BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 16963
[Redacted]	)	
Petitioners.	)	DECISION
	)	
	)	

On August 16, 2002, the Income Tax Audit Bureau of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] (the taxpayer), allowing a refund of income tax and interest for tax years ending 12/31/91 and 12/31/92 in the total amount of $(279,038).

On October 3, 2002, a timely protest and petition for redetermination was filed by the taxpayer. An informal conference was requested by the taxpayer and held on January 23, 2003.

The Tax Commission has reviewed the file, is advised of its contents, and hereby issues its decision modifying the Notice of Deficiency Determination. The issue for determination is the correct application of a capital loss arising in 1993, which in turn requires a determination whether the taxpayer was a unitary business in 1993. The Tax Commission holds that the taxpayer was a unitary business in 1993 and applies the capital loss accordingly.

Facts

Introduction

In two audit cycles, the Tax Commission audited the taxpayer for years 1989-1992 and 1994-1996, but has not audited 1993. The taxpayer has reported [Redacted] for 1991 and 1992 and a resulting capital loss to be carried from 1992, 1993, and 1994 to 1991. If the taxpayer was a single unitary business in 1993, then the capital loss is approximately $16 million; if not, then the capital loss is approximately $28 million. The taxpayer has computed its version of the capital loss by disregarding the capital gains and losses of certain affiliated companies that it contends were not unitary with the companies doing business in Idaho.

The Tax Commission’s auditor reduced the refund claimed by the taxpayer by computing the loss on a unitary combined basis in all years, which caused losses of companies doing business in Idaho to be offset by gains of other members of the unitary group in the years in which the losses were incurred. The Tax Commission paid the reduced refund and the taxpayer protested.

After receiving details of the federal audit changes, the auditor has deleted certain insurance subsidiaries from the combination. Mathematical and technical corrections pointed out in the protest have also been made, increasing 1991 business income and generating a small deficiency. The taxpayer has requested that the Tax Commission issue a decision on the question of unity in 1993, based on the facts found in the audits of the previous and following years.

The following factual discussion describes what was found for the audited years, and assumes, as the taxpayer stipulated, that the facts in 1993 were “relatively unchanged” from the facts in 1992 and 1994.

Overview of segments of taxpayer’s business

In early 1992, the taxpayer reorganized its subsidiaries into two groups. The [Redacted]groups were combined under a single new umbrella company, and a new Diversified umbrella company was formed to hold coal mining properties, telecommunications, information services, and other companies. The taxpayer's capital structure was revamped, with Classes B and C stock tracking the value of the [Redacted], and Class D stock tracking the value of the Diversified group. In the following discussion, Construction, Mining, and Diversified will be referred to as three segments, as opposed to the two groups just described, because Construction and Mining are two segments within a single group.

The Idaho nexus companies, all in the Construction segment, filed a combined Idaho return in 1992 and 1994, including only the Construction segment. In at least one other state, the taxpayer and all of its subsidiaries filed a worldwide combined return as a single unitary business for those years. In 1992 and 1994, the Idaho auditors combined all companies owned more than 50%, with the exception in 1994 of **A**, a small telecommunications company that is described below.

Construction and Mining segments

The taxpayer's construction business is large and multinational. The Construction segment acquired companies in the "materials" business, including construction aggregates. The Mining segment was originally started to keep construction equipment busy in the wintertime. It primarily operates three 50% owned low sulfur coal mines in the West, some or all of which supply coal to an electric utility that serves Idaho. The primary assets of the Mining segment are working interests (leaseholds) in coal mining properties, joint venture mining contracts, and long-term contracts to sell coal. The fee interests in the coal mines are owned by a coal properties subsidiary of the Diversified group. The Mining segment employs the senior mining management, operates and manages the mines, and collects management fees from the coal properties company equal to 30% of the coal properties company's adjusted operating income.

The financial results of the coal properties company are reflected in the formula value of the Class D Diversified group common stock, while the results of the Mining segment are reflected in the Classes B & C Construction and Mining group common stock. The taxpayer's representatives explained the placement of the mines in the Diversified group as a means to equalize the value of the C and D stocks, to make the tracking stock concept more acceptable to construction employees.

Diversified group: Information services,

Telecommunications, energy

The taxpayer's protest characterizes all of the Diversified group/segment (comprising information services, energy, and telecommunications subsegments) as "investments." These subsegments will be discussed in greater detail below.

Information services subsegment

The information services subsidiary within the Diversified group provides computer outsourcing nationwide on a long-term contract basis. It manages a nationwide area network (WAN). It also provides system integration services and design, installation and maintenance of customers' local area networks (LANs). It has a special computer center in the taxpayer's headquarters city. In 1992, 56%, and in 1994, 33% of the information services subsidiary's revenues were from other subsidiaries of the taxpayer.

Telecommunications subsegment

The telecommunications subsegment consists of the taxpayer's interest in a company that is here referred to as **A**. In 1994, it also included the taxpayer's 67% interest in a company that is here referred to as **B** (the remaining 33% of **B** being publicly traded). In 1994, identifiable assets of the telecommunications subsegment were the largest of the taxpayer's three major segments; revenue of the telecommunications segment exceeded mining revenue; but operating earnings of telecommunications were much smaller than either mining or construction.

In 1993, the taxpayer bought a controlling interest in **A**. **A** is based in an eastern state. Its main asset is a regulated local telephone company in that state. **A** also operates cable television networks in four other eastern states. **A** sells long distance service in its home state and resells long distance service elsewhere.

B was based in the taxpayer's headquarters building before 1994. It did an initial public offering in 1993. **B**, through its subsidiaries, owns a telecommunications network and leases network capacity from others to provide high quality voice, data, and other services to business and government customers. **B** builds and operates fiber optic networks, switches, and related electronic equipment in major cities in the U.S. and Europe. Subsidiaries of **B** engage in the following lines of business: Dedicated data networks for large companies; phone services to small and medium sized businesses and tenants of buildings; high speed data transmission over an asynchronous transfer mode network that interconnects LANs in different locations; services in some cities in Europe; and designing, building and maintaining networks and systems for third parties.

Energy subsegment

C is based in the taxpayer's headquarters city. **C** explores for, develops and operates power sources and plants using hydro, gas, oil and coal in the U.S. and two foreign countries. In 1993, the taxpayer's Construction and Diversified groups signed an eight-year joint venture agreement with **C** for foreign business. They agreed that if both the Construction and Diversified groups of the taxpayer and **C** agree to participate in a project, the taxpayer and **C** will share development costs 50/50, with **C** to manage the project. The taxpayer will be the preferred turnkey construction contractor.

Infrastructure subsegment

The infrastructure subsidiary within the Diversified group formed a 50/50 partnership with a third party construction company in 1993 to develop North American infrastructure projects, mainly to operate water systems and develop airport privatization projects.

Mutual fund

The taxpayer's mutual fund is a centralized repository for the various business segments, including affiliated joint ventures, pension plans, and subsidiaries. Among the securities in the mutual fund are securities that are restricted by agreement to fund equity contributions by the energy subsegment to international energy projects and to fund reclamation of coal mines. The registered investment adviser of the mutual fund is the taxpayer's investment management company, which is owned 60% by the Diversified group and 40% by the Construction group.

Unitary ties between parent and subsidiaries and between segments

The following facts point to unity. Among the parent company and the two groups, there are overlapping directors and officers. The chairman of the parent also is an officer and/or director of Construction and Mining. The Executive Vice President is an officer of the parent, a director of the information services company (in the Diversified group) and a director of Mining. The chairman of the parent exercises strong central management over the various subsidiaries. For example, the 7/22/94 board minutes show him proposing, and the board unanimously adopting, a plan to transfer certain assets among the parent, the Diversified group and the Construction segment. The taxpayer's headquarters building was transferred from the parent to the Construction group. One airplane was transferred from the parent to the Diversified group, and three airplanes were transferred to the Construction group. Riverfront industrial property was transferred from the parent to the Construction group. The chairman also had the parent's proxy in voting the parent's stock in the first-tier subsidiaries to elect their directors and officers. The chairman approves and administers the use of corporate aircraft.

The minutes of the parent and the first-tier subsidiaries present a uniform picture of smoothly running, harmonious management by the inner circle of parent officers. No dissents are mentioned, and many actions are taken by consent without meetings.

At least one member of the parent's executive committee must approve the establishment, reorganization, recapitalization, or dissolution of subsidiaries, partnerships, joint ventures and international branches.

The taxpayer provided the auditors with a corporate policies manual from the late 1980s which applies to the parent "and subsidiaries and affiliates." The manual states that the parent's vice president of finance and administration is responsible for providing guidance in developing all corporate policies. There is a systems and procedures department in the parent that drafts policies in a uniform format. Final drafts are approved by the parent's executive committee. The parent's vice president of finance and administration sets compliance standards for financial, tax and accounting, and concurs in the selection of the chief financial officer of each subsidiary.

There is a central risk management department in the parent. The parent's treasurer's office manages foreign currency exposure for all U.S. subsidiaries; centrally manages cash on a consolidated basis; and arranges for all debt of U.S. and Canadian subsidiaries. The parent maintains an internal audit department with full access to all subsidiaries.

The parent has a vice president of real estate who reviews in advance all real estate transactions, whether in the U.S. or abroad. All real estate purchases and sales, and leases of assets valued at over $350,000, must be submitted for advance approval by the parent's executive committee or the subsidiary's board of directors. Leases of assets valued in excess of $1 million must be submitted to the parent's purchasing department for approval.

Capital expenditures for data processing systems projects in excess of $10,000 and all computer and telecommunications expenditures must be approved by the parent's vice president of information services.

The parent and the two groups all have offices in the same building. The building floors are occupied as follows as of 1993:

- 2: **B** and its fiber optics subsidiary;
- 4: Construction segment;
- 10: Construction segment; parent company executives; Mining segment materials companies;
- 11: **B**'s fiber optics subsidiary;
- 14: Construction segment.

The parent renders services to, and oversees the management of, the two group umbrella companies. The services are rendered on a fee and no-fee basis.

There are common employee benefit plans across the groups, including insurance, profit sharing, 401(k), and tuition reimbursement. The parent company guarantees the payment of workers' compensation liabilities of its subsidiaries who self-insure in California.

There were intercompany sales between the Construction and Mining segments, at arm's length prices.

In 1991 and 1992, a middle-tier holding company, which was merged into the parent in late 1991, provided financing for the Construction and Mining segments at arm's length rates.

When computing the formula price at which the taxpayer will buy back an employee's stock, "a significant annual intercompany transaction reduces the value of the Class D Stock and increases the value of the Class B and Class C Stock."

Law and analysis

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 in 1992 and 1994, and the taxpayer has the burden of disproving the finding here for 1993, where the facts are presumably the same as in 1992 and 1994.

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. Construction and Mining depend upon and contribute to each other. Mining uses idle construction equipment. Mining depends upon the Diversified group because the mines themselves are owned by the Diversified group; and vice versa, because the mines of the Diversified group are managed by the Mining segment. The Construction and Mining group depends on the information services provided by the Diversified group.

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. Functional integration exists between Construction and Mining through the use of idle equipment as mentioned above. It exists between Construction and Diversified through their joint participation in the power joint venture with **C**. It exists between the parent and the three major segments in the form of asset transfers among those parties. An unidentified but "significant annual intercompany transaction" occurs from the

Diversified group to the Construction and Mining group to equalize the values of the different classes of tracking stock.

Centralization of management is shown by the overlap of officers and directors among the parent and the two major segment umbrella companies. The parent's chairman has strong authority and voting power over the subsidiaries. The chairman also regulates the use of corporate aircraft in the possession of the different groups. Uniform corporate policies and financial compliance standards are set by the parent across the groups. The parent's executive committee has veto power over various corporate changes and joint venture agreements. Real estate transactions and capital expenditures are centrally regulated.

Economies of scale exist through sharing of the parent's headquarters building with the two major groups. They also occur through the central mutual fund, which holds securities for the energy subsegment of the Diversified group. The mutual fund is managed by both the Diversified and Construction groups. There are centralized departments for risk management, treasury, borrowing, internal audit, and real estate. There are common employee benefit plans. Information services are also centralized in the Diversified group.

Accordingly, the Tax Commission finds that the taxpayer was engaged in a unitary business in 1993, and it was therefore required to file a combined report. The capital loss in 1993 is computed as in the Notice of Deficiency Determination, with the mathematical and insurance company changes mentioned above, and carried back to 1991.

Conclusion

WHEREFORE, the Notice of Deficiency Determination dated August 16, 2002, is hereby MODIFIED, and as so modified, 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 8/15/03)(interest runs at $.29 per day):

YEAR	TAX	PENALTY	INTEREST	TOTAL
12/31/91	$3,522	$0	$3,340	$6,862
12/31/92	(1,438)	0	(1,191)	(2,629)
			TOTAL DUE	$4,233

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

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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] Receipt No.

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