BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NOS. 21365 & 21366
[Redacted]	)	
Petitioner.	)	DECISION
	)	
	)	
	)	

PROCEDURE

On June 12, 2008, the Income Tax Audit Division of the Idaho State Tax Commission (Audit Division) issued a Notice of Deficiency Determination (NOD) to [Redacted], respectively. The NOD issued to [Redacted] was in the amount of $132,044 and concerned the taxable years ending December 31, 2003, December 31, 2004, and December 31, 2005. The NOD issued to [Redacted] was in the amount of $14,726 and concerned only the taxable year ending December 31, 2005.

The two companies (hereinafter Petitioners) filed a timely Petition for Redetermination of the proposed deficiencies. The Petitioners also requested an informal conference with a Tax Commissioner to discuss the deficiencies proposed by the Audit Division. The undersigned Tax Commissioner conducted an informal conference by means of telephone on February 24, 2009. Based on the information submitted by the Petitioners and a review of the Audit Division file, the Tax Commission now issues this decision.

BACKGROUND

The ultimate parent corporation in this matter is [Redacted]. On audit, the primary issue was whether the Petitioners and [Redacted] should have filed a combined report rather than the separate filing basis the Petitioners used when they filed their Idaho income tax returns. The audit staff found the entities were unitary and converted the companies to a worldwide combined reporting basis. The Petitioners agreed they were part of the [Redacted] unitary business and accepted the conversion to a worldwide combined reporting.

The issue the Petitioners protest and seek a redetermination upon involves income passed through to the combined business by means of [Redacted]. [Redacted] is a partnership, which has been directly or indirectly owned by [Redacted]. The present partnership was created in 2001. From the date of creation through June 2005, [Redacted] owned a 62 percent interest in a related company referred to as [Redacted]; [Redacted] in turn owned a 50 percent interest in [Redacted]. After June 30, 2005, [Redacted] purchased a direct 50 percent interest in [Redacted] as well as retaining its indirect interest through [Redacted]. [Redacted] owns and operates local stores that sell [Redacted] products to customers. [Redacted]. Many of the [Redacted] centers also contain [Redacted] stores and restaurants.

The Petitioners are part of a unitary business which discovers, extracts, refines, and markets [Redacted]products. The unitary business is a principle of constitutional law 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 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. The most commonly used formula for dividing the income is found in the Uniform Division of Income for Tax Purposes Act (UDITPA). Idaho and many other states have adopted UDITPA either in whole or with modifications. 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).

In this case, the Petitioners reported the income received from [Redacted] as nonbusiness income. Nonbusiness income is allocated under specific "allocation" rules. *See* Idaho Code § 63-3027(d) – (h). Pursuant to the rules, the Petitioners allocated a portion of the [Redacted] income to Idaho.

However, the Audit Division concluded that the income from [Redacted] represented business income that should be apportioned rather than allocated. 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). Many states, including Idaho, have modified the traditional three-factor formula so that the sales factor is double weighted. 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 of 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.

The Audit Division determined that, because [Redacted] markets the products of the unitary business, the income of PTC was business income. The Petitioners dispute the Audit Division's determination. In its joint protest, the Petitioners assert the merchandise and [Redacted] products marketed in Idaho by [Redacted] had no link to the Petitioners' business. The Petitioners state that the unitary business of which they are a part sells certain products to [Redacted] in other parts of the United States, but the business made no sales and transported no products to [Redacted] centers operating in Idaho. Additionally, the Petitioners state [Redacted] provided its own management, working capital, and infrastructure in obtaining the products it sold. Hence, the Petitioners conclude that [Redacted] is not part of the unitary business. Based on this reasoning, the Petitioners ask the Commission to affirm its original filing and allocate the income of [Redacted] as nonbusiness income in proportion to the Idaho contribution to [Redacted] total income.

ISSUES

1. Whether the income of [Redacted] is business income subject to apportionment or nonbusiness income subject to allocation.

2. Whether the attributes of [Redacted] should be included in the apportionment factor of the combined group.

DISCUSSION

The Petitioners' primary argument is that they do not have a unitary relationship with [Redacted]. The Petitioners suggest that, absent a unitary relationship, Idaho cannot apportion the income received from [Redacted] because such income cannot be characterized as business income. The Petitioners cite the case of Allied Signal as support for their position.

The Tax Commission agrees that in a series of cases culminating in Allied-Signal v. Director, Div. of Taxation, 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] However, the Tax Commission disagrees with the Petitioners' conclusion. As discussed below, the Court held that it is not always necessary to find a unitary relationship between the businesses that exist before apportioning income for state taxation.

The investment in a non-unitary business also can result in business income if the investment serves an operational purpose and is in itself part of the unitary business. The Allied-Signal Court described two occurrences where apportionment of income would 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.

[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).

The second occurrence upon which apportionment of income will be permitted is if the transaction from which the income is derived "serves an operational function" as opposed to an "investment function." Id. at 788. "The essential question under the operational-function test is whether the intangible asset is part of the corporate taxpayer's own unitary business, not whether two separate corporations are engaged in a common enterprise." Walter Hellerstein, State Taxation of Corporate Income From Intangibles: Allied-Signal And Beyond, 48 Tax L. Rev. 739, 791 n.315 (1993).

The United States Supreme Court in Allied-Signal clearly indicated that a taxpayer can derive apportionable unitary income from an operational transaction even though there is no unity between the payor corporation and the payee corporation. The Allied-Signal Court left the remaining test largely undefined; however, it provided one practical example of what may be referred to as "operational unity." According to the Court, "a State may include within the apportionable income of a nondomiciliary corporation the interest earned on short-term deposits in a bank located in another state if that income forms part of the working capital of the corporation's unitary business, notwithstanding the absence of a unitary relationship between the corporation and the bank." Allied Signal. 504 U.S. at 787-788. Thus, income earned on the investment of idle working capital can constitutionally be apportioned among the various states in which the corporation conducts its unitary business operations.

The Court also gave another indication of the breadth of this business income test when it cited footnote 19 of Container Corporation. In footnote 19 of Container Corp., Justice Brennen, writing for the majority, stated that "[a]s we made clear in another context in *Corn Products Co. v. Commissioner*, 350 U.S. 46, 50-53, 76 S.Ct. 20, 23-24, 100 L.Ed. 29 (1955), capital transactions can serve either an investment function or an operational function." Container Corp. 463 U.S. at 180 n.19.

Another important point that can be gleaned from the language in footnote 19 of Container Corp. is that transactions other than the short-term investment of idle working capital may be business income. The fact that the Court cited with approval the Corn Products Co. v. Commissioner decision is significant. As explained by Professor Hellerstein:

> In *Corn Products*, the Supreme Court held that a company engaged in converting corn into syrup and other products realized ordinary income and loss on the sale of corn futures even though such futures were not literally excluded from the "capital asset" definition under I.R.C. § 1221. Because the taxpayer's transactions in corn futures were designed to protect its manufacturing operations against increases in the cost of its principal raw material and to assure a ready source of supply of corn if needed, the Court held that the resulting profits and losses should be characterized consistently with Congress' perceived intent "that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss." *Corn Products*, 350 U.S. at 52.
>
> The case spawned the doctrine under which gain or loss from the sale of intangible assets, frequently stock in other corporations, was held to be ordinary gain or loss because the asset was "**bought and kept not for investment purposes, but only as an incident to the conduct of the taxpayer's business**." *John J. Grier Co. v. United States*, 328 F.2d 163, 165 (7th Cir. 1964). . . .
>
> Income from intangible assets falling under the Corn Products doctrine thus would be apportionable under the operational-function test. . . .

Hellerstein, State Taxation Of Corporate Income From Intangibles: Allied-Signal and Beyond, 48 Tax L. Rev. 739, 793-94 n.319 (1993) (emphasis added).

The Petitioners cite the recent decision by the United States Supreme Court in MeadWestvaco Corp. v. Illinois Dept. of Revenue, ___ U.S. ___, 128 S. Ct. 1498 (2008), contending that the Court overruled Allied Signal and what has been commonly referred to as the "operational function" test. Contrary to what the Petitioners imply, the Court did not overrule its previous ruling in Allied Signal or the operational function test. Instead, the Court clarified its 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 then, 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.

The connection with the petitioner's business versus passive investment distinction also is the fundamental factor in determining whether specific income is business or nonbusiness income under Idaho law. Under Idaho law, business income is defined as all "income arising from transactions and activities in the regular course of the taxpayer's trade or business and includes income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitutes integral or necessary parts of the taxpayer's trade or business operations." Idaho Code § 63-3027(a)(1). Nonbusiness income is all income other than business income. Idaho Code § 63-3027(a)(4).

Idaho Code § 63-3027 sets forth two separate and independent definitions of the term "business income." Union Pacific v. Idaho State Tax Com'n., 136 Idaho 34, 28 P.3d 375 (2001). According to the Idaho Supreme Court, the first definition for business income is "income arising from transactions and activity in the regular course of the taxpayer's trade or business." Id. at 38 – 39, 28 P.3d at 379 – 380. This definition is referred to as the "transactional test."

The second definition of business income includes "income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitutes integral or necessary parts of the taxpayer's trade or business operations." Union Pacific, 136 Idaho at 38 – 39, 28 P.3d at 379 – 380. This definition is referred to as the "functional test."

The transactional test is concerned with income arising from the ordinary course of the taxpayer's trade or business operations. In contrast, the functional test is concerned with income derived from property that is utilized in or otherwise directly connected with the taxpayer's trade or business. Union Pacific, 136 Idaho at 38 – 39, 28 P.3d at 379 – 380.

There is no requirement under the functional test that the income arises from transactions and activities in the regular course of the taxpayer's trade or business. Union Pacific, 136 Idaho at 39, 28 P.3d at 380. The key determination is whether the property acquired, managed, or disposed of was directly connected with the taxpayer's business operations.

> In our view, in order for such income to be properly classified as business income there must be a more direct relationship between the underlying asset and

> the taxpayer's trade or business. The incidental benefits from investments in general, such as enhanced credit standing and additional revenue, are not, in and of themselves, sufficient to bring the investment within the class of property the acquisitions, management or disposition of which constitutes an integral part of the taxpayer's business operations. This view furthers the statutory policy of distinguishing that income which is truly derived from passive investments from income incidental to and connected with the taxpayer's business operations.

American Smelting, 99 Idaho at 933, 592 P.2d at 48. The important distinction is whether the property was directly connected with the taxpayer's unitary business activity or merely a passive investment.

The asset in this case is the Petitioners' interest in [Redacted]. Accordingly, the question for the Commission to answer is whether the Petitioners' interest in the partnership was connected with the Petitioners' unitary business.

The protest filed by the Petitioners provides an answer to the question. In their protest, the Petitioners state in part:

> [Redacted], ...

Protest at page 3.

The Tax Commission disagrees with the Petitioners' inference that, in order to be unitary, the businesses must contribute to, or be dependent upon, each other in a "macro" sense. In Container Corp, the Court, while citing the Mobil "factors of profitability" with approval, also made clear that the overarching inquiry in determining whether two or more enterprises are engaged in a unitary business is the existence of a "sharing or exchange of value not capable of precise identification or measurement – beyond the mere flow of funds arising out of a passive investment or a distinct business operation – which renders formula apportionment a reasonable method of taxation." Container Corp, 463 U.S. at 166.

Similarly, 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. Succinctly stated, if the operation of one company is dependent upon or contributes to the operation of another company, the operations are unitary. If there is no such dependency or contribution, the businesses are considered to be separate. *See* Edison, 183 P.2d at 21. The Idaho Supreme Court has cited with approval the contribution – dependency test first articulated in Edison. *See* Albertson's Inc. v. State, Dept. of Rev., 106 Idaho 810, 815 - 816, 683 P.2d 846, 851 - 852 (1984).

None of the cases require that either business contribute to one another or be dependent upon one another in an absolute or "macro" sense. A unitary business is not a passive investment and is not a distinct business operation. But where the facts and circumstances establish an interrelationship or flow of values that goes beyond a mere passive investment or a distinct business operation, it is likely that a unitary relationship exists "which renders formula apportionment a reasonable method of taxation."

The Commission appreciates that, in the grand scheme, the sales to [Redacted], and indeed, the income from [Redacted], may represent only a small part of the Petitioners' overall business. Indeed, the sales to [Redacted] represent only about 1.5 percent to 1.9 percent of the unitary business's total annual sales. However, the Commission notes this still means that the sales to [Redacted] for each of the years in question amounts to $635 million, $715 million, and $1.2 billion respectively. In any event, the Commission is not aware of a *de minimis* exception for the unitary principle, nor have the Petitioners cited any authority that supports finding such an exception. Regardless of the volume in terms of overall percentage, it seems apparent, on the face of the Petitioners' statements, that the interest in [Redacted] is part of the Petitioners' unitary business. It is only logical that the Petitioners' interest in an entity which sells the Petitioners' [Redacted] is part of the Petitioners' unitary business. The Commission finds there is a contribution or "flow of value" between the Petitioners and [Redacted]. The income of [Redacted] passed through to the Petitioners is business income subject to apportionment.

The Petitioners' real issue seems to be with the result of the apportionment rather than the business income determination.

[Redacted]
Protest at page 3. In short, the Petitioners ask the Commission to account for the Idaho portion of the [Redacted] business by geographical location, regardless of whether the income is business income or nonbusiness income.

Such geographic accounting ignores not only that [Redacted]is part of the petitioners' business, but also ignores that [Redacted] itself is an entity that operates in multiple states. [Redacted] has failed to explain why the Commission should view the Idaho operations of [Redacted] in isolation. As stated by the U.S. Supreme Court: "The principal virtue of the unitary business principle of taxation is that it does a better job of accounting for the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise than, for example, geographical or transactional accounting." Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 783 (1992) (citations and internal quotations omitted).

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). Under these standards articulated by the Supreme Court, states are given wide latitude in developing a formula that can be used to apportion the business income of a single multistate entity or of a unitary business.

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, in certain instances, either the taxpayer or the Commission can request an alternative apportionment when standard apportionment fails to accurately reflect the taxpayer's business activity that occurs in Idaho.

Alternative apportionment is a rare 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). In sum, the party requesting alternative apportionment must demonstrate that standard apportionment results in a sufficient distortion of the Petitioners' business activity in the state; simply advocating a better method than the standard formula is not enough. Union Pacific, 139 Idaho at 122, 83 P.3d at 578, *citing* Appeal of New York Football Giants, (Opinion on Pet. Rhg., Calif. St. Bd. of Equalization, June 28, 1979).

The Petitioners imply that standard apportionment does not reflect its business activities in Idaho and that a separate geographical accounting would be more appropriate. However, the Petitioners have not demonstrated why it would be "reasonable" to depart from the standard apportionment formula, as the term "reasonable" has been defined by the Idaho Supreme Court. Without more explanation, the Commission must conclude that alternative apportionment is not appropriate in this case.

CONCLUSION

For the reasons stated above, the Commission upholds the determination of the Audit Division.

WHEREFORE, the Notice of Deficiency Determination on June 12, 2008, is hereby APPROVED and MADE FINAL.

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

DEFICIENCY ASSERTED FOR MPH

YEAR	TAX	INTEREST	TOTAL
2005	$12,741	$2,833	$15,624

DEFICIENCY ASSERTED FOR MOC

YEAR	TAX	INTEREST	TOTAL
2003	$23,481	$ 8,139	$ 31,620
2004	28,238	8,039	36,331
2005	58,605	13,258	71,863
			$139,814

TOTAL AMOUNT ASSERTED: $155,438

Interest is calculated through November 16, 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 Petitioners' right to appeal this decision is enclosed with this decision. As set forth in the enclosed explanation, you must deposit with the Commission 20 percent of the total amount due in order to appeal this decision. The 20 percent deposit in this case is $31,088 and will be held as security for the payment of tax until the appeal is resolved.

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

DATED this ________ day of ____________________, 2009.

IDAHO STATE TAX COMMISSION

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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.

____