

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 15329
[Redacted],)	
)	DECISION
Petitioner.)	
)	
)	

On November 21, 2000, the Income Tax Audit Bureau of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] (the “taxpayer”), proposing additional income tax and interest for tax years ending 09/29/95, 09/27/96, and 10/03/97 in the total amount of \$68,287. This deficiency was based on an audit of the taxpayer by the Multistate Tax Commission.

On January 11, 2001, a timely protest and petition for redetermination was filed by the taxpayer. An informal conference was requested by the taxpayer and held on May 17, 2001.

The Tax Commission has reviewed the file, is advised of its contents, and hereby issues its decision affirming the Notice of Deficiency Determination. The issues for decision are the treatment as business or nonbusiness income of gain on the sale of a division and gain on the sale of stock received as partial consideration for the sale of the division. The Tax Commission holds that both of these gains are business income.

Facts

The taxpayer is an employee-owned cluster of service businesses. Its parent was formed by management when they did a leveraged buyout of the taxpayer. One of the lines of business is the renting, selling, cleaning, maintenance, and delivery of uniforms, public safety equipment, mats, cloths, towels and similar items, and the direct marketing of these items. The taxpayer has a history of acquiring smaller companies in this line of business, including three such companies during this audit period.

In 1992, the taxpayer acquired a direct mail retailer of work clothes and uniforms. That retailer had a division that specialized in large-size uniforms. In FYE 1996, the taxpayer sold this large-size division to a retailer partnership that specializes in large-size clothing.

Part of the consideration for this sale was warrants to purchase partnership interests in the buyer. The buyer converted to a corporation and went public. In FYE 1997, when SEC restrictions on sale of the taxpayer's stock in the buyer expired, the taxpayer sold that stock.

Another line of business is health care management, specifically general management and specialized services to emergency rooms; other hospital specialties; and medical services to correctional institutions. In FYE 1997, the company sold an approximate 83% interest in its subsidiary that provides these services.

The taxpayer has historically filed "nexus combination" returns in Idaho. These returns combine only the taxpayer's subsidiaries that operate in Idaho or are qualified to do business in Idaho. The returns for the audit period showed losses. As a result of this filing method, in years before the audit period, the income and factors of the large-size division were not included in the returns.

The auditors combined the taxpayer with its parent and all of its subsidiaries in which it had greater than 50% ownership. This caused the disputed gains on the large-size division and the buyer stock to be included in the tax computation. The auditors treated the gains as business income.

The taxpayer has not protested the combination and has not claimed that the gain on the sale of the 83% of the health care subsidiary was nonbusiness income.

The taxpayer claims that the gains on the large-size division and the buyer stock are nonbusiness income. The protest argues that the nexus combination filing method in past years denied the taxpayer an Idaho tax benefit from the apportionment factors of the sold division, and

hence it is unfair to tax the taxpayer on the gain on the sale of that division.

Law and Analysis

Idaho Code § 63-3027 provides in pertinent part as follows:

§ 63-3027. COMPUTING TAXABLE INCOME OF CORPORATIONS.

The Idaho taxable income of any corporation with a business situs in this state shall be computed and taxed in accordance with the rules set forth in this section:

(a) As used in this section, unless the context otherwise requires:

(1) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitute integral or necessary parts of the taxpayer's trade or business operations. Gains or losses and dividend and interest income from stock and securities of any foreign or domestic corporation shall be presumed to be income from intangible property, the acquisition, management, or disposition of which constitute an integral part of the taxpayer's trade or business; such presumption may only be overcome by clear and convincing evidence to the contrary. . . .

(4) "Nonbusiness income" means all income other than business income.

...

The taxpayer argues that it is not regularly in the business of disposing of lines of business, and that in such a case, any gain on disposition of a line of business cannot be business income. This argument reflects a long-running debate in state tax circles over whether the quoted definition of business income contains a so-called functional test, or more specifically, whether the words following "and includes" establish a separate test for business income from the words preceding those two words. The Idaho Supreme Court has read the quoted definition

to answer that question in the affirmative. *American Smelting & Refining Co. v. Idaho St. Tax Comm.*, 99 Idaho 924, 931-932, 592 P.2d 39, 46-47 (1979), *rev'd on other grounds*, 458 U.S. 307 (1982). Thus, even if the sales of the division and the stock are not transactions in the regular course of the taxpayer's trade or business (a question that we need not decide), they may still generate business income under the functional test.

More specifically, "income from the . . . disposition of tangible and intangible property" is business income "when such . . . disposition constitute[s an] integral or necessary part[] of the taxpayer's trade or business operations." Here, the disposal of a division is a disposal of both tangible and intangible property, and the sale of stock is a disposal of intangible property. The words "integral or necessary" mean not absolutely essential to, but contributing to and identifiable with, the taxpayer's trade or business operations. *Id.*, 99 Idaho at 932, 592 P.2d at 46. It is the taxpayer's burden to disprove that link.

One thrust of the functional test is to treat as business income the gain on sale of assets that produced business income in the past. Here, there is no evidence that the income of the sold division would have been nonbusiness income in the past, had the taxpayer filed correctly in Idaho. The taxpayer's incorrect nexus combination filing method presumably saved it considerable amounts of Idaho taxes, and it should not further take advantage of its own wrong to claim lack of a previous Idaho tax benefit from the division's apportionment factors.

The court cases in other states that have treated dispositions of businesses as generating nonbusiness income have all involved complete terminations of a line of business or a liquidation of a company. Here, the taxpayer continues in the uniform business after the sale of the large-size division. Treatment of the gain on sale of the division as business income is consistent with the taxpayer's conceded treatment of the gain on sale of part of its medical services subsidiary as

business income. We conclude that the disposition of the large-size division generated business income.

As to the sale of the buyer stock, the Legislature has added a sentence to § 63-3027(a)(1), as follows: “Gains . . . from stock . . . of any foreign or domestic corporation shall be presumed to be income from intangible property, the acquisition, management, or disposition of which constitute an integral part of the taxpayer's trade or business; such presumption may only be overcome by clear and convincing evidence to the contrary.” Here, although the gain on the stock is a candidate for nonbusiness treatment (see our decision in Docket No. 13857), the taxpayer has offered no documentation of the kind that would support such treatment.

Turning to the U.S. Constitution, the permissible reach of Idaho and other states in taxing an apportioned share of corporate income under the statute is restricted by the Commerce Clause and by the Due Process Clause of the Fourteenth Amendment. These clauses have been interpreted by the U.S. Supreme Court to require that even if income may be business income under a state statute, the state may only tax the multistate or foreign income of a nondomiciliary corporation if there is both a “minimal connection” between the interstate or foreign 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 or multinational business if the business is unitary. But the state may not tax the business' 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, Inc. v. State, Dept. of Rev.*, 106 Idaho 810, 815 n.4 (1984).

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 of unity 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. Again, the burden is on the taxpayer to disprove unity.

Here, there is no evidence that the sold division was not part of the taxpayer’s unitary business. It was a portion of a uniform business that predated and continued after the division was sold. In the absence of evidence of unusual circumstances, we find the gain to have been part of the unitary business.

The U.S. Supreme Court has stated that even if the source of the income is not part of the unitary business, a state can apportion and tax the income if the source of the income has or performs an “operational function” of the unitary business. *Allied-Signal, Inc. v. Director, Div. of Tax.*, 504 U.S. 768, 785 (1992). The Court stated:

We agree that the payee and payor need not be engaged in the same unitary business as a prerequisite to apportionment in all cases. *Container Corp. [of America v. Franchise Tax Bd.]*, 463 U.S. 159 (1983) says as much. What is required instead is that the capital transaction serve an operational rather than an investment function. ... Hence, in *ASARCO [Inc. v. Idaho State Tax Comm.]*, 458 U.S. 307 (1982) although we rejected the dissent’s factual contention that the stock investments constituted “interim uses of idle funds ‘accumulated for the future operation of [the taxpayer’s] business [operation],” we did not dispute the suggestion that had that been so the income would have been apportionable.

504 U.S. at 787 (citations truncated). Earlier in the opinion, the Court said:

[T]he question [is] whether in pursuing maximum profits [the taxpayer] treated particular intangible assets as serving, on the one hand, an investment function, or, on the other, an operational function. . . . That is the relevant unitary business inquiry, one which focuses on the objective characteristics of the asset’s use and its

relation to the taxpayer and its activities within the taxing State. . . .

504 U.S. at 785 (citations omitted).

Here, there is no evidence to negate that the sold division performed an operational function of the unitary business. And although the gain on the stock is again a candidate for nonapportionability under the foregoing constitutional tests, the taxpayer has presented no evidence to support that treatment.

Conclusion

WHEREFORE, the Notice of Deficiency Determination dated November 1, 2000, is hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayer pay the following tax and interest (computed through 9/21/01) (interest runs at \$11.21 per day):

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
09/29/95	\$23,282	\$0	\$10,595	\$33,877
09/27/96	14,122	0	5,300	19,422
10/03/97	13,755	0	3,909	<u>17,664</u>
			TOTAL DUE	<u>\$70,963</u>

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