

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

In the Matter of the Protest of	)	
	)	DOCKET NO. 19583
[Redacted]	)	
	)	DECISION
Petitioner.	)	
_____	)	

**PROTEST SUMMARY**

The Income Tax Audit Division of the Idaho State Tax Commission issued a Notice of Deficiency Determination dated June 7, 2006, to [Redacted]. (Petitioner) for the taxable years 2003 and 2004. The Audit Division asserted a total deficiency of \$4,347 for the taxable years in question.

The Petitioner submitted a timely protest of the proposed deficiency and requested an informal conference before the Tax Commission. The Tax Commission assigned the matter as Docket No. 19583 and conducted an informal conference on December 12, 2006. The Petitioner participated by telephone.

On December 26, 2006, the Petitioner submitted additional information, including a [Redacted] Agreement and a [Redacted] Agreement. The parties participated in a second informal conference on July 12, 2007. Following the second conference, the Tax Commission deemed the matter fully submitted and ready for a decision.

**FACTS**

The Petitioner is a [Redacted]. The company expanded its operations into the United States in [Redacted] and developed a specialty niche for [Redacted]. In [Redacted] the company purchased a [Redacted] company which was merged into the Petitioner's business as the [Redacted].

In [Redacted], the Company decided to direct its efforts to higher-end [Redacted] and sold the [Redacted]. It sold the Division to [Redacted], a separate corporation, for cash and a [Redacted] percent interest in [Redacted]. The Petitioner paid tax on the transaction, including its receipt of both the cash and the new ownership interest.

The Petitioner and [Redacted] entered into a [Redacted] Agreement and a [Redacted] Agreement which allowed the Petitioner to continue its operations for a short period of time. In [Redacted], the [Redacted] stock was sold to a third party. When the Petitioner sold its [Redacted] percent interest in [Redacted] it reported the gain as nonbusiness income.

### **ISSUE PROTESTED**

The sole issue in this case is whether the gain from the Petitioner's [Redacted] percent interest in [Redacted] is business income or nonbusiness income. It is the Petitioner's position that after its sale of the [Redacted], the [Redacted] percent interest it retained in [Redacted] was simply a passive investment, as opposed to an operational investment, and therefore constituted nonbusiness income pursuant to the Supreme Court's ruling in the Allied Signal case. The Audit Division concluded the gain on the sale of stock constituted business income based on the history of the company and the statutory presumption regarding a sale of stock.

### **ANALYSIS**

#### **1. Background regarding the Apportionment of the Business Income of a Multistate Business.**

In 1965, Idaho adopted, with some modification, the Uniform Division of Income for Tax Purposes Act (UDITPA), Idaho Code § 63-3027. The Act contains a formula for determining the portion of a multistate business's total income which is attributable to Idaho and therefore subject to Idaho's income tax.

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 attributable to business activities within its borders. Allied-Signal, Inc. v. Director, Div. of Tax., 504 U.S. 768, 772-773 (1992). 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 Petitioner's property located in Idaho by its property located

everywhere. Idaho Code § 63-3027(k). Likewise, the payroll factor is calculated by dividing the Petitioner’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:

The result of the above equation is then multiplied by the corporation’s total business income to determine the corporation’s share of the state’s business’s income tax liability in a given state. Cor. 1983)Error!

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

**Bookmark not defined.** 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.

**2. Constitutional Concerns Regarding the Apportionment of Income.**

In a series of cases culminating in Allied-Signal, 504 U.S. 768 (1992), the United States Supreme Court provided an analytical framework for determining the constitutional restraints on state apportionment of income.<sup>1</sup> The Allied-Signal Court described two occurrences where apportionment of income from intangibles (such as the gain on the sale of 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 entities. The “unitary business” concept is a concept that permits application of the UDITPA apportionment formula to a

<sup>1</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).

single business enterprise that is conducted by means of separately incorporated entities. In an economic sense, the unitary business conducted by the separately incorporated entities is no different from a similar business composed of a single corporation with several separate divisions. For tax reporting, these two types of business structures should be treated the same.

Idaho Code § 63-3027(t) provides that two or more corporations may be considered a single corporation for income tax purposes, provided more than 50 percent of the voting stock of each of them is owned directly or indirectly by a common owner or owners, and such treatment is necessary to accurately reflect income. In this case the Petitioner owned [Redacted] percent of the stock of [Redacted]. Therefore, the Petitioner and [Redacted] will not be treated as a “single corporation” or unitary business.

The Allied Signal Court found that 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. “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).

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. 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). Thus, transactions other than a short-term investment of idle working capital may meet the operational-function test.

### **3. The Statutory Definition of Business Income**

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.

#### **4. The Gain in Question is Business Income that is Properly Subject to Apportionment**

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.").

The Tax Commission finds that the record contains very little evidence supporting the Petitioner's position. Instead, the record before the Tax Commission evidences a strong operational tie between the Petitioner's ownership in [Redacted] and the Petitioner's unitary business.

During the informal conference in this matter, the Petitioner referenced a [Redacted] Agreement and a [Redacted] Agreement entered into between the Petitioner and [Redacted]. The agreements were the result of the [Redacted] sale of the Petitioner's [Redacted] Division to [Redacted]. The Petitioner represented these agreements were to "clean up" existing obligations

of the Petitioner. The Tax Commission requested the [Redacted] Agreement and the [Redacted] Agreement which the Petitioner submitted after the informal conference.

A review of the agreements demonstrates that the Petitioner used the agreements as a means of winding-up its business; however, in doing so the Petitioner continued to operate its unitary business and to generate business income. The [Redacted] Agreement states “the parties wish to provide for the continued distribution by the affiliates of [the Petitioner] of certain products of the Business to be hereafter manufactured by [Redacted].” [Redacted] The agreement further provides that the Petitioner’s affiliates would continue to receive the same products as they received before the Petitioner sold its [Redacted] Division to [Redacted]. [Redacted] The Petitioner’s affiliates also would pay the same price for the products as they received before the Petitioner sold its [Redacted] to [Redacted]. [Redacted]

The agreement states that the Petitioner’s affiliates will distribute and sell the products in the same geographic markets as the Petitioner’s affiliates “distributed and sold the Products on behalf of the Business” before the sale of the [Redacted]. [Redacted] The agreement also contained a no-competition clause, stating that “[Redacted] shall not, while any given Territory is subject to this Agreement, sell or supply the Products or any products similar to the Products to any person, firm or corporation operating in such Territory with the prior written consent of the [Petitioner’s affiliate] which is the distributor in such Territory.” [Redacted] The Petitioner’s affiliates also were granted the “royalty-free right the trademarks of [[Redacted]]” related to the products and the Petitioner’s’ distribution of the products. [Redacted]

### **CONCLUSION**

The [Redacted]percent interest that the Petitioner retained in [Redacted] following the sale of its [Redacted] Division to [Redacted] was not merely a passive investment. The

[Redacted]% represented a continuation of the Petitioner's business operations as it existed before the sale. The gain which the Petitioner realized on the sale of its interest in [Redacted] is business income under the functional test set forth in Idaho statutes. Moreover the business income is properly subject to apportionment under the constitutional considerations announced by the Supreme Court in Allied Signal.

WHEREFORE, the Notice of Deficiency Determination dated June 7, 2006, is hereby AFFIRMED, APPROVED and MADE FINAL.

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

<u>YEAR</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
12/31/2003	\$3,386	\$759	\$4,145
12/31/2004	455	75	<u>530</u>
		TOTAL AMOUNT DUE	<u>\$4,675</u>

Interest is calculated through November 16, 2007.

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

An explanation of the taxpayer's right to appeal this decision is enclosed with this decision. As set forth in the enclosed explanation, you must deposit with the Tax Commission 20 percent of the total amount due in order to appeal this decision. The 20 percent deposit in this case is \$935 and will be held as security for the payment of taxes until the appeal is finally resolved.

DATED this \_\_\_\_\_ day of \_\_\_\_\_, 2007.

IDAHO STATE TAX COMMISSION

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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.

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