

01-0005
AUDIT
SIGNED 11-01-2002

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER,)	FINDINGS OF FACT,
)	CONCLUSIONS OF LAW,
Petitioner,)	AND FINAL DECISION
)	
v.)	Appeal No. 01-0005
)	Account No. #####
)	
AUDITING DIVISION OF)	
THE UTAH STATE TAX)	Tax Type: Corporate Franchise
COMMISSION,)	
)	Judge: Phan
Respondent.)	

Presiding:

Pam Hendrickson, Commission Chair
Jane Phan, Administrative Law Judge

Appearances:

For Petitioner: PETITIONER REP 1, Treasurer & Vice President/Tax, PETITIONER
 PETITIONER REP 2, Tax Accountant
For Respondent: RESPONDENT REP 1, Assistant Attorney General
 RESPONDENT REP 2, Manger, Corporate Franchise Tax Auditing

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for a Formal Hearing on August 22, 2002. Based upon the evidence and testimony presented at the hearing, the Tax Commission hereby makes its:

FINDINGS OF FACT

1. Petitioner is appealing a corporate franchise tax audit deficiency issued for the fiscal years ending March 31, 1997 and March 31, 1998.
2. The Statutory Notice was issued on December 6, 2000.
3. The total amount of the corporate franchise tax in issue from the hearing is \$\$\$\$\$.

The deficiency stems from gains on the sales of stock in COMPANY A and COMPANY B during the tax

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years 1997 and 1998. The amount of tax at issue for the sale of COMPANY A stock is \$\$\$\$\$. The amount of tax at issue for the sale of COMPANY B stock is \$\$\$\$\$.

4. Petitioner's corporate domicile is STATE 1. When Petitioner filed its STATE 1 tax returns for the fiscal years at issue, it claimed on the STATE 1 return that the sale of COMPANY A and COMPANY B stock was business income. However, on its Utah returns for those same fiscal years, Petitioner claimed that the sale of the COMPANY A and COMPANY B stock was non-business income and, therefore, would only be allocated to the state of corporate domicile. The reason given by Petitioner's representative for this inconsistent treatment was that they thought STATE 1 law was different from Utah law at that time.

5. In March 1998 the Supreme Court of STATE 1 issued a decision which clarified that the state's statutory definition of "business income," was no more expansive than the definition contained in the Uniform Division of Income for Tax Purposes Act (UDITPA). *See Firststar Corporation, v. Commissioner of Revenue*, 575 N.W.2d 835, at 838 (1998).

6. During the audit period Petitioner sold its 30% stock ownership interest in COMPANY A and the gain from the sale is one of the items at issue. In 1984 Petitioner had helped create COMPANY A in COUNTRY, so that COMPANY A would become an distributor for Petitioner's product in CONTINENT. COMPANY A continued as the CONTINENT distributor for Petitioner for twelve years. Petitioner owned a 30% interest in COMPANY A throughout this period. However, the companies did not share centralized management. They did not share administrative staff, centralized accounting or offices. Petitioner did not lend COMPANY A money nor guarantee its loans. Petitioner did have directors to represent the 30% interest on the board.

7. Petitioner did own other foreign distributorships, some were 100% owned subsidiaries and one owned 49% by Petitioner. Petitioner's representative stated that Petitioner preferred to have no ownership interest in distributorships, but found it necessary on occasion in order for distributorships to

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become operational. In the United States Petitioner does not use distributorships and markets its product directly.

8. The second gain at issue came from the sale of stock of COMPANY B. Petitioner and COMPANY B were two completely separate business entities prior to 1995. In September 1995, a reverse triangular merger was implemented through which, in exchange for COMPANY B stock, Petitioner transferred to COMPANY B three divisions which had up to that point been part of Petitioner's unitary business for COMPANY B stock. The three division exchanged were: 1) (X); 2) (X); and 3) (X). In return, Petitioner acquired approximately 16% of the stock of COMPANY B. This reverse triangular merger was a tax deferred transaction, meaning that at the time of the exchange Petitioner did not pay federal tax on the transaction. The reason Petitioner and COMPANY B entered into the exchange was so that they could each focus on their own lines business. Petitioner's representatives point out that structuring the exchange as a reverse triangular merger was very complex and that it was done for business purposes and not to circumvent state tax laws. They assert that the legal fees for the merger alone were more than any possible state tax savings.

9. After the merger, Petitioner no longer produced cards which was COMPANY B' main business and COMPANY B discontinued manufacturing card personalization equipment which was Petitioner's main business. Once the merger was complete, these two companies continued to operate as separate businesses. There were no shared offices, facilities, or management, and no centralized accounting. COMPANY B did purchase equipment from PETITIONER at arms length pricing. Petitioner and COMPANY B were clearly not unitary.

10. The gain which Respondent is seeking to tax arose later as a result of Petitioner selling in December 1996 and October 1997 its shares of the COMPANY B stock. At the time the stock was sold Petitioner recognized a gain for federal tax purposes.

APPLICABLE LAW

- (1) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business . . .
- (4) "Nonbusiness income" means all income other than business income. (Utah Code Ann. 59-7-302(1) & (4).)

All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three. (Utah Code Ann. 59-7-311.)

A. Business and Non business Income Defined. Section 59-7-302 defines business income as income arising from transactions and activity in the regular course of the taxpayer's trade or business operations. In essence, all income that arises from the conduct of trade or business operations of a taxpayer is business income. For purposes of administration of the Uniform Division of Income for Tax Purposes Act (UDITPA), the income of the taxpayer is business income unless clearly classifiable as nonbusiness income. 1. Nonbusiness income means all income other than business income and shall be narrowly construed . . . (Utah Admin. Rule R865-6F-8(A).)

DISCUSSION

As Respondent explains in its Formal Hearing Brief there are two considerations for the Commission in this matter. First, are the gains from the COMPANY B and COMPANY A transactions "business income" within the Utah statutory provisions, and second, does the taxation of the gains comport with constitutional protections.

In considering the first question, the Utah statute defines "business income" at Utah Code Ann. Sec. 59-7-302. Utah, and other states with a definition similar to Utah's definition of "business income,"

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have concluded that the statute presents two separate tests which are commonly referred to as the transactional test and the functional test. It is Respondent's position that the income at issue from both COMPANY B and COMPANY A transactions is "business income" pursuant to the functional test. The Commission has recognized a functional test in both appeal decisions¹ and by rule.² It is import to note that the Commission has determined that the statutory definition set out at Utah Code Ann. Sec. 59-7-302(1) requires that only one

¹ Utah State Tax Commission Appeal Nos. 90-1607, 90-1521 and 93-0481.

² Utah Admin. Rule R865-6F-8(A)(3)(b).

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or the other of the two tests be met.³ The functional test includes as business income, income from tangible and intangible property if the acquisition, management, or disposition of the property constitute integral parts of the taxpayer's regular trade or business. In addition, the Commission notes that income is considered to be business income "unless clearly classifiable as nonbusiness income," Utah Admin. Rule R865-6F-8.⁴

³ This position is supported by cases in other jurisdictions with a similar statute. See Polaroid v. Offerman, 507 S.E.2d 284 (N.C. 1998); and Hoechst Celanese Corp. v. Franchise Tax Board, 22 P.3d 324, 335 (Cal. 2001) cert. denied 122 S.Ct. 614 (2001).

⁴In addition, the general rule is that a taxpayer claiming immunity from a tax has the burden of establishing the exemption. See Container Corp. v Franchise Tax Bd, 463 U.S.159, 175-76 (1983).

In addition to these Utah statutory requirements the Commission must also consider the second question, the constitutional limitation. As explained by Respondent in its Formal Hearing Brief, the United States Supreme Court has found that there is a constitutional limitation, requiring that there be sufficient nexus between the income and the taxpayer's business activities within the state.⁵ The United States Supreme Court has found sufficient nexus where the taxpayer operates a business in the taxing state and the assets involved in the transaction served an operational, as opposed to merely an investment function.⁶

In reviewing the facts involved in the transaction with COMPANY A, the Commission finds that the sale of the COMPANY A stock meets the functional test and, therefore, the gain from the sale is "business income" for purposes of the Utah Statute. In looking at the constitutional requirements, COMPANY A was more than a passive investment. As Respondent points out, Petitioner used COMPANY A to make better use of its resources, expand distribution and improve its economic condition. There was an operational or business purpose for establishing COMPANY A and operating it as a subsidiary. Petitioner needed COMPANY A to sell its products in the COUNTRY market. In addition, it was not uncommon for Petitioner to own its foreign distributorships, in whole or part. This was a typical activity in the regular course of Petitioner's trade or business. Therefore, Petitioner's gain on the sale of COMPANY A stock meets the constitutional limitations and is "business income" within the provision of Utah Code Ann. Sec. 59-7-302. As "business income" it is apportionable to Utah.

Turning to Petitioner's transaction with COMPANY B, in order to find that the gain met the functional test in this instance and, therefore, the Utah statutory requirements, the Commission first looks at the reverse triangular merger. The card manufacturing plant and service bureau subsidiaries which Petitioner

⁵ Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 165-66 (1983).

⁶ Allied Signal, Inc. v Director, Div. of Taxation, 504 U.S.

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transferred to COMPANY B were assets that had been used in Petitioner's unitary business and the fact that the taxable gain was deferred until the COMPANY B stock was sold one year or more later does not change the inherent nature of the transaction as that of the sale of business assets. Petitioner sold 25% of the COMPANY B stock received in the merger transaction in 1996 and the remainder was sold in 1997. Petitioner realized a gain on both sales.

In considering the constitutional limitations, on taxing the gain from the COMPANY B transaction, the Commission looks at Petitioner's purpose in acquiring the COMPANY B stock. This was not a passive investment, it was a transaction with a business or operational purpose. Petitioner wanted to focus on its main line of business and it exchanged for stock subsidiaries which were not in that line of business. The Commission concludes that there was an operational purpose and the constitutional requirements have been met.

CONCLUSIONS OF LAW

1. Both the gains from the COMPANY A and the COMPANY B stock sale transactions meet the functional test and are therefore "business income" within the definition set out at Utah Code Ann. Sec. 59-7-302.

2. As "business income" the gains from the sale of the COMPANY B and COMPANY A stock are apportioned to the state of Utah. Utah Code Ann. Sec. 59-7-311.

DECISION AND ORDER

Based upon the foregoing, the Tax Commission sustains the corporate franchise tax audit

768,787 (1992) .

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deficiency as set out in the Statutory Notice dated December 6, 2000, for the fiscal years ending March 31, 1997 and March 31, 1998. It is so ordered.

DATED this ____ day of _____, 2002.

Jane Phan
Administrative Law Judge

BY ORDER OF THE UTAH STATE TAX COMMISSION:

The Commission has reviewed this case and the undersigned concur in this decision.

DATED this ____ day of _____, 2002.

Pam Hendrickson
Commission Chair

R. Bruce Johnson
Commissioner

Palmer DePaulis
Commissioner

Marc B. Johnson
Commissioner

Notice of Appeal Rights: You have twenty (20) days after the date of this order to file a Request for Reconsideration with the Tax Commission Appeals Unit pursuant to Utah Code Ann. §63-46b-13. A Request for Reconsideration must allege newly discovered evidence or a mistake of law or fact. If you do not file a Request for Reconsideration with the Commission, this order constitutes final agency action. You have thirty (30) days after the date of this order to pursue judicial review of this order in accordance with Utah Code Ann. §§59-1-601 and 63-46b-13 et. seq.

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