

**STATE OF NORTH CAROLINA**  
**COUNTY OF WAKE**

**BEFORE THE**  
**SECRETARY OF REVENUE**

**IN THE MATTER OF:** )  
 )  
The Refund Claim for Corporate Income Taxes )  
for the year ending December 31, 1991 by )  
 )  
[Taxpayer] )  
 )  
vs. )  
 )  
N.C. DEPARTMENT OF REVENUE )

**FINAL DECISION**  
Docket No. 2000-5

An Administrative Hearing was conducted before Michael A. Hannah, Assistant Secretary of Revenue, in the city of Raleigh on August 16, 2000 regarding a denial of a claim for refund of corporate income tax for tax year ended December 31, 1991 filed by [Taxpayer]. [Taxpayer] was represented by [both out-of-state and in-state counsel]. The Corporate, Excise, and Insurance Tax Division (hereafter “Division” or “Department”) was represented by William M. Daniel, Director, Lennie Collins, Assistant Director, Bobby L. Weaver, Jr., Administration Officer, and Kay Linn Miller Hobart, Esq., Assistant Attorney General. At the hearing, Mr. Hannah requested the parties to submit additional briefs after the hearing in support of their positions.

**ISSUES**

The issues to be decided in this matter are as follows:

- I. Whether Taxpayer is permitted to use an alternative formula or apportionment method in making a report or return of its income to this State other than the applicable apportionment formula provided by statute or by order in writing of the Tax Review Board.
- II. Whether the income from the sale of Taxpayer’s internal operating divisions constitutes business or nonbusiness income.
- III. Whether North Carolina is constitutionally precluded from taxing the gain because the [out-of-state] operating divisions were not part of the Taxpayer’s unitary business.

## EVIDENCE

The following items were introduced by the parties at or subsequent to the hearing as exhibits and made part of the record:

*Submitted by the Department:*

- D-1 Taxpayer's North Carolina Franchise and Corporate Income Tax Return for the 1991 Tax Year.
- D-2 Taxpayer's Amended North Carolina Franchise and Corporate Income Tax Return for the 1991 Tax Year.
- D-3 Index From Tax Review Board Record From Administrative Decision No. 444. (Record from the Tax Review Board Submitted with Exhibit # D-40).
- D-4 Copy of Taxpayer's 1991 Alternative Apportionment Methodologies Submitted at the Augmented Tax Review Board Hearing.
- D-5 Letter dated April 3, 1992 from [the Accounting Staff Manager] for [Parent Corporation] to Mr. Bart McClean, Executive Secretary of the Tax Review Board and Petition for Review.
- D-6 Letter dated April 7, 1992 from [the Accounting Staff Manager] for [Parent Corporation] to the Corporation Income and Franchise Tax Division of the North Carolina Department of Revenue.
- D-7 Letter dated April 15, 1992 from C.B. (Bart) McLean, Jr., Executive Secretary of the Tax Review Board to [the Accounting Staff Manager] for [Parent Corporation].
- D-8 Letter dated December 28, 1993 from [the Accounting Staff Manager] for [Parent Corporation] to Mr. C.B. McLean, Jr., Executive Secretary of the Tax Review Board.
- D-9 Letter dated October 17, 1994 from Janet L. Shires, Executive Secretary of the Tax Review Board, to [Taxpayer's Representative].
- D-10 Letter dated October 26, 1994 from [Taxpayer's Representative] to Janet L. Shires, Executive Secretary of the Tax Review Board.
- D-11 Letter dated October 28, 1994 from Janet L. Shires, Executive Secretary of the Tax Review Board, to [Taxpayer's Representative].
- D-12 Letter dated April 18, 1995 from Janet L. Shires, Executive Secretary of the Tax Review Board, to [Taxpayer's Representative].

- D-13 Letter dated May 8, 1995 from [an attorney representing the Taxpayer] to Janet L. Shires, Executive Secretary of the Tax Review Board.
- D-14 Letter dated June 16, 1995 from Janet L. Shires, Executive Secretary of the Tax Review Board, to [an attorney representing the Taxpayer].
- D-15 Letter dated July 17, 1995 from [an attorney representing the Taxpayer] to the Honorable Janice H. Faulkner, Secretary of the North Carolina Department of Revenue.
- D-16 Letter dated July 17, 1995 from [an attorney representing the Taxpayer] to the Honorable Janice H. Faulkner, Secretary of the North Carolina Department of Revenue.
- D-17 Letter dated July 17, 1995 from [an attorney representing the Taxpayer] to the Honorable Janice H. Faulkner, Secretary of the North Carolina Department of Revenue.
- D-18 Letter dated July 18, 1995 from [an attorney representing the Taxpayer] to Janet L. Shires, Executive Secretary of the Tax Review Board.
- D-19 Letter dated July 19, 1995 from Janet L. Shires, Executive Secretary of the Tax Review Board, to [an attorney representing the Taxpayer].
- D-20 Letter dated August 16, 1995 from Janet L. Shires, Executive Secretary of the Tax Review Board, to [an attorney representing the Taxpayer].
- D-21 Letter dated August 24, 1995 from [an attorney representing the Taxpayer] to Janet L. Shires, Executive Secretary of the Tax Review Board.
- D-22 Letter dated August 28, 1995 from Janet L. Shires, Executive Secretary of the Tax Review Board, to [an attorney representing the Taxpayer].
- D-23 Letter dated July 5, 1996 from Kay Linn Miller Hobart, Assistant Attorney General, to [an attorney representing the Taxpayer].
- D-24 Memorandum dated February 27, 1997 from [two attorneys representing the Taxpayer] to Jack L. Harper, Director of Corporate, Excise and Insurance Tax Division, and Kay Linn Miller Hobart, Assistant Attorney General.
- D-25 Letter dated April 14, 1998 from [an attorney representing the Taxpayer] to Jack Harper, Director of Corporate, Excise and Insurance Tax, and Kay Linn Miller Hobart, Esq., Assistant Attorney General.
- D-26 Letter dated April 15, 1998 from Jack Harper, Director of Corporate, Excise and Insurance Tax, to [an attorney representing the Taxpayer].
- D-27 Letter dated July 9, 1999 from [an attorney representing the Taxpayer] to Michael A. Hannah, Assistant Secretary of Revenue; Jack Harper, Director of Corporate, Excise and

Insurance Tax, and Kay Linn Miller Hobart, Esq., Assistant Attorney General.

- D-28 Letter dated July 20, 1999 from [an attorney representing the Taxpayer] to Jack Harper, Director of Corporate, Excise and Insurance Tax.
- D-29 Letter dated August 3, 1999 from [an attorney representing the Taxpayer] to Jack Harper, Director of Corporate, Excise and Insurance Tax.
- D-30 Letter dated August 16, 1999 from [an attorney representing the Taxpayer] to Jack Harper, Director of Corporate, Excise and Insurance Tax.
- D-31 Letter dated September 27, 1999 from [an attorney representing the Taxpayer] to Jack Harper, Director of Corporate, Excise and Insurance Tax.
- D-32 Letter dated September 30, 1999 from Kay Linn Miller Hobart, Esq., Assistant Attorney General, to [an attorney representing the Taxpayer].
- D-33 Letter dated November 23, 1999 from [an attorney representing the Taxpayer] to Michael A. Hannah, Assistant Secretary of Revenue.
- D-34 Letter dated November 30, 1999 from Michael A. Hannah, Assistant Secretary of Revenue, to [an attorney representing the Taxpayer].
- D-35 Letter dated December 14, 1999 from Jack Harper, Director of Corporate, Excise and Insurance Tax to [an attorney representing the Taxpayer].
- D-36 Letter dated December 14, 1999 from Jack Harper, Director of Corporate, Excise and Insurance Tax to Michael A. Hannah, Assistant Secretary of Revenue.
- D-37 Letter dated December 16, 1999 from [an attorney representing the Taxpayer] to Michael A. Hannah, Assistant Secretary of Revenue.
- D-38 Letter dated December 28, 1999 from [an attorney representing the Taxpayer] to Jack Harper, Director of Corporate, Excise and Insurance Tax.
- D-39 Letter dated March 24, 2000 from Michael A. Hannah, Assistant Secretary of Revenue, to [an attorney representing the Taxpayer].
- D-40 North Carolina Department of Revenue Pre-Hearing Brief with Exhibits #s 1 through 9 submitted by the Division to Michael A. Hannah, Assistant Secretary of Revenue on May 22, 2000.

Exhibit # 1 – Record from Tax Review Board Index.

Exhibit # 2 - Letter dated July 17, 1995 from [an attorney representing the Taxpayer] to the Honorable Janice H. Faulkner, Secretary of the North Carolina Department of Revenue.

Exhibit # 3 - Letter dated July 17, 1995 from [an attorney representing the Taxpayer] to the Honorable Janice H. Faulkner, Secretary of the North Carolina Department of Revenue.

Exhibit # 4 - Letter dated July 17, 1995 from [an attorney representing the Taxpayer] to the Honorable Janice H. Faulkner, Secretary of the North Carolina Department of Revenue.

Exhibit # 5 - Taxpayer's North Carolina Franchise and Corporate Income Tax Return for the 1991 Tax Year.

Exhibit # 6 – Schedule submitted by Taxpayer to Augmented Tax Review Board Showing Taxpayer's 1991 North Carolina Apportionment Alternatives.

Exhibit # 7 – Augmented Tax Review Board Administrative Decision No. 444.

Exhibit # 8 - Taxpayer's Amended North Carolina Franchise and Corporate Income Tax Return for the 1991 Tax Year.

Exhibit # 9 - Letter dated July 5, 1996 from Kay Linn Miller Hobart, Assistant Attorney General, to [an attorney representing the Taxpayer].

- D-41 Taxpayer's Pre-Hearing Brief submitted by [Taxpayer's out-of-state counsel] to Michael A. Hannah, Assistant Secretary of Revenue on June 19, 2000.
- D-42 North Carolina Department of Revenue's Motion to Dismiss the Administrative Tax Hearing Dated July 20, 2000.
- D-43 Assistant Secretary of Revenue's Ruling on the Motion to Dismiss the Administrative Tax Hearing Dated July 21, 2000.
- D-44 Letter dated August 2, 2000 from Michael A. Hannah, Assistant Secretary of Revenue, to [Taxpayer's in-state counsel].
- D-45 North Carolina Department of Revenue Hearing Brief submitted by the Corporate, Excise and Insurance Tax Division to Michael A. Hannah, Assistant Secretary of Revenue on August 14, 2001.
- D-46 Motion in Limine filed by the Division to Michael A. Hannah, Assistant Secretary of Revenue, on August 16, 2000 regarding the [testimony of one expert witness for the Taxpayer].
- D-47 Motion in Limine filed by the Division to Michael A. Hannah, Assistant Secretary of Revenue on August 16, 2000 regarding the [testimony of another expert witness for the Taxpayer].

- D-48 Letter dated September 15, 2000 from Michael A. Hannah, Assistant Secretary of Revenue, to [Taxpayer's out-of-state counsel].
- D-49 Letter Dated September 25, 2000 from Kay Linn Miller Hobart to Michael A. Hannah, Assistant Secretary of Revenue.
- D-50 Letter dated September 31, 2000 from Michael A. Hannah, Assistant Secretary of Revenue, to [Taxpayer's out-of-state counsel].
- D-51 Letter dated November 27, 2000 from Michael A. Hannah, Assistant Secretary of Revenue, to [Taxpayer's out-of-state counsel].
- D-52 Response to [Taxpayer's] Motion for a Ruling submitted by Kay Linn Miller Hobart to Michael A. Hannah, Assistant Secretary of Revenue on November 30, 2000.

Exhibit # 1 - Affidavit of Harlan E. Boyles dated September 7, 2000.

Exhibit # 2 - Document and Information Request submitted by the Department in Response to [Taxpayer's] Motion for a Ruling.

- D-53 North Carolina Department of Revenue Post-Hearing Brief submitted by the Corporate, Excise, and Insurance Tax Division to Michael A. Hannah, Assistant Secretary of Revenue on November 30, 2000.

*Submitted by the Taxpayer:*

- T-1 Report entitled "Discussion and Analysis: [Taxpayer's] 1991 North Carolina State Income Tax" prepared by [a CPA].
- T-2 Report entitled "[Expert Report]" prepared by [a professor and expert witness] for [Taxpayer's out-of-State counsel] in connection with the [Taxpayer's petition] concerning the allocation formula for corporate income tax purposes for the year ending December 31, 1991.
- T-3 Report entitled "[Expert Opinion]" prepared by [another professor and witness for Taxpayer].
- T-4 Report entitled "Treatment of Gain on Sale of [Divisions]" prepared by [a CPA] dated August 11, 2000.
- T-5 Schedule of Taxpayer's Federal Depreciation Recapture prepared by [a CPA].
- T-6 Response by [a CPA] to the North Carolina Department of Revenue's Questions Dated October 27, 2000.
- T-7 Taxpayer's Opening Hearing Brief submitted by [Taxpayer's out-of-state counsel] to Michael A. Hannah, Assistant Secretary of Revenue on October 31, 2000.

- T-8 Taxpayer's "Motion for a Ruling That the Evidence Presented Can Support a Decision for the Taxpayer" submitted by [Taxpayer's out-of-state counsel] to Michael A. Hannah, Assistant Secretary of Revenue on October 31, 2000.
- T-9 Taxpayer's Reply Brief submitted by [Taxpayer's out-of-state counsel] to Michael A. Hannah, Assistant Secretary of Revenue on December 8, 2000.
- T-10 Taxpayer's "Reply on Motion for a Ruling That the Evidence Presented Can Support a Decision for the Taxpayer" submitted by [Taxpayer's out-of-state counsel] to Michael A. Hannah, Assistant Secretary of Revenue on December 8, 2000.

### **FINDINGS OF FACT**

Based on the foregoing evidence of record, the Assistant Secretary makes the following findings of fact:

1. [Taxpayer], [an out-of-state] corporation, was authorized to begin doing business in North Carolina on or about January 28, 1971.
2. In 1991, [Taxpayer's] principal place of business was [outside North Carolina].
3. Taxpayer is in the business of providing telecommunication services.
4. Prior to 1991, Taxpayer provided local telephone services in North Carolina, [and several other States].
5. Each local telephone company in each state was operated as an internal division of [Taxpayer].
6. The assets of each division were acquired for use in the Taxpayer's regular business operations.
7. The assets of each division were utilized, controlled and managed as an integral part of Taxpayer's regular business operations.
8. Taxpayer is a 95.5% owned subsidiary of [Parent Corporation and is] located at the same physical address as [Parent Corporation].
9. The headquarters division of Taxpayer performed many corporate functions for the operating divisions, including the following services: a) revenue accounting and billing staff support; b) regulatory accounting; c) ad valorem tax compliance, including preparation of reports and filing of returns with governmental agencies; d) property accounting services; e) payroll processing staff support; f) payroll, materials and accounts payable systems support; g) advertising administration; h) intercompany data network

operations; i) general accounting services, including maintenance of general books and operating reports and financial statements, preparation and filing of reports with governmental agencies, systems and procedures services and budget support services; j) external relations services, including public relations and carrier relations; k) executive direction and support; l) general purpose computer systems and information management services; m) legal services; n) human resources staff support; o) cost separation and access tariff services; p) access management services; q) revenue accounting services; r) centralized message investigation services; s) centralized cash processing services; t) message processing services; u) carrier access billing services; v) end user billing and collection services; w) centralized contract negotiation and administration services, including monitoring conformance to negotiated vendor contracts; and x) miscellaneous general services supporting Taxpayer's activities, including local personnel, copy center and printing.

10. Taxpayer maintains its records in accordance with the standard classification of accounts prescribed by the Federal Communications Commission (FCC).
11. [Taxpayer] has annually filed a North Carolina corporate franchise and income tax return since 1971.
12. Taxpayer sold the internal operating divisions providing service to [two other states] in 1991.
13. The divisions [that were sold] were operated as part of Taxpayer's regular business operations until the moment of disposition.
14. At no time in its filing history in this State did the Taxpayer seek separate accounting based on the distinct activities of the divisions. Except for the period from 1970 to 1977 where taxpayer utilized a separate accounting methodology without statutory authority or permission from the augmented Tax Review Board, Taxpayer filed its returns with this state based on statutory apportionment of its total income, including the operating revenues of all divisions in the apportionment formula.
15. During all years of operation, the four internal operating divisions produced apportionable business income to Taxpayer.
16. During all years of operation, the assets of the divisions incurred expenses, including, among others, depreciation, insurance and taxes, affecting the amount of net income apportionable to this state.
17. During all years of operation, the expenses associated with all four divisions were classified as business expenses on Taxpayer's return.
18. For federal income tax purposes, the sale of the two divisions resulted in a capital gain of \$48,599,294 and ordinary income of \$120,497,279, representing depreciation recapture.



19. On September 16, 1992, the Taxpayer filed its North Carolina Corporate Income Tax Return for the calendar year 1991, after having applied for an extension of time for filing the return on March 13, 1992.
20. Taxpayer's original 1991 tax return was filed using North Carolina's statutory method of allocating income to North Carolina pursuant to G.S. 105-130.4(n).
21. Taxpayer's original 1991 North Carolina Corporate Income Tax Return reported business income subject to apportionment of \$194,067,031 with an apportionment factor of 30.22%.
22. Taxpayer classified the income, both ordinary income and capital gain, from the sale of the assets of the two divisions as apportionable business income on its original return, which it signed under penalties of perjury.
23. As a [telecommunications] company, Taxpayer apportions its business income using a single gross operating revenue factor as provided by G.S. 105-130.4(n).
24. The original return reported business income apportioned to North Carolina in the amount of \$58,647,057. Taxpayer's 1991 tax liability was \$4,646,872.
25. [Taxpayer] filed a petition requesting separating accounting method of allocation for calendar year 1991 with the North Carolina Augmented Tax Review Board on April 3, 1992, pursuant to G.S. 105-130.4(t).
26. [Taxpayer's] petition requesting the separate accounting method of allocation was based upon [Taxpayer's] position that the statutory apportionment method of allocating taxes subjected the Taxpayer to income taxation on a greater portion of its income than is reasonably attributable to its business in North Carolina as a result of gains from the sale of two divisions located in [other states].
27. [Taxpayer's] Petition was received and acknowledged by letter dated April 15, 1992, to [Taxpayer] from Bart McLean, Executive Secretary to the Tax Review Board.
28. By letter dated October 26, 1994, Taxpayer requested a continuance of the hearing date before the Augmented Tax Review Board originally scheduled for November 1994.
29. The requested continuance was granted in a letter dated October 28, 1995 from Janet L. Shires to Taxpayer.
30. By letter dated April 18, 1995 this matter was scheduled for hearing before the Augmented Tax Review Board.
31. Taxpayer filed a supplement to its original petition on May 8, 1995.

32. A hearing was held on May 9, 1995 before the augmented Tax Review Board (consisting of the three members of the regular Tax Review Board and the Secretary of Revenue).
33. Taxpayer submitted, at the hearing on its petition for separate accounting, a document comparing three alternative filing methodologies: a) as filed, b) separate accounting, and c) bifurcated apportionment. The petition states “[t]his gain [from the sale of the two divisions] is considered business income to be apportioned. . . .Therefore, absent a granting of relief, the income cannot be allocated out of North Carolina, but must be apportioned under G.S. 105-130.4.”
34. On June 16, 1995, after consideration of the evidence, contentions and arguments, the augmented Board concluded that Taxpayer failed to overcome the presumption established in G.S. 105-130.4(t)(4) and ordered by Administrative Decision No. 444 that Taxpayer employ the method of apportionment prescribed by the North Carolina General Statutes, which is the formula set out in G.S. 105-130.4(n).
35. On July 17, 1995, Taxpayer filed an amended North Carolina Corporate Income Tax Return for the tax year 1991, using the alternative bifurcated apportionment formula presented to and rejected by the augmented Board, seeking a refund of \$4,148,822.
36. By letter of July 17, 1995, Taxpayer demanded a refund of this amount pursuant to G.S. 105-266.1.
37. Also, by separate letter dated July 17, 1995, Taxpayer demanded a refund of the same amount under G.S. 105-267.
38. The amended return filed by Taxpayer used the alternative bifurcated apportionment formula submitted to and rejected by the augmented Tax Review Board.
39. On its amended return, Taxpayer divided its total business income of \$194,067,031 into “[operating] income” of \$23,735,379 and “division sale income” of \$170,331,652 on the amended return.
40. Taxpayer classified both categories, “[operating] income” and “division sale income,” as “business income” on its amended return.
41. On its amended return, Taxpayer applied the gross operating revenue factor of 30.22%, as reflected on its original return, to the “[operating] income,” producing a figure of \$7,172,832.
42. Taxpayer did not apply the gross operating revenue factor of 30.22% to the “division sale income” on its amended return. Instead, it employed a self-created three-factor formula of zero percent, consisting of property, payroll and sales, which it applied to the “division sale income.”

43. The amended return states that “[s]ince no property, payroll or sales tied to the sales of the divisions were located in North Carolina, the appropriate North Carolina apportionment factor for the gain on the sale of the divisions is 0%.”
44. Taxpayer’s bifurcated formula apportioned none of the income from the sale of its two operating divisions to North Carolina.
45. Taxpayer also filed a petition for judicial review of the Board’s decision on July 17, 1995.
46. The Secretary of Revenue filed a motion to dismiss Taxpayer’s petition for judicial review on August 21, 1995.
47. On September 19, 1995, Taxpayer filed a motion for a confidentiality order. The parties also filed a joint motion to extend the time to file the record from the Tax Review Board until Taxpayer’s motion for confidentiality was heard. These motions have not been heard, and the record before the augmented Board has not been filed with the court.
48. By letter of July 6, 1996, the Department denied Taxpayer’s request for a refund under G.S. 105-267 as untimely; the Department also denied Taxpayer’s request for a refund under G.S. 105-266.1.
49. The Department also made a motion to dismiss the administrative tax hearing with the Assistant Secretary of Revenue. This procedural issue was addressed in pre-hearing briefs filed by both parties, and a motion to dismiss was filed with the Assistant Secretary of Revenue on July 20, 2000.
50. On July 21, 2000, the Assistant Secretary of Revenue ruled that Taxpayer may obtain an administrative tax hearing under G.S. 105-266.1.
51. An Administrative Tax Hearing before the Secretary of Revenue was conducted by the hearings officer on August 16, 2000 in the Revenue Building on 501 North Wilmington Street.
52. Taxpayer has not produced any evidence or other documentation to support its claim raised at the hearing that the gain from the sale of its business assets is nonbusiness income allocable to states other than North Carolina.

#### **CONCLUSIONS OF LAW**

Based on the foregoing findings of fact, the Assistant Secretary makes the following conclusions of law:

1. The Taxpayer is subject to corporate income taxation in this State pursuant to G.S. 105-130 *et seq.*

2. G.S. 105-130.3 imposes a tax upon the State net income of every C corporation doing business in this State.
3. Taxpayer is a C corporation.
4. Taxpayer obtained a Certificate of Authority to do business as a corporation in North Carolina from the Office of the Secretary of State on January 28, 1971.
5. “State net income” means the taxpayer’s federal taxable income as determined under the Code, adjusted as provided in G.S. 105-130.5 and, in the case of a corporation that has income from business activity that is taxable both within and without this State, allocated and apportioned to this State as provided in G.S. 105-130.4.
6. Taxpayer is a multi-state corporation pursuant to G.S. 105-130.4(b).
7. Taxpayer is a “public utility” under G.S. 105-130.4(a)(6).
8. G.S. 105-130.4(a)(6) defines “public utility,” in pertinent part, as “any corporation that is subject to control of one of more of the following entities: the North Carolina Utilities Commission, the Federal Communications Commission...that owns or operates for public use any plant, equipment, property, franchise, or license for the transmission of communications....”
9. As a [telecommunications] company, Taxpayer must apportion all its business income using the gross operating revenue factor as determined under G.S. 105-130.4(a)(n).
10. G.S. 105-130.4(a)(n) stipulates that: “All business income of a telephone company shall be apportioned to this State by multiplying the income by a fraction, the numerator of which is gross operating revenue from local service in this State plus gross operating revenue from toll services performed wholly within this State plus the proportion of revenue from interstate toll services attributable to this State as shown by the records of the company plus the gross operating revenue in North Carolina from other service less the uncollectible revenue in this State, and the denominator of which is the total gross operating revenue from all business done by the company everywhere less total uncollectible revenue....”
11. The income from the sale of the [out-of-state] operating divisions is business income pursuant to G.S. 105-130.4 and the Department’s rule, North Carolina Administrative Rule 17 NCAC 5C .0703.
12. G.S. 105-130.4(a)(1) defines “Business income” as: “income arising from transactions and activity in the regular course of the corporation's trade or business and includes income from tangible and intangible property if the acquisition, management, and/or disposition of the property constitute integral parts of the corporation's regular trade or business operations.”

13. The statutory definition of business income contains two prongs--a “transactional” prong and a “functional” prong.
14. If either the functional or the transactional test is met, the income in question is properly classified as business income.
15. Under the functional test, if the income-producing property constitutes an integral part of the taxpayer’s trade or business, the income constitutes business income.
16. The fact that a transaction is an isolated or extraordinary transaction is irrelevant under the functional test.
17. The acquisition of the property in question, the assets associated with the two internal operating divisions which Taxpayer sold, constituted an integral part of Taxpayer’s trade or business operations.
18. The management of the property in question, the assets associated with the two internal operating divisions which Taxpayer sold, constituted an integral part of Taxpayer’s trade or business operations.
19. The disposition of the property in question, the assets associated with the two internal operating divisions which Taxpayer sold, constituted an integral part of Taxpayer’s trade or business operations.
20. If the assets were used in Taxpayer’s regular business prior to disposition to produce apportionable business income, the functional prong of the business income definition has been met.
21. Business assets cannot become nonbusiness assets without a definite conversion to nonbusiness use.
22. To constitute nonbusiness use, the property must be utilized for the production of nonbusiness income for a period of at least three years prior to the disposition.
23. Any gain or loss from the disposition of assets must retain the classification established prior to the dispositive transaction.
24. The disposition of assets generates apportionable business income when the assets have been used in the regular business of the Taxpayer. These assets have been depreciated and incurred expenses, and have affected the amount and percentage of business income apportionable to the state in prior years.
25. The gain from the sale of the [out-of-state] divisions satisfies the functional prong and therefore constitutes business income under G.S. § 105-130.4(a)(1).

26. North Carolina Administrative Rule 17 NCAC 5C .0703 was promulgated by the Secretary of Revenue under authority of G.S. 105-262 and 105-264 to interpret G.S. 105-130.4.
27. Administrative Rule 17 NCAC 5C .0703 is *prima facie* correct.
28. Administrative Rule 17 NCAC 5C .0703(2) states, in pertinent part, that “A gain or loss from the sale, exchange or other disposition of real or personal property constitutes business income if the property while owned by the taxpayer was used to produce business income.”
29. The gain from the sale of the [out-of-state] divisions was properly classified by Taxpayer and the Department as apportionable business income under G.S. § 105-130.4(a)(1) and the Department’s rule.
30. Taxpayer’s gain from the sale of the [out-of-state] operating divisions is not “operating revenue” and is, therefore, excluded from the apportionment factor pursuant to G.S. 105-130.4(n).
31. The statutory formula does not permit inclusion of the gain from the sale of the divisions in either the numerator or denominator of the formula.
32. The Secretary is without authority to issue a refund to Taxpayer based upon inclusion of the gain grossed up by a factor of four in the denominator of the apportionment formula.
33. The Secretary is without authority to issue a refund to Taxpayer based upon separate accounting.
34. The Secretary is without authority to issue a refund to Taxpayer based on a bifurcated apportionment formula.
35. The amended return filed by Taxpayer is not a lawful return.
36. The Secretary lacks authority to issue a refund based upon an unlawful return.
37. A finding that the inclusion of the gain from the sale of the operating divisions in the pre-apportionment base taxes income “out of all appropriate proportion” to Taxpayer’s activities in the state or “leads to a grossly distorted result” requires a ruling by the Secretary that the statutory formula operates in an unconstitutional manner.
38. A finding that the bifurcated apportionment formula employed by Taxpayer is necessary to avoid the taxation of activities outside North Carolina requires a ruling or declaration by the Secretary that the statutory formula in G.S. 105-130.4(n) operates in an unconstitutional manner.

39. A finding that the exclusion of receipts from the sale of the out-of-state divisions from the denominator of the apportionment formula would result in an unconstitutional distortion is appropriate only if the Secretary makes a ruling or declaration that the statutory formula in G.S. 105-130.4(n) operates in an unconstitutional manner.
40. The Secretary has no authority under G.S. 105-266.1 to order the refund of an invalid or illegal tax, since questions of constitutionality are for the courts.
41. G.S. 105-266.1 does not provide an exception to the general rule that voluntary payments of unconstitutional tax are not refundable.
42. G.S. 105-258 states, in relevant part that: “The Secretary of Revenue, for the purpose of...determining the liability of any person for any tax...shall have the power to examine... any books, papers, records, or other data which may be relevant or material to such inquiry...”
43. In accordance with the provisions of G.S. 105-241.1, the Secretary of Revenue must, after conducting a hearing, make a decision based on the best information available.
44. The denial of the refund requested on the amended return was proper under the laws and the facts.

### **DECISION**

The Taxpayer is a corporation headquartered in [another state] that owns and operates four local [telecommunication] service franchises through its four separate company divisions located in North Carolina [and three other states]. In 1991, the Taxpayer sold the two operating divisions located in [two of the states] and included the gain from the sale as business income subject to apportionment on its North Carolina Corporate Income and Franchise Tax Return for that year which was filed on September 16, 1992. On April 13, 1992, the Taxpayer had filed a petition for separate accounting method of allocation with the Tax Review Board. A hearing on that petition was held on May 9, 1995, and the Board denied the Taxpayer’s request on June 16, 1995, in its Administrative Decision No. 444.

On July 17, 1995, the Taxpayer filed (1) a petition seeking judicial review of Administrative Decision No. 444, (2) an amended North Carolina Corporate Income Tax Return

for 1991 seeking a refund of \$4,148,822 that was calculated by using the bifurcated apportionment formula originally sought and later rejected in its petition to the Tax Review Board, (3) a letter to the Secretary of Revenue demanding a refund of this amount pursuant to G.S. 105-266.1 and (4) a second letter to the Secretary of Revenue also demanding a refund under G.S. 105-267.

The Department responded by (1) filing a motion with the court to dismiss the Taxpayer's petition for judicial review on August 21, 1995, (2) denying the Taxpayer's request for a refund under G.S. 105-267 as untimely on July 6, 1996, (3) denying the Taxpayer's request for a refund under G.S. 105-266.1 based upon the facts of the case on July 6, 1996 and (4) filing a motion on July 20, 2000, with the Assistant Secretary of Revenue contending that the Taxpayer was not entitled to an administrative tax hearing because it may not simultaneously seek a refund under both G.S. 105-266.1 and 105-267. The Assistant Secretary ruled on July 21, 2000, that the Taxpayer could obtain an administrative tax hearing regarding its refund request under G.S. 105-266.1 and the hearing was held on August 16, 2000.

There are two issues presented in this case. The first issue is whether the Taxpayer is entitled to use some apportionment formula other than the one required by G.S. 105-130.4 to apportion that gain. The second issue is whether the gain from the sale of [two of the out-of-state] Divisions should be excluded from apportionable income in North Carolina.

The Taxpayer makes the primary argument that it should be entitled to use a bifurcated apportionment formula whereby "[operating] income" would be subject to apportionment by the gross operating revenue factor and the gain from the sale of the divisions would be subject to apportionment by the standard three-factor formula. The Taxpayer also argues that the gain from the sale of the two divisions should be excluded from the North Carolina apportionable tax base



in reliance upon two different theories. First, the Taxpayer argues that the gain on the sale of the divisions is nonbusiness income. Second, it contends that there is no unitary or operational connection between the gain and the Taxpayer's activities in North Carolina.

**1. IS THE TAXPAYER ENTITLED TO USE A BIFURCATED APPORTIONMENT FORMULA TO APPORTION ITS INCOME?**

G.S. 105-130.4(n) specifically sets forth the apportionment method to be applied to all of the business income of the Taxpayer, a telephone company. The statute requires that the business income base be multiplied by a gross operating income revenue factor. In its amended North Carolina Corporate Income and Franchise Return for 1991, the Taxpayer improperly employed the use of an alternative allocation method other than the formula specifically prescribed by the statute and other than the formula required by the order of the augmented Tax Review Board in Administrative Decision No. 444. G.S. 105-130.4(t)(1) provides the legal means for a corporation to obtain relief from a purportedly unreasonable apportionment formula that results in a tax that is disproportionately high in relation to the corporation's earnings in North Carolina. This procedure was correctly followed by the Taxpayer until such time as an undesirable result was obtained from the Augmented Tax Review Board. When its amended tax returns were filed, the Taxpayer blatantly ignored the Board's order and utilized the very apportionment formula that had been previously rejected.

The Taxpayer argues that taxes can only be properly imposed by this State upon income of a multistate corporation that is "earned within the State of North Carolina in its interstate business, and reasonably attributable to its interstate business done or performed within the borders of this State." *Gulf Oil Corp. v. Clayton*, 267 N.C.15, 21, 147 S.E.2d 522, 527 (1966). It then makes three arguments in support of its assertion that the use of the statutorily required single factor formula is improper in this case. First, the Taxpayer contends that including the

gain from the sale of the divisions in the apportionable tax base and apportioning such gain by the operating revenue factor does not reflect a reasonable sense of how the income was generated. *Container Corp. of Am. v. Franchise Tax Board*, 463 U.S. 159, 169 (1983). The Taxpayer argues that the gain from the sale of the divisions is a “non-operational gain” that is “wholly unrelated to the single-factor operating income formula used by North Carolina to apportion such gain...” (Taxpayer’s Opening Brief at 26). Taxpayer insists that the “gross operating revenue factor as applied to operating and non-operating income of [Taxpayer] has resulted in an amount of net taxable income apportioned to North Carolina which is simply not fairly or reasonably related to [Taxpayer’s] activities in North Carolina” (Taxpayer’s Exhibit T-1, D & T Report, at 3).

The Taxpayer’s second argument against the use of the single factor apportionment formula is that the tax imposed is out of all proportion to its activities in North Carolina. It then goes on to cite four separate reasons why this statement is true. First, the Taxpayer argues that the single-factor operating income formula, by including the gain from the sale of the divisions in the apportionable tax base, draws “income into North Carolina that has no connection with the State, thus taxing income that is ‘out of all appropriate proportion’ to the Taxpayer’s activities in this state.” *Hans Rees’ Sons v. North Carolina ex rel. Maxwell*, , 283 U.S. 123, 135 (1931). Secondly, the Taxpayer insists that “the apportionment formula is even more offensive than the formula at issue in *Hans Rees*” because the operating revenue factor has no relationship to the generation of the gain from the sale of the divisions. (Taxpayer’s Opening Brief at 31).

Thirdly, the Taxpayer asserts that the apportionment formula attributes income to North Carolina that is “far in excess of [Taxpayer’s] separate accounting income attributable to the North Carolina Division’s activities.” (Id.) Finally, the Taxpayer contends that because the gain

from the sale of the divisions is classified as non-operating income under the Uniform System of Accounts, a method of separate accounting methodology required by both the North Carolina Utilities Commission and the Federal Communication Commission for determining utility rates, the gain should not be considered in the apportionment base. The Taxpayer states that the inclusion of the gain in the Taxpayer's operating income results in a gross operating margin in excess of fifty-six percent, nearly twice the industry combined rate for 1991, and a rate that would clearly not be permitted by regulators. (Id., at 34).

The Taxpayer's third and final argument against the propriety of the single factor apportionment formula is that it generates a grossly distorted result. *Norfolk & Western Ry. v. Missouri State Tax Commission*, 390 U.S.317, 326 (1968). The Taxpayer supports this argument by noting that a comparison of its potential tax liability using a separate accounting method and excluding the gain from the sale of the divisions to the liability resulting from an inclusion of the gain in the tax base and apportioning the gain using the single-factor operating revenue formula increases the Taxpayer's tax liability by 2.5 times. This statistically significant increase in tax, the Taxpayer concludes, means that the apportionment formula must have had a distortive and excessive result.

The Taxpayer also asserts two alternative theories as justification for its refund request. First, if it is determined that the gain from the sale of the two divisions is includible in the apportionable tax base, then the single-factor operating revenue formula should be replaced with a formula that more closely reflects how the gain was generated. Or, at the very least, the apportionment formula must include in the denominator the receipts from the sale of the [two] Divisions grossed up by a factor of four. This would permit the apportionment of the gain from the sale of the two divisions to be based upon factors that reflect how the gain was generated.

(Taxpayer's Opening Brief at 36). The second alternative theory presented by the Taxpayer is that it should be permitted to utilize a separate accounting method to "ensure that extraterritorial values are not taxed.... (Id. at 37).

G.S. 105-130.4(t)(1) augments the Tax Review Board by the addition of the Secretary of Revenue for purposes of considering a taxpayer's request for a modification to the statutorily required apportionment formula. An agreement with any of the Taxpayer's arguments noted above would require acceptance of the premise that the Secretary of Revenue can authorize the use of some modified apportionment formula other than the one required by G.S. 105-130.4(n). Such a premise is clearly unreasonable since it would require a conclusion that the Legislature would first designate the Secretary of Revenue as a member of the Augmented Tax Review Board to participate in the determination of a corporate taxpayer's request to use some apportionment formula other than the one required by statute and then permit her to change, unilaterally and at her sole discretion, the decision of the very board of which she was a member.

This is just not logical. While the Taxpayer has presented some arguments worth considering regarding the issue of whether it should be permitted to use a modified apportionment formula or separate accounting to account for the gain from the sale of the [two] divisions, the Tax Review Board is the proper forum for that process, not an administrative tax hearing. Moreover, some of the issues raised by the Taxpayer involve constitutional claims or defenses, or would require a ruling that the statute is being applied in an unconstitutional manner. The Secretary of Revenue does not have to the authority to do so.

I must therefore rule that the Secretary of Revenue does not have the authority to permit the Taxpayer to use any apportionment formula other than the one required by G.S. 105-130.4(n) to apportion the gain from the sale of the [two] divisions on its North Carolina Corporate Income

and Franchise Return for 1991. Furthermore, I rule that the Secretary of Revenue does not have the authority to either modify the apportionment factor as requested by the Taxpayer or to permit the Taxpayer to utilize a separate accounting. These issues should properly be decided, and in fact have already been decided, by the Augmented Tax Review Board as set forth in G.S. 105-130.4(t)(1).

**2. IS THE GAIN FROM THE SALE OF THE [TWO] DIVISIONS BUSINESS INCOME UNDER THE TRANSACTIONAL TEST AND/OR THE FUNCTIONAL TEST?**

G.S. 105-130.4(a)(1) defines business income as “income arising from transactions and activity in the regular course of the corporation’s trade or business and includes income from tangible and intangible personal property if the acquisition, management, and/or disposition of the property constitute integral parts of the corporation’s regular trade or business operations.” In interpreting this statute, the North Carolina Supreme Court has determined that it establishes two tests for determining whether a corporation’s income is business income: the transactional test and the functional test. *Polaroid Corp v. Offerman* 349 N.C. 290, 507 S.E.2d 284 (1998). The Taxpayer asserts that the gain from the sale of the [two] divisions does not constitute business income under G.S. 105-130.4(a)(1) because it does not satisfy either the transactional test or the functional test cited in *Polaroid* and is therefore nonbusiness income pursuant to G.S. 105-130.4(a)(5).

**A. Transactional Test**

The Department has not contested the Taxpayer’s assertion that the gain from the sale of the two divisions does not meet the requirements of the transactional test and so I will not rule on that issue.

**B. Functional Test**

The functional test set forth in G.S. 105-130.4 states that business income “includes income from tangible or intangible property if the acquisition, management, and/or disposition of the property constitutes integral parts of the corporation’s regular trade or business operation.” Under the functional test, once assets are determined to constitute an integral part of the taxpayer’s regular trade or business operation, any income from those assets is considered business income without any limitation on how it was received. (*Polaroid* at 300). In this case, the [two] divisions were decidedly integral parts of the Taxpayer’s regular business operations, therefore, any income generated from those assets, including the gain from the sale of those divisions, is business income. Under the functional test, the extraordinary or non-recurring nature of the gain from the sale is irrelevant. (*Id* at 296).

The Taxpayer argues that the North Carolina Supreme Court’s ruling in *Union Carbide Corp. v. Offerman* 351 N.C. 310, 526 S.E.2d 167 (2000) indicates that the two controlling elements of the functional test require an inquiry here into whether the [two] divisions were essential parts of its business operations in North Carolina. (Taxpayer’s Opening Brief at 13) (underlining added). The Taxpayer then goes on to cite many facts that it contends show there were no operational connections between the [two] divisions and the North Carolina division, as well as many other facts which indicate that the North Carolina division was not involved in the sale of those other two divisions in any way. (*Id* at 13-17).

In further support of its contention that the functional test requires the property in question be part of a corporation’s business operations in North Carolina, the Taxpayer noted that the North Carolina Supreme Court stated in *Polaroid* that the North Carolina Corporate Income Tax Act is based upon the Uniform Division of Income for Tax Purposes Act (“UDITPA”). “UDITPA was designed to apportion among the states in which a multistate or

multinational corporation does business the fair amount of net taxable business income *earned by the corporation's activities in each state*. *Polaroid Corp. v. Offerman*, at 304 507 S.E.2d at 294 (citing *Pledger v. Getty Oil Exploration Co.*, 309 Ark. 257, 262, 831 W.W.2d 121 (1992) (emphasis added by the Taxpayer). According to the Taxpayer, the North Carolina Supreme Court's discussion of UDITPA requires a conclusion that the Legislature, by enacting the North Carolina Corporate Income Tax Act, "specifically intended that the provisions of the Act only apportion income 'earned by the corporation's activities in each state'" because that Act is based upon UDITPA. (Taxpayer's Reply Brief at 5).

Therefore, the Taxpayer reasons, when the Legislature enacted G.S. 105-130.4(a)(1) it did not intend to apportion income to this State that was not earned by a corporation's activities in North Carolina. The Taxpayer's argument continues that since that statute must be read in a manner consistent with this legislative intent, then business income should only include income derived from property that constitutes a corporation's regular business operations in North Carolina. The Taxpayer then concludes that because the gain from the sale of the [two] divisions was not derived from the Taxpayer's regular business operations in North Carolina, that gain cannot properly be apportioned to this State.

This novel approach to interpreting G.S. 105-130.4(a)(1) has at least one fatal flaw. An acceptance of the Taxpayer's interpretation would in effect nullify the basic tenets underlying the apportionment theory of UDITPA and negate the very need for an apportionment formula. It appears that the Taxpayer is in essence attempting to utilize a separate accounting of those activities that can be specifically associated with an individual state. I do not interpret the quotation from *Polaroid* noted by the Taxpayer in the same way. In my estimation, the phrase "UDITPA was designed to apportion among the states in which a multistate or multinational

corporation does business the fair amount of net taxable business income *earned by the corporation's activities in each state*" was not intended to by the North Carolina Supreme Court to limit the application of the functional test in the manner suggested by the Taxpayer. (emphasis added by the Taxpayer). Such an interpretation would quite simply be contrary to the very purpose of apportionment.

The North Carolina Supreme Court has never ruled that G.S. 105-130.4(a)(1) requires that assets disposed of must have been essential to the selling corporation's business operations in this State in order for the gain from such sale to be considered business income as contended by the Taxpayer. The proper inquiry in this case under the functional test as set forth in *Polaroid* is whether the two operating divisions disposed of were acquired and managed as integral parts of the Taxpayer's regular business. The reasoning of the North Carolina Supreme Court in *Polaroid* does not require appending the phrase "in this state" onto the language of G.S. 105-130.4(a)(1).

Furthermore, it is obvious that the gain from the sale of the [two] divisions should clearly be classified as business income under Administrative Rule 17 NCAC 5C.0703. That rule states in relevant part that:

"The gain or loss recognized on the sale of property...may be business or nonbusiness income depending upon the relation to the taxpayer's trade or business:

...

**(2) A gain or loss from the sale, exchange or other disposition of Real or personal property constitutes business income if the property while owned by the taxpayer was used to produce business income...**

(emphasis added)

This administrative rule represents the policy of the Department regarding this issue since at least 1967 and was cited with approval by the North Carolina Supreme Court in *Polaroid* as an



accurate reflection of legislative intent in the wording of G.S. 105-130.4(a)(1). *See* 349 N.C. at 303, 507 S.E.2d at 294. The record clearly shows that the Taxpayer, during the years preceding the sale of the two divisions, regularly and consistently reported the income from those operations as business income on its North Carolina Corporate Franchise and Income Tax Returns and apportioned that income properly in compliance with G.S. 105-130.4. Because the two divisions were used by the Taxpayer to produce business income, there can be no doubt that the gain from the sale of the two divisions is therefore business income under Rule .0703(2).

The Taxpayer cites *Laurel Pipe Line Co. v. Pennsylvania*, 537 Pa. 205, 642 A.2d 472 (1994) in support of its position that the gain from the sale of independent and separate business divisions constitutes nonbusiness income. In that case, the Pennsylvania Supreme Court determined that a company engaged in both intrastate and interstate transportation of refined petroleum products over company-owned pipelines generated nonbusiness income when it sold the interstate pipeline but retained and continued to operate the intrastate pipeline. The Taxpayer argues that the Pennsylvania court focused on the issues of the company's divestiture of an independent and separate business unit and also the cessation of one of the separate businesses as determinative in that case. Likewise, the Taxpayer continues, its "sale of the [two] divisions constituted a complete cessation of [Taxpayer's] business in [the two states]" and the gain should therefore be considered nonbusiness income in North Carolina. (Taxpayer's Reply Brief at 8)

While the Department accurately responds that the decision of another state court is not binding in North Carolina, it is worthwhile to note its reply with regard to *Laurel Pipe Line*. The Department cites an extremely significant factor that distinguishes that case from the Taxpayer's circumstances by correctly noting that the applicable language in the Pennsylvania statute under consideration read "acquisition, management *and* disposition" of the property, while the North

Carolina statute at issue here reads “acquisition, management *and/or* disposition of the property” in determining whether it is an integral part of a corporation’s regular business. In my opinion, this is a very important distinction.

In *Laurel Pipe Line*, the Pennsylvania court focused on the fact that while the taxpayer continued to operate its intrastate pipeline, the sale of the taxpayer’s interstate pipeline constituted a liquidation of a separate and distinct aspect of the pipeline business, namely, the interstate pipeline business. It appears that the Pennsylvania court’s emphasis on the fact that the disposition of the pipeline was not an integral part of the taxpayer’s regular trade or business was crucial to their determination that the gain from the sale was not business income. This focus on the disposition of the interstate pipeline, while critical given the use of the word “and” in the Pennsylvania statute as noted above, is not determinative in the Taxpayer’s case here because the North Carolina statute uses the word “or.”

While the disposition of a corporation’s assets arguably may not occur as an integral part of its regular business, especially in a partial liquidation, the acquisition and management of the [assets] as an integral part of its regular business in this case is all that is required for the gain from their sale to be considered business income under the North Carolina statute.

Even if an interstate pipeline business can be considered separate and distinct from an intrastate pipeline business as determined by the Pennsylvania court in *Laurel Pipe Line*, I am not convinced that the sale of two operating divisions of a company that provide the same telecommunications services in different states would be considered separate and distinct.

Moreover, the Department also pointed out another critical distinction between *Laurel Pipe Line* and this case. There, the pipeline that was sold had ceased producing business income to the taxpayer and was, in fact, idle. Here, by contrast, the two divisions produced business

income up until the time of disposition. Furthermore, under Administrative Rule 5C.0703, assets that generate business income cannot produce nonbusiness income upon disposition unless they produced nonbusiness income for three years prior to being disposed of.

The Taxpayer has cited the recent decision of the North Carolina Court of Appeals in *Lenox, Inc. v. Offerman*, No. COA99-1267 (N.C. Ct. App. Dec. 5, 2000) in further support of its argument that the gain from the sale of the [two] Divisions constitutes nonbusiness income. While the majority in that case did rule that the gain from the sale by a manufacturer of consumer goods of an operating division that manufactured fine jewelry was nonbusiness income, I believe that there are sufficient significant factual distinctions between the sale transactions and the operations of the taxpayer in *Lenox* and those of the Taxpayer here to distinguish the two cases. Indeed, the sale of the Taxpayer's two divisions here would very likely be considered business income under the reasoning of the majority in *Lenox*.

In *Lenox*, the majority opinion, in synthesizing the results of four cases it found relevant to its analysis, *McVean & Barlow, Inc. v. New Mexico Bureau of Revenue*, 543 P.2d 489, N.M. Ct.App.1975), *Welded Tube Co. v. Commonwealth*, 515 A.2d 988 (Pa.Commw.Ct.1986), *Texaco-Cities Service Pipeline Co. v. McGaw*, 695 N.E. 2d 481 (Ill.1998), and *Laurel Pipe Line*, stated that “whether the business liquidation results in a complete cessation of the company’s involvement in that line of business is particularly relevant.” (*Lenox* at 4) (underling added). Thus, the *Lenox* court found that “(c)essation ultimately justified treating the gains as nonbusiness income in *McVean & Barlow* and *Laurel Pipe Line*, whereas non-cessation justified classification as business income in *Welded Tube* and *Texaco-Cities*.”(Id).

The liquidation of the taxpayer’s jewelry division in *Lenox*, whereby it completely extricated itself from that particular line of business, jewelry, can be distinguished from the

Taxpayer's sale here of its [two] divisions. In the Taxpayer's case, it did not completely cease its involvement in the telecommunications business with the liquidation of the two divisions because it remained in that line of business in other states, including North Carolina, following the sale. In my opinion, the gain from the sale of the [two] divisions is business income under the court's reasoning in *Lenox* because there was no cessation of the Taxpayer's involvement in the telecommunications business.

In addition, I most respectfully disagree with the majority decision in *Lenox* and opine that the well reasoned dissent more closely follows the decision of the North Carolina Supreme Court in *Polaroid v. Offerman*. The income that was produced by the [two] divisions prior to their sale was business income and was recognized as such by the Taxpayer. Because the Legislature is presumed to always act with full knowledge of statutes, "the fact that our state statute requires *only* that the 'disposition of the property constitute integral parts of the corporation's regular trade or business operations,' and not the 'acquisition and management' as well, serves as notice that as long as the asset handled by the corporation produced income as an integral part of the corporation's regular trade or business operations, that income is business income. N.C. Gen. Stat. 105-130.4(a)(1). (*Lenox, Inc. v. Offerman*, dissenting opinion of Judge Hunter). (underlining added).

The Secretary of Revenue has a right to appeal the decision in *Lenox* to the North Carolina Supreme Court as a matter of law and I must therefore conclude that the issue has not been adjudicated with sufficient finality to be binding or determinative here.

[The Taxpayer is a single entity and is not simply] the North Carolina division. The Taxpayer operates each of the four divisions that provided the same type of telecommunications services in each of the four states in which the divisions operated. There is no doubt that each of

the four operating divisions were integral and essential parts of the telecommunications service operations provided by Taxpayer in its regular business. In fact, they were treated as such by the Taxpayer for tax accounting purposes. Even assuming, arguendo, that the disposition of the [two] divisions may not have been integral to the Taxpayer's business, because those two divisions were acquired and managed as integral parts of the Taxpayer's regular business, the gain from their sale is business income as defined in G.S. 105-130.4(a)(1) under the functional test and also as clearly defined in Administrative Rule 17 NCAC 5C .0703(2).

**3. IS THERE A UNITARY CONNECTION BETWEEN THE GAIN FROM THE SALE OF THE [TWO] DIVISIONS AND THE TAXPAYER'S ACTIVITIES IN NORTH CAROLINA?**

In this case, the Department insists that it has not been given the opportunity to review certain documents that it deems relevant and important to allow a proper determination of the issue of whether there is a unitary connection between the gain from the sale of those out-of-state divisions and North Carolina. (Departments Response to Motion p. 3) The Department asserts that it would be prejudiced by its inability to review certain documents that it claims are relevant to those two issues and requests that it be provided with those documents by the Taxpayer. (Id., at Exhibit 2). The Taxpayer responds that there is sufficient evidence in the record to determine both issues.

While the procedural requirements of the Rules of Evidence properly and necessarily provide order, fairness and uniformity to judicial proceedings, the North Carolina Legislature has seen fit to specifically exclude the application of these rules from administrative tax hearings in G.S. 105-141.1(c). This is, in my opinion, to permit the Secretary of Revenue to consider in her deliberations certain documents or other evidence that, while potentially excludable under the technical and stringent standards of the Rules of Evidence, should properly be considered by her

because the information is relevant to, or probative of, the issue of the correct amount of tax due. Such an arrangement is clearly proper so that both the representatives of the Department and the taxpayer in a controversy can have an opportunity to present fully and completely the best information available to the trier of fact, unfettered by the burdensome restrictions of legal procedures and evidentiary rulings that could unnecessarily envelope both sides in a morass of civil procedure.

The determination of whether the gain from the sale of the [two] divisions of the Taxpayer was unitary with its operations in North Carolina involves very complex facts and requires a very detailed inquiry into the nature of the relationships between the Taxpayer and its operating divisions over several years. In my judgment, there is presently not sufficient evidence in the record to properly and equitably make that determination under the “best information available” standard specifically required by G.S. 105-242.1. While the Taxpayer makes the argument that there is sufficient evidence in the record to reach a conclusion on that issue, I must disagree in light of the importance and complexity of the matter. In my opinion, the Secretary of Revenue has been granted broad powers to determine the types and amount of information that can be requested during the administrative tax hearing process.

The purpose of an administrative tax hearing is to permit the Secretary of Revenue, or her designee, the opportunity to review and deliberate all of the documents, facts and circumstances that can reasonably be made available so that she can make the best informed, well reasoned determination of the proper tax liability of a taxpayer. This position is supported by G.S. 105-258, which states in relevant part that:

The Secretary of Revenue, for the purpose of ...  
determining the liability of any person for any tax ...  
shall have the power to examine...any books, papers  
records, or other data which may be relevant or

material to such inquiry.

Thus, it appears from the statute that the only restriction upon the types of documents that can be requested by the Secretary to make such a determination is that they must be relevant or material.

I am very cognizant of the fact that my tenure as the hearings officer will terminate at the end of 2000, which would seem at first blush to require my ruling on all of the issues presented in this case. However, a hurried, ill-considered final decision made in the interest of practical expediency and without the benefit of careful consideration and quiet reflection upon the best information available would not properly serve either the Taxpayer or the Department.

There is, in my opinion, sufficient evidence in the record to rule upon the issues of whether the Taxpayer is entitled to utilize a bifurcated apportionment formula and whether the gain from the sale of the [two] divisions is business or nonbusiness income. Accordingly, I have done so earlier in this final decision. However, with regard to the issue of whether the two divisions were unitary with the Taxpayer's operations in North Carolina, I believe that some of the documents requested by the Department in its Exhibit 2 of the Response to Motion are relevant and material to the matter and should be provided to the Department for review.

The Taxpayer has, by the arguments made at the hearing and later clarified in its opening brief, presented the significant issue of whether the [two] divisions are unitary with the Taxpayer's business operations in North Carolina. The evidence presented by the Taxpayer raises significant and important questions that warrant further investigation and clarification regarding that issue. It would be inappropriate to close the record now and render a final decision with those questions unanswered.

Furthermore, to deny the Department's request to obtain those documents that it deems necessary for making a proper determination of the tax liability of the Taxpayer would unfairly prejudice the Department's case. If the Department had certain documents in its possession that the Taxpayer now chose to request, I would not hesitate to require that the Department provide them and to also allow the Taxpayer reasonable time to review and respond to them. The "lateness of the hour" here is not sufficient grounds to deny the Department's request for additional documents. The Department is entitled to a copy of those documents that can be provided without creating an undue burden on the Taxpayer. The Taxpayer would not be significantly prejudiced by such a requirement to provide documents and to have the issue of unitariness determined at a later date by my successor. The interest of the Department in obtaining those documents that it considers so important to its case outweighs any inconvenience that may be suffered by the Taxpayer as a result of a requirement to provide them.

The record in this case is very complete, including not only a complete written transcript of the hearing held on August 16, 2000, that was prepared by and submitted for the record by the Taxpayer, but also an audio recording of the entire hearing, as well as supplemental briefs submitted by both sides following the hearing. These documents would permit the new hearing officer to have access to all of the information in the record and to fully and completely review it during deliberations. This review of the record could easily be supplemented by submission of additional briefs and written or oral arguments by both sides solely on the issue of unitariness without the need for the Taxpayer to incur the expenses involved with reconvening the hearing in Raleigh.

This procedure would provide both the Taxpayer and the Department with a reasonable and equitable solution that does not prejudice or unduly burden either side. If either side



concludes that such an arrangement is not satisfactory, then it may request and should be granted the opportunity to convene the hearing under the new hearings officer on the issue of unitariness. In my opinion, this arrangement provides an equitable and fair solution that affords due process to the Taxpayer.

I have reviewed the document request made by the Department in Exhibit 2 to its Response to Motion, as well as the Taxpayer's objection to the document request. While some of the items requested by the Department may arguably be redundant or overlapping, some of the documents would clearly be relevant or material to the question of the proper tax liability of the Taxpayer as required by G.S. 105-258. In my opinion, the Taxpayer's general objection to all of the documents requested is too broad and lacks sufficient detail with regard to each of the separately numbered requests to properly make a determination of relevance or materiality for each document. Accordingly, I must order that that all of the documents requested in Exhibit 2 of the Department's Response to Motion be provided by the Taxpayer to the Department no later than June 30, 2001, or by a later date if so requested by the Taxpayer and upon a proper showing of why such an extension would be necessary. In the alternative, the Taxpayer may request, and should be granted, an evidentiary hearing either in Raleigh, or through an exchange of written arguments, on the issue of whether any of the documents requested by the Department should be provided by the Taxpayer. The details of this arrangement should be determined by my successor.

Therefore, the Taxpayer's request to use a bifurcated apportionment formula or any other modified formula to apportion the gain from the sale of the two divisions is denied. The Taxpayer's request to use a separate accounting of the gain from the sale of the two divisions is

denied. The Taxpayer's request for a refund of corporate income tax based on its claim that the gain from the sale of the [two] divisions is nonbusiness income is denied.

The Taxpayer's request for a refund based upon its claim that there is no unitary connection between the gain from the sale of the [two] divisions and its operations in North Carolina is taken under advisement pending further proceedings as stated herein.

Made and entered this 29<sup>th</sup> day of December, 2000.

Signature \_\_\_\_\_

Michael A. Hannah  
Assistant Secretary of Revenue