

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 18731
[Redacted],)	
)	DECISION
Petitioner.)	
_____)	

On March 10, 2004, the Income Tax Audit Division of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] (“taxpayer” or “[Redacted]”) asserting an Idaho income tax liability in the amount of \$266,296 for the 1997 through 1999 taxable years. On May 11, 2004, the taxpayer filed a timely appeal and petition for redetermination. An informal conference was requested by the taxpayer and was held on July 21, 2005. The Tax Commission, having reviewed the file, hereby issues its decision.

FACTS AND PROCEDURAL HISTORY

[Redacted] The current protest involves the 1997 through 1999 taxable years. The Tax Commission’s audit staff made a number of adjustments to the [Redacted] water’s edge combined group returns and imposed both the 5% negligence penalty and the 10% substantial understatement penalty.

ISSUES PROTESTED

There were a number of audit adjustments made to the 1997 through 1999 Idaho water’s edge combined returns filed by [Redacted]. Most of the adjustments are not being protested. According to the follow-up protest letter submitted by the [Redacted] representative, the taxpayer is only protesting the following adjustments:

1. Business income treatment of income from certain intangibles. [Redacted] asserts that the audit staff erred in treating certain income as apportionable business income. The income at issue can be categorized as follows:
 - a. Dividends received from non-unitary affiliates.

- b. Royalty income received from non-unitary affiliates.
 - c. Gains and losses from the sale of “unused land.”
 - d. Gains and losses from “forward exchange contracts.”
 - e. Gains and losses “generated . . . as a result of divesting itself of entire businesses or business segments.”
2. Computational errors. [Redacted] asserts that the Notice of Deficiency Determination needs to be adjusted to correct two computational errors.
- a. “Unrealized Transfer Profit” recognized in 1999. The issue here is whether the amount of the adjustment should be \$339,698,000 as set out in the Notice of Deficiency Determination or \$339,698 as asserted by [Redacted].
 - b. Overstatement of the 1997 Idaho sales factor numerator. [Redacted] claims that it erroneously overstated its 1997 Idaho sales factor numerator by \$26,496,403.
3. Imposition of Penalty. The audit staff asserted both the 5% negligence penalty and the 10% substantial understatement penalty. [Redacted] asks that the penalties be abated.

[Redacted]

After the conclusion of the informal conference, the taxpayer and the audit staff were able to resolve the two “computational errors” asserted in the follow-up protest letter. By agreement, the taxpayer has conceded the first of the two claimed computational errors, and the audit staff has agreed to make the modification to the Idaho sales factor as requested in the second claimed computational error. A Modified Notice of Deficiency Determination was prepared and sent to the taxpayer’s representative on October 20, 2005. Those agreed-to items are no longer in dispute. That leaves the business / nonbusiness items and the imposition of the penalties to be addressed in this final decision.

It should also be noted that after the original Notice of Deficiency Determination was issued, the taxpayer provided a copy of a federal Revenue Agent Report (“RAR”) covering the 1997 and 1998 taxable years. The RAR adjustments were not incorporated into the Modified

Notice of Deficiency Determination issued on October 20, 2005. However, we will incorporate the 1997 and 1998 RAR adjustments into this final decision.

ANALYSIS

A. **Business Income Treatment of Income from Intangible Assets.**

1. **Dividends from Non-Unitary Affiliates.**

The business/nonbusiness treatment of dividends received from non-unitary corporations presents difficult legal and factual issues. To the extent the taxpayer can show that its ownership of stock of the dividend-paying corporation is a passive investment, the dividend income will be nonbusiness income under the Allied-Signal “operational function” test. If, on the other hand, the ownership of stock of the dividend-paying corporation serves an operational function, the dividends should be treated as business income. *See Allied-Signal Inc. v. Director, Division of Taxation*, 504 U.S. 768, 787, 112 S.Ct. 2251, 2263 (1992). Unfortunately, the contours and limits of the “passive investment” / “operational function” dichotomy are not well defined. As a result, reasonable people can disagree as to whether the facts merit business or nonbusiness treatment of dividends received from non-unitary corporations. In addition, determining the relevant facts is not always easy.

The dividends at issue in this protest are listed in the spreadsheet attached hereto as Appendix A. The spreadsheet divides the dividend-paying corporations into “non-unitary domestic affiliates” and “non-unitary foreign affiliates.”

The issue as it relates to the “domestic” affiliates appears to be fairly straightforward. The dividends at issue are from a [Redacted] ([Redacted]) that is discussed in the 1998 [Redacted] form 10-K[Redacted] and from [Redacted] companies. Given the nature of [Redacted]’s unitary business, which includes a [Redacted] operating segment, it appears to us

that ownership of these non-unitary affiliates serves an operational function rather than an investment function. More to the point, [Redacted] has not convinced us that the ownership in these companies is unrelated to its overall unitary business operations. *See Allied-Signal*, 504 U.S. at 787, 112 S.Ct. at 2263 (“It remains the case that [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 those carried out in the taxing State.”) (Internal quotations omitted). Thus, we find that the dividends received from [Redacted] and from the [Redacted] companies are apportionable business income. Based on the information currently in the file, [Redacted] has not established that the audit adjustments relating to the dividends paid by non-unitary domestic affiliates are erroneous.

We also uphold the adjustments relating to the “non-unitary foreign affiliates.” Under the Idaho water’s edge election, dividends received from foreign corporations are included in apportionable business income subject to an 85% dividend received deduction. *See* I.C. §63-3027C(c)(1) (“Dividends received from payors incorporated outside the fifty (50) states and District of Columbia, to the extent taxable, shall be treated as income subject to apportionment.”).¹ Therefore, these dividends (net of the dividend received deduction) are to be treated as business income under the Idaho water’s edge computation regardless of any unitary relationship. [Redacted] has not convinced us that the audit staff erred.

b. Royalty Income from Non-Unitary Affiliates.

[Redacted] also asserts that royalty income it received from non-unitary affiliates is nonbusiness income. Given the nature of [Redacted]’s business, we must respectfully disagree. In order to overturn the audit adjustment, [Redacted] must establish that the intellectual property generating the royalty income serves an investment function as opposed to an operational

function. According to the audit report, [Redacted] provided no documentation to substantiate the treatment of these royalty payments as nonbusiness income. Audit Narrative Report, p. 8. Based on the information currently in the record, [Redacted] has not met its burden of proof.

c. Gains and Losses from the Sale of Unutilized Land.

[Redacted] next asserts that the gains and losses it recognized from certain land sales should be treated as nonbusiness income. From a theoretical standpoint, we agree. To the extent the land was not used in the [Redacted] unitary business operations, the gain should be treated as nonbusiness income. [Redacted] states that all the land at issue was not used in its regular trade or business operations. More specifically, according to the [Redacted] representative:

The parcels of land were acquired for numerous reasons and at various times [Redacted]. Many of the parcels were located in proximity to the Taxpayer's plant sites around the country and may have been intended for future expansion or to increase green space surrounding plant sites. In general, the parcels were sold because they were idle and were not used as part of the Taxpayer's regular trade or business.

[Redacted]

For purposes of resolving this protest, the Commission will accept the explanation provided by the [Redacted] representative. While the record before us is not as detailed as we would like, we are unable to find any evidence within the file to refute the general statement that all of the land at issue was idle and was not used in the taxpayer's trade or business operations. Therefore, we find that the taxpayer has met its burden of proof on this issue. The audit adjustment relating to the "unutilized land" will be reversed.

d. Gains and Losses Realized from "Forward Exchange Contracts."

In order to hedge against fluctuations in foreign currency exchange rates, [Redacted] enters into "forward exchange contracts." "A forward exchange contract is a contract between two parties whereby one party contracts to sell and the other party contracts to buy one currency

for another, at an agreed future date, at a rate of exchange which is fixed at the time the contract is entered into.” [Redacted] [Redacted] claims that the gains and losses generated from these forward exchange contracts are nonbusiness income. We must respectfully disagree. The foreign currency hedging activity appears to serve an operational function as opposed to an investment function. [Redacted] enters into these exchange contracts for the express purpose of limiting its exposure to fluctuations in the foreign currency exchange rates. These sorts of hedging activities tend to be viewed as operational in nature. *See, e.g., Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 180, n. 19, 103 S.Ct. 2933, 2948 n. 19 (1983). *See generally*, Hellerstein, State Taxation Of Corporate Income From Intangibles: Allied-Signal and Beyond, 48 Tax L. Rev. 739, 793-94 n.319 (discussing footnote 19 of Container Corp.) In addition, the audit report reflects that the taxpayer provided no documentation to substantiate the nonbusiness treatment of these gains and losses. Audit Narrative Report, p. 9. Therefore, we find that, based on the record currently before this Commission, [Redacted] has not met its burden of establishing that the gains and losses at issue were derived from investment activity having no relationship to the taxpayer’s unitary business operations. The income generated from these forward exchange contracts is properly treated as apportionable business income.

We also find that the foreign currency exchange contracts are “liquid assets” as defined in Idaho Income Tax Administrative Rule 570.03. That Rule provides in relevant part that “[l]iquid assets include foreign currency, and trading positions therein, other than functional currency used in the regular course of the taxpayer’s trade or business.” Rule 570.03.a., IDAPA 35.01.01.570.03.a (2005) (emphasis added). That administrative Rule also provides that

If a taxpayer holds liquid assets in connection with one (1) or more treasury functions of the taxpayer, and the liquid assets produce business income when sold, exchanged or otherwise disposed, the overall net gain

from those transactions for each treasury function for the tax period is included in the sales factor.

Rule 570.03, IDAPA 35.01.01.570.03 (2005). Rule 570.03 requires that the net gain, as opposed to the gross proceeds, be included in the sales factor calculation. The purpose of this Rule is to prevent distortion in the sales factor computation relating to liquid assets that are sold or exchanged as part of the normal treasury function of a large, multi-state business. Based on the record before us, it appears that the audit staff correctly applied this Rule to the net gains from the forward exchange contracts. As a result, no additional adjustment or modification is necessary. The audit adjustment is upheld.

e. Gains from Divestiture of Entire Businesses or Business Segments.

[Redacted] contends that the gains recognized from the sale of certain business segments should be treated as nonbusiness income. Again, we find that the record contains very little evidence supporting the taxpayer's position. While we certainly recognize and respect the arguments set out by the taxpayer's representative during this protest, arguments are not evidence. 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 is incorrect. Albertson's Inc. v. State, Dept. of Revenue, 106 Idaho 810, 814, 683 P.2d 846, 850 (1984). In addition, the applicable Idaho statute establishes a strong presumption that income from stock or other securities is business income. Idaho Code § 63-3027(a)(1) ("Gains or losses and dividend and interest income from stock and securities of any foreign or domestic corporation shall be presumed to be income from intangible property, the acquisition, management, or disposition of which constitute an integral part of the taxpayer's trade or business; such presumption may only be overcome by clear and convincing evidence to the contrary."). The practical reality is that the audit

adjustments proposed by the Income Tax Audit Division are presumed to be correct, and the burden of establishing error is on the taxpayer. Absent competent evidence to the contrary, we have no alternative but to uphold the audit findings.

There were several gains that [Redacted] has characterized as relating to the “divestiture” of an entire line of business or a discrete business segment. The most significant of these transactions can be summarized as follows:

- [Redacted] As part of that transaction, [Redacted] sold assets (equipment, buildings and technology) to the joint venture. [Redacted] is claiming that the gain or loss from the sale of the assets to the joint venture is nonbusiness income.
- [Redacted] In 1998 a [Redacted] corporation purchased all but 6% of [Redacted]’s shares of [Redacted]. In 1999 [Redacted] sold the remaining 6% of its shares. Prior to the 1998 sale [Redacted] held 50% of the [Redacted] stock. [Redacted] treated the gain as business income on its originally filed 1998 and 1999 Idaho combined group returns. However, in this protest the taxpayer argues that the gain should be treated as nonbusiness income.
- Sale of [Redacted]. Prior to 1996 [Redacted] was the majority owner of the stock of “[Redacted].” In 1996 [Redacted] “began to gradually reduce its ownership interest in [Redacted] stock. . . .” In 1999 [Redacted] sold shares of [Redacted] which resulted in a decrease in its ownership from approximately 68% to approximately 51%. [Redacted] treated the gain as business income on its originally filed return, but now claims that the gain should be recharacterized as nonbusiness income.

Based on the record, we are unable to find that [Redacted] has met its burden of establishing that the gains from the sale of these assets qualify as nonbusiness income. As a result, the audit adjustments are upheld.

B. Imposition of Penalties.

The audit staff asserted both the 5% negligence penalty and the 10% substantial understatement penalty. The negligence penalty was asserted “due to [the taxpayer’s] repeated failure to provide adequate documentation to support the nonbusiness income claimed on [its]

return.” Explanation of Items, p. 7. The substantial understatement penalty was asserted because the underpayment of tax exceeded the \$10,000 threshold in all three years.

[Redacted] asserts that the negligence penalty is not warranted. According to the taxpayer’s representative: “Taxpayer has provided adequate support for its nonbusiness income positions and has provided an adequate response to all other requests from the audit team. Taxpayer has demonstrated that it had a reasonable basis for its tax return positions and has not acted negligently in filing its Idaho income tax reports for the tax years at issue.” [Redacted] After careful consideration, the Tax Commission will agree to waive the negligence penalty. While we believe that the penalty was properly asserted (*see* IDAPA 35.02.01.410.02.k), we do not believe that imposition of both the negligence penalty and the substantial understatement penalties are warranted in this case. In effect, we find that the lack of adequate substantiation for many of the taxpayer’s nonbusiness income claims is sufficiently addressed through the substantial understatement penalty.

With respect to the substantial understatement penalty, [Redacted] simply asks that the penalty be reevaluated and recalculated “after the Commission has reviewed and adopted the changes proposed” by the taxpayer’s representative. *Id.* The substantial understatement penalty is set out in Idaho Code § 63-3046(d). Subsection (d)(7) provides that “[t]he state tax commission may waive all or any part of the [substantial understatement penalty] on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith.” I.C. § 63-3046(d)(7). The Tax Commission is unable to find that the understatement in Idaho tax during the years under audit was based on reasonable cause or that the taxpayer acted in good faith. Much of the understatement of tax relates to audit adjustments that were not protested. Of those adjustments that were protested, the taxpayer

provided very little documentation to substantiate its position. In the final analysis, the Commission simply does not believe that waiver of the substantial understatement penalty is warranted under the circumstances.

CONCLUSION

WHEREFORE, the Modified Notice of Deficiency Determination dated March 10, 2005, is hereby MODIFIED and as so Modified is APPROVED, AFFIRMED, AND MADE FINAL.

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

<u>PERIOD</u>	<u>TAX (REFUND)</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
1997	\$(20,440)		\$(10,875)	\$(31,315)
1998	63,743	\$6,369	29,000	99,112
1999	43,456	4,399	16,596	<u>64,451</u>
		TOTAL	AMOUNT DUE	<u>\$132,248</u>

Interest is calculated through January 31, 2006, and will continue to accrue at the rate set forth in Idaho Code § 63-3045(6) until paid.

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

An explanation of the taxpayer's right to appeal this decision is enclosed.

DATED this ____ day of _____, 2006.

IDAHO STATE TAX COMMISSION

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.
