BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 18340
[Redacted]	)	
Petitioner.	)	DECISION
	)	
	)	

On July 27, 2004, the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination to [Redacted] (petitioner), proposing additional income tax, penalty, and interest for the taxable year September 30, 2001, in the total amount of $54,636. The petitioner filed a timely protest and petition for redetermination.

Initially, the petitioner requested an informal hearing before the Commission; however, the hearing was subsequently canceled at the petitioner's request. In an e-mail received by the Commission on February 7, 2005, the petitioner understood that "the hearing may be re-scheduled for another date, if so desired, after we [the petitioner] determine the approach we will be taking with this matter." As of the date of this Decision, the petitioner has not submitted additional information or another request for a hearing. Therefore, the Commission, having reviewed the file, hereby issues its decision.

I.

FACTS AND PROCEDURAL HISTORY

Petitioner filed an Idaho corporate income tax return for tax year ending September 30, 2001. The return filed was a combined return, and the filing method used for the filing of the unitary combined return was water's edge. On line 25 of the Idaho return was a deduction for $592,945,000 with the following notation "See Stmt 1." Statement 1 provided the following limited explanation "[Redacted]."

The Commission's Income Tax Audit Division selected the return for a "desk audit." On April 20, 2004, an auditor for the Commission sent a letter to the petitioner requesting additional information regarding the $592,945,000 deduction. Since the petitioner did not respond to the auditor's April 20, 2004, information request, on July 27, 2004, the auditor issued a Notice of Deficiency Determination disallowing the $592,945,000 deduction and adjusting the total everywhere sales factor by the amount of the adjustment.

On September 27, 2004, the petitioner filed a petition for redetermination.

II.

ISSUES PROTESTED

Three issues have been raised in this administrative protest relating to the disallowance of the petitioner's deduction for non-business income. Those issues are: [1]

1. The income should be treated as non-business income since the income does not fall within Idaho Code section 63-3027 statutory definition of business income.

2. Income from a "cessation of a business" or "liquidation of a business" results in non-business income.

3. Treating the income as business income would be in violation of the Due Process and Commerce Clause.

III.

ANALYSIS

The petitioner owns [Redacted] subsidiaries either directly or indirectly. The following table identifies the primary entities involved in the transaction at issue and provides a simplified overview of the structural relationship of the entities involved.

[Redacted]. was acquired by the petitioner in 1997 as part of the acquisition of [Redacted].[2] On October 6, 2000, [Redacted] sold 100% of the stock of [Redacted]., an unrelated third party. [Redacted] entered into an agreement to treat the stock sale as an asset sale in accordance with Internal Revenue Code section 338(h)(10).

On page five of the petitioner's petition for redetermination, the petitioner provides the Commission with an overview of the petitioner's business activities:

[Redacted]

Additional information regarding the sale was obtained from a [Redacted] Newsletter, in which it was stated that[3]

[Redacted]

The petitioner argues that the gain on the sale of the corporate entities within which the [Redacted] business was held was the sale of entities that were not part of a unitary business transacting business within Idaho. Hereinafter the sale of the entities engaged in the [Redacted] business will be referred to as the "[Redacted] business."

The petitioner's claim that the [Redacted] business was not part of its unitary business conflicts with the petitioner's prior actions. In February of 2000, Commission audit staff audited the petitioner's returns for tax years June 30, 1996, through September 30, 1998. One of the issues Commission staff sought to address was whether or not petitioner was conducting a unitary business. According to Commission audit staff, the petitioner had stated to them that the petitioner files unitary returns in eight states, the petitioner was unitary, and the petitioner would

[1] Petition for Redetermination dated September 27, 2004, pages 3 thru 5.
[2] February of 2000 [Redacted], page 1.
[3] February of 2000 [Redacted] Newsletter, page 1.

not contest a unitary finding by Idaho unless Idaho law is very different from other unitary states.[4] As a result of the petitioner's statements, Audit issued a Notice of Deficiency Determination on June 19, 2000, finding that the petitioner was engaged in a unitary business for tax years June 30, 1996, through September 30, 1998. The [Redacted] business was included as part of the unitary group for tax year September 30, 1998, the year in which the [Redacted] business was acquired by the petitioner. The petitioner did not protest the inclusion of the [Redacted] business in the unitary group. The following tax year ending September 30, 1999, the petitioner filed a combined return with Idaho selecting the water's-edge filing method and, in that year as well as the following year (September 30, 2000), included the [Redacted] business as part of the combined unitary group. A water's-edge election is binding on a taxpayer. Idaho Code section 63-3027C(a). A taxpayer that makes a water's-edge election shall take into account the income and apportionment factors <u>of only affiliated corporations in a unitary relationship</u> (with one exception not pertinent to the case at hand). Idaho Code section 63-3027B(a).

As previously mentioned, both parties involved in the sale and purchase of the [Redacted] business agreed to treat the stock sale as a "deemed sale of assets" in accordance with section 338 of the Internal Revenue Code. It is undisputed that the gain resulting from the "deemed asset sale" of the [Redacted] business was included in the consolidated federal return filed by the petitioner and its subsidiaries. According to the petitioner, the gain amounted to $592,945,000. However, the Commission was unable to verify the amount of the gain by reviewing the detail attached to the Idaho corporate income tax return filed by the combined group. Gains of $526,898,672 and $38,430,937 were reported on the petitioner's consolidated federal return line

[4] See for example the prior Notice of Deficiency Determination dated June 19, 2000, Explanation of Items, page 1, Item 3.

8 (capital gain net income) and line 9 (net gain from Form 4797), respectively, resulting in a total gain of $565,329,609. The total gain reported on the federal return was less than the gain from the sale of the [Redacted] business due to the netting of line 9 losses from other subsidiaries outside of the [Redacted] business. However, from the detail attached to the federal return, the Commission has identified the following gains included in the line 8 and line 9 amounts as follows:

Name	**EIN**	**Federal Return Line 8**	**Federal Return Line 9**	**Total**
[Redacted]	22-3025711		$6,111,000	$6,111,000
[Redacted]	51-0265897	$511,913,000	60,055,000	$571,968,000
[Redacted]	51-0280269	$9,744,000		$9,744,000
[Redacted]	43-1202790	$1,647,000		$1,647,000
[Redacted]	62-1314054	$3,476,000		$3,476,000
Totals		$526,780,000	$66,166,000	$592,946,000

The Commission assumes for purposes of this decision that the gain reported in the federal consolidated return by these five entities plus an unidentified $1,000 downward adjustment was used to arrive at the $592,945,000 amount reported on the Idaho income tax return as the nonbusiness income from the sale of the [Redacted] business.

1. Statutory Considerations - Business Versus Nonbusiness Income.

A taxpayer and its affiliates shall be presumed to be part of a unitary business and all income of that business shall be presumed to be apportionable business income if a valid water's-edge election has been made. Idaho Code section 63-3027(D)(a). Idaho Code section 63-3027(a) governs the business versus nonbusiness classification.

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 section 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'n., 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 Comm'n.*, 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 section 63-3027(a)(1). Nonbusiness income is all income other than business income. Idaho Code section 63-3027(a)(4).

The Idaho Supreme Court 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 Comm'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, Idaho Code section 63-3027D(a) establishes a presumption for taxpayers making the water's-edge election that all income of the companies included in the combined return is business income. Thus, the burden is on the petitioner to establish that the gain at issue in this administrative protest is non-business income.

The fact that prior to its sale the [Redacted] business had been included since its acquisition as part of the petitioner's unitary group, especially where the petitioner voluntarily included the [Redacted] business in a combined filing, makes the petitioner's "nonunitary" argument very unpersuasive. Given 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] prior treatment of [Redacted] as part of its unitary business operations, when coupled with the statutory presumption found in Idaho Code section 63-3027D, is sufficient to uphold the auditor's reclassification of the gain as business income. The Commission therefore holds that the gain from the sale of the [Redacted] business meets the statutory definition of "business income."

2. Cessation/Liquidation Of Business

The petitioner asserts that under the functional test the gain or loss from the sale of an entire line of business is nonbusiness income. In other words, the petitioner argues that there is an exception to the functional test relating to the "divestiture of entire lines of business" citing various non-Idaho state court cases as authority for its position. While this is a relatively common argument, there is nothing in Idaho's statutory language or the Idaho Supreme Court's interpretation of that language to support such an exception. It is true that a few courts in other states have grafted a "divestiture of a line of business" exception into their business income statutes. *See, e.g., McVean & Barlow, Inc. v. New Mexico Bureau of Revenue*, 543 P.2d 489 (N.M. Ct. App. 1975); *Laurel Pipe Line Co. v. Commonwealth*, 642 A.2d 472 (Pa. 1994). *But see Appeal of Oryx Energy Co.*, Cal. St. Bd. of Equal., July 9, 2003 (2003 WL 21693922) (California State Board of Equalization has unequivocally rejected the argument that the

functional test contains any sort of "liquidation exception"). It is also true that this specific issue has yet to be addressed by an Idaho court. However, the Commission finds that the petitioner'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, which states:

> **04. Gains Or Losses From Sale Of Assets.** Gain or loss from the sale, exchange or other disposition of real and tangible or intangible personal property is business income if the property, while owned by the taxpayer, was used in the taxpayer's trade or business. However, if the property was used to produce nonbusiness income, the gain or loss is nonbusiness income.

Absent some competent Idaho authority to support its claim that the functional test does not apply when an asset is sold as part of a divestiture of an entire line of business, the gains from sale of the petitioner's [Redacted] business constitute business income under Idaho law.

3. Constitutional Considerations -- Unitary Business Income.

Having determined that the gain on the sale of the [Redacted] is properly treated as business income under the Idaho statute, the Commission next examines 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.[5] The 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.*

[Redacted]

Wisconsin Dept. of Revenue, 447 U.S. 207, 224, 100 S.Ct. 2109, 2120 (1980)) (internal quotations and modifications omitted). Put another way:

[Redacted]*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 the petitioner and the [Redacted] business in the years leading up to the sale of the [Redacted]. As a result of this finding, the Commission finds that the gain at issue may be included in the apportionable tax base of the petitioner's combined group without upsetting the Due Process and Commerce Clause principles described above. More to the point, the Commission finds that the petitioner 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 [Redacted] business is upheld.

WHEREFORE, the Notice of Deficiency Determination dated July 27, 2000, is hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the petitioner pay the following tax, penalty, and interest:

YEAR	TAX	PENALTY	INTEREST	TOTAL
September 30, 2001	$41,652	$6,248	$8,932	$56,832

Interest is calculated through August 15, 2005, and will continue to accrue at the rate set forth in Idaho Code section 63-3045.

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the petitioner's rights 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] Certified No.

_____