

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of )  
 ) DOCKET NO. 20716  
[Redacted],[Redacted] )  
 )  
Petitioner. ) DECISION  
 )  
 )  
 )  
 )  
 )  
\_\_\_\_\_ )

BACKGROUND

The Income Tax Audit Bureau (Audit Bureau) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (NODD) dated August 29, 2007, to [Redacted] (Petitioner) for the taxable years ending May 25, 2003, and May 30, 2004. The NODD by the Bureau totaled \$250,422 which included tax and interest.

The Petitioner submitted a protest of the proposed deficiency on October 31, 2007. The Petitioner requested a hearing before a Tax Commissioner to discuss the Notice of Deficiency Determination. Before a hearing was scheduled, the Commissioner asked the Petitioner to submit additional information which could resolve some of the outstanding issues under protest. The Petitioner and the Audit Bureau exchanged information over the next few months. As a result of the exchange, the parties agreed to modify the original deficiency.

With some of the issues resolved, the undersigned Commissioner conducted a hearing on December 15, 2009. During the hearing, the Petitioner submitted more information which was subsequently submitted to the Audit Bureau for its consideration. Once again, the Petitioner and the Audit Bureau continued to exchange information and cooperate in determining the amount of liability. On June 15, 2010, the Petitioner and Audit Bureau informed the Commissioner that they had resolved all but two of the issues. This matter was deemed submitted and ready for a decision on that date.

[Redacted]

The Tax Commission has reviewed the file and all of the information submitted. The Commission now issues its decision. The Tax Commission accepts the agreed-upon modifications to the original NODD, but upholds the Audit Bureau on the remaining two issues.

## **ISSUES**

This decision addresses the two remaining issues: (1) How the receipts from futures trading should be accounted for in the sales factor of the formula which apportions income earned by a multistate business, and (2) the determination of the charitable contribution deduction for the combined group.

## **DISCUSSION**

### **I. HOW RECEIPTS FROM THE TRADING OF [Redacted] IS ACCOUNTED FOR 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, Inc. v. State, Dept. of Rev., 106 Idaho 810, 815 n.4, 683 P.2d 846, 851, n.4 (1984).

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 Audit Bureau agree that the futures trading business is part of the Petitioner's unitary business. The Petitioner is a [Redacted] of [Redacted]. It buys and sells [Redacted] on a daily basis as part of its normal business operations. The Petitioner stated that, for every physical purchase or sale of [Redacted]. Because the [Redacted] there may be significant fluctuations in prices and market conditions during the year. By means of futures, the Petitioner protects itself from both supply and price fluctuations. The futures contracts generally are not closed out by a physical delivery or shipment [Redacted]. Instead, the futures are closed out when the Petitioner enters into an offsetting futures contract.

1. The parties' respective positions on whether the receipts should be included in the sales factor under standard apportionment.

When the Petitioner filed tax returns with Idaho, the Petitioner included all the gross receipts from all futures trading in the sales factor denominator. The Audit Bureau conducted an audit and concluded the contracts in which the [Redacted] was physically shipped or delivered

[Redacted]

involved sales of tangible personal property (i.e., [Redacted]) and should be included in both the numerator and denominator of the sales factor since it was a sale of a tangible personal property. The Audit Bureau subsequently included the physical sales of grain in the sales factor for apportionment purposes.

However, since the offsetting futures contracts resulted in no physical delivery or shipment of the [Redacted], the Audit Bureau determined that those particular transactions were not sales or exchanges of tangible personal property.

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. 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 ruled that the futures proceeds should be completely excluded from the sales factor denominator.

However, the 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

[Redacted]

protest under review, the California Court of Appeals 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 Commission is not specifically aware of the current status of that case but believes the case is back with the Superior Court on remand to determine whether an alternative apportionment is appropriate.

The Petitioner reported the trading receipts at gross in the sales factor denominator, noting that Idaho Income Tax Administrative 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 [Redacted] futures is an integral part of its regular trade or business. The rule comports with Idaho Code § 63-3027(a)(5) which provides that the term "sales" means all gross receipts of a taxpayer which are apportioned and not 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). There seems to be no dispute that the receipts are subject to apportionment rather than allocation and that the futures would result in inventory at the close of the taxable year if not otherwise

disposed of by the Petitioner. Accordingly, the Commission concludes that the proceeds from the futures trading constitute “sales” for apportionment purposes.

2. Alternative apportionment.

Although the California Court of Appeals reversed the Superior Court’s ruling and concluded that the futures proceeds were “sales” under UDITPA, the Court of Appeals 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.

The Audit Bureau asserts that if the sales denominator included the gross receipts of the trading business, then the apportionment would 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 Audit Bureau believes the sales factor will be unfairly diluted.

This is precisely the type of concern that underlies the Tax Commission's decision in Docket No. 12715 which 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 No. 12715 decision at p. 15. The 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 No. 12715 decision at p. 33.

This case does not involve the same type of securities that were at issue in Docket No. 12715, but the futures have the same potential for distortion. Like other securities, futures are traded on an exchange, market to market daily, and the risk is born 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. Thus, the trading of futures is a trading with frequent turnover of the securities which results in distortion.

In cases where the futures contracts are satisfied by the physical delivery of [Redacted], the sale is complete and an actual transfer of the commodity occurs. The Petitioner recognizes that it is appropriate to include the physical sales of [Redacted] in the sales factor, but suggests it is a matching of the futures proceeds with the physical sales. The futures trading certainly is a hedging activity related to the ultimate price and supply of [Redacted] used by the Petitioner. However, the match suggested by the Petitioner does not appear to be proportionate.

For instance, in the last audit cycle, the Multistate Tax Commission (MTC) audited the Petitioner and included physical sales of approximately \$500 million in the sales factor denominator with approximately \$30 million apportioned to Idaho. If gross receipts of the futures had been included as the Petitioner suggested then, and now, the sales denominator would have increased by about \$3.3 billion with none of the sales apportioned to Idaho. On its face, this seems disproportionate. It is difficult to understand why \$3.3 billion in gross receipts of futures only results in \$500 million of physical sales.

The Tax Commission has promulgated administrative rules that address situations in which alternative apportionment may be appropriate. Specifically, the Tax Commission has adopted the MTC in Income Tax Administrative Rule 570 and the pertinent part of the rule states:

[Redacted]

## **570. SPECIAL RULES -- SALES FACTOR (RULE 570).**

\* \* \*

### **02. Gross Receipts From Intangibles.**

\* \* \*

**b.** If business income from intangible property cannot readily be attributed to any particular income producing activity of the taxpayer, the income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor. For example, if business income in the form of dividends received on stock, royalties received on patents or copyrights, and interest received on bonds, debentures or government securities results from the mere holding of the intangible personal property by the taxpayer, the dividends, royalties and interest shall be excluded from the denominator of the sales factor.

Under this rule, the sales are not included in either the numerator or the denominator of the sales factor.

The Tax Commission concludes that the sale or exchange of the futures that are offset and do not result in physical delivery of [Redacted] cannot readily be attributed to any particular income producing activity. The offsetting of the futures is simply a trading function that cancels outstanding contracts. It is not necessarily a specific income-producing activity. In fact, as noted in the California General Mills case, the overall futures trading often results in a loss. The primary goal is to stabilize price and supply, not necessarily gain. Moreover, the offsetting transaction on the exchange is not an activity attributable to any particular state.

Based on the rule governing alternative apportionment, the Tax Commission upholds the Audit Bureau regarding its sales factor determination. Only those futures that result in the physical delivery of [Redacted] are included in the sales factor denominator and numerator.

## **2. THE CHARITABLE CONTRIBUTION DEDUCTION OF THE COMBINED GROUP.**

[Redacted]

Internal Revenue Code § 170 imposes a limit on corporations as to the amount of deductions they may claim for charitable deductions. It limits the deduction to 10 percent of the corporation's taxable income. Contributions that are not deductible in a given year because of this limitation may be carried forward to the next five subsequent taxable years.

The federal income tax system allows corporations to file their returns as a "consolidated" group for convenience purposes. Many states, including Idaho, use a similar concept called "combined reporting." There often is a difference between combined reporting at the state level and consolidated reporting at the federal level. For example, as indicated above, a state may tax only those entities with which it's a sufficient connection. In contrast, the taxation jurisdiction of the federal government is much broader, and the consolidated group often may include more entities than the state combined group.

The federal charitable contribution limitation is based on the consolidated group that files the consolidated return with the Internal Revenue Service. The Petitioner argues that the limitation should be recalculated for state tax purposes because the combined group that files a return with Idaho is different than the Petitioner's consolidated group for federal income tax purposes.

The Petitioner has not cited any authority for changing the charitable contribution deduction for Idaho income tax purposes. The prevailing authority is in fact contrary to what the Petitioner requests. Idaho models its state income tax on the provisions of the federal tax code.

63-3002. DECLARATION OF INTENT. It is the intent of the legislature by the adoption of this act, insofar as possible to make the provisions of the Idaho act identical to the provisions of the Federal Internal Revenue Code relating to the measurement of taxable income, to the end that the taxable income reported each taxable year by a taxpayer to the internal revenue service shall be the identical sum reported to this state, subject only to modifications contained in the Idaho law; to achieve this result by the application of the various provisions of the Federal Internal Revenue Code relating to the definition of income, exceptions

therefrom, deductions (personal and otherwise), accounting methods, taxation of trusts, estates, partnerships and corporations, basis and other pertinent provisions to gross income as defined therein, resulting in an amount called "taxable income" in the Internal Revenue Code, and then to impose the provisions of this act thereon to derive a sum called "Idaho taxable income"; to impose a tax on residents of this state measured by Idaho taxable income wherever derived and on the Idaho taxable income of nonresidents which is the result of activity within or derived from sources within this state. All of the foregoing is subject to modifications in Idaho law including, without limitation, modifications applicable to unitary groups of corporations, which include corporations incorporated outside the United States.

Idaho Code section 63-3002 (emphasis added). This is not to say that Idaho follows federal law in every instance. The Idaho Legislature has provided specific modifications regarding the computation of taxable income for Idaho purposes, and the treatment of net operating losses differs from how such losses are treated for federal income tax purposes. *See* Idaho Code § 63-3022.

However, not being made aware of any provision in Idaho law that would allow the Petitioner to modify the amount of charitable contribution allowed as a deduction at the federal level, the Tax Commission must follow the directives of Idaho Code § 63-3002 and incorporate the federal deduction for Idaho income tax purposes. The Tax Commission affirms the Audit Bureau's determination of this issue.

### **CONCLUSION**

WHEREFORE, the Notice of Deficiency Determination referenced above, as modified by the subsequent agreement between the Audit Bureau and the Petitioner, is hereby **AFFIRMED** and **APPROVED** without further modification by this decision; and as approved by this decision is **MADE FINAL**.

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

[Redacted]

<u>PERIOD</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
5/25/2003	90,251	38,293	128,544
5/30/2004	72,362	26,560	<u>98,922</u>
	TOTAL AMOUNT DUE:		<u>227,466</u>

Interest is calculated through October 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 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 (20%) of the total amount due in order to appeal this decision. The 20 percent deposit in this decision amounts to \$45,493 and will be held as security for the payment of the amount asserted above until the appeal is finally determined.

DATED this \_\_\_\_ day of \_\_\_\_\_ 2010.

IDAHO STATE TAX COMMISSION

\_\_\_\_\_  
COMMISSIONER

**CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_ day of \_\_\_\_\_ 2010, 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. \_\_\_\_\_

[Redacted]