

11-2917
TAX TYPE: CORPORATE FRANCHISE TAX
TAX YEARS: 4-1-04 THROUGH 3-31-11
DATE SIGNED: 8-27-2013
COMMISSIONERS: B. JOHNSON, M. CRAGUN, R. PERO
EXCUSED: D. DIXON
GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

TAXPAYER,

Petitioner,

v.

AUDITING DIVISION OF THE
UTAH STATE TAX COMMISSION,

Respondent.

INITIAL HEARING ORDER

Appeal No. 11-2917

Account No. #####

Tax Type: Corporate Franchise Tax

Audit Period: 4/1/04 – 3/31/11

Judge: Phan

Presiding:

Jane Phan, Administrative Judge

Appearances:

For Petitioner: REPRESENTATIVE-1 FOR TAXPAYER, Senior Manager,
PROFESSIONAL SERVICE COMPANY, By Telephone
REPRESENTATIVE-2 FOR TAXPAYER, PROFESSIONAL SERVICE
COMPANY, By Telephone
REPRESENTATIVE FOR TAXPAYER-3, CFO, (X), By Telephone
For Respondent: REPRESENTATIVE FOR RESPONDENT, Assistant Attorney General
RESPONDENT-1, Manager, Corporate Franchise Tax Auditing
RESPONDENT-2, Senior Auditor

STATEMENT OF THE CASE

This matter came before the Commission for an Initial Hearing in accordance with Utah Code §59-1-502.5, on February 26, 2013. Petitioner (“Taxpayer”) filed an appeal of a Corporate Franchise Tax audit deficiency of additional tax and the interest accrued thereon for the audit period of April 1, 2004 through March 31, 2011. The audit was issued by Statutory Notice on September 29, 2011. The amount of tax at issue was \$\$\$\$ plus the interest, which as of the date of the notice had been \$\$\$\$\$. The issue in this hearing is whether imputed interest income should have been included in the Taxpayer’s

apportionable income.

APPLICABLE LAW¹

(1) Each domestic and foreign corporation, except those exempted under Section 59-7-102, shall pay an annual tax to the state based on its Utah taxable income for the taxable year for the privilege of exercising its corporate franchise or for the privilege of doing business in the state.

(2) The tax shall be 5% of a corporation's Utah taxable income.

(3) The minimum tax a corporation shall pay under this chapter is \$100. (Utah Code Sec. 59-7-104.)

a) "Utah taxable income" means Utah taxable income before net loss deduction less Utah net loss deduction. (b) "Utah taxable income" includes income from tangible or intangible property located or having situs in this state, regardless of whether carried on in intrastate, interstate, or foreign commerce. (Utah Code Sec. 59-7-101(34).)

"Utah taxable income before net loss deduction" means apportioned income plus non business income allocable to Utah net of related expenses. (Utah Code Sec. 59-7-105(35).)

"Unadjusted income" means federal taxable income as determined on a separate return basis before intercompany eliminations as determined by the Internal Revenue Code, before the net operating loss deduction and special deductions for dividends received. (Utah Code Sec. 59-7-(29).)

"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. (Utah Code 59-7-302(1)(d).)

"Non business income" means all income other than business income. (Utah Code 59-7-302(1)(h).)

Utah Code Ann. §59-1-1417 provides, "[i]n a proceeding before the commission, the burden of proof is on the petitioner..."

There was a revision to Utah Admin. Rule R865-6F-8 during the audit period. In 2005 the rule provided at R865-6F-8(A)(3)(c) provided:

Interest. Interest income is business income where the intangible with respect to which the interest was received arises out of or was created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the intangible is related to or incidental to trade or business operations.

In 2010 Utah Admin. Rule R865-6F-8(2)(e)(iii) the rule provided:

Interest. Interest income is business income where the intangible with respect to which the interest was received arises out of or was created in the regular course of the

¹ This decision cites to the 2010 Utah Tax Code unless otherwise noted.

taxpayer's trade or business operations, or where the purpose for acquiring and holding the intangible is an integral, functional, or operative component of the taxpayer's trade or business operations, or otherwise materially contributes to the production of business income of the trade or business operations.

DISCUSSION

Taxpayer is a manufacturer of (X) products and is a STATE domiciled corporation. In 1997, NAME-1 who was the Taxpayer's sole owner and shareholder at that time died without making a will. The shares of stock in the Taxpayer were the primary asset of the estate. NAME-1 intestacy caused a number of estate tax implications. Subsequently, the Taxpayer "loaned" over a period from December 1997 to June 2003 an approximate total of \$\$\$\$ to NAME-1 estate to satisfy estate taxes, claims related to the beneficiaries and estate expenses. The short term demand loans were authorized by NAME-2, an officer of the Taxpayer.

The reason provided by the Taxpayer for this arrangement was that it was requested by the estate, and if payment had not been made to the estate, the estate would likely have sold shares in the Taxpayer to pay the expenses. These were unwritten loans with no repayment terms and no interest charged. There have been no payments made towards the loans so the current balance is the same as when the final loans were issued in 2003. For U.S. GAAP financial reporting purposes, the Taxpayer may not accrue interest income or list these loans as assets and they were essentially treated under the financial reporting rules as a distribution.

However, for federal income tax purposes, the loans were required to be treated as short term demand loans under IRC Sec. 7872 and the IRS made a determination that interest would have to be imputed to the Taxpayer consistent with that section. The Taxpayer entered into an agreement with the IRS formalizing the interest on the loans at a rate of %%% for a period of three years. This was, however, phantom income because the Taxpayer never received any interest income during this period from the loans. The imputed interest was subsequently reported on the Taxpayer's Federal Corporate Income Tax Return as it was included on Line 5 (Interest Income) for fiscal years ending in March 31, 2007, 2008, 2009, 2010 and 2011. The Taxpayer also listed the loans as assets of its business by including them on Line 14 (Other Assets) of the Schedule L balance sheet on its Federal Form 1120. For the Utah Corporation and Franchise Tax Returns the taxpayer did not include the imputed interest income amounts in its apportionable income because the Taxpayer treated the income as nonbusiness income, which would be allocable to the state of STATE.

The parties were in dispute over whether the Taxpayer's action in issuing the loan would be considered a business purpose. The reason given by the Taxpayer for issuing the payment to the estate as a loan instead of another form of distribution was that it was at the request of the estate. The Taxpayer indicated that the estate needed the funds to pay the tax and other obligations, otherwise it would have

sold all or some portion of the shares of stock representing the ownership interest of the Taxpayer to raise the necessary funds. This may have resulted in a change of ownership of the Taxpayer. The Taxpayer's representative stated that had there been a change in ownership it would not necessarily have affected the Taxpayer's operations as a manufacturer of (X). The Taxpayer argues that the creation of the loan had no connection to the Taxpayer's actual business operations. The imputed interest could not be used to advance the Taxpayer's business operations because it was never received. The Taxpayer argues that the fact that this was structured in the form of a loan did not have a business advantage for the Taxpayer and was actually detrimental to the Taxpayer, so that there could not have been a decision based on a business purpose.

In considering the arguments and the law in this matter, the Commission agrees with the Division's contention that the Taxpayer must assume the tax consequences of how it had structured the payment as a loan to the estate rather than another type of distribution. Regardless of the fact that no interest was being received during the period at issue and that the Taxpayer may not under GAAP financial reporting list the loans as an asset, the IRS has required the Taxpayer to impute interest income on the loan amounts. This phantom income is included in the Taxpayer's federal taxable income on Line 5 of its Federal Form 1120 returns. As noted by the Division, the Utah Supreme Court in *Ivory Homes v. Utah State Tax Comm'n*, stated, "when a taxpayer has chosen to conduct business under a particular arrangement, it cannot disregard the consequences of that arrangement when it would otherwise be to the taxpayer's disadvantage." 266 P.3d 751, 756 (Utah 2011). Additionally Utah Admin. Rule R865-6f-14 does indicate that in matters involving the determination of net income for Utah corporation franchise tax purposes, the state is to follow as closely as possible the federal requirements. The Taxpayer may not then try to re-characterize the "loan" transaction as something else for state tax purpose. The remaining issue for consideration in this matter is whether this imputed interest income is business income or non-business income.

Business income is apportioned among the states in which business is conducted. On the other hand "non-business income" is allocated to specific states according to statutory rules. Non-business interest income is allocated to the state of the corporation's commercial domicile. Therefore, if the imputed interest income was considered to be "non-business income" it would not need to be included in apportionable income. Definitions for "business income" and "non-business income" are found at Utah Code 59-7-302. The Commission has in prior decisions concluded that Utah Code Sec. 59-7-302(1) (d) includes two separate tests and if either are met the income is considered to be business income.² The two tests are commonly referred to as the "transactional" test and the "functional" test.

² *Utah State Tax Commission, Findings of Fact, Conclusions of Law and Final decisions in Appeal No. 05-0792.*

Utah Code Sec. 59-7-302(1)(d) provides that the income is business income if it is “from transactions and activity in the regular course of the taxpayer’s trade or business” which is the transactional test. It is clear that the loan and imputed interest are not from transactions and activity in the regular course of the taxpayer’s trade or business and the Division does not argue the income meets the transaction test.

However, Utah Code Sec. 59-7-302(1)(d) also provides that business income is “income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer’s regular trade of business operations,” which is the functional test. Because the income at issue is interest income, or deemed interest income, guidance is provided at Utah Admin. Rule R865-6F-8(2)(e)(iii). The rule indicates in pertinent part to this case that interest income is business income “where the purpose for acquiring and holding the intangible is an integral, functional, or operative component of the taxpayer’s trade or business operations, or otherwise materially contributes to the production of business income of the trade or business operations.”

The Taxpayer argues that the loan and the deemed interest do not contribute to the production of business income, noting that the Taxpayer has never received a payment of any kind toward the principal and the loans were non interest loans. Therefore, the reality was that there was no interest income. The Division argues that the purpose of the loan was to prevent an ownership change. The Division argues that despite the Taxpayer’s statement that an ownership change may not affect the business, there are numerous implications of what a change in ownership could mean and so the decision to make the loan was integral to the business. A new owner could close the business and liquidate the assets. It was the Division’s contention the decision to issue the loan payment to prevent a change in ownership was integral to the production of business income.

The parties were unable to provide any case law directly on point and the Commission is unaware of any prior decisions dealing directly with the treatment of a loan made to prevent a change in ownership. The most similar prior Tax Commission case is *Findings of Fact, Conclusions of Law and Final Decision in Appeal No. 05-0792*³ which dealt with losses resulting from the termination of a merger agreement. In that case the Commission concluded that the taxpayer had entered into a merger agreement with one company for a strategic business purpose, but then was required to terminate that agreement when a different company submitted a superior proposal. The Commission decided that the loss qualified as a business income or loss. In another prior Tax Commission decision, *Findings of Fact, Conclusions of Law and Final Decision, Appeal No. 08-0892*, the Commission dealt with dividends deemed received for federal tax purposes. Although not directly similar, this was undistributed income which the petitioner

³ Many prior Tax Commission decisions including those cited herein are available in a redacted format at tax.utah.gov/commission-office/decisions.

in that case had reported as income on its federal return. The Commission in that case held that the dividends should be treated as income for purposes of the Utah Corporate Franchise and Income Tax Act.

The Division did point out that there have been several cases from other jurisdictions that have held that actions taken to retain or attract workers satisfies the functional test because these actions are integral to the business and contribute materially to the taxpayer's production of business income.⁴

However, upon reviewing the facts and the law in this case the Commission does not agree with the Division that preventing a change of ownership "is an integral, functional, or operative component of the taxpayer's trade or business operations, or otherwise materially contributes to the production of business income" under Utah Admin. Rule R865-6F-8(2)(e)(iii). The Taxpayer, a corporate entity, would continue to function in a manner to optimize the interests of the shareholders regardless of who those shareholders might be. Further, the Commission does not find that acquiring and holding the intangible is an integral component of the Taxpayer's trade or business operation because structuring the transaction as a loan rather than a distribution to the estate was detrimental to the Taxpayer. From the information provided and argued at the hearing, the structure of the transaction was designed to benefit the estate, and has caused the Taxpayer to impute phantom income on which the Taxpayer is incurring tax liability. Taxpayer may not claim the loan as an asset for GAAP financial reporting and has no expectation of being repaid even the principal. The GAAP characterization of the loan as a distribution reflects the economic reality that the loan is not a "real" business asset and was made for no operational business purpose. The loan is certainly not materially contributing to the production of business income.

We agree with the Division that retaining key employees may constitute a business purpose. In other circumstances, maintaining existing management could constitute a business purpose. In this case, however, the Taxpayer's statement that "any change in ownership would not necessarily have affected the Taxpayer's operations" is un rebutted. Given the very limited record before us, and in the absence of any authority to the contrary, we find that the loan in this case was solely for the benefit of the estate to pay estate taxes, and not for any operational purpose of the business. The audit deficiency of additional tax and interest should be abated.

DECISION AND ORDER

Based on the foregoing, the Commission abates the Corporate Franchise Tax audit deficiency against the Taxpayer for the period from April 1, 2004 through March 31, 2011. It is so ordered.

This decision does not limit a party's right to a Formal Hearing. However, this Decision and

⁴ The Division cites, *Hoechst Celanese Corp. v. Franchise Tax Bd*, 22 P.3d 324, 339 (Cal. 2001), *Appeal of American Snuff Co.*, 8 Calif. Tax Cases 101, Apr. 20, 1960; *Appeal of Kroehler Manufacturing Co.*, Cal. St. Bd. Of Equal., Apr. 6, 1977; *Montana Dept of Revenue v. American Smelting*, 567 P.2d 901, 907 (Mont. 1977).

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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