

BEFORE THE UTAH STATE TAX COMMISSION

<p style="text-align: center;">;</p> <p style="text-align: center;">Petitioner,</p> <p>v.</p> <p>AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION,</p> <p style="text-align: center;">Respondent.</p>	<p><b>ORDER ON PETITIONER'S AMENDED MOTION FOR SUMMARY JUDGMENT AND RESPONDENT'S AMENDED CROSS-MOTION FOR SUMMARY JUDGMENT</b></p> <p>Appeal No. 16-1358</p> <p>Account No.</p> <p>Tax Type: Corporate Franchise Tax</p> <p>Tax Years:</p> <p>Judge: Marshall</p>
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**Presiding:**

John L. Valentine, Commission Chair  
Michael J. Cragun, Commissioner  
Rebecca L. Rockwell, Commissioner  
Jan Marshall, Administrative Law Judge

**Appearances:**

For Petitioner: Steve Young, Holland and Hart  
Nate Runyan, Holland and Hart  
Rebecca Taylor, Holland and Hart

For Respondent: Norman Lobins, Deloitte  
Susan Barnum, Assistant Attorney General  
Mark Wainwright, Assistant Attorney General  
Valerie Newson, Auditing Division  
Angie Hillas, Auditing Division

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission on March 15, 2021 for a hearing on the Petitioner's ("Taxpayer" or " ") Motion for Summary Judgment and the Respondent's ("Division") Cross-Motion for Summary Judgment.<sup>1</sup>

The Petitioner filed an Amended Motion for Summary Judgment on May 13, 2020. The Respondent filed an Amended Motion for Summary Judgment and Memorandum in Support, as well as a Memorandum in Opposition to the Petitioner's Motion on June 26, 2020. The Petitioner filed its Reply Memorandum on July 31, 2020. The Respondent filed its Reply Memorandum on October 23, 2020. The parties agree that there is no genuine issue of material fact.

APPLICABLE LAW<sup>2</sup>

Utah Code Ann. §63G-4-102(4) provides that the Commission may issue orders on motions for summary judgment in Tax Commission appeals as follows:

- (4) This chapter does not preclude any agency, prior to the beginning of an adjudicative proceeding, or the presiding officer during an adjudicative proceeding from...
  - (b) granting a timely motion to dismiss or for summary judgment if the requirements of 12(b) or Rule 56 of the Utah Rules of Civil Procedure are met by the moving party, except to the extent that the requirements of those rules are modified by this chapter.

Rule 56 of the Utah Rules of Civil Procedure allows for a Motion for Summary Judgment.

Subsection (a) specifically provides, in part:

A party may move for summary judgment, identifying each claim or defense—or the part of each claim or defense—on which summary judgment is sought. The court shall grant summary judgment if the moving party shows that there is no genuine dispute as to any material fact and the moving party is entitled to judgment as a matter of law...

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. Utah Code Ann. § 59-7-303(1) 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."

For purposes of UDITPA, Utah Code Ann. § 59-7-302(1), defines "business income" and "nonbusiness income" as follows:

- (d) "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

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<sup>1</sup> The matter was scheduled as a Formal Hearing. However, the parties argued their respective Motions for Summary Judgment, and intend for the Commission's Order in this matter to constitute final agency action.

<sup>2</sup> The Commission cites to, and applies, the 2012 version of the Utah Code.



intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations...

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

Utah Code Ann. § 59-7-311 sets forth the method of apportionment of business income, as follows:

- (1) For a taxable year, all business income shall be apportioned to this state by multiplying the business income by a fraction calculated as provided in this section.
- (2)
  - (b) Subject to the other provisions of this part, for a taxable year that begins on or after January 1, 2011, a taxpayer, except for a sales factor weighted taxpayer, shall elect to calculate the fraction for apportioning business income to this state using:
    - (i) the method described in Subsection (2)(c); or
    - (ii) the method described in Subsection (2)(d).
  - (c) For purposes of Subsection (2)(a) or (b), a taxpayer described in Subsection (2)(a) or (b) may elect to calculate the fraction for apportioning business income as follows:
    - (i) the numerator of the fraction is the sum of:
      - (A) the property factor as calculated under Section 59-7-312;
      - (B) the payroll factor as calculated under Section 59-7-315; and
      - (C) the sales factor as calculated under Section 59-7-317; and
    - (ii) the denominator of the fraction is three.
  - (d) For purposes of Subsection (2)(a) or (b), a taxpayer described in Subsection (2)(a) or (b) may elect to calculate the fraction for apportioning business income as follows:
    - (i) the numerator of the fraction is the sum of:
      - (A) the property factor as calculated under Section 59-7-312;
      - (B) the payroll factor as calculated under Section 59-7-315; and
      - (C) the product of:
        - (I) the sales factor as calculated under Section 59-7-317; and
        - (II) two; and
    - (ii) the denominator of the fraction is four.
  - (e) In accordance with Title 63G, Chapter 3, Utah Administrative Rulemaking Act, the commission may make rules providing procedures for a taxpayer described in Subsection (2)(a) or (b) to make the election required by this Subsection (2).

Administrative 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) Definitions.
  - (e) "Business income" means income of any type or class, and from any activity, that meets the relationship described in Subsection (2)(b), the transactional test, or Subsection (2)(c), the functional test. 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...

- (i) "Nonbusiness income" means all income other than business income.
- (l) "To contribute materially" includes being used operationally in the taxpayer's trade or business. Whether property contributes materially is not determined by reference to the property's value or percentage of use. If an item of property contributes materially to the taxpayer's trade or business, the attributes, rights, or components of that property are also operationally used in that business. However, property that is held for mere financial betterment is not operationally used in the taxpayer's trade or business.

(2) Business and Nonbusiness Income.

- (a) Apportionment and Allocation. Section 59-7-303 requires that every item of income be classified as either business income or nonbusiness income. Income for purposes of classification as business or nonbusiness includes gains and losses. Business income is apportioned among jurisdictions by use of a formula. Nonbusiness income is specifically assigned or allocated to one or more specific jurisdictions pursuant to express rules. An item of income is classified as business income if it falls within the definition of business income. An item of income is nonbusiness income only if it does not meet the definitional requirements for being classified as business income.
- (b) Transactional Test. Business income includes income arising from transactions and activity in the regular course of the taxpayer's trade or business.
  - (i) If the transaction or activity is in the regular course of the taxpayer's trade or business, part of which trade or business is conducted within the state, the resulting income of the transaction or activity is business income for Utah purposes. Income may be business income even though the actual transaction or activity that gives rise to the income does not occur in this state.
  - (ii) For a transaction or activity to be in the regular course of the taxpayer's trade or business, the transaction or activity need not be one that frequently occurs in the trade or business. Most, but not all, frequently occurring transactions or activities will be in the regular course of that trade or business and will, therefore, satisfy the transactional test. It is sufficient to classify a transaction or activity as being in the regular course of a trade or business if it is reasonable to conclude transactions of that type are customary in the kind of trade or business being conducted, or are within the scope of what that kind of trade or business does. However, even if a taxpayer frequently or customarily engages in investment activities, if those activities are for the taxpayer's mere financial betterment rather than for the operations of the trade or business, those activities do not satisfy the transactional test. The transactional test includes income from sales of inventory, property held for sale to customers, and services commonly sold by the trade or business. The transactional test also includes income from the sale of property used in the production of business income of a kind that is sold and replaced with some regularity, even if replaced less frequently than once a year.
- (c) Functional Test. Business income also includes 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.



- (i) The following definitions apply to this Subsection (2)(c).
  - (A) "Acquisition" means the act of obtaining an interest in property.
  - (B) "Disposition" means the act, or the power, of relinquishing or transferring an interest in or control over property to another, either in whole or in part.
  - (C) "Integral part" means property that constitutes a part of the composite whole of the trade or business, each part of which gives value to every other part, in a manner that materially contributes to the production of business income.
  - (D) "Management" means the oversight, direction, or control, whether directly or by delegation, of the property for the use or benefit of the trade or business.
  - (E) "Property" includes an interest in, control over, or use of property, whether the interest is held directly, beneficially, by contract, or otherwise, that materially contributes to the production of business income.
- (ii) Under the functional test, business income need not be derived from transactions or activities that are in the regular course of the taxpayer's own particular trade or business. It is sufficient, if the property from which the income is derived is or was an integral, functional, or operative component used in the taxpayer's trade or business operations, or otherwise materially contributed to the production of business income of the trade or business, part of which trade or business is or was conducted within the state. Property that has been converted to nonbusiness use through the passage of a sufficiently lengthy period of time, generally five years, or that has been removed as an operational asset and is instead held by the taxpayer's trade or business exclusively for investment purposes, has lost its character as a business asset and is not subject to this subsection. Property that was an integral part of the trade or business is not considered converted to investment purposes merely because it is placed for sale.
- (iii) Income that is derived from isolated sales, leases, assignments, licenses, and other infrequently occurring dispositions, transfers, or transactions involving property, including transactions made in liquidation or the winding-up of business, is business income if the property is or was used in the taxpayer's trade or business operations.
  - (A) Property that has been converted to nonbusiness use has lost its character as a business asset and is not subject to Subsection (2)(c)(iii).
  - (B) Income from the licensing of an intangible asset, such as a patent, copyright, trademark, service mark, know-how, trade secrets, or the like, that was developed or acquired for use by the taxpayer in its trade or business operations, constitutes business income whether or not the licensing itself constituted the operation of a trade or business, and whether or not the taxpayer remains in the same trade or business from or for which the intangible asset was developed or acquired.
- (iv) Under the functional test, income from intangible property is business income when the intangible property serves an operational function as opposed to solely an investment function. The relevant inquiry focuses on whether the property is or was held in furtherance of the taxpayer's trade or



business, that is, on the objective characteristics of the intangible property's use or acquisition and its relation to the taxpayer and the taxpayer's activities. The functional test is not satisfied where the holding of the property is limited to solely an investment function as is the case where the holding of the property is limited to mere financial betterment of the taxpayer in general.

- (v) If the property is or was held in furtherance of the taxpayer's trade or business beyond mere financial betterment, income from that property may be business income even though the actual transaction or activity involving the property that gives rise to the income does not occur in this state.
  - (vi) If with respect to an item of property a taxpayer takes a deduction from business income that is apportioned to this state, or includes the original cost in the property factor, it is presumed that the item of property is or was integral to the taxpayer's trade or business operations. No presumption arises from the absence of any of these actions.
  - (vii) Application of the functional test is generally unaffected by the form of the property, whether tangible or intangible, real or personal. Income arising from an intangible interest, for example, corporate stock or other intangible interest in a business or a group of assets, is business income when the intangible itself or the property underlying or associated with the intangible is or was an integral, functional, or operative component of the taxpayer's trade or business operations.
    - (A) Property that has been converted to nonbusiness use has lost its character as a business asset and is not subject to this Subsection (2)(c)(vii).
    - (B) While apportionment of income derived from transactions involving intangible property as business income may be supported by a finding that the issuer of the intangible property and the taxpayer are engaged in the same trade or business, that is, the same unitary business, establishment of that relationship is not the exclusive basis for concluding that the income is subject to apportionment.
    - (C) It is sufficient to support the finding of apportionable income if the holding of the intangible interest served an operational rather than an investment function of mere financial betterment.
- (d) Relationship of Transactional Test and Functional Tests to the United States Constitution.
- (i) The due process clause and the commerce clause of the United States Constitution restrict states from apportioning income as business income that has no rational relationship with the taxing state. The protection against extra-territorial state taxation afforded by these clauses is often described as the unitary business principle. The unitary business principle requires apportionable income to be derived from the same unitary business that is being conducted as least in part in the state.
  - (ii) The unitary business conducted in this state includes both a unitary business that the taxpayer alone may be conducting and a unitary business the taxpayer may conduct with any other person. Satisfaction of either the transactional test or the functional test complies with the unitary business principle, because each test requires that the transaction or activity, in the case of the transactional test, or the property, in the case of the functional



test, to be tied to the same trade or business that is conducted within the state. Determination of the scope of the unitary business conducted in the state is without regard to the extent to which this state requires or permits combined reporting.

(e) Business and Nonbusiness Income Application of Definitions...

- (ii) Gains or Losses From Sales of Assets. Gain or loss from the sale, exchange, or other disposition of real property or of tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in, or was otherwise included in the property factor of the taxpayer's trade or business. However, if the property was utilized for the production of nonbusiness income or it was previously included in the property factor and later removed from the property factor before its sale, exchange, or other disposition, the gain or loss constitutes nonbusiness income. See Subsection (8)(a)(ii).

(3) Unitary Business.

(a) Unitary Business Principle.

- (i) The Concept of a Unitary Business. A unitary business is a single economic enterprise that is made up of either separate parts of a single business entity or a group of business entities related through common ownership that are sufficiently interdependent, integrated and interrelated through their activities so as to provide a synergy and mutual benefit that produces a sharing or exchange of value among them and a significant flow of value to the separate parts. This flow of value to a business entity located in this state that comes from being part of a unitary business conducted both within and without the state is what provides the constitutional due process definite link and minimum connection necessary for the state to apportion business income of the unitary business, even if that income arises in part from activities conducted outside the state. The business income of the unitary business is then apportioned to this state using an apportionment percentage provided by Section 59-7-311. This sharing or exchange of value may also be described as requiring that the operation of one part of the business be dependent upon, or contribute to, the operation of another part of the business. Phrased in the disjunctive, the foregoing means that if the activities of one business either contribute to the activities of another business or are dependent upon the activities of another business, those businesses are part of a unitary business.
- (ii) Constitutional Requirement for a Unitary Business. The sharing or exchange of value described in Subsection (3)(a)(i) that defines the scope of a unitary business requires more than the mere flow of funds arising out of a passive investment or from the financial strength contributed by a distinct business undertaking that has no operational relationship to the unitary business. In this state, the unitary business principle shall be applied to the fullest extent allowed by the United States Constitution. The unitary business principle shall not be applied to result in the combination of business activities or entities under circumstances where, if it were adverse to the taxpayer, the combination of those activities or entities would not be allowed by the United States Constitution.
- (iii) Separate Trades or Businesses Conducted Within a Single Entity. A single entity may have more than one unitary business. In those cases, it is



necessary to determine the business, or apportionable, income attributable to each separate unitary business as well as its nonbusiness income, which is specifically allocated. The business income of each unitary business is then apportioned by a formula that takes into consideration the in-state and out-of-state factors that relate to the respective unitary business whose income is being apportioned.

(iv) Unitary Business Unaffected by Formal Business Organization. A unitary business may exist within a single business entity or among a group of business entities related through common ownership, as defined in Section 59-7-101.

(b) Determination of a Unitary Business.

(i) A unitary business is characterized by significant flows of value evidenced by factors such as those described in *Mobil Oil Corp. v. Vermont*, 445 US 425 (1980): functional integration, centralization of management, and economies of scale. These factors provide evidence of whether the business activities operate as an integrated whole or exhibit substantial mutual interdependence. Facts suggesting the presence of the factors mentioned above should be analyzed in combination for their cumulative effect and not in isolation. A particular characteristic of a business operation may be suggestive of one or more of the factors mentioned above.

(ii) Description and Illustration of Functional Integration, Centralization of Management, and Economies of Scale.

(A) Functional Integration. Functional integration refers to transfers between, or pooling among, business activities that significantly affect the operation of the business activities. Functional integration includes transfers or pooling with respect to the unitary business's products or services, technical information, marketing information, distribution systems, purchasing, and intangibles such as patents, trademarks, service marks, copyrights, trade secrets, know-how, formulas, and processes. There is no specific type of functional integration that must be present. The following is a list of examples of business operations that support the finding of functional integration. The order of the list does not establish a hierarchy of importance.

(I) Sales, Exchanges, or Transfers. Sales, exchanges, or transfers (collectively "sales") of products, services, and intangibles between business activities provide evidence of functional integration. The significance of the intercompany sales to the finding of functional integration will be affected by the character of what is sold and the percentage of total sales or purchases represented by the intercompany sales. For example, sales among business entities that are part of a vertically integrated unitary business are indicative of functional integration. Functional integration is not negated by the use of a readily determinable market price to affect the intercompany sales, because those sales can represent an assured market for the seller or an assured source of supply for the purchaser.

(II) Common Marketing. The sharing of common marketing features among business entities is an indication of functional integration when the marketing results in significant mutual advantage.



Common marketing exists when a substantial portion of the business entities' products, services, or intangibles are distributed or sold to a common customer, when the business entities use a common trade name or other common identification, or when the business entities seek to identify themselves to their customers as a member of the same enterprise. The use of a common advertising agency or a commonly owned or controlled in-house advertising office does not by itself establish common marketing that is suggestive of functional integration. That activity, however, is relevant to determining the existence of economies of scale and centralization of management.

- (III) Transfer or Pooling of Technical Information or Intellectual Property. Transfers or pooling of technical information or intellectual property, such as patents, copyrights, trademarks and service marks, trade secrets, processes or formulas, know-how, research, or development provide evidence of functional integration when the matter transferred is significant to the businesses' operations.
  - (IV) Common Distribution System. Use of a common distribution system by the business entities, under which inventory control and accounting, storage, trafficking, or transportation are controlled through a common network provides evidence of functional integration.
  - (V) Common Purchasing. Common purchasing of substantial quantities of products, services, or intangibles from the same source by the business entities, particularly where the purchasing results in significant cost savings and is significant to each entity's operations or sales, provides evidence of functional integration.
  - (VI) Common or Intercompany Financing. Significant common or intercompany financing, including the guarantee by, or the pledging of the credit of, one or more business entities for the benefit of another business entity or entities provides evidence of functional integration, if the financing activity serves an operational purpose of both borrower and lender. Lending that serves an investment purpose of the lender does not necessarily provide evidence of functional integration.
- (B) Centralization of Management. Centralization of management exists when directors, officers, and other management employees jointly participate in the management decisions that affect the respective business activities and that may also operate to the benefit of the entire economic enterprise. Centralization of management can exist whether the centralization is effected from a parent entity to a subsidiary entity, from a subsidiary entity to a parent entity, from one subsidiary entity to another, from one division within a single business entity to another division within a business entity, or from any combination of the foregoing. Centralization of management may exist even when day-to-day management responsibility and accountability has been decentralized, so long as the management has an ongoing operational role with respect to the business activities. An operational role may be effected through mandates, consensus building, or an overall operational



strategy of the business, or any other mechanism that establishes joint management.

- (I) Facts Providing Evidence of Centralization of Management. Evidence of centralization of management is provided when common officers participate in the decisions relating to the business operations of the different segments. Centralization of management may exist when management shares or applies knowledge and expertise among the parts of the business. Existence of common officers and directors, while relevant to a showing of centralization of management, does not alone provide evidence of centralization of management. Common officers are more likely to provide evidence of centralization of management than are common directors.
  - (II) Stewardship Distinguished. Centralized efforts to fulfill stewardship oversight are not evidence of centralization of management. Stewardship oversight consists of those activities that any owner would take to review the performance of or safeguard an investment. Stewardship oversight is distinguished from those activities that an owner may take to enhance value by integrating one or more significant operating aspects of one business activity with the other business activities of the owner. For example, implementing reporting requirements or mere approval of capital expenditures may evidence only stewardship oversight.
- (C) Economies of Scale. Economies of scale refers to a relation among and between business activities resulting in a significant decrease in the average per unit cost of operational or administrative functions due to the increase in operational size. Economies of scale may exist from the inherent cost savings that arise from the presence of functional integration or centralization of management. The following are examples of business operations that support the finding of economies of scale. The order of the list does not establish a hierarchy of importance.
- (I) Centralized Purchasing. Centralized purchasing designed to achieve savings due to the volume of purchases, the timing of purchases, or the interchangeability of purchased items among the parts of the business engaging in the purchasing provides evidence of economies of scale.
  - (II) Centralized Administrative Functions. The performance of traditional corporate administrative functions, such as legal services, payroll services, pension and other employee benefit administration, in common among the parts of the business may result in some degree of economies of scale. A business entity that secures savings in the performance of corporate administrative services due to its affiliation with other business entities that it would not otherwise reasonably be able to secure on its own because of its size, financial resources, or available market provides evidence of economies of scale.
- (c) Indicators of a Unitary Business.
- (i) Business activities that are in the same general line of business generally constitute a single unitary business, as for example, a multistate grocery chain.



- (ii) Business activities that are part of different steps in a vertically structured business almost always constitute a single unitary business. For example, a business engaged in the exploration, development, extraction, and processing of a natural resource and the subsequent sale of a product based upon the extracted natural resource, is engaged in a single unitary business, regardless of the fact that the various steps in the process are operated substantially independently of each other with only general supervision from the business's executive offices.
- (iii) Business activities that might otherwise be considered as part of more than one unitary business may constitute one unitary business when the factors outlined in Subsection (3)(b) are present. For example, some businesses conducting diverse lines of business may properly be considered as engaged in only one unitary business when the central executive officers are actively involved in the operations of the various business activities and there are centralized offices that perform for the business the normal matters a truly independent business would perform for itself, such as personnel, purchasing, advertising, or financing.

Section 721 of the Internal Revenue Code provides for the nonrecognition of gain or loss on the contribution of property in exchange for an interest in the partnership, as follows:

- (a) General rule  
No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.
- (b) Special rule  
Subsection (a) shall not apply to gain realized on a transfer of property to a partnership which would be treated as an investment company (within the meaning of section 351) if the partnership were incorporated.
- (c) Regulations relating to certain transfers to partnerships  
The Secretary may provide by regulations that subsection (a) shall not apply to gain realized on the transfer of property to a partnership if such gain, when recognized, will be includible in the gross income of a person other than a United States person.
- (d) Transfers of intangibles  
For regulatory authority to treat intangibles transferred to a partnership as sold, see section 367(d)(3).

Under Utah Code Ann. §59-1-1417, the burden of proof is generally on the petitioner, 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.
- (2) Regardless of whether a taxpayer has paid or remitted a tax, fee, or charge, the commission or a court considering a case involving the tax, fee, or charge shall:
- (a) construe a statute imposing the tax, fee, or charge strictly in favor of the taxpayer; and
  - (b) construe a statute providing an exemption from or credit against the tax, fee, or charge strictly against the taxpayer.

MATERIAL FACTS

1. The tax at issue is corporate franchise tax.
2. The Respondent (“Division”) issued a Statutory Notice to the Petitioner (“Taxpayer” or ) on August 15, 2016 for the 2011 and 2012 tax years. There was no audit tax due for the 2011 tax year. For the tax year, the Division assessed audit tax of and interest of through .<sup>3</sup>
3. The Taxpayer timely filed a Petition for Redetermination on , appealing the Division’s audit assessment.
4. was created in as a Delaware C-corporation that filed Federal Form 1120, U.S. Corporate Income Tax Return and Utah Form TC-20. Declaration).
5. is a corporation used as a “blocker” between unrelated investors and the operational company it invested in so that these investors are not subject to income tax filing requirements or other regulations in the states where the operational company operates. These investors commit money to a investment entity (a fund) with broadly defined investment parameters and specified terms. (Petitioner’s Response to 1st Set of Discovery).
6. Unrelated entities (state pension plans, colleges, insurance companies, etc.) provided funds to ; and was charged to invest those funds on a four to seven-year horizon. These investors and do not have any officers, board members, or employees in common. The investors and did not participate in any joint purchasing, selling, or other joint operations and did not buy or sell any products or services from each other. The investors and were independent from each other and there was no operational flow of value between the investors and as the investors and were connected only through the investors providing funds to invest. Declaration).

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<sup>3</sup> Interest continues to accrue on any unpaid balance.



7.                    was created as an investing entity. It had no property or payroll, and no independent business activity other than investing. (                    Declaration).
8.                    owned                    % of                    ; which owned                    % of                    ; both of which are Delaware limited partnerships. (Organization Chart, Exhibit A of Respondent's Amended Motion for Summary Judgment).
9. On                    ,                    (through                    ) entered into an agreement with                    to form                    (Partnership Agreement).
10.                    and                    each owned a 50% direct interest in                    for the tax years ending                    (                    Declaration).
11.                    operated an oil and natural gas pipeline and processing facility that engaged in oil and natural gas gathering, processing and treating in                    Utah (                    ) during the audit period. (                    Declaration,                    Press Release).
12. In the Partnership Agreement,                    (through                    ) warranted it had the power and authority to own, lease and operate its properties, rights or assets, and carry on its business. It warranted it had been afforded access and opportunity to inspect the "                    Assets" and that it inspected and reviewed all due diligence items made available by                    and that it was relying on representations, warranties, and covenants in the Agreement and its own inspections and investigation to satisfy itself as to the condition and suitability of the "                    Assets" and that it was an experienced and knowledgeable investor in the oil and gas business. (Partnership Agreement).
13. On                    ,                    entered into an agreement acquiring                    Company, which engaged in natural gas gathering and processing in                    . (                    Declaration).
14. In                    ,                    acquired                    in a transaction valued at                    . As part of that transaction,                    acquired all of the subsidiaries of                    , including                    which held a 50% interest in                    . (                    and                    Declarations).
15. Through negotiations with                    became aware that                    ,                    wanted to own 100% of, and eliminate any other equity interest in,                    . (                    and                    Declarations). This is evidenced by                    offer to acquire                    50% interest in                    . (                    Declaration).

16. To acquire [redacted] 50% ownership interest in [redacted], [redacted] offered [redacted] PTP Units. [redacted] accepted the [redacted] PTP units for its 50% ownership interest in [redacted] ( [redacted] Declaration).
17. As part of the negotiations with [redacted] considered both a cash sale and an exchange of PTP units in exchange for [redacted] interest in [redacted] and ultimately structured the transaction as an exchange of PTP units of [redacted] for the 50% [redacted] interest owned by [redacted] ( [redacted] Declarations).
18. The motivation for this structure was that [redacted] wanted to acquire [redacted] and preferred to use its PTP units as currency rather than spending the large amount of cash needed to execute the transaction. [redacted] Declaration).
19. On [redacted] contributed its 50% limited liability company interest in [redacted] to [redacted] in exchange for [redacted] PTP Units. ( [redacted] Declarations).
20. On [redacted] sold its [redacted] PTP units on the New York Stock Exchange for [redacted], resulting in the taxable gain. ( [redacted] Declarations).
21. [redacted] reported the transaction for federal income tax purposes as a non-recognition transaction resulting in a carryover basis for [redacted] under Internal Revenue Code (“IRC”) §721 and subsequently resulting in an IRC §708(b)(1)(B) termination of [redacted]. [redacted] was merged into [redacted] and ceased to exist as an independent entity. [redacted] did not recognize a gain on the contribution of its membership interest in [redacted]; the gain was deferred. Additionally, neither [redacted] nor [redacted] would be entitled to a stepped-up basis in [redacted] or the assets of [redacted] from the partnership interest transferred to [redacted] from [redacted] pursuant to IRC §723. Rather, [redacted] retained a carryover basis of the 50% [redacted] interest in the newly-acquired [redacted] PTP units under IRC §722. The IRS has not challenged the structure or reporting of the transaction as described above. ( [redacted] Declaration).
22. As a result of the transactions on [redacted] had a gain of [redacted] ( [redacted] portion of the gain was [redacted] ). ( [redacted] Declaration).
23. After the transactions were completed, the proceeds were distributed to [redacted] partners and further distributed to [redacted] partners’ partners and/or shareholders, which included [redacted] ( [redacted] Declaration).



24. received its share of the gain. The gain was distributed to the investors, and then ceased to exist and filed final returns for the tax year ending , 2012. ( Declaration).
25. When indirectly obtained the PTP units and later sold those units, the transactions were negotiated and consummated outside of Utah. ( Declaration).
26. and did not have any officers, board members, or employees in common with . and also did not participate in any joint purchasing, selling or other joint operations with and did not buy or sell any products or services from . ( Declaration).
27. and were independent from and there were no operations between and or and only connection to was through their ownership interest of PTP units. ( Declarations).
28. timely filed Utah Corporation Franchise or Income Tax Returns (“TC-20s”) for the tax years at issue. ( Declaration).
29. reported the gain as non-apportionable, nonbusiness income on its Utah return. ( Declarations).
30. In its original Utah returns for , reported its Utah apportionment fraction was 100%. ( Declaration).
31. On , filed a amended return. On that amended return, reported its apportionment fraction as %, which flowed up to based on activity. ( Declarations).
32. In Statement 3 of the amended return, calculated its Utah income to be a loss of if it were to categorize the gain as business income and apply the Utah apportionment factor of %. ( Declaration).
33. The Division did not accept the apportionment fraction. ( Declaration).
34. The Division has accepted the Utah apportionment fraction of % as set forth in amended return. This apportionment factor largely flowed up to based on ’s activity. The Division has agreed to apply that apportionment fraction to the Gain. ( Declaration).
35. reported substantially all of its income/loss as apportionable income/loss on Line 13 of Utah Form TC-65 for , and reported 100% Utah apportionment for and % for . ( Declaration).

36. \_\_\_\_\_, a partnership, reported substantially all income/loss as apportionable business income/loss on Line 13 and reported a 100% Utah apportionment fraction on its Utah Form TC-65 for \_\_\_\_\_ (Declaration).
37. \_\_\_\_\_, a partnership, reported all income/loss as apportionable business income/loss on Line 13 and reported a 100% Utah apportionment on its Utah Form TC-65 for \_\_\_\_\_. (Declaration).
38. In \_\_\_\_\_, \_\_\_\_\_ received a Schedule K-1 from \_\_\_\_\_ (\_\_\_\_\_ reflecting its share of the gain on its \_\_\_\_\_ % ownership interest in \_\_\_\_\_. (Declaration).
39. \_\_\_\_\_ has reported to \_\_\_\_\_ its Utah apportionment fraction for \_\_\_\_\_ as \_\_\_\_\_ % (Declaration, Post-hearing submission).
40. After the Division issued its Notice of Deficiency in this case, \_\_\_\_\_ filed an amended Utah tax return. \_\_\_\_\_ footnoted the \_\_\_\_\_ apportionment fraction for \_\_\_\_\_ of \_\_\_\_\_ to the Division so the Division could apply the \_\_\_\_\_ % apportionment fraction to the gain on audit. (Declaration).
41. \_\_\_\_\_ had four board of director positions. The owners of \_\_\_\_\_ shared board representation based on their respective ownership interests. \_\_\_\_\_ appointed two board members to oversee the investment, and \_\_\_\_\_ appointed two members. While neither group controlled the board, \_\_\_\_\_ controlled the operations of \_\_\_\_\_ as it had extensive oil and gas experience and \_\_\_\_\_ and \_\_\_\_\_, as investment entities, did not. (Declaration).
42. The chairman of the board was appointed by \_\_\_\_\_, and \_\_\_\_\_ entered into a Management Services Agreement with \_\_\_\_\_ wherein \_\_\_\_\_ managed and handled all day-to-day and other operations of \_\_\_\_\_. Additionally the officers of \_\_\_\_\_ were appointed by \_\_\_\_\_. None of the officers or employees of \_\_\_\_\_ were affiliated with \_\_\_\_\_ or any \_\_\_\_\_ entities. (Declaration).
43. Other than the two board members appointed by \_\_\_\_\_, \_\_\_\_\_ (or any related entity) and \_\_\_\_\_ (or \_\_\_\_\_ and its owners) did not have any officers, board members, or employees in common \_\_\_\_\_ (or any related entity) and \_\_\_\_\_ and its owners) did not participate in any joint purchasing, selling or other joint operations and did not buy or sell any products or services from each other. \_\_\_\_\_ were independent from each other and, with the exception of the two shared board members, there was no operational flow of value between \_\_\_\_\_ as \_\_\_\_\_ and \_\_\_\_\_ were connected to \_\_\_\_\_ only as investors in \_\_\_\_\_. (Declaration).



ARGUMENTS

The Taxpayer's representative argued that there are three issues for the Commission to consider. He stated that if the Taxpayer prevails on any of the arguments, the audit assessment should be abated. The Taxpayer's representative stated that the first issue is determining the proper apportionment factor, assuming that the gain is "business income." He stated that the second issue is whether Utah has constitutional authority to apportion the income. The Taxpayer's representative stated that the third issue is whether Utah law allows the Division to tax the gain.

In its Memorandum, argued that if the Commission finds the gain from the sale is apportionable business income, the law requires the Division to use 's Utah apportionment factor of % to apportion the gain, rather than the apportionment factor. argued that the apportionment factor is relevant for flowing-up and apportioning the 2012 net operating loss; however, it maintains that the gain to should be apportioned using the apportionment factor because it was the sale of the PTP units that gave rise to the gain and each transaction was meaningful and necessary.

stated that the apportionment factor is appropriate for operating income, but maintains that the gain is separate, and separation between the two streams of income is required. The Taxpayer's representative stated that the transfer of PTP units for 's 50% interest in was nontaxable as a §721 transaction. He argued that the transaction was not set out in this way for tax avoidance, but because would not pay cash. The Taxpayer's representative stated that bore the risk that the value of the units would decrease between the time of negotiation and the transfer on June 4, 2012. Additionally, he noted that when sold the PTP units on the stock exchange, it was considered a "block trade" at a % discount. The Taxpayer's representative argued that lost money because of the way wanted to structure the transaction, and would have preferred cash. It is position that the gain was generated by the taxable sale of the partnership interest. argued that if the apportionment factor were used, it would ignore the separate and necessary transaction that resulted in the acquisition and sale of the PTP units. maintains that to ignore this step in the transaction is inappropriate under established law.

In its Memorandum, cited to *Esmark v. Comm'ner of Internal Rev.*, 90 T.C. 171 (U.S. Tax Ct. 1988) and *Turner Broadcasting Sys. Inc. v. Comm'ner of Internal Rev.*, 111 T.C. 315 (U.S. Tax Ct. 1998), which establish that each separate, necessary, and meaningful step of a transaction must be respected and cannot be collapsed through the step-transaction doctrine, the substance over form doctrine, or any other legal theory. argued that Utah law expressly incorporates federal law in

determining taxable income, citing to Utah Code Ann. §59-7-104 and §59-7-101, and thus the referenced cases and IRS guidance are persuasive authority. In its Memorandum, [redacted] noted that prior Commission decisions recognized and applied the legal concept that transactions with “economic substance” and/or “business purpose” must be respected.

[redacted] argued in its Memorandum that under IRS Rev. Ruling 79-250, each meaningful step of a transaction must be respected. [redacted] maintained that in the instant case, there was a non-taxable exchange of the [redacted] partnership interest for [redacted] PTP units, and then the subsequent sale of those units by [redacted] that resulted in the gain. It is [redacted]’s position that the first transaction occurred because [redacted] wanted to acquire [redacted], but did not want to pay cash for it, and that it was a separate and necessary transaction indeed for an important, meaningful, and valid business purpose.

[redacted] argued that this exchange must be respected under *Esmark, Turner*, and IRS Rev. Rul. 79-250.

It is [redacted]’s position that it was the second transaction, the sale of the [redacted] PTP units that created the gain. [redacted] argued that to the extent that gain is considered business income, it is the [redacted] apportionment factor that must be applied to the gain. The Taxpayer’s representative noted that for 2012, [redacted] issued a K-1 to [redacted] for the PTP units. He stated that the [redacted] K-1 reports the PTP units sold, but not the day-to-day income from [redacted].

i. The Taxpayer’s representative explained that the IRS does not require the day-to-day income to be reported. He stated that all sales that occur each month are treated as having occurred on the last day of the previous month, which was May 31, 2012 in the instant case.

The Taxpayer’s representative argued that constitutionally, Utah cannot tax the gain because there is no unitary relationship. In its Memorandum, [redacted] noted that the U.S. Supreme Court has held that where an out of state taxpayer sells an asset, and that asset is “another business” that operates in a state, that state has constitutional authority to apportion the gain from that sale only if the out-of-state taxpayer and the in-state business share a “unitary relationship” based on “functional integration, centralized management, and economies of scale.”<sup>4</sup>

The Taxpayer’s representative maintained that [redacted] does not share a unitary relationship with [redacted]. In its Memorandum, the Taxpayer argued there was no functional integration or economies of scale between [redacted] and [redacted]. The two entities did not do business together, and thus did not participate in any joint purchasing, selling, or other joint operations, and they did not buy or sell products or services from each other. [redacted] further argued that there was no

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<sup>4</sup> *MeadWestvaco Corp. ex rel. Mead Corp. v. Ill. Dep’t of Revenue*, 533 U.S. 16, 30 (2008); *Allied-Signal, Inc. v. Dir. Div. of Taxation*, 504 U.S. 768, 789 (1992); *Container Corp. of Am. v. Franchise Tax Board*, 463 U.S. 159, 179 (1983); *F.W. Woolworth v. Taxation and Revenue Dept. of N.M.*, 458 U.S. 354, 364 (1982); *ASARCO, Inc. v. Idaho St. Tax Comm’n*, 458 U.S. 307, 326 (1982).



centralized management between \_\_\_\_\_ and \_\_\_\_\_, as \_\_\_\_\_ and \_\_\_\_\_ did not have any officers, board members, or employees in common with \_\_\_\_\_. Finally, \_\_\_\_\_ noted that it was independent from \_\_\_\_\_ and there was no operational flow of value between \_\_\_\_\_ and \_\_\_\_\_ and \_\_\_\_\_ and \_\_\_\_\_ were connected to \_\_\_\_\_ only as investors in \_\_\_\_\_.

The Taxpayer's representative stated that in four separate cases, *ASARCO*, *Woolworth*, *Allied-Signal*, and *Mead*, the Supreme Court of the United States held that states are prohibited from apportioning similar gains from the sale of a business because the taxpayer and the sold business were not unitary. He argued that in each of the four cases, the taxpayer had even more of a connection with the businesses being sold than in the instant case. The Taxpayer's representative noted that the Division did not argue that the Taxpayer was unitary with \_\_\_\_\_ or \_\_\_\_\_.

The Taxpayer's representative stated that in Appeal No. 99-0652, the Commission ruled consistent with the Supreme Court decisions in *ASARCO*, *Woolworth*, and *Mead*. In its Memorandum, the Taxpayer explained that the taxpayer in Appeal No. 99-0652 acquired and sold a 22% ownership interest in an entity in a similar line of business. The two entities agreed to "exchange information on management systems, vendor pricing and the best stocking items, and assist each other in obtaining discounted prices from vendors or selling merchandise to each other at cost." Additionally, the taxpayer's CEO held a position on the board of directors for the company being sold. The Commission concluded in Appeal No. 99-0652 that comparing the ties between the taxpayer and the sold business, and the facts of the *ASARCO*, *Woolworth*, and *Mead* cases, that the facts aligned with those in *Allied Signal*, and the Division was prohibited from apportioning the gain to Utah.

The Taxpayer's representative stated that in Appeal Nos. 05-0792 and 11-2285, the Commission found that the operational function test was applicable. He argued that the operational function test does not apply when the asset in question is another business. The Taxpayer's representative noted that the facts of Appeal Nos. 05-0792 and 11-2285 are not clear from the redacted decisions, and neither of the decisions addressed the *Mead* decision in full. He argued that in *Mead*, the Court rejected the operational function argument and stated that it was not intended to modify the unitary business principle.

The Taxpayer's representative argued that the facts do not support a finding that \_\_\_\_\_ and \_\_\_\_\_ are unitary. He stated that the connections in the instant case are far less than those in the other cases, and argued that Utah is constitutionally prohibited under the decisions in *ASARCO*, *Allied-Signal*, *Woolworth*, and *Mead* from apportioning the gain from the sale of the partnership interest. The Taxpayer's representative argued that under the Division's approach, the gain in all four of the aforementioned cases would have been apportionable. He stated that the Division had

argued in its Memorandum that the unitary approach is not applicable because the instant case is not combining corporations. He argued that while the unitary test does apply in forced combinations, it also applies in the instant case. The Taxpayer's representative stated that in *Mead*, the Court noted that if there is nexus with a state, the inquiry shifts from whether to what can be taxed. He stated that when another "business" has been sold, the unitary test is the applicable standard under *Mead*.

The Taxpayer's representative stated that the final argument is that under the plain language of the Utah code, the gain is not apportionable business income. It is [redacted] position that the gain was the result of an extraordinary event that was not part of [redacted] regular trade or business and thus does not constitute "business income" under Utah Code Ann. 59-7-302(1). In its Memorandum,

[redacted] explained that under Utah law, the income of a pass-through entity is characterized as business income or nonbusiness income, and then passed through to shareholders and taxed. [redacted] noted that "nonbusiness income" is defined as "all income other than business income" in Utah Code Ann. §59-7-302(1)(h), and that "business income" is defined as "[i]ncome 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."

[redacted] argued, in its Memorandum, that in order to constitute "business income" the acquisition, management, and disposition must constitute "integral parts of the taxpayer's regular trade or business operations."

[redacted] argued that it is a holding company, and as such did not have a regular business operation and that an extraordinary event does not constitute an integral part of the taxpayer's regular trade or business income. The Taxpayer's representative stated that in this case, the

[redacted] PTP units were sold. He argued that the [redacted] PTP units were never used in the Taxpayer's trade or business. [redacted] maintains that the sale of its interest in [redacted] was part of an extraordinary event, in which [redacted] and [redacted] ceased to exist. [redacted] noted that it did not reinvest the proceeds in other oil or gas assets, and the sale did not benefit [redacted]'s regular trade or business in any way.

The Taxpayer's representative also argued that if the Commission concludes the statute is ambiguous, that the ambiguity must be construed in favor of the taxpayer. In its Memorandum,

[redacted] noted that in [redacted], a Commissioner of the Utah State Tax Commission at the time, stated that he believed the statute was ambiguous and did not give appropriate guidance to taxpayers doing business in Utah. The Taxpayer's representative argued that it is difficult to say that the definition of nonbusiness income is not ambiguous.



It was the Division's position that [redacted] gain is taxable Utah business income. The Division's representative noted that [redacted] was formed as a C-corporation, and for most of its existence, its business was to hold only one asset, which was a partnership interest in [redacted]. She stated that [redacted] was the source of all operating income that flowed up to the Taxpayer through [redacted] and [redacted]. The Division's representative argued that likewise, when [redacted] sold the [redacted] interest, that the gain on the sale flowed up to [redacted]. She stated that the tax is ultimately imposed on pass-through entity taxpayers, and that as a C-corporation, [redacted] is the entity that is taxed. The Division's representative stated that the income realized by [redacted]'s sale of its interest in [redacted] flowed up to [redacted] as if [redacted] had sold [redacted] itself. She noted that under Utah Code Ann. § 59-10-1404, regardless of whether, or how income is characterized for federal tax purposes, the item of income is from the same source and incurred in the same manner as it was for the source of the income.

The Division's representative stated that Rule R865-6F-8(11)(e) addresses apportionment of partnership income, and that all income or loss is to be included and apportioned according to a three-factor formula of property, payroll, and sales. She argued that under Rule 8, [redacted]'s apportionment factors flow up to [redacted] to the extent of its ownership of [redacted]. In turn, the apportionment factors reported by [redacted] from [redacted] are the exclusive factors of [redacted], and they flow up to the extent of [redacted] ownership of [redacted]. It was the Division's position that because neither [redacted] nor [redacted] had any property, payroll or sales factors other than the factors flowing up from their ownership of [redacted], [redacted]'s factors reflect the Utah property, payroll, and sales of [redacted]'s operations in Utah.

It was the Division's position that the gain from the sale was part of [redacted] regular trade or business so that it constituted business income taxable to Utah. The Division's representative stated that business income is apportioned to each state through a three-factor formula based on the taxpayer's property, payroll and sales in a particular state in comparison to its total property, payroll and sales everywhere. In its Memorandum, the Division noted that under Utah Code Ann. §59-7-302(1)(d), "business income" is defined as "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 constitute integral parts of the taxpayer's regular trade or business operations." Under Utah Code Ann. §59-7-302(1)(b), "nonbusiness income" is defined as "all income other than business income."

The Division's representative argued that the gain at issue meets the functional test for business income. In its Memorandum, the Division argued there is a strong presumption that income is business

income and cited Rule R865-9F-8(2)(a), which provides: “[a]n item of income is classified as business income if it falls within the definition of business income. An item of income is nonbusiness income only if it does not meet the definitional requirements for being classified as business income.” The Division’s representative explained that Rule 8 sets forth the definition of business income in Utah Code Ann. §59-7-302(1)(d) and includes two separate tests: the “transactional test” and the “functional test.” She stated that Subsection (2)(c) of Rule 8, the functional test, includes “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 Division’s representative stated that [redacted]’s trade or business activity consisted of acquiring, managing, and disposing of a partnership interest in [redacted], meeting the definitions of those terms provided in Subsection (2)(c) of Rule 8.

The Division’s representative stated that “acquisition” is the act of obtaining an interest in property. She stated that [redacted] was formed solely to hold the interest in [redacted]. The Division’s representative stated that shortly after [redacted] was formed, it acquired [redacted], through [redacted], by entering into a Contribution Agreement with [redacted] in [redacted]. She stated that “management” is oversight, direction, or control. The Division’s representative stated that [redacted], through [redacted], appointed half of the [redacted] board, participated with other partnership members in [redacted] to acquire [redacted], and determined whether to continue to hold the [redacted] interest. She stated that “disposition” is the act or power of relinquishing an interest or control of a property. The Division’s representative noted that from its inception, [redacted] planned to dispose of its interest. She stated that as its only asset, the interest in [redacted] was integral to [redacted]’s business. The Division’s representative noted that [redacted] issued a press release that it was selling, and [redacted] was purchasing, [redacted].

In its Memorandum, the Division argued that the Commission previously addressed a nearly identical situation in Appeal No. 11-2285, and ruled that the gain at issue in that case was business income under the functional test. The Division noted that like the instant appeal, the taxpayer in Appeal No. 11-2285 was a corporation whose only business activity was holding a limited partnership interest in an intermediary partnership, and the only business activity of that intermediary partnership was holding an interest in an operating entity that conducted business partly in Utah. In that case, the taxpayer had no control over the decision to sell the operating entity interest. The Division noted that the Commission ruled the gain from the sale constituted business income under the functional test because the taxpayer had a trade or business, which was holding its one interest, and so the gain from the sale of that interest constituted business income under the functional test. The Division noted that [redacted] has argued it is a holding company that has no trade or business. The Division maintains that [redacted] is a business



entity and that the statutes and rules at issue, as well as the UDITPA provisions they incorporate, anticipate that business entities, such as \_\_\_\_\_, are engaged in trade or business operations. The Division noted that the Commission addressed the same argument in Appeal No. 11-2285, and reasoned that “[t]his argument ignores the fact that the taxpayer and (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.” The Division’s representative stated that Utah does not recognize a liquidation exception in the functional test. She stated that if the property is or was used in business operations, the gain is business income.

In its Memorandum, the Division pointed out that since 2007, several other courts have agreed that the liquidation of a business creates business income. The Division cited to *Harris Corp. v. Arizona Dept. of Rev.*, 213 Ariz. 377, 384 (2013)<sup>5</sup>, which held that “a liquidation exception cannot be reconciled with the functional test.” The Division noted that the Court in *Harris Corp.* reasoned that adoption of a liquidation exception would result in a lack of symmetry, where assets would be depreciated and deducted, reducing business income prior to disposition of the assets, but upon sale gain would become nonbusiness income. The Court further noted that a single state might capture all of the income, while states that had allowed expenses on an apportioned basis would shoulder the deductions. The Division argued that would be the result in the instant case if \_\_\_\_\_ prevails on its argument that the gain is nonbusiness income. The Division noted that all of the business income and loss of \_\_\_\_\_ flowed up to its partners, including \_\_\_\_\_. The Division noted that if \_\_\_\_\_ gain is treated as nonbusiness income, then the gain would not be taxable to Utah. The Division stated that it would also not be taxable in Delaware, the state of corporate domicile, or New York, where the Taxpayer has its address for corporate tax filing. The Division’s representative stated that Utah shouldered the expenses and deductions, bore the ecological burdens, and provided the infrastructure to allow the business to operate, but would get nothing from its sale under \_\_\_\_\_ argument. However, if the gain is deemed business income, then the gain will be apportioned to Utah based on \_\_\_\_\_ apportionment factors, regardless of commercial domicile.

The Division’s representative argued that the Division correctly applied the apportionment fraction of \_\_\_\_\_ %, and that \_\_\_\_\_ position that it can use \_\_\_\_\_ apportionment fraction of \_\_\_\_\_ % is without merit. The Division maintains the apportionment fraction of \_\_\_\_\_ % is

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<sup>5</sup> The Division noted that in *First Data Corp. v. Arizona Dept. of Rev.*, 313 P.3d 548, 552 (AZ 2013), the Court also rejected the liquidation exception. Additionally, the Division noted that Oregon in *Crystal Communications Inc. v. Dept. of Revenue*, No. 4769, 2010 WL 287462 (Or. Tax Ct. July 19, 2010), 297 P.3d 1256 (2013) also noted the lack of symmetry in the liquidation exception. Also, the Division pointed out that California rejected the liquidation exception in *Jim Beam Brands Co. v. California Franchise Tax Bd.*, 34 Cal Rptr. 2d 874 (CA 1<sup>st</sup> Dist. 2005).

appropriate because the gain was generated by the sale of a Utah partnership and no Utah statute or rule supports the use of an apportionment fraction other than the taxpayer's own.

The Division argued that the gain at issue resulted from the sale of \_\_\_\_\_, a Utah partnership, and not from the sale of the \_\_\_\_\_ PTP units. In its Memorandum, the Division noted that the PTP units did not increase in value between \_\_\_\_\_ through \_\_\_\_\_, obtained the PTP units from \_\_\_\_\_ on \_\_\_\_\_, as consideration for the \_\_\_\_\_ interest, and sold them on \_\_\_\_\_. The gain recognized on the tax return was due to the increase in value of \_\_\_\_\_, not the form of compensation that was used to make the purchase, as noted on \_\_\_\_\_'s federal tax return. The Division's representative noted that \_\_\_\_\_ reported the gain from the sale in \_\_\_\_\_. She stated that the return identifies the item sold as \_\_\_\_\_ that was acquired in \_\_\_\_\_ and sold on \_\_\_\_\_. The return indicates ordinary gain and that \_\_\_\_\_ had to recapture depreciation. The Division's representative argued that the depreciation and gain were passed through to \_\_\_\_\_'s partners, including the Taxpayer.

The Division's representative argued that there is no basis in Utah law for apportionment position. She stated that the gain at issue is Taxpayer's income through \_\_\_\_\_. The Division's representative stated that the gain is not \_\_\_\_\_'s gain or income, and that there is no statutory basis for using \_\_\_\_\_ apportionment fraction. In the Division's Memorandum, the Division explained that income or loss generated by a partnership is reported to the corporate partner on Schedule K-1 for inclusion in the corporation's income on the Federal Form 1120. The Division noted that the Utah Form TC-20 begins with the income on Federal Form 1120, and thus the partnership income is included in the Utah income. The Division noted that under Rule R865-9F-8(11)(e), when a corporation's Utah TC-20 return includes income or loss generated by a partnership the apportionment factors of the partnership are included "on the basis of the corporation's ownership interest" in addition to the corporation's own factors.

The Division's representative argued that IRC §721 analysis is not relevant for purposes of treatment of the gain. She stated that neither \_\_\_\_\_ nor \_\_\_\_\_ sought to partner with \_\_\_\_\_. The Division's representative stated that it is evident through the documents provided that the intent was to cash out \_\_\_\_\_'s interest in \_\_\_\_\_. She stated that \_\_\_\_\_'s return correctly reported the gain coming from the disposition of \_\_\_\_\_, not the \_\_\_\_\_ PTP units.

In its Memorandum, the Division noted that IRC §721(a) provides, "No gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership." The Division went on to explain that the basis of property contributed to a partnership by partners is preserved so that unrecognized gain or loss is



deferred until it is realized by the partnership. It is the Division's position that while [redacted] did not receive cash until the following day when the PTP units were sold, the 50% interest in [redacted] was not contributed to form a partnership with [redacted]. The Division noted that in the Purchase Agreement, the [redacted] PTP units were consideration for the sale of the assets, [redacted], and were given in lieu of cash at the request of [redacted]. The Division cited to *Superior Trading, LLC v. C.I.R.*, 137 T.C. 70, 82 (2011), which found that if a taxpayer "never considered itself a partner in a joint enterprise...it c[an] not have contributed [property] to a partnership within the meaning of section 721(a)." The Division also cited to *Russian Recovery Fund Ltd. v. United States*, 122 Fed. Ct. 600, 617 (2015), which found that a taxpayer did not contribute property "in exchange for an interest in a partnership" pursuant to IRC §721(a) since the taxpayer "had no real intention of becoming a partner" evidenced by the taxpayer wanting to "[c]ash out its position...as quickly as possible." The Division also cited to *Comm'r v. Culbertson*, 337 U.S. 733, 742 (1949) and *Wilkinson v. Comm'r*, 49 T.C. 4, 12 (1967) in support of looking at the facts and determining whether the parties truly intended to "join together."

It was the Division's position that the transfer of [redacted]'s interest in exchange for [redacted] PTP units is correctly treated as a sale of property. In its Memorandum, the Division noted that under IRC §707(a)(2)(b) "partnership contributions may be recharacterized as sales if the contributing partner receives distributions from the partnerships that are, in effect, consideration for the contributed property." The Division noted that 26 C.F.R. §1.707-3(c) states: "if within a two-year period a partner transfers property to a partnership and the partnership transfers money or other consideration to the partner, the transfers are presumed to be a sale of the property to the partnership unless the facts and circumstances clearly establish that the transfers do not constitute a sale." The Division stated that the PTP units were consideration for [redacted] interest in [redacted], and the number of units received was calculated to reflect the value of [redacted] interest in [redacted]. The Division noted that the Agreement between [redacted] and [redacted] described the transaction as a "purchase," that [redacted] is the "Seller" and [redacted] is the "Buyer," and the PTP units are the "Seller consideration." The Division stated that the Agreement also included language that "Seller hereby agrees to sell and assign to Buyer, and Buyer hereby agrees to purchase and assume from Seller, the Seller Interests...in consideration for the issuance by Buyer to the Seller of a number of validly issued, fully paid, and non-assessable Common Units." The Division argued that where the consideration received was transferred within a two-year period, the transfers are presumed to be a sale of property. The Division stated that the property sold was [redacted] interest in [redacted], and the sale generated the gain reflected on [redacted]'s return. The Division maintains the gain was created by the sale of [redacted] on [redacted] and

the cashing in of the PTP units on [redacted] was within two years, and is therefore viewed as the sale of the property interest ([redacted]).

The Division's representative stated that the Division is not relying on the step-transaction doctrine. She stated that a taxpayer's business income is always apportioned using a taxpayer's own apportionment fraction. The Division's representative stated that because neither the Taxpayer nor [redacted] had any of their own property, payroll, or sales, the factors to be used are from [redacted]. She stated that regardless of how it was generated, the gain is [redacted]'s gain.

In its Memorandum, the Division argued that under the step-transaction doctrine, the transaction between [redacted] and [redacted] should be consolidated into a single taxable event. The Division noted that the IRS and other taxing jurisdictions will treat purportedly separate steps in a transaction as integrated in certain situations. The Division cited to *Minn. Tea Co.*, 302 U.S. at 613-614 and *Del Commercial Properties Inc. v. Comm'r*, 251 F.3d 210 (D.C. 2001) to support its position that the plan may be consolidated or disregarded if the taxpayer could have accomplished the same result more directly and the plan merely serves as a tax avoidance device. The Division wrote that the step transaction doctrine "treats the steps in a series of formally separate but related transactions involving the transfer of property as a single transaction, if all the steps are substantially linked. Rather than viewing each step as an isolated incident, the steps are viewed together as components of an overall plan."<sup>6</sup> The Division noted that there are three tests for the step transaction doctrine, and noted that the Courts have determined that only one of the tests needs to be satisfied in order for the step transaction doctrine to operate.

In its Memorandum, the Division contended that even if [redacted]'s actions qualify as a Section 721 transaction, that the two steps should be viewed as one substantive event, the sale of [redacted]. The Division noted that the Court in *Superior Trading* found that where the Court did not "invent new steps or reorder the chronological sequence of actual steps"... that *Esmark* and similar cases did not preclude the Tax Court from applying the step transaction doctrine. The Division argued it is not inventing new steps, or reordering the chronological sequence of events, but is merely characterizing the transaction in a manner that accurately reflects its true substance. The Division noted that it is following the chain of events that [redacted] has laid out. [redacted] transferred its interest in [redacted] to [redacted] in exchange for [redacted] PTP units. The PTP units were weighted to reflect the value of [redacted]'s interest in [redacted]. The day after receiving the PTP units, they were sold on the New York stock exchange. The Division noted that there is no dispute as to the order of events, nor whether certain steps did or did not take place. The Division stated that the parties merely disagree about the characterization of the events. The Division argued that since a recharacterization that accurately reflects the substance of the

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<sup>6</sup> *Green v. U.S.*, 13 F.3d 577,583 (2d Cir. 1994).



transaction is not an act of “creation” the Division is not barred from employing the step transaction doctrine.<sup>7</sup>

The Division’s representative argued that \_\_\_\_\_’s unitary arguments are misplaced, as the Division is not attempting to combine the income of corporations. In its Memorandum, the Division argued that in filing Utah returns, \_\_\_\_\_ acknowledged that it had nexus with Utah for tax filing purposes, and that it was subject to Utah tax on its distributive share of its partnership income. The Division’s representative stated that the income is not from the holding of interest in other corporations, but flows through the partnerships. She stated that the Division is not seeking to combine \_\_\_\_\_ with \_\_\_\_\_ or with \_\_\_\_\_ in order to tax \_\_\_\_\_’s portion of the income from the gain. Rather, the Division is seeking to tax only the income of \_\_\_\_\_. The Division’s representative argued that the combination of entities is not required or applicable.

The Division’s representative argued that the gain from the sale of \_\_\_\_\_ is taxable income to \_\_\_\_\_ because it is business income received by \_\_\_\_\_ from the flow up of that gain. \_\_\_\_\_ owns \_\_\_\_\_ % of \_\_\_\_\_ through two partnerships. It is the Division’s position that any unitary combination is not necessary, and the case law relied upon by \_\_\_\_\_ is inapplicable. In its Memorandum, the Division argued that the U.S. Supreme Court cases that \_\_\_\_\_ relies upon, as well as Appeal No. 99-0652, do not deal with the sale of partnerships, but rather with corporations or divisions of corporations, which are taxable entities, so that unitary combination is necessary to tax an ownership interest. The Division noted that in those cases, the corporation making the sale, and the corporate interest sold each had separate business operations with their own apportionment factors, and are unlike the instant case. The Division noted that in the instant case, the only operation generating apportionment existed with the sold partnership interest, and the selling entity had no operations of its own other than holding the partnership interest.

#### DISCUSSION

A motion for summary judgment under Rule 56 of the Utah Rules of Civil Procedure is appropriate in this matter. There are no genuine disputes as to any material facts. The Taxpayer has submitted a Motion for Summary Judgment. As explained in detail below, the Commission finds the Taxpayer is entitled to judgment as a matter of law in this case.

Utah has adopted the Uniform Division of Income for Tax Purposes Act (“UDITPA”) provisions to determine the portion of income from a multi-state business that is subject to Utah tax. The provisions are found in Utah Code Ann. §59-7-302 through §59-7-321, and provide the basis for determining

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<sup>7</sup> *Associated Wholesale Grocers, Inc. v. U.S.*, 927 F.2d 1517, 1527 (10<sup>th</sup> Cir. 1991) and *Kuper v. Comm’r*, 533 F.2d 152, 158 (5<sup>th</sup> Cir. 1976).

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.

“Business income” is defined in Utah Code Ann. §59-7-302 as follows:

“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 operation.

Business income is commonly apportioned to each state through the use of a three-factor formula that is based on the taxpayer’s property, payroll, and sales in a particular state in comparison to its total property, payroll, and sales.

Rule R865-6F-8(1)(e) provides, “[b]usiness income’ means income of any type or class, and from any activity that meets the relationship described in Subsection (2)(b), the transactional test, or Subsection (2)(c), the functional test.” Under Subsection (2)(b) of Rule 8, the transactional test concerns income “[a]rising from transactions and activity in the regular course of the taxpayer’s trade or business.” The functional test found in Subsection (2)(c) of Rule 8 concerns “[i]ncome 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 previously determined that only one of the two tests must be met in order to satisfy the definition of “business income.”<sup>8</sup>

In Appeal Nos. 05-0792 and 11-2285, the Commission found that the sale of an asset may generate apportionable business income under the functional test found in UDITPA. In doing so, the Commission reasoned that the acquisition, management, and disposition of the asset constituted an integral part of the taxpayer’s business, even though there was no unitary relationship.

In Appeal No. 05-0792, the Commission reasoned that the U.S. Supreme Court has determined that an asset may serve an operational function instead of an investment function. The Commission relied on *Allied-Signal v. Dir., Div. of Taxation*, 504 U.S. 768 (1992). The Commission specifically noted that the Court stated in *Allied-Signal* that situations could occur in which UDITPA apportionment might be constitutional even though “the payee and the payor [were] not...engaged in the same unitary business” if an asset served an “operational” rather than an “investment” function in that business. The Commission noted that the U.S. Supreme Court had reconfirmed its *Allied-Signal* position in *Mead*, as follows:

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 part of a taxpayer’s unitary business even if what we may term a “unitary relationship” does not exist between the “payor and payee...”

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<sup>8</sup> See Appeal Nos. 11-2285 and 09-3091.



[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.

The Commission used the same reasoning in Appeal No. 11-2285. Like the instant case, the taxpayer in Appeal No. 11-2285 and another entity were created for the purpose of investing in a third entity and then realize a profit from it. The Commission found those activities constituted their regular trade or business operations, concluding that the acquisition and disposition of an asset constituted an integral part of the taxpayer’s regular trade or business operations and served an operational function. The Commission concluded that the income from the sale of the entity qualified as business income under the functional test, found in Rule 8(1)(c)(ii), which 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.”

The gain at issue in the instant case is “business income” under the functional test. The Taxpayer’s trade or business was to purchase an interest, through various partnerships, in \_\_\_\_\_, and then hold it in anticipation of selling it for a profit. Additionally, the Taxpayer included the gains and losses generated by the interest in \_\_\_\_\_ as apportionable business income prior to the sale. This supports a finding that, like the taxpayer in Appeal No. 11-2285, the gain would be business income under the functional test.

The Commission notes that the instant case is distinguishable from Appeal No. 11-2285<sup>9</sup>, as it involves a §721 transaction, rather than a cash sale. Under IRC §721, “[n]o gain or loss shall be recognized to a partnership or to any of its partners in the case of a contribution of property to the partnership in exchange for an interest in the partnership.” The Division argued that §707 of the Internal Revenue Code was applicable, and that the transaction was taxable. Section 707(a)(2)(B) provides:

(B) Treatment of certain property transfers

If—

- (i) there is a direct or indirect transfer of money or other property by a partner to a partnership,
- (ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and

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<sup>9</sup> It appears that the Commission’s decision in Appeal No. 11-2285 is inconsistent with the U.S. Supreme Court’s decision in *MeadWestvaco v. Illinois Dep’t of Revenue*, 2008 U.S. Lexis 3473 (2008). However, that facts of that case are not before the Commission in this matter, and the Commission declines to analyze the decision in Appeal No. 11-2285 further.

(iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property, such transfers shall be treated either as a transaction described in paragraph (1) or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.

The Commission is not persuaded that the transaction was a “disguised sale” under Section 707 of the IRC. transferred its interest in to in exchange for PTP units. Though sold the PTP units the next day on the stock exchange, the structure of the transaction does not appear to have been for tax avoidance purposes. would not pay cash. Further, bore the risk of the value of the PTP units decreasing from the time of negotiations to the date of the exchange, and actually did lose money because the sale of the PTP units was considered a block trade.

The Commission has determined that the gain was “business income” under the functional test. Rule R865-9F-8(d)(ii) provides, in part, “[s]atisfaction of either the transactional test or the functional test complies with the unitary business principle, because each test requires that the transaction or activity, in the case of the transactional test, or the property, in the case of the functional test, be tied to the same trade or business that is conducted within the state.” The Commission determined in Subsection (3)(a)(ii) of Rule 8 that “[t]he unitary business principle shall be applied to the fullest extent allowed by the United States Constitution.” However, the Commission also noted that “[t]he unitary business principle shall not be applied to result in the combination of business activities or entities under circumstances where, if it were adverse to the taxpayer, the combination of those activities or entities would not be allowed by the United States Constitution.” Thus, the Commission must consider whether Utah can constitutionally tax the gain in the instant case.

In *Allied-Signal, Inc. v. Dir., Div. of Taxation*, 504 U.S. 768 (1992), the Court declined to adopt the definition of “business income” found in UDITPA as the standard for whether income may be apportioned to a state. The Multistate Tax Commission filed a brief as *Amicus Curiae*, in which it urged the Court “to hold that the Constitution does not require a unitary business relation...” and “to adopt as the constitutional test the standard set forth in the business income definition in Section 1(a) of the Uniform Division of Income for Tax Purposes Act.” *Id.* at 786. The Court noted,

In the abstract, these definitions may be quite compatible with the unitary business principle. See *Container Corp., supra*, 463 U.S., at 167, 103 S.Ct., at 2941 (noting that most of the relevant provisions of the California statute under which we sustained the challenged tax there were derived from UDITPA). Furthermore, the unitary business principle is not so inflexible that as new methods of finance and new forms of business evolve it cannot be modified or supplemented where appropriate. It does not follow,



though, that apportionment of all income is permitted by the mere fact of corporate presence within the State...

We agree that the payee and the payor need not be engaged in the same unitary business as a prerequisite 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.

*Id.* at 786-787.

Like the taxpayer in Appeal No. 11-2285, \_\_\_\_\_ has argued that under *MeadWestvaco v. Illinois Dep't of Revenue*, 2008 U.S. Lexis 3473 (2008), the test for apportionment was whether the taxpayer and the underlying business are unitary, and rejected the "operational function" test. As noted previously, in Appeal No. 11-2285, the Commission found that the Court reconfirmed its *Allied-Signal* position in *MeadWestvaco*, and cited the following:

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."

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.

From this, the Commission concluded that the acquisition and disposition of an asset, which in Appeal No. 11-2285 was an interest in another business, constituted an integral part of the taxpayer's trade or business and served an operational function, and was apportionable to Utah.

In *MeadWestvaco*, the Illinois Appellate Court had ruled that Illinois could tax an apportioned share of Mead's gain on the sale of its wholly owned Lexis/Nexis business division, despite the trial court's factual determination that Mead and Lexis/Nexis were not unitary, on the grounds that Mead's investment in Lexis/Nexis served an "operational purpose" in Mead's business within the meaning of *Allied-Signal*. The Supreme Court vacated the decision of the Illinois Appellate Court, stating that the lower court erred by considering the operational test after determining that Mead and Lexis/Nexis were not unitary. The Court recognized that under the operational function analysis, specific assets, but not other businesses, can be a part of a taxpayer's unitary business, even if there is no unitary relationship between payor and payee. The Court reviewed the examples in other cases, i.e., a short-term bank deposit,

where the taxpayer is not unitary with its banker; and a commodities hedging contract where the taxpayer is not unitary with its counterparty to the hedging transaction.

The Court in *MeadWestvaco* confirmed that under the concept of operational function, an asset could be part of a unitary business, even if a unitary relationship does not exist between payor and payee. However, the Court in *MeadWestvaco* went on to note, "Where, as here, the asset in question is another business, we have described the 'hallmarks' of a unitary relationship as functional integration, centralized management, and economies of scale." In the instant case, the asset in question is another business. Thus, the Commission must consider functional integration, centralized management, and economies of scale in determining a unitary relationship. \_\_\_\_\_ through \_\_\_\_\_ did not share centralized management or economies of scale with \_\_\_\_\_ nor was there functional integration between the two. There - being no unitary relationship under the *MeadWestvaco* analysis, the gain cannot constitutionally be taxed by Utah.



Jan Marshall  
Administrative Law Judge

DECISION AND ORDER

Based on the foregoing, the Commission grants the Taxpayer's Amended Motion for Summary Judgment, and denies the Division's Amended Cross-Motion for Summary Judgment. The Division's audit, with respect to the gain at issue, shall be abated. It is so ordered.


DATED this 27 day of January, 2022.



John L. Valentine  
Commission Chair



Rebecca E. Rockwell  
Commissioner



Michael J. Cragun  
Commissioner



Jennifer N. Fresques  
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. §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 Ann. §59-1-601 et seq. and §63G-4-401 et seq.