BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 26151
[Redacted],	)	
	)	
Petitioners.	)	DECISION
	)	
	)	

BACKGROUND

On November 15, 2013, the Audit Division (Audit) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (NODD) to [Redacted] (Petitioners) proposing income tax, penalty, and interest for taxable years September 30, 2007, through September 30, 2010, in the total amount of $8,048,051[1]. On January 16, 2014, the Petitioner filed a timely protest. On February 24, 2014, the file was transferred to the Legal/Tax Policy Division for resolution. The Commission sent the Petitioners a letter outlining their options for resolving a protested audit. An informal hearing was held on February 18, 2015, at the Boise office of the Tax Commission. The Commission makes this decision with the information provided at the hearing and the information available in the file.

ISSUES

The issues are based on the sale of one of the Petitioners' subsidiaries, [Redacted] and how that sale was reported.

1. Whether the gross receipts from the sale of [Redacted] should be excluded from the numerator and denominator of the Idaho sales factor.

[1] The petitioners filed an Idaho Form 41 group return under the name of [Redacted]. The petitioners are those corporations shown on schedules 1100 attached to the NODD.

2. Whether a company that is a member of a combined group[2] can transfer Net Operating Losses[3] (NOLs) to another group member to offset their taxable income.

3. Whether a combined group can keep and use the NOL earned by a subsidiary that is sold and has left the group.

4. What portion of an Investment Tax Credit (ITC) carryover can be used when the company that owns the ITC is sold and leaves the combined group during the taxable year?

5. Whether a combined group can keep the ITC carryover earned by a subsidiary that is sold, after it has left the group.

DISCUSSION

On October 1, 2008, the first day of the taxable year ending September 30, 2009, the Petitioner sold [Redacted], a wholly owned subsidiary, which owned and operated a large [Redacted] in Idaho. The departing company had an NOL at the beginning of that year of $20,304,022 and ITC of $1,974,261.

The Petitioner filed their September 30, 2009 Idaho corporation income tax return including the gain from the sale as business income, but did not include the gross receipts from the sale in either the numerator or denominator of the Idaho sales factor. The Petitioner also claimed $21,019,733 in NOL and $1,087,612 of ITC from the carryover on the amended September 30, 2009 income tax return. The only item changed on the amended return was to carry back $100,000 of NOL from taxable year ended September 31, 2010.

[2] Idaho Code section 63-3027(t) defines when two or more corporations with at least 50% common ownership will be treated as a single taxpayer for purposes of calculating their income tax liability. IDAPA 35.01.01.340, 360 & 365, also govern the use of a combined report.
[3] Idaho Code section 63-3022(c)(1) Allows a net operating loss to be carried forward for up to 20 years.

LAW

FIRST ISSUE - Whether the gross receipts of the sale of [Redacted] should be excluded from the numerator and denominator of the Idaho sales factor.

Business income is apportioned among the states in which the unitary business operates. Each state uses one or more ratios to divide or "apportion" the business income to determine the amount of income subject to each state's income tax. The most commonly used formula is found in the Uniform Division of Income for Tax Purposes Act, or UDITPA, which Idaho and many other states have adopted, either in whole, or with modifications. Idaho's apportionment formula is set out in Idaho Code § 63-3027 (i), which states in part that "all business income shall be apportioned to this state under subsection j of this section, by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus two (2) times the sales factor, and the denominator of which is four (4), except as provided in paragraph (2) of this subsection." The property factor is computed by dividing the Petitioner's property located in Idaho by its property located everywhere. Idaho Code § 63-3027(k). Likewise, the payroll factor is calculated by dividing the Petitioners' Idaho payroll by their payroll everywhere. Idaho Code § 63-3027(n). And finally, the sales factor is derived by dividing the company's Idaho sales by its sales everywhere. Idaho Code § 63-3027(p). Set out as a mathematical formula, the Idaho apportionment formula is represented by the following equation:

$$\frac{\left[\left(\dfrac{\text{Idaho property}}{\text{Total property}}\right) + \dfrac{\text{Idaho payroll}}{\text{Total payroll}} + \left(2 \times \dfrac{\text{Idaho sales}}{\text{Total sales}}\right)\right]}{4}$$

The result of the above equation is then multiplied by the corporation's total business income to arrive at the portion of the business income apportioned to Idaho.

The three-factor apportionment formula uses the location of a business's property, payroll, and sales to approximate the extent of the business activity in a given state. Most states that impose a tax on corporate income use some variation of the three-factor apportionment formula. Many states, including Idaho, have modified the traditional three-factor formula so that the sales factor is double weighted.

Only the sales factor is at issue in this case. The Petitioner claims that the gross receipts from the sale should be excluded from the sales factor, based on Idaho Code section 63-3027 which states:

> (r) Sales, other than sales of tangible property, are in this state, if:
> (1) The income-producing activity is performed in this state; or
> (2) The income-producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

Pursuant to the above paragraph, if a sale of intangible property occurs, both in Idaho and outside Idaho, the sale is assigned to the state where the greater cost of performance of the income producing activity takes place.

The Petitioner sold a business which operated a [Redacted] located in Idaho. The Petitioner concedes that the income realized from the sale is business income, but maintains the gain was realized from the sale of intangible property (stock). Pursuant to Idaho Code § 63-3027(r), if a sale of intangible property occurs, both in Idaho and outside Idaho, the sale is assigned to the state where the greater cost of performance occurred. The Petitioners state that greater cost of performance associated with the sale (such as negotiations and drafting stock transfers and agreements) occurred outside of Idaho. The Petitioners did not include any of the sale proceeds in the Idaho numerator of the sales factor.

Audit disallowed the Petitioners' treatment of the sale. Through the stock sale, the Petitioner effectively sold the business and the underlying assets of the business to unrelated parties. This was not simply a sale of passive stocks unrelated to the Petitioners' primary business. Rather, this was a sale of an operational part of the Petitioners' business, which included the physical [Redacted] located in Idaho.

The Petitioners state that "The negotiations related to the sale, the sale, and the research, property verification, and property valuations involved in the process occurred in several states, including [Redacted]." No specific cost of performance analysis or documentation has been provided to the Tax Commission for examination. There have been no direct costs associated with the sale identified.

The Petitioners have argued that the gross receipts from the sale of [Redacted] should not be included in the sales factor numerator or denominator at all. The Petitioners' various arguments in support of this assertion rely on an analysis of a Tax Commission decision, Docket No. 18719, Income Tax Administrative Rule 570.02.b, Income Tax Administrative Rule 550.05.d, and Income Tax Administrative Rule 450.01.

The Petitioners are relying on their reading of a prior decision in Docket No. 18719[4]. The taxpayer in that case was actually requesting that the gross receipts be included in the numerator of their corporate domicile. If we were to follow that logic, we would have to put the gross receipts in the Idaho numerator, which is the commercial domicile of the Petitioner. In that case, the Commission declined to put the gross receipts in the numerator of the taxpayer's commercial domicile because there were other states identified that were the source of the intangible assets, including Idaho. In Docket No. 18719, the sale of the intangible assets was

[4] http://tax.idaho.gov/decisions/0718719_19549.pdf.

sourced to the location of the customers, in a variety of states, and the nature of the intangible assets made them very mobile. That was why it was decided that they could not place the gross receipts in the numerator or denominator of the taxpayer's commercial domicile. In the present case, no other states have been identified as contributing to the intangible assets being transferred. All of [Redacted] customers were in Idaho and they were all stationary.

This case is distinguished from Docket No. 18719 in several ways, including the fact that the income producing activity of [Redacted] all took place in Idaho. One significant difference is that the Petitioner's stock was not publicly traded. There is no fair market value of the stock independent of the value of the underlying assets. The Commission finds that the income producing activity associated with [Redacted] was, in large part, developing, growing, and operating the [Redacted], not just in signing a contract to sell the stock. Therefore, the gross receipts should be included in the numerator and denominator of the Idaho sales factor. The Petitioner has not provided a cost of performance analysis and therefore has not met its burden of proof.

In Docket No. 18719, there was a choice of which states to assign the sale to. In the present case the subsidiary sold was 100 percent in Idaho. In the decade leading up to the sale, the parent that made the sale was founded and based in Boise, and had an Idaho factor that ranged from 82 percent to 85 percent. It was clearly an Idaho company doing business in Idaho. The subsidiary that was sold had an Idaho apportionment factor of 100 percent in all recent years. The gain realized by the sale of [Redacted] was based on years of operating and building the assets, customer lists, and the goodwill of the company, and is not limited to the very last transaction of signing over the title to the company by selling the stock. Based on the income tax returns filed in the last several years, 100 percent of those transactions producing the income of the company took place in Idaho. To presume that you could research the value of the assets without spending significant time and costs in Idaho does not appear credible.

Audit disagreed with the Petitioner's position and made an adjustment to include the gross receipts from the sale in the Idaho numerator and the everywhere denominator. Audit offered the following explanation in the NODD:

> An adjustment was made to include the gross proceeds from the sale of [Redacted] in the 9/30/2009 Idaho numerator. As set forth in Idaho Income Tax Administrative Rule 570.02, the income producing activity can be readily identified; since, according to a news release dated July 1, 2008, [Redacted], [Redacted].
>
> Idaho Income Tax Administrative Rule 570.02 states in part:
> "If the income producing activity in respect to business income from intangible personal property can be readily identified, the gross receipts shall be included in the denominator of the sales factor and, if the income producing activity occurs in Idaho, in the numerator of the sales factor as well."[5]

The Petitioner, in comparing this case to Docket No. 18719, made the statement "If the [Redacted] sale was all included in the Idaho sales factor, it would not be fair to those other states which helped provide the income produced by [Redacted].[6]" There is no evidence that there were any other states involved in the income produced by [Redacted]. The Petitioner has not provided an analysis of the costs of performance, other than a statement in their presentation provided at the informal hearing "The negotiations related to the sale, the sale, and the research, property verification, and property valuations involved in the process occurred in several states, including [Redacted][7]."

We disagree that this case is comparable to Docket No. 18719 and have referred the Petitioner to Docket No. 20731 as a case more closely aligned with the facts in this case. It is important to point out a critical distinction between this case and Docket No. 18719. In 18719,

---

[5] Notice of Deficiency Determination issued November 15, 2013.
[6] Pg. 4, Protest letter received January 16, 2014 from [Redacted].
[7] Summary of Issues, pg. 3, dated February 18, 2015, presented at the informal hearing.

the taxpayer was requesting that the gross receipts be placed in the numerator of the company's commercial domicile. The auditor in that case disagreed, pointing out that because at least some of the accounts making up the intangible assets were in Idaho and various other states, it would not be fair to put them all in the numerator of taxpayer's commercial domicile. In the present case, the assets, both tangible and intangible, are 100 percent in Idaho, which is also the commercial domicile of the Petitioner. The only logical approach is to put the gross receipts in the Idaho numerator and the denominator of the sales factor. There is no reason to remove the sale from the factor completely. The income producing activity can be readily identified as taking place in Idaho.

The circumstances in this case are very similar to another case[8], Docket No. 20731, October 2009, in which the taxpayer described its sale as merely a "stock sale." However, just like in Petitioners' case presently before us, the taxpayer in 20731 sold a controlling interest in the business and the underlying operational assets of the business to unrelated parties by way of a stock sale. The Commission concluded in that case that "This was not a sale of passive stocks unrelated to the Petitioner's primary business." Rather, this was a sale of an operational part of the Petitioner's business, which included the physical utility assets located in Idaho.

Idaho Income Tax Administrative Rule 570.02.a. provides that if the income producing activity in respect to business income from intangible personal property can be readily identified, the income is included in the denominator of the sales factor, and if the income producing activity occurs in Idaho, in the Idaho numerator of the sales factor as well.

As discussed above, Income Tax Administrative Rule 570 sets forth special rules for the sales factor income under the authority of Idaho Code § 63-3027(s).

[8] Docket No. 20731, pg. 16 section III, Gains and Interest Income from a Partial Sale of Business. Issued Oct. 2009.

In this specific instance, the Tax Commission finds that the alternative apportionment provision relied upon by Audit is reasonable. First, the division of income fairly represents the Petitioners' business activity in Idaho and, if applied uniformly, would result in taxation of no more or no less than 100 percent of the Petitioners' income. Audit applied the rule, which would prorate the income in relation to the property present in Idaho. In this case, all of the assets are located in Idaho. If every UDITPA state followed suit, then no more or less than 100 percent of the Petitioners' income would be subject to state income taxes.

Second, under the Petitioners' argument, when the stock is sold to an unrelated party and the Petitioners had effectively divested themselves of the business and assets, the proceeds would not be assigned to any state. Such an assignment would ignore that the operational business had been transferred, including assets of the business located in Idaho. The revenue producing activity can be readily identified and located in Idaho.

Third, the proposed alternative apportionment reflects the economic reality of the business activity engaged in by the Petitioners in the taxing state. It is the transfer of a controlling interest in the operational business that generates income, not simply the transfer of unrelated stock in the abstract. In this particular stock exchange, new owners gained control of the operational business.

The Tax Commission finds that Audit has met its burden of showing that reasonableness requires a departure from the standard apportionment provisions. The audit adjustments in this regard are upheld.

The Petitioners also pointed to Rule 450.01 in attempting to apply Docket No. 18719, which requires that the total of the sales factor numerators be equal to the sales factor denominator. If the gross receipts from the sale of [Redacted] are placed in the Idaho numerator and the everywhere denominator, then Income Tax Administrative Rule 450.01 would not be violated. The total of the numerators would equal the denominator.

SECOND ISSUE - Whether a combined group member can transfer NOLs to another group member to offset their taxable income.

The Petitioners refer to Treasury Regulation 1.1502-21(b)(2)(ii)(A), a [Redacted] regulation governing what happens when a member that has an NOL being carried forward leaves the consolidated group. That suggestion ignores the distinction between a [Redacted] consolidated income tax return and an Idaho combined income tax return. As a matter of course, a consolidated return allows netting or sharing NOLs. Idaho does not allow members of a combined group to share or transfer NOLs.

The last sentence of Idaho Code section 63-3027(t)(1) says:

> "The use of a combined report does not disregard the separate corporate identities of the members of the unitary group. Each corporation which is transacting business in this state is responsible for its apportioned share of the combined business income plus its nonbusiness income or loss allocated to Idaho, minus <u>its</u> net operating loss carryover or carryback."

Income Tax Administrative Rules 200 & 365 both address NOLs.

> **200. NET OPERATING LOSS – CORPORATIONS** Section 63-3021, Idaho Code.
>
> 01. Unitary Taxpayers. Each corporation included in a unitary group must determine its respective share of the Idaho apportioned net operating loss incurred by the unitary group for the taxable year. A corporation's share of the net operating loss is computed using its Idaho apportionment factor for the year of the loss. The corporation must add or subtract its nonbusiness income or loss allocated to Idaho to its share of the apportioned loss.
>
> **Rule 365. USE OF THE COMBINED REPORT** Section 63-3027, Idaho Code.
>
> 01. In General. Use of the combined report does not disregard the separate corporate identities of the members of the unitary group. The combined report is simply the computation, by the formula apportionment method, of the unitary business income reportable to Idaho by the separate corporate members of the unitary group. For purposes of this rule, included corporation means a corporation

> required to file an Idaho income tax return as a result of its own activities in Idaho and using a combined report. (3-20-97)
> 02. Separate Computations. Each included corporation shall: (3-20-97)
> a. Be responsible for computing and paying its tax including any minimum tax due pursuant to Sections 63-3025 and 63-3025A, Idaho Code, as determined by the combined report. (3-20-97)
> b. Separately compute Idaho tax credits and limitations, except the investment tax credit, which is applied pursuant to Section 63-3029B, Idaho Code, and Rules 710 through 717 of these rules. (3-20-97)
> c. Separately determine and pay the permanent building fund tax required by Section 63-3082, Idaho Code. (3-20-97)
> 03. Net Operating Loss. The Idaho net operating loss carryover or carryback for each included corporation is limited to <u>its</u> share of the combined net operating loss apportioned to Idaho for each taxable year. See Rule 200 of these rules.

Income Tax Administrative Rule 365.03 answers this question. Each corporation included in a combined report is limited to its share of the combined net operating loss apportioned to Idaho for each taxable year.

<u>THIRD ISSUE</u> – Whether a combined group can keep the NOL earned by a subsidiary that is sold and has left the group to use the NOL in subsequent taxable years.

The Petitioners argue that since Idaho law is silent on how to treat NOLs in a year that a member leaves a combined group, therefore, we must look to the federal law. Idaho addresses NOLs in a number of statutes and administrative rules. See Idaho Code sections 63-3021, 63-3027, and Income Tax Administrative Rules 200 and 365[9].

In both the original and amended Idaho corporation income tax returns for the year ended September 30, 2009, the Petitioner used the total NOL of all the subsidiaries together to reduce the combined Idaho taxable income of the entire combined group. Based on Idaho Income Tax Administrative Rule 200.01, each corporation in an Idaho combined return must track and use its own NOL.

---

[9] IDAPA 35.01.01.200 & 35.01.01.365.

FOURTH ISSUE – What portion of an ITC carryover can be used when the company that owns the ITC is sold and leaves the combined group during the taxable year.

The last sentence in Idaho Code section 63-3029B(6) says:

> "For a combined group of corporations, credit carried forward may be claimed by any member of the group unless the member who earned the credit is no longer included in the combined group."

As of the end of the first day of the fiscal year, [Redacted], the subsidiary that earned the ITC, was no longer in the combined group of the Petitioner. The subsidiary that left the group still owns the credit and is entitled to claim the remaining balance either on its own or as a member of a new combined group. As of the second day of the fiscal year, [Redacted] is no longer a member of the combined group.

> **711. IDAHO INVESTMENT TAX CREDIT: TAXPAYERS ENTITLED TO THE CREDIT** Section 63-3029B, Idaho Code.
>
> 01. Unitary Taxpayers. A corporation included as a member of a unitary group may elect to share the investment tax credit it earns but does not use with other members of the unitary group. Before the corporation may share the credit, it must claim the investment tax credit to the extent allowable against its tax liability.

As of the end of taxable year September 30, 2008, the Petitioner had $1,972,103 of unused ITC carryover as a group. $200,382 of that amount was earned by, and belongs to, one of the companies in the Petitioner's combined group other than [Redacted]. It is presumed that the subsidiary that was sold owned assets that had generated $1,771,721 of that credit. According to the auditor's notes, a request for information to clarify which corporation owned the equipment went unanswered. Since [Redacted] historically purchased the majority of the equipment in Idaho, we have concluded that all of the credit, other than the amount specifically identified, will be treated as belonging to [Redacted]. Following the calculation provided in Income Tax Administrative Rule 711.01.b, we divided the 1 day by 365 days and then multiplied that ratio by each corporation's tax liability is equal to $20,510 (see table below). In the NODD, Audit only allowed $2,147 of ITC, representing the ITC belonging to one of the subsidiaries that remained in the combined group after the sale of the departing company.

The next section was added during the 2012 legislative session to clarify the Commission's practice and to avoid the over claiming of tax credits by buyers and sellers of companies.

> 711.01.b. In the taxable year when a corporation that earned the investment tax credit is acquired or disposed of, only a portion of the tax of the other members of the unitary group may be offset with shared investment tax credit from that corporation. To determine the allowable portion of the tax, a percentage is calculated by dividing the number of days that the corporation that earned the investment tax credit is included in the unitary group's taxable year by the total number of days in the taxable year. The tax for each member with an Idaho filing requirement is multiplied by the percentage. The result is the amount of tax that can be offset with a share of the credit, subject to other limitations imposed by law or related rules.

This decision increases the amount allowed by the $20,510 to reflect the amount available while [Redacted] was a member of the combined group, reducing the adjustment to $1,067,102.

Company	Total	III	IGC	Pet. Op	Pet. Eng.	InterWest	III Explor.	III Argen.
Tax Liab.	7,478,072	5,416,128	20	2,048,097	2,189	11,598	20	20
Owned ITC				(2,147)				
Net				2,045,950				
Shared ITC Liab.* 1/365	(20,510)	(14,839)	(10)	(5,605)	(6)	(32)	(6)	(6)
Claimed	1,087,612							
Adjustment	<u>1,067,102</u>							

<u>FIFTH ISSUE</u> - Whether a combined group can keep the ITC carryover earned by a subsidiary that is sold, after it has left the group.

711. IDAHO INVESTMENT TAX CREDIT: TAXPAYERS ENTITLED TO THE CREDIT Section 63-3029B, Idaho Code. Continued from above.

> 01.a. The credit available to be shared is the amount of investment tax credit carryover and credit earned for the taxable year that exceeds the limitation provided in Section 63-3029B(4), Idaho Code. The limitation is applied against the tax computed for the corporation that claims the credit. Credit shared with another member of the unitary group reduces the carry forward.

CONCLUSION

FIRST ISSUE - Whether the gross receipts from the sale of [Redacted] should be excluded from the sale's factor.

The Petitioners did not provide a cost analysis to support their position. The income producing activities of [Redacted] occurred entirely within Idaho. Since the location of the income producing activity can be readily identified, the gross receipts from the sale need to be included in the Idaho sales factor, both the numerator and the denominator[10].

The NODD is relying on Income Tax Administrative Rule 570, which is in this section on "Special Rules", Rules 560 through 590.

> 560. SPECIAL RULES (RULE 560). Section 63-3027(s), Idaho Code.
>
> 01. In General. A departure from the allocation and apportionment provisions of Section 63-3027, Idaho Code, is permitted only in limited and specific cases. Section 63-3027(s), Idaho Code, may be invoked only when unusual fact situations that ordinarily are unique and nonrecurring produce incongruous results pursuant to the apportionment and allocation provisions contained in Section 63-3027, Idaho Code.

In this case, applying the cost of performance to the stock sale and ignoring the operational business as the Petitioners propose would lead to an incongruent result. The Tax Commission upholds the NODD on this issue.

[10] Idaho Code section 63-3027 (r) (1); Income Tax Administrative Rule 550.05.a & b.

SECOND ISSUE – Whether a combined group member can transfer an NOL to another group member to offset their taxable income.

The Commission concludes that Idaho law is very clear on this issue. Members of a combined group are not permitted to share or transfer NOLs. The NODD is upheld on this issue.

THIRD ISSUE – Whether the NOL that is earned and carried forward can be used by other members in a combined group during the year the company that earned it left and in the subsequent years.

Idaho Income Tax Administrative Rule 200.01 requires that each company in a unitary group track their own NOLs. Idaho law does not allow sharing or transferring NOLs of any kind. [Redacted] did not have any Idaho taxable income during the tax year ended September 30, 2009 and was therefore unable to use any of their NOL.

Once [Redacted] left the combined group, any NOL carry over that remains leaves the group with [Redacted]. The [Redacted] consolidated statutes and regulations do not apply to combined filing on this issue. The Commission upholds the NODD on this issue.

FOURTH ISSUE - What portion of an ITC carryover can be used when the company that owns the ITC is sold and leaves the combined group during the taxable year?

Audit allowed the current year amount earned by one of the other members of the combined group. This decision prorates the ITC by the number of days that the company, which was sold, remained in the group.

FIFTH ISSUE - Whether a combined group can keep the ITC carryover earned by a subsidiary that is sold, after it has left the group.

Once the company that owns the ITC is sold and has left the group, there is no ITC remaining with the parent or any other member of the combined group. The [Redacted] consolidated statutes and regulations do not apply to combined filing on this issue. The Commission hereby modifies the NODD on this issue by allowing an additional $20,510 of income tax credit.

THEREFORE, the NODD dated November 15, 2013, and directed to [Redacted] is hereby AFFIRMED.

YEAR	TAX	PENALTY	INTEREST	TOTAL
09/30/07	$ 0	$ 0	$ 0	$ 0
09/30/08	0	0	0	0
09/30/09	6,367,802	636,780	1,409,287	8,413,869
09/30/10	0	0	0	0
			TOTAL	$8,413,869

Interest is calculated through July 31, 2015, and will continue to accrue at the rate set forth in Idaho Code section 63-3045.

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

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

DATED this ________ day of ___________________ 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.

____