BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 20731
[Redacted]	)	
Petitioner.	)	DECISION
	)	
	)	

BACKGROUND

The Income Tax Audit Division (Division) of the Idaho State Tax Commission issued a Notice of Deficiency Determination (NODD) dated August 15, 2008, to [Redacted] (Petitioner) for the taxable years ending May 26, 2002, May 25, 2003, and May 30, 2004. The deficiency determined by the Division totaled $1,402,998 which included tax, penalty, and interest.

The Petitioner submitted a protest of the proposed deficiency on October 14, 2008. After reviewing the protest, the Division agreed with the Petitioner and changed the way in which certain payments were applied to the determined deficiency. This change resolved the fifth issue presented in the written protest. On October 15, 2008, the Division issued a modified NODD which contained the agreed-to change and revised the total deficiency to $1,372,823.

The Petitioner asked to continue its protest of the other four issues presented in its written protest and requested an informal conference before the Tax Commission. On November 11, 2008, the file was transferred to the undersigned Commissioner. The Commissioner conducted an informal conference on April 20, 2009, at the offices of the Tax Commission. Representatives of the Petitioner appeared in person. The Petitioner submitted supplemental information to the Commissioner on May 11, 2009.

The Tax Commission has reviewed the file and the submitted information. The Commission now issues this decision further modifying the NODD and granting, in part, the relief requested by the Petitioner.

ISSUES

The Petitioner asserts the following issues in its protest of the deficiency determined by the Division:

1. [Redacted].
2. [Redacted].
3. [Redacted].
4. The Petitioner also protests the penalties asserted by the Division in the proposed deficiency.

DISCUSSION

I. CRUDE OIL TRADING PROCEEDS IN THE SALES FACTOR DENOMINATOR

A. The Unitary Business and Combined Reporting

The unitary business principle finds its roots in constitutional law as developed under the Commerce and Due Process Clauses. The principle is premised upon the concept 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. of America v. Franchise Tax Bd., 463 U.S. 159, 164 – 169 (1983). 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).

When a single corporation, or a "unitary" group of corporations, does business across state lines, each state may tax an apportioned share of the business income. Each state may tax only on the income associated with the business activity within its borders. A state may not tax the business's income that is "derived from unrelated business activity" or a "discrete business enterprise." Allied-Signal, Inc. v. Director, Div. of Tax., 504 U.S. 768, 772-773 (1992) (citations and internal quotation marks omitted); Albertson's, supra, 106 Idaho at 815 n.4.

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. 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 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 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).

The three-factor apportionment formula, by means of 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.

B. Determining the Sales Factor with Regard to the Trading Business

In this case, the Petitioner and the Division agree that the crude oil trading business is part of the Petitioner's unitary business. Since the Petitioner's core process is food manufacturing and distribution, the Petitioner could have argued the trading business was a discrete line of business that should be considered separately from the Petitioner's unitary business. The Petitioner has a trading group that supports the food business through such things as the trading of commodity futures. There is no dispute between the parties as to that part of the trading business.

However, the crude-oil-trading (GOT) business unit of the Petitioner's trading group buys and sells physical crude oil for profit. The traded crude oil is not used in the other aspects of the Petitioner's unitary business.

The crude oil trading industry consists of various parties who purchase and sell large quantities of crude oil by the barrel. "Gatherers" purchase crude oil from the well head and deliver it to the pipeline network where they sell it to other parties in the trading market. "Refiners," such as [Redacted], ultimately purchase crude oil on the market for delivery to their refineries for processing into a variety of useable products. "Brokers" buy from and sell to other parties in the market by matching buyers with sellers, but they have no capacity for storage of crude oil purchased. "Physical Merchandisers," also buy from and sell to other parties, but they also maintain the capacity to physically store crude oil. "Majors," such as [Redacted] and [Redacted], operate refineries, maintain storage facilities, and also buy and sell crude oil on the market depending on market fluctuations.

GOT is a Physical Merchandiser participating in the physical merchandising of crude oil by buying and selling crude oil on the market and by routinely storing large quantities of oil in inventory until price changes warrant reselling at a profit. GOT takes title to crude oil purchased and maintains risk of loss for the crude oil placed into storage tanks.

GOT sells between six and eight million barrels of crude oil per month, primarily in Oklahoma, Louisiana, and Texas. The principle exchange location is in Cushing, Oklahoma, which is the primary delivery point for the [Redacted] for Light Crude Oil. Title and risk of loss is transferred at the delivery point where GOT maintains storage capacity for up to 4.5 million barrels of crude oil with third-party storage facilities.

When these facts were discussed at the conference conducted by the Tax Commission, the Petitioner's representatives specifically stated that the Petitioner was not contesting the unitary issue. The Petitioner also readily conceded that the proceeds from its trading business was business income.

Because neither unity nor the business nature of the income are in question, the only issue to be addressed by the Tax Commission is whether the proceeds from the trading business should be included in the sales denominator on a gross or net basis.

1. The Petitioner's position

The Petitioner reported the trading proceeds at gross in the denominator, noting that Idaho Rule 525 specifically states:

> **01. In General**. ***Sales mean all gross receipts*** of a taxpayer not allocated as nonbusiness income. The sales factor for each trade or business of the taxpayer includes ***all gross receipts derived by the taxpayer from transactions and activity in the regular course of that trade or business***.
>
> **02. Examples**.
> **a.** If a taxpayer manufactures and sells or purchases and resells goods or products, sales includes all gross receipts from sales of the goods or products held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. ***Sales also includes gross receipts from the sale of other property that would be properly included in the taxpayer's inventory if on hand at the close of the taxable year***. . . . (Emphasis by the Petitioner.)

The Petitioner asserts the buying and selling of crude oil is the regular trade or business of GOT, and the crude oil is also held as inventory, in storage, by GOT. Therefore, pursuant to the rule, the gross receipts of the crude oil trading must be included in the sales factor denominator.

The rule comports with the relevant statute. Idaho Code § 63-3027(a)(5) provides that the term “sales” means all gross receipts of a taxpayer which are apportioned and not allocated. As stated above, business income is apportioned rather than allocated. The statute further provides that the sales factor denominator is the “total sales of the taxpayer everywhere during the tax period.” Idaho Code § 63-3027(p).

2. <u>The Audit Division’s position</u>

The Division excluded from the sale factor denominator the commodity trading proceeds in excess of net gains. The Division included only the net gains of the oil trading business on three grounds.

First, the Division cited Idaho Administrative Income Tax Rule 570.03 which provides in pertinent part:

> Net Gains: “If gains and losses on the sale of liquid assets are not excluded from the sales factor by other provisions of this rule, such gains or losses shall be treated as provided in Subsection 570.03 of this rule. This subsection does not provide rules relating to the treatment of other receipts produced from holding or managing such assets. If a taxpayer holds liquid assets in connection with one (1) or more treasury functions of the taxpayer, and the liquid assets produce business income when sold, exchanged or otherwise disposed, the overall net gain from those transactions for each treasury function for the tax period is included in the sales factor.”

The Division concluded the crude oil trading business was a treasury function as the oil was not used directly in the Petitioner’s food-related business.

Second, the Division cited a previous decision of the Tax Commission in which the Tax Commission included only the net proceeds from the trading activities of a taxpayer.

> A legal decision (Docket # 12715) issued by the Idaho State Tax Commission states: “The Tax Commission here decides to follow case law in a number of other states and to allow inclusion of the <u>net</u> proceeds in the sales factor instead of the gross proceeds. The lesson of Pacific and Merrill is that one must compute the percentage of business income generated by the intangible activity in question and compare it with the percentage of combined gross receipts from that activity.”

Division Protest Summary at p. 6. The Division applied the decision in Docket 12715 and concluded:

> In this audit of [the Petitioner], if the gross proceeds of the commodity trading are added to the sales denominator, then between 26.5% and 38.3% of gross receipts would produce only between 1.6% and 5.6% of the taxpayer's business income. The fact that the company had no intention to deliver the commodity to a [Petitioner's] facility, nor utilize the commodity for production or manufacturing shows that including the gross proceeds of the crude oil trading in the sales denominator does not fairly reflect the regular course of the company's business. The auditors perceive this as distortive of the sales factor.

Division Protest Summary at p. 7. Additionally, the Division noted that including only the net proceeds of the trading activity was consistent with the Petitioner's reporting of the same transactions reported on the 10-Ks the Petitioner filed with the Securities and Exchange Commission. The Petitioner's accounting firm stated:

> "These amounts are reported at net for financial statement purposes because of the accounting principle of conservatism under which it is appropriate for [Redacted] to reflect these high-volumes, low-margin sales at the net amount to investors."

Letter dated 9/16/05 from Ernst & Young as set forth in the Petitioner's 2004 Annual Report.

Third, the Division questions whether the receipts from such trading even qualified as a "sale" under the terms of the UDITPA formula.

> In General Mills v. Franchise Tax Board, (Case # 439929) the court concluded that under the plain language of UDITPA, futures trading does not qualify as "sales income" and cannot be used for tax apportionment purpose. The court also found that while futures trading may serve a purpose, it is qualitatively different from its main business.

Division Protest Summary at p. 6.

3. <u>Analysis of the parties' positions</u>

a. <u>Sales under UDITPA</u>

The Petitioner's argument is that its crude oil trading constitutes "sales" under UDITPA and, accordingly, the gross receipts from the sales should be included in the sales factor denominator. The Division notes that a California court found receipts from futures trading were not "sales" receipts under UDITPA.

In the case of General Mills v. Franchise Tax Board, the Superior Court of California, County of San Francisco, held:

> As the evidence has established, unlike transactions in the cash market, in the futures market the actual purchase or sale of a commodity rarely occurs under the contract. Rather, as a hedger, General Mills' goal is to lock in the price of wheat . . . . Furthermore, at any time before the close of the open future, either party can unilaterally decide to offset the contract. . . . the Clearinghouse terminates open contracts at offset and no longer carries them on its books. This practice indicates the reality of futures contracts is such that, unlike conventional sales, they initially have no value. . . . Accordingly, offsetting a futures contract does not constitute performance of the contract within the context of this litigation. Thus, it is more appropriate that futures contracts are viewed as an adjustment to the cost-of-goods sold, not an increase in sales.

Superior Court Decision at pp. 8-9. Finding that the futures proceeds were adjustments to the cost of goods sold, the court rules that the futures proceeds should be completely excluded from the sales factor denominator.

The Tax Commission finds that the Superior Court's holding cited above does not apply to the Petitioner's circumstances. This protest involves forward contracts as opposed to futures contracts.

As discussed with the Petitioner at the conference, while futures and forward contracts are contracts to deliver a commodity on a future date at a prearranged price, they are different in several respects. Forwards transact only when purchased and on the settlement date. Futures, on the other hand, are rebalanced, or "marked to market," every day to the daily spot price of a forward with the same agreed-upon delivery price and underlying asset. The fact that forwards are not rebalanced daily means that, due to movements in the price of the underlying asset, a large differential can build up between the forward delivery price and the settlement price. This means that one party will incur a big loss at the time of delivery (assuming they must transact at the underlying spot price to facilitate receipt/delivery).

This in turn creates a credit risk. More generally, the risk of a forward contract is that the supplier will be unable to deliver the required commodity or that the buyer will be unable to pay for it on the delivery day. The rebalancing of futures eliminates much of this credit risk by forcing the holders to update daily to the price of an equivalent forward purchased that day. This means that there will usually be very little additional money due on the final day to settle the futures contract.

The daily futures-settlement failure risk is borne by an exchange, rather than an individual party, limiting credit risk in futures. Futures are always traded on an exchange, whereas forwards always trade over-the-counter, or can simply be a signed contract between two parties. In the case of physical delivery, the forward contract specifies to whom to make the delivery. The counterparty for delivery on a futures contract is chosen by the clearinghouse.

Futures also are highly standardized, whereas some forwards are unique. Futures contracts ensure their liquidity by being standardized.

In contrast to the commodity futures in the General Mills case, the Petitioner is not engaged in a hedging activity; that is to ensure the availability and price of grain for future sales and delivery which is the primary business of General Mills. Rather, the Petitioner's trading of crude oil is unrelated to its food-oriented business and appears to be speculation rather than hedging. The Superior Court found the distinction between hedging and speculation to be significant.

> General Mills has stated repeatedly that its futures trading serves to control price volatility of grain in support of its main business, the production and distribution of grain products. Were General Mills a speculator in futures, its sales of futures would undoubtedly be includable in its gross receipts for

> apportionment purposes. Because General Mills is a hedger, this case is distinguishable from *Merrill Lynch* where the court held that commodities sales were includable as gross receipts. . . .

Superior Court Decision at p. 18.

Moreover, the Tax Commission recognizes that neither the General Mills case nor its attendant issue is yet resolved in the state of California. Following the audit, and during the pendency of protest under review, the California Court of Appeal issued a decision which reversed the Superior Court and held that the gross proceeds from the futures trading was includable in the sales factor. *See* General Mills v. Franchise Tax Board, 172 Cal. App. 4th 1535, 92 Cal. Rptr. 3d 208 (2009). The Tax Commission is not aware of the current status of the case.

Based on the above analysis, the Tax Commission concludes that the proceeds from the crude oil trading constitute "sales" for apportionment purposes.

b. Alternative Apportionment

Although the California Court of Appeal reversed the Superior Court's ruling on whether the proceeds were "sales" under UDITPA, the court remanded the General Mills case back to Superior Court for a determination of whether including the gross receipts distorted the results of the standard UDITPA apportionment.

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 Petitioner's business activity in this state, the Petitioner may petition for or the state 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 business activity that occurs in Idaho, an alternative apportionment formula may be determined.

However, alternative apportionment is the exception, not the rule. The Idaho Supreme Court examined the alternative apportionment provisions and stated that "There is a very strong presumption in favor of the normal three-factor apportionment and against the applicability of the relief provisions." Union Pacific v. Idaho State Tax 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). The party asserting alternative apportionment bears the burden of showing that the alternative apportionment is appropriate. Union Pacific, 139 Idaho at 576, 83 P.3d at 120 *citing* Burlington Northern, Inc. v. Idaho State Tax Comm'n, 121 Idaho 808, 828 P.2d 837 (1992).

Departure from the standard apportionment formula should be avoided except where reasonableness requires a departure. Union Pacific, 139 Idaho at 577, 83 P.3d at 121, *citing* Pierce, The Uniform Division of Income for State Tax Purposes, 35 TAXES 747, 781 (1957). The Court then identified what grounds of "reasonableness" would support a deviation from the standard apportionment formula.

> "Reasonableness" has been defined as being made up of three elements: (1) the division of income fairly represents business activity and if applied uniformly would result in taxation of no more or no less than 100 percent of the Petitioner's income; (2) the division of income does not create or foster lack of uniformity among UDITPA jurisdictions; and (3) the division of income reflects the economic reality of the business activity engaged in by the Petitioner in the taxing state.

Union Pacific, 139 Idaho at 577, 83 P.3d at 121, *citing* Twentieth Century-Fox Film Corp. v. Dep't of Revenue, 299 Or. 220, 700 P.2d 1035 (1985).

The Division asserts that if standard apportionment includes the gross receipts of the trading business, then it will not fairly reflect the Petitioner's business activities in Idaho. By including the gross receipts in the denominator and attributing none of the trading activity to the Idaho numerator, the Division believes the sales factor will be unfairly diluted.

This is precisely the type of concern that underlies the Tax Commission authority cited by the Division. Income Tax Rule 570.03 provides that certain liquid assets held in a treasury function shall be included in the sales factor on a "net" basis. Similarly, the Tax Commission's decision in Docket 12715 was concerned because a high percentage of gross receipts from a trading activity generate a relatively small percentage of the unitary group's business income. Both authorities set forth on alternative apportionment of income to more accurately reflect a taxpayer's business activity in this state.

However, it is important to understand the reason for the Tax Commission's concern. The decision in Docket 12715 explained:

> The treatment of gross receipts from turnover of securities in a corporate treasury function has generated significant controversy in recent years. The concern of state taxing agencies is that frequent turnover of securities results in large gross receipts with relatively low profit margins, the bulk of the gross receipts constituting returns of capital or basis. The securities sales often have nothing to do with the market or customers of the taxpayer's business.

Docket 12715 Decision at p. 15. The Tax Commission further explained that for longer-term investments with less turnover, or "churning" as it is sometimes referred to, it may be appropriate to place the proceeds in the sales factor at gross rather than net.

> On the other hand, certain of the taxpayer's investments involved a material risk of market fluctuations over a relatively long holding period, and some of these generated large profits on sale. Investments with these characteristics do not distort the formula to the same degree as the mortgage backed and Treasury securities sales, and should be included in the sales factor using gross proceeds.

Docket 1271 Decision at p. 33.

The Division labored under the impression that the Petitioner's trading activities was the trading of futures. It was not clear until the conference in this matter that the Petitioner conducted the trading by means of forward contracts. It is possible that, in some cases, futures trading may result in distortion due to the possibility of frequent turnover. Futures are traded on an exchange, marked to market daily, and the risk is borne by the clearinghouse. As evidenced in the General Mills case in California, futures frequently involve an offset to satisfy the contract rather than a physical delivery of the underlying commodity.

The forward contracts entered into by the Petitioner are not traded on an exchange and are not frequently offset. They are contracts for the physical exchange of a commodity between the parties. Given the general differences between the two types of commodity contracts, it appears there is not as much opportunity for churning the forward contracts.

The Tax Commission appreciates that the Division applied the litmus test set forth in its previous decisions. The Commission also recognizes that the trading activities seem to have been conducted on a low margin basis. Comparing the gross receipts of an activity to the percentage of business income it generates is a legitimate test to identify possible distortion. But by itself, it is not enough to justify alternative apportionment. As stated by the California Court of Appeal:

> Moreover, many transactions that do not generate profit are nevertheless included in "sales" for UDITPA purposes, such as sales to consumers at cost or at a loss that are designed to bring customers into a store or promote the company's products and thus ultimately generate profit for the company. (See *Royal Crown Cola Co.* (Nov. 12, 1974) 74 SBE 047 [Cal. Tax Rptr. (CCH) ¶ 205-168; 1974 Cal. Tax Lexis 4] [unprofitable sales must be included in sales factor]; *Hammond Organ Co.* (May 17, 1962) 62 SBE 025 [Cal. Tax Rptr. (CCH) ¶ 201-928; 1962 Cal. Tax Lexis 67] [promotional activity must be included in sales activity].)

General Mills, 172 Cal.App.4th at 1547, 92 Cal.Rptr.3d at 217-18.

The Tax Commission cannot say that the trading activity in this instance requires alternative apportionment without knowing more about what causes the resulting low margin. Accordingly, the Tax Commission reverses the audit adjustment and upholds the inclusion of gross receipts as reported on the Petitioner's return.

II. THROWBACK SALES

The Petitioner reported that certain sales with an Idaho origin were taxable in three other states and therefore not taxable in Idaho. The Division determined the sales were not taxable in those three states and assigned the sales to Idaho as the origin state.

Idaho Code § 63-3027(q) provides that sales of tangible personal property are in Idaho if the property is delivered or shipped to a purchaser (other than the United States government) within Idaho. The statute also provides that sales of tangible personal property are in Idaho if the property is shipped from Idaho and the taxpayer is not taxable in the state of delivery. Idaho Code § 63-3027(q)(2). A taxpayer is taxable in another state if: (1) the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or (2) the state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not impose a tax. Idaho Code § 63-3027(6)(c).

During the years in question, the Petitioner reported certain sales to Utah regarding companies LW, B, and LI. Utah is a Finnegan state as set forth in Utah Tax Commission Rule R865-6F-24 which states that a unitary group of corporations is considered a single taxpayer for purposes of the assignment of sales in the sales factor of the apportionment fraction." As a result, sales of tangible personal property by any member of the unitary group delivered or shipped into Utah are includable in the Utah sales numerator. Sales included in the Utah sales factor numerator are subject to tax in Utah and therefore should not be thrown back to Idaho.

The Petitioner also contested certain sales of tangible personal property company [Redacted] made to purchasers in Missouri and South Carolina. Company [Redacted] filed a return with both states and paid a fee. Company [Redacted] paid a franchise tax to Missouri. The franchise tax was based on the par value of the corporation's outstanding shares and surplus. Company [Redacted] paid a license tax to South Carolina based on the value of its capital stock and paid-in-capital. The Commission finds company [Redacted] was subject to tax in the states of Missouri and South Carolina.

For the reasons stated above, the Commission reverses the throwback adjustments made by the Division.

III. GAIN AND INTEREST INCOME REGARDING PARTIAL SALE OF BUSINESS

The Petitioner sold a controlling interest in a business which included a beef plant located in Idaho. The Petitioner concedes that the income realized from the sale is business income, but maintains the gain was realized from the sale of intangible property (stock). Pursuant to Idaho Code § 63-3027(r), if a sale of intangible property occurs both in Idaho and outside Idaho, the sale is assigned to the state where the greater cost of performance occurred. The Petitioner states that greater cost of performance associated with the sale (such as negotiations and drafting stock transfers and agreements) occurred at its place of commercial domicile. Accordingly, the Petitioner assigned the sale to its state of commercial domicile for sales factor purposes. The Petitioner did not include any of the sale proceeds in the Idaho numerator of the sales factor. Additionally, the Petitioner assigned the interest income on the finance notes received in the sale to its state of commercial domicile.

The Division disagreed with the Petitioner's characterization of the sale. Through the stock sale, the Petitioner effectively sold a controlling interest in the business and the underlying assets of the business to unrelated parties. This was not a sale of passive stocks unrelated to the Petitioner's primary business. Rather, this was a sale of an operational part of the Petitioner's business which included the physical [Redacted] plant located in Idaho.

Idaho Income Tax Rule 570.02.a. provides that if the income producing activity in respect to business income from intangible personal property can be readily identified, the income is included in the denominator of the sales factor, and if the income producing activity occurs in Idaho, in the Idaho numerator of the sales factor as well. The Division reasoned that at least part of the business income generated by the sale of stock was attributable to the operational assets of the business. Accordingly, the Division included a pro rata share of the sales proceed in the Idaho sales numerator to account for the proceeds attributable to the Idaho [Redacted] plant.

The Tax Commission agrees with the Division. As discussed above, Income Tax Rule 570 set forth alternatives for the apportionment of business income under the authority of Idaho Code § 63-3027(s).

In this specific instance, the Tax Commission finds that the alternative apportionment provision relied upon by the Division is reasonable. First, the division of income fairly represents the Petitioner's business activity in Idaho and, if applied uniformly, would result in taxation of no more or no less than 100 percent of the Petitioner's income. The Division prorated the income in relation to the property present in Idaho. If every UDITPA state followed suit, then no more or less than 100 percent of the Petitioner's income would be subject to state income taxes.

Second, the division of income does not create or foster lack of uniformity among UDITPA jurisdictions. As stated by the Idaho Supreme Court, the purpose of the UDITPA apportionment provisions is for each state to tax the income generated by the business activity occurring in that particular state. Union Pacific, supra. Because the standard apportionment provisions of UDITPA does not always accomplish this purpose, UDITPA provides for alternative apportionment relief, which is nearly identical to the relief found in Idaho Code § 63-3027(s). The relief provisions may be invoked by either the taxpayer or the state taxing authority. In this case, the standard apportionment provisions relied upon by the Petitioner does not fairly reflect the Petitioner's business in the various states in which the Petitioner conducts its business, including the state of Idaho. Under the Petitioner's argument, if all of the stock had been sold to an unrelated party and the Petitioner had effectively divested itself of the business and assets, then all of the proceeds would be assigned to the Petitioner's state of commercial domicile. Such an assignment would ignore that the operational business had been transferred, including assets of the business located in Idaho.

Third, the proposed alternative apportionment reflects the economic reality of the business activity engaged in by the Petitioner in the taxing state. It is the transfer of a controlling interest in the operational business that generates income, not simply the transfer of unrelated stock in the abstract. In this particular stock exchange, new owners gained control of the operational business.

The Tax Commission finds that the Division has met its burden of showing that reasonableness requires a departure from the standard apportionment provisions. The audit adjustments in this regard are upheld.

IV. THE PENALTIES ASSERTED BY THE DIVISION

The Division asserted both a 5 percent negligence penalty and a 10 percent substantial understatement penalty. The penalties are abated for the first two issues discussed in this decision as the Tax Commission has found for the Petitioner.

The penalties for the third issue regarding the partial sale of the [Redacted] business also are abated. Pursuant to Idaho Code § 63-3046(d)(5), the substantial understatement penalty is reduced if a taxpayer relied on substantial authority for the treatment of any item. The Petitioner relied upon the standard apportionment provisions of Idaho Code § 63-3027 to report the gain from the sales and the interest on the associated notes. Given that the Tax Commission is asserting alternative apportionment to apportion the income in question, the Commission cannot say that the Petitioner was negligent in its reporting of the income.

CONCLUSION

WHEREFORE, the Modified Notices of Deficiency referenced above, including refunds denied therein, are hereby FURTHER MODIFIED and as modified by this Decision is MADE FINAL.

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

PERIOD	TAX	INTEREST	TOTAL
5/26/2002	$446,840	$164,198	$611,038
5/25/2003	137,612	32,963	170,575
5/30/2004	68,491	18,514	87,005
		LESS PAYMENTS RECEIVED	($771,458)
		TOTAL AMOUNT DUE	$97,160

Payments in the amount of $771,458 regarding agreed upon issues and federal changes have been credited against the Petitioner's liability in this calculation. Interest is calculated through January 15, 2010, 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's must deposit with the Tax Commission 20 percent (20%) of the total amount due in order to appeal this decision. The 20 percent deposit in this case amounts to $19,432 and will be held as security for the payment of taxes until the appeal is finally determined.

An explanation of the Petitioner's right to appeal this decision is enclosed.

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.

____