BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of [Redacted] Petitioners.	)	DOCKET NO. 18721, 18722, 18723, 18724, 18725, 18726, 18727,18728, 18729, 18730 DECISION

On October 14, 2003, the Income Tax Audit Division of the Idaho State Tax Commission issued Notices of Deficiency Determination to [Redacted](“Petitioners”) asserting a total Idaho income tax liability in the amount of $47,272 for the 1997 through 1999 taxable years. On December 15, 2003, the Petitioners filed a combined petition for redetermination and requested an informal conference.

The Tax Commission conducted an informal conference on February 28, 2006. The Petitioners’s representatives participated by telephone. Staff from the Audit Division appeared in person.

PROCEDURAL HISTORY

The field audit was conducted at [Redacted] former corporate headquarters in [Redacted] on October 21, 2002. [Redacted] and its subsidiaries filed separate Idaho corporate income tax returns. The current protest involves various taxable years from 1997 through 1999 for the different entities. The Tax Commission’s audit staff made a number of audit adjustments to the separate returns filed by [Redacted]combined the returns on a worldwide basis.

ISSUES PROTESTED

According to the protest letter submitted by the [Redacted] representative dated December 15, 2003, and again confirmed verbally at the informal conference, the Petitioners are only protesting the following adjustments made by the audit staff:

1. Foreign Sales Corporation income amounts. The Petitioners contest the Audit Division's Foreign Sales Corporation income amounts. The Petitioners argue that the Foreign Sales Corporation (FSC) income amounts in the audit are incorrect. The Audit Division estimated the FSC income because the Petitioners had not provided the necessary FSC returns. This issue has been resolved because the Petitioners have provided the FSC returns for the years in question. The appropriate adjustments have been made to the work papers.

2. Foreign subsidiaries income amounts. The Petitioners also dispute the Audit Division's decision to include the income of two foreign corporations in the Petitioners' taxable income. The Petitioners argue that the foreign corporations should not be included in the unitary group because they are not greater than 50% owned by [Redacted]. The Audit Division included the foreign corporations in the unitary group because the Audit Division believed that the foreign corporations were greater than 50 percent owned. This issue has been resolved because the Petitioners have provided information confirming that the two foreign entities are less than 50 percent owned by [Redacted] and its consolidated subsidiaries. The appropriate adjustments have been made to the work papers.

3. [Redacted] Stock. The Petitioners oppose the characterization of the gain from the sale of [Redacted] stock as business income. The Petitioners assert the gain is not business income because the stock was purchased for a hostile takeover attempt. The Audit Division determined the gain to be business income because the takeover bid had a business purpose.

4. Sale of Warrants by [Redacted] Corporation. The Petitioners characterized the gain from the sale of certain warrants as nonbusiness income. The Petitioners assert the gain is not business income because the warrants represented a passive investment. The Audit Division determined the gain to be business income because the gain appeared to be for research and development purposes.

5. Sale of [Redacted]. The Petitioners also dispute the characterization of the gain from the sale of [Redacted] as business income. The Petitioners argue that [Redacted] was kept as a separate line of business and, therefore, the gains recognized from the sale should not be subject to Idaho tax. The Audit Division included the gains from the sale because it appeared that [Redacted] was in the same general lines of business as [Redacted].

FACTS

[Redacted] Corporation is a global provider of industrial products and services, technical products and systems, service solutions, and vehicle components. [Redacted] products include storage area networks, fire detection and building life-safety products, TV and radio broadcast antennas and towers, transformers, substations, and industrial mixers and valves. Its products and services also include specialty service tools, diagnostic systems, service equipment, technical information services, and vehicle components. With over 14,000 employees worldwide, [Redacted] is a multinational corporation with operations in 19 countries.

In 1998, [Redacted] merged with [Redacted] in what was deemed a reverse acquisition because [Redacted] was approximately twice the size of [Redacted]. [Redacted] Technology, Inc. was a division of [Redacted] at the time of the acquisition.

[Redacted] is a leading worldwide UPS (uninterrupted power supply) manufacturer supplying UPS products for mid-range computers. After the merger with [Redacted] and [Redacted] were kept as separate business units. In 1999, [Redacted] sold [Redacted] plc.

Also in 1998, [Redacted] purchased stock in [Redacted] in preparation for a hostile takeover attempt. [Redacted] is a Fortune-500 automotive parts company. The takeover bid failed when [Redacted] entered into a merger agreement with [Redacted]. When the takeover bid failed, [Redacted] sold the [Redacted] stock for a gain of $13,667,552.

[Redacted] [Redacted] was also a business unit of [Redacted]. [Redacted] designs, manufactures, markets, and services networking and switching products for storage, data and telecommunications networks. In 1998, [Redacted] licensed technology from [Redacted]. [Redacted] also acquired investment warrants from [Redacted]. [Redacted] provides customer communications and information management using multiple messaging technologies.

ANALYSIS

The Tax Commission considered the comments made at the informal conference and reviewed the information submitted by both the Petitioners and the Audit Division. Based on its review, the Tax Commission affirms the Notice of Deficiency Determination in part.

Business and Nonbusiness Income

Gains from the disposition of stock, warrants, and from the sale of a business are classified as either business or nonbusiness income. In 1965 Idaho adopted, with slight modification, the Uniform Division of Income for Tax Purposes Act (UDITPA). Under UDITPA, a corporation’s business income is apportioned between states in which the corporation does business and a corporation’s nonbusiness income is allocated to its state of domicile.

Idaho distinguishes between the business and nonbusiness income of a corporation that receives income from business activities in more than one state. Idaho Code § 63-3027(a)(1) sets forth two separate and independent definitions of the term "business income." *Union Pacific Corp. v. Idaho State Tax Comm'n*, 136 Idaho 34, 38, 28 P.3d 375, 380 (2001). According to the Idaho Supreme Court, the first definition for business income is "income arising from transactions and activity in the regular course of the taxpayer's trade or business." *Id.* The second definition of business income includes "income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitute integral or necessary parts of the taxpayer's trade or business operations." *Id.* at 39, 28 P.3d at 380.

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.

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 and Refining C. v. Idaho State Tax Comm'n*, 99 Idaho 924, 931, 592 P.2d 39, 46 (1979) ("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 *American Smelting*:

> 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. 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.

There is a strong presumption under Idaho law that income derived from stock or other securities is business income so long as the stock acquisition, management, or disposition is an integral part of the taxpayer's trade or business. Idaho Code § 63-3027(a)(1). Thus, the burden is on the taxpayer to establish that the gains and losses from the sale of stock or other securities is nonbusiness income.

The gain or loss from the sale of a subsidiary is treated as business income gain or loss if the corporation and the subsidiary are a "unitary business." A unitary business is a single economic enterprise that is made up of a group of commonly owned or controlled business entities. Whether business entities constitute a unitary business is a factual determination.

Idaho has a presumption of unity where there is a finding that the taxpayer (1) is 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. IDAPA 35.01.01.340.02 (2005).

1. Gain from the Sale of the [Redacted] Corporation Stock

The Petitioners argue that the gain from the sale of the [Redacted] stock is nonbusiness income because it was acquired for a hostile takeover attempt. The auditor included the gains from the sale of the [Redacted] stock because [Redacted] held the stock as a potential means of furthering its automotive parts business. [Redacted] is in the automotive parts business and one of the four business segments of [Redacted] is vehicle components.

In this case, [Redacted] acquired the [Redacted] stock for a hostile takeover bid. When the [Redacted] announced its merger with [Redacted], [Redacted] withdrew its offer to acquire [Redacted] and sold the stock. Although [Redacted] is in the same line of business as [Redacted] (i.e., automotive parts), the appropriate inquiry is whether the acquisition or disposition of the [Redacted] stock was an integral part of [Redacted] unitary trade or business. Because there is no indication that [Redacted] is in the business of corporate raiding or trading stock, the sale of the stock would not be considered to have occurred in the regular course of [Redacted] business operations. The acquisition or disposition of the [Redacted] stock was a random occurrence outside the normal business operations of [Redacted]. Therefore, the sale of the [Redacted] stock does not constitute apportionable business income. The $13,667,552 gain from the sale of the [Redacted] stock has been removed from apportionable income.

2. Gain from the sale of the [Redacted] **Corporation Warrants**

The Petitioners argue that the gain from the sale of the warrants held by [Redacted] are nonbusiness income. The auditor included the gains from the sale of the warrants because the warrants appeared to serve an operational business function (i.e., research and development) of [Redacted].

In 1998, [Redacted] acquired investment warrants in [Redacted], Inc. A warrant is an option to purchase the shares of a corporation at a specified price and for a specified period of time. It is issued as a security and is intended to be publicly traded. The [Redacted] warrants did not give [Redacted] any voting rights and the warrants could not be exercised until 1999. In June 1999, [Redacted] sold the warrants for a gain of $13,932,099.

Based on the limited amount of information in the audit, the acquisition or disposition of the [Redacted] warrants appears to have been an investment in an unrelated company. Therefore, the gain from the sale of the warrants does not constitute apportionable business income. The $13,932,099 has been removed from apportionable income for the 1999 taxable year.

3. Gain from the sale of [Redacted]**.**

The Petitioners argue that the gain from the sale of [Redacted] is nonbusiness income because [Redacted] has always been treated as a separate business unit with its own set of books and reporting statements. The auditor included the gains from the sale of [Redacted] because [Redacted] signed a unitary concession letter, and [Redacted] is in the same general line of business as [Redacted].

The Commission agrees with the Audit Division. [Redacted] signed a unitary concession letter in which it conceded that all its consolidated subsidiaries are part of a unitary group. In addition, in a prior Tax Commission audit of [Redacted] Corporation, [Redacted] was part of the unitary group with [Redacted] before the merger with [Redacted]. The record before the Commission demonstrates that [Redacted] and [Redacted] were in the same general line of business.

[Redacted] supplies equipment and instruments for the process control, electrical and industrial technology industries. [Redacted] acquired [Redacted] Technology Inc. in 1995. [Redacted] designs and makes systems to protect computers and other sensitive equipment from power irregularities.

According to its annual 10-K Report, [Redacted] is comprised of four business segments. The Technical Products and Systems segment includes operations that design, manufacture, and market uninterruptible power supply equipment. Thus, although the Petitioners may view their power process controls division as separate, they appear to be in the same general line of business. As a result, the Division's deficiency determination regarding the gains from the sale of [Redacted] Corporation is upheld.

CONCLUSION

WHEREFORE, the Notices of Deficiency Determination dated October 14, 2003, are hereby MODIFIED in accordance with the foregoing analysis and, as so modified, are hereby APPROVED, AFFIRMED, and MADE FINAL.

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

[Redacted][Redacted].

YEAR	TAX	PENALTY	INTEREST	TOTAL AMOUNT DUE
1997	$2,142	$- 0 -	$1,189	$3,331
1998	(5,570)	- 0 -	(2,664)	(8,234)
1999	(22,768)	- 0 -	(9,222)	(31,990)

[Redacted]

YEAR	TAX	PENALTY	INTEREST	TOTAL AMOUNT DUE
1997	$810	$- 0 -	$452	$1,262
1998	- 0 -	- 0 -	- 0 -	- 0 -
1999	85	- 0 -	34	119

[Redacted]

YEAR	TAX	PENALTY	INTEREST	TOTAL AMOUNT DUE
1999	$5,688	$ - 0 -	$2,303	$7,991

[Redacted]

YEAR	TAX	PENALTY	INTEREST	TOTAL AMOUNT DUE
1997	$ (200)	$- 0 -	$ (111)	$(311)
10/06/98	(162)	$- 0 -	(78)	(240)
12/31/98	(22)	$- 0 -	(11)	(33)

[Redacted]

YEAR	TAX	PENALTY	INTEREST	TOTAL AMOUNT DUE
1997	$5,766	$- 0 -	$3,201	$8,967
1998	5	- 0 -	- 0 -	5
1999	2,719	- 0 -	1,101	3,820

[Redacted]

YEAR	TAX	PENALTY	INTEREST	TOTAL AMOUNT DUE
1998	$(451)	$- 0 -	$(216)	$ (667)

[Redacted]

YEAR	TAX	PENALTY	INTEREST	TOTAL AMOUNT DUE
1997	$41,577	$- 0 –	$23,079	$64,656

1998	(644)	- 0 –	(309)	(953)
1999	(169)	- 0 -	(69)	(238)

Interest is calculated through June 20, 2006.

DEMAND for immediate payment of the combined total amount of $47,516 is hereby made and given.

An explanation of the Petitioners' right to appeal this decision is enclosed with this decision. As set forth in the enclosed explanation, you must deposit with the Tax Commission twenty percent (20%) of the total amount due in order to appeal this decision. The twenty percent deposit in this case is $ 9,503.20 and will be held as security for the payment of taxes until the appeal is finally resolved.

DATED this ________ day of __________________________, 2006.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of ________________, 2006, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[REDACTED] Receipt No.

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