

STATE OF NORTH CAROLINA
COUNTY OF WAKE

BEFORE THE ASSISTANT
SECRETARY FOR
ADMINISTRATIVE TAX
HEARINGS

IN THE MATTER OF:)
)
The Protest of a Proposed Assessment of)
Additional Corporate Income Tax for the)
period ending December 31, 2000 by the)
Secretary of Revenue of North Carolina.)
)
vs.)
)
)
)
(TAXPAYER))

Final Decision
Docket No. 2006-111

This matter was heard before Eugene J. Cella, Assistant Secretary for Administrative Tax Hearings, at the North Carolina Department of Revenue in the City of Raleigh on October 11, 2006 regarding an assessment of additional corporate income tax, penalty, and interest proposed against (Taxpayer), hereinafter referred to as "Taxpayer," for the tax year 2000. (Representative 1) of (law firm 1) and (representative 2) of (law firm 2) represented Taxpayer. The Corporate, Excise and Insurance Tax Division was represented by Gregory B. Radford, Director, Lennie A. Collins, Assistant Director, Donna P. Powell, Assistant Director, and Bobby L. Weaver, Jr., Administration Officer. Greg P. Roney, Assistant Attorney General, also represented the Department.

ISSUE

Whether \$(several) million received by Taxpayer from a lawsuit settlement with (third party 1) is business income within the meaning of G.S. 105 130.4(a)(1), as it existed during the year at issue.

EVIDENCE

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

Submitted by the Division:

D-1 Taxpayer's Corporate Income and Franchise Tax Return for the tax year 2000.

- D-2 Notice of Income Tax Assessment for the tax year 2000 dated August 9, 2005.
- D-3 Auditor's Report for Corporate Income Tax for the tax year 2000 dated June 30, 2005.
- D-4 Letter from (Taxpayer employee 1), Treasury and Tax Manager with Taxpayer, to Michael Murray, Interstate Examination Division, dated April 7, 2005.
- D-5 Letter of Protest from (Taxpayer employee 1) to Gregory B. Radford, Director of the Corporate, Excise and Insurance Tax Division, dated August 24, 2005.
- D-6 Letter from (Taxpayer employee 1) to Bobby L. Weaver, Administrative Officer in the Corporate, Excise and Insurance Tax Division, dated November 15, 2005.
- D-6A Copies of the complaints: Taxpayer vs. (third party 2 and third party 3).
- D-6B Copies of the complaints: Taxpayer vs. (third party 2, third party 3 and third party 1).
- D-6C Pages from a Taxpayer Senior Unsecured Revolving Credit Facility Memorandum dated November 1998.
- D-6D Letter from (Taxpayer employee 1), Lending Asst. of (bank), to (Taxpayer employee) dated October 19, 2005.
- D-6E Taxpayer Daily Cash Management Analysis Ledger Balance Summary.
- D-6F Taxpayer Senior Notes.
- D-6G Prospectus from (financial company), dated March 11, 1992
- D-6H Schedule of 1999 & 1998 Bond Repurchases
- D-7 Letter from Bobby Weaver to (representative 3) with (accounting firm) dated January 20, 2006.
- D-8 Letter from (representative 1) with (law firm 1) to Bobby Weaver dated February 17, 2006.
- D-9 Power of Attorney and Declaration of Representative.
- D-10 Letter from Bobby Weaver to (representative 1) dated April 7, 2006.
- D-11 Letter from Eugene Cella, Assistant Secretary of Revenue, to (representative 1) dated June 9, 2006.

- D-12 Joint Venture Agreement between Taxpayer and (third party 1) dated January 11, 1999.
- D-13 Services Agreement between (Taxpayer) Manufacturing Company, hereinafter referred to as "(TMC)," and Taxpayer dated December 27, 2001.
- D-14 Printing & Distribution Agreement between (TMC) and Taxpayer dated December 27, 2001.
- D-15 Settlement Agreement and Release of Claims between (third party 1, third party 2 and third party 3), and Taxpayer dated February 29, 2000.
- D-16 History of Taxpayer as published on (its website)
- D-17 Chronology of Taxpayer's Press Releases (March 1999 to February 2002)
- D-18 Taxpayer's October 7, 1999 Press Release as published on (unrelated company's website)
- D-19 Taxpayer's March 7, 2000 Press Release as published on (unrelated company's website).
- D-20 Taxpayer's April 26, 2000 Press Release as published on (unrelated company's website).
- D-21 Taxpayer's August 14, 2000 Press Release as published on (unrelated company's website).
- D-22 Taxpayer's August 31, 2000 Press Release as published on (unrelated company's website).
- D-23 Taxpayer's September 20, 2000 Press Release as published on (unrelated company's website).
- D-24 Taxpayer's October 26, 2000 Press Release as published on (unrelated company's website).
- D-25 Taxpayer's November 14, 2000 Press Release as published on (unrelated company's website).
- D-26 Order on Motion for Limited Admission of (representative 2) to Practice Pro Hac Vice.

- D-27 Internet article posted on (unrelated company's website) dated January 27, 2003 entitled "(Taxpayer) Selects (unrelated company) as Strategic Email Communications Providers".
- D-28 The Department's Tax Hearing Brief for Docket No. 2006-111.
- D-29 Letter dated November 3, 2006 from Eugene Cella to Greg P. Roney, Assistant Attorney General, and (representative 1) of (law firm 1).
- D-30 Letter dated November 8, 2006 from Eugene Cella to (representative 1).
- D-31 Taxpayer's August 30, 2006 Press Release as published on (unrelated company's website).
- D-32 Excerpt from the 2005 10-K filed with the Securities and Exchange Commission on March 14, 2006.
- D-33 Excerpt from the 2004 10-K filed with the Securities and Exchange Commission on March 15, 2005.
- D-34 Excerpt from the 2003 10-K filed with the Securities and Exchange Commission on March 12, 2004.
- D-35 Excerpt from the 2002 10-K filed with the Securities and Exchange Commission on March 25, 2003.
- D-36 Excerpt from the 2001 10-K filed with the Securities and Exchange Commission on March 29, 2002.
- D-37 Excerpt from the 2000 10-K filed with the Securities and Exchange Commission on March 27, 2001.
- D-38 Excerpt from the 1999 10-K filed with the Securities and Exchange Commission on March 28, 2000.
- D-39 Taxpayer's July 14, 1999 Press Release as published on (unrelated company's website).
- D-40 Taxpayer's July 22, 1999 Press Release as published on (unrelated company's website).
- D-41 Taxpayer's September 2, 1999 Press Release as published on (unrelated company's website).

- D-42 Taxpayer's October 21, 1999 Press Release as published on (unrelated company's website).
- D-43 Attorney General's Opinion dated January 7, 1947.
- D-44 Administrative rule T17 NCAC Chapter 5C.0703.
- D-45 The Department's Tax Post-Hearing Brief for Docket No. 2006-111.

Submitted by Taxpayer:

- T-1 Taxpayer's Affidavit in Support of Request for Redetermination of Assessment, by (taxpayer employee 2), including Exhibits A through E attached thereto, dated October 4, 2006, and submitted October 10, 2006.
- T-2 Taxpayer's Brief for Petitioner for Docket No. 2006-111.
- T-3 Taxpayer's Supplemental Brief for Petitioner for Docket No. 2006-111.
- T-4 Taxpayer's Affidavit in Support of Request for Redetermination of Assessment, by (taxpayer employee 2), dated November 20, 2006, and submitted November 20, 2006.
- T-5 Taxpayer's Reply Brief for Petitioner.
- T-6 Taxpayer's Affidavit in Support of Request for Redetermination of Assessment, by (taxpayer employee 2), dated January 19, 2007.

FINDINGS OF FACT

Based on the foregoing evidence of record, the Assistant Secretary for Administrative Tax Hearings makes the following findings of fact:

1. Taxpayer was incorporated in Delaware on (Date 1) and is headquartered in (city), (state other than North Carolina).
2. Taxpayer qualified to transact business as a corporation in North Carolina on (Date 2)).
3. The company is a leading company in the marketing promotion industry.
4. Taxpayer's principal clients are packaged consumer goods companies to whom it provides a range of services for creating, printing and delivering promotional

materials such as coupons and samples through newspapers and other means.

5. During the audit period, Taxpayer's principal products were free standing inserts which are multiple page booklets containing coupons, rebates and other consumer offers that are distributed to consumers nationwide through insertion in local Sunday newspapers.
6. Taxpayer operates one of its three manufacturing facilities in (city), North Carolina. The (city) facility is approximately 188,000 square feet and is solely related to printing and distributing cents off coupons.
7. In the late 1990s, Executive Vice President and Chief Operating Officer (new president)) succeeded (former president) as President and Chief Executive Officer.
8. Under (new president)'s leadership, Taxpayer began positioning itself to be more customer-driven versus product-driven, and developed a strategic growth plan, including expanding its existing marketing business into a segment of the industry known as Customer Relationship Marketing (CRM), also known as one-to-one loyalty marketing.
9. CRM offers retail clients customized communications programs designed to increase their shoppers' loyalty and ensure shopper retention through the combined application of traditional and alternative marketing solutions.
10. Taxpayer was engaged in segments of the CRM industry as early as 1999 and made deliberate strategic investments or alliances to better position itself in that industry during 1999 and 2000. Taxpayer was actively engaged in the CRM business before and after the (third party 1) contract.
11. Taxpayer referred to this initiative as CARS (Customer Attainment and Retention System). CARS included expanding Taxpayer's existing marketing business into the CRM segment of the industry and the internet (e-commerce).
12. From July 1998 until January 1999, Taxpayer and (third party 1) negotiated the establishment of a new joint venture for the purpose of developing software, processes, know-how, and business strategies for the CRM segment of the industry.
13. On January 11, 1999, Taxpayer and (third party 1) entered into an agreement to form the joint venture. Taxpayer would own 72% of the equity interests in the venture and (third party 1) would own 28%.
14. Under the agreement, Taxpayer was to provide up to \$4.9 million of the capital funding set forth in the pro forma business plan.

15. The new business entity was created to develop a business that would provide supermarkets with a one stop turnkey service to reach their customers with promotional materials that made use of individual shopping data collected at supermarkets.
16. Taxpayer passed over other interested partners before selecting (third party 1) as its joint venture partner because of (third party 1)'s unique qualifications to ensure the success of the enterprise. Those qualifications included (third party 1)'s capacity to develop the necessary software and its familiarity with in-store data collection systems.
17. (Third party 1) had a special relationship with the supermarket industry developed through its position as the premiere consultant to that industry.
18. Within days of entering into the joint venture agreement, (third party 1) decided not to proceed with the agreement and withdrew from the joint venture after one of its major clients, (third party 2), threatened to withdraw its business if (third party 1) entered into the joint venture with Taxpayer.
19. Taxpayer initiated suit against (third party 1) for breach of contract, breach of fiduciary duty and other matters.
20. Taxpayer also initiated suit against (third party 1)'s clients, (third party 2 and third party 3), for tortious interference with the contract, tortious interference with prospective contractual rights, and aiding and abetting the breach of (third party 1)'s fiduciary duty to Taxpayer as its joint venture partner.
21. Taxpayer sought \$(several) million in compensatory and punitive damages.
22. (Third party 1) in turn sued Taxpayer claiming that no contract between Taxpayer and (third party 1) existed, and requested that the (County), (state other than North Carolina) Circuit Court stop Taxpayer from further harming (third party 1) and its reputation by proceeding with its suit in (another state other than North Carolina).
23. On February 29, 2000, Taxpayer and (third party 1) agreed to settle their differences. (Third party 1) paid a lump sum of \$(several) million to Taxpayer for the settlement and release.
24. The settlement agreement with (third party 1) was designed to compensate Taxpayer for lost profits resulting from (third party 1)'s breach of contract, which affected Taxpayer's business in the CRM segment of the market.
25. The contract with (third party 1) was a component of Taxpayer's business plan to expand its services into other segments of the marketing industry.

26. According to a press release issued by Taxpayer on March 7, 2000, (new president), (Taxpayer's) chairman, president and chief executive officer, is quoted as saying, "We are pleased with the settlement, which will help us advance our loyalty marketing initiatives. Our CRM business is making great progress, and this settlement will contribute to its ongoing development, as well as provide other benefits to our shareholders."
27. Taxpayer timely filed its North Carolina Corporate Income and Franchise Tax Return for the tax year ending December 31, 2000 on October 15, 2001 under an approved extension of time for filing.
28. Taxpayer reported business income subject to apportionment of \$206,247,321 and an apportionment factor of 7.8876%. Taxpayer reported \$(several million) as nonbusiness income, consisting of proceeds of \$(several million) from the lawsuit settlement with (third party 1) less related expenses of \$(less tyhan a million).
29. Taxpayer stated on the return that "the nonbusiness income represents proceeds from a lawsuit settlement for breach of fiduciary relationship and tortuous interference. The income is extraordinary in nature & does not represent lost profits." Therefore, Taxpayer allocated the nonbusiness income outside North Carolina.
30. The Department disagreed with Taxpayer's classification of the proceeds as nonbusiness income and reclassified the income as business income. The reclassification increased Taxpayer's North Carolina income tax liability by \$186,168.00.
31. On August 9, 2005, the Department of Revenue proposed an assessment of additional corporate income tax, a ten percent negligence penalty, and interest in the amount of \$253,736.41.
32. Taxpayer objected to the proposed assessment and timely requested a hearing before the Secretary of Revenue.
33. Taxpayer's corporate income tax for the tax year was understated by 14.24%.
34. Taxpayer claims that the failed joint venture with (third party 1) represented a cessation of a business. Taxpayer further claims that it was not actively engaged in the customer relationship marketing (CRM) business during the time that the dispute with (third party) arose and was being resolved.
35. The CRM business did not cease with the failed joint venture with (third party 1). The joint venture is not the business. CRM is the business.
36. The settlement proceeds contributed to the continuation of Taxpayer's CRM business.

37. In a press release dated July 22, 1999 reporting second quarter earnings for the 1999 year, Taxpayer states, "As [Taxpayer] continues to move on the continuum from database marketing to customer relationship marketing, management believes this business has the potential to reach the size and profitability of its flagship FSI business."
38. In mid-1999, Taxpayer signed a strategic marketing agreement with another software company, (software company). The agreement named (software company) as a preferred technology supplier to Taxpayer for CARS.
39. (Software Company)'s (software) enabled Taxpayer to analyze shopper information databases for retail marketing opportunities, and then prioritize marketing investments according to potential return on investment.
40. Taxpayer's alliance with (software company) was consummated to provide customized software that analyzes shopper information databases and develops promotions to maximize customer profitability.
41. In mid-1999, Taxpayer formed a division, referred to as its Customer Relationship Marketing Group, to provide database-marketing promotions for the retail industry using a proprietary encrypting program and AZTEC codes. The division generated revenues from clients in several categories, including after-market automotive, foodservice, eye care, and major supermarket chains.
42. (New vice-president), vice president of Taxpayer's newly formed Customer Relationship Marketing Group (CRMG), said, "We believe this agreement enhances our ability to execute customer relationship marketing programs for retailers. [Taxpayer]'s experience in promotion communication is complemented well by (software company)'s software, systems integration expertise and technology team."
43. Taxpayer attributed some of its Impact Promotions sales of \$118.1 million to the CRMG in its SEC 10-K filing for 1999. The goal of CRMG, as stated in the 1999 10-K, "is to provide retailers with a turnkey service that builds long-term customer relationships and increases profitability."
44. In September of 1999, Taxpayer made another strategic move to advance its Internet initiatives and develop CARS by acquiring a majority interest in (e-commerce solution provider), a subsidiary of (unrelated party).
45. (E-commerce solution provider) offered software and e-commerce solutions that allow supermarkets to implement full service consumer home-shopping programs, from the creation and hosting of supermarket web sites to online and offline ordering, all the way through to pick, scan and pack technology for order fulfillment.

46. At the time, (e-commerce solution provider) was the most widely installed service in this segment of the grocery home shopping market, and was expected to grow to over 300 stores in the next year.
47. In a press release dated September 2, 1999, Taxpayer's president and CEO is quoted as saying "The investment in (e-commerce solution provider) helps put (Taxpayer) in direct contact with retailers, who play a critical role in one-to-one relationship marketing. Not only does this investment move forward our Internet initiatives, it is also another step toward a comprehensive customer attainment and retention system."
48. In 1999, Taxpayer made a thirty percent (30%) investment in (relationship marketing company) to provide a retail-sponsored direct mail vehicle targeting frequent shopper households based on prior purchase behavior.
49. (Relationship marketing company) represented over 1,500 grocery retail outlets throughout the United States, providing Taxpayer with immediate retailer relationships. (Relationship marketing company)'s ability to target offers by accessing shopper data allowed Taxpayer to enhance consumer loyalty to its retail partners.
50. Taxpayer claims in its supplemental brief and affidavit that it was merely a passive investor in (relationship marketing company) and that none of its employees participated in the day to day operations or management of (relationship marketing company).
51. Taxpayer actively managed (relationship marketing company) and developed its CARS initiative.
52. Taxpayer's president and CEO is quoted as saying, "(Relationship marketing company)'s existing relationships and targeted direct mail product provide us with an important next step in the development of CARS...The ability to target offers by accessing shopper data allows (relationship marketing company) to enhance consumer loyalty to its retail partners."
53. In a press release dated October 7, 1999, Taxpayer announced that it appointed (new general manager), formerly vice president of its northeast sales division, to vice president and general manager of its Customer Relationship Marketing Group. The press release also states that (new general manager) will be responsible for the general management of (relationship marketing company), as well as the development of CARS.
54. In its reply brief, Taxpayer states that "(new general manager) was not involved with relationship marketing when the joint venture agreement with [third party 1] was signed. Rather, she was Vice President of [Taxpayer]'s Northeast Sales Division. Further, her role as manager in October 1999 demonstrates that

[Taxpayer] did not have a relationship marketing business of its own. One of her chief functions as relationship marketing group manager was to determine if it would be feasible for [Taxpayer] to launch its own relationship marketing business.”

55. Before October 1999, Taxpayer had already entered the CRM market.
56. In the following year, Taxpayer purchased a minority interest in (an unrelated party) and acquired (another unrelated party), which also enhanced its loyalty programs to retail trade through (another unrelated party)’s customer base.
57. Taxpayer also acquired (a direct-to-door sampling business) and signed an agreement with (another unrelated company) to combine (relationship marketing company) and (another unrelated party)’s Retail Marketing Systems (RMS) to produce (a relationship marketing systems company).
58. As a result of Taxpayer’s investments and acquisitions, (relationship marketing company) is recognized today as a premier customer relationship marketing solution provider that markets its customized communications and software products and services to consumer package goods manufacturers and high transaction volume retailers worldwide.
59. Taxpayer claims that its lawsuit and the resulting settlement agreement with (third party 1) was an extraordinary event.
60. Taxpayer has engaged in litigation as a regular part of its trade or business since its settlement agreement with (third party 1).
61. In August 2006, Taxpayer sued (a company) in the (another state) Chancery Court to rescind its \$(several million) merger agreement with (a company) based on fraud and material adverse changes, alleging that (a company) management materially misrepresented the financial health of the company and failed to reveal internal control deficiencies.
62. Earlier in 2006, Taxpayer filed a lawsuit in (another state) Federal Court against (several related companies). The complaint alleged that (several related companies) had tied the purchase of its in-store promotion and advertising services to the purchase of space in its FSI and that (several related companies) had attempted to monopolize the FSI market. The complaint alleged damages in excess of \$(several million), injunctive relief and costs for violation of the Sherman Act.
63. In February 1999, Taxpayer brought a lawsuit against (an unrelated company) asserting that (unrelated company) wrongfully obtained proprietary information from Taxpayer’s newspaper delivered sampling business. The litigation against (unrelated company) was eventually amicably resolved by mutual agreement between the parties, similar to Taxpayer’s suit against (third party 1).

64. Taxpayer described each of the above lawsuits, including the lawsuit with (third party 1), in its annual reports and 10-K filings with the SEC as “arising in the ordinary course of business.”
65. Taxpayer states that the Division “attempts to paint a contrary picture by relying on press releases that contain public relations puffery and that are irrelevant for purposes of applying the transactional and functional tests because they are dated at least six months after the [third party 1] contract was entered into and aborted.”
66. The Division presented public information and statements made by Taxpayer, including SEC reports filed by Taxpayer during the relevant period.
67. Taxpayer’s statements were not puffery, but were factual statements showing that Taxpayer’s business activities at the relevant time included the CRM business and the expansion of its CRM business through acquisitions and joint ventures.

CONCLUSIONS OF LAW

Based on the foregoing findings of fact, the Assistant Secretary for Administrative Tax Hearings makes the following conclusions of law:

1. Under the North Carolina Corporate Income Tax Act, which is closely patterned after the Uniform Division of Income for Tax Purposes Act (UDITPA), a multistate corporate taxpayer’s income is divided into two classes for purposes of apportionment and allocation--“business income” and “nonbusiness income.” Business income is apportioned among all states in which the taxpayer does business by use of a statutory formula; nonbusiness income is allocated entirely to a particular state.
2. For the tax year at issue, “business income” was defined as “income arising from transactions and activities 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 trade or business.”
3. The definition of “business income” contains two independent and alternative tests--a “transactional” test and a “functional” test. If either the transactional or functional test is met, the income in question is properly classified as business income.
4. North Carolina Administrative Rule 17 NCAC 5C.0703 supplements and amplifies the definition of business and nonbusiness income. The rule provides that “[t]he

classification of income by the labels customarily given them, such as interest, rents, royalties, or capital gains, is of no aid in determining whether that income is business or nonbusiness income. The gain or loss recognized on the sale of property ... may be business income or nonbusiness income depending upon the relation to the taxpayer's trade or business....”

5. The transactional test arises from the first clause of the definition of “business income.” This definition looks at whether the transaction or activity which gave rise to the income occurred in the regular course of the taxpayer's trade or business.
6. Under the transactional test, to determine whether business income is derived from a transaction or activity in the regular course of the corporation's trade or business, one must consider the frequency and regularity of similar transactions, the former practices of the business, and the taxpayer's subsequent use of the income.
7. Taxpayer was actively engaged in acquiring interests in outside marketing ventures as an integral part of its regular trade or business. The creation of the (third party 1) contract by the efforts of Taxpayer's officers and employees through negotiation is part of the regular business. The contract's creation was a result of Taxpayer's unitary business activities. Thus, it was acquired in the course of Taxpayer's regular trade or business.
8. The settlement proceeds contributed to the continuation of Taxpayer's CRM business.
9. The contract between Taxpayer and (third party 1), which resulted in the receipt of settlement proceeds, was entered into in the regular course of Taxpayer's CRM business; satisfies the transactional test; and therefore constitutes business income.
10. The functional test appears in the following portion of the statute: “Business income ... includes income from tangible and intangible property if the acquisition, management, and/or disposition of the property constitutes integral parts of the corporation's regular trade or business operations.” This test is often described as requiring an analysis of the relationship of the income-producing property to the taxpayer's regular trade or business.
11. Damages received as compensation for lost profits are taxable in the same manner as the profits themselves would have been taxable to the award recipient, had they been earned by the taxpayer in the ordinary course of its business.
12. In Polaroid Corp. v. Offerman, 349 N.C. 290, 507 S.E.2d 284 (1998), cert. denied, 526 U.S. 1098 (1999), the North Carolina Supreme Court ruled that since

the Kodak judgment constitutes income "in lieu of" profits Polaroid ordinarily would have obtained in the marketplace, the "lost profits" award fits within the functional test and this state's definition of business income.

13. Under the functional test, if the income-producing property constitutes an integral part of the taxpayer's trade or business, the income from any transaction involving the property also constitutes business income.
14. Applying the functional test, the issue is the source or origin of income. If the settlement award arose from the contract with (third party 1), any actions Taxpayer may have taken to collect that income are irrelevant to its character or nature for income tax purposes.
15. The settlement income in question arose from Taxpayer's contractual agreement with (third party 1). The existence of the contract with (third party 1) gave Taxpayer a right to \$(several) million in damages for (third party 1)'s breach of the agreement.
16. The contract was negotiated for the benefit of Taxpayer's growing CRM business. As such, it added value to Taxpayer's business operations and is therefore properly considered an asset. The acquisition of the joint venture contract with (third party 1) constituted an integral part of taxpayer's trade or business.
17. Applying the functional test, this situation is controlled by Polaroid.
18. The fact that the income was received as the result of a legal settlement rather than from marketplace sales is irrelevant.
19. The potential earnings would have been business income received from Taxpayer's regular trade or business operations.
20. The settlement with (third party 1) is not the liquidation of a line of business because Taxpayer continued its CRM business.
21. The settlement award from (third party 1) satisfies the functional test and therefore constitutes business income.
22. The settlement award was properly classified by the Department as apportionable business income under either the transactional or functional test.
23. A penalty equal to ten percent of the tax deficiency is imposed for negligent failure to comply with the Revenue Laws or rules issued pursuant thereto.
24. Penalties may be waived or reduced upon the making of a record for the reasons therefore.

25. The ten percent negligence penalty was properly imposed but qualifies for waiver under the Department's Penalty Policy.

DECISION

This case only presents one issue for resolution. The issue to be addressed is whether the \$(several) million received by Taxpayer from the lawsuit settlement with (third party 1) is business income within the meaning of G.S. 105 130.4(a)(1), as it existed during the year at issue.

Applying the functional test, this situation is controlled by Polaroid. There is no question that the settlement agreement with (third party 1) was designed to compensate Taxpayer for lost profits resulting from (third party 1)'s breach of contract, which affected Taxpayer's business in the CRM segment of the market. The contract with (third party 1) was a component of Taxpayer's business plan to expand its services into other segments of the marketing industry. The potential earnings would have been business income received from Taxpayer's regular trade or business operations.

The settlement in this matter was intended to compensate Taxpayer for damages resulting from lost profits as a result of (third party 1)'s breach of contract. Since the settlement award constitutes income "in lieu of" profits Taxpayer ordinarily would have obtained in the marketplace, I hold that the award proceeds fit within the functional test and this state's definition of business income for North Carolina corporate tax purposes.

The award proceeds also fit within the transactional test. As Taxpayer built its CRM business, Taxpayer was actively engaged in acquiring interests in outside marketing ventures as an integral part of its regular trade or business. The creation of the (third party 1) contract by the efforts of Taxpayer's officers and employees through negotiation was part of the regular business, and the contract's creation was a result of Taxpayer's unitary business activities. Thus, the contract between Taxpayer and (third party 1), which resulted in the receipt of settlement proceeds, was entered into in the regular course of Taxpayer's CRM business and satisfies the transactional test.

After considering the arguments presented at the hearing and the briefs filed by both parties, I find that the proceeds from the settlement agreement were properly reclassified as business income and included in Taxpayer's North Carolina taxable income.

The proposed assessment of additional income tax, interest and penalty, as modified to waive the penalty in its entirety, is correct under the law and are hereby sustained and determined to be final and collectible, together with interest as allowed by law.

This the _____ day of _____, 2007.

Signature _____

Eugene J. Cella
Assistant Secretary of Revenue