BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 19311
[Redacted]	)	
	)	DECISION
Petitioner.	)	
	)	

On December 29, 2005, the Idaho State Tax Commission's (Commission) Income Tax Audit Bureau (Bureau) issued a Notice of Deficiency Determination (NODD) to [Redacted] (petitioner) proposing additional income tax, penalty, and interest for the taxable years 2001, 2002, and 2003, in the total amount of $115,224. The petitioner filed a timely protest and petition for redetermination. An informal telephone hearing was held on August 29, 2006. The petitioner provided the Commission with an extension of time until July 31, 2007, in which to issue a Decision. The Tax Commission, having reviewed the file, hereby issues its decision.

I. ISSUES

The petitioner did not protest any issues with respect to tax year 2001. On its Idaho 2002 and 2003 Idaho corporate income tax returns, the petitioner excluded from apportionable income $820,863,205 and $993,943, respectively. It is the Commission's understanding that the $820,863,205 represents gain on the sale of the petitioner's [Redacted] business and the $993,943 represents income from investments in four different partnerships. The Bureau reclassified the income as business income and apportioned the income to Idaho. The petitioner protested the apportioning of the income and presented three arguments in support of its position.

1. The gain on the sale of the stock should not be treated as business income under Idaho's statutory definition of business income because the acquisition, management, or disposition of the [Redacted] business (i.e. stock) was not an integral part of the petitioner's business and did not occur in the regular course of the petitioner's business. Furthermore, the

petitioner was not in the business of acquiring and disposing of [Redacted] businesses and, once acquired, the [Redacted] business was managed separately from the [Redacted] business.

2. Even if found to be business income, Idaho lacks the requisite jurisdiction to tax the gain as the [Redacted] business was not part of the petitioner's unitary business.

3. The partnership income was from non-unitary partnerships as the petitioner was not a general partner in the partnerships, and its ownership interest was less than 50 percent.

II. SUMMARY OF HOLDINGS

The Tax Commission affirms the Notice of Deficiency Determination issued December 29, 2005, as follows:

1. Gain on sale of [Redacted] business. Idaho has the requisite connection to apportion the gain realized on the sale of the corporate stock in which the [Redacted] business was held. The petitioner has not met its burden of showing that the [Redacted] business was not part of the petitioner's unitary business. Furthermore, the investment in the [Redacted] business was not merely a passive investment; it served an operational function, and the sale of subsidiaries' stock is business income under the functional test set forth in Idaho Code § 63-3027. Accordingly, the Commission upholds the Bureau regarding the treatment of the gain on the sale of stock as business income.

2. Income from investments in partnerships. The Commission finds that the petitioner has not met its burden of showing that the partnership income was nonbusiness income. Accordingly, the Commission upholds the Bureau regarding the treatment of the partnership income as business income.

3. Substantial underpayment penalty. The Tax Commission upholds the Bureau's imposition of the Idaho Code § 63-3046 ten percent substantial understatement penalty.

4. [Redacted] investment tax credit. Although not part of the NODD or the petitioner's protest letter, during the appeal process a discussion ensued regarding the Idaho Code § 63-3029I income tax credit for investment in [Redacted] equipment. The petitioner may very well have equipment that would qualify for the credit; however, since the petitioner has not provided the Commission with an order issued by the Public Utilities Commission confirming that the installed equipment is qualified [Redacted] equipment as required by Idaho Code § 63-3029I(4), the NODD is not modified to include any credit under Idaho Code § 63-3029I.

III. DISCUSSION OF FACTS

A. In General

In this Decision, the following abbreviations will be used:

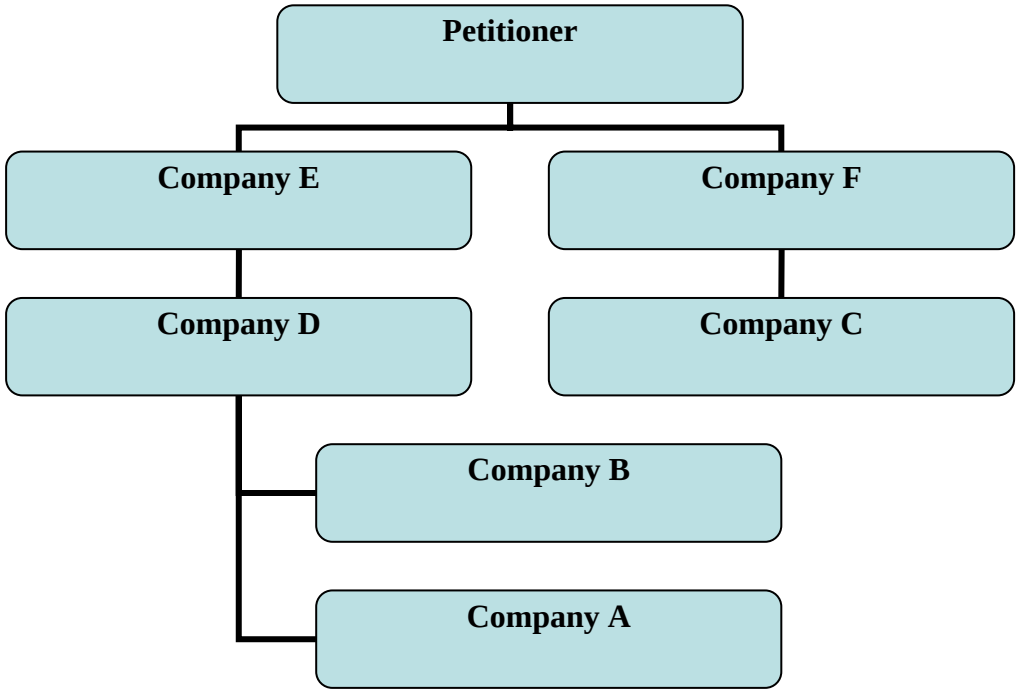
[Redacted].

By means of a Stock Purchase Agreement [Redacted], the petitioner acquired all of the capital stock of Company A and Company B [Redacted], [Redacted] Pursuant to the same Stock Purchase Agreement referenced above, immediately following the [Redacted] Purchase, the petitioner acquired all of the capital stock of Company C from Company Z (basically, an acquisition of all of the [Redacted]assets of Z) [Redacted] [Redacted] In its Annual Report, the petitioner describes the acquisition, in pertinent part, as follows:

[Redacted]

Following the [Redacted], Company A and Company B became wholly-owned subsidiaries of Company D. Company D was a wholly-owned subsidiary of Company E which was a wholly-owned subsidiary of the petitioner. After the acquisition, Company C became a wholly-owned subsidiary of Company F which was a wholly-owned subsidiary of the petitioner. The petitioner is the parent of a substantial number of other subsidiaries not previously

mentioned; however, those companies are not at issue in this decision. Basically, after the [Redacted], the corporate structure, with respect to the entities at issue, was as follows:



Prior to the [Redacted], the petitioner only had one wholly-owned subsidiary transacting business (providing [Redacted] service [Redacted]) within Idaho; however, as part of the [Redacted], the petitioner acquired a second subsidiary that owned and operated [Redacted] in another part of Idaho. The number of subsidiaries conducting business within Idaho increased from two to five by the end of 2003. The activities engaged in by these subsidiaries included providing [Redacted] service, buying and selling [Redacted], providing [Redacted] services to Idaho customers, and one non-Idaho subsidiary that had nexus with Idaho as a result of performing services within Idaho.

The petitioner contends that its [Redacted]lines of business were maintained separately within the structure of its overall affiliated group. In 1998 it executed an internal realignment of its corporate structure to segregate the [Redacted] lines of business. The petitioner served as the parent [Redacted] business. Company E, the wholly-owned subsidiary of the petitioner, served

as the parent [Redacted] line of business. The petitioner's assets included investments in wholly-owned subsidiaries owning and operating [Redacted] assets. Company E's assets primarily consisted of general partnerships, limited partnerships, limited liability companies, and subsidiaries that owned and operated various [Redacted] operating assets. The [Redacted] assets and investments acquired in the [Redacted] were held by Company E prior to the sale of Company E on August 1, 2002.

The petitioner, consistent with other [Redacted] companies at the time, sought to combine or "bundle" a number of its [Redacted] services together, including the implementation of a fully-integrated [Redacted] system. While the petitioner acknowledged that it may have intended, and initially made an effort, to develop its [Redacted] business into a single, assimilated whole, it insists that its bundling efforts were never consummated. The desired integration was allegedly never attained. Ultimately, having concluded that it was in the company's best interest to divest itself of its [Redacted] operations and concentrate on its core [Redacted] business, the petitioner dispensed with its total [Redacted]component on August 1, 2002, less than five years after the [Redacted].

The actual mechanics of the sale are unclear; however, for purposes of this decision, the Commission is assuming that the sale included Company E and its subsidiaries, Company D, Company B, and Company A.

A review of the petitioner's Form 10-K and Form 8-K reveals that:

1. Form 10-K for the fiscal year ended December 31, 2002. The Company (i.e. the petitioner and subsidiaries) reported that:
    a. The Company divested its:

i. [Redacted]Minority [Redacted] equity interests representing approximately 1.8 million [Redacted] and

ii. Licenses to provide [Redacted] covering 1.3 million [Redacted].

b. The Company retained a minority interest in one market, which it agreed to sell to the same purchaser of the [Redacted] business for approximately $68 million, subject to several closing conditions.

c. The Company incurred $30.5 million of expense in developing the [Redacted] portion of the Company's billing system.

d. The proceeds from the sale of the [Redacted] along with other operational proceeds were used to finance the acquisition of [Redacted] properties [Redacted].

2. Form 8-K dated March 19, 2002. The Company reported that:

a. In late 2000, the Company began offering competitive local [Redacted] services, coupled with [Redacted] other Company services, to small and medium-sized businesses [Redacted].

b. The Company was in the process of developing an integrated [Redacted] system which will enable the Company to offer customers value packaging and produce a single bill for multiple services [Redacted].

c. Certain service subsidiaries of the Company:

i. Provide installation and maintenance services, materials and supplies, and managerial, technical, accounting, and administrative services to the [Redacted] operating subsidiaries.

ii. Provide and bill management services to subsidiaries and, in certain instances, make interest-bearing advances to finance construction of plant, purchases of equipment, or acquisitions of other businesses.

B. Prior Idaho Filings

The Bureau has previously conducted a desk audit on the petitioner's 1982 through 1984 corporate returns, a field audit of the petitioner's 1993 through 1995 corporate income tax returns, and a field audit of the petitioner's 1997 through 1999 corporate income tax returns.

The 1982 through 1984 desk audit resulted in a letter issued to the petitioner explaining that the petitioner and its subsidiaries should be filing on a combined basis for tax years 1982 through 1984. The petitioner filed amended returns for tax years 1982 through 1984 and 1985 reporting on a worldwide unitary basis.

In the ITA audit of tax years 1993 through 1995, the petitioner had filed these years on a combined basis and had included the w[Redacted] businesses in the combined filing. The petitioner had been in the [Redacted] business for a number of years prior to the [Redacted] Acquisition. The petitioner argued that capital gains from the sale of certain minority held limited partnership interests should be treated as NBI since the [Redacted] partnerships sold were not unitary with the [Redacted] business in Idaho; however, according to the auditor's notes taken during the field audit, the petitioner had conceded that its [Redacted] operations were unitary with its [Redacted] business. Accordingly, the Bureau took the position that the sale of such interests was business income from the sale of an operational asset. The total amount of tax liability at issue was only $4,765. The petitioner paid the amount sought.

The Bureau's audit on tax years 1997 through 1999 resulted in the issuance of a NODD seeking tax and interest totaling $140,640. The petitioner had filed these years on a combined filing and had included the [Redacted] business in the combined report. As previously mentioned, 1997 was the first year of the [Redacted] Acquisition. The petitioner treated the companies acquired in the [Redacted] Acquisition as part of the unitary group of corporations

included in the combined report in 1997, 1998, and 1999. On audit, the Bureau held that instant unity was lacking during the first year of the [Redacted] Acquisition and removed the acquired companies from the combined report in tax year 1997. For tax years 1998 and 1999, the Bureau did not disturbe the petitioner's treatment of the [Redacted] business as being part of its unitary business. The majority of the $140,640 deficiency related to the reclassification of nonbusiness income to business income (partnership income from cellular partnerships, gain on the sale of a large "competitive access" subsidiary's stock, and the gain on the sale of interests in [Redacted] partnerships). The petitioner did not protest the NODD and simply paid the $140,640.

IV. ADOPTION OF UDITPA AND COMBINED REPORTING

In 1965 Idaho rewrote Idaho Code § 63-3027 wherein Idaho codified the majority of the Uniform Division of Income for Tax Purposes Act (UDITPA) provisions. I.C. § 63-3027.[1] Idaho Code § 63-3027 contains rules for determining the portion of a corporation's total income from a multistate business transacting business within and without this state and, therefore, subject to Idaho taxation. In general, Idaho Code § 63-3027 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, I.C. § 63-3027(i); while non-business income is allocated to a specific jurisdiction, I.C. § 63-3027(d)-(h).[2]

In addition to the codification of the UDITPA provisions, Idaho retained language that had been added to the Idaho Code in 1959 whereby "a parent and subsidiary corporation may,

[1] 1965 Session Laws ch. 254, § 1, p 639.
[2] Unless otherwise noted, reference to Idaho Code and rules refers to the Idaho Code and rules in place for the years at-issue.

when necessary to accurately reflect income, be considered a single corporation."[3] I.C. § 63-3027(t). Idaho Code § 63-3027(t) is a clarification of the application of UDITPA to unitary businesses conducted through a multicorporate structure and viewed as a refinement of the basic apportionment principle when dealing with a unitary business being conducted through an affiliated group of corporations. Albertson's Inc. v. State, Dept. of Rev., 106 Idaho 810, 815 - 816, 683 P.2d 846, 851 - 852 (1984). Its purpose is to permit application of the UDITPA formula to a single business enterprise which is conducted by means of separately incorporated entities. See United States Steel Corp. v. Multistate Tax Commission, 434 U.S. 452, 473, n. 25, (1978). In an economic sense, such a business is no different than a similar business composed of a single corporation with several separate divisions. Over the years, a number of approaches have been utilized to determine the existence of a unitary business. Compare Butler Brothers v. McColgan, 17 Cal.2d 664, 111 P.2d 334, (1941), *aff'd* 315 U.S. 501 (1942) (three unities approach - unity of ownership, unity of operation, and unity of use); Edison California Stores, Inc. v. McColgan, 30 Cal.2d 472, 183 P.2d 16 (1947) (dependency/contribution approach); and Mobil Oil Corp. v. Com'r of Taxes, 445 U.S. 425 (1980) (functional integration, centralization of management, and economies of scale). For tax reporting purposes, such businesses should be treated the same. American Smelting & Ref'g Co. v. Idaho St. Tax Comm., 99 Idaho 924, 934-935, 592 P.2d 39, 49-50 (1979), *rev'd on other grounds;* ASARCO Inc. v. Idaho State Tax Commission, 458 U.S. 307 (1982). The Idaho Court adopted many of these same principles for defining a unitary business. Albertson's Inc. v. State, Dept. of Rev., 106 Idaho 810, 815 - 816, 683 P.2d 846, 851 - 852 (1984).

[3] 1959 Session Laws ch. 299, § 27, p. 613, 625.

V. ISSUE ANALYSIS AND FINDING

A. The Gain On The Sale Of The Stock Of Company E Is Business Income Since Company E And Its Subsidiaries Were Part Of Petitioner's Unitary Business.

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 [Redacted] business is not part of the unitary group. The Commission does not believe that the petitioner has met its burden of showing that the [Redacted] businesses were not part of a unitary business, especially given:

1. The statements contained in the petitioner's Form 10-K and 8-K that:
    a. The development of a single integrated billing system included both the [Redacted] businesses, and the petitioner incurred at least $30.5 million of expense to develop the [Redacted] portion of the Company's billing system.
    b. In late 2000, the Company began offering competitive local [Redacted] services, [Redacted] other Company services, to small and medium-sized businesses [Redacted].
    c. Certain service subsidiaries of the petitioner provide installation and maintenance services, materials and supplies, and managerial, technical, accounting, and

administrative services to the [Redacted] operating subsidiaries as well as possibly billing for management services.

2. The petitioner's past Idaho filing practice included treating the [Redacted] business as unitary. The Bureau reasoned that, if [Redacted] business was part of the unitary group in the past, it was unitary up through time of sale; thus, the proceeds from the sale [Redacted] should be included in the income of the unitary group in the year of sale. The Commission agrees.

B. The Petitioner's Ownership In Company E And Subsidiaries Served An Operational Purpose. Therefore The Gain On The Sale Of Company E's Stock Is Business Income.

The petitioner suggested that, absent a unitary relationship, Idaho cannot apportion the gain realized from the sale of its [Redacted] business. The petitioner cites the case of Allied-Signal, Inc. v. Director, Div. of Tax., 504 U.S. 768 (1992), 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.[4] However, the Tax Commission disagrees with the petitioner's conclusion. 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 [Redacted] business) would be consistent with the Due Process and Commerce Clause provisions of the United States Constitution. First, apportionment

[4] The alluded to cases are Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425, (1980); ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307 (1982); F.W. Woolworth Co. v. Taxation and Revenue Dept., 458 U.S. 354 (1982); Container Corporation of America v. Franchise Tax Bd., 463 U.S. 159 (1983); and Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, (1992).

would be permitted if there was unity between the payor and the payee. That is, apportionment would be permitted if the payor and the payee were engaged in the same unitary business.

The second occurrence upon which apportionment of income from intangibles would be permitted was if the capital transaction from which the income was derived "serves an operational function" as opposed to an "investment function." Id. at 788. 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.

The Allied-Signal Court left this operational-function test largely undefined; however, it provided one practical example. 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 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 concept 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 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 (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 several statements regarding how it views the relationship between the [Redacted] business but has not provided documentation to the Commission for examination. In contrast, the record before the Commission evidences an operational relationship [Redacted] rather than just a passive investment. While the Commission certainly recognizes the arguments set out by the petitioner's representative during this protest, without supporting documentation those arguments are not evidence.

C. The petitioner has not met its burden of showing that the income from the partnerships is not business income.

In 2003, the petitioner treated the income from four partnerships as nonbusiness income. According to the petitioner in its petition for redetermination:

> . . . the partnership income that was earned in both 2002 and 2003 was clearly non-unitary as [the petitioner] was not a general partner in the partnerships and its ownership interest was less than 50%. The income from the non-unitary partnerships was inadvertently treated as apportionable on the 2002 return and thus an adjustment should be made for 2002 to treat that income as allocable.

Since the petitioner had treated the partnership income as business income in 2002, the Bureau did not need to make an adjustment for that year; however, the Bureau did adjust the

petitioner's 2003 tax return to reclassify the treatment of the partnership income from nonbusiness to business.

With respect to investments in partnerships, a business income determination is not simply made based upon the status of the partner (i.e. general or limited) or the fact that the ownership percentage is 50 percent or less. The petitioner has not provided any authority that would bind Idaho to such an approach. Rather, as previously discussed, the Allied Court indicated that a taxpayer can derive apportionable unitary income from an operational transaction even though there is no unity between the payor and the payee. The apportionment of income from an intangible will be permitted if the capital transaction from which the income is derived "serves an operational function" as opposed to an "investment function." Little to no documentation has been provided to the Commission regarding these partnerships and the partnerships' relationship to the petitioner's business. 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 deficiency determination is incorrect. Albertson's Inc. v. State, Dept. of Revenue, 106 Idaho 810, 814, 683 P.2d 846, 850 (1984). The Commission finds that the petitioner has not met that burden and, therefore, upholds the Bureau's treatment of the partnership income as business income.

D. The imposition of the substantial understatement penalty is upheld.

The Bureau imposed a 10 percent substantial understatement penalty pursuant to Idaho Code § 63-3046.[5] Idaho Code § 63-3046 states in pertinent part:

> **§ 63-3046. Penalties and additions to the tax in case of deficiency.**
>
> . . .
>
> (d) (1) If there is a substantial understatement of tax for any taxable year, there shall be added to the tax an amount equal to ten per cent (10%) of the amount of any underpayment attributable to such understatement.
> (2) For purposes of this subsection, there is a substantial understatement of tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of:
> (i) Ten per cent (10%) of the tax required to be shown on the return for the taxable year, or
> (ii) Five thousand dollars ($5,000).
> (3) In the case of a corporation, paragraph (d)(2)(ii) of this section shall be applied by substituting ten thousand dollars ($10,000) for five thousand dollars ($5,000).
> (4) For purposes of paragraph (d)(2) of this section, the term "understatement" means the excess of:
> (i) The amount of tax required to be shown on the return for the taxable year, over
> (ii) The amount of the tax imposed which is shown on the return.
> (5) The amount of the understatement under paragraph (4) shall be reduced by that portion of the understatement which is attributable to:
> (i) The tax treatment of any item by the taxpayer if there is or was substantial authority for such treatment, or
> (ii) Any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return.
> (6) ...

[5] For the period January 1, 2001, through March 7, 2001, the substantial understatement penalty was in subsection (e), the subsection cited in the NODD; however, effective March 8, 2001, subsection (e) was renumbered as subsection (d). See 2000 Session Laws ch. 19, sec 1, p. 35, 36 and 2001 Session Laws ch. 270, sec. 8, p. 977, 986.

> (7) The state tax commission may waive all or any part of the addition to tax provided by this section on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith.

The computation of the amount of the understatement of tax and the determination that it is substantial are mechanical processes under subsections (2), (3), and (4) of the quoted subsection. The understatements here are substantial within the meaning of those provisions to the extent that the audit treatment of the protested items is upheld herein.

The understatement subject to the penalty must be reduced if there is "substantial authority" for the taxpayer's position. Under federal interpretations of the Internal Revenue Code language from which subsection (d) was borrowed, "substantial authority" is an objective standard. It requires more than a "reasonable basis" for the taxpayer's position, but less than a "more likely than not to prevail" standard.

Since the petitioner has not provided documentation to support its factual assertions, especially given the petitioner's prior treatment of the [Redacted] business as part of its unitary group and the inclusion of the partnership income as business income in the prior year, the petitioner has not demonstrated that it relied upon substantial authority with respect to the treatment of the gain on the stock of Company E and the income from the partnerships. Additionally, the understatement subject to the penalty must also be reduced to the extent the facts supporting the petitioner's treatment are adequately disclosed in the tax return. Here, the mere claiming of a line item of nonbusiness income discloses no facts other than the existence of a claim. No facts were disclosed in the return to support the petitioner's treatment.

Finally, the Commission "may" waive the penalty on a showing of reasonable cause "and" good faith. The Commission does not question the petitioner's good faith; however, reasonable cause is also an objective test requiring some ascertainable event or condition causing the erroneous

reporting. No such cause is claimed. Even if it were, the language of this paragraph is discretionary, not mandatory.

The penalty is sustained.

E. The NODD is not modified to allow for any Idaho Code § 63-3029I credit.

Idaho Code § 63-3029I provides that "for taxable years beginning after January, 1, 2001, there shall be allowed to a taxpayer a nonrefundable credit . . . for qualified expenditures in qualified [Redacted] equipment in Idaho." Given that the audit period in this case involved tax years 2001 through 2003 and that the petitioner would appear to be the type of business that the [Redacted] credit was intended to target, during the appeals process Idaho's [Redacted] credit was pointed out to the petitioner. The petitioner reviewed its records and felt, after analyzing Idaho's statute, that they would be entitled to a substantial credit of $50,000 or more. Idaho Code § 63-3029I(4) states in pertinent part that "No equipment described in . . . this section shall qualify for the credit . . . until the taxpayer applies to and obtains from the Idaho public utilities commission an order confirming that the installed equipment is qualified [Redacted] equipment." The petitioner was given additional time in which to obtain an order from the Idaho Public Utilities Commission but, at the time of this Decision, has not provided the Commission with said order. Therefore, no modification is made to the NODD with respect to allowing an Idaho Code § 63-3029I credit.

WHEREFORE, the Notice of Deficiency Determination dated December 29, 2005, is hereby 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
2001	$ (47,152)		$(15,900)	$ (63,052)
2002	132,551	$13,255	36,182	181,988
2003	4,902		1,079	5,981
			TOTAL DUE	$124,917

Interest is calculated through October 26, 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 Commission 20 percent of the total amount due in order to appeal this decision. The 20 percent deposit in this case amounts to $24,984 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]
[Redacted]
[Redacted]

Receipt No.

_____