BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 24989
[Redacted],	)	
	)	
Petitioner.	)	DECISION
	)	

BACKGROUND

[Redacted] (Petitioner) protested the Notice of Deficiency Determination (NODD) issued by the Income Tax Audit Bureau (Audit), dated June 12, 2012, asserting income tax, penalty, and interest in the total amount of $10,620 for taxable years 2008, 2009, and 2010. On September 6, 2012, Audit transferred the case to the Tax Policy Department for resolution. On September 19, 2012, the Commission sent a letter to the POA explaining the Redetermination process and the Petitioner's rights to a hearing, including the right to provide additional information to be considered. A telephonic hearing was held on December 11, 2012.

DISCUSSION

In the Form 10-K filed with the SEC the Petitioners say in their business description; "We are a leading provider of necessary professional services and business information to legal, financial, real estate, and governmental affairs sectors in the United States." In the section on the history of the company they make the comment, "We have a successful history of growth through acquisitions. We have completed more than 70 acquisitions under both our predecessor company from 1992 through March 2003, and since March 2003, including two acquisitions in 2010."

The Petitioner has their corporate offices in [Redacted]. For the years related to this NODD, they filed an Idaho combined income tax return, including their wholly owned subsidiary located in Idaho.

ISSUES

1. Whether the Petitioner's income from a thirty five percent investment in the [Redacted]), is apportionable business income or should be subtracted as allocated income to the petitioner's domicile state.

LAW AND ANALYSIS

Idaho Code section 63-3027 describes how to compute the Idaho taxable income of a multistate or a group of unitary corporations doing business in Idaho and at least one other state.

> 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:
> (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 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.

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).

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.

Whether two or more business entities constitute a unitary business is a factual determination that has spawned considerable litigation over the years. No bright-line test can be employed in determining whether two or more business entities are engaged in a unitary business. "Unity can be established under any one of the judicially acceptable tests (Butler Bros., Edison California Stores, Container, etc.), and cannot be denied merely because another of those tests does not simultaneously apply." California Franchise Tax Board Notice 92-4, 1992 WL 207038. And even within these different definitions of what constitutes a unitary business, there is an unmistakable level of subjectivity. While the decision maker will be presented with various facts that either weigh for or against a finding of unity, in many cases, reasonable people can disagree whether the weight of the evidence tips the scales in one direction or the other. Allied-Signal, Inc. v. Director, Division of Taxes, 504 U.S. 768, 785, 112 S.Ct. 2251, 2262 (1992) ("If lower courts have reached divergent results in applying the unitary business principle to different factual circumstances, that is because . . . any number of variations on the unitary business theme are logically consistent with the underlying principles motivating the approach, . . . and also because the constitutional test is quite fact sensitive."). (Citations and internal quotations omitted.) But for all its problems and shortcomings, the unitary business principle is the backbone of modern state corporate income tax law. Formula apportionment, such as is required by Idaho Code § 63-3027, would not be possible absent the advent and development of the unitary business principle. *See* Mobil Oil Corp. v. Com'r of Taxes of Vermont, 445 U.S. 425, 439, 100 S.Ct. 1223, 1232 (1980) ("the linchpin of apportionability in the field of state income taxation is the unitary-business principle.")

The facts and circumstances of the Petitioner's relationship to the [Redacted] involve several elements of Unity. Due to the lack of a "bright line" and the subjectivity of determining unity, it is difficult to weigh the relevant import of each element. [Redacted] and the Petitioner are in the same line of business. The Petitioner's business model is to grow by acquisition. They are made up of subsidiaries that have local specialization and local market dominance. [Redacted] has both of those characteristics of local specialization and dominance. Local specialization seems to favor the lack of unity view. However, that is true of most of the Petitioner's subsidiaries.

In the NODD, Audit points out that there are several elements of business income present in the [Redacted] investment in [Redacted]. Being in the same line of business creates a natural tendency to assume that it meets the functional test and possibly the transactional test. The acquisition of [Redacted] was made in the ordinary course of business and fits the Petitioners business strategy.

Note 3, of the Petitioner's "Notes to Consolidated Financial Statements" as filed with the SEC says: "According to the terms of the membership operating agreement, any [Redacted] member may, at any time after November 20, 2011, exercise a "buy-sell" provision, as defined, by declaring a value for [Redacted] as a whole. If this were to occur, each of the remaining members must decide whether it is a buyer of that member's interest or a seller of its own interest at the declared stated value."

Idaho Code section 63-3027 says in part; "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 such acquisition, management, or disposition constitutes integral or necessary parts of the

taxpayer's trade or business operations…" Because of the use of the disjunctive "or" this is a more broad and inclusive definition than some of the [Redacted] state statues.

Courts have said that the mere ability to control or availability of control does not prove that Unity exists. The control has to be exercised.

The Income Tax Administrative Rules that define Business Income are Rules 35.01.01.330-336. Portions of the relevant rules follow.

332. BUSINESS AND NONBUSINESS INCOME DEFINED: TRANSACTIONAL TEST (RULE 332).

> **01. In General**. Business income includes income arising from transactions and activity in the regular course of the taxpayer's trade or business. (4-6-05)
> **02. Business Income for Idaho**. If the transaction or activity is in the regular course of the taxpayer's trade or business, part of which trade or business is conducted within Idaho, the resulting income of the transaction or activity is business income for Idaho. Income may be business income even though the actual transaction or activity that gives rise to the income does not occur in Idaho. (4-6-05)
> **03. Regular Course of the Taxpayer's Trade or Business**. For a transaction or activity to be in the regular course of the taxpayer's trade or business, the transaction or activity need not be one that frequently occurs in the trade or business. Most, but not all, frequently occurring transactions or activities will be in the regular course of that trade or business and will, therefore, satisfy the transactional test. It is sufficient to classify a transaction or activity as being in the regular course of a trade or business, if it is reasonable to conclude transactions of that type are customary in the kind of trade or business being conducted or are within the scope of what that kind of trade or business does. However, even if a taxpayer frequently or customarily engages in investment activities, if those activities are for the taxpayer's mere financial betterment rather than for the operations of the trade or business, such activities do not satisfy the transactional test. The transactional test includes, but is not limited to, income from sales of inventory, property held for sale to customers, and services that are commonly sold by the trade or business. The transactional test also includes, but is not limited to, income from the sale of property used in the production of business income of a kind that is sold or replaced with some regularity, even if replaced less frequently than once a year. (4-6-05)

333. BUSINESS AND NONBUSINESS INCOME DEFINED: FUNCTIONAL TEST (RULE 333).

Section 63-3027(a)(1), Idaho Code. (4-6-05)

01. In General. Business income also includes income from tangible and intangible property, if the acquisition, management or disposition of the property constitutes an integral or necessary part of the taxpayer's regular trade or business operations. (4-6-05)

02. Terms. (4-6-05) **a.** "Property" includes any interest in, control over, or use in property (whether the interest is held directly, beneficially, by contract, or otherwise) that materially contributes to the production of business income. (4-6-05) **b.** "Acquisition" refers to the act of obtaining an interest in property. (4-6-05) **c.** "Management" refers to the oversight, direction, or control (directly or by delegation) of the property for the use or benefit of the trade or business. (4-6-05) **d.** "Disposition" refers to the act, or the power, to relinquish or transfer an interest in or control over property to another, in whole or in part. (4-6-05) **e.** "Integral part" refers to property that constituted a part of the composite whole of the trade or business, each part of which gave value to every other part, in a manner that materially contributed to the production of business income. (4-6-05)

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. (4-6-05)

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. (4-6-05)

05. Operational Function Versus Investment Function. Under the functional test, income from intangible property is business income when the intangible property serves an operational function as opposed to solely an investment function. The relevant inquiry focuses on whether the property is or was held in furtherance of the taxpayer's trade or business, that is, on the objective characteristics of the intangible property's use or acquisition and its relation to the taxpayer and the taxpayer's activities. The functional test is not satisfied where the holding of the property is limited to solely an investment function as is the case where the holding of the property is limited to mere financial betterment of the taxpayer in general. (4-6-05)

06. Property Held in Furtherance of Trade or Business. If the property is or was held in furtherance of the taxpayer's trade or business beyond mere financial betterment, then income from that property may be business income even though the actual transaction or activity involving the property that gives rise to the income does not occur in Idaho. (4-6-05)

335. NONBUSINESS INCOME (RULE 335).

Section 63-3027(a)(1), Idaho Code. 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. (4-6-05)

Section 63-3027(a)(4), Idaho Code. (3-20-97)

01. Nonbusiness Income. Nonbusiness income is all income other than business income. All deductions relating to the production of nonbusiness income shall be allocated with the income produced. Any allowable deduction that applies to both business and nonbusiness income of the taxpayer shall be prorated to those classes of income to determine income subject to tax. When used in these rules, the term nonbusiness income includes nonbusiness losses unless the context clearly indicates otherwise. (3-20-97)

02. Offset of Interest Expense Against Nonbusiness Income. Interest on indebtedness incurred or continued to purchase or to carry investment that generates nonbusiness income is offset against the income produced. <u>If the facts do not support such a matching of the interest expense to the nonbusiness income,</u>

the portion of the taxpayer's interest expense that is offset against income from nonbusiness investments shall be an amount that bears the same ratio to the aggregate amount allowable to the taxpayer as a deduction for interest for the taxable year as the taxpayer's nonbusiness income mentioned in the preceding sentence bears to the taxpayer's total income for the taxable year. Aggregate amount allowable means the taxpayer's total interest expense deducted in determining taxable income as defined in Section 63-3011B, Idaho Code, plus interest expense disallowed under sections 265 and 291 of the Internal Revenue Code, plus interest expense from a pass-through entity, plus the interest expense of a corporation that, pursuant to Sections 63-3027 and 63-3027B through 63-3027E, Idaho Code, is included in a combined report with the taxpayer for the taxable year. See Rule 115 of these rules for the calculation of total income. (3-15-02)

03. Allocated to Idaho. Nonbusiness income, net of interest and other related expense offsets, that is attributable to Idaho is allocated to Idaho. (3-20-97)

04. Allocated to Other States. Nonbusiness income, together with interest and other related expense offsets, is allocated to other states if it is not attributable to Idaho. (3-20-97)

As evidenced by the rules cited, the determination of whether income from an investment is business or non-business income is a subjective process. There is no bright line text. Courts have said that unity is the linchpin of business income. While there are some elements of unity in the present case, the Petitioner's ownership percentage would indicate a lack of control. Each case has to be considered by its own facts and circumstances.

CONCLUSION

The Commission has concluded that the NODD does not present conclusive evidence that the investment in [Redacted] is business income. The Commission recognizes that circumstances may change or more factors could be discovered that support the finding of a unitary relationship between the Petitioner and [Redacted].

However, the tax returns as filed were not correct. Idaho Income Tax Administration Rule 335.02, requires the calculation of the interest charges for nonbusiness income if the facts

don't allow a direct matching of costs. The interest offset as required by the Idaho Code and Rule has been calculated and the NODD is modified to include those amounts.

THEREFORE, the Notice of Deficiency Determination dated June 12, 2012, and directed to [Redacted] is Modified by this decision to allow the allocated income with the calculated offset.

IT IS ORDERED that the taxpayers pay the following tax, penalty, and interest:

YEAR	TAX	PENALTY	INTEREST	TOTAL
12/31/2008	$ 112	$0	$19	$ 131
12/31/2009	298	0	37	335
12/31/2010	198	0	15	213
				$ 679

The Commission updated the interest through March 30st, 2013, on the Petitioner's tax liability.

DEMAND for immediate payment of the foregoing amount is hereby made and given.

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

DATED this _____ day of _____ 2013.

IDAHO STATE TAX COMMISSION

_____

COMMISSIONER

CERTIFICATE OF SERVICE

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.

_____