

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)
) DOCKET NO. 18900
[Redacted],)
) DECISION
Petitioner.)
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)

PROCEDURAL HISTORY

On May 16, 2005, the Income Tax Audit Division of the Idaho State Tax Commission issued a Notice of Deficiency Determination [Redacted] (Petitioner) asserting an Idaho income tax liability in the amount of \$740,172 for the 2000 through 2002 taxable years. On July 18, 2005, the Petitioner filed a timely appeal and petition for redetermination. An informal conference was requested by the Petitioner and was held on February 28, 2006.

At the informal conference the Petitioner discussed the issues, as set forth below, and agreed to provide additional information. The Petitioner submitted the additional information on March 3, 2006. The Audit Division examined the information and asked the Petitioner to provide supplemental nexus information concerning four affiliated companies. The Petitioner agreed and submitted the nexus information on April 18, 2006. After reviewing all of the post-conference information submitted by the Petitioner, the Division issued a modified Notice of Deficiency Determination on July 8, 2006, that reduced the proposed deficiency.

The parties subsequently discussed the reduced deficiency determination and reached an agreement regarding the deficiencies for the taxable years 2000 and 2002. On October 6, 2006, the parties entered into a Compromise and Closing Agreement for the taxable years 2000 and 2002, leaving only the deficiency for taxable year 2001 at issue.

In the agreement, the Petitioner asked the Tax Commission to issue a redetermination of the modified deficiency for the taxable year 2001. At that time, the proposed deficiency for the 2001 taxable year was \$384,128. While preparing this decision (redetermination), the Tax Commission found the Petitioner had filed a Federal Form 1139 showing a capital loss carryback from the 2004 taxable year to the 2001 taxable year. The Tax Commission asked the Audit Division to make a determination concerning the federal claim. On October 11, 2006, the Audit Division issued a modified Notice of Deficiency Determination specifically for the taxable year 2001 which incorporated the capital loss carryback. The capital loss carryback reduced the proposed deficiency to \$285,217.

The Tax Commission provided the modified Notice of Deficiency Determination for the taxable year 2001 to the Petitioner for its review. On November 1, 2006, the Petitioner stated its agreement with the Audit Division's capital loss carryback calculations and asked the Tax Commission to issue a decision regarding the remaining protested issues associated with the modified Notice of Deficiency Determination for the 2001 taxable year.

ISSUES

[Redacted] and its unitary subsidiaries filed Idaho corporate income tax returns using the water's edge combined reporting method. The Tax Commission's Audit Division made a number of adjustments to the [Redacted] water's-edge combined group returns and imposed both the 5 percent negligence penalty and the 10 percent substantial understatement penalty.

The Petitioner filed a blanket Petition for Redetermination which, in a general sense, protested all of the adjustments made by the Audit Division for the 2000 through 2002 audit cycle. The Petitioner did not set forth specific issues for redetermination in its petition.

However, at the informal conference the Petitioner specified the following as the issues it wished to protest:

1. The same issues protested in [Redacted], namely, whether the income from dividends, capital gains, royalties, and interest were business or nonbusiness income;
2. In particular for this audit cycle, whether the gain from the sale of a [Redacted] constituted business or nonbusiness income;
3. Whether the Idaho sales of certain subsidiaries should have been excluded from the Petitioner's combined sales factor numerator because Idaho did not have sufficient nexus with the entities;
4. Whether the audit staff erred in adjusting the sales factor to include undocumented sales of a certain subsidiary as throwback sales;
5. A request from the Petitioner to correct the sales factor numerator it reported after the Petitioner discovered a computational error in the reported number;
6. A request to apply a capital loss carryback of \$1,102,669,879 from the 2004 taxable year to the 2001 taxable year; and
7. A request to abate the 5 percent negligence penalty and the 10 percent substantial understatement penalty imposed by the Audit Division.

As stated above, the parties resolved several of these issues. Following the informal conference, the Petitioner submitted: (1) a schedule correcting the Petitioner's Idaho sales factor numerator; (2) a list of entities the Petitioner believed should be removed from the sales numerator as exempt organizations; (3) a copy of the federal form reporting the capital loss carryback; and (4) a revised list of the sales of a certain Idaho subsidiary which identified throwback sales under the *Joyce* rule.

The Audit Division accepted and incorporated a majority of the submitted information, thereby resolving issues 4, 5, and 6. The remaining issues also are narrowed because the parties reached an agreement regarding taxable years 2000 and 2002. Accordingly, issues 1, 2, 3, and 7, as they apply to taxable year 2001, are discussed below.

HOLDING

The Tax Commission reviewed the audit file and the post-conference information submitted by the Petitioner. For the reasons stated below, the Tax Commission affirms the Audit Division regarding the tax and interest for the 2001 taxable year as set forth in the modified Notice of Deficiency Determination issued October 11, 2006. The Tax Commission also upholds the 10 percent substantial underpayments imposed by the Audit Division but abates the 5 percent negligence penalty.

DISCUSSION

1. Issues Common to Previously Protested Audit Cycle.

At the informal conference, the Petitioner stated the issues present in Docket No. 18731 were also present in this matter. This is the third audit cycle involving this taxpayer for which the Tax Commission has issued a decision. Docket No. [Redacted] involved the taxable years ending December 31, 1995, and December 31, 1996. The issues in that case were: (1) whether the income from dividends, capital gains, royalties, and interest were nonbusiness or business income; and (2) whether certain companies of the Petitioner's unitary group were entitled to deduct certain foreign taxes.

Docket No. [Redacted] involved the taxable years ending December 31, 1997, December 31, 1998, and December 31, 1999. In that case the [Redacted] the Audit Division erred in treating certain income as apportionable business income. The income at issue was 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 "unutilized 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."

The Tax Commission issued a decision in Docket No. [Redacted] which upheld the Audit Division on all of the above issues except the issue concerning gains and losses from unutilized land. The Tax Commission upheld the Audit Division because the Petitioner had not provided sufficient information to meet its burden of proof.

Because the parties resolved the deficiencies for the taxable years 2000 and 2002 after the informal conference, it is unclear to what extent the Petitioner intends to apply the protested issues from Docket No. [Redacted] to the remaining 2001 taxable year. Based on a review of the Audit Division's work papers and modified Notice of Deficiency Determination, it appears to the Tax Commission that the only audit adjustments remaining in the taxable year 2001 are the business income adjustments discussed below regarding the Petitioner's sale of a [Redacted] company.

Nonetheless, to the extent the Petitioner intends to apply its previous protest to the 2001 taxable year, the Tax Commission finds that by simply incorporating its previous protest and not providing additional information in this audit cycle, the Tax Commission is bound by its decision in Docket No. [Redacted] and must again find that the Petitioner has not met its burden of proof. Accordingly, the Tax Commission herein incorporates by reference its decision in Docket No. [Redacted] regarding common issues presented in that case and the tax year 2001 presently before the Tax Commission, with the exception of gains or losses from the sale of unutilized land.

In Docket No. [Redacted], the Petitioner specifically addressed gains and losses for unutilized land. The Petitioner provided a statement that indicated the land at issue was not used in its regular trade or business operations; therefore the gains or losses from the sale of the land should be treated as nonbusiness income or losses. In its decision, the Tax Commission stated

“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.”

In contrast to Docket No. [Redacted], the Petitioner has not identified sales of specific properties for the 2001 taxable year, nor has the Petitioner provided any proof that the gains or losses resulted from the sales of properties that were idle and not used in the taxpayer’s trade or business. Thus, to the extent this “unutilized land” issue is present in the taxable year 2001, the Tax Commission finds the Petitioner has not met its burden of proof.

2. Business Income Treatment of Gains from the Divestiture of a [Redacted] Business.

At the informal conference, the Petitioner identified one specific business/nonbusiness income adjustment it wished to protest. The Petitioner was a partner in a [Redacted] business. In October of 2001, the partnership sold the [Redacted] business to the [Redacted]. The Petitioner reported the gain from the sale of the business assets and partnership interest (approximately [Redacted]) as nonbusiness income. The Audit Division reclassified the income as apportionable business income.

The Tax Commission addressed the same [Redacted] business in a previous decision. In Docket No. [Redacted], the Tax Commission noted the Petitioner is one of the largest [Redacted] companies in the world. Originally, the Petitioner owned the entire [Redacted] company, but in 1992 the Petitioner partially divested itself of the [Redacted] business by placing it in a partnership. The Petitioner owned 50 percent of the company, and an unrelated company (also in the [Redacted] business) owned the remaining 50 percent of the company. The Petitioner

asserted that, because it had divested itself of a controlling interest in the business, the dividends the Petitioner received from the restructured [Redacted] business should be treated as nonbusiness income. The Tax Commission rejected the Petitioner's arguments and found the dividends to be business income.

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

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

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

Under Idaho's tax laws, business income is defined as all "income arising from transactions and activities in the regular course of the taxpayer's trade or business and includes income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitutes integral or necessary parts of the taxpayer's trade or business operations." Idaho Code § 63-3027(a)(1). Nonbusiness income is all income other than business income. Idaho Code § 63-3027(a)(4).

Idaho Code § 63-3027 sets forth two separate and independent definitions of the term "business income." Union Pacific v. Idaho State Tax Com'n., 136 Idaho 34, 28 P.3d 375 (2001). 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.* at 38 – 39, 28 P.3d at 379 – 380. 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.*

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.

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. 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.

[Redacted] contends that income (this time the gains recognized from the sale) of the [Redacted] business should be treated as nonbusiness income and that the income should not be apportioned to Idaho. The Tax Commission previously found that the [Redacted] company was part of the unitary business, and accordingly the Audit Division presumed that the sale of the business would constitute business income under the functional test.

The Tax Commission finds that the record contains very little evidence supporting the Petitioner's position. The Petitioner has made the same arguments regarding the divestiture of the business as it did when it restructured the business in 1992. While the Tax Commission certainly recognizes the arguments set out by the Petitioner'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). The applicable Idaho statute also 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, the Tax Commission upholds the audit findings.

3. Removing Tax Exempt Entities from the Sales Factor

As indicated above, during the conference the Petitioner identified several adjustments it wanted to make to the returns filed with the state of Idaho. Specifically, the Petitioner submitted a list of entities that it believed should be removed from the Idaho sales numerator as exempt organizations.

The power of Idaho to tax non-Idaho corporations is limited by a federal statute known as Public Law 86-272, codified at 15 U.S.C. § 381, which provides in pertinent part:

(a) No State ... shall have power to impose ... a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; ...

The question is whether the subsidiaries’ activities in Idaho are limited to protected “solicitation,” in which case the subsidiaries sales should be removed from the sales factor as the Petitioner requested.

The Petitioner specifically requested that three subsidiaries [Redacted] be removed from the sales factor reported for the 2001 taxable year. The request was forwarded to the Audit Division which then asked the Petitioner to complete and return Nexus Questionnaires for each subsidiary.

The Petitioner completed and returned the questionnaires. Ultimately, the Audit Division removed two of the three companies. The Division removed companies [Redacted]; however, it did not remove company [Redacted]

Company [Redacted] is a company acquired by the Petitioner. Before being acquired by the Petitioner, Company [Redacted] stated it had nexus with Idaho and regularly reported its sales to Idaho. On the questionnaire the Petitioner completed and returned with regard to [Redacted] [Redacted], the Petitioner stated the nexus activities of Company [Redacted] “[Redacted].” Noting that [Redacted] [Redacted] continues to operate in the same manner after being acquired by the Petitioner, as it had before the acquisition, the Division declined to remove the company from the Idaho sales numerator.

The Tax Commission also finds the Petitioner’s response to be confusing. If Company [Redacted] business practice did not change after being acquired by the Petitioner, it is difficult to understand how a mere change in ownership changed the nexus between the state of Idaho and the business. The Petitioner has not met its burden of proof. Accordingly, the Audit Division is upheld in declining the Petitioner’s request to remove Company [Redacted] from the Idaho sales numerator.

4. Imposition of Penalties.

The audit staff asserted both the 5 percent negligence penalty and the 10 percent substantial understatement penalty. The negligence penalty was asserted due to the Petitioner’s failure to provide adequate documentation to support the nonbusiness income claimed on its return. The substantial understatement penalty was asserted because the underpayment of tax exceeded the \$10,000 threshold.

The Tax Commission considered the same matter in Docket No. [Redacted]. In that case the Tax Commission stated:

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.

Neither the Petitioner nor the Audit Division presented any evidence or discussion that suggests this case should be treated differently.

The Tax Commission observes that the overwhelming majority of the remaining deficiency for the taxable year 2001 involves the business income issue associated with the sale of the [Redacted] company. The Tax Commission found the company to be part of the Petitioner's unitary business in previous proceedings. Despite this, the Petitioner provided no documentation to substantiate its position. Therefore, the Tax Commission simply does not believe that waiver of the substantial understatement penalty is warranted.

CONCLUSION

WHEREFORE, the modified Notice of Deficiency Determination for the 2001 taxable year issued on October 11, 2006, is hereby MODIFIED and as so Modified is APPROVED, AFFIRMED, AND MADE FINAL.

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

<u>PERIOD</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2001	\$198,946	\$19,894	\$56,441	<u>\$275,281</u>

Interest is calculated through January 20, 2007, 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 petitioner's right to appeal this decision is enclosed. 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 amounts to \$55,056 and will be held as security for the payment of taxes until the appeal is finally determined.

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.
