BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 2-015-233-024
	)	
	)	
Petitioner.	)	DECISION
	)	

The Income Tax Audit Bureau (Bureau) at the Idaho State Tax Commission (Tax Commission) issued a Notice of Deficiency Determination (Notice) to (Petitioner) asserting an income tax deficiency of $64,181 for tax year 2017. Petitioner filed a timely appeal and petition for redetermination of the Notice.

The primary issue for decision is whether Petitioner's long-term gain from the sale of stock is business income or nonbusiness income. The Tax Commission as reviewed the file and hereby issues its decision to cancel the Notice.

BACKGROUND

Based on the information submitted, Petitioner is a distributor of heating, ventilation, and air conditioning (HVAC) systems and equipment headquartered in Washington State. Starbucks (Company A) is a chain of coffeehouses. Petitioner and Company A are unaffiliated, not a unitary business, and are in unrelated industries.

In 1991 or before, Petitioner purchased $3,625 in stock of Company A for an initial share price of $0.3125. In 2017, Petitioner sold all its shares in Company A for a long-term capital gain of $6,157,448. Petitioner used the proceeds from the sale of stock to pay down debt. It treated the long-term capital gain as nonbusiness income allocated to Washington.

The Bureau requested Petitioner provide documentation supporting its treatment of the long-term capital gain as nonbusiness income. The Bureau reviewed the information submitted by

Petitioner and found it did not support Petitioner's position. The Bureau determined the long-term capital gain was business income subject to Idaho apportionment under the "function test". The Bureau found the capital gain was an integral or necessary part of Petitioner's business operations. Petitioner filed a timely appeal and petition for redetermination of the Notice.

LAW

Every item of income must be classified either as business income or nonbusiness income. Income for purposes of classification as business or nonbusiness includes gains and losses. Business income is apportioned among jurisdictions by use of a formula. Nonbusiness income is specifically assigned or allocated to one (1) or more specific jurisdictions pursuant to express rules. An item of income is classified as business income if it falls within the definition of business income. An item of income is nonbusiness income only if it does not meet the definitional requirements for being classified as business income.

Idaho Code section 63-3027 and Income Tax Administrative Rules 325 and 330 through 336 provide definitions, rules and tests, and examples for determining business and nonbusiness income. Some Idaho court cases that provide useful guidance on the matter include *American Smelting & Ref'g Co. v. Idaho State Tax Commission*, 99 Idaho 924, 927, 592 P.2d 39, 42 (1979); *ASARCO Inc. v. Idaho State Tax Commission,* 458 U.S. 307, 102 S.Ct. 3103 (1982); and *Union Pacific v. Idaho State Tax Commission*., 136 Idaho 34, 28 P.3d 375 (2001).

ANALYSIS

Petitioner's gain on the sale of stock, purchased over 25 years ago of an unaffiliated company in an unrelated industry, is nonbusiness income. As explained by the Idaho Supreme Court in *Union Pacific v. Idaho State Tax Commission,* the first definition for business income is "income arising from transactions and activity in the regular course of the taxpayer's trade or business." 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 constitute integral or necessary parts of the taxpayer's trade or business operations."

These two separate definitions are commonly referred to as the "transactional test" and 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 operations.

There is no requirement under the functional test that the income arise from transactions and activities in the regular course of the taxpayer's trade or business. The key determination is whether the acquisition, management, or disposition of the property was directly connected with the taxpayer's business operations. The important distinction under the functional test is whether the property was directly connected with the taxpayer's business activity or whether it was merely a passive investment.

In this case, Petitioner invested $3,625 in Company A stock for an initial share price of $0.3125. Petitioner purchased the stock before Company A's initial public offering. Petitioner held onto the stock for over 25 years. During that time the stock split several times. In 2017, it sold the stock for almost $62 a share for a $6,157,448 long-term capital gain. As pointed out in *American Smelting & Ref'g Co. v. Idaho State Tax Commission:*

> 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.

Following the same reasoning, the Tax Commission finds, in order for the long-term capital gain in this case to be properly classified as business income, there must be a more direct relationship between the underlying asset and the Petitioner's trade or business operations of selling HVAC systems and equipment. The fact that Petitioner's investment in Company A brought in additional revenue, and may have enhanced its credit standing, 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.

In the Notice, the Bureau cites Idaho Decision Docket No. 19312 in support of its decision. The Bureau is correct in that there is a strong presumption under Idaho law that income derived from stock or other securities is business income, such presumption may only be overcome by clear and convincing evidence to the contrary, and the burden is on the taxpayer to prove otherwise.

However, the facts in Idaho Decision Docket No. 19312 are significantly different. In that case, the evidence indicated the taxpayer purchased stock to assume control, acquire, or merge with other companies to expand its business operations. In other words, to expand its business and business relationships. This clearly constituted an integral part of the taxpayer's business operations.

In the current case, there is no evidence that the gains were directly connected to Petitioner's HVAC business or the HVAC industry. The information does not indicate that Petitioner invested in Company A with an intent to integrate or enter into the business of Company A. The character of the investment appears to be passive. The investment does not appear to have any relation to the day-to-day operations of Petitioner's business or related to industry interests or partnerships for growth of the business.

In a protest summary, the Bureau notes that the Montana Department of Revenue audited Petitioner for the same issue and Petitioner paid the $1,217 deficiency. This fact counts against Petitioner. However, this one factor alone is not sufficient to establish the gain as business income. The Tax Commission finds Petitioner's payment of the Montana deficiency was not an admission that the gain was business income, but rather a business decision.

ADDITOINAL NOTES

In 2011, Petitioner purchased $9,830 in stock of a solar company. In 2017, they sold the stock for a ($7,989) loss. Following the same reasoning as above, the Tax Commission finds this item of income to be nonbusiness income.

CONCLUSION

Based on the documents reviewed and information collected, Petitioner's $6,157,448 gain on the sale of stock, purchased over 25 years ago for $3,625, of an unaffiliated company in an unrelated industry, is nonbusiness income.

THEREFORE, the Notice of Deficiency Determination dated March 31, 2021, is hereby CANCELED, in accordance with the provisions of this decision.

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

DATED this ________ day of __________________________ 2022.

IDAHO STATE TAX COMMISSION

CERTIFICATE OF SERVICE

I hereby certify that on this ________ day of ______________________________ 2022, 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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