BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 18020
[Redacted]	)	
Petitioner.	)	DECISION
	)	
	)	

On February 17, 2004, 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 $642,638 for the 1998 through 2000 taxable years. On April 20, 2004, the taxpayer filed a timely appeal and petition for redetermination. An informal conference was held in Boise, Idaho on November 29, 2004. The Tax Commission, having reviewed the file, hereby issues its decision in this matter.

I.

SUMMARY OF FACTS AND PROCEDURAL HISTORY

This is a "forced combination" case. The only contested issue in this protest is the audit determination that [Redacted] was part of a unitary business being conducted by [Redacted] during 1998 through 2000. [Redacted]. is the U.S. parent of a group of corporations that manufacture, market and distribute eyeglass frames, sunglasses, sport goggles, and related eyewear. [Redacted] is in turn 100% owned by a foreign parent, [Redacted]. [Redacted]. is a privately owned [Redacted] company that is the parent of a worldwide unitary eyewear business. [Redacted]. issues annual consolidated financial statements in which it refers to itself and its consolidated subsidiaries as the "[Redacted]." *See, e.g.,* 2000 annual report of [Redacted] [Redacted]. is included in the consolidated financial statements issued by the parent. 2000 annual report, p. 35. Thus, the foreign parent holds [Redacted] out to the public as part of the "[Redacted]."

[Redacted] is a [Redacted] corporation with its principal offices in [Redacted], Idaho. [Redacted] was founded in 1970 by [Redacted], an avid skier, to develop and market the first [Redacted]. The product proved to be very successful, and by 1989 [Redacted] had grown to approximately $9 million in annual sales. From 1989 through 1995 the company expanded and began offering a more diversified line of products, including [Redacted]. [Redacted] acquired the majority interest in [Redacted] in 1996.

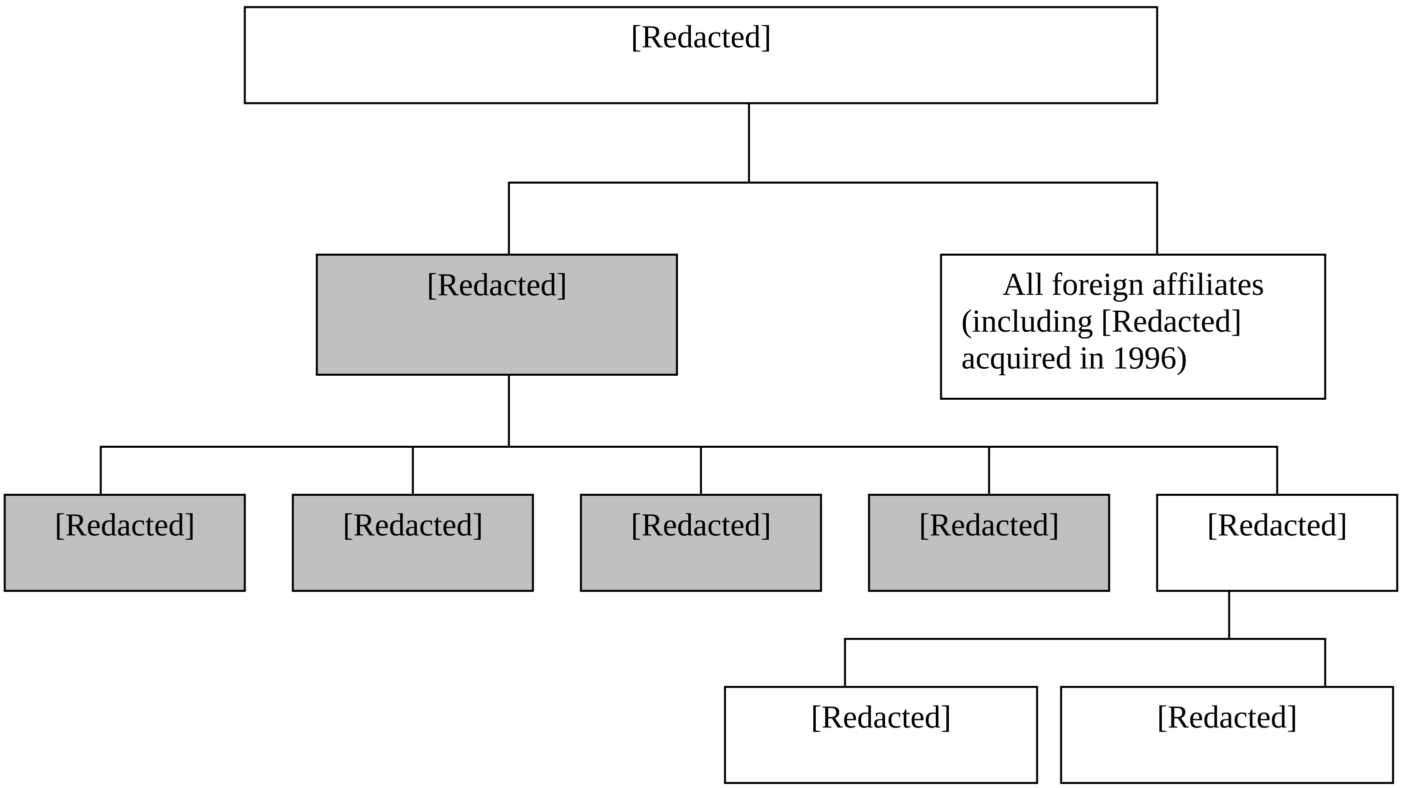
[Redacted]. and its subsidiaries are in the business of manufacturing and marketing [Redacted]. According to [Redacted]'s Inc. website:

[[Redacted]
[Redacted] (accessed 11/19/04). This characterization of [Redacted]'s business is supported by statements found in [Redacted]'s former website:

> The **[Redacted]** is present in over **120** countries worldwide, marketing its products through its own subsidiaries as well as through sole distributors.
>
> As far as country are [sic] concerned, **[Redacted]** is implementing a development policy leading to the opening of subsidiaries in the most attractive markets from a quantitative and qualitative point of view.
>
> This enables **[Redacted]** to have a more direct relationship with its clients and a more organized network better suited to the context in which the company operates.
>
> In this way, **[Redacted]** exports not only its products, but also its business philosophy and its image. **[Redacted]** manufactures and markets [Redacted]with a variety of features designed to appeal to different target consumers: [Redacted], so that all demands and requirements are met. The **Group**'s policy regarding the extension of its supply of products and the diversification of the distribution channel should be interpreted with this strategy in mind.
>
> Its famous collections, . . . are distributed through more than 130,000 outlets throughout the world, assuring the **[Redacted]** top world ranking in the [Redacted] field.
>
> Thanks to the **[Redacted]** take-overs, [Redacted] has also increased its presence in the field of [Redacted], earning itself a top position in this sector too.

[Redacted] (accessed 12/16/2003) (bolding in original).

A simplified corporate structure of [Redacted] and affiliated subsidiaries for the years under audit can be diagrammed as follows (ownership percentages are all believed to be 100%) (subsidiaries highlighted in gray were included within the federal consolidated income tax return for years at issue):



Even though [Redacted] was treated as part of the "[Redacted]" for financial reporting purposes during the years at issue, [Redacted] filed single entity Idaho income tax return for 1998, 1999, and 2000. The Commission's audit staff conducted a field audit of [Redacted]' 1998, 1999, and 2000 single entity Idaho corporate income tax returns. The primary audit adjustment made to those returns was to combine [Redacted] and its more than 50% owned subsidiaries [[Redacted]. (1998 and 1999 only); [Redacted] (1999 and 2000 only); and

[Redacted]] and to calculate the Idaho tax owed by [Redacted] under Idaho's combined reporting method.

There was one other audit adjustment made to the Idaho returns, relating to the disallowance of the Idaho investment tax credit, but the taxpayer has not protested that adjustment. In any event, the audit resulted in a deficiency as follows:

Year	Tax	Penalty	Interest	Total
1998	$140,766	$14,077	$48,994	$203,837
1999	175,262	17,526	48,125	240,913
2000	152,813	15,281	29,794	197,888
			TOTAL DUE	$642,638

II.

ISSUE

The sole issue raised in this administrative protest is whether the audit staff correctly concluded that [Redacted] was engaged in a unitary business with [Redacted] and the other members of the "[Redacted]" during 1998 through 2000.

III.

ANALYSIS

A. INTRODUCTION.

In 1965 Idaho adopted, with slight modification, the Uniform Division of Income for Tax Purposes Act (UDITPA). *See* 1965 Sess. Laws, Ch. 254, p. 639 (amending Idaho Code § 63-3027 to provide for allocation and apportionment of corporate income per UDITPA). UDITPA sets forth the process for determining the portion of a multistate corporation's total income that is to be attributed to Idaho for income tax purposes. UDITPA divides a corporation's income into two classes: (1) business income, and (2) nonbusiness income. Business income is apportioned according to a three-factor formula, while nonbusiness income is allocated to a specific state according to set allocation rules. *See* Idaho Code § 63-3027(i) (providing for the apportionment of business income via a three-factor formula) and Idaho Code § 63-3027(d) – (h) (providing allocation rules relating to certain types of nonbusiness income). The business income apportioned to Idaho, and the nonbusiness income allocated to Idaho, are subject to Idaho's corporate income tax.

Idaho has modified the basic UDITPA income attribution rules to require "combined reporting" of the income of certain affiliated corporations. Idaho Code § 63-3027(t). As explained by the Idaho Supreme Court in <u>Albertson's, Inc. v. State, Dept. of Rev.</u>, 106 Idaho 810, 683 P.2d 846 (1984), combined reporting is a refinement of the UDITPA apportionment principle.

> The combined reporting provision of subsection (s) [now I.C. § 63-3027(t)] is a further refinement of the basic apportionment principle. Its purpose is to permit application of the UDITPA formula to a single business enterprise which is conducted by means of separately incorporated entities. In an economic sense such a business is no different than a similar business composed of a single corporation with several

> separate divisions. For tax reporting purposes such businesses should be treated the same.

Id. at 814-815, 683 P.2d at 850-851 (citations omitted) (*quoting* American Smelting & Ref'g Co. v. Idaho St. Tax Comm., 99 Idaho 924, 934-935, 592 P.2d 39, 49-50 (1979), *rev'd on other grounds*, ASARCO Inc. v. Idaho State Tax Commission, 458 U.S. 307, 102 S.Ct. 3103 (1982)).

As currently codified, Idaho Code § 63-3027(t) provides in part that "[f]or purposes of this section . . . the income of two (2) or more corporations, wherever incorporated, the voting stock of which is more than fifty percent (50%) owned directly or indirectly by a common owner or owners, when necessary to accurately reflect income, shall be allocated or apportioned as if the group of corporations were a single corporation, in which event . . . [t]he Idaho taxable income of any corporation subject to taxation in this state shall be determined by use of a combined report which includes the income . . . of all corporations which are members of a unitary business, allocated and apportioned using apportionment factors for all corporations included in the combined report and methods set out in this section." With certain exceptions not relevant here, the Idaho Income Tax Administrative Rules provide that any corporation that is a member of a unitary business and is transacting business within this state must compute its Idaho corporate income tax liability under the combined reporting method. IDAPA 35.01.01.600.02 (2004). The issue raised in this administrative protest is whether [Redacted] -- which unquestionably transacts part of its business operations in Idaho -- is a member of the unitary business conducted by [Redacted]. and its affiliated subsidiaries.

B. OVERVIEW OF THE UNITARY BUSINESS CONCEPT.

Before moving to the merits of the taxpayer's argument, it may be useful to provide an overview of the unitary business concept. Generally speaking, a unitary business is a single economic enterprise that is made up of a group of commonly owned or controlled business entities. Prior to the advent of the unitary business concept in the early 1900s, most states generally determined the amount of income earned within their borders by applying separate accounting principles to each separate business entity. However, by the early part of the twentieth century, with the growing size and complexity of multistate businesses, the separate accounting method of measuring taxable income proved to be unsatisfactory. Because large corporations typically do business through networks of interlocking subsidiaries and divisions, enabling the enterprise to shift income, expenses, property, payroll, and sales among its various subsidiaries and divisions at will, the States sought a way to more accurately account for and tax the in-state income of these multistate (and often multi-entity) business enterprises. This led to the development of the unitary business concept. The unitary business concept -- as refined through the requirement of "combined reporting" -- treats a group of commonly owned businesses as a single unit for purposes of allocating and apportioning the income of that enterprise among the various states where it conducts its business operations. *See generally*, Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 164 – 169, 103 S.Ct. 2933, 2940 – 2942 (1983) (discussing the unitary business principle in light of the California combined reporting requirement).

Whether two or more business entities constitute a unitary business is a factual determination that has spawned considerable litigation over the years. A primary reason for this is that there is no clearly established definition of what constitutes a unitary business. Rather, courts have articulated several different definitions or standards that can be used to determine whether a group of commonly owned businesses are engaged in a single unitary enterprise. And even within these different definitions of what constitutes a unitary business, there is an unmistakable level of subjectivity. While the decision maker will be presented with various facts that either weigh for or against a finding of unity, in many cases reasonable people can disagree whether the weight of the evidence tips the scales in one direction or the other. Allied-Signal, Inc. v. Director, Division of Taxes, 504 U.S. 768, 785, 112 S.Ct. 2251, 2262 (1992) ("If lower courts have reached divergent results in applying the unitary business principle to different factual circumstances, that is because . . . any number of variations on the unitary business theme are logically consistent with the underlying principles motivating the approach, . . . and also because the constitutional test is quite fact sensitive."). (Citations and internal quotations omitted.). But for all its problems and shortcomings, the unitary business principle is the backbone of modern state corporate income tax law. Formula apportionment, such as is required by Idaho Code § 63-3027, would not be possible absent the advent and development of the unitary business principle. *See* Mobil Oil Corp. v. Com'r of Taxes of Vermont, 445 U.S. 425, 439, 100 S.Ct. 1223, 1232 (1980) ("the linchpin of apportionability in the field of state income taxation is the unitary-business principle.")

The use of formula apportionment to determine the amount of income of a unitary business that is subject to tax by a state was first upheld by the United States Supreme Court in Underwood Typewriter Co. v. Chamberlain, 254 U.S. 113, 41 S.Ct. 45 (1920). In approving the state of Connecticut's formula apportionment method, the Court opined that the state's method of measuring the amount of income from activities taking place within the state was at least as accurate, if not more so, than the separate accounting method advocated by the taxpayer. Id. at 120 – 121, 41 S.Ct. at 47. More importantly, the Court held that the taxpayer had not met its burden of showing that the state's apportionment formula method resulted in the taxation of income that was unrelated to business activities taking place within the state.

The holding in Underwood Typewriter was amplified a few years later in Bass, Ratcliff & Gretton, Ltd v. State Tax Comm'n, 266 U.S. 271, 45 S.Ct. 82 (1924), where the Supreme Court used for the first time the term "unitary business" in describing an interconnected multistate business enterprise:

> So in the present case we are of opinion that, as the Company carried on the **unitary business** of manufacturing and selling ale, in which its profits were earned by a series of transactions beginning with manufacture in England and ending in sales in New York and other places – the process of manufacturing resulting in no profits until it ends in sales – the State was justified in attributing to New York a just proportion of the profits earned by the Company from such **unitary business**.

Id. at 282, 45 S.Ct. at 84 (emphasis added). While the Supreme Court utilized the term "unitary business," it did not go on to define that term. It was actually the California Supreme Court in Butler Brothers v. McColgan, 111 P.2d 334 (1941), *aff'd* 315 U.S. 501, 62 S.Ct. 701 (1942), that first provided some insight into what factors are relevant in determining the existence of a unitary business.

In Butler Brothers, the taxpayer operated a wholesale dry goods and general merchandising business, purchasing from manufacturers and selling only to retailers. The taxpayer had set up several wholesale distributing houses throughout the United States, including one in California. Each of these wholesale distributing houses maintained its own set of books, and accounted for its own sales. In addition, each distributing house incurred direct operating expenses which were charged against income; and each distributing house also claimed indirect expenses relating to the overall business enterprise such as executives salaries, corporate overhead, and centralized advertising. These indirect expenses were allocated among the various distributing houses in accordance with recognized accounting principles. This "separate accounting" approach resulted in the taxpayer claiming that it suffered an operating loss from its activities in California even though the corporation recognized an overall profit.

The California taxing authority disallowed the separate accounting treatment used to compute the taxpayer's California income tax liability and, instead, required the company to employ an apportionment formula. On appeal to the California Supreme Court, the issue was framed as follows:

> The sole question to be determined on this appeal is whether it is lawful and proper for the [Franchise Tax Commissioner] to insist upon use of the formula for allocation of income in a case such as this, or whether the company is entitled to use the separate accounting of its San Francisco house to determine its net income in the state of California. The answer to this question depends entirely on the nature of the business conducted within and without the state by [the taxpayer], a foreign corporation. It is only if its business within this state is truly separate and distinct from its business without this state, so that the segregation of income may be made clearly and accurately, that the separate accounting method may properly be used. Where, however, interstate operations are carried on and that portion of the corporation's business done within the state cannot be clearly segregated from that done outside the state, the unit rule of assessment is employed as a device for allocating to the state for taxation its fair share of the taxable values of the taxpayer.

<u>Butler Brothers v. McColgan</u>, 111 P.2d 334, 336 (Cal. 1941). The California Supreme Court then went on to uphold the apportionment method employed by the Franchise Tax Commissioner. In doing so, the California Supreme Court held that Butler Brothers was engaged in a single unitary business. Factors relied upon by the California Supreme Court to support its finding of unity were the presence of "(1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use in its centralized executive force and general system of operations." <u>Id.</u> at 341. These factors (unity of ownership, unity of operation, and unity of use) have since become known as the "three unities" test. While not expressly embracing the "three unities" test employed by the California

Supreme Court, the United States Supreme Court went on to uphold the lower court's finding that Butler Brothers was engaged in a unitary business and that formula apportionment was a constitutionally permissible way to determine the amount of income from that unitary business that was fairly attributable to business activities taking place in California. 315 U.S. 501, 62 S.Ct. 701 (1942).

The California Supreme Court was also instrumental in establishing another test or standard that can be employed in determining whether a group of commonly owned corporations are engaged in a unitary business. In Edison California Stores, Inc. v. McColgan, 183 P.2d 16 (Cal. 1947), the California Supreme Court articulated what has since come to be known as the "contribution – dependency" test. As succinctly set forth by the California Supreme Court: "If 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, the operations are unitary; otherwise, if there is no such dependency, the business within the state may be considered to be separate." Id. at 21. The Idaho Supreme Court has cited with approval both the three unities test set out in Butler Brothers and the contribution – dependency test first articulated in Edison California Stores. *See* Albertson's Inc. v. State, Dept. of Rev., 106 Idaho 810, 815 - 816, 683 P.2d 846, 851 - 852 (1984).

A third test that is commonly used in determining the existence of a unitary business was set out by the United States Supreme Court in Mobil Oil Corp. v. Com'r of Taxes of Vermont, 445 U.S. 425, 100 S.Ct. 1223 (1980). In that case, Vermont asserted that dividends received by Mobil Oil Corporation from certain of its wholly or majority owned subsidiaries should be included as business income, a portion of which was attributable to the State of Vermont based on a statutory apportionment formula. In response Mobil Oil Corporation pointed out that none of these subsidiaries conducted any business activity within Vermont and, therefore, in a separate accounting sense the dividend income was derived from business activities unrelated to Mobil Oil Corporation's Vermont activities. In rejecting Mobil Oil's argument and holding that the dividend income could constitutionally be included in the Vermont pre-apportionment tax base, the U.S. Supreme Court found that Mobil Oil had failed to establish that the subsidiaries in question were not part of its unitary petroleum operations. In doing so, the Supreme Court opined that "separate accounting, while it purports to isolate portions of income received in various states, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale." Id. at 438, 100 S.Ct. at 1232. The Court then went on to state that "[b]ecause these factors of profitability [functional integration, centralized management, and economies of scale] arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.' Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required." Id.

The Mobil Oil "factors of profitability" have been cited with approval in subsequent U.S. Supreme Court cases as one permissible method of identifying a unitary business. *See, e.g.*, F.W. Woolworth Co. v. Taxation & Revenue, 458 U.S. 354, 364 - 370, 102 S.Ct. 3128, 3135 - 3138 (1982) (finding little or no evidence of functional integration, centralization of management, or economies of scale). However, in Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 103 S.Ct. 2933 (1983), the Court, while citing the **Mobil** "factors of profitability" with approval, also made clear that the overarching inquiry in determining whether two or more enterprises are engaged in a unitary business is the existence of a "sharing or exchange of value not capable of precise identification or measurement – beyond the mere flow of funds arising out of a passive investment or a distinct business operation – which renders formula apportionment a reasonable method of taxation." Id. at 166, 103 S.Ct. at 2940. The above quoted passage is particularly insightful in that it set the parameters of a unitary business by explaining what it is not. A unitary business is **not** a passive investment and is **not** a distinct business operation. But where the facts and circumstances establish an interrelationship or flow of values that goes beyond a mere passive investment or a distinct business operation, it is likely that a unitary relationship exists "which renders formula apportionment a reasonable method of taxation."

As evidenced by the court decisions discussed above, there is no bright-line test that can be employed in determining whether two or more business entities are engaged in a unitary business. "Unity can be established under any one of the judicially acceptable tests (Butler Bros., Edison California Stores, Container, etc.), and cannot be denied merely because another of those tests does not simultaneously apply." California Franchise Tax Board Notice 92-4, 1992 WL 207038. In addition, all these various definitions are for the most part subjective in nature. In some circumstances, determining that a group of companies is engaged in a unitary business can be quite easy. For example, a unitary business will almost always exist where the commonly owned corporations are all directly or indirectly engaged in a single line of business, or where the commonly owned corporations are all directly or indirectly engaged in one or more steps in a vertical process. However, the question becomes much harder where the commonly owned businesses are not engaged in the same line of business and are not engaged in one or more steps along a vertical process. In these cases the finding of a unitary business often comes down to a subjective weighing of the various indicia of unity such as functional integration, centralization of management, and economies of scale.

C. PRESUMPTION OF UNITY.

For constitutional purposes, the U.S. Supreme Court has consistently held that the burden is on the taxpayer to show that there is no unitary relationship between a parent and its subsidiary and, as a result, the state -- in making a unitary finding -- is attempting to tax income derived from activities of a "discrete business enterprise" carried on outside its borders. *See, e.g.*, Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207, 223, 100 S.Ct. 2109, 2120 (1980) ("In order to exclude certain income from the apportionment formula, the company must prove that 'the income was earned in the course of activities unrelated to the sale of petroleum products in that State.'") (*Quoting* Mobil Oil Corp. v. Com'r of Taxes, 445 U.S. 425, 439, 100 S.Ct. 1223, 1232 (1980)). Thus, in the present administrative protest, the burden is on [Redacted] to show that it is not part of the [Redacted] unitary group.

In addition to the general burden of proof that falls on a taxpayer when contesting a finding of unity, there is an added "presumption" of unity that must be overcome in certain circumstances. A number of states, including Idaho, have enacted rules or regulations that establish a presumption of unity upon a finding that the taxpayer is (1) engaged in the same type of business as the parent; (2) is part of a vertically integrated business enterprise; or (3) is a member of a group of corporations that has strong centralized management. More specifically, Idaho Income Tax Administrative Rule 340.02 provides as follows:

> **02. Single Trade Or Business.** The following factors indicate a single trade or business, and the presence of any of these factors creates a strong presumption that the activities of the corporation or affiliated group constitute a single trade or business:
>
> **a.** Same Type of Business. A corporation or affiliated group is generally engaged in a single trade or business if all 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.

> **b.** Steps in a Vertical Process. A corporation or affiliated group is almost always engaged in a single trade or business if its various divisions or affiliates are engaged in different steps in a large, vertically structured enterprise. For example, a taxpayer that explores for and mines copper ores and fabricates the refined copper into consumer products is engaged in a single trade or business, regardless of the fact that the various steps in the process are operated substantially independent of each other with only general supervision from the enterprise's executive offices.
>
> **c.** Strong Centralized Management. A corporation or affiliated group is considered one (1) trade or business if there is a strong central management, coupled with the existence of centralized departments for functions such as financing, advertising, research, or purchasing. For example, a corporation or affiliated group is considered one trade or business if the central executive officers are normally involved in the operations of the divisions or affiliates and centralized offices perform the normal matters for the divisions or affiliates that a truly independent business would perform for itself, such as accounting, personnel, insurance, legal, purchasing, advertising, or financing.

IDAPA 35.01.01.340.02. (2004). To be sure, a finding of unity can be made even where none of these three presumptions are present. Likewise, the presumptions set out in the Idaho administrative rule are rebuttable, so a taxpayer can still prove lack of unity even if one of the presumptions is met. But as a general matter, a finding of unity is likely where one of the administrative presumptions is met, and it will be the rare case where a taxpayer is able to overcome the presumption.

It is worth noting that in Container Corp. of America v. Franchise Tax Bd., the U.S. Supreme Court indicated that it was not troubled by the use of an administrative rule that provided that affiliated companies in the same line of business are presumed to be unitary. According to the Court in Container Corp.:

> Appellant also argues that the state court erred in endorsing an administrative presumption that corporations engaged in the same line of business are unitary. This presumption affected the state court's reasoning, but only as one element among many. Moreover, considering the limited use to which it was put, we find the "presumption" . . . to be reasonable. . . . When a corporation invests in a subsidiary that engages in

> the same line of work as itself, it becomes much more likely that one function of the investment is to make better use – either through economies of scale or through operational integration or sharing of expertise – of the parent's existing business-related resources.

Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 178, 103 S.Ct. 2933, 2947 (1983). In effect, the Supreme Court has recognized that the use of an administrative presumption, if reasonable on its face and supported by other evidence of unity, is a useful tool in making the unitary determination.

In the present protest we find that [Redacted] is in the same general line of business as [Redacted] and the other members of the "[Redacted]." Each of the more than 50% owned subsidiaries of [Redacted]. is engaged in one facet or another in the manufacture and distribution of [Redacted]. While [Redacted] argues that it is in a different line of business than [Redacted] *see* Taxpayer's Pre-conference Brief p. 9, we find that argument to be unconvincing. *See generally*, A.M. Castle & Co. v. Franchise Tax Bd., 43 Cal.Rptr.2d 340, 349 (Cal.App. 1 Dist. 1995) ("In our view, two corporations are engaged in the same 'general line' of business when: (1) the two businesses are *similar* (but not necessarily identical); and (2) after the two corporations are combined, it permits the parent corporation to make better use of the existing business related resources."). As a result, [Redacted] is required to present sufficient evidence to overcome the presumption of unity. As discussed more fully below, we find that the company has successfully met its burden, and we therefore reverse the audit staff's determination that [Redacted] is part of the [Redacted] unitary group.

D. APPLICATION OF THE THREE UNITIES TEST.

One of the commonly applied tests of unity is the "three unities" test first articulated in Butler Brothers v. McColgan, 111 P.2d 334, 336 (Cal. 1941). Under this test two or more corporations will be considered as conducting a single unitary business if there is evidence establishing "(1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use in its centralized executive force and general system of operations." Id. at 341. This was the test most heavily relied on by the audit staff. *See* Notice of Deficiency Determination, Explanation of Items, pp. 2 – 3. As a result, we will start our analysis by applying this test.

1. Unity of Ownership.

The first prong of the three unities test looks at the degree of ownership and control the parent has over the purportedly unitary subsidiary. "Unity of ownership is always present in the case of a single corporation, and, in those states that require combined reporting of affiliated corporations, unity of ownership generally exists when more than 50 percent of the stock of the corporations are owned by a common parent or by the same person." Hellerstein & Hellerstein, State Taxation, ¶ 8.09[3][a]. During the years at issue [Redacted]. indirectly owned 100% of [Redacted]. Thus, there is unity of ownership. [Redacted] concedes this fact. Taxpayer's Pre-conference Brief, p.11.

2. Unity of Operation.

Unity of operation generally consists of common staff functions such as purchasing, personnel, advertising, accounting, legal services and financing. A.M. Castle & Co. v. Franchise Tax Bd., 43 Cal.Rptr.2d 340, 348 (Cal.App. 1 Dist. 1995). The sharing of these types of staff functions is highly indicative of a unitary business because of the cost savings and "flow of values" that normally arise from the pooling and sharing of common resources.

[Redacted] asserts that there is very little sharing of common staff functions between itself and its parent. According to the taxpayer, [Redacted] sells [Redacted] that are "developed, marketed and distributed in completely separate channels from [Redacted]. The Pre-conference Brief continues:

> Each company uses its own unique sales force for its own products. Generally, each company sells products to different customers. [Redacted]developed its own distribution channels, which are well established, for its performance/sport products. Such distribution channels are distinct from traditional retail [Redacted] channels utilized by [Redacted]. For example, [Redacted] primarily distributes its products through sporting goods stores, whereas [Redacted] primarily distributes its products through department stores. Research and development for [Redacted] is completely unrelated to that of [Redacted]. Consequently, [Redacted] develops its own products resulting from [Redacted] third-party designers, who do no work for [Redacted]. Marketing strategies, advertising and promotion of [Redacted] is entirely different from that of [Redacted]. . . . [E]ach company uses its own advertising agency. [Redacted] makes its own shipping arrangements and does not share common shipping or transportation services with [Redacted] entities. [Redacted] maintains its own separate customer service center and call-in telephone numbers. Therefore, each company has dissimilar operations from conception of products to delivery of products.

Taxpayer's Pre-conference Brief, pp. 9 – 10.

The audit staff counters by pointing out that "there is some centralization in the purchase of insurance policies and accounting." Notice of Deficiency Determination, Explanation of Items, p. 2.[1] However, the evidence supporting this finding is sketchy. During the informal conference the representative of [Redacted] stated that in the first two years under audit (1998 and 1999) [Redacted] shared no insurance policies with [Redacted]. In 2000 [Redacted] was included within the cargo insurance policy taken out by [Redacted] which related to the shipment of parts and materials from China. But with respect to all other insurance policies taken out by [Redacted] in 2000, [Redacted] was not included within the coverage. [Redacted] does use the

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[1] The audit report also asserts that a finding of unity of operation is supported by evidence showing an overlap in the top executive positions of [Redacted] and that the annual capital budget of[Redacted] must be approved by key executives of [Redacted]. We find these factors to be more germane to the "unity or use" prong of the three unities test. As a result, we will consider the evidence of managerial oversight in Part III.D.3 of this decision.

same accounting firm as [Redacted] for purposes of tax preparation, but this is not particularly indicative of unity of operation in the absence of any other sharing or pooling of staff functions.

After carefully reviewing the entire record, we are not convinced that there is sufficient sharing of common staff functions such as central purchasing, advertising, accounting and personnel to warrant a finding of unity of operation. When [Redacted]acquired [Redacted] in 1996, [Redacted] was an established [Redacted] with its own established sources of supply and its own established customer base. For this reason, it is not particularly surprising that [Redacted] share relatively few common staff functions. In this respect, the present protest is reminiscent of the facts set out in A.M. Castle & Co. v. Franchise Tax Bd., 43 Cal.Rptr.2d 340 (Cal.App. 1 Dist. 1995). The issue in that case was whether A.M. Castle & Co. was unitary with its wholly owned subsidiary, Hy-Alloy Steels Co. Id. at 342. In analyzing the question of unity under the three unities test, the California Court of Appeals provided the following discussion of the evidence relating to the unity of operation element of the test:

> Generally, unity of operation refers to "staff" functions, such as purchasing, personnel, advertising, accounting, legal services and financing. Perhaps because Castle purchased Hy-Alloy as a fully formed business, the two companies have maintained largely separate staff functions. Each company maintains separate advertising, accounting, legal, research and development, and personnel departments. The two companies also retained different law firms as their outside counsel. Although the companies had some overlapping insurance, there was no significant integration between the day-to-day administrative operations of the two companies. Consequently, Castle has raised a colorable issue that there was no unity of "operation" between the two companies.

Id. at 348.[2]

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[2] It is worth noting that even though the California Court of Appeals found that A.M. Castle & Co. had raised a "colorable issue" that unity of operation was not met, the Court went on to find that "Castle and Hy-Alloy are *unquestionably* unitary under the dependency or contribution test." Id. at 348. This serves to highlight the fact that the various tests used to determine the existence of a unitary business are independent of one another and that a strong showing of unity under one of the judicially recognized tests cannot be overcome by a showing that the elements required under a different test are not met.

While it is likely that over time the staff functions of [Redacted] and the other members of the [Redacted] will become more integrated and "unitary," during the years under review the evidence clearly supports the taxpayer's assertion that there is no unity of operation between [Redacted] and the other members of the [Redacted].

3. Unity of Use.

"Unity of use refers primarily to the integration and control of executive forces. . . . Unity of use exists where one corporation controls another corporation with respect to major policy matters at the highest levels." A.M. Castle at 348. Evidence supporting a finding of unity of use is set out in the audit report as follows:

> At least two of the Officers in [Redacted] occupy top executive positions within [Redacted] . . . and [Redacted]. Minutes of the Board of Director and Executive Committee meetings of [Redacted] are recorded with unanimous consent of the shareholders. . . . Because of the common officers and directors and the common ownership, the minutes of the [Redacted] Board of Directors and the Executive Committee are approved with the unanimous consent of the shareholders. The [Redacted] capital budget is reviewed and approved on an annual basis by [Redacted]).
>
> . . . .
>
> As noted [above] top executive positions within . . . [Redacted] are key executives in [Redacted]. Financial statements are prepared by [Redacted] to be sent to its parent, [Redacted], for preparation of the federal and state income tax returns. The same information is also sent to [Redacted] foreign parent. [Redacted] [Redacted] parent approves [Redacted] operating plans.
>
> During the audit period there were intercompany sales between [Redacted] and [Redacted] and its subsidiaries ranging from $1,717,314 in 1998 to $4,159,635 in 2000. During 1999 and 2000, [Redacted] pays rent to [Redacted]., a wholly owned subsidiary of [Redacted].

Notice of Deficiency Determination, Explanation of Items, p. 2. The audit report also cites evidence of financial dealings between [Redacted] and the other members of the [Redacted], including a $1.1 million loan to [Redacted] made by [Redacted]. Id. at p. 3.

On its face, the evidence cited in the audit report showing managerial oversight, intercompany transactions, and financing arrangements is strong evidence of unity of use. However, [Redacted] argues that the oversight by management of [Redacted] was minimal, and the intercompany transactions and financial dealings cited in the audit report were inaccurately characterized. According to the Taxpayer's Pre-conference Brief:

> The audit report identified certain factors in justifying a unitary relationship. The auditor believed that such factors created a "substantial interrelationship" and a "substantial flow of value." These factors are either insufficient to justify a unitary relationship or are factually inaccurate.
>
> *Management.* In the audit report, the Idaho STC incorrectly alleged that [Redacted] and the [Redacted]entities shared directors and officers and key executives. [Redacted] shared none of its nine officers with [Redacted] and only two of the nine with [Redacted]. Similarly, [Redacted]shared none of its four directors with [Redacted] and only one director with [Redacted]. The two common officers and one common director did not participate in any daily or regular operations of [Redacted] and were in these positions merely for oversight of [Redacted] investment in [Redacted] similar to any parent/subsidiary relationship. For example, they approved (not selected) executive management positions, and reviewed periodic financial information, compensation and benefits, and significant litigation risks. Further, these individuals lived and worked on the East coast, and rarely visited the [Redacted] headquarters in Idaho. These individuals spent virtually 100% of their time on [Redacted] business. . . . Certainly, the mere de minimis involvement that exists here is not the type of interaction that is contemplated in any meaningful unitary relationship to create a flow of value or create synergies justifying a combination of legal entities for Idaho taxation. Such activity does not even rise to the level of common centralized management. Such function represents nothing more than the coordination of investor information.
>
> . . . .
>
> The audit report also mentioned that the capital budget was reviewed and approved on an annual basis by [Redacted], the two shared officers. However, this approval occurred one day a year. Generally, there were only minimal changes to the budget and only done at a "high level" rather than specific "line item" adjustments. Any line item changes to the budget were left to the discretion of [Redacted] employees. More importantly, all other items such as approval of budgets for noncapital purchases and

> contracts with vendors and customers were not reviewed by [Redacted]. . . .
>
> . . . .
>
> *Intercompany Activity.* The audit report incorrectly alleged that during the audit period [Redacted] entities financed [Redacted] operations through intercompany loans. However, this is incorrect. There was no lending between affiliates to finance operations. The audit report also stated that in 1998, [Redacted] loaded $1.1 million to [Redacted]. This loan was a one-time loan for a relatively small amount to allow certain executives to pay their personal income taxes related to the exercise of their stock options. The loan had no connection with [Redacted] business operations. The audit report also stated that [Redacted] loaned approximately $27 million to [Redacted] for the purpose of acquiring [Redacted]. These funds were not used at all in [Redacted] business. Rather, all funds were transferred to the unaffiliated seller.
>
> The audit report also stated that there was evidence of intercompany accounts receivable and accounts payable between [Redacted] and [Redacted] and its subsidiaries. With the exception of a tax sharing account in the year 2000 only and an intercompany account with a Canadian affiliate (discussed below), these accounts consisted of incidental items representing less than one percent of [Redacted] activity. The audit report indicated that there were intercompany sales between $1.7 million and $4.2 million for the audit period. These relatively low level sales occurred primarily through two affiliates. One of them, [Redacted], was an affiliate that resold [Redacted] products into Canada, averaging about $1.4 million for the audit period. The other affiliate, [Redacted], resold [Redacted] products in Europe for two years of the audit period, averaging about $2.2 million. The low level sales to [Redacted] did not create any unitary relationship with [Redacted] or [Redacted] as there were no intercompany sales/activities between [Redacted] and these two foreign entities. Additionally, these activities related to entities beyond the scope of Idaho's Notice.

Taxpayer's Pre-conference Brief, pp. 3 – 7.

We agree with the taxpayer that the managerial oversight from [Redacted] was minimal. We also agree with the taxpayer that the intercompany loan between [Redacted] and [Redacted] is not solid evidence of unity where the loan was not used by [Redacted] in its business operations but, instead, was used to pay federal income taxes owed by certain executives from the exercise of stock options. We disagree with the taxpayer, however, on its claim that the intercompany sales between [Redacted] and the other members of the [Redacted] were *de minimis* and insufficient to support a finding of unity. The record reflects that there were intercompany sales between [Redacted] and at least two of [Redacted]'s foreign affiliates ([Redacted]) in the total amounts of $1.7 million in 1998, $3.3 million in 1999, and $4.2 million in 2000. This represents roughly 5 to 8 percent of [Redacted]'s total sales during these years. This is not an insignificant amount either in real numbers or in the percentage of total sales. Thus, we agree with the audit staff that the intercompany sales between [Redacted] and affiliates of [Redacted] are relevant evidence supporting a finding of unity of use. For purposes of determining whether a unitary relationship exists between [Redacted] and the other members of the [Redacted], it makes no difference that these intercompany sales were between entities that are not included in the Idaho combined group calculation. *See* Idaho Income Tax Administrative Rule 340.04, IDAPA 35.01.01.340.04. (2004) ("The existence of a unitary business relationship shall be determined by reference to the relationship that exists between all related and affiliated corporations, not just those corporations whose income and apportionment factors are required to be considered.")

We also find the statements contained in the former website of [Redacted]. to be relevant in determining whether the unity of use prong of the three unities test is met. According to that website:

> The **[Redacted]** is present in over **120** countries worldwide, marketing its products through its own subsidiaries as well as through sole distributors.
>
> . . . **[Redacted]** exports not only its products, but also its business philosophy and its image. **[Redacted]** manufactures and markets [Redacted]with a variety of features designed to appeal to different target consumers: from [Redacted], so that all demands and requirements are met. The **Group**'s policy regarding the extension of its supply of products

> and the diversification of the distribution channel should be interpreted with this strategy in mind.

[Redacted] (accessed 12/16/2003) (bolding in original). This statement shows an overall "Group" business philosophy that is established and fostered by the parent and pushed down to the subsidiaries. To the extent this business philosophy is pushed down to [Redacted], it is evidence of unity of use. However, [Redacted] contends that the statement on the parent's website is not an accurate reflection of [Redacted] dealings with [Redacted] "When [Redacted] acquired [Redacted] was committed to operate in a decentralized manner by having [Redacted] run its own business and make ALL day-to-day decisions on nearly every important aspect of its operations. As an established business unique from [Redacted], [Redacted] believed that [Redacted] would be more successful by giving the Company autonomous decision making power. Consequently, [Redacted] left local [Redacted] management in place <u>**and did not integrate [Redacted]'s philosophies into [Redacted]**</u>." Taxpayer's Pre-conference Brief, p. 4 (emphasis added).

There is conflicting evidence concerning the extent that [Redacted]pushed down its business philosophy to [Redacted]. On the one hand the parent's website boasts that it "exports not only its products, but also its business philosophy and its image." On the other hand the representative of [Redacted] states that [Redacted] allowed [Redacted] to conduct its business with almost complete autonomy and did not integrate the [Redacted] business philosophy into [Redacted]. After careful consideration, we find the statements of the [Redacted] representative to be credible and will accept as true his statement that [Redacted] did not integrate its business philosophy into [Redacted] during the years under review. Key to this determination is that [Redacted] has maintained its own logo -- which is quite distinct from the [Redacted] logo-- and that the [Redacted] website does not tout its relationship with [Redacted].

After careful consideration of all the evidence relating to unity of use, we find that [Redacted] has met its burden of showing that this requirement is lacking. While the intercompany sales between [Redacted]and subsidiaries of [Redacted] is strong evidence of unity of use, there is no other evidence of "integration and control of executive forces" or that [Redacted] is controlled by "another corporation with respect to major policy matters at the highest levels." A.M. Castle & Co. v. Franchise Tax Bd., 43 Cal.Rptr.2d 340, 348 (Cal.App. 1 Dist. 1995). Thus, we cannot agree with the audit finding that unity of use is present during the years under review.

Because two of the three elements under the "three unities" test have not been met, we are unable to find that [Redacted] was part of the [Redacted] unitary business under this test. We now turn to the Mobil "factors of profitability" test.

E. APPLICATION OF THE MOBIL FACTORS OF PROFITABILITY TEST.

Another test of unity that is commonly applied is the "factors of profitability" test established in Mobil Oil Corp. v. Com'r of Taxes of Vermont, 445 U.S. 425, 100 S.Ct. 1223 (1980). In Mobil Oil, the taxpayer "attempted to characterize its ownership and management of subsidiaries and affiliates as a business distinct from its sale of petroleum products in this country." Id. at 440, 100 S.Ct. at 1233. In rejecting this contention, the Supreme Court "noted that separate accounting, while it purports to isolate portions of income received in various States, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale. Because these factors of profitability arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.'" Id. at 438, 100 S.Ct. at 1232 (citations omitted).

Applying the factors of profitability to the facts of the present case, the Tax Commission finds that [Redacted] has carried its burden of showing that its income is derived from a discrete business enterprise unrelated to its parent's unitary business operations.

1. Functional Integration.

The "functional integration" factor is concerned with the level or significance of the exchange of goods or services between the related entities. The purpose of this factor is to support a finding of unity where there is actual or potential manipulation of income or expenses between related entities. Where there is a transfer or sharing of resources under which the related entities could manipulate transfer prices or the amount charged for services, the functional integration factor will usually be met. As described by one commentator:

> [Functional] integration could generally be found when transactions between two entities were not undertaken at arm's length. This suggests that the Court is concerned about situations in which a company can lower its costs by manipulating transfer prices between itself and another entity. Since a company would generally have to be closely related with any entity willing to sacrifice revenue by selling below market price, it could safely be deduced that any such alliance constitutes a unitary business."

Mirage, A Solidification of the Unitary Business Principle: AlliedSignal, Inc. v. Director, Division of Taxation, 46 Tax Lawyer 541, 547 (Winter 1993) (footnote omitted).

There is no question that evidence of manipulation in transfer pricing is strong evidence of unity. The determination of functional integration where such evidence exists represents an easy case for this Commission and for the Courts. However, we firmly believe that functional integration can exist even where goods and services are transferred under strict "transfer pricing" guidelines. Where there is a significant level of intercompany transfers of goods, services, technologies, operational expertise, or overall operation strategy, there is high likelihood that the entities are functioning together as a unitary business. Thus, the application of strict transfer pricing guidelines on the amount charged for goods or services between related entities does not necessarily defeat a finding of unity.

In the present protest we find that there is a sufficient flow of goods between [Redacted]and several of the [Redacted] subsidiaries to support a finding of functional integration. More specifically, [Redacted] reported intercompany sales with at least two of [Redacted]'s foreign affiliates ([Redacted]) in the total amounts of $1.7 million in 1998, $3.3 million in 1999, and $4.2 million in 2000. A significant portion of these intercompany sales were made to [Redacted] which then marketed and sold the [Redacted] line of products in Europe. In addition, the audit staff reports that a review of [Redacted] accounts payable indicates that [Redacted] acquires "[Redacted]" branded inventory from [Redacted] and then marketed and sold that inventory through its distribution outlet in the Untied States. Prior to [Redacted]acquiring [Redacted] in 1996 (the same year [Redacted] acquired [Redacted]), [Redacted] was a direct competitor of [Redacted] in the [Redacted]. The fact that these two former competitors -- now tied together through their common parent -- sell one another's products is strong evidence of functional integration.

There is also evidence of functional integration relating to the marketing and sale of [Redacted] products in Canada. According to the February 10, 1999, Executive Committee Meeting minutes of [Redacted]: "Mr. [Redacted] summarized the current status of [Redacted] (a newly proposed business unit) and the transition [of] [Redacted] distribution to this new Canadian business unit. Mr. [Redacted] and Mr. [Redacted] suggested that the operations be consolidated through the existing Canadian holding company." The background relating to this discussion by the [Redacted] Executive Committee is not well developed in the audit file. However, it appears that the thrust of the discussion was related to opening or increasing the market for [Redacted] products in Canada through the relationship between [Redacted]. This is evidence of functional integration.

While perhaps not as well-developed as it could be, we find the evidence set out in the audit file sufficient to support a finding that there was some functional integration between [Redacted] and the other members of the [Redacted].

2. Centralization of Management.

The second "factor of profitability" referred to by the U.S. Supreme Court in Mobil is centralization of management. This factor relates to the role the parent plays in the management and operations of its subsidiaries. This factor does not necessarily require detailed interaction in the day-to-day activities of the subsidiary so long as the parent is active in directing the overall business strategy of the subsidiaries. As pointed out by the U.S. Supreme Court in Container Corp. of America v. Franchise Tax Bd.:

> Two of the factors relied on by the state court [in finding unity] deserve particular mention. . . .
>
> The second noteworthy factor is the managerial role played by [Container Corporation of America] in its subsidiaries' affairs. We made clear in *F.W. Woolworth Co*. that a unitary business finding could not be based merely on "the type of occasional oversight – with respect to capital structure, major debt, and dividends – that any parent gives to an investment in a subsidiary . . . ." 458 U.S., at 369, 102 S.Ct., at 3138. As *Exxon* illustrates, however, mere decentralization of day-to-day management responsibility and accountability cannot defeat a unitary business finding. 447 U.S., at 224, 100 S.Ct., at 2120. **The difference lies in whether the management role that the parent does play is grounded in its own operational expertise and its overall operational strategy**. In this case, the business "guidelines" established by [Container Corporation of America] for its subsidiaries, the "consensus" process by which appellant's management was involved in the subsidiaries' business decisions, and the sometimes uncompensated technical assistance provided by [Container Corp.], all point to precisely the sort of operational role we found lacking in *F.W. Woolworth*.

Container Corp. at 180 n. 19, 103 S.Ct. 2948 n. 19. (Emphasis added).

There is no doubt that strong centralized management is often a hallmark of a unitary business operation. *See* ASARCO, Inc. v. Idaho State Tax Commission, 458 U.S. 307, 102 S.Ct. 3103 (1982) (Lack of active managerial control over foreign subsidiaries was a factor emphasized by the Supreme Court in finding that income received from the foreign subsidiaries was not apportionable business income.); F.W. Woolworth Co. v. Taxation and Revenue Dept., 458 U.S. 354, 102 S.Ct. 3128 (1982) (Decentralized management was a factor emphasized by the Supreme Court in overturning the lower court's finding of unity between F.W. Woolworth Company and its foreign subsidiaries.) But centralized management or active managerial control is not dispositive. If it were, then the U.S. Supreme Court in ASARCO and F.W. Woolworth would have applied a strict bright-line "centralization of management" test rather than also looking at functional integration and economies of scale as part of its overall "factors of profitability" inquiry. So long as there is evidence that the parent is guiding its subsidiary's business decisions or overall business strategies, the centralization of management factor will be met.

In the present administrative protest we do not find any convincing evidence that [Redacted]. was directing or guiding the business decisions or business strategies of [Redacted]. As pointed out in Part III.D.3 of this decision, we are accepting as true the statement from [Redacted]'s representative that "[Redacted]left local [Redacted] management in place **and did not integrate [Redacted]'s philosophies into [Redacted]**." Taxpayer's Pre-conference Brief, p. 4 (emphasis added). The other evidence cited in the audit report relevant to centralization of management can be summarized as follows: [Redacted] owns indirectly 100% of [Redacted]; two of the nine officers of [Redacted] are also officers or directors of [Redacted]; Mr. [Redacted] and Mr. [Redacted] (the two shared officers) approve [Redacted]'s annual budget; and [Redacted] provides weekly and monthly financial reports and "Key Data Reports" to [Redacted]. Taken as a whole, we do not find the facts cited in the audit report to be sufficient to establish that [Redacted]. or any of its subsidiaries played a material role in the business operations or business strategies of [Redacted]. To paraphrase from the U.S. Supreme Court's decision in Container Corp., it does not appear to us that the management role that [Redacted]. does play in the operations of [Redacted] is grounded in [Redacted]'s own operational expertise and its overall operational strategy. *See* Container Corp. at 180 n. 19, 103 S.Ct. 2948 n. 19.

3. Economies of Scale.

The final "factor of profitability" set out in Mobil Oil is economies of scale. While listed as the third of three factors, it may be more appropriate to view "economies of scale" as the result that is achieved when there is significant functional integration and centralization of management. *See generally,* Hellerstein & Hellerstein, State Taxation, ¶ 8.07[2][d] n. 317 and accompanying text.[3] In many respects it is difficult to distinguish the facts that support a finding of economies of scale from the facts relevant in finding functional integration and centralization of management. The same general kinds of facts that support a finding of functional integration and centralization of management (i.e., the pooling and sharing of resources, the centralization or departmentalization of "staff" functions, intercompany loans or other financing relationships, and the oversight and direction of a common business strategy) also support a finding of economies of scale. As a result, it is not entirely clear whether this "factor" should be considered an independent indicator of unity or whether it is simply a descriptive way to explain the effect of unity. But this debate can wait for another day. For purposes of this decision we will treat economies of scale as an independent factor.

"Simply stated, economies of scale exist when a doubling of inputs results in more than a doubling of output. When economies of scale exist, average costs decrease as output increases over a given range." Mirage, A Solidification of the Unitary Business Principle: AlliedSignal, Inc. v. Director, Division of Taxation, 46 Tax Lawyer 541, 549 (Winter 1993). This factor emphasizes the relationship between two or more entities that allows for the reduction of costs or

[3] According to the Hellerstein treatise: "The Court [in Exxon, ASARCO and F.W. Woolworth] thus linked the 'centralized management' criterion to the 'economies of scale' criterion. Indeed, the Court in *Woolworth* characterized its inquiry as involving 'the extent to which there was centralization of management or achievement of *other economies of scale*.' *Woolworth*, 458 US 354, 366, 102 S. Ct. 3128 (1982) (emphasis supplied)."

increase in output. Examples of economies of scale were set out by the U.S. Supreme Court in Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207, 100 S.Ct. 2109 (1980) and F.W. Woolworth Co. v. Taxation & Revenue Dept., 458 U.S. 354, 102 S.Ct. 3128 (1982). As contrasted with the facts set out in Exxon Corp., the Court in F.W. Woolworth found no significant evidence of economies of scale between the four foreign subsidiaries at issue and the parent corporation:

> Woolworth has proved that its situation differs from that in *Exxon*, where the corporation's Coordination and Services Management office was found to provide for the asserted unitary business
>
> > "long-range planning for the company, maximization of overall company operations, development of financial policy and procedures, financing of corporate activities, maintenance of the accounting system, legal advice, public relations, labor relations, purchase and sale of raw crude oil and raw materials, and coordination between the refining and other operating functions 'so as to obtain an optimum short range operating program.'" [Exxon], 447 U.S., at 211, 100 S.Ct., at 2114.
>
> In this case the parent company's operations are not inter-related with those of the subsidiaries so that one's "stable" operation is important to the other's "full utilization" of capacity. The Woolworth parent did not provide "many essential corporate services" for the subsidiaries, and there was no "centralized purchasing office . . . whose obvious purpose was to increase overall corporate profits through bulk purchases and efficient allocation of supplies among retailers." And it was not the case that "sales were facilitated through the use of a uniform credit card system, uniform packaging, brand names, and promotional displays, all run from the national headquarters.

Id. at 369 – 370, 102 S.Ct. at 3138 (citations and footnote omitted) (*quoting* Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207, 100 S.Ct. 2109 (1980)).

We do not read the above quoted passage from F.W. Woolworth to mean that the level of economies of scale found to exist in Exxon is the benchmark from which all other unitary cases are measured. To be sure, there was significant evidence of economies of scale in Exxon and very little evidence of economies of scale in F.W. Woolworth. These cases, in many respects, represent the extremes. But it is important to recognize that a finding of unity can be supported by evidence of economies of scale that exceed the facts cited in F.W. Woolworth but which do not approach the facts cited in Exxon.

In the present protest we find very little evidence of economies of scale. The business operations of [Redacted] do not appear to benefit in any meaningful way from its relationship with [Redacted] outside of the intercompany marketing and sales of [Redacted] products discussed above in relation to the functional integration factor. According to the letter of protest, [Redacted] conducts its own research and development of products; has its own sources of manufacture and supply; does its own marketing and promotion; and has its own sources for distributing its products. In addition, "[t]he [Redacted] entities and [Redacted] do not have common hiring policies, common pre-employment tests, common applications, [common] human resources or [common] personnel software programs. [Redacted] maintains benefits and retirement plans . . . separate from the [Redacted] entities. . . . [Redacted] also has its own payroll processing system and providers. Moreover, third parties supporting operations of [Redacted] and the [Redacted] entities are completely separate and independent." Taxpayer's Pre-conference Brief, pp. 10 – 11. Finally, "[Redacted] does not acquire raw materials or products from other members of the combined group nor does it rely on any patents, trademarks or copyrights from the other members of the combined group." Notice of Deficiency Determination, Explanation of Items, p. 2. In short, it does not appear that [Redacted] benefited from any economies of scale as a result of its relationship with [Redacted].

To the extent [Redacted]. or the other members of the [Redacted] benefit from lower costs or higher output as a result of their relationship with [Redacted] those benefits are not clearly evident from the record before us. As a result, we find that the economies of scale "factor of profitability" has not been met.

4. Conclusion – No Flow of Values.

When analyzing all of the "factors of profitability" together, the Commission finds that [Redacted] has met its burden of showing that it is engaged in a discrete business enterprise from [Redacted] and the other members of the [Redacted]. There is simply no clear evidence of a flow of values, "beyond the mere flow of funds arising out of a passive investment or a distinct business operation," from which to sustain the audit staff's finding of unity. Container Corp. at 166, 103 S.Ct. at 2940. Stated another way, we find insufficient connection between the income generated by [Redacted]. and its subsidiaries from business activity taking place outside of Idaho to permit the inclusion of that income in the calculation of [Redacted]' Idaho income tax liability under Idaho's combined reporting mechanism.

IV.

CONCLUSION

Based on the foregoing analysis, the Tax Commission determines that [Redacted] was not a member of the [Redacted] unitary group of companies during the years at issue. The audit determination to the contrary is hereby reversed.

WHEREFORE, the Notice of Deficiency Determination dated February 17, 2004, 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 taxes, penalty and interest:

PERIOD	TAX	PENALTY	INTEREST	TOTAL
1998	$ -0-	$-0-	$ -0-	$ -0-
1999	10,688	-0-	3,485	14,173
2000	10,289	-0-	2,535	12,824
			TOTAL AMOUNT DUE	$ 26,997

Interest is calculated through February 28, 2005, and will continue to accrue at the rate set forth in Idaho Code § 63-3045(6) until paid. In addition, all Idaho investment tax credit and Idaho net operating losses have been completely utilized during the audit period; so there is no ITC or NOL carryover available for 2001.

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 ____________________, 2005.

IDAHO STATE TAX COMMISSION

____

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of __________________, 2005, 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.
[Redacted] [Redacted] [Redacted] [Redacted]	

____