BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of [Redacted], Petitioner.	)))))))))	DOCKET NO. 15101, 15102 & 15104 DECISION

On August 15, 2000, the Income Tax Audit Bureau of the Idaho State Tax Commission issued three Notices of Deficiency Determination proposing additional income tax and interest. One was issued to [Redacted] for the tax year ending 4/30/94. One was issued to each of [Redacted] and [Redacted], for tax years ending 12/31/93, 12/31/94, and 12/31/95. The total amount of the three notices was $394,787. The three companies, together with their parent and all sister corporations, are collectively referred to herein as the "taxpayer."

On September 25, 2000, three timely protests and petitions for redetermination were filed by the taxpayer. An informal conference was requested by the taxpayer and held on April 19, 2001.

The Tax Commission has reviewed the file, is advised of its contents, and hereby issues its decision affirming the Notice of Deficiency Determination. We hold that the taxpayer was a single unitary business during the years in issue.

Returns, audit, and protest proceedings

The taxpayer originally filed separate Idaho income tax returns for the three companies to which the Notices of Deficiency Determination have been issued. On those returns, separately computed carryovers of net operating losses cancelled out all income, and only the minimum tax was paid.

The Multistate Tax Commission (MTC) conducted a joint audit on behalf of Idaho and other states. The audit effort was begun in 1997, but the taxpayer did not admit the auditors to its office until December of 1998, and that office was not in the city from where the taxpayer had been managed during the years in question.

The taxpayer provided minimal information, declining to answer or document inquiries on unity. The taxpayer never provided a list of subsidiaries and the states in which they filed. The taxpayer provided the first four pages of its federal consolidated return only under threat of summons enforcement. The taxpayer never commented on the draft audit workpapers. Despite this course of conduct on its part, the taxpayer's representatives later wrote to the Idaho State Tax Commission that "many of the conclusions included in the MTC report may have been based upon incomplete information."

Using available information, the MTC concluded that the taxpayer is a single unitary business. The Idaho deficiencies are based on this audit.

The taxpayer's representatives at the informal conference were former employees of a company that was merged with the taxpayer in 1996. They disclaimed any personal knowledge of the taxpayer's operations during the audit period. However, they did agree that, if the company were a single unitary business, then the computations of income, factors, and tax in the audit would be correct.

Applicable law

Idaho Code § 63-3027(t) provides that two or more corporations may be considered a single corporation for income tax purposes, provided that more than 50% of the voting stock of each of them is owned directly or indirectly by a common owner or owners, and such treatment is necessary to accurately reflect income. The Idaho Supreme Court has interpreted this statute to require combined reporting by a unitary business. E.g., Albertson's, Inc. v. State, Dept. of Rev., 109 Idaho 810 (1984).

Unitary business is a concept of constitutional law under the Commerce and Due Process Clauses. A state may tax the multistate income of a nondomiciliary corporation if there is both a "minimal connection" between the interstate activities and the taxing state, and a rational relationship between the income attributed to the taxing state and the in-state value of the corporate business. A state need not attempt to isolate the in-state income producing activities from the rest of the business. The state may tax an apportioned share of the multistate business if the business is unitary. But the state may not tax the business's income that is "derived from unrelated business activity" or a "discrete business enterprise." Allied-Signal, Inc. v. Director, Div. of Tax., 504 U.S. 768, 772-773 (1992)(citations and internal quotation marks omitted); Albertson's, supra, 106 Idaho at 815 n.4.

Among the tests of unity is whether "the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state;" if it does, the business is unitary. Edison Cal. Stores v. McColgan, 30 Cal. 2d 472, 481, 183 P.2d 16, 21 (1947), quoted at 106 Idaho at 815. Another test asks "whether contributions to income result from functional integration, centralization of management, and economies of scale." F. W. Woolworth Co. v. Taxation & Rev. Dept., 458 U.S. 354, 364 (1982), quoted at 106 Idaho at 816.

If a unitary business is present, it is well established that arm's length pricing of transactions between segments of the business does not negate unity. Exxon Corp. v. Wisconsin Dep't of Rev., 447 U.S. 207, 226 (1980). The taxpayer here relies on federally enforced arm's length pricing of transactions between its regulated telecommunications system and its unregulated subsidiaries as the main support for its position that there is no unity between those two sides of its business. The taxpayer's argument proves too much. If it were accepted, then a regulated telecommunications company could never be unitary with any company in another type of business, no matter how strong the business ties and central management. No constitutional case has so held.

In 1965, Idaho adopted with slight modification the Uniform Division of Income for Tax Purposes Act (UDITPA), Idaho Code § 63-3027. The Act contains a formula for determining the portion of a corporation's total income from a multistate business which is attributable to Idaho and therefore subject to Idaho's income tax.

Combined reporting is a refinement of the apportionment principle. Its purpose is to permit application of the UDITPA apportionment formula to a single business enterprise that is conducted by means of separately incorporated entities. In an economic sense, such a business is no different from a similar business composed of a single corporation with several separate divisions. For tax reporting, such businesses should be treated the same. Combined reporting can be required only in the case of a unitary business. When the Tax Commission has found that a subsidiary is part of the taxpayer's unitary business, then the taxpayer has the burden of proving that the finding is incorrect. Albertson's, supra, 106 Idaho at 814-815. Here, the auditors have so found, and the taxpayer has the burden of disproving the finding.

Facts and analysis

Business overview

The taxpayer is [Redacted] in 1984. The taxpayer owns former [Redacted] operating companies (BOCs), all of which operate outside Idaho. The BOCs cover certain Local Access and Transport Areas ("LATAs"), within which the BOCs offer local and toll "intraLATA" service. The Federal Communications Commission (FCC) regulates the BOCs as to their interstate activities. Outside companies, such as [Redacted]and [Redacted], provide "interLATA" or long distance service to the BOCs' customers.

Unity of the telecommunications business

In 1993, the taxpayer reorganized its operations from a geographic emphasis to an emphasis on customer type. The lines of business or "LOBs" include consumer, carrier service (connections for long distance companies), small business, large business, directory, public and operator (pay phones), and federal systems. The LOBs function across the separate legal entities of the BOCs. There is a Network LOB that manages the hardware, software, installation and maintenance of the phone network across all the LOBs. It is self-evident that a telephone network, like a railroad, must be interconnected so that each customer can dial every other customer. This fact, plus the existence of the Network LOB, establishes functional integration and economies of scale within the telecommunications subgroup of the taxpayer.

The taxpayer has been introducing enhanced calling features, such as voice mail; answering service; a feature that allows a given phone line to answer multiple phone numbers, each number ringing differently; busy redial; return call; call forwarding; and home intercom. Most of the taxpayer's BOCs offer these services under a common, system-wide brand name.[1]

A subsidiary within the telecommunications subgroup of the taxpayer sells customer premises equipment (CPE) to residential and small business customers and [Redacted] to a variety of business customers.[2]

There is a wholly owned subsidiary of the ultimate parent that is a network services company (NSC). The NSC provides central planning, marketing, procurement, financial, legal,

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[1] 1993 form 10-K, page 16.

[2] 1993 form 10-K, page 22.

accounting, technical support, and other management services to the taxpayer's BOCs. The NSC has a funding subsidiary that provides short term financing and cash management services to the BOCs.[3] These centralized services reinforce the unity within the telecommunications subgroup of the taxpayer.

The taxpayer also has joint venture subsidiaries engaged in cellular, PCS, and wireless.

The taxpayer's telecommunications companies are all in the same line of business. They are horizontally integrated, with central services providing economies of scale. This is a classic unitary communications business.

When asked at the informal conference if the taxpayer has a position on whether the communications side of its business is unitary, the taxpayer's representatives claimed not to know. Their written response on June 26th was an answer to an entirely different question that was not asked, i.e., whether the Idaho taxpayers were unitary with the communications companies.

<u>Unity within the leasing subgroup of companies;</u>

<u>disposition of leasing companies</u>

In 1984, the taxpayer purchased a leasing company, renaming it with the taxpayer's name.[4] In 1986, the taxpayer acquired a capital company.[5] The taxpayer's board minutes in 1991 show a decision to reduce in an orderly manner the taxpayer's financial services business, and a public announcement to this effect was made in 1993.

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[3] 1993 form 10-K, page 23.

[4] Press release of an unrelated company (April 24, 2000)(provided by state of Utah)(hereinafter cited as "press release").

[5] 1993 form 10-K, page F-3.

A capital company is the parent of the largest of the taxpayer's leasing companies. In 1986, the founder of the acquired leasing company became CEO of the capital company.[6] The capital company provides administrative functions, including data processing, accounting, legal, tax, human resources and office management, to the leasing company, which in turn provided similar services to other equipment leasing affiliates.[7] The large leasing company is a financier and lessor of office, medical, and other equipment sold by many vendors. "In addition, [the leasing company] provides leasing of [customer premises equipment] to customers of other [taxpayer] companies . . . ."[8]

The leasing company does business in Idaho and filed separate Idaho returns.

A leasing capital company was a big ticket lessor of airplanes and ships. It was organized in 1993 for the sole purpose of transferring nonleveraged leases to the large leasing company. In 1993, the taxpayer filed a registration statement for an initial public offering of the leasing capital company,[9] but this offering was apparently never consummated. The leasing capital company filed a separate Idaho return for the short period ended 4/30/94.

From the foregoing, we conclude that the large leasing company, its immediate parent capital company, and the leasing capital company are a unitary subgroup. They are in the same line

[6] Press release.

[7] Letter from taxpayer to Oregon Dept. of Revenue, page 3 (March 13, 2001).

[8] 1993 form 10-K, page 23. This directly contradicts the letter sent by the taxpayer's representative, at pages 2 and 5 (June 26, 2001): "The leveraged leasing companies were not in the business of leasing telephone equipment. They were in the business of leasing large value assets such as airplanes, ships, power plants, etc. The leasing companies had no connection to the telephone business or to [the taxpayer's telephone] customers." See similar language sent to Utah (April 30). This discrepancy is significant and undermines the credibility of the taxpayer's representatives.

[9] 1993 annual report, pages 8 and 39.

of business (leasing), and use central services. The leasing capital company and the large leasing company are unitary because the former transferred leases to the latter.

In 1994, the taxpayer sold the assets of the large leasing company, except for leveraged lease and project finance portfolios.

<u>Unity within the computer maintenance subgroup of companies;</u>

<u>disposition of those companies</u>

The taxpayer's business systems services company provides hardware and software maintenance, network support, disaster recovery, and other services for more than 5,000 makes and models of computer equipment and associated peripherals. It operates from over 200 locations in the United States and Canada.[10] It filed separate Idaho returns.

It has a computer technology division that provides parts, repair, and refurbishment services to end users, manufacturers, and service companies throughout the world.

An international business systems company provides computer maintenance and other end user computer services in Europe, through companies that are jointly owned with a third party. It provides services in Australia and New Zealand through a partnership with a company based there.[11]

The taxpayer sold the business systems services subsidiary plus some European computer maintenance operations in 1995. The sold businesses had annual revenues in the range of $400 million and 4,100 employees as of the end of 1994.[12]

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[10] 1993 annual report, page 4.

[11] 1993 form 10-K, page 22.

[12] 1995 form 10-K, pages 104 and 113 of 162.

An international enterprises subsidiary provides administrative services to the business systems services company.[13] According to 1993 board minutes, the former was a high-level holding company for a line of business, which would be the computer maintenance group.

The auditors did not find specific evidence of unity within the computer maintenance business. But given the evidence as to the rest of the taxpayer's operations and the taxpayer's legal burden of disproving unity, the absence of evidence of lack of unity points to a unitary result as to the computer maintenance subgroup.

Unity among non-telecommunications companies

A financial services company provides financing and cash management services to non-telecommunications companies.[14] It issues medium term notes, which are guaranteed by the ultimate parent. Holders of the financial services company's notes do not have recourse to the stock or assets of the taxpayer's telephone subsidiaries.[15] Audit schedules show that in 1995, the large leasing company owed $173,400,000 to the financial services company; nontelephone subsidiaries owed $622,871,540 to the financial services company.

Given the centralized financing of non-telecommunications companies, we conclude that the non-telecommunications companies (including leasing and computer maintenance) are unitary among themselves.

Unity between the telecommunications

and non-telecommunications subgroups of the taxpayer

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[13] Letter from taxpayer to Oregon, page 4 (March 13, 2001). In the June 26 letter to Idaho, the taxpayer's representative states at page 2 that the enterprises company "merely provided management oversight on behalf of" the business systems services company.

[14] 1993 form 10-K, page 23; 1995 form 10-K, page 12 (page 15 of 162 of SEC download).

[15] 1995 form 10-K, page 134 of 162.

We now reach the key unitary issue in this audit. Are the non-telecommunications subsidiaries that operate in Idaho, unitary with the telecommunications subgroup of the taxpayer? Unfortunately, the MTC audit contains information that mostly supports unity within the telecommunications group, and lumps non-telecom subs as "other," so only a few specifics on the leasing and computer maintenance companies are known.

There is extensive overlap of parent company officers with subsidiary boards and officers. There is parent supervision of capital expenditures over $5 million. In 1991, board minutes show a company-wide ethics compliance program.

In 1995, 51 people transferred from regulated to nonregulated companies, and 29 transferred in the other direction. The taxpayer, in its letter of June 26, 2001, denied that any transfers occurred between business systems services and network services.

Although the taxpayer's representatives repeatedly argue that the network services company (NSC) only provided services within the telecommunications subgroup, published statements show that the NSC provides "certain corporate services . . . on a centralized basis" to non-telecommunications companies.[16] The MTC obtained a schedule showing how the NSC's costs were allocated out across both telecommunications and non-telecommunications companies in 1993. The NSC charged $4,268,418 to the large leasing company in 1993, the largest item of which was for accounting services.

A Delaware investment holding company invests all excess cash of the taxpayer. Its portfolio was in the $300 million range. It is the parent of the financial services company mentioned above. The MTC audit file contains an electronic mail from a taxpayer employee that states the foregoing facts. But on June 26, 2001, the taxpayer's representative wrote to Idaho that

[16] 1993 form 10-K, page 23.

the investment company does not invest the excess cash of either the business systems services company or the large leasing company "since [the investment company] is in a borrowing position."[17] This contradiction between evidence from an operating employee and the taxpayer's tax department raises concerns about accuracy.

As mentioned above, the largest company in the leasing subgroup leases customer premises telephone equipment to the taxpayer's telephone customers. The common customer base shows that operational strategies and knowledge are shared between the two groups. We conclude that the leasing subgroup is unitary with the communications subgroup.

As to the computer maintenance group, the taxpayer's representative stated that a schedule of intercompany transactions of the computer maintenance group for 1995 "is unavailable"[18] and "cannot be located."[19] Again, given the nature of available evidence as to the rest of the taxpayer's companies and the taxpayer's legal burden to disprove a unitary finding, we conclude that that burden has not been met. The computer maintenance subgroup is unitary with the telecommunications subgroup.

The taxpayer emphasizes that the FCC enforces detailed rules and "separations procedures" to keep accounting records separate as between interstate services subject to FCC regulation, and local services subject to state public utility commission (PUC) regulation, on the one hand; and between regulated and unregulated businesses, on the other hand. The latter rules require that transactions between the two sides must be at "market prices," or if market prices are not available, at either cost or market in a manner to minimize shifting of costs from the

[17] Letter at page 3, items # 11 & # 12.

[18] June 26 letter, page 3, item #10.

[19] Same, page 4, item # 13.

unregulated side to the regulated side. The taxpayer adopted a cost allocation manual, which was approved by the FCC. State PUCs are free to employ different rules as to intrastate accounting.

It is well established that market pricing between segments of a unitary business does not detract from unity if the underlying integration is present. Here, the FCC-mandated pricing rules do not detract from the functional integration, centralized management, and economies of scale that the evidence otherwise shows. The taxpayer has failed to carry its burden of disproving the auditors' finding of unity by clear and cogent evidence.

Conclusion

WHEREFORE, the Notices of Deficiency Determination dated August 15, 2000, are hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayer pay the following tax and interest (computed through December 5, 2001) for:

[Redacted] (interest accrues at $42.79 per day)

YEAR	TAX	PENALTY	INTEREST	TOTAL
12/31/93	$ 11,274	$0	$ 6,922	$ 18,196
12/31/94	143,922	0	76,461	221,383
12/31/95	987	0	461	1,448
			TOTAL DUE	$241,027

[Redacted] (interest accrues at $6.58 per day)

YEAR	TAX	PENALTY	INTEREST	TOTAL
12/31/93	$ 3,707	$0	$2,277	$ 5,984
12/31/94	17,375	0	9,351	26,7261
12/31/95	3,000	0	1,400	4,400
			TOTAL DUE	$37,110

[Redacted] (interest accrues at $24.30 per day)

YEAR	TAX	PENALTY	INTEREST	TOTAL
04/30/94	$88,693	$0	$52,411	$141,104
			TOTAL DUE	$141,104

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the taxpayer's right to appeal this decision is enclosed with this decision.

DATED this ___ day of ______, 2001.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of ________________, 2001, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[REDACTED] Receipt No. [Redacted]

ADMINISTRATIVE ASSISTANT 1