

After this Tax Commission order was issued, it was appealed to a further proceeding, and then the Parties settled before the proceeding. While this is not a final commission order, the Commission reserves the right to redact its decisions and to consider if the order gives general guidance, assists in understanding or applying the law, or addresses new laws or case law or new issues, or provides the benefit of the Commission's thinking and reasoning for taxpayers and tax practitioners. This ruling was based on the facts given to the Commission and the arguments made by the parties. This redacted order does not note what items may have been vacated due to the settlement between the Parties.

11-2285

TAX TYPE: CORPORATE FRANCHISE

TAX YEAR: 1-1-07 THROUGH 12-31-07

DATE SIGNED: 10-2-2013

COMMISSIONERS: B. JOHNSON, D. DIXON, M. CRAGUN, R. PERO

BEFORE THE UTAH STATE TAX COMMISSION

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| <p>TAXPAYER,</p> <p style="padding-left: 40px;">Petitioner,</p> <p>v.</p> <p>AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION,</p> <p style="padding-left: 40px;">Respondent.</p> | <p style="text-align: center;">INITIAL HEARING ORDER</p> <p>Appeal No. 11-2285</p> <p>Account No. #####</p> <p>Tax Type: Corporate Franchise</p> <p>Audit Period: 01/01/07 – 12/31/07</p> <p>Judge: Chapman</p> |
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Presiding:

Kerry R. Chapman, Administrative Law Judge

Appearances:

For Petitioner: REPRESENTATIVE FOR TAXPAYER-1, Representative (by telephone)
REPRESENTATIVE FOR TAXPAYER-2, Representative (by telephone)

For Respondent: REPRESENTATIVE FOR RESPONDENT-1, Assistant Attorney General
RESPONDENT-2, from Auditing Division
RESPONDENT-3, from Auditing Division

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for an Initial Hearing pursuant to the provisions of Utah Code Ann. §59-1-502.5, on December 4, 2012.

TAXPAYER has appealed a corporate franchise tax assessment that Auditing Division (the "Division") has imposed for the period January 1, 2007 through December 31, 2007 ("audit period"). On May 25, 2011, the Division issued a Statutory Notice – Corporate Franchise Tax ("Statutory Notice"), in

which it imposed corporate franchise tax and interest¹ for the audit period, as follows:

| <u>Tax</u> | <u>Penalties</u> | <u>Interest</u> | <u>Total</u> |
|------------|------------------|-----------------|--------------|
| \$\$\$\$\$ | \$\$\$\$\$ | \$\$\$\$\$ | \$\$\$\$\$ |

The taxpayer, elected to be treated as a corporation for United States tax purposes. TAXPAYER was created to invest all of its capital in an underlying partnership, “Y”, through “Z”. (Y) operated its business in three states, including Utah. Neither TAXPAYER nor the (Z) is a Utah entity. TAXPAYER owned a 25.77% limited partnership interest in the (Z), and the (Z) owned a 30.77% interest in (Y). The taxpayer explained that the (Z) acquired the interest in (Y) in YEAR-1 in anticipation that the value of the interest in (Y) would appreciate and that the (Z) would be able to sell the interest for a profit.

Income earned by the (Z) flowed through to TAXPAYER and the other partners in the (Z). In YEAR-2, the (Z) sold its 30.77% interest in (Y), which appears to have generated \$\$\$\$\$ of income that flowed through to TAXPAYER. Neither TAXPAYER nor the (Z) had any control over (Y) or any control over the decision to sell the (Z) interest in (Y). The taxpayer explains that a “third-party co-sponsor” had complete control to decide if and when to sell (Y) and that the (Z) was contractually obligated to sell its interest in (Y) when the co-sponsor elected to sell. The sale of (Y) resulted in the cessation of business for both TAXPAYER and the (Z) because they had no other assets. On the taxpayer’s YEAR-2 Utah corporate franchise tax return, it reported the income from the (Y) sale as nonbusiness income, even though TAXPAYER had reported what it described as “normal” income and losses generated by (Y) as business income.

The Division determined that TAXPAYER improperly classified the income from the (Y) sale as nonbusiness income and, as a result, had improperly excluded it from business income that would be subject to apportionment to Utah. The Division “restored” the income from the (Y) sale to the taxpayer’s Utah apportionment base and assessed additional taxes and interest resulting from this change.

1 Interest continues to accrue until any tax liability is paid.

The taxpayer contests the Division's assessment on two bases. First, the taxpayer claims that it properly classified the income from the (Y) sale as nonbusiness income because its investment in (Y) was held as a non-unitary investment asset. The taxpayer explained that TAXPAYER did not have management control or authority to actively participate in the operation of the (Z). TAXPAYER also had no employees or officers. [The] TAXPAYER'S managing member was "X", which also happened to be a member of the (Z). In addition, the taxpayer explained that the (Z) did not have management control or authority to actively participate in the operation of (Y). As a result, TAXPAYER claims that any distributable share of income generated by the (Y) asset is nonbusiness income that is allocable to the state of the taxpayer's commercial domicile and is not subject to apportionment to Utah. For these reasons, the taxpayer asks the Commission to reverse the Division's assessment in its entirety.

Second, in case the Commission determines that the income generated from the sale of the (Y) interest is business income that is subject to apportionment to Utah, the taxpayer contends that the Division's Utah apportionment percentage is too high. The Division did not include the sale of the interest in (Y) in either the numerator or the denominator of the Utah sales factor. The taxpayer contends that the sale of the (Y) interest should be included in the sales factor denominator but not its numerator. The taxpayer points out that the term "sales" is defined to mean "all gross receipts of the taxpayer not allocated under Sections 59-7-306 through 59-7-310." Utah Code Ann. §59-7-302(5) (2007). It argues that should the income generated by the (Y) sale be considered "business income," it would constitute a "gross receipt" that should be included in the denominator of the sales factor. As to the numerator, the taxpayer refers the Commission to UCA §59-7-319(4)(a) (2012), which provides that ". . . a receipt in connection with intangible property is considered to be in this state if the intangible property is used in this state."² The taxpayer argues that Section 59-7-319(4)(a) clarifies that the (Y) sale is not in Utah

² Section 59-7-319(4)(a) was not found in Utah law during the 2007 audit period. It did not come into effect until January 1, 2009. At the hearing, the Division's counsel asked for the current version of

because TAXPAYER did not, in and of itself, engage in any business activity within the state of Utah and therefore cannot “use” its intangible partnership interest within the state and, thus, should not be included in the numerator of the sales factor.

For these reasons, the taxpayer has recalculated the Division’s sales factor to include the sale of the (Y) interest in the denominator, but not the numerator of the sales factor, which it contends would: 1) reduce the sales factor from 5.01336% to 1.89326%;³ 2) reduce the Utah apportionment percentage from 6.3008% to 5.2608%; and 3) reduce the additional taxes that are due from the \$\$\$\$ amount shown on the Division’s Statutory Notice to \$\$\$\$\$. As a result, if the Commission deems the income from the (Y) sale to be business income, the taxpayer asked the Commission to revise the Division’s assessment to reflect additional tax of only \$\$\$\$\$.⁴

As to the taxpayer’s arguments concerning the classification of the income from the (Y) sale as business income, the Division argues that a partner’s share of partnership income and factors is required to be included with the operations of the corporation in accordance with Utah Admin. Rule R865-6F-8(10)(e) (2007).⁵ The Division also contends that the Commission has addressed a similar issue in *USTC*

Utah law to be used to determine the taxpayer’s 2007 tax liability. Although the taxpayer cited to a version of law that came into effect subsequent to the audit period, it asked for the law in effect during the 2007 audit period to be used to determine its tax liability. In hearings before the Commission, the substantive tax issues are generally, if not always, analyzed using the law in effect during the audit period, while matters that are procedural in nature (i.e., burden of proof) are generally resolved using current law.

3 It appears that the taxpayer added \$\$\$\$ to the denominator of the sales factor to account for the (Y) sale. If this were the amount at which the (Z) sold its interest in (Y), it is noted that the sales price is very close to the \$\$\$\$ of income that appears to have been realized from the sale. Neither party discussed the relationship of these numbers at the hearing.

4 It appears that the taxpayer failed to deduct from this \$\$\$\$ amount the \$\$\$\$ of corporate franchise taxes it had previously paid to Utah for 2007. Deducting the \$\$\$\$ already paid would reduce the remaining tax liability to \$\$\$\$\$, but only if the Commission were to accept the taxpayer’s sales factor argument.

5 In the Division’s Answer to Petition for Redetermination and Notice, the Division referred to a one subsection of Rule 8 (Subsection (10)(e)) that was in effect during the audit period and to two subsections of Rule 8 (Subsections (2)(c) and (2)(e)(ii)) that were not adopted until September 9, 2008, which is subsequent to the audit period. It may not matter which version of Rule 8 is used because the information accompanying the proposed revisions that were adopted on September 9, 2008 indicates that

Appeal No. 97-1416 (Order Apr. 29, 1999),⁶ in which it stated that “an item of partnership gain ‘has the same character for a partner as if realized directly from the source from which realized by the partnership’” (citing Utah Code Ann. §59-10-302(1)).

Finally, the Division contends that definition of “business income” found in Section 59-7-302(1) (2007) provides for both a transactional and functional test when determining business income. The Division contends that the taxpayer is a corporation whose sole business activity consists of holding a limited partnership interest in the (Z) and that the sole business activity of the (Z) consists of holding an interest in (Y). As a result, it contends that the acquisition, management, and disposition of that asset constitute an integral part of both the taxpayer’s business and the (Z) business operations under the functional test.⁷ For these reasons, the Division contends that the income realized from the (Y) sale is business income subject to apportionment to Utah and asks the Commission to sustain its assessment in its entirety.

As to the taxpayer’s second argument concerning the inclusion of the (Y) sale in the denominator but not the numerator of the sales factor, the Division contends that the (Y) sale should not be included in the sales factor at all. The Division contends that the (Y) sale is the sale of an intangible interest and that Rule 8(10) provides for such sales not to be included in the sales factor.

the revisions were proposed to “reflect current Commission practice.” Nevertheless, as explained earlier, the substantive tax issues will be analyzed using the law in effect during the audit period, while procedural matters are determined using current law.

⁶ This decision and other selected decisions can be reviewed on the Commission’s website at <http://www.tax.utah.gov/commission-office/decisions>. It is noted, however, that the Order in *Appeal No. 97-1416* was issued for an Initial Hearing. After this Order was issued, one of the parties requested to proceed to a Formal Hearing. Before the Formal Hearing was held, however, the parties stipulated to an agreement that resulted in the dismissal of *Appeal No. 97-1416*.

⁷ The Division acknowledged that Rule 8 did not specifically refer to the “functional test” by name until after the audit period, but explains that the Commission had used both the transactional test and the functional test to derive “business income” for a number of years prior to the audit period. The Division also acknowledged that the Commission, like some courts around the country, has used the functional test to determine “business income,” even though some other courts have not recognized the functional test.

As to business income, the taxpayer countered that the income from the (Y) sale does not qualify as business income under the functional test because an unrelated co-sponsor, not the (Z), controlled whether to sell the (Z) interest in (Y). The taxpayer contends that income realized from a “one-time” sale is different from normal income and, as a result, is not the type of “partnership or joint venture income” that is subject to apportionment under Rule 8(10)(e).

Furthermore, the taxpayer contends that the Commission’s reasoning in *Appeal No. 97-1416* was “overturned” by the U.S. Supreme Court’s decision in another matter, specifically in *MeadWestvaco v. Illinois Dep’t of Revenue*, 2008 U.S. LEXIS 3473 (2008). The taxpayer states that the Commission’s reasoning in *Appeal No. 97-1416* was based on whether the underlying business served an “operational function,” which the U.S. Supreme Court rejected in *MeadWestvaco*. The taxpayer contends that under *MeadWestvaco*, the test is whether or not the taxpayer and the underlying business are unitary. Because an unrelated party handled the (Y) sale and because neither the taxpayer nor the (Z) were unitary with (Y), the taxpayer reiterated its position that income from the “one-time” sale of the (Z) interest in (Y), unlike “normal” income, is not business income that is subject to apportionment.

The Division, however, contends that a unitary business is not required for the income from the (Y) sale to be deemed “business income” under the functional test and rejects the taxpayer’s argument that *MeadWestvaco* provides otherwise.

APPLICABLE LAW

1. Utah’s Uniform Division of Income For Tax Purposes Act (“UDITPA”) provisions are set forth in Title 59, Chapter 7, Part 3 of the Utah Code. UCA §59-7-303(1) (2007)⁸ provides that “[a]ny 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. For purposes of the UDITPA provisions, UCA §59-7-302 defines “business income,”

8 All cites are to the 2007 version of Utah law, unless otherwise indicated.

“nonbusiness income,” and “sales,” as follows in pertinent 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.

....

(4) “Nonbusiness income” means all income other than business income.

(5) “Sales” means all gross receipts of the taxpayer not allocated under Sections 59-7-306 through 59-7-310.

....

3. UCA §59-7-317 provides that “[t]he sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period.”

4. Utah Admin. Rule R865-6F-8 (“Rule 8”) provides guidance concerning the classification of “business income” and the calculation of the sales factor, as follows in pertinent part:

1. 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.

(a) Nonbusiness income means all income other than business income and shall be narrowly construed.

(b) 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.

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

....

(ii) 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 Subsection (7)(a)(ii).

....

9. Sales Factor. In General.

(a) Section 59-7-302(5) defines the term "sales" to mean all gross receipts of the taxpayer not allocated under Section 59-7-306 through 59-7-310. Thus, for purposes of the sales factor of the apportionment formula for the trade or business of the taxpayer, the term sales means all gross receipts derived by the taxpayer from transactions and activity in the regular course of the trade or business. The following are rules determining sales in various situations.

....

(v) In the case of a taxpayer engaged in the sale, assignment, or licensing of intangible personal property such as patents and copyrights, sales includes the gross receipts therefrom.

....

(vii) In some cases certain gross receipts should be disregarded in determining the sales factor in order that the apportionment formula will operate fairly to apportion to this state the income of the taxpayer's trade or business. See Subsection (10)(c).

....

(b) Denominator. The denominator of the sales factor shall include the total gross receipts derived by the taxpayer from transactions and activity in the regular course of its trade or business, except receipts excluded under Subsection (10)(d).

....
10. Special Rules:

....
(c) Sales Factors.

The following special rules are established in respect to the sales factor of the apportionment formula:

(i) Where substantial amounts of gross receipts arise from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, those gross receipts shall be excluded from the sales factor. For example, gross receipts from the sale of a factory or plant will be excluded.

....

(iii) Where the income producing activity in respect to business income from intangible personal property can be readily identified, that income is included in the denominator of the sales factor and, if the income producing activity occurs in this state, in the numerator of the sales factor as well. . . .

(A) Where business income from intangible property cannot readily be attributed to any particular income producing activity of the taxpayer, the income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor. . . .

(B) Exclude from the denominator of the sales factor, receipts from the sales of securities unless the taxpayer is a dealer therein.

....

(e) Partnership or Joint Venture Income. Income or loss from partnership or joint

venture interests shall be included in income and apportioned to Utah through application of the three-factor formula consisting of property, payroll and sales. For apportionment purposes, the portion of partnership or joint venture property, payroll and sales to be included in the corporation's property, payroll and sales factors shall be computed on the basis of the corporation's ownership interest in the partnership or joint venture, and otherwise in accordance with other applicable provisions of this rule.

5. UCA §59-1-1417 (2012) provides that the burden of proof is upon the petitioner in proceedings before the Commission, with limited exceptions as follows:

- (1) In a proceeding before the commission, the burden of proof is on the petitioner except for determining the following, in which the burden of proof is on the commission:
 - (a) whether the petitioner committed fraud with intent to evade a tax, fee, or charge;
 - (b) whether the petitioner is obligated as the transferee of property of the person that originally owes a liability or a preceding transferee, but not to show that the person that originally owes a liability is obligated for the liability; and
 - (c) whether the petitioner is liable for an increase in a deficiency if the increase is asserted initially after a notice of deficiency is mailed in accordance with Section 59-1-1405 and a petition under Part 5, Petitions for Redetermination of Deficiencies, is filed, unless the increase in the deficiency is the result of a change or correction of federal taxable income:
 - (i) required to be reported; and
 - (ii) of which the commission has no notice at the time the commission mails the notice of deficiency.

....

DISCUSSION

The first issue to be addressed is whether the income from the (Y) sale is business income or nonbusiness income. If the Commission finds that the income is nonbusiness income, as the taxpayer contends, the Division's assessment will be reversed, and the second issue concerning the calculation of the sales factor will not need to be addressed. On the other hand, if the Commission agrees with the Division that the (Y) sale income is business income, the income is subject to apportionment and Utah taxation. In this case, the Commission would address the second issue and determine whether or not the taxpayer has shown that the Division improperly calculated the Utah sales factor.

Business Income or Nonbusiness Income. Utah has adopted the UDITPA provisions to determine the portion of income from a multi-state business that is subject to Utah tax. These provisions are

contained at Sections 59-7-302 through 59-3-321 and provide the formula for allocating and apportioning multi-state income. The formula divides income into two separate categories, i.e., business income and nonbusiness income. Business income is commonly apportioned to each state through the use of a three-factor formula that is based on the taxpayer's property, sales and payroll in a particular state in comparison to its total property, sales and payroll. Nonbusiness income is generally allocated to the state in which the taxpayer is domiciled. Section 59-7-302 defines "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.

There is a strong inference that income is "business income." Rule R865-6F-8(1) ("Rule 8") provides that "the income of the taxpayer is business income unless clearly classifiable as nonbusiness income." Furthermore, Rule 8(1)(a) specifies that "nonbusiness income . . . shall be narrowly construed."⁹

The Commission has consistently found that Utah's definition of "business income" includes two separate tests that are commonly referred to as the "transactional" test and the "functional" test. The transactional test concerns income that arises "from transactions and activity in the regular course of the taxpayer's trade or business." The functional test concerns "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." The Commission has determined that the definition of "business income" requires that only one or the other of the two tests be met, an interpretation supported by cases in other jurisdictions with a similar definition.¹⁰

9 The rule is supported by United States Supreme Court rulings, which clarify that the taxpayer has the "distinct burden of showing by clear and cogent evidence that [the state tax] results in extraterritorial values being taxed." See *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159 (1983); *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980).

10 See *Polaroid v. Offerman*, 507 S.E.2d 284 (N.C. 1998); *Hoechst Celanese Corp. v. Franchise Tax*

The taxpayer contends that the income realized from the (Y) sale is not business income because neither it nor the (Z) had unitary business operations with (Y). The Commission, however, has found that the sale of an *asset* may generate business income under the functional test even where a taxpayer and the company whose interest was sold did not operate a unitary business. In *USTC Appeal No. 05-0792* (Findings of Fact, Conclusions of Law, and Final Decision Mar. 18, 2009), for example, the Commission found that the income from the sale of an asset was business income under the functional test because the acquisition, management, and disposition of the asset constituted an integral part of in the taxpayer's business, even though there was no unitary relationship and even though the sale of the asset was an extraordinary event.

In reaching its decision in *Appeal No. 05-0792*, the Commission considered that the U.S. Supreme Court has determined that an *asset* may serve an operational function instead of an investment function. In *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768 (1992), the Court explained that “the existence of a unitary relation . . . is one justification for apportionment, but not the only one.”¹¹ The Court further stated in *Allied-Signal* that situations could occur in which UDITPA apportionment might be constitutional even though “the payee and that payor [were] not . . . engaged in the same unitary business.” Specifically, the Court determined that an “asset” could form part of a taxpayer's unitary business if it served an “operational” rather than an “investment” function in that business.

Although the taxpayer suggests otherwise, the U.S. Supreme Court reconfirmed its *Allied-Signal* position in *MeadWestvaco v. Illinois Dep't of Revenue*, 2008 U.S. LEXIS 3473 (2008), explaining that:

our references to “operational function” in *Container Corp.* and *Allied-Signal* were not intended to modify the unitary business principle by adding a new ground for apportionment. The concept of operational function simply recognizes that an asset can be a part of a taxpayer's unitary business even if what we may term a “unitary relationship” does not exist between the “payor and payee.”

Board, 22 P.3d 324 (Cal. 2001).

11 See also *Container Corp.*

The Court further explained in *MeadWestvaco* that:

[i]n each case, the “payor” was not a unitary part of the taxpayer’s business, but the relevant asset was. The conclusion that the asset served an operational function was merely instrumental to the constitutionally relevant conclusion that the asset was a unitary part of the business being conducted in the taxing State rather than a discrete asset to which the State had no claim.

In this case, TAXPAYER and the (Z) do not operate a unitary business with (Y). Nevertheless, both TAXPAYER and the (Z) were created to invest all of TAXPAYER’S capital in (Y) in anticipation that the interest in (Y) would appreciate and could be sold for a profit. The taxpayer contends that the taxpayer was a holding company with no business operations. This argument ignores the fact that taxpayer and the (Z) were both created to invest capital in (Y) and then to realize a profit from it, activities that constituted their regular trade or business operations. As a result, the acquisition and disposition of an asset, in this case the interest in (Y), constitutes an integral part of the taxpayer’s and the (Z) regular trade or business operations and served an operational function. Accordingly, the income from the (Y) sale qualifies as business income under the functional test.

In addition, Rule 8(1)(c)(ii), which recognizes the functional test, provides that a “[g]ain 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.” Although TAXPAYER and the (Z) were managed by another entity or other entities, they both had a trade or business, which was to purchase an interest in (Y) and then hold it in anticipation of selling it for a profit. In addition, TAXPAYER included the gains and losses generated by the interest in (Y) as apportionable business income prior to the sale, which supports the conclusion that TAXPAYER and the (Z) were using the interest in (Y) for an operational business purpose. The sale of this asset furthered the business conducted by both TAXPAYER and the (Z).

Finally, the fact that the (Z) sold the interest in (Y) and the income flowed to TAXPAYER does not affect the Commission's decision. Rule 8(10)(e) provides that "[i]ncome or loss from partnership or joint venture interests shall be included in income and apportioned to Utah through application of the three-factor formula consisting of property, payroll and sales." The (Z), like TAXPAYER, was created to invest in an asset (i.e., the interest in Y) and hold the asset in anticipation of selling it for a profit. The sale furthered the (Z) operational business function and is properly classified as business income at the (Z) level. As a result, the income maintains the same character when it flows up to TAXPAYER. For these reasons, the taxpayer has not met its burden to show that it would be unconstitutional for Utah to tax a portion of the income realized from the sale of the interest in (Y). Accordingly, the Division's determination that the income is business income that is subject to apportionment to Utah should be sustained.

Sales Factor. Because the Commission has found the income generated from the (Y) sale to be business income, the taxpayer's second issue concerning the apportionment of that income to Utah must be addressed.

The taxpayer contends that the sales factor should be recalculated by including the (Y) sale in its denominator, but not its numerator. The Division, however, contends that the income should not be included in the sales factor at all because the (Y) sale was the sale of an intangible. The taxpayer did not contest the Division's assertion that the sale was the sale of an intangible. The Division, though, did not cite to any specific statute or rule providing for the sale of an intangible to be excluded from the calculation of the sales factor. In fact, various portions of Utah law provide for certain sales of intangibles to be included in the sales factor.¹²

Nevertheless, it appears that the sale of the interest in (Y) occurred in a state outside of Utah. To

¹² For example, see Rule 8(9)(a)(v), which provides for sales of intangible personal property such as patents and copyrights to be included in gross receipts for purposes of the sales factor.

include such a sale in the denominator, but not numerator, of the Utah sales factor could result in the apportionment formula not operating fairly to apportion the taxpayer's income to Utah in accordance with Rule 8(9)(a)(vii). Rule 8(10)(c)(i) specifically provides that "[w]here substantial amounts of gross receipts arise from an incidental or occasional sale of a fixed asset used in the regular course of the taxpayer's trade or business, those gross receipts shall be excluded from the sales factor." In this case, the sale, though the sale of intangible property, was the sale of the only asset owned by the taxpayer through the (Z). To include such a significant sale in the denominator, but not the numerator, reduces the Utah sales factor by more than half, which has the effect of significantly reducing the Utah apportionment percentage. Furthermore, Rule 8(10)(c)(iii)(B) provides that receipts from the sales of securities are excluded from the denominator of the sales factor unless the taxpayer is a dealer. TAXPAYER is not a securities dealer.

For these reasons, it does not appear unreasonable or improper for the Division to have excluded the (Y) sales from the sales factor when determining the Utah apportionment percentage. In any case, the taxpayer has not provided sufficient evidence to show that the exclusion of the (Y) sale from the Utah sales factor unfairly apportions its business income to Utah. For these reasons, the Division's assessment, as reflected in the Statutory Notice, should be sustained.

Kerry R. Chapman
Administrative Law Judge

DECISION AND ORDER

Based on the foregoing, the Commission sustains the Division's assessment in its entirety. It is so ordered.

Appeal No. 10-2086

This decision does not limit a party's right to a Formal Hearing. However, this Decision and Order will become the Final Decision and Order of the Commission unless any party to this case files a written request within thirty (30) days of the date of this decision to proceed to a Formal Hearing. Such a request shall be mailed to the address listed below and must include the Petitioner's name, address, and appeal number:

Utah State Tax Commission
Appeals Division
210 North 1950 West
Salt Lake City, Utah 84134

Failure to request a Formal Hearing will preclude any further appeal rights in this matter.

DATED this _____ day of _____, 2013.

R. Bruce Johnson
Commission Chair

D'Arcy Dixon Pignanelli
Commissioner

Michael J. Cragun
Commissioner

Robert P. Pero
Commissioner

Notice: If a Formal Hearing is not requested as discussed above, failure to pay the balance resulting from this order within thirty (30) days from the date of this order may result in a late payment penalty.