BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 16503
[REDACTED]	)	
Petitioner.	)	DECISION
	)	
	)	

On February 21, 2002, the Income Tax Audit Bureau of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] (taxpayer), proposing additional income tax and interest for tax years ending 12/31/97, 12/31/98, and 12/31/99 in the total amount of $227,231.

On April 9, 2002, a timely protest and petition for redetermination was filed by the taxpayer. An informal conference was requested by the taxpayer and held on July 11, 2002. A single issue is raised as to each of a number of dispositions of the taxpayer's corporate assets: Were the gains and/or losses on such dispositions business income within the meaning of Idaho Code § 63-3027(a)(1)? To the extent this question is answered in the affirmative as to a particular transaction, the Tax Commission also considers the issue of whether Idaho may, consistently with the Commerce and Due Process Clauses of the U.S. Constitution, tax an apportioned share of the gain and/or loss in question.

The Tax Commission has reviewed the file, is advised of its contents, and hereby issues its decision modifying the Notice of Deficiency Determination.

Facts

The taxpayer is a multinational pharmaceutical and health care products company, with whose subsidiaries and affiliates it conducts a unitary business. In each year of the audit period, it filed a combined return in Idaho as a single unitary group, including the income and apportionment factors of all U.S. and foreign companies in which the parent company, directly or indirectly, owns more than 50%. Since there is no dispute as to the composition of the unitary group, for convenience in this decision, the term "taxpayer" will be used as shorthand for the unitary group members that are included in the combined filing. Activities described below as those of the taxpayer include the activities of majority owned subsidiaries that have been acquired by the taxpayer over time. Corporations in which the taxpayer had an ownership interest are referred to by pseudonyms in **bold type.**

The taxpayer has a history of disposing of assets. The history of such dispositions before the disputed audit period is relevant to establish the regular course of the taxpayer's trade or business.

Dispositions of wholly owned subsidiaries

Businesses referred to in this subheading were wholly owned corporate subsidiaries of the taxpayer before being divested. The taxpayer included the income of the divested companies in business income, and included their property, payroll, and sales in the combined apportionment factors, during the period of its ownership.

In 1993, the taxpayer spun off to its shareholders the common stock of **A**, into which the taxpayer had previously placed certain businesses that it chose to discontinue. The taxpayer retained redeemable preferred stock of **A**, two classes of which were redeemable starting in 1998 and a third class of which was redeemable starting in 1999. The taxpayer and **A** agreed that the taxpayer would provide certain services and products to **A** at arm's length prices, as is common after a spinoff.

In 1994, the taxpayer was acquired by another company for cash, financed by debt. The acquiring company announced its intention to pay down the acquisition debt as quickly as possible, using cash flow from cost savings and proceeds of sales of its own and the acquired company's businesses that the acquirer regarded as "non-core." The acquirer and the acquired company began filing a single combined income tax return with Idaho starting with the 1995 year. The service contracts with **A** were discontinued.

In 1994, the taxpayer acquired **B**, a surgical tool and device company, which was added to the taxpayer's existing central treasury and cash sweep functions. After the acquisition described in the preceding paragraph, the taxpayer immediately put **B** on the block, and it was sold in a transaction that was treated as an asset sale under Internal Revenue Code (IRC) § 338(h)(10).

Before the 1980s, the taxpayer produced and sold a line of oral health products, but exited that business in the 1980s, retaining its pharmaceutical businesses. The taxpayer retained the stock of **C**, an oral health company that did all of its business in another continent. In 1995, the taxpayer sold the **C** stock and, as a result, no longer did any oral health business.

In 1995, **A** redeemed from the taxpayer the two classes of preferred stock that were originally not redeemable until 1998.

In 1995, the taxpayer sold **D**, which produced veterinary products.

In 1996, the taxpayer sold 80% of **G**, which was in the food business. The taxpayer retained a 20% interest in **G**, which became a closely held subsidiary of an investment group. In 1997, the investment group did an initial public offering of **G**, and the taxpayer sold an additional 5% of **G** in an installment transaction, generating annual gains starting in 1997. The taxpayer emphasizes its minority interest and argues that the 1997 transaction "was an extraordinary circumstance and clearly was not done in the normal course of business."

In 1996, the taxpayer sold **H**, which produced surgical products.

In 1997, the taxpayer sold **I**, an inactive subsidiary, the sole asset of which was abandoned real property. This sale generated a loss.

In 1998, the taxpayer sold **J** and **K**, which made medical supplies and devices. The taxpayer calls this a "divestiture of an entire line of business." Also in 1998, the taxpayer sold **L**, a subsidiary that made contraceptives. This is described as "the complete sale of the contraceptive line."

In 1999, the taxpayer sold **M** and **N**, which made capsules for drugs. Again, this is a "divestiture of an entire line of business."

<u>Sales of minority interests</u>

The taxpayer has a history of buying stakes up to 10% in companies engaged in various aspects of medical, veterinary, and biotechnology research and development, most of which are publicly traded. After holding periods of two to fifteen years, the taxpayer has sold the stakes. Six such sales occurred in the 1993-1996 period. In the 1997-1999 period, the exact number of such sales has not been specified. In addition, the taxpayer in the 1997-1999 period has claimed as nonbusiness income its gains and/or losses on an unspecified number of sales of small interests in stock, whose business is not specified. The argument is that "buying and selling of stock is not a normal or integral part of Taxpayer's business."

In 1994 and 1995, the taxpayer contracted with **E**, an affiliate of an unrelated foreign company, to perform research. The taxpayer bought stock in **E**, paying a premium above market value as compensation for the research. A foreign subsidiary of the taxpayer collaborated with **E** in drug discovery research, and the taxpayer reimbursed **E** for **E**'s costs. The research was managed by a committee consisting of three persons representing the taxpayer and three persons representing **E**. **E** licensed the resulting products to the taxpayer. In 1996, the research was phased out and the taxpayer sold the **E** stock.

In 1995, the taxpayer sold small interests in two reinsurance companies that had been formed originally by consortia of pharmaceutical companies. Sales by other taxpayers of interests in these reinsurance companies have been ruled by the Tax Commission to generate business income. See Docket Nos. 7789 (1995) and 13772 (2000). In 1997, the taxpayer sold all of its remaining holdings in these two companies.

In 1987 and 1989, the taxpayer invested in **F**, a company that makes medical equipment. The taxpayer and **F** agreed to develop certain drugs jointly, and **F** appointed the taxpayer as **F**'s exclusive distributor. In 1989 through 1994, the taxpayer loaned funds to **F**, secured by **F**'s intellectual property. These funds were to help fund **F**'s research and development. The taxpayer's ownership in **F** was in the range of 8% to 10%. The taxpayer sold its stock in **F** in 1996 and 1997.

In 1996, the taxpayer entered into a collaborative research and license agreement with **O**, a privately held company. This agreement was terminated in 1999, and the taxpayer sold its stock in **O**.

<u>Sales of intellectual property</u>

The taxpayer licensed rights to a certain drug from an unrelated company. In 1997, the taxpayer sold the license back to the licensor in an installment transaction, with gain recognized annually, starting in 1997. The taxpayer argues that the "selling of contracts is not a normal or integral part of Taxpayer's business."

In 1997, the taxpayer divested two particular products as part of an agreement with the Federal Trade Commission. The taxpayer calls this a "divestiture of [two] complete line[s] of business." Also in 1997, the taxpayer sold trademarks "associated with an entire line of business." The argument is that "the sale of trademarks is not an integral part of Taxpayer's business."

In 1998, the taxpayer granted an unrelated licensee an exclusive license to market a certain drug in the U.S. The license included know-how, regulatory approvals, and trademarks for the drug. One month later, the taxpayer sold all of its rights to the licensee, who became the full owner. The buyer paid annual installments starting in 1998 and running through 2002.

In 1998, the taxpayer terminated a license dating back to 1989 from a foreign drug company. The license permitted the taxpayer to make, use and sell certain trademarked drugs, and was accompanied by supply and co-promotion agreements, which were also terminated. The terminations resulted in a gain. The taxpayer argues that this "resulted in the complete removal of [the taxpayer] from this class of products."

In 1998, the taxpayer licensed a foreign company to manufacture and market certain drugs in the U.S. The licensee paid the taxpayer a non-refundable, non-creditable license fee. The taxpayer calls this "the divestiture of entire lines of business."

In 1998, the taxpayer sold an unspecified intangible asset as part of the divestiture of **J** and **K**, described above.

In 1999, the taxpayer divested its worldwide rights to its brand of a certain drug and generic equivalents. This sale generated annual installments of gain beginning in 1999. Also in 1999, the taxpayer granted a company an exclusive license in a certain trademark in the U.S. The product in question "is a small, non-promoted product with relatively flat sales being manufactured in a plant which was identified for closure." Also in 1999, the taxpayer divested its rights and know-how in a certain drug. Also in 1999, the taxpayer assigned rights to a certain line of drugs to an unrelated company, "due to limited growth potential." Other unspecified intangibles were sold in 1999.

<u>Sales of land, buildings, and other tangible assets not in corporate form</u>

In the 1993-1996 audit period, the taxpayer did not claim any dispositions of land, buildings, and other tangible assets not in corporate form as generating nonbusiness income, so the Tax Commission lacks information on the taxpayer's history of disposing of such assets before the current audit period.

In the current audit period, the taxpayer sold land and buildings in various locations that had either been abandoned or had stood idle for years. Although the taxpayer included these assets in its property factor, which supports business income treatment, the Tax Commission is satisfied that these abandoned and idle assets were converted to nonbusiness use and modifies the Notice of Deficiency accordingly.

An unidentified property in Mexico was sold in 1998. The taxpayer claims nonbusiness treatment of this gain because "the gain is foreign in nature."

Some active warehouses and other real estate were sold in 1999, because the taxpayer relocated its activities that had been conducted there. Other real estate parcels were sold in 1997-1999 for unspecified reasons. In 1999, the taxpayer also claims nonbusiness treatment of "various disposition[s] of machinery and equipment," generating losses. The taxpayer states that "the buying and selling of property is not an integral part of Taxpayer's business."

<u>Home state tax returns</u>

The taxpayer's headquarters state does not employ combined reporting. The taxpayer provided copies of the returns that it filed with its home state for the years 1997, 1998, and 1999 for the company that was the acquirer in 1994 and the company that was acquired in 1994. These returns show that the federal taxable income (form 1120, line 28) of each of the two companies, with state adjustments not relevant here, is apportioned to the home state. No deduction is made for the home state's equivalent of nonbusiness income that would be allocated 100% to the home state. The taxpayer's nonbusiness claim in Idaho is therefore not consistent with its reporting to its home state.

Law and analysis

Business versus nonbusiness income

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 Idaho Supreme Court has held that paragraph (a)(1) embodies two tests for business income. *Union Pacific Corp. v. Idaho St. Tax Comm.,* 136 Idaho 34, 28 P.3d 375 (2001). The first test, referred to by practitioners as the "transactional" test, classifies as business income "income arising from transactions and activity in the regular course of the taxpayer's trade or business." The second test, referred to by practitioners as the "functional" test, classifies as business income "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."

The taxpayer defines itself as "not in the business of disposing" of wholly owned subsidiaries, minority interests, intellectual property, and other assets. Such a self-definition begs the question. The above history of dispositions of such assets shows that such transactions are regularly engaged in by this taxpayer. The transactions generate business income and/or loss under the transactional test.

There is a split of authority among the states as to whether the disposition or termination of a line of business generates business income under the Uniform Division of Income for Tax Purposes Act (UDITPA), after which Idaho Code § 63-3027 is patterned. *Compare, e.g.,* A. Chang, *The Conflict Between the Cessation-of-Business Concept and the Functional Test in California and Other UDITPA States,* MULTISTATE TAX COMM. REV. 8 (Oct. 2001) (available online at http://www.mtc.gov/news&vws/October%202001%20Review.PDF) *with, e.g.,* J. Vesely, *Is Cessation of a Business Every State's Business or ...?,* PILLSBURY WINTHROP LLP STATE & LOCAL TAX BULL. (June 2002)(available online at http://tax.pillsburywinthrop.com/state/bull0206.shtml). Taxpayers seeking nonbusiness treatment argue that cessation of a line of business is outside the regular course of trade or business operations.

While the Tax Commission takes the position that a disposition resulting in cessation of a line of business can generate business income, the question has not been passed upon by the Idaho courts. The Idaho statute is unique among the states, in that it substitutes the word "or" for "and" between the words "management" and "disposition" in the functional test. The Idaho statute also contains a statutory presumption that gains from stock sales are business income.

The taxpayer managed its wholly owned subsidiaries as an integral part of its trade or business operations. It acquired and disposed of minority interests as an integral part of its trade or business operations, because many of the companies were either working in the same field of health care as the taxpayer or actually engaged in business transactions with the taxpayer. The taxpayer acquired, managed, and disposed of the intangibles and other assets not in corporate form as an integral part of its trade or business operations. The Tax Commission is particularly skeptical of this integrated pharmaceutical taxpayer's treatment of each individual drug as a separate line of business. The disputed transactions generate business income and/or loss under the functional test.

Constitutional limitations on apportionment of income

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, a 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).

The taxpayer bears the burden to prove "that the income was earned in the course of activities unrelated" to its unitary business activities in the taxing state. *Mobil Oil Corp. v. Commissioner*, 445 U.S. 425, 439 (1980). The taxpayer bears the burden to prove that the Tax

Commission's decision on the constitutional point is incorrect. *Albertson's, supra,* 106 Idaho at 814.

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.

The taxpayer's protest relies primarily on the statute and raises constitutional issues only as a secondary argument. The Tax Commission here briefly opines on the constitutional issues, relying on facts available in the record. In the case of the wholly owned subsidiaries, they are in the same general line of health care products, which in turn shows commonality of customer base and sharing of knowledge. The fact of 100% ownership establishes undivided control by the parent. Many of the minority interests are also in the same line of business, and in many cases are also tied to the taxpayer by functional integration in the form of joint research and/or licenses. The intangibles disposed of are mainly drugs that the taxpayer developed or previously distributed; drug development and distribution are the taxpayer's primary business. The tangible assets disposed of are land, buildings, machinery, equipment, and the like, all used actively in the taxpayer's business (except for the idle and abandoned items that are held to be nonbusiness in this decision). All of the assets disposed of were held in furtherance of the taxpayer's 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).

Based on the information available, the Tax Commission finds that the sold subsidiaries, minority interests, intangibles, and other assets performed an operational function of the taxpayer's unitary business. In particular, minority interests in companies outside the health care line may be repositories for short-term investments of idle funds.

Conclusion

WHEREFORE, the Notice of Deficiency Determination dated February 21, 2002, is hereby MODIFIED, and as so modified, is APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayer pay the following tax and interest (computed through 4/3/03)(interest runs at $24.66 per day):

YEAR	TAX	PENALTY	INTEREST	TOTAL

12/31/97	$56,975	-0-	$21,077	$ 78,052
12/31/98	99,658	-0-	29,180	128,838
12/31/99	23,386	-0-	5,140	28,526
			TOTAL DUE	$235,416

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 ___________________, 2003.

IDAHO STATE TAX COMMISSION

____
COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _______________, 2003, 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]

[Redacted]

____