BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO.17719
[Redacted]	)	
Petitioner.	)	DECISION
	)	
	)	

On August 28, 2003, the Income Tax Audit Division of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] ("taxpayer") asserting an Idaho income tax liability in the amount of $639,977 for the 5/1999 through 5/2002 taxable years. On October 29, 2003, the taxpayer filed a timely appeal and petition for redetermination. An informal conference was requested by the taxpayer and was held on May 11, 2004. The Tax Commission, having reviewed the file, hereby issues its decision in this matter.

I.

FACTS AND PROCEDURAL HISTORY

[Redacted] is the world's leading supplier of software for information management. The company develops, manufactures, markets and distributes computer software that falls within two broad categories: (1) system software, and (2) internet business applications software. The company is headquartered in [Redacted]. During the years under audit [FYE 5/31/99 – 5/31/02], the company maintained an office in [Redacted] and had between 22 and 24 employees that either worked out of the [Redacted] office or who worked at a particular customer's Idaho offices to provide support services at the customer's business location.

[Redacted] has elected to file Idaho returns on the worldwide combined reporting method for all years under audit. In FYE 5/31/99 [Redacted] sold a number of shares in one of its subsidiaries, [Redacted], from which it recognized a gain of $24.5 million. In FYE 5/31/00 [Redacted] sold another block of [Redacted] stock from which it recognized a gain of $6.497

billion. As a result of these two sales, [Redacted]'s ownership interest in [Redacted] dropped from 90.78% to 74.16%. This gain was treated as nonbusiness income on [Redacted]'s Idaho combined group returns. The size of the gain and the nonbusiness tax treatment led the Tax Commission's audit staff to select the [Redacted] combined group returns for audit. After conducting a field audit, the audit staff recharacterized the gain from the sale of [Redacted] as business income. The audit staff also made a number of other audit adjustments, including recharacterizing other gains originally reported as nonbusiness income as business income. The audit staff then issued the Notice of Deficiency Determination that is the subject matter of this administrative protest.

II.

ISSUES PROTESTED

Four issues have been raised in this administrative protest. Those issues are:

1. Whether the audit staff erred in disallowing nonbusiness income treatment on the gain from the sale of the following assets:

    a. $6,521,876,231 gain from the sale of [Redacted] stock.

    b. $472,571,233 gain from the sale of [Redacted] stock (fka [Redacted]).

    c. $29,860,328 gain from the sale of intellectual property and other assets held by [Redacted]."

    d. Gain from sale of stock of various nonunitary subsidiaries as follows:

        i. $79,522,803 from the sale of "[Redacted]."

        ii. $9,873,710 from the sale of "[Redacted]."

        iii. $741,241 from the sale of "[Redacted]."

        iv. $2,676,513 from the sale of "[Redacted]."

v. $897,679 from the sale of "[Redacted]."

2. Whether the audit staff erred in regard to the amount of income from unitary foreign subsidiaries that is to be included in the pre-apportionment taxable income of the [Redacted] combined group under Idaho Code § 63-3027(t)(2)(ii).

3. Whether the audit staff erred in regard to the amount of Foreign Sales Corporation (FSC) income that is to be included in the pre-apportionment taxable income of the [Redacted]combined group under Idaho Code § 63-3027(t)(2)(ii) for the 5/31/00 fiscal year.

4. Whether the 10% substantial understatement penalty imposed for FYE 5/31/00 should be waived.

III.

ANALYSIS

A. Business/Nonbusiness Treatment of the Gain Recognized from the Sale of Stock and Intellectual Property.

1. Introduction.

The first issue raised in this protest is whether the Tax Commission's audit staff correctly recharacterized the gains from the sale of stock and intellectual property as business income. There are four stock/asset sales that need to be separately analyzed. The first, and by far the most significant in terms of the amount at issue, is the sale by [Redacted] of a portion of its interest in [Redacted]. The other stock/asset sales at issue are the sale of stock in [Redacted], the sale of intellectual property and other assets held by [Redacted] "[Redacted]," and the sale of stock of various non-unitary corporations.

2. Gain from the Sale of [Redacted].

[Redacted] was formed in 1982 as a first tier subsidiary of [Redacted]. In 1991 [Redacted] created a holding company [[Redacted].] and transferred most of its stock in [Redacted] into that holding company. But from 1982 until January 31, 1999, [Redacted] held, either directly or indirectly, 100% of the outstanding stock of [Redacted]. In February 1999 [Redacted] issued some additional shares of voting common stock in an initial public offering in [Redacted]. At that same time [Redacted] sold 250,000 of its shares. These two transactions resulted in the reduction of [Redacted] ownership percentage from 100% to 84.59%. A year later [Redacted] sold another 8,700,000 shares, reducing its ownership percentage to 74.16%. But it is significant to note that [Redacted] was created by [Redacted] and that from 1982 until January 1999 [Redacted] held 100% of the shares of [Redacted].

In order for Idaho to tax an apportionable share of the gain on the sale of the [Redacted] stock, that gain must meet the statutory definition of business income found in the Idaho Income Tax Act. If the gain falls within the statutory definition of business income, the analysis shifts to the constitutional limitations found in the Due Process Clause and the Commerce Clause of the United States Constitution. We will first turn to the statutory considerations.

a. Statutory Considerations -- Business/Nonbusiness Income.

In 1965 Idaho adopted with slight modification the Uniform Division of Income for Tax Purposes Act (UDITPA). That uniform act, as modified, is found at Idaho Code § 63-3027. As described by the Idaho Supreme Court:

> The Act contains rules for determining the portion of a corporation's total income from a multistate business which is attributable to this state and therefore subject to Idaho's income tax. In general, UDITPA divides a multistate corporation's income into two groups: business income and non-business income. Business income is apportioned according to a

> three factor formula, while nonbusiness income is allocated to a specific jurisdiction.

American Smelting & Ref'g Co. v. Idaho St. Tax Comm., 99 Idaho 924, 927, 592 P.2d 39, 42 (1979) (citations to statute omitted), *rev'd on other grounds,* ASARCO Inc. v. Idaho State Tax Commission, 458 U.S. 307, 102 S.Ct. 3103 (1982).

Business income is defined as all "income arising from transactions and activities 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 constitutes integral or necessary parts of the taxpayer's trade or business operations." Idaho Code § 63-3027(a)(1). Nonbusiness income is all income other than business income. Idaho Code § 63-3027(a)(4).

The Idaho Supreme Court has recently held that the above quoted statutory language sets forth two separate and independent definitions of the term "business income." Union Pacific v. Idaho State Tax Com'n., 136 Idaho 34, 28 P.3d 375 (2001). These two separate definitions are commonly referred to as the "transactional test" and the "functional test." The transactional test is concerned with income arising from the ordinary course of the taxpayer's trade or business operations. In contrast, the functional test is concerned with income derived from property that is utilized in or otherwise directly connected with the taxpayer's trade or business operations. Id. at 38 – 39, 28 P.3d at 379 – 380. Thus, there is no requirement under the functional test that the income arise from transactions and activities in the regular course of the taxpayer's trade or business. Id. at 39, 28 P.3d at 380. The key determination is whether the acquisition, management, or disposition of the **property** was directly connected with the taxpayer's business operations. American Smelting at 931, 592 P.2d at 46 ("business income includes . . . income from tangible and intangible property if that property has the requisite connection with the corporation's trade or business."). Property that is not directly connected to the taxpayer's trade or business operations, such as passive investment property, does not generate business income. As pointed out in the American Smelting case:

> In our view, in order for such income to be properly classified as business income there must be a more direct relationship between the underlying asset and the taxpayer's trade or business. The incidental benefits from investments in general, such as enhanced credit standing and additional revenue, are not, in and of themselves, sufficient to bring the investment within the class of property the acquisitions, management or disposition of which constitutes an integral part of the taxpayer's business operations. This view furthers the statutory policy of distinguishing that income which is truly derived from passive investments from income incidental to and connected with the taxpayer's business operations.

Id. at 933, 592 P.2d at 48.

As indicated above, the important distinction under the functional test is whether the property was directly connected with the taxpayer's business activity or whether it was merely a passive investment. Under Idaho law, there is a general presumption that the business versus nonbusiness income determination of the Idaho State Tax Commission is correct, and the burden is on the taxpayer to establish that the Commission's determination was incorrect. Albertson's Inc. v. State, Dept. of Revenue, 106 Idaho 810, 814, 683 P.2d 846, 850 (1984). In addition, the statute itself establishes a strong presumption that income from stock or other securities is business income. Idaho Code § 63-3027(a)(1) ("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.") Thus, the burden is clearly on the taxpayer to establish that the gains and losses at issue in this administrative protest are nonbusiness income.

According to the audit staff, [Redacted] is the [Redacted] operating arm of the [Redacted] group of companies. "[Redacted] has been licensed to distribute [Redacted] products in Japan pursuant to a Distributorship Agreement first entered into with [Redacted] in June 1987. Under the Agreement, [Redacted] appointed [Redacted] as its authorized distributor of [Redacted] products in [Redacted]. [Redacted] distributed [Redacted] software products and provided support, education, and consulting services with respect to [Redacted] products. Further, [Redacted] granted [Redacted] the right to market, promote and sublicense [Redacted] products to sub licensees in [Redacted] for use on computer systems located in [Redacted]." (Audit Narrative, pp. 4 – 5.) Under this Distributorship Agreement, [Redacted] received royalty payments of between $115 million and $260 million during the years under audit. Based on these factors, and based on the "same type of business" presumption set out in Income Tax Administrative Rule 340.02.a, the audit staff has determined that [Redacted] is part of the [Redacted] unitary group.[1]

[Redacted]'s representative argues that [Redacted] is not part of the [Redacted] unitary group. He states that the royalty payments and other flows of value resulting from the Distributorship Agreement were all based on arms-length pricing. He further points out that [Redacted] is a [Redacted] corporation that conducts its business in [Redacted], and that [Redacted] "did not share or control operational resources used by [Redacted], such as purchasing, software development, warehousing, distribution, other facilities or capital assets. . . . [Redacted]] did not share administrative or financial services with [Redacted], nor did they share a common operational strategy." (Letter of protest, pp. 3 – 4.) Finally, the

[1] Idaho Income Tax Administrative Rule 340.02.a provides that "[a] corporation or affiliated group is generally engaged in a single trade or business if all of its activities are in the same general line. For example, a taxpayer operating a chain of retail grocery stores is almost always engaged in a single trade or business."

taxpayer's representative points out that, with the exception of one director, [Redacted] did not share common officers or directors with [Redacted].

[Redacted] was included in the Idaho worldwide combined group returns for at least some tax years prior to 5/31/99. It is not clear from the record currently before the Commission how many years [Redacted] was included as part of the Idaho combined group; but the fact that [Redacted] was part of the unitary group in years prior to the sale of the stock makes [Redacted]'s "nonunitary" argument very unpersuasive. Given the fact that [Redacted] has been included as part of the Idaho combined group returns over the course of the past several years, the Tax Commission finds that the acquisition and management of [Redacted] constituted an integral part of the taxpayer's unitary business operations. [Redacted]'s prior treatment of [Redacted] as part of its worldwide unitary business operations, when coupled with the statutory presumption in favor of classifying gain on the sale of stock as business income, is sufficient to uphold the auditor's reclassification of the gain as business income. We therefore hold that the gain from the sale of the [Redacted] stock meets the statutory definition of "business income."

b. Constitutional Considerations -- Unitary Business Income.

Having determined that the gain on the sale of the [Redacted] stock is properly treated as business income under the Idaho statute, we next examine the relevant federal constitutional limitations. In a series of cases culminating in Allied-Signal, Inc. v. Director, Div. of Taxes, 504 U.S. 768, 112 S.Ct. 2251 (1992), the United States Supreme Court has provided an analytical framework for determining the constitutional restraints on state apportionment of income.[2] The

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[2] The alluded to cases are Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425, 100 S.Ct. 1223 (1980); ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 102 S.Ct. 3103 (1982); F.W. Woolworth Co. v. Taxation and Revenue Dept., 458 U.S. 354, 102 S.Ct. 3128 (1982); Container Corporation of America v. Franchise Tax Bd., 463 U.S. 159, 103 S.Ct. 2933 (1983); and Allied-Signal, Inc. v. Director, Div. of Taxes, 504 U.S. 768, 112 S.Ct. 2251 (1992).

starting point is the recognition that the Due Process clause and the Commerce Clause of the United States Constitution preclude states from taxing nondomiciliary corporations on income "derived from unrelated business activity which constitutes a discrete business enterprise" with no connection to the taxing state. Allied-Signal at 773, 112 S.Ct. at 2255 (*quoting* Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207, 224, 100 S.Ct. 2109, 2120 (1980)) (internal quotations and modifications omitted). Put another way:

> The Due Process and Commerce Clauses of the Constitution do not allow a State to tax income arising out of interstate activities -- even on a proportional basis -- unless there is a " 'minimal connection' or 'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the state and the intrastate values of the enterprise.' " *Exxon Corporation v. Wisconsin Dept. of Revenue*, 447 U.S., at 219-220, 100 S.Ct., at 2118, *quoting Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S., at 436, 437, 100 S.Ct., at 1231. At the very least, this set of principles imposes the obvious and largely self-executing limitation that a State not tax a purported "unitary business" unless at least some part of it is conducted in the state. See *Exxon Corp*., 447 U.S., at 220, 100 S.Ct., at 2118; *Wisconsin v. J.C. Penney Co*., 311 U.S. 435, 444, 61 S.Ct. 246, 249, 85 L.Ed. 267 (1940).

Container Corporation of America v. Franchise Tax Board, 463 U.S. 159, 165-166, 103 S.Ct. 2933, 2940 (1983).

The Supreme Court provided some insight into the breadth of the constitutional limitation on apportionment of income in Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425, 100 S.Ct. 1223 (1980), where the Court stated that "the linchpin of apportionability in the field of state income taxation is the unitary-business principle." *Id.* at 439, 100 S.Ct. at 1232. In short, income derived from the unitary business of the taxpayer may be apportioned among the various states in which the taxpayer conducts its unitary business. Such apportionment is consistent with the federal limitations found in the Due Process and Commerce clauses. As described by one commentator:

> Under the unitary business principle, if a taxpayer is carrying on a single "unitary" business within and without the state, the state has the requisite connection to the business' out-of-state activities to justify the inclusion of

> all of the income generated by the combined effect of the out-of-state and in-state activities in the taxpayer's apportionable tax base. By the same token, if the taxpayer's income-producing activities carried on within the state are not unitary with its income-producing activities carried on elsewhere, the state is constitutionally constrained from including the income arising from those out-of-state activities in the taxpayer's apportionable tax base. Although it was not until 1980 that the Court declared that "the linchpin of apportionability in the field of state income taxation is the unitary business principle," this principle, as the Court recognized, was not "new." Indeed, even at the time it had "been a familiar concept in our tax cases for over sixty years."

Walter Hellerstein, MULTISTATE TAX PORTFOLIOS § 1190:02.A.1 (Footnotes omitted).

In Allied-Signal the Court reaffirmed the unitary business principle as the linchpin of apportionability. According to the Court:

> [T]he unitary business rule is a recognition of two imperatives: the States' wide authority to devise formulae for an accurate assessment of a corporation's intrastate value or income; and the necessary limit on the States' authority to tax value or income which cannot in fairness be attributed to the taxpayer's activities within the State.

Allied-Signal at 780, 112 S.Ct. at 2259. The Allied-Signal Court then went on to describe the two occurrences where apportionment of income from intangibles will be allowed under the unitary business principle. First, apportionment will be permitted if there is unity between the payor and the payee. That is, apportionment is permitted if the payor and the payee are engaged in the same unitary business. It was this payor-payee unity which was at issue in Mobil (unity found), ASARCO (unity not found), and F.W. Woolworth (unity not found). Payor-payee unity is dependent on the relationship of the payor and payee corporations. The analysis focuses on the tried and true indicia of unity: (1) functional integration, (2) economies of scale, and (3) centralized management.

The second occurrence upon which apportionment of income from intangibles will be permitted is if the capital transaction from which the income is derived "serves an operational function" as opposed to an "investment function." Id. at 788, 112 S.Ct. at 2263 - 2264. "The essential question under the operational-function test is whether the intangible asset is part of the corporate taxpayer's own unitary business, not whether two separate corporations are engaged in a common enterprise." Walter Hellerstein, State Taxation of Corporate Income From Intangibles: Allied-Signal And Beyond, 48 Tax L. Rev. 739, 791 n.315.

In the present administrative protest, the Commission has found that there was a unitary relationship between [Redacted] and [Redacted] in the years leading up to the sale of the [Redacted] stock. As a result of this finding of payor – payee unity, the Commission has no doubt that the gain at issue may be included in the apportionable tax base of the [Redacted] combined group without upsetting the Due Process and Commerce Clause principles described above. More to the point, the Commission finds that [Redacted] has failed to meet its burden of establishing that the inclusion of this gain in the apportionable tax base violates the constitutional constraints set forth in Allied Signal and its predecessors. Therefore, the audit adjustment relating to the gain from the sale of the [Redacted] stock is upheld.

3. Gain from the Sale of [Redacted].

[Redacted] also has an uphill battle with respect to the gain from the sale of [Redacted]. That business was first formed in 1995 as a division of [Redacted]. It was incorporated in 1996 as [Redacted]., and later changed its name to [Redacted]. The subsidiary was included as part of the Idaho combined group for FYE 1997, 1998, and 1999. In fact, on the 1998 Idaho combined group return, the taxpayer included a statement verifying that [Redacted] was unitary and included a large loss as business income (loss) in that year. During FYE 2000 [Redacted] issued a number of shares of common stock in an initial public offering, which resulted in [Redacted] ownership dropping below 50% following the offering. As a result, [Redacted] was not included in the Idaho combined group in FYE 2000 and 2001, the years of the stock sales at issue in this administrative protest.

The taxpayer's representative asserts that the "[Redacted] stock was sold pursuant to [Redacted]'s plan to divest itself of that business. The proceeds of those sales were invested by [Redacted] and were not used to fund any of [Redacted]'s operations. All intercompany transactions between [Redacted] were at arms-length. [Redacted] did not share or control operational resources used by [Redacted], . . . [and] did not share technical information or expertise with [Redacted]." (Letter of protest, p. 5.) In short, the taxpayer's representative contends that [Redacted] was never part of the [Redacted] unitary group of companies. The audit staff, on the other hand, contends that [Redacted] was unitary with [Redacted] in all years prior to the 2000 fiscal year. More specifically, the audit staff points out that [Redacted] began as a division of [Redacted] in 1995 and that after being incorporated as a separate business entity in 1996 [Redacted] was included in the Idaho combined group returns filed for the 1996 through 1999 fiscal years. In addition, the Idaho combined group return filed for the fiscal year ending 5/31/1998 included the following statement: "Since[] [Redacted] ownership percentage is over 50% and has a unitary relationship with [Redacted] the entire fiscal 1998 taxable loss ($16,689,116) is being reported on the combined Idaho return."

Based on the record currently before this Commission, we find that [Redacted] was part of the [Redacted] unitary group during each year of its existence up through the 1999 fiscal year, when [Redacted]'s ownership percentage dropped below 50%. The fact that [Redacted] treated [Redacted] as part of its unitary group on the FYE 5/97 through 5/99 returns it filed with the State of Idaho, coupled with the statutory presumption in favor of classifying gain on the sale of stock as business income, is sufficient to support this finding. As a result, the Commission must determine whether the gain from the sale of stock in a former unitary subsidiary is business or nonbusiness income.

Under a functional test, income derived from the acquisition, management or disposition of property is treated as business income so long as the property was directly connected with the taxpayer's business operations. American Smelting & Ref'g Co. v. Idaho St. Tax Comm., 99 Idaho 924, 933, 592 P.2d 39, 48 (1979), *rev'd on other grounds*, ASARCO Inc. v. Idaho State Tax Commission, 458 U.S. 307, 102 S.Ct. 3103 (1982). Because [Redacted] was treated by [Redacted] as part of [Redacted]'s unitary group during the years leading up to the stock sale, there is a strong argument that the gain from the sale of stock is business income under the functional test. Furthermore, the subsidiary was not "nonunitary" for any length of time prior to the stock sale, and there appears to be a significant business relationship between [Redacted] and [Redacted] even after [Redacted] interest went below 50%. Given these factors, the Commission finds that the gain from the sale of the [Redacted] stock was business income under the Idaho statute. Furthermore, the Commission finds that [Redacted] has failed to meet its burden of establishing that inclusion of that gain in the combined group's pre-apportionment tax base is inconsistent with the Due Process and Commerce Clause constraints set forth in Allied Signal and the other U.S. Supreme Court decisions discussed above. As a result, the audit adjustment is upheld.

4. Gain from the Sale of Intellectual Property and Other Assets Held by the [Redacted]Division.

The third stock/asset sale at issue in this administrative protest relates to the gain recognized in FYE 5/31/00 from the sale of various assets held by the [Redacted]. "The intangibles sold that generated the capital gain were software, code and customers lists, as well as [Redacted]'s assets, operations, employees, etc." (Audit Narrative, p. 6.) These assets were sold as part of [Redacted]'s decision to divest itself of its [Redacted]. According to the taxpayer's representative:

> [Redacted]intellectual property was purchased for cash by [Redacted] in an asset acquisition in the mid 1990's. Included in the acquisition was the hiring of [Redacted] employees and the assumption of [Redacted]'s office leases in [Redacted]. The [Redacted] assets became a division of [Redacted] upon acquisition. Following acquisition, [Redacted] maintained separate operations from [Redacted] at its offices in [Redacted]. . . . [Redacted] have never shared office space. [Redacted]'s assets, operations, employees, etc., were sold in an asset sale in FYE 5/31/2000, resulting in the reported gain. That gain was invested by [Redacted], not used to fund operations, and was treated as nonbusiness income.

Letter of protest, p. 6.

Again, it is significant to note that even though [Redacted] now claims that [Redacted] was never functionally or operationally integrated into the [Redacted] unitary business operations, the [Redacted] was treated as part of the [Redacted] unitary group on the Idaho combined group returns filed for each of the taxable years ending prior to the asset sale. Thus, under the functional test for determining whether income is properly characterized as business or nonbusiness income, there is a very strong argument that the gain at issue here was properly characterized by the audit staff as business income. At a minimum, [Redacted] bears the burden of explaining why it has taken inconsistent positions with respect to the unitary nature of its [Redacted]. To date, [Redacted] has not provided a very convincing explanation for this inconsistent treatment. Since [Redacted] treated the income and loss from its [Redacted] as apportionable business income in the years leading up to the asset sale, we find that those assets were directly connected with the unitary operations of [Redacted] and, as a result, the gain from the sale of those assets is properly classified as business income. Whether or not those assets were sold as part of a divestiture of a line of business is not material under the functional test.

See Tax Commission (Consolidated) Decision in Docket Nos. 16707 & 16708, pp. 9 – 10. ("[T]he Commission finds that the taxpayer's claim that there is an exception to the functional test for gains and losses derived from the divestiture of an entire line of business is contrary to the plain language of the statute and is contrary to the Tax Commission's interpretation of the statute set out in Income Tax Administrative Rule 345.04.") The audit adjustment reclassifying the gain as business income is upheld.

5. Sale of stock in various non-unitary subsidiaries.

The final group of transactions included within issue # 1 is the sale of stock of several non-unitary subsidiaries. The taxpayer asserts that the gains from the sale of stock in these companies were properly treated as nonbusiness income on the Idaho combined group returns filed for the 2000 and 2001 taxable years. In support of [Redacted] claim that it had properly treated the gains as nonbusiness income, the taxpayer's representative included the following discussion in the letter of protest:

> These assets consisted of the sale of equity interests in [Redacted]. [Redacted] has no operational interest in these companies, only an investment interest. [Redacted] purchased these assets on national trading markets (e.g., NASDAQ or NYSE). Never did [Redacted] own a percentage great enough requiring the reporting of same to SEC officials. These were pure investment securities similar to those that individual investors purchase in attempting to maximize the return on excess cash.
>
> The operations of these companies were always completely separated from [Redacted]. [Redacted] invested the gain from the sale of these assets, did not use those monies to fund operations and treated that gain as nonbusiness income. These assets were acquired solely for the purpose of investment. [Redacted] had no operational interest in these companies, only an investment interest. The operations of these companies were always completely separated from [Redacted].

Letter of protest, pp. 6 – 7.

After careful review, the Commission finds that the taxpayer has met its burden of establishing that the gains at issue do not meet either the transactional or functional test for determining business income. As a result, we find that the gains recognized by [Redacted] from the sale of these non-unitary subsidiaries constitute nonbusiness income. The audit adjustments relating to the gains from the sale of stock in those nonunitary subsidiaries listed at page 3 of this Decision are hereby reversed.

B. Income to be Attributed to the Foreign Subsidiaries.

The next issue raised in this protest relates to the amount of foreign affiliate income that is required to be reported in the pre-apportionment tax base of the [Redacted] and Subsidiaries worldwide combined returns during each of the years at issue. The audit staff adjusted the amount of foreign affiliate income reported on the Idaho combined group returns to conform to the pre-tax book income shown on the federal Form 5471 filed for each of the unitary foreign subsidiaries included within the combined group. See Idaho Code § 63-3027(t)(2)(ii) (setting out general rule for determining the amount of foreign affiliate income to include in the combined group pre-apportionment tax base). It does not appear that [Redacted] disputes this audit adjustment in principle. Instead, [Redacted] points out that it has "recently filed amended federal forms 5471 for the years ended 5/00 & 5/01. The primary changes to these forms involved the inclusion of stock option income attributable to foreign employees." (Letter of protest, p. 12.) Although not entirely clear from the letter of protest, it appears that [Redacted] is asserting that the amount of pre-tax book income shown on these amended federal Forms 5471 should be used to compute the income attributable to its unitary foreign subsidiaries.

The letter of protest filed on behalf of the taxpayer provides a very ambiguous description of the issue that is being protested and virtually no analysis explaining why the audit adjustment should be reversed or modified. Based on the record currently before this Commission, we are unable to determine whether there is any legal or factual basis to support the taxpayer's claim that the audit adjustment should be modified. Absent a more well defined statement of the issue, and absent some legal or factual basis for upsetting the audit staff's determination, we have no alternative but to reject the taxpayer's claim of error. See Albertson's, Inc. v. State, Dept. of Revenue, 106 Idaho 810, 814, 683 P.2d 846, 850 (1984) (The burden of proof is on the taxpayer to prove that the decision of the Tax Commission is incorrect.); Parsons v. Idaho State Tax Commission, 110 Idaho 572, 574-575 n.2, 716 P.2d 1344, 1346-1347 n.2 (Ct. App. 1986) (a State Tax Commission deficiency notice is presumed to be correct and the burden is on the taxpayer to show that the deficiency is erroneous). The audit staff's determination of the amount of foreign affiliate income is hereby upheld.

C. FSC Income Adjustment.

The third issue raised in this protest involves the amount of FSC income to be included in the worldwide combined pre-apportionment tax base. The audit staff determined that the amount of FSC income includable in the pre-apportionment tax base was $151,925,697, which is the amount of pre-tax net book income reported by [Redacted] on the federal Form 1120-FSC it filed for the 5/31/2000 taxable year. See FYE 5/31/2000 Form 1120-FSC, Schedule M, lines 1 & 2. The taxpayer, on the other hand, asserts that the proper amount of FSC income to include in the pre-apportionment tax base should be $145,000,000. (Letter of protest, p. 13.) After reviewing both the 5/31/2000 [Redacted] federal consolidated income tax return and the 5/31/2000 [Redacted] federal Form 1120-FSC, the Commission finds that the audit adjustment made by the audit staff was proper. The pre-tax book income reported on the 1120-FSC return equals $151,925,697. It is not clear where or how the taxpayer derived the $145,000,000 figure that it claims is the proper amount to be included in the pre-apportionment tax base. Absent a more thorough explanation to support the taxpayer's claim of error, the Commission finds no basis for reversing or modifying this audit adjustment.

D. Imposition of the 10% Substantial Understatement Penalty.

The final issue to be addressed in this administrative protest is whether the 10% substantial understatement penalty that was imposed on the tax deficiency asserted for the 5/31/2000 taxable year should be waived. The substantial understatement penalty is set out in Idaho Code § 63-3046(d). Subsection (d)(7) provides that "[t]he state tax commission may waive all or any part of the [substantial understatement penalty] on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith." I.C. § 63-3046(d)(7). The majority of the tax deficiency asserted for the 5/31/2000 taxable year relates to the recharacterization of the gain from the sale of the [Redacted] stock from nonbusiness to business income. The Tax Commission is unable to find that the understatement in Idaho tax in FYE 5/31/2000 was based on reasonable cause or that the taxpayer acted in good faith. Up until recognizing the sizable gain from the sale of a portion of its interest in [Redacted], [Redacted] had consistently treated its subsidiary as part of its worldwide unitary group. In addition, during the informal conference the taxpayer's representative admitted that [Redacted] treated the gain from the sale of the [Redacted] stock as business income on its 5/31/2000 [Redacted] worldwide combined income tax return. Given this inconsistent treatment from year-to-year and state-to-state, the Commission does not believe that waiver of the substantial understatement penalty is warranted under the circumstances.

IV.

CONCLUSION

WHEREFORE, the Notice of Deficiency Determination dated August 28, 2003, is MODIFIED in accordance with the foregoing analysis, 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, penalty and interest:

PERIOD	TAX	PENALTY	INTEREST	TOTAL
1999	$ (4,934)	$	$ (1,754)	$ (6,688)
2000	449,956	44,996	125,226	620,178
2001	7,875		1,558	9,433
2002	35,814		4,486	40,300
			Total Amount Due	$663,223

Interest is calculated through November 30, 2004, and will continue to accrue at the rate set forth in Idaho Code § 63-3045(6) until paid.

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 ____________________, 2004.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of ___________________, 2004, 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]
[Redacted]
[Redacted]

Receipt No.

____