BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 19722
[Redacted],	)	
	)	DECISION
Petitioner.	)	
	)	
	)	

PROCEDURAL BACKGROUND

On August 29, 2006, the Income Tax Audit Division of the Idaho State Tax Commission (Audit Division) issued a Notice of Deficiency Determination (NODD) to [Redacted] (hereinafter the "Petitioner") asserting additional corporate income tax and interest in the amount of $18,112 for the taxable year 2002. The Notice of Deficiency Determination resulted from a follow-up audit conducted by the Audit Division for the taxable years 1999 through 2001. On September 19, 2006, the Petitioner filed a Petition for Redetermination of the deficiency. The Petitioner requested an informal conference before the Commission.

On February 1, 2007, the Tax Commission conducted an informal conference to discuss the audit staff's deficiency determination with the Petitioner. The Petitioner's representatives participated by telephone. Staff from the Audit Division appeared in person. During the informal conference, the Petitioner's representative and staff from the Audit Division agreed that several issues could be addressed and resolved if the Petitioner submitted additional information. The parties agreed the Petitioner would submit additional information which would be reviewed by the Audit Division, and a second conference would be conducted following the Division's review.

The Petitioner submitted additional information on February 7, 2007. The Audit Division reviewed the information as well as amended returns the Petitioner filed. On February 14, 2007, the Audit Division issued a modified NODD. The modified NODD asserted a proposed deficiency of $4,011 with interest calculated to February 26, 2007.

At the Petitioner's request a second informal conference was conducted on March 1, 2007. As before, the Petitioner's representatives participated by telephone and staff from the Audit Division appeared in person. At the informal conference, the Petitioner stated that the two issues identified below were the only issues remaining.

ISSUES

The Audit Division included [Redacted] ([Redacted]) and its subsidiaries in a worldwide combined report for Idaho income tax purposes. The Petitioner protested the inclusion of [Redacted] and its subsidiaries based on the following grounds:

1. [Redacted] and its subsidiaries is a "Finance Group" that is not unitary with the [Redacted] corporations (the [Redacted] group) that filed income tax returns in Idaho; and

2. However, if found to be part of the unitary business, the Finance Group companies should be considered financial institutions and the income of the group should be apportioned pursuant to the MTC Recommended Apportionment Formula for Financial Institutions.

The Commission, having reviewed the file and considered all of the information submitted by both the Petitioner and the Audit Division, now issues a decision addressing the issues presented in this matter.

FACTS

[Redacted]. and the [Redacted] filed [Redacted] returns with the state of Idaho for the year in question. The companies sell [Redacted]. At the request of the Tax Commission, [Redacted] filed a return on a combined worldwide basis. The worldwide return excluded the "Finance Group" companies.

For the taxable year at issue, 2002, and previous taxable years, the Audit Division conducted an audit specifically to determine whether [Redacted] and its subsidiaries were unitary with the filing companies. The Audit Division determined [Redacted] and its subsidiaries were unitary with the [Redacted].

The Audit Division found unity between the [Redacted] and the finance group based on several facts discovered during the audit. The parent owned 100 percent of the stock of all of the financial entities. All subsidiaries, including the [Redacted], adhered to a company-wide Code of Business Conduct established by the parent. [Redacted]

[Redacted] companies played an operational role in the sales of [Redacted]. For instance, [Redacted] provided retail financing to customers. The Audit Division estimated that approximately 31 percent of new [Redacted] purchased in 2001 occurred as a result of installment lending from the subsidiary. The subsidiary provided credit services [Redacted] to [Redacted] customers and [Redacted] for the purchase of [Redacted]. [Redacted] credit applications for consumers of [Redacted] display the [Redacted] logo. Another [Redacted] subsidiary, [Redacted], offered long-term [Redacted] leases as an alternative financing method.

[Redacted] and its subsidiaries offered extended service plans for the [Redacted]. In addition, [Redacted] and its subsidiaries offered insurance to [Redacted] members with specific discounts, including [Redacted] plans, disability insurance, and credit life.

The Finance Group also provided wholesale financial services to [Redacted]. During 2001, 96 percent of authorized [Redacted] dealers in the United States and Canada used the [Redacted] wholesale financial services. European dealers received wholesale financing from another finance company.

In terms of operational financing, [Redacted] and its subsidiaries issued commercial paper and entered into agreements with financial institutions to provide bank credit and liquidity. [Redacted]

A centralized steering committee directed the three business processes of [Redacted]. The steering committee is referred to as the Leadership and Strategy Council. [Redacted] divided its business into three essential processes or "[Redacted]": (1) the [Redacted]; (2) the [Redacted]; and (3) the [Redacted]. The [Redacted] consists of managers from each process, the Chief Operating Officers of [Redacted], as well as the Chief Executive Officer of [Redacted]. The [Redacted] is responsible for making decisions on business issues that impact the [Redacted], developing high-level policies, and advising the Chief Executive Officer.

LAW AND ANALYSIS

1. Unity

Generally speaking, a unitary business is a single economic enterprise that is made up of a group of commonly owned or controlled business entities. Idaho Code § 63-3027(t) provides that two or more corporations may be considered a single corporation (unitary) 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. The Idaho Supreme Court has interpreted this statute to require combined reporting by a unitary business. Albertson's, Inc. v. State, Dept. of Rev., 106 Idaho 810 (1984).

The over-arching principle of a unitary business is that there must be a flow of value among the entities (a synergy, not necessarily a flow of goods). Container Corporation of America v. Franchise Tax Bd., 463 U.S. 159, 178 (1983). There can be a flow of value even with arm's-length pricing of the loans between the affiliated entities. Cf. Exxon Corp. v. Wisconsin Dept. of Rev., 447 U.S. 207, 226 (1980).

In determining whether a group of entities is operating as a unitary business, the Idaho Supreme Court has cited with approval both the three unities test set out in Butler Brothers v. McColgan, 111 P.2d 334 (1941), *aff'd* 315 U.S. 501, 62 S.Ct. 701 (1942), and the contribution – dependency test first articulated in Edison California Stores, Inc. v. McColgan, 183 P.2d 16 (Cal. 1947). *See* Albertson's, 106 Idaho at 815 - 816, 683 P.2d at, 851 - 852. Applying both the Butler Brothers and the Edison criteria, [Redacted] and its subsidiaries are unitary with [Redacted].

A. Butler Brothers – 3 Unities

The Audit Division analyzed the facts under the three factors articulated in the Butler Brothers case. The three factors are (1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use in its centralized executive force and general system of operations. These factors (unity of ownership, unity of operation, and unity of use) have become known as the "three unities" test.

[Redacted] argues against "unity of use" in stating the Finance Group and the [Redacted] Group have separate management teams. The [Redacted] Group manufactures, distributes, and sells [Redacted] [Redacted]. The Finance Group is "not involved in the development, manufacturing, marketing, or servicing of [Redacted] and related products." Additionally, [Redacted] asserts that the Finance Group is not unitary in its operations because it is engaged in a separate and distinct line of business. All transactions between the Finance Group and the [Redacted] Group are arm's-length transactions. The Finance Group has its own employees, assets, business locations, and accounting systems that are not integrated with the [Redacted] Group.

Despite these statements, the flow of value between these two groups is obvious. The facts set forth by the Audit Division show unity of ownership (100 percent owned by parent). Unity of operation also is evident. The Finance Group helps the [Redacted] Group sell [Redacted]. The [Redacted] Group in turn provides the [Redacted] clientele for the Finance Group – dealer and purchasers of [Redacted]. The facts in this case also evidence a centralized executive force. While each group may have separate management teams, statement in annual reports represent that the [Redacted] made business and policy decisions for both groups.

The Petitioner's arguments that the Finance Group is a separate line of business, with separate accounting and management, are similar to those advanced by the taxpayer in Butler Brothers. In Butler Brothers the taxpayer operated wholesale dry goods and general merchandising business, purchasing from manufacturers, and selling only to retailers. The taxpayer had set up several wholesale distributing houses throughout the United States, including one in California. Each of these wholesale distributing houses maintained its own set of books and accounted for its own sales. In addition, each distributing house incurred direct operating expenses which were charged against income; and each distributing house also claimed indirect expenses relating to the overall business enterprise such as executives salaries, corporate overhead, and centralized advertising. These indirect expenses were allocated among the various distributing houses in accordance with recognized accounting principles. This "separate accounting" approach resulted in the taxpayer claiming that it suffered an operating loss from its activities in California even though the corporation recognized an overall profit.

The California Supreme Court disallowed the separate accounting treatment used to compute the taxpayer's California income tax liability and, instead, required the company to employ an apportionment formula, finding that the business was unitary. Butler Brothers v.

McColgan, 111 P.2d 334, 336 (Cal. 1941). The Court emphasized that one must look to the nature of the business conducted and how it relates to the operations of the unitary business as a whole rather than how the business is accounted for in terms of financial reporting.

While not expressly embracing the "three unities" test employed by the California Supreme Court, the United States Supreme Court went on to uphold the lower court's finding that Butler Brothers was engaged in a unitary business and that formula apportionment was a constitutionally permissible way to determine the amount of income from that unitary business that was fairly attributable to business activities taking place in California. Butler Brothers, 315 U.S. 501, 62 S.Ct. 701 (1942).

When one looks to the nature of the business conducted by the Finance Group and how it relates to the operations of the unitary business as a whole (rather than how the business is accounted for in terms of financial reporting), the relationship between the "Finance Group" and the "[Redacted]" is that of a unitary business.

B. <u>The Edison Test – Dependency or Contribution</u>

The California Supreme Court was also instrumental in establishing another test or standard that can be employed in determining whether a group of commonly owned corporations are engaged in 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. As succinctly set forth by the California Supreme Court: "If the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary; otherwise, if there is no such dependency, the business within the state may be considered to be separate." Id. at 21.

The dependency and contribution between the two groups is apparent in this case. Again, the Finance Group helps the [Redacted] sell [Redacted]. The [Redacted] in turn provides the exclusive clientele for the Finance Group – dealer and purchasers of [Redacted].

2. The Alternative Apportionment of Income provided in the "Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions" does not Apply to the Petitioner.

The Petitioner asserts that even if the Finance Group is considered to be part of the unitary business, the [Redacted] and its subsidiaries should be treated as financial institutions for the purposes of apportioning and allocating the Petitioner's business income.

A. [Redacted] and its Subsidiaries do not Qualify as "Financial Institutions" under the Applicable Regulation.

The Idaho Income Tax Rule 582.04 provides that a taxpayer will not be treated as a financial institution until the taxpayer proves by clear and cogent evidence that more than 50 percent of its income-producing activity is in substantial competition with banks and other lending institutions.

It is not apparent from the facts presented by the Petitioner that more than 50 percent of its income producing activity is in substantial competition with the banks and other lending institutions. While a part of the unitary business offers financing to retail customers, it does not appear that the credit business results in more than 50 percent of the Petitioner's income. [Redacted].

[Redacted]

In making the argument that [Redacted] and its subsidiaries should be treated as financial institutions, the Petitioner is seeking an alternative method of apportioning the income of the unitary business. Thus, to fully understand the Petitioner's argument, one must first be familiar with both the standard method of apportioning income and the alternative methods of apportionment income.

B. Standard Apportionment and Allocations of the Income of a Unitary Business.

In 1965, Idaho adopted, with 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 corporation's total income from a multistate business 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 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 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:

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

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.

C. Alternative Apportionment.

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 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 or the Tax Commission may require, in respect to all or any part of the Petitioner'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 Petitioner's business activity in this state; or
> > (4) The employment of any other method to effectuate an equitable allocation and apportionment of the Petitioner's income.

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

D. The Recommended Formula for Financial Institutions is an Alternative Apportionment.

The protest argues that combining the Finance Group with the [Redacted] is only appropriate if the apportionment factors of [Redacted] and its subsidiaries are computed under the Financial Institutions Formula. The formula referenced in the Petitioner's protest is the

Multistate Tax Commission's "Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions" (hereinafter "MTC Recommended Formula"). The MTC Recommended Formula contains specific allocation and apportionment rules relating to banks and similar financial institutions.

The "Recommended Formula" was promulgated by the Multistate Tax Commission in November 1994 after years of drafting and refinement and with considerable input from the affected industry members. *See* Resolution Adopting Proposed Uniform Method for Allocation and Apportionment of Net Income from Financial Institutions, reprinted with permission in 1800 T.M., *State Taxation of Banks and Financial Institutions (CA, IL, NY, TN),* Worksheet 1. The MTC Recommended Formula includes several significant modifications to the apportionment computation. The primary modifications were to include certain intangible assets in the property factor calculation and to establish a set of rules for sourcing gross receipts from various types of financial activities. For instance, loans cannot be included in the combined property denominator under standard apportionment formula. Idaho Code § 63-3027(k) provides (emphasis added):

> The property factor is a fraction, ... the denominator of which is the average value of all the Petitioner's <u>real and tangible personal</u> property owned or rented and used during the tax period.

Since loans are intangible, the standard apportionment formula excludes them from the property factor.

Pursuant to that authority to modify the statutory formula, the Idaho State Tax Commission has adopted a set of "special industry regulations." *See* Idaho Income Tax Administrative Rule 580.01, IDAPA 35.01.01.580.01 (setting forth special industry rules adopted by the State Tax Commission). Among the special industry regulations adopted by the State Tax Commission is the MTC Recommended Formula. Idaho Income Tax Administrative

Rule 580.01.g, IDAPA 35.01.01.580.01.g; Income Tax Administrative Rule 582.01, IDAPA 35.01.01.582.01. The MTC Recommended Formula has been adopted by Idaho for taxable years beginning on or after January 1, 1998. *See* Idaho Income Tax Administrative Rule 580.01.g, IDAPA 35.01.01.580.01.g.

E. The Facts of this Case do not Warrant Application of the Alternative Apportionment provided in the Recommended Formula.

The Petitioner's underlying contention is that the standard apportionment formula improperly causes [Redacted] contribution to business income to be apportioned to Idaho and other states using only the Petitioner's retail factors. The Petition asserts this perceived problem can be corrected by including the Finance Group's intangibles factor in the apportionment formula pursuant to the Recommended Formula.

As stated above, the Tax Commission finds that the Petitioner and the affiliated corporations of [Redacted] and its subsidiaries are not a financial institution. Under the application of the Recommended Formula as proposed by the Petitioner, little of the Finance Group's business activity would be attributed to Idaho. Given the contribution of the Finance Group to the unitary business and unitary business's reliance on the Finance Group, the Tax Commission cannot accept the Petitioner's position. In fact, it seems the opposite may be true. Including the intangibles as suggested by the Petitioner may cause an undue dilution of the apportionment factors. The Petitioner suggests sourcing loans to its state of commercial domicile and states without an income tax, thereby over-weighting the apportionment of income to its commercial domicile and non-taxing states, while under-weighting the apportionment to other states in which the Petitioner conducts a unitary business.

There is a very strong presumption in favor of the normal three-factor apportionment and against the applicability of alternative apportionment. <u>Union Pacific v. Idaho State Tax</u>

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). In this case, the Petitioner failed to meet its burden of proof.

CONCLUSION

WHEREFORE, the Modified Notice of Deficiency Determination dated February 14, 2007, is hereby APPROVED, AFFIRMED, and MADE FINAL.

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

YEAR	TAX	PENALTY	INTEREST	TOTAL
12/31/2002	$4,011	- 0 -	$1,099	$5,110

Interest is calculated through November 2, 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 $1,022 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.

____