09-3091
TAX TYPE: CORPORATE FRANCHISE TAX
TAX YEARS: 1-1-05 TO 12-31-06
DATE SIGNED: 2-10-2011
COMMISSIONERS: B. JOHNSON, M. JOHNSON, M. CRAGUN
EXCUSED: D. DIXON
GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER, Petitioner, vs. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	**FINDINGS OF FACT, CONCLUSIONS OF LAW, AND FINAL DECISION** Appeal No. 09-3091 Account No. ##### Tax Type: Corporate Franchise Audit Period: 1/1/05 to 12/31/06 Judge: Phan

Presiding:
Marc Johnson, Commissioner
Michael J. Cragun, Commissioner
Jane Phan, Administrative Law Judge

Appearances:
For Petitioner: REPRESENTATIVE-1 FOR PETITIONER, Attorney At Law, CPA
REPRESENTATIVE-2 FOR PETITIONER
For Respondent: REPRESENTATAIVE FOR RESPONDENT, Assistant Attorney General
RESPONDENT-1, Director Auditing Division
RESPONDENT-2, Tax Audit Manager, Corporate Franchise Tax Auditing

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for a Formal Hearing pursuant to Utah Code Secs. 59-1-501 and 63G-4-204 et al., on August 11, 2010. Based upon the evidence and testimony presented at the hearing, the Tax Commission hereby makes its:

FINDINGS OF FACT

1. Petitioner is appealing an audit deficiency for the period of January 1, 2005 through December 31, 2006. The Statutory Notice of audit deficiency was issued on September 8, 2009. The amount of the audit deficiency issued against Petitioner is tax totaling $$$$$. Interest was assessed and as of the date of the Statutory Notice, was $$$$$. Interest continues to accrue on any unpaid balance. The Taxpayer timely appealed the audit and the matter proceeded to the Formal Hearing.

2. The Petitioner in this proceeding is limited to PETITIONER ("PETITIONER"). PETITIONER was incorporated under the laws of STATE on September 29, 1997. It was originally incorporated under the name BUSINESS-1, but the name was changed in 1998 to PETITIONER. The shareholders elected S-corporation status on December 10, 1997. REPRESENTATIVE-2 FOR PETITIONER his spouse and three children were shareholders of PETITIONER, whose combined ownership was approximately 49% during the period at issue. All members of the REPRESENTATIVE-2 FOR PETITIONER family were residents of STATE during all of 2005. For the 2006 year some of the family members were part year residents of STATE or non-STATE residents. None were residents of Utah. Two additional shareholders, NAME-1and NAME-2 owned the remaining 51% of the shares. Both were residents of Utah during the audit period at issue.

3. REPRESENTATIVE-2 FOR PETITIONER was the registered agent for the PETITIONER, and the registered office for the BUSINESS-1 was located in STATE from the time of in BUSINES- 1 through to the present. REPRESENTATIVE-2 FOR PETITIONER testified that with the stock that he owned individually combined with the stock owned by his family members he effectively controlled more stock than any other shareholder. The evidence presented at the hearing indicated that REPRESENTATIVE-2 FOR PETITIONER made the policy decisions for PETITIONER, while other shareholders managed the operations of the subsidiaries. REPRESENTATIVE-2 FOR PETITIONER was a director of PETITIONER. However, from the date of in BUSINESS-1 until May 2005, REPRESENTATIVE-2 FOR PETITIONER was not an officer of PETITIONER. Up to May 2005, NAME-1 was the chairman and NAME-2 the President/Treasurer and both were directors. Both NAME-1 and NAME-2 testified at the hearing that policy decisions for PETITIONER were made by REPRESENTATIVE-2 FOR PETITIONER determined where the BUSINESS-1 would do its banking, which attorneys and accountants to retain plus matters of financing and redeeming out shareholders. After May 2005, REPRESENTATIVE-2 FOR PETITIONER was appointed Chairman of the Board of Directors.

4. PETITIONER had originally been incorporated to effectuate the purchase of BUSINESS-1, which was an operating business engaged in the formulation and sale of wet food bases, seasoning and flavorings to food industry businesses including restaurants, hotels and food chains. There were some different corporate structuring and name changes, but on May 22, 2001 PETITIONER organized and incorporated BUSINESS-2, (BUSINESS-2), which was the entity that owned and operated the wet food base company prior to and during the audit period. From 1997 through 2002 the administrative offices of BUSINESS-2 were in

STATE-1 with warehouses in CITY-1 and CITY-2. In 2002 BUSINESS-2 moved its administrative offices to CITY-3, Utah. The operations of BUSINESS-2 were primarily overseen by NAME-2. This was an operating business entity that formulated and sold food bases. It did not manufacture the bases during the audit period, but instead produced the products through contract packing with other manufacturers.

5. The parties testified at the hearing that the intent in acquiring BUSINESS-1 was to operate it long term. The intent was not to purchase the business for the purpose of turning around and reselling it.

6. In 2001 a decision was made by PETITIONER to acquire another operating company, BUSINESS-3 ("BUSINESS-3"), thought to be complimentary to the BUSINESS-2 business. BUSINESS-4 ("BUSINESS-4") was organized under the laws of STATE-2 on April 20, 2001, to effectuate the purchase. BUSINESS-4 acquired 80% of BUSINESS-3 on May 27, 2005 from an unrelated party. BUSINESS-3 was a Utah limited liability company and was an operating entity in the business of manufacturing dry soup mixes that were sold retail to supermarkets and grocery stores. This company had been headquartered in CITY-4, Utah prior to the acquisition by BUSINESS-4. BUSINESS-3 had a manufacturing and warehousing facility with administrative offices in Utah. After the purchase of BUSINESS-3, the operations and headquarters remained in CITY-4, Utah. BUSINESS-3 was primarily overseen by NAME-1. The remaining 20% interest in BUSINESS-3 was retained by the prior owner, BUSINESS-5.

7. After additional restructuring, by 2005, BUSINESS-4'S name had been changed to BUSINESS-6 ("BUSINESS-6"). BUSINESS-6 was the 100% owner of BUSINESS-2, which was taxed as a partnership and disregarded entity, with income and expenses flowing up to BUSINESS-6. BUSINESS-6 also owned 80% of BUSINESS-3. BUSINESS-3 was also taxed as a partnership with 80% of its income and expenses flowing up to BUSINESS-6 and the remaining 20% to the prior owner.

8. NAME-2 managed the day to day operations of BUSINESS-2. NAME-1 managed the day to day operations of BUSINESS-3. Both NAME-2 and NAME-1 were directors and officers of BUSINESS-6 as well as each of the operating entities. BUSINESS-2 and BUSINESS-3 were operated with separate accounting, offices and locations. However, there were some interrelated transactions. They jointly set up employee benefits and health insurance. BUSINESS-3 paid some $$$$$ per year to NAME-2 for 'consulting'. There were some transactions between the two Companies with BUSINESS-3 acquiring some food base products from BUSINESS-2 and BUSINESS-2 acquiring a dried salad dressing mix from BUSINESS-3. These transactions were based on arms length prices.

9. As both BUSINESS-2 and BUSINESS-3 were taxed as partnerships, their income and

expenses flowed up to BUSINESS-6. However, BUSINESS-6 was also taxed as a partnership and so the combined income and expenses from BUSINESS-3 and BUSINESS-2 would then flow up to BUSINESS-6'S partners. PETITIONER owned a 45.5498% interest in BUSINESS-6, so that percent of income and expenses flowed up to PETITIONER. The remaining 54.4151% ownership interest was held by individual partners comprised of the REPRESENTATIVE-2 FOR PETITIONER and his family members, NAME-2, NAME-1, as well as GROUP-1 and GROUP-2. PETITIONER continued as an S BUSINESS-1 in 2005, so taxes flowed through to the individual owners who were REPRESENTATIVE-2 FOR PETITIONER and family members, NAME-2, and NAME-1.

10. In 2002 through 2006 PETITIONER was a holding BUSINESS-1 that did not directly own any operating assets. It did own the interest in BUSINESS-6 and BUSINESS-6 owned the interests in the operating entities; 100% of BUSINESS-2 and 80% of BUSINESS-3 up until May 2005. These two operating entities were both headquartered in Utah. Because of this, PETITIONER'S Utah apportionment fraction as reported on its Utah form TC-20S for 2005 was 92.5529%. During the audit, the Division recalculated the Utah apportionment factor to be 92.6639% and the Taxpayer did not disagree with the recalculation.

11. For each tax year 2002 through 2006, PETITIONER'S Utah S BUSINESS-1 return was filed listing as the mailing address a Utah address. Further, each of these returns stated that Utah was the state of commercial domicile and that the corporate books and records were maintained in Utah.

12. For the years 2002 through 2004, PETITIONER'S Utah S BUSINESS-1 returns were prepared by the Utah offices of ACCOUNTING FIRM and were signed by NAME-2, who was a Utah resident, and also the President of PETITIONER. During this same period PETITIONER'S federal returns were filed also using a Utah address as the mailing address.

13. On each of its Utah returns for 2002 through 2004, PETITIONER treated the income from its two subsidiaries, BUSINESS-2 and BUSINESS-3 as business income and apportioned the income to Utah based on its apportionment factor which was in excess of 89% for each of these years.

14. On May 27, 2005, BUSINESS-6 sold its entire partnership interest in BUSINESS-3. Approximately 95% of the gain was recognized from this sale in 2005 and the remaining 5% of the gain in 2006. This gain flowed up to the partners of BUSINESS-6. PETITIONER, as a 45.5849% owner of BUSINESS-6, recognized gain on the sale in the amount of $$$$$ for 2005 and $$$$$ for 2006. The gain was based on the excess of the proceeds PETITIONER received from the sale of the partnership interest in BUSINESS-3 in the amount of $$$$$ over its share of the tax basis for its indirect interest in BUSINESS-3 in

the amount of $$$$$. The remaining 54.4151% of the gain flowed up to the other partners of BUSINESS-6.

15. The proceeds from the gain on the sale of BUSINESS-3 were not reinvested by PETITIONER into its continuing operations with BUSINESS-2 or to acquire another operating entity. PETITIONER used the proceeds to redeem shares from NAME-1and or they were distributed to remaining shareholders of PETITIONER.

16. As PETITIONER is an S-Corporation for which tax flows through to the shareholders, PETITIONER would not incur tax directly on the gain from the sale of BUSINESS-3 because the tax flowed up to the shareholders. However, Utah imposes withholding requirements in relation to the nonresident shareholders. In this case REPRESENTATIVE-2 FOR PETITIONER and his family members were nonresident shareholders of PETITIONER.

17. As an S corporation, PETITIONER filed a federal form 1120S. For its federal filing for the 2005 tax year PETITIONER reported its share of the income and loss which flowed through from BUSINESS-6 which included the $$$$$ gain from the sale of BUSINESS-3. On line 17e of Schedule K of its federal form 1120S was $$$$$. When filing its 2005 Utah S BUSINESS-1 return, PETITIONER did not include the gain from the sale of the BUSINESS-3 as business income on its return. It had deducted the gain from the sale of BUSINESS-3, and instead of reporting income of $$$$$ on line 1 of Schedule A of the Utah form TC-20S ("Federal income/loss from form 1120S, Schedule K, line 17e"), it had reported a loss of $$$$$. The return also reported a Utah apportionment fraction of 92.5529% and stated that the commercial domicile of PETITIONER was in Utah.

18. After the Division audited the return, the Division treated the gain from the sale of BUSINESS-3 as business income apportionable to Utah and the other states in which it does business based on the apportionment fraction. The Division multiplied the gain to PETITIONER by the Utah apportionment fraction and by the nonresident shareholder percentage to determine $$$$$ was taxable to Utah for the nonresident shareholders' withholding resulting in $$$$$ in additional tax plus the interest accrued thereon.

19. For its 2005 STATE Tax-Option(S) Corporate Franchise or Income Tax Return, PETITIONER treated the gain as business income and apportioned it to STATE based on its apportionment percentage in that state, which was 1.0958%. The Division found this return inconsistent with the Utah return.

20. The testimony, at the hearing, however, was that the individual shareholders of PETITIONER who were residents in STATE, had, in fact, claimed and paid tax on the gain in STATE on their individual income tax returns for 2005. Further, the testimony was that PETITIONER as an S-Corporation would not

have had a tax liability to the State of STATE on the gain because the tax liability flowed through to the individual shareholders.

APPLICABLE LAW

During the audit period at issue Utah law required that S-Corporations pay or withhold a tax on behalf of nonresident shareholders at Utah Code Sec. 59-7-703(2)(b) (2005 & 2006)[1] as follows:

> The amount paid or withheld by an S Corporation under Subsection (2)(a) shall be determined by: (i) calculating the items of income or loss from federal form 1120S, Schedule K; (ii) applying the apportionment formula to determine the amount apportionable to Utah; (iii) reducing the amount apportioned to Utah by the percentage ownership attributable to resident shareholders; and (iv) applying the rate to the remaining balance.

"Business income" and "Nonbusiness" income are defined at Utah Code Sec. 59-7-302 (2005 & 2006) 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.
> ****
> (4) "Nonbusiness" income means all income other than business income.

A further definition of business and nonbusiness income is provided at Utah Administrative Rule R865-6F-8 as follows:

> A. Business and Nonbusiness Income Defined . . . 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 classified as nonbusiness income.
> 1. Nonbusiness income means all income other than business income and shall be narrowly construed.
> ****
> 3. Business and Nonbusiness Income. Application of Definitions. The following are rules for determining whether particular income is business or nonbusiness income:
> ****
> 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 . . .
> ****

> J. Special Rules:
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> 5. Income or loss from partnership or joint venture interests shall be included 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.

CONCLUSIONS OF LAW

1. From the uncontested facts in this matter, PETITIONER held an ownership interest in BUSINESS-6, which in turn held an ownership interest in BUSINESS-3. During the years prior to 2005, PETITIONER included the income generated by BUSINESS-3 as apportionable business income on its tax return filings. The Division argues that as the income generated by BUSINESS-3 was business income, the proceeds from the sale of BUSINESS-3 was also business income. The Division's position is consistent with the Tax Commission's interpretation of Utah Code Sec. 59-7-302 and there is no basis before the Commission to overturn its long standing position.[2] Further, this position is consistent with Utah Admin. Rule R865-6F-8 which provides at (A)(3)(b) that "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."

2. PETITIONER argues that it has no trade or business, and, therefore, the gain could not constitute business income. Petitioner supports its contention that PETITIONER was, in fact, a holding company that did not directly own operating assets. However, the Petitioner's argument that it, therefore, had no trade or business is misplaced. Its business was to own and manage its interests including its subsidiaries that held operating entities. The testimony and evidence at the hearing indicated that in order to accomplish this, PETITIONER retained accountants and attorneys, set up banking relationships to obtain loans for the needs of the businesses, made determinations on which entities to acquire and made other policy decisions regarding the subsidiaries. PETITIONER managed and oversaw negotiations and the preparation of contracts and agreements to facilitate the purchase and operation of those entities. These were activities that PETITIONER engaged in with continuity and regularity. PETITIONER was operating a trade or business and

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1 The Commission cites to and applies the law in affect during the audit period.
2 USTC Appeal Nos. 90-1607, 90-1521, 93-0004, 93-0481, 97-1416, 01-0005 and 04-0970.

the income generated by its subsidiaries constituted business income, which PETITIONER had properly claimed on its tax returns from up through 2004.

3. As it is the Commission's conclusion that the income at issue is business income, and, therefore, apportionable to Utah and other states in which it did business, the state of commercial domicile is not relevant to this decision. "Commercial domicile" is defined as the "principal place for which the trade or business of the taxpayer is directed or managed." Utah Code Sec. 59-7-302(5). There was a conflict between the current witness testimony and affidavits provided at the hearing, and the way that PETITIONER had been filing its tax returns prior to and during the period at issue. Because the state of commercial domicile is not relevant to this decision, the Commission declines to make a determination on this point.

DISCUSSION

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 Utah Code Ann. §59-7-302 through §59-7-321 and provide the basis for determining whether income is allocated to the state of commercial domicile or apportioned among the states in which business is transacted. Business income is apportioned, while nonbusiness income is allocated under these provisions.

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.

Further, the Tax Commission rule clarifies that income is generally "business income." Rule R865-6F-8(A) provides that "the income of the taxpayer is business income unless clearly classifiable as nonbusiness income." Subsection 8(A)(1) of that rule specifies that "nonbusiness income . . . shall be narrowly construed."[3]

The Commission has consistently found that Utah Code Sec. 59-7-302(1) provides two separate bases by which income is considered business income. These are commonly referred to as the "transactional" test and the "functional" test. The transactional test is income that arises "from transactions and activity in the regular

3 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. STATE-1 Dept. of Revenue*, 447 U.S. 207 (1980).

course of the taxpayer's trade or business." The functional test is "income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." The Commission has consistently determined that meeting the functional test alone is sufficient to categorize income as business income.[4]

The Commission has recognized and applied the functional test in its prior decisions where there has been a sale or liquidation of a subsidiary of the business and as stated in Appeal No. 93-0004 (Quoting Appeal no. 93-0481) the Commission found:

> "The transaction itself need not reflect the taxpayer's normal trade or business under the functional test; gain from the sale of assets constitutes business income if the assets themselves were used to generate business income. Under this approach, gain or loss from the sale of a business constitutes business income or loss if the assets sold were used by the taxpayer in its unitary business to produce business income."

In this case it was uncontested that BUSINESS-3 had been producing business income which was claimed by PETITIONER on its tax returns as such. Furthermore, Utah Admin Rule R865 6F-8(A)(3)(b) recognizes the functional test, providing that "[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, other jurisdictions have come to different conclusions on the interpretation of similar provisions, the Utah Tax Commission is not alone in its interpretation and application of a functional test. In *Hoechst Celanese Corp. v. Franchise Tax Board*, 22 P.3d 324 (Cal. 2001), the California Supreme Court interpreted California's definition of "business income," which is the same as Utah's, and found as follows:

> 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."

PETITIONER points to the analysis of Judge Schofield of the Utah Fourth District Court, in the matter of *Chambers et al v. Utah State Tax Commission*, Case No. 050402915 TX, as support for its position that

4 *See* Utah State Tax Commission Appeal Nos. 90-1607, 90-1521, 93-0004, 97-1416, 01-0005 and 04-0970.

BUSINESS-6'S sale of its entire interest in BUSINESS-3 would not constitute business income. PETITIONER'S representatives recognize that they may not cite the decision as precedence as it was vacated by the Utah Supreme Court, but instead ask that the Commission consider the analysis and discussion of the judge in that ruling. In the ruling, Judge Schofield discusses interpretations by other states of statutes similar to Utah's UDIPTA provisions, in which those states came to conclusions that are inconsistent with the Division's position. The Utah State Tax Commission does recognize that there are a number of jurisdictions who have interpreted the UDIPTA provisions differently. However, the Utah Tax Commission is not alone in its interpretation of these provisions and the Division has followed the Commission's long standing position in this audit. Accordingly, the audit should be sustained.

Jane Phan
Administrative Law Judge

DECISION AND ORDER

Based upon the foregoing, the Tax Commission sustains the audit deficiency against the PETITIONER for the tax years 2005 and 2006. It is so ordered.

DATED this _____ day of _____, 2011.

R. Bruce Johnson
Commission Chair

Marc B. Johnson
Commissioner

D'Arcy Dixon Pignanelli
Commissioner

Michael J. Cragun
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. Sec. 63G-4-302. 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 Sec. 59-1-601 et seq. and 63G-4-401 et seq.

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