BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 19109
[Redacted]	)	
Petitioner.	)	DECISION
	)	
	)	

PROCEDURAL HISTORY

On August 29, 2005, the Income Tax Audit Division of the Idaho State Tax Commission issued a Notice of Deficiency Determination (NODD) to the [Redacted] (Petitioner) asserting an Idaho income tax liability in the amount of $115,758 for the taxable years ending July 1, 2000; June 30, 2001; June 29, 2002; and June 28, 2003. On October 25, 2005, the Petitioner filed a timely appeal and petition for redetermination. An informal conference was requested by the Petitioner and was held on March 16, 2006.

Following the informal conference, the Petitioner submitted additional information regarding the relationship between the parent corporation and a subsidiary (Company D). Specifically, the information described the amount of the parent's products distributed by the subsidiary and the percentage of the subsidiary's total sales which consisted of sales of the parent's products. The Petitioner submitted this information on June 15, 2006.

On July 5, 2006, the Tax Commission received amended returns from the Petitioner claiming capital loss carrybacks from taxable years 2002, 2003, and 2004 to the taxable year ending June 30, 2001. The Audit Division examined the amended returns and asked the Petitioner to provide additional information. The Audit Division noted that the Internal Revenue Service had adjusted the Petitioner's returns while this matter was pending. Among the adjustments made by the Internal Revenue Service was a carryback of the capital loss from the 2002 taxable year to the 2001 taxable year.

Following its examination of the amended returns, the Audit Division issued a modified NODD. In its modified determination, the Audit Division incorporated the federal adjustments, including the taxable year 2002 capital loss carryback. In addition, the Division incorporated the other capital loss carrybacks Petitioner reported on its amended returns. The carryback of the capital losses reduced the taxable year 2001 tax liability from $29,224 to $21,044. The combined effect of all of the adjustments allowed by the Audit Division was to reduce the total tax liability for all of the years in question from $93,851 to $81,471.

The Tax Commission provided the modified NODD to the Petitioner on September 18, 2006. The Petitioner responded to the modified NODD on December 22, 2006. The Petitioner acknowledged the Audit Division incorporated the capital loss carry backs and federal adjustments in the modified NODD; however, the Petitioner stated it wished to continue its protest regarding the issue identified below.

ISSUES

On its Idaho returns the Petitioner excluded from apportionable income a $1,240,848,790 gain the Petitioner realized from the sale of its stock of subsidiary Company D. The Audit Division reclassified the income as business income, and apportioned the gain to Idaho and other states in which the Petitioner conducts business. The Petitioner protested the apportioning of the gain and presented three arguments in support of its position.

1. Idaho lacks the requisite jurisdiction to tax the gain because the Petitioner is not in a unitary relationship with Company D.
2. Pursuant to the United States Supreme Court's holding in Allied Signal, Idaho cannot apportion the gain because the Petitioner's investment in Company D did not have an operational purpose but rather was a passive investment.

3. The Company D stock gain is nonbusiness income that should be allocated to the Petitioner's state of domicile because the sale of Company D stock fails both the transactional and functional test used to determine business income as set forth in Idaho Code § 63-3027.

HOLDING

The Tax Commission reviewed the audit file and the post-conference information submitted by the Petitioner. The Tax Commission affirms the Audit Division regarding the modified Notice of Deficiency Determination issued September 18, 2006. Idaho has the requisite connection to apportion the gain realized on the sale of Company D stock. The Commission finds that the Petitioner is unitary with Company D. Also, the investment in Company D was not merely a passive investment; it served an operational function. As a result, the sale of Company D stock is business income under the functional test set forth in Idaho Code § 63-3027. The Tax Commission also upholds the five percent negligence penalty imposed by the Audit Division.

FACTS

The Petitioner is a manufacturer and marketer of consumer products. [Redacted]. As part of its consolidation, the Petitioner disposed of several companies. The Petitioner sold Company A [Redacted], Company B [Redacted], and Company C [Redacted]. Additionally, the Petitioner divested itself of Company D, one of the largest [Redacted] distributors in the United States. This restructuring occurred just before the audit years at issue.

The Audit Division audited the Petitioner for the taxable years ending June 30, 2001; June 29, 2002; and June 28, 2003. The main issue in the audit concerned certain income the Petitioner excluded from apportionable income on its return. The Petitioner characterized the excluded income as income from "non-unitary subsidiaries." The Audit Division asked for a listing of the "non-unitary subsidiaries," but the Petitioner did not provide a list or otherwise identify the “non-unitary” companies. The Division conducted research and determined that the “non-unitary” income excluded by the Petitioner was gains realized on the Petitioner’s sale of Company D in December 2000 and the sale of Company A in 2001. However, the record on this matter is not clear, and it may be that the “non-unitary subsidiaries” category included other companies as well.

The Division also found that the Petitioner filed on a water’s-edge basis, but the Petitioner had not filed a water’s-edge election as required by Idaho law. The audit report states this has been an on-going issue. During the audit for 1990-1992, the Multistate Tax Commission (MTC) found, and the Audit Division later confirmed, that the Petitioner was a unitary, worldwide business. For 1990-1992 the Audit Division changed the Petitioner’s reporting from a water’s-edge to a worldwide reporting. During an audit for 1993 through 1995, the Tax Commission’s Audit Division again found the Petitioner to be a unitary business that was required to file on a “Simplot” basis for the taxable year 1993 and on a worldwide basis for 1994 and 1995. Once again, the Audit Division changed the Petitioner’s water’s-edge reporting.

Based on the above facts, the Audit Division recomputed the Idaho returns for the years in question on a worldwide filing basis and reversed the “non-unitary subsidiaries” adjustments to the income the Petitioner reported. The result of these adjustments was a proposed deficiency of $109,396 ($89,057 tax, $15,887 interest, and $4,452 penalty). The Division also incorporated federal adjustments for the year ending July 1, 2000, in its audit report. The federal adjustments for the 2000 taxable year resulted in a deficiency of $6,362 ($4,794 tax and $1,568 interest).

The Petitioner did not protest the Audit Division changing its filing status from a water’s-edge to a worldwide reporting, or the Division incorporating the federal adjustments for the taxable year ending July 1, 2000, or the Division reversing the “non-unitary’ exclusions of gains from the sales of companies other than Company D. The only issue presented by the Petitioner in its written protest is whether or not the gain realized from the sale of Company D should be included in the apportionable income of the Petitioner's unitary business.

Company D is a [Redacted] distributor. Among the [Redacted] distributed by Company D were [Redacted] products manufactured and sold by the Petitioner. The Petitioner states the [Redacted] distributed by Company D only amounted to about six-tenths of a percent of the Petitioner's total annual sales. Also, the sale of the Petitioner's [Redacted] product amounted to about five percent of the Company D's total annual sale. In terms of dollars, the sale of the Petitioner's food products amounted to more than $120,000,000 of sales annually for both the Petitioner and Company D.

LAW AND ANALYSIS

1. The Unitary Business and Combined Reporting

In the previous audit cycles referenced above, both the Multistate Tax Commission and the Idaho State Tax Commission found that Company D was part of the Petitioner's unitary business. The unitary business concept treats a group of commonly owned businesses as a single unit for purposes of allocating and apportioning the income of that enterprise among the various states where it conducts business. *See generally*, Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 164 – 169 (1983)(discussing the unitary business principle in light of the California combined reporting requirement). As stated by the U.S. Supreme Court: "The principal virtue of the unitary business principle of taxation is that it does a better job of accounting for the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise than, for example, geographical or transactional accounting." Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 783 (1992) (citations and internal quotations omitted).

Idaho modified the Uniform Division of Income for Tax Purposes Act (UDITPA) allocation and apportionment provisions to require "combined reporting" of the income of certain affiliated corporations. Idaho Code § 63-3027 governs the computation of Idaho taxable income of a multistate or unitary corporation and provides in relevant part:

> **63-3027. COMPUTING IDAHO TAXABLE INCOME OF MULTISTATE OR UNITARY CORPORATIONS**. The Idaho taxable income of any multistate or unitary corporation transacting business both within and without this state shall be computed in accordance with the rules set forth in this section:
> * * * *
>
> (t) For purposes of this section and sections 63-3027B through 63-3027E, Idaho Code, the income of two (2) or more corporations, wherever incorporated, the voting stock of which is more than fifty percent (50%) owned directly or indirectly by a common owner or owners, when necessary to accurately reflect income, shall be allocated or apportioned as if the group of corporations were a single corporation, in which event:
>
> (1) The Idaho taxable income of any corporation subject to taxation in this state shall be determined by use of a combined report which includes the income, determined under subparagraph (2) of this subsection, of all corporations which are members of a unitary business, allocated and apportioned using apportionment factors for all corporations included in the combined report and methods set out in this section. The use of a combined report does not disregard the separate corporate identities of the members of the unitary group. Each corporation which is transacting business in this state is responsible for its apportioned share of the combined business income plus its nonbusiness income or loss allocated to Idaho, minus its net operating loss carryover or carryback.

Idaho Code § 63-3027(t)(underscore added). As explained by the Idaho Supreme Court:

> The combined reporting provision of subsection (s) [now I.C. § 63-3027(t)] is a further refinement of the basic apportionment principle. Its purpose is to permit application of the UDITPA

> formula to a single business enterprise which is conducted by means of separately incorporated entities. In an economic sense such a business is no different than a similar business composed of a single corporation with several separate divisions. For tax reporting purposes such businesses should be treated the same.

Albertson's Inc., 106 Idaho at 814-815, 683 P.2d at 850-851 (1984). In a recent case, the Idaho Supreme Court affirmed the principle it articulated in Albertson's.

> AIA Services also cites *Albertson's, Inc. v. State, Dept. of Revenue,* 106 Idaho 810, 683 P.2d 846 (1984), for the proposition that all members of a unitary group are required to file a combined return. In *Albertson's,* the issue was "whether it is appropriate to treat the income of a Texas corporation which is a wholly-owned subsidiary of Albertson's, Inc. as income of the parent corporation, subject to apportionment under the Idaho version of the Uniform Division of Income for Tax Purposes Act (UDITPA)." *Id.* at 811, 683 P.2d at 847. . . . The Court concluded that the "result thus reached [by combining the unitary group] is exactly what Albertson's would have paid in Idaho taxes had the subsidiary never been formed." *Id.* at 818, 683 P.2d at 854.

AIA Services, Inc., 136 Idaho at 187, 30 P.3d at 966. The purpose of combined reporting is to more accurately reflect the income of the unitary group.

Company D and the Petitioner are part of a unitary business. In Edison California Stores, Inc. v. McColgan, 183 P.2d 16 (Cal. 1947), the California Supreme Court articulated what has since come to be known as the "contribution – dependency" test. Succinctly stated, if the operation of one company is dependent upon or contributes to the operation of another company, the operations are unitary. If there is no such dependency or contribution, the businesses are considered to be separate. *See* Edison, 183 P.2d at 21. The Idaho Supreme Court has cited with approval the contribution – dependency test first articulated in Edison California Stores. *See* Albertson's Inc. v. State, Dept. of Rev., 106 Idaho 810, 815 - 816, 683 P.2d 846, 851 - 852 (1984).

The Petitioner made several statements in its Petition for Redetermination indicating the Petitioner did not exercise control over Company D and that there "was no sharing or controlling of operational resources (e.g. purchasing, software development, warehousing, facilities or other capital assets)." The Petitioner essentially is asserting that its relationship with Company D is not "unitary" under the criteria articulated in the Mobil Oil Corp. case, because centralized management of the companies does not exist.

The Petitioner correctly notes that in Mobil Oil Corp. v. Com'r of Taxes of Vermont, 445 U.S. 425 (1980), the United States Supreme Court set forth another test used to determine the existence of a unitary business. Vermont asserted that dividends received by Mobil Oil Corporation from certain of its wholly or majority owned subsidiaries should be included as business income, a portion of which was attributable to the State of Vermont based on a statutory apportionment formula. In response Mobil Oil Corporation pointed out that none of these subsidiaries conducted any business activity within Vermont and, therefore, in a separate accounting sense the dividend income was derived from business activities unrelated to Mobil Oil Corporation's Vermont activities. In rejecting Mobil Oil's argument and holding that the dividend income could constitutionally be included in the Vermont pre-apportionment tax base, the U.S. Supreme Court found that Mobil Oil had failed to establish that the subsidiaries in question were not part of its unitary petroleum operations.

In doing so, the Supreme Court opined that "separate accounting, while it purports to isolate portions of income received in various states, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale." Mobil, 445 U.S. at 438. The Court then went on to state that "[b]ecause these factors of profitability [functional integration, centralized management, and economies of scale] arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.' Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required." Id.

The Mobil Oil "factors of profitability" have been cited with approval in subsequent United States Supreme Court cases as one permissible method of identifying a unitary business. *See, e.g.*, F.W. Woolworth Co. v. Taxation & Revenue, 458 U.S. 354, 364 - 370 (1982) (finding little or no evidence of functional integration, centralization of management, or economies of scale). However, in Container Corp, supra, the Court, while citing the Mobil "factors of profitability" with approval, also made clear that the overarching inquiry in determining whether two or more enterprises are engaged in a unitary business is the existence of a "sharing or exchange of value not capable of precise identification or measurement – beyond the mere flow of funds arising out of a passive investment or a distinct business operation – which renders formula apportionment a reasonable method of taxation." Container Corp, 463 U.S. at 166.

The above quoted passage is particularly insightful in that it set the parameters of a unitary business by explaining what it is not. A unitary business is not a passive investment and is not a distinct business operation. But where the facts and circumstances establish an interrelationship or flow of values that goes beyond a mere passive investment or a distinct business operation, it is likely that a unitary relationship exists "which renders formula apportionment a reasonable method of taxation."

Whether one applies the contribution-dependency test or the three factors of profitability, the Tax Commission finds there is a contribution or "flow of value" between Company D and the Petitioner. Company D and the Petitioner contributed to each other's business. Company D distributed [Redacted] products of the Petitioner. Company D provided a [Redacted] products outlet to the Petitioner, and the Petitioner's [Redacted] products were part of Company D's annual sales.

The Tax Commission also notes that the audit staff relied on the past unitary findings of the Audit Division and the MTC. Staff reasoned that if Company D was part of the unitary group in the past, the proceeds from the sale of Company D should be included in the income of the unitary group in the year of sale. The Tax Commission agrees.

Moreover, the Audit Division discovered facts during the audit that demonstrate control and centralized management. The auditors reviewed the minutes of the Board of Directors of the Petitioner. Company D was a wholly-owned subsidiary in the Petitioner's affiliated group. On January 27, 2000, the Petitioner's Board approved a $32 million construction of a Company D warehousing facility in [Redacted]. The Petitioner's Board of Directors also approved the compensation and benefits plans for Company D's employees. In May of 2000, the Petitioner's Board directed Company D to enter into various separation agreements and certain administrative (tax, employee, etc.) sharing agreements to define the relationships of the Petitioner to a number of the Petitioner's other entities. In particular, the Board wanted to redefine the relationship between one of the Petitioner's limited liability companies and Company D. This instruction was the beginning of efforts to reshape the Petitioner's unitary business and position Company D for sale. The Petitioner's Board later directed the officers of Company D to amend Company D's articles of incorporation so that Company D could provide a public offering.

The United States Supreme Court has consistently held that the burden is on the taxpayer to show that there is no unitary relationship between a parent and its subsidiary and, as a result, the state -- in making a unitary finding -- is attempting to tax income derived from activities of a "discrete business enterprise" carried on outside its borders. *See, e.g.*, Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207, 223 (1980) ("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 the sale of petroleum products in that State.'" *Quoting* Mobil Oil Corp. v. Com'r of Taxes, 445 U.S. at 439. Thus, in the present administrative protest, the burden is on [Redacted] to show that Company D is not part of the unitary group.

Based on the discussion that occurred at the informal conference and the information submitted after the conference, it is apparently the Petitioner's contention that the Petitioner and Company D also are not unitary because the amount of contribution between the two companies only accounts for a small part of each company's overall business. The Petitioner concedes that Company D distributed the Petitioner's [Redacted] products to the benefit of both the Petitioner and Company D. However, the Petitioner states that the food distribution by Company D only amounted to about six-tenths of a percent of the Petitioner's total annual sales. Also, Company D's sale of the Petitioner's [Redacted] product only amount to about five percent of the Company D's total sales. While one could argue such a connection is *de minimis* in terms of percentages, it is noteworthy that the business activity in question still amounts to more than $120,000,000 of [Redacted] sales on an annual basis for both the Petitioner and Company D.

In any event, the Tax Commission is not aware of a *de minimis* exception for the unitary business concept nor has the Petitioner cited any authority that supports finding such an exception. The only authority cited by the Petitioner stated that:

> [T]he unitary business rule is a recognition of two imperatives: the State's wide authority to devise a formulae for an accurate assessment of a corporation's intrastate value or income; and the necessary limit on the State's authority to tax value or income which cannot in fairness be attributed to the taxpayer's activities within the State.

Petitioner's Written Protest, citing Allied-Signal, 504 U.S. 768, 779-780 (1992)(emphasis supplied by the Petitioner).

In short, the Petitioner asserts that including Company D in the unitary group and including the gain on the sale of Company D stock in apportionable income does not fairly reflect the Petitioner's business activities in the state of Idaho. As discussed below, the Petitioner's argument is misplaced. The argument would be more properly directed at the state's apportioning of the income of the unitary business rather than the unitary relationship of the companies.

2. Apportioning Business Income for Purposes of State Taxation.

The language from Allied-Signal quoted by the Petitioner speaks to how the income is apportioned once it is determined that a unitary relationship exists.[1] When a single corporation, or a "unitary" group of corporations, does business across state lines, each state may impose income tax only on that portion of the income earned within its borders. To that end, the income of the unitary business is divided among the states in which the business operates. 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 (1982). Nonbusiness income is allocated and attributed to a particular state under specific “allocation” rules. *See* Idaho Code § 63-3027(d) – (h) (rules relating to the allocation of nonbusiness income).

Business income is apportioned among the states in which the unitary business operates. Each state uses one or more ratios to divide or "apportion" the business income to determine the amount of income subject to each state’s income tax. The most commonly used formula is found in UDITPA, which Idaho and many other states have adopted either in whole or with modifications. Idaho’s apportionment formula is set out in Idaho Code § 63-3027 (i), which states that “[a]ll business income shall be apportioned to this state . . . by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus two (2) times the sales factor, and the denominator of which is four (4). . . .” Id. The property factor is computed by dividing the taxpayer’s property located in Idaho by its property located everywhere. Idaho Code § 63-3027(k). Likewise, the payroll factor is calculated by dividing the taxpayer’s Idaho payroll by its payroll everywhere. Idaho Code § 63-3027(n). And finally, the sales factor is derived by dividing the company’s Idaho sales by its sales everywhere. Idaho Code § 63-3027(p). Set out as a mathematical formula, the Idaho apportionment formula is represented by the following equation:

$$\frac{\left(\frac{\text{Idaho property}}{\text{Total property}} + \frac{\text{Idaho payroll}}{\text{Total payroll}} + 2 \text{ x } \left(\frac{\text{Idaho sales}}{\text{Total sales}}\right)\right)}{4}$$

[1] Although, as discussed below, the Allied-Signal Court also held that the income received on an investment in a non-unitary subsidiary could be apportioned and taxed if the investment served as an operational investment rather

The result of the above equation is then multiplied by the corporation's total business income to arrive at the portion of the business income apportioned to Idaho.

The three-factor apportionment formula, by means the location of a business's property, payroll, and sales, approximates the extent of the business activity in a given state. Container Corp., supra. Most states that impose a tax on corporate income use some variation of the three-factor apportionment formula. Many states, including Idaho, have modified the traditional three-factor formula so that the sales factor is double weighted.

The crux of the Petitioner's argument is that when Company D's income is included in apportionable income, too much income is being apportioned to Idaho, *i.e.*, Idaho's standard apportionment formula overstates the amount of business income subject to tax. Thus, the Petitioner's argument is more correctly viewed as an argument about apportionment than an argument about the unitary relationship between Company D and the Petitioner.

The United States Supreme Court stated that "the Constitution imposes no single [apportionment] formula on States … and … the Court [has] declined to undertake the essentially legislative task of establishing a single constitutionally mandated method of taxation." Goldberg v. Sweet, 488 U.S. 252, 261 (1989). A "margin of error [is] inherent in any method of attributing income among the components of a unitary business." Container Corp., 463 U.S. at 184. Such a formula need not "identify the precise geographic source of a corporation's profits." Moorman Mfg. Co. v. Bair, 437 U.S. 267, 273 (1978). Rather, a State is required to strive for a "'rough approximation' of the corporate income that is 'reasonably related to the activities conducted within the taxing state.'" Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207, 223 (1980), quoting Moorman Mfg. Co., 437 U.S. at 273. Under the standards articulated by the

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than a passive investment.

Supreme Court, once the unitary relationship has been established, states are given wide latitude in developing a formula that can be used to apportion the business income of the combined group.

Although states are given wide latitude in fashioning their respective apportionment formula under the United States Constitution, Idaho's apportionment statute recognizes that there are instances in which the standard apportionment formula does not accurately reflect the extent of the unitary group's business activity in the state of Idaho. Idaho Code § 63-3027(s) provides that:

> **63-3027. COMPUTING IDAHO TAXABLE INCOME OF MULTISTATE OR UNITARY CORPORATIONS.** The Idaho taxable income of any multistate or unitary corporation transacting business both within and without this state shall be computed in accordance with the rules set forth in this section:
> * * * *
> (s) If the allocation and apportionment provisions of this section do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the state tax commission may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
> (1) Separate accounting, provided that only that portion of general expenses clearly identifiable with Idaho business operations shall be allowed as a deduction;
> (2) The exclusion of any one (1) or more of the factors;
> (3) The inclusion of one (1) or more additional factors which will fairly represent the taxpayer's business activity in this state; or
> (4) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

These provisions are often referred to as "alternative apportionment." When standard apportionment fails to accurately reflect the business activity that occurs in Idaho, an alternative apportionment formula may be determined.

The Idaho Supreme Court examined the alternative apportionment provisions and stated that "There is a very strong presumption in favor of the normal three-factor apportionment and against the applicability of the relief provisions." Union Pacific v. Idaho State Tax Commission., 139 Idaho 572, 576, 83 P.3d 116, 120 (2004) *citing* Roger Dean Enterprises, Inc. v. State, 387 So.2d 358, 363 (Fla.1980). The Idaho Supreme Court also found:

> The alternative formula is the exception, and the party who wants to use an alternative formula accordingly has the burden of showing that the alternative is appropriate. Merely because the use of an alternative form of computation produces a higher business activity attributable to New Hampshire, is not in and of itself a sufficient reason for deviating from the legislatively mandated formula. *St. Johnsbury Trucking Co., Inc. v. State of New Hampshire*, 118 N.H. 209, 385 A.2d 215, 217 (1978). The party asserting alternative apportionment--in this case, the Commission,--bears the burden of showing that the alternative apportionment is appropriate. *Burlington Northern, Inc. v. Idaho State Tax Comm'n supra*, 121 Idaho 808, 828 P.2d 837 (1992).

Union Pacific, 139 Idaho at 576, 83 P.3d at 120. The purpose of alternative apportionment is to give both the tax agency and the taxpayer some latitude in fashioning a more equitable apportionment and allocation for a particular business activity; however, departure from the standard apportionment formula should be avoided except where reasonableness requires a departure. Union Pacific, 139 Idaho at 577, 83 P.3d at 121, *citing* Pierce, The Uniform Division of Income for State Tax Purposes, 35 TAXES 747, 781 (1957).

The Idaho Supreme Court specifically identified what grounds of “reasonableness” would support a deviation from the standard apportionment formula.

> "Reasonableness" has been defined as being made up of three elements: (1) the division of income fairly represents business activity and if applied uniformly would result in taxation of no more or no less than 100 percent of the taxpayer's income; (2) the division of income does not create or foster lack of uniformity among UDITPA jurisdictions; and (3) the division of income reflects the economic reality of the business activity engaged in by the taxpayer in the taxing state. *Twentieth Century Fox Film Corp. v. Dep't of Revenue*, 299 Or. 220, 700 P.2d 1035 (1985).

Union Pacific, 139 Idaho at 55, 83 P.3d at 121. The party requesting alternative apportionment must demonstrate that standard apportionment results in a significant distortion of the taxpayer’s business activity in the state; simply advocating a better method than the standard formula is not enough. Union Pacific, 139 Idaho at 122, 83 P.3d at 578, *citing* Appeal of New York Football Giants, (Opinion on Pet. Rhg., Calif. St. Bd. of Equalization, June 28, 1979).

In the Union Pacific case, the Tax Commission was the party seeking alternative apportionment, and therefore the Tax Commission had the burden to prove its proposed apportionment was reasonable. The Tax Commission showed that Union Pacific's method of apportioning the income did not accurately reflect the extent of Union Pacific's business activity in Idaho and that the alternative apportionment proposed by the Tax Commission was reasonable.

The Petitioner in this case implies that including Company D in the combined group distorts the amount of income apportioned to Idaho. However, the Petitioner does not identify how the standard apportionment formula fails to reflect the extent of the Petitioner's business activity in the state of Idaho. It appears that the only alternative apportionment proposed by the Petitioner simply is to remove Company D from the combined group. There is no evidence that such a removal would be reasonable. In accordance with the Idaho Supreme Court's decision in Union Pacific the Tax Commission finds that the Petitioner has not sufficiently demonstrated that it is reasonable to depart from the standard apportionment formula and therefore failed to meet its burden of proof.

3. The Gain as Apportionable Business Income

The Petitioner suggested that, absent a unitary relationship, Idaho cannot apportion the gain realized from the sale of Company D. The Petitioner cites the case of Allied Signal as support for its position. The Tax Commission agrees that in a series of cases culminating in Allied-Signal, supra, the United States Supreme Court provided an analytical framework for determining the constitutional restraints on state apportionment of income.[2] However, the Tax Commission disagrees with the Petitioner's conclusion. As discussed below, the Court held that it is not always necessary to find a unitary relationship exists before apportioning income for state taxation. The investment in a non-unitary business also can result in business income if the investment serves an operational purpose.

The Allied-Signal Court described two occurrences where apportionment of income from intangibles (such as the gain on the sale of Company D stock) will be consistent with the Due Process and Commerce Clause provisions of the United States Constitution. 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.

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 (1993).

The United States Supreme Court in Allied-Signal clearly indicated that a taxpayer can derive apportionable unitary income from an operational transaction even though there is no unity between the payor corporation and the payee corporation. It is this operational function test which

[2] 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).

was at issue in Allied-Signal that also is at issue in this protest with respect to the gain from the sale of Company D stock.

The Allied-Signal Court left this operational-function test largely undefined; however, it 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." Allied Signal. 504 U.S. at 787-788. 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. In footnote 19 of Container Corp., Justice Brennen, writing for the majority, stated that "[a]s we made clear in another context in *Corn Products Co. v. Commissioner*, 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. 463 U.S. at 180 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, then the income derived from the taxation cannot be taxed by a nondomicilary 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 (1993) (emphasis added).

The operational versus passive investment distinction also is the fundamental factor in determining whether specific income is business or nonbusiness income under Idaho law. Under Idaho tax law, 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. This definition is referred to as the "transactional test."

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 constitutes integral or necessary parts of the taxpayer's trade or business operations." Union Pacific, 136 Idaho at 38 – 39, 28 P.3d at 379 – 380. This definition is referred to as 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. Union Pacific, 136 Idaho 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. Union Pacific, 136 Idaho at 39, 28 P.3d at 380. The key determination is whether the property acquired, managed, or disposed of was directly connected with the taxpayer's business operations. American Smelting, 99 Idaho 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.

American Smelting, 99 Idaho 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.

Idaho statutes establish 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.”). Under Idaho law, there also 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 Tax Commission finds that the record contains very little evidence supporting the Petitioner's position. The Petitioner has made the same legal arguments regarding the divestiture of the business as it did when the business was included in the unitary group in the past. While the Tax Commission certainly recognizes the arguments set out by the Petitioner's representative during this protest, arguments are not evidence.

Over the past decade, the Multistate Tax Commission and the Idaho State Tax Commission have found that the Petitioner and Company D is unitary and that the income generated by Company D is business income. On its face, the fact that the Petitioner is a [Redacted] manufacturer and Company D is a [Redacted] distributor who distributes the Petitioner's products evidences an operational tie between the two companies. The Petitioner's investment in Company D was not merely a passive investment. Therefore the Tax Commission affirms the Audit Division's business income determination.

4. Imposition of Penalties.

The Audit Division imposed a five percent substantial understatement penalty pursuant to Idaho Code § 63-3046(a). A negligence penalty is asserted if any part of the deficiency is due to negligence or disregard of Idaho's rules and regulations governing taxation but without the intent of defraud. The Tax Commission observes that the Petitioner continues to file on a water's-edge basis without filing the proper election, an issue that has been addressed with the Petitioner in previous audits. The Audit Division and the MTC also found Company D to be part of the Petitioner's unitary business in previous taxable years. Therefore, the Commission finds that waiver of the penalty is not warranted.

CONCLUSION

WHEREFORE, the modified Notice of Deficiency Determination provided to the Petitioner on September 18, 2006, is 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
7/1/00	$ 4,794	$ - 0 -	$ 2,006	$ 6,800
6/30/01	28,948	1,052	9,800	39,800
Capital Loss Carryback to 2001	(7,904)		(1,219)	(9,123)
6/29/02	24,838	1,242	6,617	32,697
6/28/03	30,795	1,540	6,536	38,871
TOTAL	$81,471	$3,834	$23,740	$109,045

Interest is calculated through April 23, 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 the Petitioner 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 $21,809 and will be held as security for the payment of taxes until the appeal is finally determined.

DATED this ____ day of ____________________, 2007.

IDAHO STATE TAX COMMISSION

____
COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of __________________, 2007, 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.

____