BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 20927
[Redacted],	)	
	)	DECISION
Petitioners.	)	
	)	
	)	

BACKGROUND

On November 30, 2007, the Income Tax Audit Division issued a Notice of Deficiency Determination to [Redacted] (hereinafter referred to collectively as [Redacted]) asserting a proposed deficiency of $66,402 for the taxable years ending January 31, 2004, and January 29, 2005. The primary issues centered around gains [Redacted] recognized from the sale of stock of three related companies. [Redacted] treated the gains as nonbusiness income and allocated the gains to [Redacted], its state of commercial domicile. The Audit Division (Division) reclassified the gains as business income and issued the proposed deficiency.

On February 1, 2008, [Redacted] filed a timely petition for redetermination with the Division. Among other issues, [Redacted] asserted the proposed deficiency for the taxable year 2004 was outside the time for assessment as provided in Idaho Code § 63-3068.

After receiving the petition for redetermination, the Division revised the proposed deficiency. The Division agreed the taxable year ending January 31, 2004, was beyond the statute of limitations, so it was removed from the deficiency. As a result, the Division issued a modified deficiency that concerned only the taxable year ending January 29, 2005, in the amount of $20,036.

The Division issued the modified deficiency to [Redacted] on February 12, 2008. On March 10, 2008, [Redacted] responded and stated it wished to continue its protest regarding the business income, versus nonbusiness income, issues present in the remaining taxable year. The Division transferred the matter to the Tax Policy and Legal Section for resolution. At [Redacted] request, the undersigned Commissioner conducted an informal conference by means of telephone on July 29, 2008.

The Tax Commission has reviewed the file, including all of the information submitted by [Redacted] and the Division, and now issues its decision. For the reasons discussed below, the modified deficiency issued by the Division on February 12, 2008, is affirmed in part and reversed in part.

ISSUES PROTESTED

The remaining taxable year involves gains from [Redacted] holdings in two companies. [Redacted] sold an option to purchase a 15 percent interest in [Redacted] (a holding company with [Redacted]). [Redacted] also sold its 22 percent stock interest in [Redacted]. At one time, [Redacted] wholly-owned both companies but had divested itself of control over the span of several years. The question is whether the gain realized from these sales should be treated as business income apportionable to Idaho, or as nonbusiness income allocated to [Redacted].

DISCUSSION

1. The sale of an option to purchase a 15 percent interest in [Redacted].

Prior to 2002, [Redacted] owned 100 percent of [Redacted]. At that time, [Redacted]. was an operating company specializing in womens' clothing. [Redacted] operates several similar businesses, including [Redacted] ([Redacted]).

On November 8, 2002, [Redacted] was reincorporated as [Redacted] and became a holding company. [Redacted] then transferred all of the stock of [Redacted]. and its subsidiaries ([Redacted]) into [Redacted].

On November 27, 2002, [Redacted] (through its wholly-owned subsidiary [Redacted]) sold [Redacted]. [Redacted] received cash in exchange for the [Redacted] stock and an option or "warrant" to purchase a 15 percent interest in [Redacted].

On March 16, 2004, [Redacted] surrendered its option to [Redacted] for a cash payment of $20 million with a contingency that if [Redacted] made an [Redacted] of its stock, [Redacted] would receive an additional payment. [Redacted] made the [Redacted] and, in October 2004, paid an additional $45,291,024. In total, [Redacted] received $65,291,024 for surrendering its option back to [Redacted].

It is the gain from the sale of the option that is at issue. [Redacted] asserts the gain is nonbusiness income allocable to [Redacted]. [Redacted] states it was not unitary with [Redacted] in 2004 because it sold the business in 2002. Additionally, while [Redacted] continued to provide some distribution services after 2002, those services were transition services provided under a four-year agreement. According to [Redacted] the agreement was an arms-length transaction. Based on this, [Redacted] maintains the providing of services does not create an operational tie with [Redacted] that would convert the gain on the sale of the option into business income.

[Redacted] has correctly noted the rules for business income. The gain either had to be from a unitary business or from an investment that served an operational purpose. It is true that [Redacted] and [Redacted] were not in a unitary relationship as of 2004 when the option was surrendered.

However, there was an operational tie. [Redacted] depended on [Redacted] to transport, sort, pack, and distribute substantially all of its merchandise. [Redacted] contracted with unrelated third parties to import the merchandise from foreign ports. Also, [Redacted] provided

[Redacted] services for human resources, employee benefits, information technology, logistics and distribution, store design and construction, real estate transactions, tax, travel, treasury, and cash management. This is further supported by the fact that the same year the option was sold, [Redacted] voluntarily terminated the service agreement with [Redacted]. It seems [Redacted] relied upon [Redacted] for services mainly because [Redacted] held the 15 percent stock option.

Also, the sale of the option is no more than a deferred gain from the 2002 sale of [Redacted] from [Redacted]. The option was simply additional compensation for the sale of the [Redacted] stock. The value of the option was not fully determined until later, but it is still part of the gain of the 2002 sale. There is no question that at the time of the sale in 2002, [Redacted].

Accordingly, the Division is upheld on the business income classification of this issue.

2. <u>The sale of [Redacted] 22 percent interest in [Redacted].</u>

On July 2, 1995, [Redacted], through its wholly-owned subsidiary [Redacted]. [Redacted] owned 100 percent of [Redacted] from 1995 until late in 1999. On August 31, 1999, [Redacted] sold 60 percent of its interest to [Redacted]. At that point, [Redacted] maintained that [Redacted] was no longer unitary with [Redacted]. In July 2001, [Redacted] made an [Redacted]. As a result of the offering [Redacted] previous 40 percent interest was diluted to 22 percent.

On July 29, 2004, [Redacted] sold its remaining 22 percent interest to [Redacted]. [Redacted] reported the gain as nonbusiness income because it had not been in a unitary relationship with [Redacted] for several years and there was no operational tie ([Redacted] of [Redacted]).

The Division reclassified the gain on the 22 percent sale as business income. The Division cited the Commission's decision in Docket No. 17719 and the statutory presumption regarding the sale of stock as authority for its reclassification of the income.

In its Petition for Redetermination, [Redacted] correctly points out that the facts addressed by the Commission in Docket No. 17719 are distinguishable. The company in Docket No. 17719 was in a unitary relationship with its wholly-owned subsidiary when it sold stock of its subsidiary. The Company sold 20 percent of the subsidiary stock but continued to hold the remaining 80 percent of the stock. After the sale of 20 percent of its stock, the subsidiary continued to be an operational part of the parent's unitary business. Based on the above history, it appears that [Redacted] was not part of [Redacted] [Redacted] unitary group, nor did it have an operational tie with [Redacted] before or after the sale.

The Division correctly noted there is a statutory presumption that a gain on stock is business income (Idaho Code § 63-3027(a)(1), but it is a rebuttable presumption. Based on the information provided, the Commission finds that [Redacted] was not a part of the normal lines of business of [Redacted] and lacked a unitary relationship after 1999. The facts rebut the statutory presumption.

Because [Redacted] has sufficiently rebutted the Division's grounds for the deficiency as it relates to the sale, the Division is reversed on this particular audit adjustment.

CONCLUSION

WHEREFORE, the Modified Notice of Deficiency Determination dated February 12, 2008, is further MODIFIED and as so Modified is APPROVED, AFFIRMED, AND MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayer pay the following tax, penalty, and interest:

PERIOD	TAX	PENALTY	INTEREST	TOTAL
1/29/2005	$8,894	$0	$2,185	$11,079
			TOTAL DUE	**$11,079**

Interest is calculated through March 2, 2009, 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 taxpayer's right to appeal this decision is enclosed. As set forth in the enclosed explanation, the taxpayer 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 amounts to $2,216 and will be held as security for the payment of taxes until the appeal is finally determined.

DATED this ________ day of ___________________, 2008.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ________ day of __________________, 2008, 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.
COURTESY COPY TO:
[Redacted]

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