

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

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| In the Matter of the Protest of |) | |
| |) | DOCKET NO. 23058 and 25032 |
| [Redacted], |) | |
| |) | |
| Petitioner. |) | DECISION |
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INTRODUCTION AND PROCEDURE

On December 20, 2011, the staff of the Income Tax Audit Bureau of the Idaho State Tax Commission (Tax Commission) issued two Notices of Deficiency Determination to [Redacted] (Petitioner), denying claimed refunds and proposing some additional income taxes, penalties, and interest for the periods ending December 31, 2002, through December 31, 2008. On February 17, 2012, the petitioner filed a timely protest and petition for redetermination.¹

FACTUAL BACKGROUND

[Redacted] is a [Redacted] corporation, formed in 2006.² Its principal place of business is in [Redacted].³ For [Redacted] income tax purposes, [Redacted] is a [Redacted].⁴ [Redacted] is owned by [Redacted], which, as explained below, is a subsidiary of [Redacted].

[Redacted] is a [Redacted] corporation established on [Redacted]. [Redacted] owns a 76.5 percent share in the capital of a [Redacted] [Redacted]. The other 23.5 percent interest in [Redacted], an unrelated company. [Redacted] holds a controlling interest in a group of companies engaged in the [Redacted] of [Redacted].

¹ An NODD was originally issued on April 12, 2011 and was protested on June 10, 2011. Petitioner provided some additional documentation and information to audit staff after that and as a result, audit staff issued the new modified NODDs on December 20, 2011.

² See Petition to Use Alternative Apportionment dated 2/13/2009

³ Id. p. 2

⁴ Id.

[Redacted], among others. It also retains license to import international trademark [Redacted]. In addition to its [Redacted] production, [Redacted] is involved in the production and sale of certain brands of [Redacted] brands. It also is involved in the distribution of the [Redacted]. [Redacted] has [Redacted]: [Redacted] are [Redacted].

Most jurisdictions in the United States prohibit the direct sale of [Redacted] from the manufacturer to [Redacted] then to a retailer, and then to the consumer. *See Granholm v. Heald*, 544 U.S. 460, 466, 125 S. Ct. 1885, 1892, 161 L. Ed. 2d 796 (2005) ([Redacted]); *see also* Idaho Code §§ 23-1007 and 23-1309.

[Redacted] a [Redacted] corporation. On July 17, 2006, [Redacted] entered into an agreement with [Redacted] to establish a joint venture.⁵

Pursuant to the [Redacted], a [Redacted] limited liability company. [Redacted] transferred substantially all of its assets relating to [Redacted] [Redacted] brands and the liabilities associated therewith to [Redacted]. [Redacted] then made a cash contribution to [Redacted] in an amount substantially equal to the assets contributed by [Redacted]. [Redacted] are equal partners in [Redacted].⁶ [Redacted] became the sole [Redacted] of Petitioner's [Redacted] throughout the United States.⁷

The agreement provided, "Except as authorized by the Board in accordance with this Agreement, no Member (in his, her, or its capacity as such) or representative of a Member shall take part in the day-to-day management, or the operation or control, of the business and affairs of the Company."⁸ [Redacted] Board of Directors (Board) consisted of [Redacted] directors, [Redacted] from [Redacted], none of whom were authorized to receive compensation for their services. The Board also consisted of two co-chairmen – one from [Redacted] and one from

⁵ Id.

⁶ Id.

⁷ Factual Background provided by Petitioner's counsel March 16, 2015.

⁸ See, Amended and Restated Limited Liability Company Agreement [Redacted], paragraph 3.5.

[Redacted]. A president was appointed by the Board, and the position has been continuously filled by Mr. [Redacted] who was tasked with expanding his previous distribution market from the western United States to the entire United States. The agreement set forth the duties and powers of the board:

4.2. Powers and Authority of the Board. Except where approval of the Members is expressly required by nonwaivable provisions of applicable law or as otherwise specifically provided in this Agreement, the Board shall have full, exclusive and complete discretion to direct and control the business and affairs of the Company, to make all decisions affecting the business and affairs of the Company and to authorize management of the Company or such other Persons as it may designate to take all such actions as it deems necessary or appropriate to accomplish the foregoing and the purposes of the Company as set forth herein. Without limiting the generality of the foregoing, but subject to the other provisions of this Article IV, the Board shall have the power and authority to cause the Company to:

- (a) expend funds in furtherance of the purposes of the Company;
- (b) invest and reinvest in securities or other property of any character, real or personal, including, but not limited to, common and preferred stocks, bonds, notes, debentures, mortgages, leases and partnership interests (general or limited);
- (c) sell, exchange or otherwise dispose of any such securities or other property at public or private sale and to grant options for the purchase, exchange or other disposition thereof, and to exercise or sell any options and any conversion, subscription, voting and other rights, discretionary or otherwise, in respect thereof;
- (d) manage and keep in force such insurance as may be required to reasonably protect the Company and its assets;
- (e) borrow money and/or guarantee obligations, on such terms and at such rates of interest as the Board may deem advisable and proper;
- (f) pledge the credit of the Company and grant security interests in Company assets for Company purposes;
- (g) appoint and remove officers and employees of the Company;
- (h) employ such agents, independent contractors, attorneys and accountants as the Board deems reasonably necessary;
- (i) commence, defend, compromise or settle any Claims for and on behalf of the Company;

(j) execute, deliver and file any amendment, restatement or revocation of the Certificate of Formation as may be necessary or appropriate to reflect actions properly taken by the Board and/or the Members under this Agreement;

(k) execute, deliver, file and/or record any and all instruments, documents or agreements of any kind which the Board may deem appropriate or as may be necessary or desirable to carry out the purposes of the Company; and

(l) take such other actions as the Board of Directors may reasonably believe to be necessary or desirable to carry out the purposes of the Company.

Only the Board, acting as provided in this Agreement, shall have the power to bind the Company, except and to the extent otherwise set forth in Article V or as expressly delegated to any other Person by the Board, but such delegation shall not cause the Board to cease to be responsible for the management of the Company. The expression of any power or authority of the Board in this Agreement shall not in any way limit or exclude any other power or authority which is not specifically or expressly set forth in this Agreement.⁹

The agreement also includes instructions about what kind of actions required a vote of approval from the board:

(c) Notwithstanding the provisions of Section 4.5(b), but subject to Section 4.5(d), the following actions or transactions shall require the affirmative vote, approval or consent of all four (4) of the [Redacted]:

(i) the approval of and any amendments or modifications to or departure from the [Redacted] Period Business Plan and each Business Plan thereafter;

(ii) any amendments or modifications to the Strategic Pricing Initiative and the parameters referred to therein;

(iii) the assumption of the representation of any third party brands, or the purchase, licensing, sale or other acquisition or disposition of brands;

(iv) any change in the prices of products sold by the Company other than as provided by the Strategic Pricing Initiative;

(v) any amendments to the Certificate of Formation, the Administrative Services Agreement, the [Redacted], the Sub-license Agreement or this Limited Liability Company Agreement;

(vi) the issuance of additional Membership Interests or rights therein;

(vii) any merger, conversion, consolidation or other business combination;

⁹ See, Amended and Restated Limited Liability Company Agreement of [Redacted], paragraph 4.2.

(viii) any (A) voluntary dissolution or liquidation, (B) filing of a petition in bankruptcy, (C) appointment of a receiver, or (D) assignment for the benefit of creditors of the Company;

(ix) (A) paying or making any dividend or distribution to any Member other than as provided in Section 10.2 (a) or (B) any change in the dividend or distribution policies set forth in Article X;

(x) any material change in accounting or tax policies, other than changes required by GAAP, including any change or revocation of the “Entity Classification Election” under the Code, or any similar provision enacted in lieu thereof, or any corresponding provision of state tax laws or any action that will cause the Entity Classification Election of the Company to be changed;

(xi) any borrowing of money or other incurrence of indebtedness or the grant of any security interest or lien in Company assets;

(xii) any capital expenditures not authorized by a line item in the current Business Plan, in excess of \$1,000,000, individually, or \$5,000,000 in the aggregate in any Fiscal Year;

(xiii) any acquisition of assets, equity or debt of another business or Person outside the ordinary course of the Company’s business;

(xiv) any sale, exchange, lease, mortgage, pledge or other disposition, directly or indirectly, of any of the assets of the Company other than in the ordinary course of business;

(xv) any disposition of an asset, other than inventory disposed of in the ordinary course of business, with either a book or fair market value in excess of \$250,000 not specifically authorized in a disposition plan incorporated into the current Business Plan;

(xvi) any (A) Insider Business, (B) any Claim, right or remedy arising out of Insider Business pursuant to Section 3.4, (C) any agreements or commitments which, by their terms, restrict the Company from making any mandatory distribution in the amount contemplated by Section 10.2(a), or (D) any action, transaction or series of transactions with a single unaffiliated third party during any Fiscal Year of the Company not authorized by a line item in the current Business Plan (1) in the ordinary course of business of the Company, involving in the aggregate an amount in excess of \$250,000, or (2) outside the ordinary course of business of the Company, involving in the aggregate an amount in excess of \$50,000;

(xvii) determination on behalf of the Company to appoint or terminate the President, the Chief Financial Officer, or any other senior management and compensation decisions related thereto;

(xviii) appointment of a new Co-Chairman or a new President of the Company;

(xix) any material departure from the strategic direction developed by the Members for the business of the Company;

(xx) with respect to each Member's initial Capital Contribution, the allocation of the aggregate carrying value of the assets contributed by the Member among the specific assets contributed;

(xxi) the revaluation of the value of any Company properties;

(xxii) any change in the Company's independent accountants or auditors; and

(xxiii) the approval of the proposal for the transfer of the Services to the Company pursuant to Section 7.1 of the Administrative Services Agreement.¹⁰

¹⁰ See, Amended and Restated Limited Liability Company Agreement of [Redacted], paragraph 4.5.

In a news release taken from [Redacted] website, [Redacted] Chairman and Chief Executive Officer, [Redacted]made the following statement regarding the formation of [Redacted]

We are pleased with the creation of this joint venture and believe that it offers [Redacted].¹¹

[Redacted], distributed, and marketed the [Redacted] portfolio and other products throughout the entire United States. To do this, it maintained storage and distribution facilities across the U.S. It also employed a sales force that solicited the business of distributors nationwide.¹²

The joint venture with [Redacted] created an opportunity for [Redacted] to import and market its brands in the U.S. under a single entity.¹³ This provided the [Redacted] products ([Redacted]) nationwide marketing support.¹⁴ It also permitted [Redacted] the ability to implement consistent and focused marketing efforts such as promotions, sponsorships, and advertising on behalf of those products.¹⁵ In the end, the partners of [Redacted] hoped to maximize growth potential for those brands.¹⁶

ISSUES PRESENTED

1. Is [Redacted] share of the income, flowing through from [Redacted], business income that should be apportioned with all of Petitioners' other business income?
 - a. Is [Redacted]? Does it matter?

¹¹ [Redacted]

¹² [Redacted].

¹³ [Redacted]

¹⁴ [Redacted].

¹⁵ Id. page 20.

¹⁶ Id.

- b. Can the [Redacted] income be business income under the functional test regardless of whether [Redacted] is unitary with [Redacted]?
2. If [Redacted] income from [Redacted] is business income, whether alternative apportionment is appropriate.
3. Should the sales of Agriculture to the [Redacted] in [Redacted] be thrown back into the Idaho sales factor because Agriculture is not taxable in [Redacted] on those sales?

LAW AND ANALYSIS

Petitioner's Share of the [Redacted] income should be apportioned together with all of Petitioner's other business income.

The question as to whether the [Redacted] income should be apportioned as business income is mostly answered by Income Tax Rule 620. [Redacted] elected to be treated as a partnership. [Redacted] were equal partners in [Redacted], each owning a 50 percent interest in [Redacted]. Rule 620 states, in part:

04. Partnership Income as Business Income of the Partner. (3-20-97)

a. Income. If the income or loss of a partnership is business income or loss to a corporate partner, its share of this net business income or loss shall be apportioned together with all other net business income or loss of the corporation. Business income or loss is defined by Section 63-3027(a)(1), Idaho Code, and Rules 330 through 336 of these rules. (4-11-06)

b. Factors. A corporate partner's share of the partnership property, payroll, and sales after intercompany eliminations, shall be included in the numerators and the denominators of the partner's property, payroll, and sales factors when computing its apportionment formula. The partner's share of the partnership's property, payroll, and sales is determined by attributing the partnership's property, payroll, and sales to the partner in the same proportion as its distributive share of partnership income if reporting net income for the taxable year or in the same proportion as its distributive share of partnership losses if reporting a net loss for the taxable year. Generally, the partnership's property, payroll, and sales includable in the corporation's factor computations is determined in accordance with Section 63-3027, Idaho Code, and related rules. To determine how the sales attribution rules of Section 63-3027(q), Idaho Code, apply to the sales factor of the corporate partner, the sales of the partnership are treated as if they were sales of the corporation. (3-30-01)

05. Partnership Income as Nonbusiness Income of Partner. (3-20-97)

a. Income. If the partnership income or loss is not business income to a corporate partner, the income is nonbusiness income as defined in Section 63-3027(a)(4),

Idaho Code, and Rules 335 through 339 of these rules. The corporate partner shall allocate the nonbusiness income to the state in which it was earned. The corporate partner, on its Idaho corporation income tax return, shall specifically allocate to Idaho its share of the nonbusiness income attributable to Idaho. (3-20-97)

b. Factors. If the partnership income or loss is nonbusiness income to the corporate partner, none of the partnership property, payroll, or sales may be included in the computation of the factors of the corporation. (3-20-97)

IDAPA 35.01.01.620. The requirement when applying rule subsections 620.04 and 620.05 is to determine whether the income of the partnership is business income to the corporate partner (as defined by Income Tax Rules 330 through 336). These rules provide that if the income is business income under the transactional or functional test then it is apportioned together with all the other business income of the corporation.

Both the transactional and functional tests for identifying business income require that the income had some connection to the unitary business of the taxpayer. The transactional test states, "Business income includes income arising from transactions and activity in the regular course of the taxpayer's trade or business." IDAPA 35.01.01.332.01. The functional test states, "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." IDAPA 35.01.01.333.01. Both tests refer to the taxpayer's "trade or business." "Trade or business" is defined as "the unitary business of the taxpayer." IDAPA 35.01.01.331.02.a. To reach the conclusion that income is business income under either test, part of the analysis involves identifying whether or not the income had a connection to taxpayer's unitary business (i.e., "trade or business").

However, when a corporate partner receives partnership income that arose out of an investment activity limited to the mere financial betterment of the taxpayer in general, it is not

business income under either the transactional or functional test. Income Tax Rule 332.02

explains, regarding 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.

Income Tax Rule 333.05 addresses the operational versus investment scenario under the functional test:

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.

Income Tax Rule 330.08 provides further explanation regarding application of the functional test:

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 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.

Petitioner's ownership interest in [Redacted] (and the income generated from this ownership interest) was more than an investment activity limited to the mere financial betterment of the taxpayer in general. Petitioner did not simply make a passive investment in a partnership; but rather, Petitioner was a 50 percent partner in a partnership that was the exclusive distributor of Petitioner's [Redacted] products in the United States and was established by Petitioner to "create strategic alignment across the nation and the ability to create even more growth in one of the world's most dynamic [Redacted] markets." Petitioner expected that "the joint venture [would] benefit from the existing momentum and popularity of our brands with consumers, add value to our business, and expand our mutual relationship..." Petitioner's ownership interest in [Redacted] was held in furtherance of Petitioner's trade or business; Petitioner's role in creating and holding a 50 percent partner interest in [Redacted] served an operational purpose. Thus, Petitioner's share of the [Redacted] income is business income under the functional test and should be included within Petitioner's business income subject to apportionment pursuant to Income Tax Rule 620.

The facts suggest that [Redacted] had a unitary relationship with the rest of Petitioner's unitary business.

Petitioner has argued that "it is essential that a unitary relationship be established between [Redacted]" before the [Redacted] income can be considered to be business income to Petitioner; to do otherwise is "constitutionally offensive and falls outside the parameters of taxable business income defined by the United States Supreme Court."¹⁷ The Tax Commission's longstanding Income Tax Rule 333.08 (quoted above) provides that it is not necessary to find that the [Redacted] entity had a unitary relationship with the Petitioner's overall unitary business to reach the conclusion above that the [Redacted] income was business income to [Redacted].

¹⁷ See Petitioners' letter the Commission's counsel dated December 11, 2014, pgs. 4-5.

Even though such a unitary finding is unnecessary, the facts of this case suggest that [Redacted] did have a unitary relationship with Petitioner's overall unitary business.

The "unitary business" and "business income" concepts are closely related. Income must have a certain connection with a taxpayer's unitary business to be "business income." IDAPA 35.01.01.331-333. The "unitary business" principle looks at a group of entities to determine whether those entities should be grouped together and treated as one business for purposes of taxation. Rule 340 addresses the unitary business principle:

01. The Concept of a Unitary Business. (4-6-05)

a. A unitary business is a single economic enterprise that is made up either of separate parts of a single business entity or of a commonly controlled group of business entities 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 flow of value to a business entity located in Idaho that comes from being part of a unitary business conducted both within and without Idaho is what provides the constitutional due process "definite link and minimum connection" necessary for Idaho to apportion business income of the unitary business, even if that income arises in part from activities conducted outside Idaho. The business income of the unitary business is then apportioned to Idaho using an apportionment percentage provided by Section 63-3027, Idaho Code. (4-6-05)

b. 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. (4-11-06)

Income tax Rule 341 discusses some of the principles for determining the existence of a unitary business:

01. In General. Unity can be established under any one (1) of the judicially acceptable tests ([Redacted]), and cannot be denied merely because another of those tests does not simultaneously apply. (4-11-06)

02. Significant Flows of Value. A unitary business is characterized by significant flows of value evidenced by factors such as those described in *Mobil Oil Corp. v. Vermont*, 445 U.S. 425 (1980): functional integration, centralization of

management, and economies of scale. These factors provide evidence of whether the business activities operate as an integrated whole or exhibit substantial mutual interdependence. Facts suggesting the presence of the factors mentioned above should be analyzed in combination for their cumulative effect and not in isolation. A particular business operation may be suggestive of one (1) or more of the factors mentioned above. (4-11-06)

Part of the Audit Bureau's reasoning that [Redacted] was unitary with Petitioners' combined group was the idea that [Redacted] was part of a vertically integrated business.

Income Tax Rule 343 addresses vertically structured businesses:

02. Steps in a Vertical Process. Business activities that are part of different steps in a vertically structured business almost always constitute a single unitary business. For example, a business engaged in the exploration, development, extraction, and processing of a natural resource and the subsequent sale of a product based upon the extracted natural resource, is engaged in a single unitary business, regardless of the fact that the various steps in the process are operated substantially independently of each other with only general supervision from the business's executive offices.

[Redacted] was the exclusive distributor of Petitioner's [Redacted] products in the United States. Petitioner had three [Redacted] facilities (one in Idaho) that provide supply for Petitioner's eight [Redacted]. Petitioner also owned a business that manufactured [Redacted]. Petitioner owned four distributors that distributed [Redacted] products abroad. It appears that federal and state laws would have prohibited Petitioner from creating a wholly-owned entity to distribute Petitioner's products in the United States. To be a 50 percent partner in [Redacted], seems to be as close as Petitioner could get to being in complete control of the distribution of Petitioner's products in the United States. It appears from the facts, that [Redacted] was a part of Petitioner's vertically structured business; and that it played a key role in Petitioner's overall business activity of producing and selling [Redacted] products in the United States.

Petitioner's arguments have focused on the "control" element. Petitioner has emphasized the fact that with its 50 percent interest, Petitioner did not have majority control over [Redacted]. Petitioner has argued that it had no role or control in the day-to-day business activities of

[Redacted]. But as can be seen from the [Redacted], Petitioner’s employees constituted half of the board of directors for [Redacted]. This board had a significant amount of managerial control (e.g., power to hire and fire [Redacted] employees, expend funds for [Redacted], borrow money for [Redacted], invest and reinvest [Redacted] money, manage insurance [Redacted]). The agreement established that “only the Board” would “have the power to bind [[Redacted]],” except as delegated to a person by the board, “but such delegation [would] not cause the Board to cease to be responsible for the management of the Company.” There were many actions specified in the agreement that required a unanimous vote of the board. Petitioner may not have had a majority control; but it certainly cannot be said that Petitioner had no control over [Redacted].

Control is only one consideration among the various methods for defining and identifying a unitary business. Idaho Income Tax Rule 341 addresses the “determination of a unitary business” and explains that “Unity can be established under any one (1) of the judicially acceptable tests ([Redacted]), and cannot be denied merely because another of those tests does not simultaneously apply.”

Petitioner’s ownership interest in [Redacted] was more than a passive investment; there was a flow of value to Petitioner’s unitary business by entering into the joint venture with [Redacted] to create the [Redacted] partnership. In Container Corp., the Court, while citing the Mobil “factors of profitability” with approval, also made clear that the overarching inquiry in determining whether two or more enterprises are engaged in a unitary business is the existence of a “sharing or exchange of value not capable of precise identification or measurement – beyond the mere flow of funds arising out of a passive investment or a distinct business operation –

which renders formula apportionment a reasonable method of taxation.” Container Corp. of Am. v. Franchise Tax Bd., 463 U.S. 159, 166, 103 S. Ct. 2933, 2940, 77 L. Ed. 2d 545 (1983).

Similarly, in Edison California Stores, Inc. v. McColgan, 183 P.2d 16 (Cal. 1947), the California Supreme Court articulated what has since come to be known as the “contribution – dependency” test. Succinctly stated, if the operation of one company is dependent upon or contributes to the operation of another company, the operations are unitary. If there is no such dependency or contribution, the businesses are considered to be separate. *See Edison*, 183 P.2d at 21. The Idaho Supreme Court has cited with approval the contribution – dependency test first articulated in Edison. *See Albertson’s Inc. v. State, Dept. of Rev.*, 106 Idaho 810, 815 - 816, 683 P.2d 846, 851 - 852 (1984) (“whether a number of business operations having common ownership constitute a single or unitary business or several separate businesses for tax purposes depends upon whether they are of mutual benefit to one another and on whether each operation is dependent on or contributory to others.”).

A passive investment is not a unitary business, nor is a distinct business operation. But where the facts and circumstances establish an interrelationship or flow of values that goes beyond a mere passive investment or a distinct business operation, it is likely that a unitary relationship exists “which renders formula apportionment a reasonable method of taxation.”

Petitioner entered the joint venture with [Redacted] to create [Redacted] for the purpose of [Redacted] becoming the exclusive distributor of Petitioner’s [Redacted] products in the United States. Petitioner expected that this new venture would provide great benefits to its business. [Redacted] played a key role in Petitioner’s vertically integrated business. [Redacted] also made important contributions to Petitioner’s business and Petitioner was completely

dependent upon [Redacted] to carry out the distribution business and produce a profit for Petitioner in the United States.

[Redacted] was a pass through entity; thus Rule 620 applies and requires an inquiry of whether Petitioner's [Redacted] income had a sufficient "connection" to Petitioner's business such that it would be business income under the transactional or functional tests. To be able to conclude that the [Redacted] income was business income, there is no requirement to find that the [Redacted] entity was part of Petitioner's unitary business group. Nevertheless, the facts seem to suggest that [Redacted] was part of Petitioner's unitary business.

The constitutional "serves an operational function" test permits a business income classification for income from a payor to a payee even if the two entities are not unitary.

Petitioner's primary argument is that it does not have a unitary relationship with [Redacted]. Petitioner suggests that, absent a unitary relationship, Idaho cannot treat the income received from [Redacted] as business income; and that such a finding is "constitutionally offensive and falls outside the parameters of taxable business income defined by the United States Supreme Court."

In a series of cases culminating in Allied-Signal v. Director, Div. of Taxation, 504 U.S. 768 (1992), the United States Supreme Court provided an analytical framework for determining the constitutional restraints on state apportionment of income.¹⁸ The Tax Commission disagrees with Petitioner's argument that the income from [Redacted] cannot be apportionable business income absent a unitary relationship. As discussed below, the Court held that it is not always necessary to find a unitary relationship exists between businesses before apportioning income for state taxation.

¹⁸ [Redacted].

Purchasing and holding an interest in a non-unitary business can result in business income if purchasing and holding the interest serves an operational purpose rather than a mere investment function. The Allied-Signal Court described two occurrences where apportionment of income (i.e., including the income as business income) would be consistent with the Due Process and Commerce Clause provisions of the United States Constitution. First, apportionment will be permitted if there is unity between the payor and the payee. That is, apportionment is permitted if the payor and the payee are engaged in the same unitary business. *Id.* at 787.

The second occurrence upon which apportionment of income will be permitted is if the transaction from which the income is derived “serves an operational function” as opposed to an “investment function.” *Id.* at 788. “The essential question under the operational-function test is whether the intangible asset is part of the corporate taxpayer’s own unitary business, not whether two separate corporations are engaged in a common enterprise.” Walter Hellerstein, State Taxation of Corporate Income From Intangibles: Allied-Signal And Beyond, 48 *Tax L. Rev.* 739, 791 n.315 (1993).

The United States Supreme Court in Allied-Signal clearly indicated that a taxpayer can derive apportionable unitary income from an operational transaction even though there is no unity between the payor corporation and the payee corporation. The Allied-Signal Court left the remaining test largely undefined; however, it provided one practical example of what may be referred to as “operational unity.” According to the Court, “a State may include within the apportionable income of a nondomiciliary corporation the interest earned on short-term deposits in a bank located in another state if that income forms part of the working capital of the corporation’s unitary business, notwithstanding the absence of a unitary relationship between the corporation and the bank.” Allied Signal; 504 U.S. at 787-788. Thus, income earned on the

investment of idle working capital can constitutionally be apportioned among the various states in which the corporation conducts its unitary business operations.

The Court also gave another indication of the breadth of this business income test when it cited footnote 19 of Container Corp. See Allied Signal; 504 U.S. at 787. In footnote 19 of Container Corp., Justice Brennan, writing for the majority, stated that “[a]s we made clear in another context in Corn Products Co. v. Commissioner, 350 U.S. 46, 50-53, 76 S.Ct. 20, 23-24, 100 L.Ed. 29 (1955), capital transactions can serve either an investment function or an operational function.” Container Corp. 463 U.S. at 180 n.19.

Another important point that can be gleaned from the language in footnote 19 of Container Corp. is that transactions other than the short-term investment of idle working capital may be business income. The fact that the Court cited with approval the Corn Products Co. v. Commissioner decision is significant. As explained by Professor Hellerstein:

In *Corn Products*, the Supreme Court held that a company engaged in converting corn into syrup and other products realized ordinary income and loss on the sale of corn futures even though such futures were not literally excluded from the “capital asset” definition under I.R.C. § 1221. Because the taxpayer's transactions in corn futures were designed to protect its manufacturing operations against increases in the cost of its principal raw material and to assure a ready source of supply of corn if needed, the Court held that the resulting profits and losses should be characterized consistently with Congress' perceived intent “that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss.” *Corn Products*, 350 U.S. at 52.

The case spawned the doctrine under which gain or loss from the sale of intangible assets, frequently stock in other corporations, was held to be ordinary gain or loss because the asset was **“bought and kept not for investment purposes, but only as an incident to the conduct of the taxpayer's business.”** *John J. Grier Co. v. United States*, 328 F.2d 163, 165 (7th Cir. 1964)

Income from intangible assets falling under the [Redacted] doctrine thus would be apportionable under the operational-function test ...

Hellerstein, State Taxation Of Corporate Income From Intangibles: Allied-Signal and Beyond, 48 Tax L. Rev. 739, 793-94 n.319 (1993) (emphasis added).

The United States Supreme Court provided further instruction regarding the operational function test in MeadWestvaco Corp. v. Illinois Dept. of Revenue, 553 U.S. 16, 128 S. Ct. 1498 (2008). The Court clarified its Allied Signal ruling and the role of the operational function test:

We explained that situations could occur in which apportionment might be constitutional even though “the payee and the payor [were] not ... engaged in the same unitary business.” 504 U.S., at 787, 112 S.Ct. 2251. It was in that context that we observed that an asset could form part of a taxpayer's unitary business if it served an “operational rather than an investment function” in that business.

Mead, 128 S.Ct. at 1507. The Court further explained that:

... our references to “operational function” in Container Corp. and Allied-Signal were not intended to modify the unitary business principle by adding a new ground for apportionment. The concept of operational function simply recognizes that an asset can be a part of a taxpayer's unitary business even if what we may term a “unitary relationship” does not exist between the “payor and payee.” See Allied-Signal, supra, at 791-792, 112 S.Ct. 2251 (O'Connor, J., dissenting); Hellerstein, State Taxation of Corporate Income from Intangibles: Allied-Signal and Beyond, 48 Tax L.Rev. 739, 790 (1993) (hereinafter Hellerstein). In the example given in Allied-Signal, the taxpayer was not unitary with its banker, but the taxpayer's deposits (which represented working capital and thus operational assets) were clearly unitary with the taxpayer's business. In Corn Products, the taxpayer was not unitary with the counterparty to its hedge, but the taxpayer's futures contracts (which served to hedge against the risk of an increase in the price of a key cost input) were likewise clearly unitary with the taxpayer's business. In each case, the “payor” was not a unitary part of the taxpayer's business, but the relevant asset was. The conclusion that the asset served an operational function was merely instrumental to the constitutionally relevant conclusion that the asset was a unitary part of the business being conducted in the taxing State rather than a discrete asset to which the State had no claim.

Mead, 128 S.Ct. at 1507-1508.

Pursuant to the Court's constitutional rulings, when determining the nature of a particular asset, the issue is whether the asset is directly connected with the unitary business or a stand-alone asset with no connection to the unitary business.

The connection with Petitioner's business versus passive investment distinction also is the fundamental factor in determining whether specific income is business or nonbusiness income under Idaho law. 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." Idaho Code § 63-3027(a)(1). Nonbusiness income is all income other than business income. Idaho Code § 63-3027(a)(4).

Idaho Code § 63-3027 sets forth two separate and independent definitions of the term "business income." Union Pacific v. Idaho State Tax Com'n., 136 Idaho 34, 28 P.3d 375 (2001). According to the Idaho Supreme Court, the first definition for business income is "income arising from transactions and activity in the regular course of the taxpayer's trade or business." Id. at 38 - 39, 28 P.3d at 379 - 380. This definition is referred to as the "transactional test."

The second definition of business income 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." Union Pacific, 136 Idaho at 38 - 39, 28 P.3d at 379 - 380. This definition is referred to as 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. Union Pacific, 136 Idaho at 38 - 39, 28 P.3d at 379 - 380.

There is no requirement under the functional test that the income arises from transactions and activities in the regular course of the taxpayer's trade or business. Union Pacific, 136 Idaho at 39, 28 P.3d at 380. The key determination is whether the property acquired, managed, or disposed of - was directly connected with the taxpayer's business operations.

In our view, in order for such income to be properly classified as business income there must be a more direct relationship between the underlying asset and the taxpayer's trade or business. The incidental benefits from investments in general, such as enhanced credit standing and additional revenue, are not, in and of themselves, sufficient to bring the investment within the class of property the acquisitions, management or disposition of which constitutes an integral part of the taxpayer's business operations. This view furthers the statutory policy of distinguishing that income which is truly derived from passive investments from income incidental to and connected with the taxpayer's business operations.

American Smelting, 99 Idaho at 933, 592 P.2d at 48. The important distinction is whether the property was directly connected with the taxpayer's unitary business activity or merely a passive investment.

The intangible property in this case is Petitioner's ownership interest in [Redacted]. Accordingly, the question for the Commission to answer is whether Petitioner's interest in [Redacted] served an operation function in furtherance of Petitioner's unitary business. As has been discussed above, the Commission finds that Petitioner's interest in [Redacted] did serve an operational function in furtherance of Petitioner's unitary business. [Redacted] was the exclusive distributor of Petitioner's [Redacted] products in the United States. [Redacted] was established by Petitioner to "create strategic alignment across the nation and the ability to create even more growth in one of the world's most dynamic [Redacted] markets." Petitioner expected that "the joint venture [would] benefit from the existing momentum and popularity of our brands

with consumers, add value to our business, and expand our mutual relationship...” Petitioner’s ownership interest in [Redacted] was held in furtherance of Petitioner’s trade or business.

United States Supreme Court case law supports the Commission’s position and justifies the approach found in Income Tax Rule 620, which looks only to see whether the income has enough of a “connection” with Petitioner’s trade or business so as to satisfy the transaction or functional tests without looking into an analysis of whether the [Redacted] entity was part of Petitioner’s unitary business.

The California State Board of Equalization articulated this distinction between the “unitary business” and “business income” concepts:

From the standpoint of general unitary theory, it is unfortunate that the three cases [Mobile, ASARCO, Woolworth] failed to distinguish between a “unitary business” and “business income,” two related but analytically distinct concepts.

Defining the parameters of the “unitary business” involves ascertaining the circumstances under which all corporations engaged in a single integrated economic enterprise may be permitted or required to file a combined report. The concept of “business income,” on the other hand, generally concerns the differentiation between truly passive investment income and income which is integrally related to the taxpayer's unitary business activities.

Merely because the operations and management of a corporation in which the taxpayer is a stockholder are not so closely connected with the taxpayer’s business activities as to be part of the taxpayer’s “unitary business” for combined reporting purposes should not mean that dividends received from the stock cannot be “income arising from transactions and activities in the regular course of the taxpayer’s trade or business” or that the “acquisition, management, and disposition” of the stock do not “constitute integral parts of the taxpayer's regular trade or business operations.” The criteria for combined reporting purposes and the definition of business income serve different purposes, ask different questions and apply different standards. The resolution of one does not compel the same resolution of the other.

Appeal of Standard Oil Co. of Cal. (Mar. 2, 1983) [1981-1984 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 400-383, p. 222-223.¹⁹

¹⁹ A copy of this decision is available at: [Redacted]

The California Supreme Court has expressed its agreement with the reasoning of the California State Board of Equalization:

Our interpretation of the functional test also accords with the SBE's interpretation over the past two decades... the SBE found that dividends from a joint venture were business income because these ventures "contributed materially to the production of operating income ... and clearly served to further the operation of" the taxpayer's business. (Standard Oil, supra, [1981-1984 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 400-383, at p. 22,571.)

Hoechst Celanese Corp. v. Franchise Tax Bd., 25 Cal. 4th 508, 533, 22 P.3d 324 (2001)

If the [Redacted] income is business income, is alternative apportionment appropriate?

At this time the Commission will also address Petitioner's request for alternative apportionment pursuant to Idaho Code section 63-3027(s). Petitioner made the following request in its protest letter:

"It should also be noted that Taxpayer's Petition for Alternative Apportionment was effectively held in abeyance pending an audit of its 2007 and 2008 income tax returns. Now that two audits of these returns have been completed, the Petition for Alternative Apportionment should now be addressed. Accordingly, Taxpayer would not object to the joinder of its Petition for Alternative Apportionment with this protest."²⁰

On February 13, 2009, Petitioner mailed a "Petition to Use Alternative Apportionment" letter to the Tax Commission. The request asked for permission to use an alternative apportionment for the taxable years ending 12/31/2008 and subsequent. Petitioner explained in the letter that it was a holding company that held a 50 percent interest in [Redacted] and a 100 percent interest in [Redacted]. Petitioner explained that it also held "interests in two minor limited liability companies, none of which engages in any significant business and none of which does any business in Idaho."²¹

Petitioners provided the following details about [Redacted] in their request letter:

²⁰ Written Protest Requesting Redetermination of Deficiency, February 17, 2012.

²¹ Id., pg. 5.

For federal income tax purposes, Agriculture is treated as a “disregarded” entity such that its assets, liabilities, and income are reported by its single member, [Redacted].

Agriculture’s principal asset is a new barley [Redacted] plant located in Idaho Falls. When the facility was first planned, it was to be situated in Manitoba, Canada. However, due in part to the intervention of Idaho’s governor, Dick Kempthorne, the plant was re-sited to Idaho. Both Agriculture and the State of Idaho made significant investments in the state. Agriculture invested in excess of \$80 million and implemented its policy to make use of local subcontractors and suppliers as much as possible to integrate into the community. The land for the plant was purchased with the aid of \$600,000 from the governor’s Department of Energy settlement fund. The governor also provided Bonneville County with a \$500,000 rural initiative check to develop a rail link for the facility. The new plant is capable of producing 100,000 tones of malted barley per year and has a yearly capacity of 6.5 million bushels of barley. Agriculture has entered into long-term contract with over 200 local Idaho barley growers and employs in excess of 30 Idaho residents.²²

Petitioner explained in its letter what it thought the results of using the standard apportionment provisions of Idaho Code section 63-3027 would be:

The standard methodology employed by [Redacted] likely will result in excess of 14.5% of its income apportioned to the state. This apportionment percentage is the third highest apportionment percentage after California and [Redacted] headquarters state, [Redacted]. [Redacted] firmly believes that such a high apportionment percentage for Idaho is not reflective of the business activities occurring in the state.

[Redacted], as a regular corporation, is the only entity that is subject to Idaho's corporate income tax. Idaho Code § 63-3025. On a stand alone basis, it conducts no business in Idaho and has no property, payroll, or sales in Idaho. Yet, it finds itself having to apportion upward of 15% of its income to Idaho.

[Redacted] is made subject to tax solely by virtue of have an interest in a limited liability company (Agriculture) that does business in the state. Idaho Admin. Rules 35.01.01.620(02). Consequently, nexus is attributed to [Redacted] solely by virtue of Agriculture's presence in the state.²³

Idaho Code § 63-3027(s) is known as the “alternative apportionment” provision (aka “section 18 relief”), this code section provides:

²² Id., pg. 4.

²³ Id., pgs. 8-9.

(s) If the allocation and apportionment provisions of this section do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the state tax commission may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

....

(4) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

The application of Idaho Code § 63-3027(s) was the central issue in the Union Pacific Corp. v Idaho State Tax Commission case before the Idaho Supreme Court. Union Pacific Corp. v Idaho State Tax Commission, 139 Idaho 572, 83 P.3d 116 (2004). The court stated:

Idaho Code section 63-3027(s) provides that the Tax Commission may require alternative apportionment (a) if the allocation and apportionment provisions of the statute do not fairly represent the extent of the taxpayer's business and (b) if the alternative apportionment is reasonable. Before the statutory apportionment can be rejected in favor of an alternative apportionment, either the Commission or the taxpayer must show that the three-part formula does not accurately reflect the taxpayer's business in the State. The party asserting alternative apportionment bears the burden of showing that alternative apportionment is appropriate.

Id. at 575 (citations omitted).

The Commission is not convinced that it does not fairly represent Petitioner's business activity in Idaho to apportion approximately 14.5 percent of its business income to the state of Idaho. Petitioner chose to file in Idaho under the water's edge election; this means that none of the foreign entities in the combined group are included in the combined tax return. This leaves only [Redacted] (a holding company) and the four LLC's it holds interests in. Petitioner explains that two of the LLCs do not engage in any significant amount of business, leaving only [Redacted] (with its primary business activity being the [Redacted] facility in [Redacted]) and [Redacted] (the nationwide [Redacted] distributor). With the water's edge election in place, the combined tax return is focused on a slice of Petitioner's unitary business that consists of: (1) a [Redacted] operation that has all its property and payroll in Idaho; and (2) a 50 percent interest in a nationwide [Redacted] distributor. Petitioner states that this gives Idaho the third highest

apportionment percentage right after [Redacted]. From the facts available, it appears that Petitioner must have significant [Redacted] sales receipts in [Redacted] to end up with a higher apportionment percentage in those states when there is such a heavy property and payroll representation in the apportionment factors in Idaho because of [Redacted] Idaho facilities.

It does not seem unreasonable or unfair for Idaho to apply its corporate income tax to 14.5 percent of Petitioner's business income when all of the employees and property related to the [Redacted] operation are in Idaho. The facts available show Agriculture operating at a loss as it produces and sells its malted barley to the [Redacted] in [Redacted]. If the [Redacted] income were out of the picture, Petitioner's only activities in its water's edge Idaho tax return would be those of Agriculture operating with a loss year after year. "The principal virtue of the unitary business principle of taxation is that it does a better job of accounting for the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise than, for example, geographical or transactional accounting."²⁴ If we look at the combined group, which includes the activities of [Redacted] along with [Redacted], we get a more accurate picture of this full unitary business that produces and sells [Redacted] products. Looking at [Redacted] alone, operating in Idaho after having received many financial incentives and benefits to locate its business here, it would seem to not fairly represent the business activity in Idaho for [Redacted] to be selling its [Redacted] to other entities in the corporate family located in [Redacted] for such a price that [Redacted] ends up operating at a loss year after year and never paying any corporate income tax to the state. But, by including the [Redacted] income in the combined report, the purposes of combined reporting and the unitary business principle are

²⁴ Allied-Signal, Inc. v. Director, Div. of Taxes, 504 U.S. 768, 783, 112 S.Ct. 2251, 2261 (1992) (citations and internal quotations omitted).

achieved by taking a wider group of activities that operate together to produce income for Petitioner and then apportioning a slice of that income to be taxable by Idaho.

Also, it must not be forgotten that Petitioner chose to make the water's edge election. It could have chosen to file on a worldwide basis and included all the attributes of the other entities in the unitary business in the apportionment factors. As it is, Petitioner chose the water's edge election, and therefore, limited the activities that are represented in the Idaho combined tax return; for the most part these activities are [Redacted] [Redacted] operations in [Redacted] and [Redacted] distribution activities throughout the country. Petitioner chose the water's edge election and should accept the heavy weighting in the Idaho property factor that comes with that choice.

Petitioner has not met its burden of showing that the application of the standard apportionment provisions of Idaho Code section 63-3027 result in an apportionment that does not fairly represent its business activity in Idaho.

Throwback sales

The Tax Commission has decided not to pursue the throwback sales issue raised by the Audit Bureau in the notice of deficiency.

SUMMARY

Pursuant to Income Tax Rule 620 and related rules, Petitioner's [Redacted] income is to be included as business income because the interest in [Redacted] served an operation function in Petitioner's unitary business. The facts suggest that [Redacted] is probably unitary with the rest of Petitioner's unitary group. However, a unitary finding is not required to support the finding that the [Redacted] income is business income; this principle is constitutionally sound and has been supported by the United States Supreme Court.

The Commission denies Petitioner’s request for an alternative apportionment. Petitioner chose a water’s edge election, which limits their combined report in such a way that the only significant business activities are those of [Redacted]operations in Idaho and the 50 percent interest in [Redacted] nationwide [Redacted] distribution business. Treating approximately 14.5 percent of Petitioner’s business income as income to be taxed in Idaho seems to fairly represent their business activity in Idaho. Petitioner has not presented facts to convince the Commission otherwise.

THEREFORE, the two Notices of Deficiency Determination associated with this case (Docket numbers 23058 and 25032), are hereby MODIFIED in accordance with the provisions of this decision, and as so modified, are APPROVED, AFFIRMED, and MADE FINAL.

Based upon the attached calculations and with interest calculated through December 31, 2015, the petitioners are entitled to a refund of the following:

| <u>YEAR</u> | <u>REFUND</u> | <u>INTEREST</u> | <u>TOTAL</u> |
|-------------|---------------|-----------------|--------------------|
| 2007 | (\$139,878) | (\$47,520) | (\$187,398) |
| 2008 | (331,211) | (91,286) | <u>(\$422,497)</u> |
| | | TOTAL REFUND | <u>(\$609,895)</u> |

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

DATED this _____ day of _____ 2015.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2015, 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.
