

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

In the Matter of the Protest of	)	
	)	DOCKET NO. 1-558-348-800
	)	
	)	
Petitioner.	)	DECISION
	)	

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(Petitioner) protested the Notice of Deficiency Determination dated February 3, 2022. Petitioner disagrees that the income from the sale of certain credits is business income subject to apportionment. The Tax Commission reviewed Petitioner’s case and found the credits were a functional part of Petitioner’s trade or business. Therefore, the Tax Commission upholds the Notice of Deficiency Determination.

**BACKGROUND**

Petitioner is a                      corporation with its principal place of business in  
Petitioner’s business activity is the

On June 7, 2021, the Multistate Tax Commission (MTC) completed an audit of Petitioner’s corporate income tax returns for the fiscal years ending March 31, 2016 through March 31, 2018. Among various other adjustments, which Petitioner did not protest, the MTC determined Petitioner’s sale of                      credits should be treated as business income and apportioned to the various states. Idaho, a member state of the MTC, signed on to the audit and received the audit information as it pertained to Idaho and Petitioner’s corporate income tax filing.

The Income Tax Audit Bureau reviewed the MTC audit, made some minor changes specific to Idaho law, and sent Petitioner a Notice of Deficiency Determination. Petitioner disagreed with the recharacterization of the income from the sales of the                      credits

as business income. Petitioner stated the income from the credits does not meet Idaho's statutory definition of business income. Petitioner stated the income is also not unitary with its business under the U.S. Constitution. Petitioner stated because the credits were managed from its principal place of business in \_\_\_\_\_ the income from the credits is beyond Idaho's taxing authority. The Bureau acknowledged Petitioner's protest and sent the matter to the Tax Commission's Appeals Unit (Appeals) for administrative review.

Appeals reviewed the case and sent Petitioner a letter that discussed the methods for redetermining a Notice of Deficiency Determination. Petitioner requested a telephone hearing which was held November 1, 2022. Attending the hearing for Petitioner were attorneys \_\_\_\_\_ in person, \_\_\_\_\_ by telephone, (collectively "Representatives") and hearing the case for the Tax Commission were Commissioner \_\_\_\_\_ Tax Appeals Specialist \_\_\_\_\_ and Deputy Attorney General \_\_\_\_\_

Representatives presented a brief history and the philosophy of Petitioner. Representatives also provided a brief history of the credits, their purpose, how they are earned, and how Petitioner used the credits. Representatives stated that because of Petitioner's existing business plan it earned credits that it did not need and therefore was able to sell the credits to others in the industry that were not meeting the government's \_\_\_\_\_ standards. Representatives stated that both before and during the audit period, Petitioner did not need to use the credits to offset its own short fall of the \_\_\_\_\_ standards and was able to sell the credits to produce dividends for its \_\_\_\_\_ parent corporation. Petitioner did not reinvest any of the income from the sale of the credits in its U.S. \_\_\_\_\_ business.

Representatives argued that the income from the sale of the credits is not business income. Representatives stated that the MTC in determining the income is business income is effectively

unitizing Petitioner and ignoring that the income from the sale of the credits is not part of Petitioner's business, which is to

Representatives pointed to *ASARCO, Inc. v. Idaho State Tax Comm'n*, 458 U.S. 307, 326 (1982), where the Supreme Court rejected the expansive view of business income, and to *Mobil Oil Corp. v. Comm'r of Taxes of Vt*, 445 U.S. 425, 440 (1980), for the premise that one must look to the underlying activity to determine the "propriety of apportionability." Representatives stated an objective view of the origin of the credits and Petitioner's ability to sell them confirms that the "propriety of apportionment" does not exist in this case. Representatives stated the credits are a creation of the government; the government issues them and can take them away. The government can also change the standards for granting credits or prohibit companies from selling them. Furthermore, the ability to sell the credits is predicated on there being companies that need credits, totally outside of Petitioner's control. Representatives stated the credits are intangible assets not used by Petitioner and are not part of Petitioner's business of

Representatives stated this is further supported by the fact that Petitioner did not provide any consideration to the government to obtain the credits and Petitioner had no cost basis in the credits.

Representatives argued that the income from the sale of the credits is nonbusiness income because it does not meet either the transactional or the functional tests. Representatives stated the sale of the credits did not arise from transactions and activities in the regular course of Petitioner's trade or business. Representatives stated the sale of the credits was peripheral to Petitioner's regular trade or business operations, which is

Petitioner took no action to acquire the credits. Petitioner did not change its business practices, or make any adjustment to its regular business. Petitioner's

business operations remained the same after [redacted] authorized the credits as its business operations were prior to the credits. Receiving credits from the [redacted] government was not a business objective. Petitioner would have developed the same [redacted] product [redacted] regardless of whether credits were awarded [redacted] Petitioner believed [redacted]

[redacted] per its business plan, would best meet market demand. Accordingly, Petitioner has never treated the credit sales as part of its core business and did not manage its business with the goal of generating income from the sale of credits.

Representatives stated Petitioner's management of the credits was not part of its regular trade or business. Only [redacted] of Petitioner's employees, out of [redacted] spent a tiny fraction of their time accounting for the credits and negotiating their sale. Representatives stated there were only a small handful of credit sales, [redacted] during the audit years, and several [redacted] sales during the same period. Representatives stated the sales of the credits are transactions that are business outliers and are de minimis transactions or activities that do not meet the express language of the transactional test. Representatives stated the underlying nature of the credit sales is fundamentally different from the regular business activities Petitioner undertakes. This further supports and confirms that the credit sales were not in the "regular course" of Petitioner's business.

As for the functional test, Representatives stated the income from the sale of the credits was not income from tangible or intangible property the acquisition, management, and disposition of which constitute integral or necessary parts of Petitioner's trade or business operations. Representatives referred to the Idaho Supreme Court's interpretation of the phrase "integral or necessary parts of the taxpayer's trade or business operations" in *American Smelting & Refining Co. v. Idaho State Tax Comm 'n*, 592 P.2d 39, 47 (Idaho 1979) as "property which, though not

absolutely essential to the conduct of the taxpayer's business, contributes to and is identifiable with the taxpayer's trade or business operations.” Quoting from *American Smelting & Refining Co.*, Representatives stated this test requires a "direct relationship between the underlying asset and the taxpayer's trade or business.” Representatives furthered their argument by citing *Noell Indus. v. Idaho State Tax Comm'n*, 167 Idaho 367 (2020), where the Idaho Supreme Court held that the sale of assets for "financial betterment," where the property does not contribute to the taxpayer's operations and thus serves only an investment purpose, does not satisfy the functional test. Representatives stated the credits serve only an investment function and are not integral to Petitioner's business operations. The credits do not contribute to and are not identifiable with Petitioner's trade or business operations. Representatives stated Petitioner had no use for the credits because its  
Representatives stated the credits were a windfall from the government that led to a financial betterment for Petitioner and its parent corporation.

Representatives also argued that Idaho did not give Petitioner anything with respect to the credits for which it can ask a return. Representatives pointed to *ASARCO, Inc v Idaho State Tax Comm 'n*, 458 U.S. 307,326 (1982) where the Court quoting from *Wisconsin v. J C. Penney Co.*, 311 U.S. 435,444 (1940) stating that "[t]he simple but controlling question is whether the state has given anything for which it can ask return." Representatives stated since Idaho has not given anything, it is not entitled to include the proceeds from the credit sales in apportionable income.

Representatives' final argument is that the credits do not meet the test of "asset unity" as laid out in *Allied-Signal, Inc. v. Dir. Div. of Taxation*, 504 US 768, 789 (1992). Representatives stated that when evaluating whether income from a specific asset satisfies the unitary business principle, the U.S. Supreme Court concluded that states may apportion income from a capital

transaction if the transaction serves an operational rather than an investment function. *Allied-Signal*, Id. Representatives stated the focus should be on the objective characteristics of the asset's use and whether it constitutes an integral part of a taxpayer's business, not the degree of financial benefit derived from the asset. Representatives stated if the government stopped issuing the credits or precluded their sale, Petitioner's business would not change a whit.

After the hearing, Representatives responded to questions they did not have the answers to during the hearing. The Tax Commission asked if the credits ever expired. Representatives stated yes, the credits do expire. Representatives stated the credits are subject to a specified carryback and carryforward provision, and that the

when those credits reach their expiration date. The Tax Commission asked if the credits are applicable on a basis, or can purchasers use a credit against a deficiency from any year. Representatives stated that the credits are earned based on each year, but they can be carried back or carried forward to satisfy requirements for other years. The regulations provide that who have earned the credits can either apply them for a carryback period or a carryforward period. Purchasers of the credits, however, are only permitted to use the credits currently or for a carryforward period to use against anticipated future credit deficiencies.

In addition to responding to these questions, Representatives provided a copy of *Union Pacific Corp. v. Idaho State Tax Commission*, CV OC 9704812D (2002) Dist. Ct. of Ada County. Representatives pointed out that the Court's decision in summary judgement confirms that a unitary asset must be "integral" to the business of the taxpayer. Representatives stated the District Court held that the dividend income constituted nonbusiness income because Union Pacific's

interest in the partnership was “more of a separate investment activity than a part of its trade or business”. Representatives stated the court pointed out that “merely acquiring property does not produce business income unless the property is managed as part of the integrated business operation”, and “merely acquiring” an asset is not enough to satisfy the functional test; the asset must be “integral” to the business. Again, Representatives stated Petitioner’s business was the  
  
Petitioner was not in the business of generating or selling credits, and it did not modify its production of its products to secure the credits.

The Tax Commission asked Representatives questions about Petitioner’s use of the credits, their management of the credits, and their policy toward the credits. Petitioner’s response was 1) they never needed to use the credits since they always exceeded the standard for each year; 2) generally the oldest credits would be sold first before selling newer credits, although there have been exceptions; and 3) they did not have a policy regarding the credits. Credits were sold when they were approached by a buyer and a price was agreed upon. Petitioner stated for all relevant years, they earned net credits that added to their inventory of credits available for sale.

### **LAW AND ANALYSIS**

The issue in this case is whether the income from the sale of credits is business income or non-business income. If the income is business income, it is included in apportionable income. If the income is non-business income, it is allocated to the appropriate state. Idaho Code section 63-3027(a)(1) defined business income for the years under review. It stated in pertinent part, “‘business income’ means income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition

constitutes integral or necessary parts of the taxpayer's trade or business." Non-business income was defined in Idaho Code section 63-3027(a)(4) to mean all income other than business income.

Petitioner is in the business of

Petitioner, as well as all other  
are required to meet certain standards for their  
that are sold in the United States. If they fail to meet those standards,  
the government penalizes them.

The government developed a system through various agencies to reward  
for exceeding established standards. That system awarded  
credits based on the compliance category and year. Petitioner received  
credits because of its business practice or model to

Petitioner argued that these credits are not part of its business of  
the transaction test for business income, and because they did  
nothing to acquire the credits nor did they count on them or use them in any way in their business,  
the credits are not integral to their business, the functional test for business income. Consequently,  
Petitioner believes the income from the sale of the credits is non-business income and is allocated  
to the state of its corporate headquarters where the sales took place.

As stated above, Idaho Code section 63-3027 defined business income which is broken  
down into two tests; the transaction test and the functional test. If the income meets either of these  
tests, the income is business income and apportioned among the various states.

Petitioner's business model is to  
As a  
result, Petitioner earned credits from the government. A portion of Petitioner's



generating these credits were sold to \_\_\_\_\_ in Idaho, who in turn sold those \_\_\_\_\_ to individuals both within Idaho and outside of Idaho.

Petitioner argued the income from the sale of the credits did not arise from transactions and activities in the regular course of its trade or business. Petitioner stated the sale of the credits was peripheral to its regular trade or business operations. Petitioner stated they did not change any of its business practices, \_\_\_\_\_ or make any adjustment to its regular business to receive the credits. Petitioner stated they have not needed to use the credits to comply with the

Petitioner stated they have never considered the credits sales as part of their core business and did not manage their business with the goal of generating income by exceeding the \_\_\_\_\_ standards.

Petitioner argued their management of the credits was not part of their regular trade or business. Petitioner stated only \_\_\_\_\_ out of \_\_\_\_\_ spent a tiny fraction of their time accounting for the credits and negotiating credit sales. Petitioner stated there were only a small handful of credit sales, but \_\_\_\_\_ sales of \_\_\_\_\_ were made during the same period. Petitioner stated the underlying nature of the credit sales is fundamentally different from its regular business activities. Petitioner stated these facts support that the credit sales were not in the "regular course" of its business of

The transaction test determines income as business income from transactions and activity arising from the regular course of the taxpayer's trade or business. Petitioner argued its regular course of trade or business is the \_\_\_\_\_ Petitioner stated its first credit sale was in \_\_\_\_\_ after being approached by \_\_\_\_\_ Petitioner stated they do not solicit buyers for their credits. Petitioner stated other contact their \_\_\_\_\_ about buying credits. The information on the

number of credits and who has credits available is public information available from the

Petitioner stated they would sell their credits if the parties could negotiate agreeable terms.

Petitioner's first credit sale was in                      Petitioner also sold credits in                      and                      Beginning                      with                      could sell or trade credits with other                      or transfer credits within their own                      to meet compliance standards.

Since Petitioner's first sale in                      Petitioner has sold roughly                      credits through fiscal year 2018. Considering that Petitioner was only able to sell the credits starting with                      roughly calendar year                      the sale of credits is becoming more frequent and regular in Petitioner's business. In addition, the sale of these credits is unique to                      The credits can only be used by                      and have, since 2011, become part of the regular course of business in the                      industry.

IDAPA 35.01.01.332.03, Idaho Administrative Income Tax Rule states,

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.

Because the sale of                      credits has become customary in                      the Tax Commission finds that the income from the sale of the credits meets the definition of the transaction test for business income.

Petitioner argued the income from the credit sales does not meet the functional test. Petitioner cited IDAPA 35.01.01.333.05, Idaho Administrative Income Tax Rule for the premise that the credits are more like an investment function than an operational function. Rule 333.05 states,

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.

The U.S. Supreme Court concluded that states may apportion income from a capital transaction if the asset "serve[s] an operational rather than an investment function." *Allied Signal, Inc. v. Dir.*, *Supra*. The Court observed: "[Treating] particular intangible assets as serving, on the one hand, an investment function, or, on the other, an operational function . . . is the relevant unitary business inquiry, one which focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing state." *Id.* at 785. In determining whether an asset serves an investment or operational function, the key question is whether an asset "is an integral part of an enterprise." The Court stated this is the test for investment versus operational assets.

Petitioner did not purchase or invest in the credits as an investment is commonly understood, nor were the credits traded among investors seeking profits from appreciation. The only market for the credits is other  
Petitioner stated they do not have a policy regarding the credits and when they sell them it is usually the oldest credits first unless negotiated otherwise. Petitioner stated they have never used the credits and that they have always

had a net increase to their credits every year (Emphasis added.). However, this statement suggests

or that did not meet the standards.

In that sense, the credits served a functional purpose in Petitioner’s business activity by allowing it to meet the standards. The credits were an integral part of Petitioner's business of

Petitioner argued that the credits are not unitary assets and therefore not apportionable. Petitioner stated the asset unity test of *Allied-Signal* focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing state. Petitioner cited an Oregon state court case, *Willamette Indus., Inc. & Subs. v. Dep't of Revenue*, 15 P.3d 18 (Ore. 2000) to support that the credits are not integral to Petitioner’s trade or business and that they did not meet the asset unity test of *Allied-Signal*.

In *Willamette*, the taxpayer sold mineral rights from out-of-state timber land owned by a forest products operation, completely independent from the forestry business other than their common ownership. The mining rights and the forest products operation could have existed completely separate. The mineral rights were not integral to the forest products business. The Oregon court found the mineral rights not to be operational assets, so the income from the sale of the mineral rights was not apportionable.

However, in this case, the credits are not unrelated to Petitioner's business. Petitioner earned the credits through its - -

In fact,

(Petitioner stated they “earned net credits that added to its inventory

of credits.” Emphasis added.) Additionally, Petitioner is not guaranteed it will not need the credits in the future, the standards could change, and Petitioner may not earn credits. Should that situation arise, these credits would clearly be integral as operational assets since they would save Petitioner from the expense of being penalized for not meeting standards. Furthermore, Petitioner’s management of the credits is that they generally sold the oldest credits first, leaving them with an inventory of usable credits; however, Petitioner would sell newer credits if they were approached by a buyer that wanted newer credits and if the parties were able to agree on a price. The credits are inseparably tied to they are integral to the business of in the United States. Therefore, the Tax Commission finds the income from the sale of the credits meets the functional test and should be treated as business income.

### CONCLUSION

Petitioner received credits for exceeding the standards set by the government for in the United States. Petitioner sold credits to other and reported the income as non-business income. In an audit by the MTC in which Idaho participated, the MTC determined the income from the sale of the credits was business income. The Income Tax Audit Bureau agreed with the MTC’s determination and adjusted Petitioner’s Idaho corporate income tax returns accordingly. Petitioner disagreed arguing that the income from the sale does not meet the transaction test or the functional test to be included as business income.

The Tax Commission considered all the information provided and finds that the credit sales were in the regular course of Petitioner’s business of and that the credits were an integral part of the Therefore, the

Tax Commission finds the income from the credit sales meets both the transaction test and the functional test and is business income subject to apportionment.

The Bureau added interest to Petitioner's Idaho tax deficiency. The Tax Commission reviewed that addition and found it appropriate and in accordance with Idaho Code section 63-3045.

THEREFORE, the Notice of Deficiency Determination dated February 3, 2022, and directed to \_\_\_\_\_ is AFFIRMED.

IT IS ORDERED that Petitioner pay the following tax and interest:

<u>YEAR</u>	<u>TAX</u>	<u>INTEREST</u>	<u>TOTAL</u>
3/31/2016	\$29,068	\$7,365	\$36,433
3/31/2017	28,962	6,336	35,298
3/31/2018	(11,912)	(2,185)	<u>(14,097)</u>
		TOTAL DUE	\$57,634

Interest is calculated to June 30, 2023.

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

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

DATED this \_\_\_\_\_ day of \_\_\_\_\_ 2023.

IDAHO STATE TAX COMMISSION

**CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_\_ day of \_\_\_\_\_ 2023,  
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:

Receipt No.

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