

01-0172
AUDIT
SIGNED 06-20-2003

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER,

Petitioner,

v.

AUDITING DIVISION OF
THE UTAH STATE TAX
COMMISSION,

Respondent.

) **FINDINGS OF FACT,**
) **CONCLUSIONS OF LAW,**
) **AND FINAL DECISION**

)

) Appeal No. 01-0172

) Account No. #####

)

) Tax Type: Corporate Franchise Tax

) Tax Years: 1997 - 1999

)

) Judge: Davis

Presiding:

G. Blaine Davis, Administrative Law Judge

Marc B. Johnson, Commissioner

Appearances:

For Petitioner: PETITIONER REP

For Respondent: RESPONDENT REP 1, Assistant Attorney General
RESPONDENT REP 2, from the Auditing Division
RESPONDENT REP 3, from the Auditing Division

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for a Formal Hearing on August 20, 2002. Based upon the evidence and testimony presented at the hearing, the Tax Commission hereby makes its:

FINDINGS OF FACT

General Overview

1. Petitioner, PETITIONER (collectively referred to as "PETITIONER"), is a unitary

group of corporations which files Utah corporate franchise tax returns on a water's edge combined basis.

2. PETITIONER. is the parent company of the unitary group, and was formerly known as COMPANY A ("COMPANY A") until a name change in the early DATE's.

3. COMPANY A, was previously a (PORTION REMOVED) company, but it filed bankruptcy in DATE. The corporation emerged from bankruptcy in DATE and became a holding company which (PORTION REMOVED).

4. In the early 1990's, COMPANY A began to shift its strategy to focus on the growth opportunities of one of its subsidiaries, PETITIONER, which (i) distributed (PORTION REMOVED); and (ii) developed and distributed (PORTION REMOVED).

5. In DATE, a (PORTION REMOVED) division of PETITIONER (the subsidiary of COMPANY A) was separately incorporated and named COMPANY B ("COMPANY B"). Later in DATE, COMPANY B had an initial public stock offering which reduced PETITIONER's ownership in COMPANY B to 53 percent. A second public stock offering in DATE reduced PETITIONER's interest in COMPANY B to 30 percent. PETITIONER purchased additional COMPANY B shares in DATE, increasing its ownership interest to 31 percent of the shares of COMPANY B.

6. By DATE, the first year of the audit period, PETITIONER and its subsidiaries were primarily engaged in providing networking and cabling solutions for private network infrastructure requirements. The 1997 Annual Report described PETITIONER's operations as

consisting of "Distribution" (sale and distribution of (PORTION REMOVED)) and "Integration" (assessment, analysis, design, integration with (PORTION REMOVED)). PETITIONER also continued to own approximately 31% of COMPANY B and its subsidiaries.

The Audit

7. The Auditing Division conducted an audit of the combined tax returns which had been filed by PETITIONER and subsidiaries for calendar years 1997 through 1999 (the "audit period"). A Statutory Notice of Deficiency was issued on January 18, 2001 which changed all items which were treated by PETITIONER as nonbusiness income or loss to apportionable business income or loss.

8. PETITIONER and subsidiaries timely filed a Petition for Redetermination, initiating the current appeal. Petitioner claims that all of the items, except for the dividends which were received on stock held solely to be able to receive the annual reports on those publicly traded companies, were originally correctly classified as nonbusiness income or loss, and should not have been reclassified by Respondent as business income or loss. Petitioner further argues that if it is determined that any of the items were appropriately reclassified as business income or loss, then the apportionment factors for any such year should be adjusted "to take into account the fact that such factors in the filed returns excluded any receipts or property considered as giving rise to non-business income in the denominators, as well as the numerator, of such apportionment factors." (Petitioner's Prehearing Memorandum).

Income at Issue

Income of COMPANY F

9. In DATE, COMPANY A acquired \$\$\$\$\$ in assets from COMPANY C. ("COMPANY C") including all of the stock of COMPANY D, 17 percent of the stock of COMPANY E, all of the stock of COMPANY F ("COMPANY F"), and various other assets. In its 1988 annual report, COMPANY A reported an intention to sell the stock of COMPANY F and certain other assets acquired from COMPANY C by the end of 1989.

10. Rather than selling COMPANY F, COMPANY A (later PETITIONER) continued to hold COMPANY F during the next decade while the operations of COMPANY F were wound down. During that time, PETITIONER treated COMPANY F as part of its unitary group and the income and operations of COMPANY F were included in the federal corporation income tax returns, and the combined corporate franchise tax returns filed in Utah. During the audit years, the property, wages and sales of COMPANY F were included in the factors apportioning the income and/or loss of PETITIONER among the various states. However, when there were dispositions of portions of the "portfolio" of COMPANY F, the resulting gains and losses were reported to Utah as nonbusiness gains or losses. It was verbally represented that the gains from those dispositions were used primarily to purchase some of the outstanding shares of PETITIONER.

11. During the 1997 through 1999 audit period, COMPANY F's assets consisted primarily of minority stock positions in certain companies, with such stock positions having been acquired by COMPANY F in the course of its business as either "equity kickers" in financing deals

or in workouts of such deals. Some of these positions were disposed of during the audit period, and PETITIONER treated the resulting gains and losses as nonbusiness income or loss on its Utah tax returns. The Auditing Division has treated such gains and losses as business income or loss.

COMPANY G and COMPANY H

12. During the audit period, two wholly owned subsidiaries of PETITIONER, namely COMPANY G and COMPANY H, were partners in COMPANY I, a limited partnership. The PETITIONER subsidiaries acquired their partnership interests by contributing cash to the partnership.

13. COMPANY G was the general partner, and COMPANY H was one of a number of limited partners in COMPANY I. A number of COMPANY F managers were also limited partners in COMPANY I. COMPANY G was entitled to in excess of 67 percent of the profits and losses of the partnership based on its general partnership interest.

14. The partnership was established to "facilitate the optimization of the COMPANY F portfolio" by providing COMPANY F managers with an entity in which they would have an ownership interest and which could generate new loan business while the old financing business of COMPANY F was winding down.

15. During the audit period, PETITIONER treated the gains and income flowing through from the partnership to COMPANY G and COMPANY H as nonbusiness income on its Utah tax returns. The Auditing Division has reclassified the gains and income as business income. During the audit years, the property, wages and sales of COMPANY G and COMPANY H were

included in the factors apportioning the income and/or loss of PETITIONER among the various states.

16. In 1999, the last year of the audit period, PETITIONER sold its partnership interests to the managers of COMPANY F and recognized a loss upon the sale. PETITIONER treated this loss as nonbusiness loss on its Utah tax return. The Auditing Division has reclassified the loss as business loss.

Income from Sale of COMPANY K Shares

17. PETITIONER acquired a minority equity interest in COMPANY J ("COMPANY J") in 1995, because the opinion of PETITIONER's president and CEO was that PETITIONER may be able to supply COMPANY J with some of the network infrastructure and logistical support that COMPANY J desired for entry into business in COUNTRY. The company sought to build (PORTION REMOVED) in various cities around the world, including COUNTRY.

18. As a result of corporate restructuring, the equity interest in COMPANY J was converted into an equity interest in COMPANY J.

19. Shortly after the acquisition, and after learning more of COMPANY K' business plans to sell the company, PETITIONER decided to sell its equity interest in COMPANY J. That interest was sold in 1996 and 1997.

20. PETITIONER recognized a gain on the 1997 sale of COMPANY J shares and income from COMPANY L in connection with the brokerage account in which the shares of COMPANY J were held. PETITIONER treated the 1997 income from the sale and disposition of the

interest in COMPANY J as nonbusiness income on its Utah tax return. The Auditing Division has reclassified these amounts as business income.

Dividends and Loss from Sale of COMPANY M Preferred Shares

21. PETITIONER, through a subsidiary, held shares of preferred stock of COMPANY M which had been acquired in the course of its previous (PORTION REMOVED) business. Those preferred shares were acquired as part of a "workout" relating to a (PORTION REMOVED) customer.

22. PETITIONER received dividends from COMPANY M in 1997, and also recognized a loss when it sold the preferred shares that same year. PETITIONER treated the dividends and loss as nonbusiness income and loss on its Utah tax return. The Auditing Division has reclassified these amounts as business income and loss.

Loss on Sale of STATE 1 Land

23. COMPANY A, through a subsidiary, acquired an undeveloped plot of land in STATE 1 as part of an acquisition of COMPANY N, which was acquired by Petitioner in the 1980's for integration into its (PORTION REMOVED). The land was not used in the (PORTION REMOVED).

24. When COMPANY A sold its (PORTION REMOVED) in the early 1990's, the purchaser was not interested in the undeveloped land because it was not used in the (X) business.

25. PETITIONER sold the land in 1997 and realized a loss on the sale. PETITIONER treated the loss as nonbusiness income on its Utah tax return. The Auditing Division

reclassified the loss as business loss.

Dividends from Stock Held for Receipt of Annual Reports

26. PETITIONER received a small amount of dividends from publicly traded companies in which it held small interests. The stock was held for the sole purpose of providing PETITIONER with the quarterly and annual reports of such companies so current trends in the publishing of reports could be reviewed and used in connection with the production of PETITIONER's annual reports.

27. In 1997, PETITIONER treated the dividends received from such companies as nonbusiness income on its Utah tax return. The Auditing Division reclassified the dividends as business income. Petitioner has acknowledged that it was appropriate to reclassify those dividends as business income.

Income from Sale of COMPANY B Shares

28. At the beginning of the audit period, PETITIONER held an equity interest in COMPANY B, a company whose operations had previously been a division of PETITIONER. COMPANY B was a company specializing in the manufacture and distribution of (X) products. Until 1993, the assets of COMPANY B were part of, and were integrally related to, the unitary business of Petitioner. COMPANY B was "spun-off" from PETITIONER in 1993, and was thereafter a publicly traded company.

29. COMPANY B was involved in a merger in 1997 which resulted in the issuance of more shares of stock. As a result, PETITIONER's ownership percentage decreased to 19 percent

at that time.

30. In 1998, PETITIONER sold its COMPANY B stock and realized a gain on the sale. PETITIONER reported the gain as nonbusiness income on its Utah tax return. The Auditing Division has reclassified the gain as nonbusiness income.

Income from Sale of Contract Rights Related to (X)Business

31. In DATE, COMPANY A and its (X) subsidiaries completed a transaction with COMPANY P and certain of its affiliates ("COMPANY P") pursuant to which substantially all of the COMPANY A subsidiaries' (X) were contributed to a COMPANY Q, which is treated as a partnership for federal tax purposes. An COMPANY A subsidiary was a 99% beneficiary of this trust. The trust, in turn, contributed the (X) to a partnership in which the trust was a 99% partner. The partnership leased all of these contributed (X) to a subsidiary of COMPANY P. The twelve year lease included an option for the COMPANY P subsidiary to purchase the (X) at the end of the term of the lease for a fixed purchase price. In negotiating the lease, the parties agreed that the exercise of the purchase option would be at a bargain price for the COMPANY P subsidiary, but the parties to the agreement could not agree upon the amount of such bargain. As a result, the lease agreement provided for an additional payment to be made to COMPANY A at the time of the exercise of the purchase option in an amount to be determined at that time. The option price was to be based on a percentage of the fair market value of the (X) at the end of the lease. The lease agreement also provided that COMPANY A could assign or sell its right to this future payment.

32. In 1998, PETITIONER sold its right to the future bargain payment and

recognized the proceeds as income. Since 1992, the items of income and loss relating to this business were reported by Petitioner as nonbusiness income or loss. PETITIONER treated this income as nonbusiness income on its Utah tax return. The Auditing Division has reclassified this income as business income.

Income from the Sale of the (X) Business Segment

33. Beginning in late 1998 and continuing into 1999, PETITIONER sold its (X) assets and operations through a series of three geographically based sales. The integration segment which was sold constituted one of PETITIONER's two primary business segments. The sale left PETITIONER with its Distribution assets and operations.

34. PETITIONER recognized substantial gains on the sale of its integration assets and operations in 1999 and treated the gains as nonbusiness income on its Utah tax return. The Auditing Division has reclassified these gains as business income.

APPLICABLE LAW

Utah Code Ann. §59-7-302 provides in relevant part:

(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 operations.

(2) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

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(4) "Nonbusiness income" means all income other than business income.

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(6) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United

States, and any foreign country or political subdivision thereof.

Utah Code Ann. §59-7-303 provides for apportionable income as follows:

- (1) Any taxpayer having income from business activity which is taxable both within and without this state shall allocate and apportion its adjusted income as provided in this part.
- (2) Any taxpayer having income solely from business activity taxable within this state shall allocate or apportion its entire adjusted income to this state.

Utah Code Ann. §59-7-305 provides:

For purposes of allocation and apportionment of income under this part, a taxpayer is taxable in another state if:

- (1) in that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or
- (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

Utah Code Ann. §59-7-306 provides for the allocation of non-business income as follows:

Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated as provided in Sections 59-7-307 through 59-7-310.

Utah Code Ann. §59-7-307 provides for the allocation of rents and royalties as follows:

- (1) To the extent that the following constitute nonbusiness income:
 - (a) net rents and royalties from real property located in this state are allocable to this state; and
 - (b) net rents and royalties from tangible personal property are allocable to this state:
 - (i) if and to the extent that the property is utilized in this state; or
 - (ii) in their entirety if the taxpayer's commercial domicile is in this

state and the taxpayer is not organized under the laws of or taxable in the state in which the property is utilized.

(2) The extent of utilization of tangible personal property in a state is determined by multiplying the rents and royalties by a fraction, the numerator of which is the number of days of physical location of the property in the state during the rental or royalty period in the taxable year and the denominator of which is the number of days of physical location of the property everywhere during all rental or royalty periods in the taxable year. If the physical location of the property during the rental or royalty period is unknown or unascertainable by the taxpayer, tangible personal property is utilized in the state in which the property was located at the time the rental or royalty payer obtained possession.

Utah Code Ann. §59-7-308 provides for the allocation of capital gains and losses as

follows:

To the extent that the following constitute nonbusiness income:

- (1) capital gains and losses from sales of real property located in this state are allocable to this state;
- (2) capital gains and losses from sales of tangible personal property are allocable to this state, if:
 - (a) the property had a situs in this state at the time of the sale; or
 - (b) the taxpayer's commercial domicile is in this state and the taxpayer is not taxable in the state in which the property had a situs; and
- (3) capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.

Utah Code Ann. §59-7-309 provides for the allocation of interest and dividends as

follows:

To the extent they constitute nonbusiness income, interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state.

Utah Code Ann. §59-7-310 provides for the allocation of patent and copyright

royalties as follows:

- (1) To the extent they constitute nonbusiness income, patent and copyright

royalties are allocable to this state:

- (a) if and to the extent that the patent or copyright is utilized by the payer in this state; or
- (b) if and to the extent that the patent or copyright is utilized by the payer in a state in which the taxpayer is not taxable and the taxpayer's commercial domicile is in this state.

(2) A patent is utilized in a state to the extent that it is employed in production, fabrication, manufacturing, or other processing in the state or to the extent that a patented product is produced in the state. If the basis of receipts from patent royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the patent is utilized in the state in which the taxpayer's commercial domicile is located.

(3) A copyright is utilized in a state to the extent that printing or other publication originates in the state. If the basis of receipts from copyright royalties does not permit allocation to states or if the accounting procedures do not reflect states of utilization, the copyright is utilized in the state in which the taxpayer's commercial domicile is located.

Utah Code Ann. §59-7-311 provides for the apportionment of business income as

follows:

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 Administrative Code Rule R865-6F-8 provides rules to interpret the statutes, and

in relevant part provides:

A. Business and Nonbusiness 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.

2. The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, and nonoperating income, is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is business income or nonbusiness income is the identification of the transactions and activity that are the elements of a particular trade or business. In general, all transactions and activities of the taxpayer that are dependent upon or contribute to the operation of the taxpayer's economic enterprise as a whole constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of business, and will constitute integral parts of a trade or business.

3. Business and Nonbusiness Income. Application of Definitions. The following are rules for determining whether particular income is business or nonbusiness income:

a) Rents from real and tangible personal property. Rental income from real and tangible property is business income if the property with respect to which the rental income was received is used in the taxpayer's trade or business or is incidental thereto and therefore is includable in the property factor under G.1.a).

b) Gains or Losses from Sales of Assets. Gain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business. However, if the property was utilized for the production of nonbusiness income the gain or loss will constitute nonbusiness income. See G.1.b).

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B. Definitions.

1. "Taxpayer," for purposes of this rule, is as defined in Section 59-7-101.
2. "Apportionment" means the division of business income between states by the use of a formula containing apportionment factors.
3. "Allocation" means the assignment of nonbusiness income to a particular state.
4. "Business activity" refers to the transactions and activity occurring in the regular course of the trade or business of a taxpayer.

C. Apportionment.

1. If the business activity with respect to the trade or business of a taxpayer

occurs both within and without this state, and if by reason of that business activity the taxpayer is taxable in another state, the portion of the net income (or net loss) arising from the trade or business derived from sources within this state shall be determined by apportionment in accordance with Sections 59-7-311 to 59-7-319.

2. Allocation. Any taxpayer subject to the taxing jurisdiction of this state shall allocate all of its nonbusiness income or loss within or without this state in accordance with Sections 59-7-306 to 59-7-310.

DISCUSSION

Utah has adopted the Uniform Division of Income For Tax Purposes Act (UDITPA) to determine the portion of income from a multi-state business which is properly subject to Utah tax.

These provisions are contained at Utah Code Ann. §59-7-302 through §59-3-321. Those provisions provide for the allocation and apportionment of multi-state income.

The UDITPA formula divides income into two separate categories, i.e., business income and nonbusiness income. Business income is apportioned to each state through the use of a three-factored formula based upon the property, sales and payroll of a taxpayer occurring in each state. (Utah Code Ann. §59-7-311). Nonbusiness income is generally allocated to the state in which the taxpayer is domiciled.

Utah Code Ann. §59-7-302 defines business income and non-business income as follows:

(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 operations.

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(4) "Nonbusiness income" means all income other than business income.

Most courts agree that the first clause in the statutory definition of business income establishes a transactional test, and numerous courts have construed the second clause as a separate functional test for business income. Uniroyal Tire Co. v. Dept. of Finance (Ala. 2000) 779 SO. 2d 227, 230. Where the courts include both a separate transactional test and a functional test, corporate income is business income if it meets either the transactional test or the functional test. This Commission has previously held that income may be business income if it meets either the transactional test or the functional test. (Appeal Nos. 90-1607, 90-1521, 93-0481, 97-1416, 93-0004, and 01-0005). None of those decisions have been overturned by any court.

The Utah State Tax Commission has specifically adopted the functional test as the test for business income for gains or losses from sales of assets in Rule R865-6F-8.A.3.B, which provides:

"Gains or Losses From Sales of Assets. Gain or loss from the sale, exchange, or other disposition of real or tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business. However, if the property was utilized for the production of nonbusiness income, the gain or loss will constitute nonbusiness income."

That rule adopted by the Utah State Tax Commission (R865-6F-8) also creates a strong inference that income is business income. Subparagraph A of the Rule provides, in relevant part:

"[A]ll 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." (Emphasis added.)

In addition, subparagraph A.1., says:

"Nonbusiness income means all other income other than business income and shall be narrowly construed." (Emphasis added.)

Subparagraph A.2., also says:

"Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is business income or nonbusiness income is the identification of the transactions and activity that are the elements of a particular trade or business. In general, all transactions and activities of the taxpayer that are dependent upon or contribute to the operation of the taxpayer's economic enterprise as a whole, constitute the taxpayer's trade or business and will be transactions and activity arising in the regular course of business, and will constitute integral parts of a trade or business." (Emphasis added.)

Petitioner, in its rebuttal memorandum states, "that even where the functional test may apply, if the transaction involves a complete or partial liquidation and cessation of a company's particular line of business, and the proceeds are distributed to the stockholder's rather than reinvested in the company, any gain or loss generated from that transaction is nonbusiness income under the functional test." (Lenox, Inc. v. E. Norris Tolson, 353 NC 659, 548 S.E.2d 513.) Some states, including STATE 2, have accepted that interpretation of the statute defining business income. However, that is just an interpretation of the statute, because the language of the statute does not contain wording discussing complete or partial liquidations, or distributions of proceeds.

The Commission has considered the cases cited by Petitioner, including Lenox, Inc. v. E. Norris Tolson, supra, McVean & Barlow, Inc. v. New Mexico Bureau of Revenue, 88 N.M. 521, 543, P.2d 489, New Mexico 1975, General Care Corp. v. Olsen, 705 S.W.2d 642 (Tennessee 1986), and Kemppel v. Zaino, Tax Commissioner, 91 Ohio S.D.3d 420, 746 N.E.2d 1073 (Ohio 2001).

After that review, the Commission does not accept the logic or the reasoning of those decisions, but believes the dissenting opinions in McVean & Barlow v. New Mexico Bureau of Revenue and Lenox, Inc. v. E. Norris, Tolson to be better reasoned.

In McVean & Barlow v. New Mexico Bureau of Revenue, *supra*, the dissenting opinion of Judge Lopez stated as follows:

The majority's opinion rests on the rationale that this was an unusual transaction for the taxpayer. I do not think that the question of novelty has anything to do with the question of whether the property sold formed an integral part of the taxpayer's business.

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The "unusual" criterion established by the majority lacks support in case law and the statute. I submit that the issue is whether the property was used to produce business income—that is, whether it formed, in its "acquisition, management, and disposition" part of the taxpayer's business.

Sperry and Hutchinson Co. v. Department of Revenue, *supra*, is helpful in elucidating this test. The issue there was whether various types of investment income were business income of a trading stamp company. The court held, with respect to two of the types of investments, that the taxpayer was engaged in the separate business of making investments and that income from these investments was business income of this separate business. With regard to other investments held for use in the stamp business, the court did not find that this income came from a separate business of the taxpayer's, but rather found the contrary—that the investments were held as part of the stamp business and the interest was therefore business income.

Sperry and Hutchinson supplies the framework with which we should look at sales of equipment. The issue is not how frequent the sales are, nor how substantial the income from them may be, but rather what the relationship of the property sold is to the business.

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Finally, the statute itself negates any requirement that the transaction must be regular to produce business income. The statement in *Western Natural* that the "transaction and activity must have been in the regular course of taxpayer's business operations" I consider to be a critically inaccurate

paraphrase of the statutory requirement that the transaction involving the property be "an integral part of the taxpayer's regular trade or business". By pulling income from tangible and intangible property into business income, the legislature has shown its intent to include more than income from inventory within the term. Once it is conceded that non-inventory items are to be included, the frequency and regularity with which a business produces income from these collateral sources is irrelevant.

Under the test of whether the equipment's use and sale benefited the taxpayer, it is clear that these proceeds were business income. The taxpayer had used this equipment in his business. It sold the equipment for a business purpose, which was to enable it to maintain the corporation after the withdrawal of the principal shareholder. The income it received should have been included in the income which was apportioned as business income.

In addition, in Lenox, Inc. v. E. Norris Tolson, *supra*, Justices Parker and Martin dissented from the majority opinion, and stated as follows:

Less than three years ago in *Polaroid Corp. v. Offerman*, 349 N.C. 290, 507 S.E.2d 284 (1998), this Court in an exhaustive opinion interpreted Section 105-130.4(a)(1) of the North Carolina Corporate Income Tax Act which defines business income. In that opinion, the Court concluded that under the plain language of the statute the definition of business income for corporate income tax purposes included both a transactional test and a functional test. *Id.* at 301, 507 S.E.2d at 293. In *Polaroid* the Court stated that under the functional test, "once a corporation's assets are found to constitute integral parts of the corporation's regular trade or business, income resulting from the acquisition, management, and/or disposition of those assets constitutes business income regardless of how that income is received." *Id.* at 306, 507 S.E.2d at 296. The Court further stated that under the functional test, "the extraordinary nature or frequency of the event is irrelevant." *Id.* at 296, 507 S.E.2d at 289.

The majority acknowledges that applying the above language, defendant is correct in its determination that the income generated from the sale of ArtCarved's assets would necessarily be classified as business income inasmuch as the assets associated with ArtCarved were integral to plaintiff's regular trade or business operations. The majority then disavows this language from *Polaroid* on the basis that the language "is a cause of

confusion" and is "in direct contravention of the functional test of our statute." The majority then states that "[t]he source of corporate income cannot be disregarded, as extraordinary or infrequent transactions may well fall outside a corporation's regular trade or business. Again, the focus must be on the asset or property that generated the income and its relationship to the corporation's regular trade or business."

The majority then purports to apply the functional test to the facts of this case. The majority emphasizes that (i) a liquidation is an extraordinary, not a recurring transaction, and is thus not a sale in the regular course of trade or business; and (ii) the proceeds of the sale were distributed to the sole stockholder and were not reinvested in plaintiff's business. The majority finds support for this analysis in footnote 6 in the *Polaroid* opinion, which suggested that liquidations are not within the purview of the functional test. *Id.* at 306, n.6. 507 S.E.2d at 296, n.6.

In my view the majority has misread the functional test as set forth in the statute and interpreted in *Polaroid*. The functional test focuses on whether the asset is found to be an integral part of the corporation's regular business, not whether the transaction is found to be part of the regular business. The critical question is whether the property or asset produced business income while it was owned by the taxpayer.

Not only does the Commission believe that the above dissenting opinions are more correct and better reasoned than the majorities in those decisions, but the Commission has, for many years, had a rule consistent with those dissenting opinions. Utah Administrative Code Rule R865-6F-8.3.B) states:

"Gains or Losses From Sales of Assets. Gain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in the taxpayer's trade or business. However, if the property was utilized for the production of nonbusiness income, the gain or loss will constitute nonbusiness income."

The above rule is also consistent with court rulings in California. In Hoechst Celanese

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Corporation v. Franchise Tax Board, (2001) 25 Cal 4th 508, 22 P.3d 344, 2001 Cal Lexis 3088, 106

Cal Rptr 2d 548, the California Supreme Court, after a detailed analysis stated:

Forming these interpretations of the statutory language into a cohesive whole, we conclude that income is business income under the functional test if the taxpayer's acquisition, control and use of the property contribute materially to the taxpayer's production of business income. In making this contribution, the income-producing property becomes interwoven into and inseparable from the taxpayer's business operations. Such an interpretation of the functional test flows from the ordinary meaning of the statutory language and the California decisions that formed the basis for the UDITPA definition of "business income."

We further note that our interpretation is consistent with Court of Appeal decisions applying the functional test. For example, the Court of Appeal has found business income where the income-producing property contributed materially to the taxpayer's production of business income. In *Citicorp*, the court held that income from a taxpayer's sale of buildings constituted business income under the functional test because "the buildings were constructed or acquired to serve as important locations for [the taxpayer's business] operations." (*Citicorp, supra*, 83 Cal.App.4th at pp. 1429-1430.) Thus, the court premised its finding of business income on the buildings' material contribution to the taxpayer's production of business income and concluded that the buildings were an indivisible part of the taxpayer's business operations. (See *ibid.*; see also *Times Mirror Co. v. Franchise Tax Bd.* (1980) 102 Cal.App.3d 872, 877-878 [income from the taxpayer's sale of a subsidiary's stock was business income because the subsidiary generated business income].)

The Commission will therefore make its decision in this case based upon the statute (U.C.A. 59-7-302), including prior interpretations thereof by the Commission, and the rule (Utah Administrative Rule R865-6F-8). Particularly relevant to a determination of this case is the portion of Utah Administrative Rule R865-6F-8-2-b), which provides, "Gain or loss from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income if

the property, while it was owned by the taxpayer, was used in the taxpayer's trade or business." In making that determination, the question is not whether the shares of stock of the company were used in the taxpayer's trade or business, but whether the underlying assets served a useful purpose in furthering one of the business lines of the taxpayer, or provided some synergism for one of the business lines of the taxpayer, or the subsidiary generated business income.

Income at Issue

Income of COMPANY F

Although Petitioner, immediately after the acquisition of COMPANY F announced its intention to sell that stock, Petitioner continued to treat COMPANY F as part of its unitary group for a period of approximately ten years. Petitioner also continued to include the income and operations of COMPANY F on its federal corporation income tax returns and its combined corporate franchise tax returns filed in Utah. The property, wages and sales of COMPANY F were included in apportioning the income and/or loss of Petitioner among the various states, thereby treating COMPANY F as part of the unitary business of PETITIONER. However, when there were dispositions of part of the portfolio of COMPANY F, the resulting gains or losses were treated as nonbusiness gains or losses. Therefore, Petitioner treated COMPANY F in an inconsistent manner in the tax returns filed in Utah.

Nevertheless, regardless of whether the tax treatment of COMPANY F by Petitioner was consistent, based upon the tests set forth above, the question is whether the property, "while it was owned by the taxpayer, was used in the taxpayer's trade or business" or whether it generated

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business income. COMPANY F met both of those standards. The gain or loss from COMPANY F meets the functional test and is business income or loss. The determination of Respondent with respect to COMPANY F is therefore sustained.

COMPANY G and COMPANY H

These two companies were wholly owned subsidiaries of Petitioner and they contributed cash to establish COMPANY I, a limited partnership. The partnership was established to "facilitate the optimization of the COMPANY F portfolio." Petitioner, through COMPANY G, was entitled to receive more than 67 percent of the profits and losses of the limited partnership. Petitioner treated the gains and income flowing through from the limited partnership as nonbusiness income on its Utah tax returns, but it treated the property, wages and sales in the factors apportioning the income and/or loss of Petitioner among the various states.

The Commission, above, determined that the income/loss of COMPANY F was business income or loss, and COMPANY I was to "facilitate the optimization of the COMPANY F portfolio." It therefore follows that COMPANY I, "while it was owned by the taxpayer, was used in the taxpayer's trade or business." The gain or loss of COMPANY G and COMPANY H meet the functional test and is business gain or loss. The determinations of Respondent with respect to COMPANY G and COMPANY H are therefore sustained.

COMPANY J

Petitioner acquired its interest in COMPANY J, which was later converted into an equity interest in COMPANY J. The purpose of acquiring COMPANY J, Inc., was to try to establish

a business presence in CONTINENT, and particularly in COUNTRY. The intended business was network infrastructure and logistical support, which would have been consistent with and similar to the (PORTION REMOVED) business of Petitioner. COMPANY K did not have just an investment purpose. It had a business purpose. While COMPANY K was owned by the Petitioner, it was to be used in the taxpayer's trade or business to produce business income. COMPANY J was to serve an operational purpose. As was stated in Allied COMPANY F, Inc. v. Director, Division of Taxation, 504 U.S. 768, 119 L. Ed 2d 533, (1992):

We agree [the companies] need not be engaged in the same unitary business as a pre-requisite to apportionment in all cases. Container Corp. says as much. What is required instead is that the capital transaction serve an operational rather than an investment function. 463 US, at 180, n 19, 77 L Ed 2d 545, 103 S Ct 2933. (Emphasis added.)

The Court later said:

[T]he mere fact that an intangible asset was acquired pursuant to a long-term corporation strategy of acquisitions and dispositions does not convert an otherwise passive investment into an integral operational one. Indeed, in Container Corp. we noted the important distinction between a capital transaction which serves an investment function and one which serves an operational function. 463 US, at 180, n 19, 77 L Ed 2d 545, 103 S Ct 2933 (citing Corn Products Refining Co. v. Commissioner, 350 US 46, 50-53, 100 L Ed 29, 76 S Ct 20 (1955)). If that distinction is to retain its vitality, then, as we held in ASARCO, the fact that a transaction was undertaken for a business purpose does not change its character. 458 US, at 326, 73 L Ed 2d 787, 102 S Ct 3103. (Emphasis added.)

The investment in COMPANY J was one which served as operational purpose. It was undertaken for a business purpose, i.e., to further the business operations of Petitioner. Therefore, any gain or loss meets the functional test and is business income or loss. The determination of

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Respondent with respect to COMPANY J is therefore sustained.

COMPANY M

The shares of COMPANY M came to a subsidiary of Petitioner as part of a workout arrangement with one of its (X) customers. Those shares of stock were then sold and converted to cash. The shares of stock were acquired from transactions and activity in the regular course of the taxpayer's (i.e., the subsidiary's) business. Accordingly, the series of transactions meet the transactional test, and the resulting gain is business income. The determination of Respondent with respect to the dividends and loss from the sale of the preferred shares of COMPANY M is therefore sustained.

STATE 1 Land

One of the subsidiaries of Petitioner was in the marine construction and dredging business. In 1997, that subsidiary acquired the assets of another similar business. That business owned the land at issue here, but the selling company would not complete the transaction unless the subsidiary also purchased the land.

That land served no useful purpose to the business operations and did not generate any business income while it was held by Petitioner. The land was not acquired, managed or disposed of for a business purpose, and the land never constituted an integral part of the taxpayer's regular trade or business operations. The land, while owned by Petitioner, was never used in the taxpayer's trade or business. Therefore, the loss thereon does not meet either the transactional test or the functional test, and was therefore non-business loss.

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Accordingly, the determination of Respondent with respect to the STATE 1 land is hereby reversed.

Dividends from Stock Held for Receipt of Annual Report

Petitioner has acknowledged that these dividends were appropriately reclassified as business income. Therefore, the determination of Respondent with respect to the dividends from shares of stock held for the receipt of the annual reports is hereby sustained.

COMPANY B Shares

Petitioner held an equity interest in COMPANY B, a company specializing in (X) products, which had previously been an operating division of Petitioner. COMPANY B was "spun-off" from Petitioner, and was thereafter a separate publicly traded company. Although the "spin-off" and subsequent securities transactions reduced the ownership percentage of Petitioner in COMPANY B, that business, "while it was owned by the taxpayer, was used in the taxpayer's trade or business." Therefore, the sale of those shares was business income. Therefore, the determination of Respondent with respect to income from the sale of COMPANY B shares is hereby sustained.

Sale of Contract Rights Related to (X) Leasing Business

Petitioner owned a (X) leasing subsidiary which entered into a transaction with COMPANY P and affiliates (COMPANY P) to contribute the (X) to a COMPANY Q which then contributed the (X) to a partnership in which the trust was a 99% partner. The partnership then leased the (X) to a subsidiary of COMPANY P. A purchase option was retained by COMPANY P to purchase the (X) at a bargain price at the conclusion of the twelve-year lease term. Petitioner

had a right to sell or assign that future payment, which it did in 1998.

The payment for the sale of the right to receive the future payments upon the purchase of the (X) by COMPANY P was received for assets which were used by Petitioner in its trade or business, and those payments were therefore business income. Accordingly, the determination of Respondent with respect to these payments is hereby sustained.

The Sale of the (X) Business Segment

Through the acquisition and disposition of various business interests over the years, Petitioner, during the audit years, was focusing on two primary business segments, which were the network integration business, and the distribution business. In 1998 and 1999, Petitioner sold its (X) business, which was one of its two primary business segments. Because this business, while owned by Petitioner, was used in the trade or business of Petitioner, the income from the sale thereof is business income. The determination of Respondent with respect to the income from the sale of the network integration business is hereby sustained.

Apportionment Factors

Petitioner has argued that if the Commission determines that any of the items were appropriately reclassified by the Respondent from non-business to business income or loss, then the apportionment factors should be adjusted “to take into account the fact that such factors in the filed returns excluded any receipts or property considered as giving rise to non-business income in the denominators, as well as the numerator, of such factors.” (Petitioner’s Prehearing Memorandum.)

At the hearing, the parties did not present sufficient evidence for the Commission to

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make a determination as to whether or not the audit correctly adjusted the apportionment factors.

DECISION AND ORDER

Based upon the foregoing, except for the loss on the STATE 1 land, the Tax Commission sustains the audit assessment and denies the remainder of the Petition for Redetermination. The determination of Respondent on the loss on the STATE 1 land is not sustained. Respondent is also ordered to review the calculation of the apportionment factors including any impacts of this decision, and make any necessary modifications to the apportionment factors. Any dispute in that determination may be reviewed by the Commission in any Formal Hearing if such is requested by either party. It is so ordered.

DATED this _____ day of _____, 2003.

G. Blaine Davis
Administrative Law Judge

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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 _____, 2003.

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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