

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NOS. 18630, 18631, and
[Redacted])	18632
Petitioners.)	
)	DECISION
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On December 9, 2004, the Income Tax Audit Division (Division) of the Idaho State Tax Commission (Commission) issued respective Notices of Deficiency Determination (NOD) to [Redacted](Petitioners), collectively, concerning taxable years 1998, 1999, and 2000. The deficiencies determined by the Division totaled \$2,792,798 which included tax, penalty, and interest.

The Petitioners timely submitted a protest of the proposed deficiencies on February 25, 2005. The Commission subsequently contacted the Petitioners and informed them of their right to a hearing. The Petitioners responded on May 18, 2005, asking the Commission to hold the protest in abeyance and conduct a conference at a later date. The Petitioners noted the Division was then completing an audit of the Petitioners related to taxable years 1995 through 1997. The Petitioners believed the audit of the previous taxable years would resolve several of the issues contained in the deficiencies asserted in the protested NODs. Additionally, the Petitioners indicated they would provide the Division with additional information for the years in question.

The Commission agreed to hold the protest in abeyance and transferred the matter back to the Division. The Petitioners and the Division met at the Petitioners' headquarters and, over the

course of several months, exchanged information. As a result, the Division and the Petitioners resolved all but one issue.

A conference was conducted on June 6, 2009, at the offices of the Commission. Legal counsel appeared on the Petitioners' behalf. The Commission has reviewed the file and the information the Petitioners submitted. Being fully advised in this matter, the Commission now issues a decision.

ISSUE

Is the gain realized by a subsidiary of [Redacted] on the sale of its shares in a financial services company business income subject to apportionment or non-business income allocated to the Petitioners' commercial domicile?

HOLDING

The Commission concludes that the gain constitutes non-business income that is not apportionable to Idaho. The Petitioners are [Redacted]. Based on the evidence before it, the Commission finds the Petitioners' investment in the financial services company was a passive investment that was not an integral part of the Petitioners' [Redacted] operating business.

DISCUSSION

In 1988, a subsidiary of one of the above-Petitioners acquired shares in a financial services company ([Redacted]). [Redacted] and its subsidiaries principally engage in the reinsurance of financial guaranties of municipal and asset-backed obligations issued by insurance companies. EFSG also underwrote other credit-based risks.

In 1995, the subsidiary monetized its investment in [Redacted]. The subsidiary executed a note which stated the subsidiary would satisfy the borrowed amount by either delivery of its [Redacted] shares or a cash payment. In 1998, when the note became due, the subsidiary elected

to deliver to the lender its shares in [Redacted]. It was this transfer of shares to the lender in satisfaction of the note that triggered the gain at question.

A. The Significance of the Business Income Determination.

In 1965, Idaho adopted, with slight 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.

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). For instance, nonbusiness capital gains and losses from the sales of intangible personal property (such as stock) are allocated to Idaho if the corporation's commercial domicile is in Idaho. Idaho Code § 63-3027(f)(3).

Business income is apportioned among the states in which the business operates. Each state uses one or more ratios to divide or "apportion" the business income to determine the amount of income subject to tax. Idaho's apportionment formula is set out in Idaho Code § 63-3027(i), which states that "[a]ll business income shall be apportioned to this state . . . by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus two (2) times the sales factor, and the denominator of which is four (4). . . ."

Id. The property factor is computed by dividing the Taxpayer's property located in Idaho by its property located everywhere. Idaho Code § 63-3027(k). Likewise, the payroll factor is calculated by dividing the Taxpayer's Idaho payroll by its payroll everywhere. Idaho Code § 63-3027(n). And finally, the sales factor is derived by dividing the Taxpayer's Idaho sales by its sales everywhere. Idaho Code § 63-3027(p).

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. of America v. Franchise Tax Bd., 463 U.S. 159 (1983). 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.

B. Constitutional Considerations Regarding the Business Income Determination.

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.¹ 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 payor and the payee. That is, apportionment is permitted if the payor and the payee are engaged in the same unitary business. The second occurrence upon which apportionment of income from intangibles will be

¹ 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).

permitted is if the capital transaction from which the income is derived “serves an operational function” as opposed to an “investment function.” Allied, 504 U.S. at 788.

1. The Unitary Business Principle

The unitary business principle is that separately incorporated entities may conduct what essentially is a single business enterprise. In an economic sense, such a multiple-entity business is no different from a similar business composed of a single corporation with several separate divisions. *See generally*, Container Corp., 463 U.S. at 164–169. The Idaho statutes implement the unitary business principle and provide that two or more corporations shall 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. Idaho Code § 63-3027(t).

In this case, the Petitioners were not unitary with [Redacted]. The Division agreed that at no time did the Petitioner own more than 50 percent of [Redacted] and that the traditional hallmarks of a unitary relationship did not exist between the business of the Petitioners’ subsidiary and [Redacted].

2. An Asset that is Part of the Taxpayer’s Unitary Business

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. MeadWestvaco Corp. v. Illinois Dept. of Revenue, ___ U.S. ___, 128 S. Ct. 1498, 1507-1508 (2008). In Mead, the Supreme Court clarified its previous ruling in Allied Signal and the role of the operational function test.

We explained that situations could occur in which apportionment might be constitutional even though “the payee and the payor [were] not ... engaged in the same unitary business.” 504 U.S., at 787, 112 S.Ct. 2251. It was in that context

that we observed that an asset could form part of a taxpayer's unitary business if it served an “operational rather than an investment function” in that business.

Mead, 128 S. Ct. at 1507. The Court further explained that:

. . . our references to “operational function” in *Container Corp.* and *Allied-Signal* were not intended to modify the unitary business principle by adding a new ground for apportionment. The concept of operational function simply recognizes that an asset can be a part of a taxpayer's unitary business even if what we may term a “unitary relationship” does not exist between the “payor and payee.” See *Allied-Signal, supra*, at 791-792, 112 S.Ct. 2251 (O'Connor, J., dissenting); Hellerstein, *State Taxation of Corporate Income from Intangibles: Allied-Signal and Beyond*, 48 Tax L.Rev. 739, 790 (1993) (hereinafter Hellerstein). In the example given in *Allied-Signal*, the taxpayer was not unitary with its banker, but the taxpayer's deposits (which represented working capital and thus operational assets) were clearly unitary with the taxpayer's business. In *Corn Products*, the taxpayer was not unitary with the counterparty to its hedge, but the taxpayer's futures contracts (which served to hedge against the risk of an increase in the price of a key cost input) were likewise clearly unitary with the taxpayer's business. In each case, the “payor” was not a unitary part of the taxpayer's business, but the relevant asset was. The conclusion that the asset served an operational function was merely instrumental to the constitutionally relevant conclusion that the asset was a unitary part of the business being conducted in the taxing State rather than a discrete asset to which the State had no claim.

Mead, 128 S.Ct. at 1507-1508. Pursuant to the Court’s constitutional rulings, when determining the nature of a particular asset, the issue is whether the asset is directly connected with the unitary business or a stand-alone asset with no connection to the unitary business.

C. Statutory Considerations of the Business Income Determination

The operational role of an asset is a fundamental factor in determining whether specific income is business or nonbusiness income under Idaho law. The term “business income” is statutorily 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 actually 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). 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 transactional test is concerned with income arising from the ordinary course of the taxpayer’s trade or business operations. This test is not at issue.

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.” In contrast to the transactional test, 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. It is the functional test that is at issue in this case.

D. Application of Law to the Asset at Issue

The Division’s position is that the pledge of the stock evidences that the stock served an operational purpose. The borrowing generated working capital for the telecommunications business. From the Division’s perspective, the investment is similar to the short term deposit in a bank account, which generates interest used as working capital in the operating business. Although the bank account is not used directly in the business, the income generated by deposits in that case is used directly in the business. The Division asserts that the Allied Signal and Mead

Court found this type of income was properly characterized as business income. Additionally, the Division notes the relevant statute establishes 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.”).

In response, the Petitioners note several points, all of which lead to the conclusion that the stock was purchased simply as an investment. First, the stock was purchased in 1988 and not pledged as a part of debt financing until 1995. The stock was then transferred three years later. Second, an asset does not become part of the unitary business simply because it is used as collateral for a loan. Third, the Petitioners exercised no control over the company, [Redacted], that issued the stock, and there was no operational tie between the Petitioners’ telecommunications business and the insurance operations of [Redacted]. Fourth, the stock does not fall within the test for an operational asset as set forth in the recent Mead decision because the stock did not make any contribution to the *operating* results of the Petitioners’ business.

The Petitioners characterize the stock pledge in 1995 as a deferred sale, which was later consummated in 1998. The Petitioners state the stock sale was nothing more than the sale of a passive investment similar to the stock sale which the Allied Signal Court found to be nonbusiness income. The Petitioners acknowledge the gain was re-invested in the Petitioners’ [Redacted] business, such is the case with any investment, and to hold otherwise “would mean that there could never be any nonbusiness income since the income or loss is only generated when the investment is closed out.”

The issue in this case is not easy to resolve. On the one hand, this is not simply a case of an investment that was sold. The stock was pledged in [Redacted], which generated immediate working capital in the short term. Not only did the pledge monetize the asset, but, as acknowledged by the Petitioners, it was a “hedging against a decline in value and at the same time preserving the potential for gain on appreciation of the share price.” Generating working capital through the collateralized notes and hedging against price fluctuations to better the Petitioners’ position begins to move the investment toward the business income examples discussed in Allied Signal. Additionally, the Supreme Court has found that “loans and loan guarantees were clearly part of an effort to ensure that ‘the overseas operations of [appellant] continue to grow and become a more substantial part of the company’s strength and profitability.’” Container, 463 U.S. at 180, n.19 *quoting* Containers Corporation’s 1964 Annual Report.

On the other hand, the Commission is troubled by the fact that the stock was purchased in [Redacted] and not pledged until [Redacted]. It appears the stock was not used for any purpose other than a straight forward investment until it was pledged in [Redacted]. The Petitioners’ subsidiary owned the stock for a total of about ten years and for approximately seven of the years, the holding of the stock appears to be as little more than a passive investment. Neither the Division nor the Petitioners suggest that a proration of the gain may be appropriate.

In addition to the Supreme Court’s rulings, the Commission must consider the statutory provisions regarding apportionable income. As discussed above, Idaho adopted a modified version of UDITPA. The Idaho Supreme Court examined the statutory definition of “business income” adopted by Idaho and held that the key determination is whether the underlying property was 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.”).

The extent of the connection of the property to the Petitioners’ business operation is an important factor. The Court found that capital gains realized from the disposition of fixed assets used in every-day business activities constituted business income. Similarly, capital gains from the disposition of certain notes and bonds which represented short-term investments of idle funds were business income. However, the Court found that additional factors must be considered when examining the dividends or gains generated by long-term securities.

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. This principle is incorporated in Income Tax Rule 333 which states that income from an asset held only for “financial betterment” is not business income under the functional test.

It is undisputed, in this case, that the gain from the long-term stock provided increased financing for the business operations of the Petitioners. It is not unique for a company to engage in debt financing by issuing notes or bonds secured by the company’s underlying business assets. What makes this case different is that the financing was obtained by pledging the stock of a non-unitary company that has no connection to the Petitioners’ business operation. The Petitioners and the Division seem to agree that the stock was not a business asset before it was pledged. Later, the stock was transferred to the lender in satisfaction of the debt, triggering a gain on the

stock.

The circumstances surrounding this particular pledge more closely resemble a sale of long-term stock which simply adds to the financial betterment of the unitary business than a short-time investment of idle funds to generate working capital. The Commission finds that under the statutory definition, the pledging of the stock was not sufficient, in itself, to support a business income determination. As a result, the audit adjustment related to this issue is reversed.

CONCLUSION

WHEREFORE, the Notices of Deficiency Determination referenced above, is hereby MODIFIED, and AS MODIFIED, is MADE FINAL by this decision.

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

<u>PERIOD</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
12/31/1998	\$122,239	\$ 86,019	\$208,258
12/31/1999	224,194	141,390	<u>365,384</u>
		TOTAL DUE	<u>\$573,842</u>

Interest is calculated through January 28, 2010, and will continue to accrue at the rate set forth in Idaho Code § 63-3045(6) until paid. In addition to reducing the NOD based on the issue discussed above, the total due also reflects an NOD reduction for issues resolved by the Division and the Petitioners' in the follow-up exchange of information. The above amount due also incorporates federal adjustments reported by the Petitioners.

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

An explanation of the Petitioners' right to appeal this decision is enclosed. As set forth in the enclosed explanation, the Petitioners must deposit with the Commission 20 percent (20%) of the total amount due in order to appeal this decision. The 20 percent deposit in this case amounts

to \$114,768.40 and will be held as security for the payment of taxes until the appeal is finally determined.

DATED this _____ day of _____ 2009.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2009, 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.
