

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 21958
[Redacted])	
)	DECISION
Petitioner.)	
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On March 12, 2009, the Idaho State Tax Commission’s (Commission) Income Tax Audit Bureau (ITA) issued a Notice of Deficiency Determination (NODD) to [Redacted] (petitioner) for taxable years 2004, 2005, 2006, and 2007. The adjustments proposed by the ITA in the NODD did not result in any additional tax due by the petitioner since the petitioner filed as a partnership; however, the adjustments do have a tax impact to its partners. The petitioner filed a timely protest and petition for redetermination. The petitioner was informed of their appeal rights. The Idaho Code section 63-3045(2) hearing was held on June 1, 2010. The Commission, after having reviewed the file, hereby issues its decision.

The petitioner is a non-Idaho partnership that, during the audit period, [Redacted]. [Redacted]. [Redacted].

The primary issue in this case is to determine how the petitioner is to report under Idaho law its [Redacted] activity. The petitioner claims that its [Redacted] activity is not [Redacted] for purposes of Idaho’s allocation and apportionment statute or that its Idaho [Redacted] activity is a separate line of business distinct from its other [Redacted] activity.

A. IN GENERAL

When the petitioner filed its Idaho partnership return, the petitioner reported zero business income subject to apportionment. The petitioner reported zero business income subject to apportionment since the petitioner believed that its [Redacted] activity did not arise to the

level of a “trade or business.” More specifically, in its petition for redetermination, the petitioner stated, in part, that the [Redacted] activities “[Redacted].”

On its Idaho partnership return, the petitioner allocated the income and expenses [Redacted] as follows:

Table 1 – Petitioner’s Approach	2007	2006	2005	2004
Gross rents	\$109,707	\$78,208	\$40,685	\$29,473
Commissions	-5,679	-4,063		
Insurance	-2,624	-3,170	-817	-664
Interest	-57,795	-47,575	-26,552	-17,602
Repairs	-2,108	-4,965	-423	
Depreciation	-24,866	-17,281	-9,718	-6,894
Taxes	-7,536	-6,144	-5,800	
Legal and professional		-2,931		
Utilities	-2,336	-3,008	-191	
Amortization	-980	-630	-630	-473
Management fees	-5,511	-3,539	-816	-547
Supplies	-113	-119	-59	-41
Loan fee		-5,957		
Other or miscellaneous		-12	-151	
Idaho source income or loss	\$159	-\$21,186	-\$4,472	\$3,252

In its NODD, the ITA argues that the petitioner is engaged in a multistate unitary “trade or business” and should have applied the Idaho Code section 63-3027 apportionment provisions to its [Redacted] income from all [Redacted] activities which would result in Idaho source income calculated as follows:

Table 2 – ITA Approach	2007	2006	2005	2004
Interest	\$3,370	\$2,860	\$3,649	\$3,407
Dividends	0	437		190
Long-term capital gain				35,148
Other Deductions:				
Legal and professional	-2,425		-1,690	-1,079
Real estate taxes				-486
Other or miscellaneous	-2,425		-517	-463
Investment interest expense				-13,105
Sch. E rental activity:				
Gross rents	169,419	136,197	98,123	82,484
Advertising				-18
Commissions	-6,769	-5,130	-968	-405
Insurance	-3,614	-4,127	-1,913	-1,775
Interest	-67,890	-59,053	-38,128	-28,579
Repairs	-10,229	-12,319	-7,759	-6,191
Depreciation	-32,074	-24,416	-16,081	-13,217
Taxes	-11,779	-10,822	-10,296	-4,301
Legal and professional	-104	-3,707	-141	-278
Utilities	-9,706	-11,844	-7,275	-5,865
Amortization	-1,187	-630	-630	-473
Management fees	-8,541	-6,618	-3,571	-3,174
Supplies	-165	-191	-173	-177
Loan fee		-5,957		-171
Other or miscellaneous	-465	-305	-587	-275
State adjustments:				
Bonus depreciation				462
Net business income	15,416	-5,625	12,043	41,659
Idaho apportionment factor	67.4367%	61.6425%	50.0506%	34.5634%
Idaho source income or loss	\$10,396	-\$3,467	\$6,028	\$14,399

The petitioner owns the Idaho [Redacted]. The petitioner entered into a contract with a [Redacted] LLC to act as its agent. The agent would use the agent’s organization [Redacted].

The agent is owned, in part, by one of the petitioner's partners. The agent also manages the [Redacted] buildings.

The auditor's file contains the following documents:

[Redacted]The file does not contain any of the agreements relating to the other [Redacted].

Under the management agreement, the contract contained the following provisions:

Agent's Rights and Responsibilities:

1. Exclusive Right - during term of agreement, the agent is the exclusive leasing agent for the premises.
2. Day-To-Day Operations - the agent was responsible for the day-to-day operations of the premises including:
 - a. Maintaining several different types of bank accounts established under agreement in trust for owners. The agent was not authorized to comingle the funds in the bank accounts with any of the agents other funds; however, the sweep investment accounts may be pooled to include funds held in trust for more than one client of agent.
 - b. Maintaining a fidelity bond on its personnel who handle or are responsible for the safekeeping of any monies of owners.
 - c. Collecting and giving receipts for all rents, charges, and other receivables on owners' accounts in connection with management and operations of premises.
 - d. Collecting from tenants' charges for returned checks, credit report fees, and a broker's commission for subleasing.

- e. Disbursing or reimbursing itself for operating expenses relating to the premises. However, the agent is not required to use the agent's funds to pay disbursements nor required to advance any monies to owners.
- f. By the 15th day of each month, furnishing to owners an income statement for the month and year-to-date, check register, cash journal, activity reconciliation and rent roll for the prior months prepared on a cash basis of accounting.
- g. Locating tenants for the premises and preparing lease agreements in a form agreed upon by owners and agent. The agent is only authorized under the agreement to prepare lease agreements and is not authorized to sign the agreements binding the owners to the agreements.
- h. Initiating, in the owner's name, all legal actions or proceedings for the enforcement of any lease term, collection of rent or other income from the premises, evicting or disposing of tenants.
- i. When expedient, settling, compromising, and releasing such legal actions or suits after consultation with owner. Any monies paid out by agent shall not exceed \$1,000 without prior approval by owner.
- j. Hiring, supervising, discharging, and paying servants, employees, contractors, or other personnel necessary for the management, maintenance, and operation of the premises. However, all employees shall be deemed employees of the owners.
- k. Maintaining, at the owners' expense, workers' compensation and employment practices liability insurance.

1. Making of ordinary repairs and replacements necessary to preserve the premises.
 - m. In the owners' name, contracting for electricity, gas, telephone, fuel, or water, and such other services as agent shall deem necessary or prudent for the operation of the premises.
3. No Responsibility - the agent assumed no responsibility for:
- a. Failure of or default by any tenant in the payment of any rent or other charges due owners,
 - b. Failure of or default by any tenant in the performance of any obligations owed by any tenant to owner pursuant to any lease or otherwise, or
 - c. Any liability for previously unknown environmental or other regulations which may become known during the period of the agreement,
 - d. Any liability to employees for their wages or compensation.
4. Compensation – the agent is entitled to:
- a. 2% of the gross receipts from the premises which includes all rents and other income and charges from the normal operation of the premises, and
 - b. Upon the agent securing a tenant, a lease commission of six percent (6%) of the gross rents for the lease period and two percent (2%) of gross rents for the extended term of a lease on lease renewals negotiated by agent.

Owners' Rights and Responsibilities

While owners delegated much of the day-to-day management [Redacted], the owners:

1. Expressly withheld from the agent any power or authority to make
 - a. Any structural changes in any building,

- b. Any other major alterations or additions in or to any such building, or
 - c. Any major alterations or additions to equipment in any such building.
- 2. Retained the right to instruct the agent on
 - a. Where to pool the sweep investment accounts,
 - b. Where to establish the money market, savings, and investment accounts the earnings of which and the costs associated with are the owners, and
 - c. Direct when excess cash balances were to be transmitted to the owners.
- 3. Retained the right to establish and change or revise all rents, fees, or deposits, and any other charges chargeable with respect to the premises.
- 4. Remained liable under the agreement for the operating expenses, and
 - a. Any expense for any one item of maintenance, alteration, refurbishing, or repair in excess of \$1,000, required the approval of the owners except in those situations involving certain emergencies.
 - b. Any contract for non-recurring items of expense in excess of \$1,000 required the approval of the owners.
- 5. Were deemed the employer of the employees that the agent hired for the management, maintenance, and operations of the premises.
- 6. Were the only ones that could bind the owners to a lease agreement even where the agent found tenants and prepared the lease documents.
- 7. Approved any settlement or compromise, in excess of \$1,000 as a result of the agent's enforcement of leases.
- 8. Were required to obtain and keep in force adequate insurance against physical damage and against liability for loss, damage, or injury to property or persons.

9. Were responsible for the curing of any environmental or other regulatory violations or hazards discovered by agent.
10. Were responsible for legal expenses regarding compliance with any law affecting the premises or activities related to them.
11. Assumed the obligations of any contract or outstanding bill executed by agent under the agreement upon termination or withdrawal from agreement.
12. Retained the right to request periodic audits of all of owners' accounts managed by agent and the cost of such audits were the owners' costs.

B. LAW AND ANALYSIS

The petitioner owns part [Redacted] in Idaho ([Redacted]). Accordingly, the petitioner is transacting business in Idaho as that term is defined in Idaho Code section 63-3023.¹ Since the petitioner is transacting business within Idaho, the petitioner is required to file an Idaho income tax return.²

A partnership that is transacting business within and without Idaho applies the “principals of allocation and apportionment of income set forth in Section 63-3027, Idaho Code, and related rules to determine the extent of partnership income that is derived from or related to Idaho sources.”³

Idaho Code section 63-3027(a) states in pertinent part:

- (a) As used in this section, unless the context otherwise requires:
- (1) "Business income" means income arising from transactions and activity 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

¹ References to Idaho Code or Rules refer to the Idaho Code or Income Tax Administrative Rules in effect for taxable year 2007 unless otherwise stated.

² Idaho Code section 63-3030(a)(9).

³ Idaho Income Tax Administrative Rule 280 (IDAPA 35.01.01.280).

such acquisition, management, or disposition constitutes integral or necessary parts of the taxpayer's trade or business operations. Gains or losses and dividend and interest income from stock and securities of any foreign or domestic corporation shall be presumed to be income from intangible property, the acquisition, management, or disposition of which constitutes an integral part of the taxpayer's trade or business; such presumption may only be overcome by clear and convincing evidence to the contrary.

(2) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(3) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(4) "Nonbusiness income" means all income other than business income.

(Underlining added.)

The petitioner, in a letter dated November 25, 2008, argues, in part:

[Redacted]

Under the petitioner's argument, because Idaho Code section 63-3027(a)(1) does not specifically mention income [Redacted] like it does for tangible personal property, the petitioner's [Redacted] activities are not a "trade or business," and each of the rental activities income and expenses should **not** be treated as business income under Idaho Code section 63-3027(a)(1) unless it is used as part of a "trade or business." Since the petitioner's real estate rental activity is not business income from a "trade or business" it must be nonbusiness income under Idaho Code section 63-3027(a)(4). Therefore, under Idaho Code section 63-3027(e)(1), only the net [Redacted] in Idaho would be treated as income allocated to Idaho.

Idaho Code section 63-3027(a)(1) defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and **includes**" (emphasis added) certain types of specific income that falls within that definition. When the term "includes" is contained within a definition, that term **does not exclude** other things that

would otherwise fall within the meaning of the term defined, in this case, the definition of business income.⁴ Therefore, nothing within the Idaho Code section 63-3027(a)(1) statutory language explicitly precludes the petitioner's [Redacted] income from [Redacted] activities from falling within the definition of business income provided that the [Redacted] income is income arising from transactions and activity in the regular course of the petitioner's trade or business.

Does the petitioner's Idaho [Redacted] constitute a "trade or business" as that term is used in Idaho Code section 63-3027(a)(1)? The Idaho statute and the Idaho income tax rules are silent on the meaning of the phrase "trade or business." In Kopp v. Baird, 79 Idaho 152, 160 (1957), the Idaho Supreme Court was faced with former Idaho Code section 63-3013(b), subd. 7, which exempts from taxation "[i]ncome of resident persons and domestic corporations of the state of Idaho . . . from the conducting and carrying on of their . . . trades or businesses, when derived from sources outside of the state of Idaho." *Id* at 322. (Emphasis added.) The taxpayers in Kopp received royalties from their investment in oil properties located in Wyoming. The Court in Kopp looked to determine whether or not the "mere ownership of said real property in the State of Wyoming constituted engaging in a trade or business. . . ." *Id.* at 159. (Emphasis added.)

The Court held that the language used in the phrase "trade or business" was disjunctive and that both terms were to be given their natural meaning and are not used synonymously. The Court discussed the term business from a "natural meaning" as well as in the "commercial sense." The Court provides the following analysis:

"Trade" commonly connotes the buying, selling, or exchanging of commodities. "Business," however, is a much broader term . . . to signify "that which busies or engages time, attention, or labor as a principal serious concern or interest." Webster's Dictionary. In this sense it embraces everything about which one can be employed.

⁴ Idaho Code section 63-3012.

“Business” in the commercial sense refers to “any activity which occupies the time, labor and attention of men for the purpose of a livelihood or profit.” *City and County of Denver v. Gushurst*, Colo.1949, 210 P.2d 616, 618. It implies some constant and connected employment. *Board of Supervisors of Amherst County v. Boaz*, 1940, 176 Va. 126, 10 S.E.2d 498. See also *Smallwood v. Jeter*, 42 Idaho 169, 244 P. 149; (remaining citations omitted)

After reviewing a variety of federal court cases dealing with similar phrases used in various federal income tax statutes, the Court in Kopp held that the taxpayers did not receive the royalties from investments in Wyoming oil properties through the taxpayers’ conducting of a trade or business.

Under federal law, the import of the term “trade or business” is not unitary throughout the tax laws; rather, it may vary depending on the background and wording of the particular provision in which it appears.⁵

If the [Redacted] activity is a trade or business is “ultimately one of fact in which the scope of a taxpayer's activities, either personally or through agents, in connection with the property, are so extensive as to rise to the stature of a trade or business.”⁶

Where it is clear from the facts that real estate is devoted to [Redacted] purposes rather than simply holding the property [Redacted], the courts have repeatedly held that such use constitutes use of property in a trade or business, regardless of whether or not it is the only property so used.⁷

After reviewing Idaho and federal case law and the level of involvement the petitioner retained under the [Redacted] agreement, either directly or through its agent, the Commission is satisfied the petitioner was more than just a “passive investor.” Therefore, the Commission finds that the petitioner was engaged in a “trade or business,” [Redacted]; the income of which under

⁵ Estate of Sherrod v. Commissioner, 774 F.2d 1057, 1065 (1985).

⁶ Bauer v. United States, 168 F.Supp. 539, 541 (Ct.Cl.1958).

⁷ Curphey v. Commissioner, 73 T.C. 766, 774 (1980).

Idaho Code section 63-3027(a) is subject to apportionment and allocation, not just allocation.

In its letter dated May 13, 2009, the petitioner argues that “the various [Redacted] properties [Redacted] are each managed separately and have their own management report – there is nothing that ties any of the properties together other than common (passive) ownership.” Essentially, the petitioner is arguing that each of its [Redacted] activities constitute a separate line of business. The petitioner’s argument raises a couple of interesting questions. First, if multiple [Redacted] activities are contained within the same legal entity, are all of the [Redacted] activities part of the same unitary business? Since the petitioner’s [Redacted] activities are similar, does that fact automatically result in a unitary business finding? The answers to the questions are found in Idaho’s Income Tax Administrative Rule 340.03 (IDAPA 35.01.01.340.03) and in the Commission’s published decisions.

Idaho’s Income Tax Administrative Rule 340.03 (IDAPA 35.01.01.340.03) recognizes that a single entity can contain more than one unitary business as follows:

* * *

03. Separate Trades or Businesses Conducted Within a Single Entity. A single entity may have more than one (1) unitary business. In such cases it is necessary to determine the business, or apportionable, income attributable to each separate unitary business as well as its nonbusiness income, which is specifically allocated. The business income of each unitary business is then apportioned by a formula that takes into consideration the in-state and the out-of-state factors that relate to the respective unitary business whose income is being apportioned.

Idaho Income Tax Administrative Rule 343.01 (IDAPA 35.01.01.343.01) states that “business activities that are in the same general line of business **generally** constitute a single unitary business.” However, just because a taxpayer engages in businesses that are similar to each other, that fact alone does not always result in a finding that the similar lines of businesses

are part of the same unitary business.⁸ Finally, even if it is undisputed that all of a taxpayer's [Redacted] activities are part of the same unitary business, where it is established that standard UDITPA produces an unfair representation of the [Redacted] activity within Idaho, Idaho Code section 63-3027(s) could nonetheless allow for stand-alone treatment.⁹ Therefore, is the petitioner's Idaho [Redacted] activity a separate line of business or is it part of a unitary business with one or both [Redacted]?

A unitary business is a concept of constitutional law defined in decisions of the United States Supreme Court.¹⁰ Idaho Income Tax Administrative Rule 340.01 provides guidance on the existence of a unitary business within a single business entity, and it states, in pertinent part:

A unitary business is a single economic enterprise that is made up . . . of separate parts of a single business entity . . . that are sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. . . .

This sharing or exchange of value may also be described as requiring that the operation of one (1) part of the business be dependent upon, or contribute to, the operation of another part of the business. Phrased in the disjunctive, the foregoing means that if the activities of one (1) business either contribute to the activities of another business or are dependent upon the activities of another business, those businesses are part of a unitary business.

When faced with a non-vertically integrated business, the existence of a sharing or exchange of value is, in many cases, difficult to identify; however, when it is present, a unitary finding is appropriate. For example, in Mole-Richardson Co. v. Franchise Tax Bd. (1990) 220 Cal.App.3d 889, 894, 269 Cal.Rptr. 662 (1990), the court essentially found a Hollywood lighting company and a Colorado farming company to be unitary on the basis that all major decisions were made by the same owners and that all accounting, payroll, insurance, pension, banking,

⁸ Commission decision in Docket No. 18020 published in 2005.

⁹ Commission decision in Docket No. 11220 published in 1997.

¹⁰ Idaho Income Tax Administrative Rule 325.11 (IDAPA 35.01.01.11).

purchasing and advertising functions were conducted out of the same office. On that basis, the court found that the two entities were able to realize sufficient cost savings and economies of scale to support a unitary finding. (Id. at p. 899.) However, in the Appeal of Unitco, Inc., Cal.St.Bd. of Equal., June 21, 1983, the Board ruled that a California corporate taxpayer that, among other things, owned warehouses in Connecticut and Hawaii, a small office building in Colorado, an apartment building in Colorado, a building in Colorado leased to the federal government, a Colorado shopping center, and a 50 percent interest in a general partnership that owned a California high rise office building and store, as well as a California bowling alley, was engaged in several separate lines of businesses rather than a single unitary business. The California taxpayer had turned the management of its directly owned real properties over to an unrelated corporation.¹¹ In the Unitco case, the California Franchise Tax Board argued, in part:

. . . this appeal presents a vivid example of a single corporation engaged in identical activities in four separate states, totally dependent upon appellant's three officers to make the major policy decisions with respect to the activities in each state, and to provide day-to-day guidance as to the activities in some of the states; such a major contribution is clearly indicative of the unitary nature of appellant's operations.

The State Board of Equalization, viewing the situation quite differently than the Franchise Tax Board (respondent), stated:

Upon examination, the factors relied on by respondent do not reflect such a significant relationship among the rental activities so that they all must be considered as part of a single integrated economic enterprise. At best, the suggested unitary connections are superficial and trivial. We are particularly impressed with the absence of any significant common relationship between appellant's rental activities. Each rental activity is separate and distinct. In no way do any of appellant's rental activities contribute to or depend upon any of the others for their success or failure. Due to the disparate nature of each of appellant's property interests and the lack of any significant common relationship between them, we cannot conclude that these activities constitute a single

¹¹ Although the corporation was considered unrelated by the California State Board of Equalization, the president and major shareholder of the management corporation was also the president and major shareholder of the California taxpayer.

economic unit. . . . There simply are no significant relationships between appellant's various rental activities which would justify a determination that the activities constituted a single unitary business under either of the two established tests.

Based upon the record before the Commission, the Commission cannot conclude that the petitioner's various [Redacted] activities constituted a single unitary "trade or business," the income from which must be apportioned by Idaho's standard three factor formula. It simply cannot be said that, based upon the record before the Commission, the petitioner's Idaho [Redacted] business contributes to or depends upon the [Redacted] activity for its success or failure or vice versa. Because of the disparate nature of each of the petitioner's [Redacted] activities and the lack of any significant common relationship between them, we do not consider these activities as constituting a single integrated economic unit. Accordingly, the Commission, based upon the record before it, finds that the Idaho [Redacted] activity is separate and distinct from the petitioner's [Redacted] activity. Therefore, the rental income reported by the petitioner from its ownership [Redacted] is the income (net of applicable expenses) that the petitioner would report on its Idaho income tax return as Idaho business income subject to apportionment.

WHEREFORE, the Notice of Deficiency Determination dated March 12, 2009, is hereby MODIFIED, APPROVED, AFFIRMED, and MADE FINAL.

An explanation of the petitioner's rights to appeal this decision is enclosed.

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.
