

**BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO**

In the Matter of the Protest of	)	
	)	DOCKET NO. 19445
[Redacted]	)	
Petitioner.	)	DECISION
	)	
	)	

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On March 23, 2006, the Idaho State Tax Commission’s (Commission) Income Tax Audit Bureau (Bureau) issued a Notice of Deficiency Determination to [Redacted] (petitioner), proposing additional income tax and interest for the taxable years 2002, 2003, and 2004, in the total amount of \$14,334. The petitioner filed a timely protest and petition for redetermination. The Commission issued its hearing rights letter on June 27, 2006, informing the petitioner of its appeals rights and subsequently followed up its hearing rights letter with a second notification on August 30, 2006. The petitioner did not respond to the Commission’s hearing rights letter. The Commission, having reviewed the file, hereby issues its decision.

On the returns filed for tax years 2002 through 2004, the petitioner treated interest income, dividend income, rental income, and income from a variety of flow-thru entities as nonbusiness income allocable [Redacted]. The Bureau disagreed with the petitioner’s nonbusiness income treatment and treated the items as business income subject to apportionment. In the petition for redetermination, the petitioner objected to the Bureau’s treatment. The income and expenses at issue are listed in Table 1 at the end of this decision.

**I. Facts**

1. The Petitioner - The petitioner was incorporated [Redacted] as a C corporation and subsequently elected to become an S corporation in [Redacted]. In [Redacted][Redacted]01, the petitioner reverted back to a C corporation status when stock owned by some of the petitioner’s

shareholders was sold [Redacted].<sup>1</sup> At some point the petitioner formed the [Redacted][Redacted] with the petitioner apparently as the sole member [Redacted][Redacted].

For the years at issue, [Redacted][Redacted] was listed as a partner/member of the following:

Name	2002 Member Interest	2003 Member Interest	2004 Member Interest
[Redacted]	40%	40%	40%
[Redacted]	52.63%	40.6%	40.6%
[Redacted]		14.992504%	17.000746%
[Redacted]			Unk

With no evidence that [Redacted] is anything other than a disregarded entity under federal law, [Redacted] for purposes of this decision will be treated as an operating division [Redacted] Hereafter any reference to “the petitioner” refers to [Redacted] as a single corporation while any reference to “the division” refers to the [Redacted] operating as a division [Redacted].

According to the petitioner, it is engaged in [Redacted] and primarily generates its income through [Redacted]. The petitioner and [Redacted] are a closely held group of entities; exactly which entities are part of this closely held group is unclear.<sup>2</sup>

In reviewing the petitioner’s [Redacted], [Redacted] and [Redacted] about the petitioner, the Commission learned that the petitioner has a tremendous passion [Redacted] The petitioner’s business model is to [Redacted] The petitioner is highly skilled [Redacted]; however, not all of the petitioner’s projects pay off, but as they do, the petitioner reinvests earnings into other projects. [Redacted] [Redacted] As a result of its investment in this entity the petitioner received ordinary income, real estate rental income, interest income and a small capital gain during the years at issue (see Table 1), all of which the petitioner allocated [Redacted]as nonbusiness

<sup>1</sup> See Page 1, 2001 Federal Form 1120S and statements attached therein for tax year ending August 31, 2001.

income. According to the petitioner, this entity was formed to construct a facility where it could formulate [Redacted] [Redacted] The petitioner acknowledges that the activities [Redacted] [Redacted] are related to that of the petitioner but argues that the activities are nonetheless distinctly separate businesses. The petitioner further acknowledges that [Redacted] some product for the division and charges the division” for said services [Redacted]. The petitioner charges [Redacted] a management fee for accounting and administrative services (actual costs plus a small profit) and rents facilities [Redacted]

3. [Redacted] - The petitioner, as a result of its investment in this entity, received ordinary income, interest income and a small capital gain during the years at issue (see Table 1), all of which was allocated [Redacted]. According to the petitioner, this entity was formed [Redacted]The petitioner acknowledges that the activities [Redacted] are related to that of the petitioner but argues that the activities are nonetheless distinctly separate businesses. The petitioner charges [Redacted] a management fee for accounting and administrative services (actual costs plus a small profit). It is unclear if the petitioner rents facilities [Redacted]

4. [Redacted] The petitioner, as a result of its investment in this entity, received ordinary income and income from rental activity (see Table 1), and apparently allocated this entity’s income to various states. According to the petitioner, this entity was formed because another unrelated entity, [Redacted]that the petitioner wanted. [Redacted] The petitioner indicated that there were no management fees being paid [Redacted] to the petitioner.

5. Rental Income and Expenses - The rental property consists of several buildings [Redacted] The petitioner, as part of the formation [Redacted] originally purchased/constructed the buildings [Redacted]; however, after the formation [Redacted] [Redacted], any subsequent

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<sup>2</sup> For example, an entity named [Redacted] was identified on the petitioner’s website as a subsidiary of the petitioner with operations back as far as 2000; however, little else is known about this entity and its interactions and

building and expansion was done [Redacted]. The petitioner rented the buildings [Redacted] at fair market value [Redacted] per year [Redacted] [Redacted]6. Interest Income - The petitioner classified interest on employee loans, overnight investments, loans to affiliates, and the interest [Redacted] receivable as nonbusiness income allocated [Redacted]. According to the petitioner, with the exception of interest on the overnight investments, the interest from the other sources has no business purpose related [Redacted]. The petitioner states that:

- Employee loans are short term loans and for the benefit of the petitioner's employees with no business purpose.
- Overnight investments are made from investing operating cash on hand overnight.
- Loans to affiliated companies are to help the cash flow of companies with similar ownership of that of the petitioner.
- With respect to the interest [Redacted] receivable, [Redacted] Over the years this process led to the creation of a large note receivable with no business purpose but to allow the minority members [Redacted] access to some of the equity that has built up. The interest is calculated [Redacted] No cash exchanges hands.

7. Other Income and Losses - In addition to the items discussed above, the petitioner claimed as nonbusiness income a minor amount of dividend income and a small loss from an investment [Redacted]

8. Total Everywhere Factors – The petitioner indicated in its limited responses that none of the [Redacted] rental property was included in the petitioner's property, payroll, or receipts factors as filed.

## **II. Law and Analysis**

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relationship to the petitioner.

1. Business And Nonbusiness Income Statutes and Administrative Rules - In 1965 Idaho adopted, with slight modification, the Uniform Division of Income for Tax Purposes Act (UDITPA). That uniform act, as modified, is found in 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).

There is a strong presumption under Idaho law that income derived 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.")

2. Idaho Courts - 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.

3. Constitutional Considerations Regarding Business Income - In a series of cases culminating in Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 112 S.Ct. 2251 (1992), the United States Supreme Court provided an analytical framework for determining the constitutional restraints on state apportionment of income.<sup>3</sup> 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. Wisconsin Dept. of Revenue*, 447 U.S. 207, 224, 100 S.Ct. 2109, 2120 (1980)) (internal quotations and modifications omitted).

The Due Process and Commerce Clauses of the Constitution do not allow a State to tax income arising out of interstate activities -- even on a proportional basis -- unless there is a " 'minimal connection' or 'nexus' between the interstate activities and the taxing State, and 'a rational relationship between the income attributed to the state and the intrastate values of the enterprise.' " *Exxon Corporation v. Wisconsin Dept. of Revenue*, 447 U.S., at 219-220, 100 S.Ct., at 2118, *quoting Mobil Oil Corp. v. Commissioner of*

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<sup>3</sup> The alluded to cases are Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425, 100 S.Ct. 1223 (1980); ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 102 S.Ct. 3103 (1982); F.W. Woolworth Co. v. Taxation and Revenue Dept., 458 U.S. 354, 102 S.Ct. 3128 (1982); Container Corporation of America v. Franchise Tax Bd., 463 U.S. 159, 103 S.Ct. 2933 (1983); and Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 112 S.Ct. 2251 (1992).

*Taxes*, 445 U.S., at 436, 437, 100 S.Ct., at 1231. At the very least, this set of principles imposes the obvious and largely self-executing limitation that a State not tax a purported “unitary business” unless at least some part of it is conducted in the state. See *Exxon Corp.*, 447 U.S., at 220, 100 S.Ct., at 2118; *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444, 61 S.Ct. 246, 249, 85 L.Ed. 267 (1940).

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 would be allowed under the unitary business principle. First, apportionment would 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 that 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 would 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.

The Court left this operational-function test largely undefined; however, the Court provided one practical example of operational unity. According to the Court, "a State may include within the apportionable income of a nondomiciliary corporation the interest earned on short-term deposits in a bank located in another state if that income forms part of the working capital of the corporation's unitary business, notwithstanding the absence of a unitary relationship between the corporation and

the bank.” *Id.* at 787-788, 112 S.Ct. at 2263. Thus, income earned on the investment of idle working capital can constitutionally be apportioned among the various states in which the corporation conducts its unitary business operations.

The Court also gave another indication of the breadth of this operational-function test when it cited footnote 19 of Container Corporation of America v. Franchise Tax Bd. In footnote 19 of Container Corp., Justice Brennan, writing for the majority, stated that “[a]s we made clear in another context in *Corn Products Refining Co. v. C.I.R.*, 350 U.S. 46, 50-53, 76 S.Ct. 20, 23-24, 100 L.Ed. 29 (1955), capital transactions can serve either an investment function or an operational function.” Container Corp. at 180 n.19, 103 S.Ct. at 2948 n.19. It is this distinction between investment and operational functions that is at the heart of the operational-function test set forth in Allied-Signal. In general terms, if a capital transaction serves an operational function, the income derived from the transaction will be treated as part of the corporation’s unitary business and is subject to apportionment. Conversely, if the transaction serves an investment function, the income derived from the transaction cannot be taxed by a nondomiciliary state unless (1) the investment transaction took place, at least in part, in that state or (2) payor-payee unity exists.

Another important point that can be gleaned from the language in footnote 19 of Container Corp. is that transactions other than the short-term investment of idle working capital may meet the operational-function test. The fact that the Court cites with approval the Corn Products Co. v. Commissioner decision is key. As explained by Professor Hellerstein:

In *Corn Products*, the Supreme Court held that a company engaged in converting corn into syrup and other products realized ordinary income and loss on the sale of corn futures even though such futures were not literally excluded from the “capital asset” definition under I.R.C. § 1221. Because the taxpayer’s transactions in corn futures were designed to protect its manufacturing operations against increases in the cost of its principal raw material and to assure a ready source of supply of corn if needed, the Court held that

the resulting profits and losses should be characterized consistently with Congress' perceived intent "that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss." *Corn Products*, 350 U.S. at 52.

The case spawned the doctrine under which gain or loss from the sale of intangible assets, frequently stock in other corporations, was held to be ordinary gain or loss because the asset was "**bought and kept not for investment purposes, but only as an incident to the conduct of the taxpayer's business.**" *John J. Grier Co. v. United States*, 328 F.2d 163, 165 (7th Cir. 1964). . . .

Income from intangible assets falling under the Corn Products doctrine thus would be apportionable under the operational-function test. . . .

Hellerstein, *State Taxation Of Corporate Income From Intangibles: Allied-Signal and Beyond*, 48 Tax L. Rev. 739, 793-94 n.319 (emphasis added).

### **III. Findings**

1. [Redacted] – The Commission finds that the income [Redacted] receivable is business income in accordance with Idaho's statutory definition of business income. The limited record before the Commission demonstrates the proceeds received by [Redacted]The inclusion of the income in the combined group's pre-apportionment tax base is consistent with the Due Process and Commerce Clause constraints set forth in Allied Signal and the other U.S. Supreme Court decisions discussed above.

2. [Redacted] Dividend Income and Interest Income (employee loans, overnight investments, and affiliate loans) – The Commission finds the income reportable by the petitioner [Redacted], employee loan interest, dividend income, overnight investment interest, and interest from loans to affiliates is business income. The limited documentation provided by the petitioner for each of these items is insufficient to overcome the presumption of the correctness of the Notice of Deficiency. See Albertson's Inc. v. State, Dept. of Revenue, 106 Idaho 810, 814

(1984) (a determination of the State Tax Commission is presumed to be correct); Parsons v. Idaho State Tax Commission, 110 Idaho 572, 574-575 n.2 (Ct. App. 1986) (a State Tax Commission deficiency notice is presumed to be correct and the burden is on the taxpayer to show that the deficiency is erroneous).

WHEREFORE, the Notice of Deficiency Determination dated March 23, 2006, is hereby APPROVED, AFFIRMED, and MADE FINAL.

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

<u>YEAR</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
2002	\$1,434	\$318	\$1,752
2003	4,632	781	5,413
2004	6,962	703	<u>7,665</u>
		TOTAL DUE	<u><u>\$14,830</u></u>

Interest is calculated through January 31, 2007, 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 taxpayer's right to appeal this decision is included with this decision.

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]  
[REDACTED]  
[REDACTED]

Receipt No.

[REDACTED]  
[REDACTED]  
[REDACTED]



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