

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)	
)	DOCKET NO. 23824
[Redacted],)	
)	
Petitioners.)	DECISION
_____)	

A Notice of Deficiency Determination (NODD) was issued to [Redacted](petitioners) ¹ seeking additional corporate income tax and interest in the amount of \$14,802, concerning taxable year ending December 31, 2007. Income tax auditors (ITA) from the Idaho State Tax Commission’s (Commission) Audit Division issued the NODD. The ITA subsequently modified the NODD as a result of [Redacted] audit adjustments, reducing the amount sought from \$14,802 to \$13,902.

The petitioners filed a timely petition for redetermination (petition). The petitioners requested an informal conference to discuss the deficiencies proposed by the ITA. [Redacted] [Redacted] conducted an informal conference by telephone on October 22, 2013. In addition to [Redacted] [Redacted], [Redacted], Tax Policy Specialist and [Redacted], Idaho Deputy Attorney General, attended the informal conference on behalf of the Commission. The petitioners were represented at the informal hearing by two of its employees: [Redacted], Manager-Income Tax Audits and [Redacted], Tax Associate.

Based on the information submitted by the petitioners and a review of the ITA’s file, the Commission now issues this decision.

The ultimate parent corporation, in this matter, is the [Redacted] [Redacted]. On audit, the primary issue was whether gain and loss on the sale of subsidiaries in 2007 should be treated

¹ Included with the term “petitioners” are those corporations with an Idaho income tax liability as reflected on the ITA’s schedule 1100 attached to and made part of the original NODD.

as business income or nonbusiness income. The subsidiaries that were sold were involved in the [Redacted] business.

The petitioners filed an Idaho corporate income tax group return utilizing worldwide combined reporting for taxable year 2007. When filing the Idaho group return for taxable year 2007, [Redacted] ([Redacted]) [Redacted] Sch. D capital gain of \$645,678,781 and [Redacted] Form 4797 gain of \$1,281,102,367 were excluded from income, subject to apportionment. Additionally, [Redacted] [Redacted] Sch. D capital loss totaling \$164,899,268 was excluded from income, subject to apportionment. It is the petitioners' treatment of these gains and losses as income not subject to apportionment that is in dispute.

The petitioners' 10-K, dated December 26, 2006, provides the following basic information regarding the sale by [Redacted] of its [Redacted] subsidiaries:

This STOCK PURCHASE AGREEMENT (this "Agreement") is entered into as of December 20, 2006, by and among [Redacted], a Delaware corporation ("U.S. Buyer"), [Redacted], a company organized under the laws of England and Wales ("U.K. Buyer" and, collectively with U.S. Buyer, "Buyer") [Redacted], a Delaware corporation ("Parent"), [Redacted], a Delaware corporation ("[Redacted]"), and [Redacted], a company organized under the laws of England and Wales ("[Redacted]" and, together with [Redacted], the "Sellers"). Buyer, Parent and the Sellers are referred to collectively herein as the "Parties."

Parent directly owns all of the outstanding capital stock of [Redacted] and indirectly owns all of the outstanding capital stock of [Redacted]. [Redacted] directly owns all of the outstanding membership interests of [Redacted], a Delaware limited liability company ("[Redacted]" and, together with [Redacted], the "Target Companies").

This Agreement provides for a transaction in which Buyer will purchase from [Redacted], and [Redacted] will sell to Buyer, all of the outstanding equity interests of [Redacted]. U.K. Buyer and [Redacted] are also party to that certain Asset Purchase Agreement dated as of the date hereof (the "Asset Purchase Agreement") attached hereto as Exhibit J-2.

[Redacted] was formed in October 2006, under Delaware law, as an LLC.² The sale of the [Redacted] stock by [Redacted] to [Redacted] was finalized and took place on March 26, 2007, whereupon, both parties made a joint election under Section 338(h)(10) of the Internal Revenue Code.³ The majority of the gain was generated by [Redacted]'s sale of [Redacted] ([Redacted]) stock.⁴

A review of the petitioners' [Redacted] consolidated return reflects that [Redacted] acquired the following [Redacted] indirectly-owned domestic corporations:⁵

[Redacted]	[Redacted]

In addition to the sale of the domestic corporations, [Redacted] also acquired, on March 26, 2007, assets from [Redacted], a foreign corporation.⁶

On November 30, 2007, [Redacted] ([Redacted]), a wholly-owned subsidiary of [Redacted], sold the stock of its wholly-owned subsidiary, [Redacted] ([Redacted]), to [Redacted].⁷ For purposes of this decision, the Commission will assume that the entire capital loss of \$164,899,268 relates to the sale of [Redacted] stock. [Redacted] in turn, was the owner of [Redacted] ([Redacted]).

The petitioners disagree with the ITA's reclassification of the gain and loss from nonbusiness income to business income. More specifically, on page five of the petitioners' petition, under Section IX, Part A, it is stated that:

² [Redacted] Certificate of Formation.

³ Petition, page 3, item 6.

⁴ Petition, page 3, footnote 1.

⁵ [Redacted] Form 8883 Asset Allocation Statement Under Section 338.

⁶ [Redacted] Form 8594 Asset Acquisition Statement Under Section 1060.

⁷ It is unclear if [Redacted] was a separate corporation or a disregarded entity. For purposes of this decision, it is assumed that [Redacted] was a disregarded entity.

[Redacted] disputes the fundamental premises of the Commission's Notice of Deficiency, which asserts that [Redacted] and the [Redacted] conducted an integrated, unitary business during the 2007 audit period and prior periods, thus making the sale of [Redacted] the sale of property which was integral, functional, or an operative component to the taxpayer's trade or business operations. The facts presented herein demonstrate that [Redacted] and the [Redacted] did not operate as an integrated unitary business in Idaho or elsewhere, and as such, the sale did not result in business income.

On pages six and seven of the petition, under section IX, Part B, the petitioners state:

The [Redacted] were not unitary with [Redacted] and were not integral or necessary to its business operations. The net gain did not contribute to, nor was it part of, [Redacted] regular business operations in Idaho. From the time [Redacted] acquired the [Redacted] to their eventual sale in 2007, the [Redacted] were active in a separate and distinct market which had no synergies with [Redacted] core markets; the [Redacted] maintained a separate headquarters and management infrastructure; and the [Redacted] had no connection with [Redacted] business conducted in Idaho.

Beginning on page two of the petition, under the heading "STATEMENT OF FACTS," the petitioners provide the following information:

1. [Redacted] is a Delaware corporation. At all times relevant herein, [Redacted] and its subsidiaries specialized in defense and government electronics, space, information technology, and technical services. [Redacted] designed, developed, manufactured, integrated, supported and provided a wide range of technologically advanced products, services, and solutions for governmental and commercial customers in the United States and abroad. Eighty four percent (84%) of [Redacted] sales in 2006 were comprised of defense contracts with the [Redacted]. Much of [Redacted] growth over the years is attributable to government defense contracts.

2. [Redacted] ("[Redacted]"), a separate line of business that was based in [Redacted], [Redacted], designed, developed, manufactured, marketed, and provided global support for business [Redacted], [Redacted] [Redacted] for the world's commercial, fractional ownership, and other [Redacted] markets.

3. To focus on the defense market, [Redacted] began to divest non-core businesses. In the fall of 2006, [Redacted] put [Redacted] into "discontinued operations" on its consolidated, financial statements. [Redacted] management felt that [Redacted] should be divested due to lack of synergies and mutual business objectives. Consequently, [Redacted] identified the business for divestiture.

4. Pursuant to the planned divestment, [Redacted] segregated [Redacted] assets, liabilities, expenses, and revenue in the consolidated balance sheet for all of [Redacted] future filings with the Securities and Exchange Commission.

5. In 2006, [Redacted] entered into a definitive agreement for the sale of [Redacted].⁸

6. On March 26, 2007, [Redacted] (“[Redacted]”), a wholly-owned subsidiary of [Redacted], sold the stock of its wholly-owned subsidiary, [Redacted], to [Redacted], whereupon, both parties made a joint election under Section 338(h)(10) of the Internal Revenue Code.

7. [Redacted] derived a gain from the sale of [Redacted] under IRC § 338(h)(10), none of which arose from the operation of a unitary business with [Redacted]. Nor did such income serve an operational function for [Redacted] business operations but, rather, arose from a passive investment.

8. [Redacted] (“[Redacted]”), a separate line of business that was based in [Redacted], [Redacted], provided, maintenance and support services to owners of fractional interests in [Redacted] who desire the flexibility for air travel that [Redacted] ownership permits but who do not require exclusive ownership of an [Redacted].

9. On November 30, 2007, [Redacted], a wholly-owned subsidiary of [Redacted], sold the stock of its wholly-owned subsidiary, [Redacted] to [Redacted].

10. [Redacted] derived a loss from the sale of [Redacted], none of which arose from the operation of a unitary business with [Redacted].

11. The net gain from the sale of [Redacted] and [Redacted] (“[Redacted]”) was not part of a unitary business with [Redacted] or related to the business that [Redacted] conducted in Idaho. Accordingly, [Redacted] excluded such net gain from its 2007 license tax return as a nonbusiness gain.

The ITA, on the other hand, concluded that, because the [Redacted] had been included as part of [Redacted] unitary group filing for taxable years 2001 through the year of sale in 2007,

⁸ Because [Redacted] represents the majority of the gain from the disposition of [Redacted] business, the petitioners in the petition refer to [Redacted] as the entity which produced the gain in issue.

any gain or loss on the sale of the stock of the subsidiaries engaged in the [Redacted] business is business income. In furtherance of their position, the ITA points to a letter from the petitioners' former Director of Income Taxes and Audits, sent to the Commission on October 18, 2002, stating that:

This is to inform you that the Idaho Corporation Income Tax Return for calendar year 2001 for [Redacted] . . . is being combined with the [Redacted] . . . In prior years, two unitary group returns were filed. We believe one unitary return is more proper under current state law and rulings. Accordingly, this year and future year tax returns will be filed as one unitary group.

In reviewing the petitioners' Idaho income tax filing history, auditors from the Multistate Tax Commission (MTC) had conducted an audit of the petitioners' Idaho income tax returns for taxable years 1995 through 1997, which resulted in a finding that the petitioners' [Redacted] business was a separate line of business. The Commission accepted the MTC's separate line of business findings, which resulted in the petitioners filing two separate unitary group returns with Idaho; one for the [Redacted] entities and one for the non-[Redacted] entities.

The separate group return filing continued until the filing of the petitioners' 2001 Idaho return at which time the [Redacted] considered the two groups to be part of the same unitary business. The petitioners included the income of the divested companies in business income, and included their property, payroll, and sales, in the combined apportionment factors, during the period of its ownership from 2001 forward. Thus, the petitioners' current claim that the [Redacted] were not part of its unitary business conflicts with the petitioners' earlier assertion that the [Redacted] business was part of its unitary business.

The determination of business or nonbusiness income is governed by section 63-3027, Idaho Code. Section 63-3027, Idaho Code, represents Idaho's version of the Uniform Division of Income for Tax Purposes Act (UDITPA). As described by the Idaho Supreme Court:

The Act [UDITPA] 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'n., 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 Comm'n., 458 U.S. 307, 102 S.Ct. 3103 (1982).

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."⁹ Nonbusiness income is all income other than business income.¹⁰

The Idaho Supreme Court held that the above quoted statutory language sets forth two separate and independent definitions of the term "business income."¹¹ These two separate definitions are commonly referred to as the "transactional test" and 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 operations.¹² Thus, there is no requirement under the functional test that the income arise from transactions and activities in the regular course of the taxpayer's trade or business.¹³ The key determination is whether the acquisition, management, or disposition of the property

⁹ Section 63-3027(a)(1), Idaho Code.

¹⁰ Section 63-3027(a)(4), Idaho Code.

¹¹ Union Pacific v. Idaho State Tax Comm'n., 136 Idaho 34, 28 P.3d 375 (2001).

¹² *Id.* at 38 – 39, 28 P.3d at 379 – 380.

¹³ *Id.* at 39, 28 P.3d at 380.

was directly connected with the taxpayer's business operations.¹⁴ Property that is not directly connected to the taxpayer's trade or business operations, such as passive investment property, does not generate business income.

Idaho Income Tax Administrative Rule 333 (Rule 333), subsections .03, .04, and .08, provide the following guidance with respect to the functional test:

03. Integral, Functional, or Operative Component of Trade or Business. Under the functional test, business income need not be derived from transactions or activities that are in the regular course of the taxpayer's own particular trade or business. It is sufficient, if the property from which the income is derived is or was an integral, functional, or operative component used in the taxpayer's trade or business operations, or otherwise materially contributed to the production of business income of the trade or business, part of which trade or business is or was conducted within Idaho. Depending on the facts and circumstances of each case, property that has been converted to nonbusiness use through the passage of a sufficiently lengthy period of time or that has been removed as an operational asset and is instead held by the taxpayer's trade or business exclusively for investment purposes has lost its character as a business asset and is not subject to the rule of the preceding sentence. Property that was an integral part of the trade or business is not considered converted to investment purposes merely because it is placed for sale.

04. Examples of Business Income Under the Functional Test. Income that is derived from isolated sales, leases, assignments, licenses, and other infrequently occurring dispositions, transfers, or transactions involving property, including transactions made in liquidation or the winding-up of business, is business income, if the property is or was used in the taxpayer's trade or business operations. Income from the licensing of an intangible asset, such as a patent, copyright, trademark, service mark, know-how, trade secrets, or the like, that was developed or acquired for use by the taxpayer in its trade or business operations, constitutes business income whether or not the licensing itself constituted the operation of a trade or business, and whether or not the taxpayer remains in the same trade or business from or for which the intangible asset was developed or acquired.

08. Application of the Functional Test. Application of the functional test is generally unaffected by the form of the property (for example, tangible or intangible property, real or personal property). Income arising from an intangible interest, for example, corporate stock or other intangible interest in a business or a group of assets, is business income when the intangible itself or the property

¹⁴ American Smelting at 931, 592 P.2d at 46 ("business income includes . . . income from tangible and intangible property if that property has the requisite connection with the corporation's trade or business").

underlying or associated with the intangible is or was an integral, functional, or operative component to the taxpayer's trade or business operations. Thus, while apportionment of income derived from transactions involving intangible property as business income may be supported by a finding that the issuer of the intangible property and the taxpayer are engaged in the same trade or business, i.e., the same unitary business, establishment of such a relationship is not the exclusive basis for concluding that the income is subject to apportionment. It is sufficient to support the finding of apportionable income if the holding of the intangible interest served an operational rather than an investment function of mere financial betterment.

Underlining added.¹⁵ Thus, based upon the plain language of the Commission's rules and based upon the petitioners' own determination that the two groups ([Redacted] and non-[Redacted]) were part of the same unitary business from 2001 forward, the gain and the loss on the sale of the [Redacted] business satisfies the functional test and constitutes business income subject to apportionment.

As for the petitioners' Commerce Clause and Due Process Clause arguments raised in its petition against the taxation of the gain and loss in dispute, Idaho Income Tax Administrative Rule 334 (Rule 334) provides:

The Due Process Clause and the Commerce Clause of the U.S. Constitution restrict states from apportioning income as business income that has no rational relationship with the taxing state. The protection against extraterritorial state taxation afforded by these Clauses is often described as the "unitary business principle." The unitary business principle requires apportionable income to be derived from the same unitary business that is being conducted at least in part in Idaho. The unitary business that is conducted in Idaho includes both a unitary business that the taxpayer alone may be conducting and a unitary business the taxpayer may conduct with any other person or persons. Satisfaction of either the transactional test or the functional test complies with the unitary business principle, because each test requires that the transaction or activity (in the case of the transactional test) or the property (in the case of the functional test) to be tied to the same trade or business that is being conducted within Idaho. Determination of the scope of the unitary business being conducted in Idaho is without regard to the extent to which Idaho requires or permits combined reporting.

¹⁵ IDAPA 35.01.01.333.

Underlining added.¹⁶ Since the gain and loss falls within the functional test as business income pursuant to Rule 334, the inclusion of the gain and loss at issue satisfies the “unitary business principle”; thus, Idaho is not prohibited from including the disputed income and loss as income subject to apportionment.

THEREFORE, the NODD dated January 12, 2011, as subsequently modified, and directed to the petitioners is hereby AFFIRMED by this decision.

IT IS ORDERED that the petitioners pay the following amount of tax, penalty, and interest:

<u>YEAR</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
2007	\$11,236	\$2,956	\$14,192

Interest is calculated through January 31, 2014, and will continue to accrue at the rate set forth in Idaho Code section 63-3045.

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.

DATED this _____ day of _____ 2013.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

¹⁶ IDAPA 35.01.01.334.

I hereby certify that on this _____ day of _____ 2013, 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.
