, 700 P.2d 1035, 1042-1044 (Or. 1985).

Applying this analytical framework, the Oregon Supreme Court has permitted both the Department of Revenue and petitioning taxpayers to invoke Section 18 relief where the moving party established that the standard three-factor formula did not fairly apportion income given the particular nature of the taxpayer's business or unusual circumstances surrounding how the income was earned. In *Twentieth Century Fox-Film v. Dept. of Revenue,* 700 P.2d 1035 (Or. 1985), the Department of Revenue argued that the three factor formula did not fairly represent the film company's activities because the property factor captured only the minimal value of the tangible personal property (i.e. the film prints) that entered Oregon, not the substantially greater value of the film negatives. The Court found that the standard formula did not fairly reflect the extent of the taxpayer's activities in Oregon and that the alternative method proposed by the Department, which allocated the value of the films to Oregon based on gross receipts from the films was reasonable. *Id.* at 1043-1044.

Likewise, in *Crocker Equipment Leasing v. Dept. of Revenue,* 838 P. 2d. 552 (Or. 1992), the Court focused on the nature of the taxpayer's unitary business, and how the business earned its income, in concluding that the taxpayer was entitled to Section 18 relief. Crocker Equipment Leasing was engaged in the business of leasing and financing tangible personal property in Oregon but the company was 100% owned by Crocker National Bank. Because the business of the parent and other subsidiaries was banking, 98% of the income of the unitary business came from intangibles, which were not reflected in the property factor under the statutory apportionment formula. The Court held that the including only tangible property in the apportionment formula did not fairly represent the taxpayer's business activity in Oregon and that the taxpayer's alternative of including intangibles in the property factor was reasonable. *Id.* at 557-558.

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In this case Magella has clearly shown, by more than a preponderance of the evidence, that the practice management agreements it must use in states that prohibit Magella from owning medical practices present a unique business circumstance that the standard apportionment formula does not adequately address. It is undisputed that the net income that Magella earns under the practice management agreements is included in the total income of the multi-state business but the substantial payroll and property of the non-subsidiary medical practices that generate that income are excluded from the apportionment formula.

More specifically, as the Department has applied the statutory three-factor formula in this case, the numerator of the payroll factor includes the high salaries paid to the physicians and other medical personnel by Magella's Alaska subsidiary, ANA, but the denominator of the payroll factor excludes the high salaries of the physicians and medical personnel in the states where Magella operates under practice management agreements. As the Informal Conference Decision recognizes:

> "It is clear after examining Magella's Alaska factors that its payroll factors, on a percentage basis, are two to three times larger than its property and sales factors in each of the three years at issue. The relatively high payroll factors clearly had a material impact on Magella's overall Alaska factors and the amount of income attributed to this state. The relatively high payroll factors in Alaska result from compensation paid to specialized medical practitioners employed by Magella's subsidiary, ANI.
>
> Comparing the payroll expenditures incurred in Alaska by Magella's subsidiary to the salaries and compensation paid by Magella for its administrative and consulting staff in Texas, it becomes apparent why the disparity exists. Doctors specializing in a particular field of medicine command higher wages than administrative staff. Is is not uncommon for physician wages and compensation to represent a medical practice's largest expenditure."

Informal Conference Decision at 15.

Thus, the Department acknowledged in the ICD that a significant "disparity" in the payroll factor exists because the payroll factor does not reflect the high salaries of the specialized medical professionals in Magella's non-subsidiary medical practices outside Alaska. But the Department rejected Section 18 relief in the ICD on the grounds that the disproportionate payroll factor "did not amount to unfairness significant enough to warrant exercise of the Department's discretion under Section 18." ICD at 16. At the time of the informal conference, the only alternative methodology that Magella had requested was separate accounting. The Department relied on *Gulf Oil* in concluding that separate accounting was not more fair than use of the standard apportionment formula.

In these proceedings before OTA, Magella requests either separate accounting or the alternative of modifying the payroll, property and sales factors to include the factors of Magella's non-subsidiary medical practices that generate most of the total income of the combined group. And the Department does not adequately address whether Magella has made the requisite factual showing under Section 18 to obtain that type of factor relief.

The Department attempts to dismiss the evidence that application of the standard three-factor apportionment formula does not fairly represent the extent of Magella's Alaska business given the unusual business structure that is dictated by legal restrictions against Magella owning medical practices in other states. For example, the Department dismissively asserts "There is nothing particularly unusual about this case." (DOR Brief at 10) The Department also asserts that Magella was just a mere contractual service provider for the out of state medical practices and "Magella's novel contention that companies with which it had a mere contractual relationship should have been included in the unitary combined group is entirely without legal foundation." (Reply Brief at 3.)

The Department overlooks the undisputed evidence that shows this is an unusual case. Unlike most multi-state businesses, Magella's business structure is dictated by stringent state law restrictions on the practice of medicine. While Alaska and some other states permit Magella to conduct its business through wholly-owned subsidiaries, other states, such as California, require that Magella conduct its business through non-subsidiary medical practices that are controlled through practice management agreements.

The financial accounting profession has recognized the unique issues presented by multi-state medical practices like Magella's. In 1997, the Emerging Issues Task Force of the Financial Accounting Standard Board ("FASB") recognized that pervasive control exercised through practice management agreements can establish a controlling financial interest in a medical practice that is the equivalent to ownership for accounting purposes. It is highly significant that during the tax period at issue Magella was deemed to have a "controlling financial interest" in its non-subsidiary medical practices and required to include them in its audited financial statements DOR's insistence that Magella's physician practice management agreements are run of the mill service contracts is unreasonable in light of the FASB treatment of the PPMAs.

In addition, it is highly significant that Magella has done more than just show that use of the standard apportionment formula results in Alaska taxable income that is approximately 297% greater than Alaska income calculated on a separate reporting basis in the three years at issue. Instead of just relying on the quantitative difference between Alaska income calculated on a separate reporting basis and the income determined by formula apportionment, Magella has submitted undisputed evidence that the business activity of its Alaska subsidiary, ANA, remained virtually the same before and after acquisition by Magella but Alaska's tax claim based on apportioned income raised dramatically after the acquisition.

More significantly, Magella has established by undisputed evidence that the net income of the n out of state, non-subsidiary medical practices are included while the payroll and property factors of those practices are not represented in the standard formula as applied by DOR. It is unusual

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that the evidence establishes such a clear disconnect between the income being apportioned and the factors used to apportion it.

Magella has met its burden of proving by a preponderance of the evidence that the unusual facts of its multi-state business lead to an unfair reflection of its business activity in Alaska under the standard apportionment formula. Magella has met the first prong of the test for factor relief under Section 18.

In addition, Magella has met the second requirement for factor relief under Section 18. Magella has shown that the alternative methodology of including the factors of the non-subsidiary medical practices is reasonable. Under the test for reasonableness developed by the Oregon Supreme Court, the taxpayer must show that its alternative method of apportioning income reflects the economic reality of the taxpayer's business activity; results in not more or less than 100 percent of the taxpayer's income being subject to tax, if applied uniformly; and does not foster lack of uniformity among UDITPA jurisdictions. Based on this factual record, Magella easily meets all three requirements.

First, Magella's alternative of adding the payroll, property and sales of the non-subsidiary medical practices that it effectively owns through the practice management agreements is precisely designed to fit the economic reality of its multi-state business in that the non-subsidiary medical practices generate a substantial portion of the total income of the business but are not included in the apportionment formula as applied by DOR. Moreover, if all taxing jurisdictions used the methodology of including both the subsidiary and non-subsidiary medical practices in the unitary combined group for tax purposes, consistent with financial accounting treatment, 100% of the combined income would be subject to tax and uniformity among taxing jurisdictions would be promoted.

For these reasons, Magella has met the statutory requirements under Section 18 for factor relief and is entitled to modification of the statutory factors to include the payroll, property and sales of its non-subsidiary medical practices. On this evidentiary record, the Department's denial of factor relief is unreasonable and arbitrary.

C. Because Magella Is Entitled to Relief Under Section 18, It is Not Necessary to Decide Whether Application of the Three Factor Apportionment Formula Distorts the Taxpayer's Alaska Income in Violation of the Commerce Clause and Due Process Clause of the United States Constitution.

The Department argues that the first, and controlling issue, for decision is whether Magella has met the high burden of establishing by clear and convincing evidence that application of the standard apportionment formula in this case results in an unconstitutional distortion of Alaska income. The Department contends that as a matter of law it is not required to grant factor relief under Section 18 unless the constitution requires relief from the standard apportionment formula. The Department's position is flawed for the reasons explained above in Section B.

Having first determined that Magella is entitled to factor relief under Section 18, it is not necessary to decide whether use of the unmodified apportionment formula in this case violates the U.S. constitution and I will refrain from addressing the constitutional issues, consistent with sound principles of jurisprudence.[1]

Conclusion

For the reasons explained above, Magella is entitled to summary judgment on its claim for apportionment factor relief under Section 18 for tax years 1998, 1999 and 2000.

This is the final decision of the Administrative Law Judge under AS 43.05.465. Due to the fact that the current term of the undersigned ALJ ends before the time for filing motions to reconsider and no new appointment will be made in the near future, the Department may not request reconsideration of this decision.[2] Pursuant to AS 43.05.465 (f) this decision becomes final for purposes of seeking judicial review sixty days from the date of service.

Order

Based on the foregoing findings and reasons it is ordered that:

1. Summary judgment is entered in favor of the taxpayer.

2. The Department shall abate its assessment and refund income taxes overpaid by Magella for tax years 1998 through 2000, plus statutory interest.

Dated: January 2, 2004

[redacted]
Administrative Law Judge

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[1] It is noteworthy that Magella has shown by clear and convincing evidence that the standard three-factor formula, as applied in unmodified form by the Department, resulted in a substantial distortion in the Alaska income of ANA and that the distortion is attributable to the failure of the standard formula to take into account the factors, particularly the payroll, of the out of state non-subsidiary medical practices that generate much of the total income of the multi-state business. In addition, the quantitative distortion in this case is of a magnitude that has been held by the U.S. Supreme Court to violate the constitution. *Hans Rees' Sons, Inc. V. North Carolina*, 283 U.S. 123 (1931) (held 250% difference between the separate accounting result and the formulary apportionment result demonstrated that the income attributed to North Carolina under the state's property factor formula was "out all appropriate proportion to the business transacted" by a multi-state taxpayer that derived substantial income from non-property sources. Id. at 135-136.

[2] Foregoing a request for reconsideration should not be objectionable to the Department given the fact that in recent years the Department has consistently filed for judicial review without seeking reconsideration of decisions in which the taxpayer prevailed.

CERTIFICATE OF SERVICE

I certify that on JAN. 5, 2004, a true and correct copy of the Decision and Order Granting Summary Judgment to the Taxpayer was sent by first class mail, or inter-departmental mail, to:

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