

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 16122
[Redacted])	
Petitioner.)	DECISION
)	
_____)	

On August 30, 2001, the Income Tax Audit Bureau of the Idaho State Tax Commission issued a Notice of Deficiency Determination to (“taxpayer”), proposing additional income tax and interest for tax years ending 12/31/94, 12/31/95, and 12/31/96 in the total amount of \$10,784. The audit was conducted for Idaho by the Multistate Tax Commission.

On October 29, 2001, a timely protest and petition for redetermination was filed by the taxpayer. An informal conference was requested by the taxpayer and held on February 28, 2002.

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: (1) whether the taxpayer and its affiliates constituted a unitary business during the years in issue; (2) whether Idaho may apportion royalties earned from foreign countries; and (3) whether Idaho may apportion interest earned from foreign affiliates. The Tax Commission answers all three questions in the affirmative.

FACTS

Unitary Issue

The taxpayer is the only domestic subsidiary of a U.S. parent holding company that is publicly traded. The taxpayer and its subsidiaries manufacture: [Redacted] The first line of business is domestic, relying on exports for foreign sales. The second line of business is both domestic and foreign, with sourcing of parts from Mexico for U.S. sales. The third line of business

primarily operates in foreign countries, selling to foreign vehicle makers, but also has “a leading presence in the U.S.”¹ through a joint venture in the U.S. It is the taxpayer’s consistent practice over time to expand into new countries by first teaming with local joint venturers. For the most part, the taxpayer and its subsidiaries sell products within the countries in which they are manufactured.

The taxpayer’s 1996 form 10-K filed with the Securities and Exchange Commission, after first describing the three lines of business, highlights a so-called [Redacted] as a proprietary management technique that it applies to all of its businesses. This technique incorporates just-in-time production, with quality control integrated into each step of manufacturing. As of 1996, “most of [the taxpayer]’s approximately 44,000 employees worldwide have been trained in [Redacted], which has been implemented in substantially all of [the taxpayer]’s production facilities.” The method has generated impressive reductions in cycle time and working capital, and strong increases in inventory turnover on a consolidated basis over time. Page 1 of the annual report for 1996 lists [Redacted] as “our core competence.”

Page 8 refers to “a multi-lingual cadre of in-house trainers around the globe,” and to “[taxpayer] College, located at our corporate headquarters,” which provides specialized training in [Redacted]. “[Redacted] is the defining culture of our company.”

Page 1 of the annual report refers to the taxpayer’s practice of using foreign joint ventures and [Redacted], and states:

These methods have allowed us to start new businesses with minimal up-front capital at risk while *maintaining operating control*.... Our approach combines local marketing and distribution expertise with [the taxpayer]’s brand names, vast practical experience, training skills, [Redacted] competence, technological leadership and capital resources.

(Emphasis added.)

¹ 1996 annual report, page 7.

The report states at page 4 that air conditioning customers “doing business in two or more regions of the world can rely on consistent quality, standards, performance and service for their indoor environment needs.”

In Europe, the plumbing line of business has the same office as the automotive line. There is a Delaware subsidiary whose name incorporates the trade marks of all three of the lines of business. A Brazilian subsidiary engages in both the plumbing and automotive businesses. A Canadian subsidiary engages in both the plumbing and air conditioning businesses.

Most subsidiaries, including the foreign, have the same slate of officers and directors for the most part. The parent lends to foreign subsidiaries where foreign banking markets are closed to competition; thus, the parent provides economies of scale in borrowing. The company sponsors pension plans covering substantially all employees worldwide.

On the other hand, foreign manufacturing is performed under trademarks similar but not identical to those in the U.S. Foreign technical specifications differ from those in the U.S., in such respects as materials, sizes and styles, pipe sizes and fittings, electrical voltage and frequency, environmental compliance, noise output, and safety and quality certifications.

[Redacted] of the taxpayer in Idaho is supported by sales representatives who solicit sales for the air conditioning and plumbing divisions. [Redacted] is not protested.

Royalties

The taxpayer receives royalties from its foreign subsidiaries. A royalty agreement with an Italian subsidiary gives the Italian company the right to use Italian patents, trademarks, inventions, designs, models, manufacturing know-how, and other intellectual property that the taxpayer developed in the U.S. related to plumbing fixtures and fittings.

The Italian agreement also provides for the taxpayer to provide technical and marketing services to the Italian company, including travel by U.S. employees of the taxpayer to Italy.

In return for the right to use and services, the Italian company is to pay a royalty of 2% of its net sales of specified products.

An agreement with a British subsidiary is essentially similar to the Italian agreement just described, but it also contains a license for the Demand Flow technology discussed above. It permits the licensee company to sell products “on behalf of [the taxpayer]” in 22 countries, including the U.S. A second British agreement (apparently a draft because it has changes marked by hand and is unsigned) deals with trademarks for air conditioning products.

The taxpayer also provided a copy of a trademark license agreement for braking systems. It covers trademarks registered in many countries.

The taxpayer’s rationale for claiming the royalties as nonbusiness income is that the payor companies are not part of the unitary business.

Interest Income

The taxpayer receives interest income from its foreign subsidiaries and affiliates. It offers more favorable terms and conditions than local financial institutions where foreign banking markets may be closed to lending competition. The taxpayer, because of its familiarity as an equity holder with the borrower’s business, is willing to lend without security. Interest rates are those prevailing in the international money markets, not the “artificially high local bank rates.”

Again, the taxpayer’s rationale for claiming the interest as nonbusiness income is that the payor companies are not part of the unitary business.

LAW AND ANALYSIS

Unitary Combination

Idaho Code § 63-3027(t) provides that two or more corporations may be considered a single corporation for income tax purposes, provided 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). The taxpayer does not dispute that the ownership requirement is satisfied here.

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’ 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.

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.

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 operations are unitary.” *Edison Cal. Stores v. McColgan*, 30 Cal. 2d 472, 481, 183 P.2d 16, 21 (1947), *quoted at* 106 Idaho at 815. Here, the domestic taxpayer, operating in Idaho, contributes intellectual property, financing at rates below local markets, and Demand Flow technology, to the foreign subsidiaries; it, therefore, contributes to them.

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. Here, the annual report admits that the taxpayer “maintain[s] operating control” over its foreign ventures. Demand Flow Technology, the taxpayer's “core competence,” is applied worldwide. These traits show centralization of management and functional integration.

Accordingly, the Tax Commission finds that the taxpayer was engaged in a unitary business during the years in issue, and is, therefore, required to file a combined report.

Business Income

Idaho Code § 63-3027 provides in pertinent part as follows (bracketed letters added):

§ **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 [A] transactions and activity in the regular course of the taxpayer's trade or business and includes [B] 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 phrases in the quoted passage that are introduced by the bracketed [A] and [B] have been interpreted to embody two separate tests for business income. *Union Pacific Corp. v. Idaho State Tax Comm.*, 136 Idaho 375, ___, 28 P.3d 375, 379-80 (2001). For convenience, practitioners refer to the test labeled [A] as the transactional test, and the test labeled [B] as the functional test.

Here, the taxpayer regularly creates intellectual property and licenses it out to related parties. It also regularly lends to its subsidiaries and affiliates at more favorable terms than those

borrowers could obtain in their local countries. The royalties and interest are business income under the transactional test in the Code.

The permissible reach of Idaho and other states in taxing an apportioned share of corporate income under the quoted statute is restricted by the Commerce Clause of, and the Due Process Clause of the Fourteenth Amendment to, the U.S. Constitution. 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).

Here, the taxpayer and its foreign subsidiaries and affiliates are engaged in two lines of business, labeled (A) and (B) at the outset of the factual portion of this decision. The commonality of the lines of business supports the inference that the taxpayer’s operational expertise is being shared. This is reinforced by the intellectual property licenses. As to the third line of foreign business, labeled (C) above, unity is reinforced by Demand Flow Technology and below-market lending.

The taxpayer has not proven by “clear and cogent evidence,” e.g., *Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 164 (1983), that unitary ties are absent between the taxpayer and the foreign subsidiaries.

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). Having disposed of the case on grounds of unity, it is unnecessary to address the operational function test.

Conclusion

WHEREFORE, the Notice of Deficiency Determination dated August 30, 2001, is hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayer pay the following tax, penalty, and interest (computed through 10/11/02)(interest runs at \$1.05 per day):

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
12/31/94	\$ 0	\$0	\$ 0	\$ 0
12/31/95	1,806	0	923	2,729
12/31/96	6,006	0	2,572	<u>8,578</u>
			TOTAL DUE	<u>\$11,307</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 _____, 2002.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _____, 2002, 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