

**BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO**

In the Matter of the Protest of )  
 ) DOCKET NO. 25422  
[Redacted], )  
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 )  
Petitioner. ) DECISION  
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\_\_\_\_\_ )

BACKGROUND

On September 13, 2012, the Income Tax Audit Division (ITA) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (NODD) to [Redacted] (Petitioner) proposing a change in taxable income for 2008, that flows through to the owner’s 2008 individual Idaho income tax return. On November 15, 2012, the Petitioner’s CPA filed a timely protest. On December 17, 2012, the file was transferred to the Legal/Tax Policy Division for resolution. The Commission sent letters on March 5, 2013 and on September 9, 2013, explaining the options available for handling a protested NODD. Idaho Power of Attorney (POA) forms were included in those letters. The Petitioners did not respond to either letter and no POA forms have been filed. The Commission reviewed this case based on the information submitted by the petitioner and the ITA’s file, and now issues this decision.

ISSUE

1. Whether interest income from a real estate installment note created for the sale of Idaho real estate is sourced to Idaho for purposes of apportioning the income of a limited liability company being taxed as a partnership.

DISCUSSION

The Petitioner reported the 2008 activity on Idaho Form 65, using an Idaho Form 42 to apportion income between Idaho and the state of domicile. The Petitioner received \$295,550 in

payments on an installment note created for the sale of some property in Idaho in 2007. \$89,847 of that was capital gain and \$205,703 was return of basis. The protest letter said that \$204,449 was received as interest income related to the installment note. The auditor included that, plus another \$584 of interest in the Idaho sales factor.

The owners only reported the \$89,847 of gain from the installment sale note on their Idaho individual income tax return as Idaho taxable income. The result was the same as if the gain from the installment note was allocated to Idaho and the interest income was allocated to Utah on the partnership return. It was clear from the protest letter that allocating the interest income was their intent<sup>1</sup>.

ITA cited Income Tax Administrative Rule 550 Sales of Other Than Tangible Personal Property, as a reason to include the interest income in the sales numerator of the apportionment factor. Paragraph 05 of Rule 550, titled “Special Rules” has some specific examples including.

Idaho Income Tax Administrative Rule 550.05

a. Gross receipts from the sale, lease, rental or licensing of real property are in Idaho if the real property is located in Idaho.

Rule 550 provides guidance on how to apportion income and the rule only becomes applicable if the income is business income.

### LAW AND ANALYSIS

The relevant laws and rules to consider are:

Partnerships Operating Within and Without Idaho. Income Tax Administrative Rule 280.01. In General. A partnership that operates within and without Idaho must apply the principles 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. The use of a combined report, however, is available only to C corporations.

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<sup>1</sup> Letter of protest from [Redacted], dated November 15, 2012.

Since the Petitioner is an LLC that has elected to be treated as a partnership for income tax purposes, we have to use the apportionment and allocation rules as if it were a corporation.

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.

(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.

(5) "Sales" means all gross receipts of the taxpayer not allocated under subsections (d) through (h) of this section.

[Redacted]

330. Business income is apportioned among jurisdictions by use of a formula. Nonbusiness income is specifically assigned or allocated to one (1) or more specific jurisdictions pursuant to express rules. An item of income is classified as business income if it falls within the definition of business income. An item of income is nonbusiness income only if it does not meet the definitional requirements for being classified as business income.

To be classified as business income, it must meet the definition of business income. All other income is nonbusiness.

331.01. In General. Business income means income of any type or class and from any activity that meets the "transactional test" described in Rule 332 of these rules, or the "functional test" described in Rule 333 of these rules. The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents,

royalties, gains, operating income, and nonoperating income, is of no aid in determining whether income is business or nonbusiness income. Underline added.

331.02. Terms Used in Definition of Business Income and in Application of Definition. As used in the definition of business income and in the application of the definition.

a. "Trade or business" means the unitary business of the taxpayer, part of which is conducted within Idaho.

b. "To contribute materially" includes, without limitation, "to be used operationally in the taxpayer's trade or business." Whether property materially contributes is not determined by reference to the property's value or percentage of use. If an item of property materially contributes to the taxpayer's trade or business, the attributes, rights or components of that property are also operationally used in that business. However, property that is held for mere financial betterment is not operationally used in the taxpayer's trade or business.

332. BUSINESS AND NONBUSINESS INCOME DEFINED: TRANSACTIONAL TEST (RULE 332). Section 63-3027(a)(1), Idaho Code. 01. In General. Business income includes income arising from transactions and activity in the regular course of the taxpayer's trade or business.

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.

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. Underline added.

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

333.05. 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. Underline added.

The Petitioner is a limited liability company that has elected to be treated as a partnership for income tax purposes. Rule 280.01, above, says that a partnership operating in more than one state, including Idaho, shall apportion and allocate their income like a corporation. The allocation and apportionment rules of Section 63-3027, Idaho Code, and related rules apply to the partnership.

Idaho Code section 63-3027 says that business income will be apportioned and nonbusiness income will be allocated. [Redacted]

#### CONCLUSION

[Redacted] interest income from a real estate installment note from the sale of Idaho real estate is sourced to Idaho for purposes of apportioning the income of a limited liability company taxed as a partnership. [Redacted]

THEREFORE, the NODD dated September 13, 2012, and directed to [Redacted] is hereby CANCELLED.

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

DATED this \_\_\_\_\_ day of \_\_\_\_\_ 2014.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

**CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_\_ day of \_\_\_\_\_ 2014, 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.