SUPERIOR COURT OF THE DISTRICT OF COLUMBIA
TAX DIVISION

NBI, INC., Petitioner,	:	
v.	:	Tax Docket No. 3691-85
DISTRICT OF COLUMBIA Respondent.	:	

ORDER

This matter came before the Court for hearing on Cross-Motions for Summary Judgment filed by petitioner, NBI Inc., and respondent, District of Columbia.

Petitioner, a computer and office automation equipment company, sells its products throughout the United States, including the District of Columbia. Respondent, over petitioner's objection, included in NBI's apportionable tax base interest income earned on investments of proceeds acquired by NBI from the issuance of stock and debentures. Petitioner claims that it is entitled to a refund of the assessed taxes for 1981 through 1983 because the District of Columbia is prohibited from taxing interest income paid by corporations that are not part of petitioner's unitary business. NBI further asserts that interest income from its long-term 14 1/2 month investments is not apportionable business income and therefore not taxable by the District. Upon review of the pleadings filed, the arguments of counsel at the hearing and the record herein, the Court makes the following:

FINDINGS OF FACT

1. NBI, Inc., the petitioner, was incorporated in Colorado in 1973, and became a Delaware corporation in 1975.

2. During the Tax Years in question, 1981-1983, NBI designed, manufactured, sold, leased and serviced word

processing and office automation systems, equipment and software.

3. Since its incorporation in 1973, NBI has consistently issued stock, debentures and other instruments to obtain working capital.

4. In October, 1980, petitioner issued 375,000 shares of common stock and an additional 25,000 shares held by a private owner were also sold at this time. At the time of the offering, NBI stated to potential investors that it intended to use the proceeds to construct additional office and manufacturing facilities, increase working capital, and finance additional equipment for lease. The company also stated in its prospectus to investors that pending their use in the business, the proceeds would be invested in short-term, interest-bearing securities. These actions were taken and eventually the proceeds from the offering and the interest earned therefrom were spent on construction of a new corporate headquarters in Boulder, Colorado, land, capital equipment and inventory.

5. In April, 1982, petitioner issued 825,000 shares of common stock intending to use the proceeds to increase working capital, finance additional equipment for lease, and purchase capital equipment. The new prospectus published for this offering also indicated that pending their use in the business, the proceeds would be invested in short-term, interest-bearing securities.

6. In November, 1982, NBI issued $40,000,000 in debentures, stating to potential investors that the proceeds would be used to increase working capital, finance higher levels of receivables and inventories, and purchase capital equipment.

7. The proceeds of each issuance of stock and debentures were invested in short-term interest bearing instruments until the proceeds and the interest thereon were spent on receivables, inventories, construction of NBI's new headquarters and the purchase of international distribution rights to its equipment.

8. In its tax returns for the tax years at issue, petitioner treated the income sought to be apportioned and taxed by the District as non-business income allocable to its commercial domicile in Colorado. On September 21, 1984, the District issued a Notice of Tax Deficiency to NBI for fiscal years 1981 through 1983 in the amounts of $13,432, $11,603, and $9,949 respectively. These amounts reflected the tax allegedly owed to the District on income from petitioner's interest-bearing investments. Respondent sought to include these proceeds within petitioner's apportionable tax base.

9. Petitioner paid the taxes on May 7, 1985 and initiated this action on October 2, 1985.

CONCLUSIONS OF LAW

Petitioner argues that the Due Process Clause of the Constitution prohibits the District from taxing interest income paid by corporations that are not part of its unitary business. Petitioner asserts that the Supreme Court decisions in ASARCO, Inc. v. Idaho State Tax Comm., 458 U.S. 307(1982) and F. W. Woolworth Co. v. Taxation and Revenue Dep't., 458 U. S. 354(1982) are dispositive of its argument that the District may not include within NBI's apportionable tax base the income from investments paid by unrelated out-of-state corporations.

The District of Columbia adopted the Multistate Tax Compact in 1981. Under Article IV of the Compact, income is divided into two classes: business and nonbusiness. Business

income is apportioned among taxing jurisdictions and nonbusiness income is allocated to the taxpayer's commercial domicile. D.C. Code § 47-441, Art. IV(2) and (4). Because NBI's commercial domicile is located in Colorado, it contends that the District may not subject the interest income in question to apportionment under the Compact unless it constitutes business income. See D.C. Code § 47-441 Art. IV(1)(a).

Petitioner maintains that both ASARCO and F. W. Woolworth, preclude subjection of the income in question to apportionment under the Compact. Each case involved the question of whether a state could tax a portion of income from intangibles received by the taxpayer from foreign subsidiaries. The Supreme Court held that the "linchpin of apportionability for state income taxation of a interstate enterprise is the unitary business principle." ASARCO at 319; F. W. Woolworth at 362. In both cases, an examination of the taxpayer's functional and managerial relationship with the out-of-state payors demonstrated they were not engaged in a unitary business with the taxpayer in the taxing state. Therefore, the Supreme Court held that apportionment of the income derived from those intangibles was prohibited by the Due Process Clause.

Petitioner analogizes those holdings to the facts of the case at bar. NBI claims that because it had no unitary business relationship with the companies in which it had invested, ASARCO prohibits the District from taxing the income as "business income." NBI further claims that the payors of interest in this case were all out-of-state organizations whose business activities "have nothing to do with the activities of the recipient in the taxing state..." ASARCO. Therefore, the Due Process Clause prevents the District from apportioning and taxing the interest on NBI's investment of proceeds derived from the issuance of its stock and debentures.

Petitioner argues in the alternative that the District erred in its application of the business income definition to the interest income earned by NBI. Petitioner cites Sperry and Hutchinson Co. v. Dept. of Revenue, 527 P.2d (1976) in support of its contention that interest income earned from the investment of funds in intangibles of a maturity in excess of one year is not business income. Petitioner claims that its investment in U.S. Stripped Coupons which earned $100,280.89 in interest during fiscal year 1983 qualifies as a long-term investment and is therefore not taxable by the District because it requires 14 1/2 months to mature.

Respondent avers that D.C. Code § 47-447 (1981 ed.) requires collection of the taxes in question. The District argues that the Multistate Tax Compact requires that business income should be included in a taxpayer's apportionable tax base, a portion of which may be taxed by the District. D.C. Code § 47-441, Art. IV(1)(a) defines business income as:

> [I]ncome [1] arising from transactions and activity in the regular course of the taxpayer's trade or business and [2] includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's business.

The District regulations explicate this concept further in 9 D.C.M.R. §125.4:

> Interest income is business income where the intangible with respect to which the interest was received arises out of or was created in the regular course of business or where the purpose for acquiring or holding the intangible is related to or incidential to the trade or business operation. 9 D.C.M.R. §125.4.

Respondent cites District of Columbia v. Pierce Associates, Inc., 462 A.2d 1129 (D.C. 1983) in support of its contention that the District legitimately taxed petitioner's interest income. Pierce held that the two clauses of D.C.

Code §47-441, Art. IV(1)(a) set up alternate tests, either of which could be used for determining whether income constituted business income. The first clause, income arising from transactions and activity in the regular course of business, was called the "transactional test." The second clause, income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations, was called the "functional test." Relying primarily on the second "functional test" set forth in Pierce, other courts have included interest income in a business' apportionable tax base. Respondent cites Holiday Inns, Inc. v. Olsen, 692 S.W.2d 850 (1985), in which the Supreme Court of Tennessee held that where the taxpayer invested funds not immediately needed in interest bearing securities, and where both the principal of and interest on those funds was used in the business, the interest income "arose from transactions and activity in the regular course of business and the acquisition, management, and disposition of these funds constitute an integral part of the taxpayer's regular course of business." Id. at 854.

Respondent also cites Sperry and Hutchison Company v. Department of Revenue, 527 P.2d 729(1974), which held that interest earned on short term securities which were: 1) purchased during periods of cash flow surplus; 2) held to satisfy the company's need for liquid capital; and 3) liquidated when the proceeds and interest were needed to meet business obligations, constituted income arising from transactions and/or activity in the regular course of taxpayer's business, and was therefore taxable.

The District distinguishes ASARCO and F.W. Woolworth from the instant case in several ways. First, respondent

states that while the two cases stand for the basic proposition that a nondomiciliary state may tax the interest income of a unitary business, the facts of those cases are quite different from those of the case at bar. As the respondent points out, the petitioner in ASARCO conceded that Idaho could treat interest income from temporary deposits of its working capital funds as apportionable business income. The Supreme Court expressly noted that the trial court made an undisputed finding that ASARCO's investments in certain of its subsidiaries were not integral or necessary to the company's business operations. The Court further stated that its opinion in no way addressed whether a taxing authority could include income earned on the temporary deposit of working capital funds. ASARCO at 329, ftnt. 1. Thus, contends the District, the rule that a taxing authority may apportion income earned on a company's short-term investment of funds pending their application to the business (see D.C. Code §41-447) was undisturbed by ASARCO.

In support of its further assertion that all of NBI's interest income is apportionable, respondent relies on District of Columbia v. Pierce Associates which held that the acquisition of buildings and facilities "constitutes an integral part of a taxpayer's trade or business ... however sporadically it arises out of normal business operations." Pierce at 1131. Additionally, the District asserts that the interest earned on the stripped coupons with 14 1/2 month maturities is also apportionable. The proceeds were invested pending their use in the business and were not held as a long-term investment. The District contends that NBI's investment in the stripped coupons was essentially liquid because of the existence of a strong, active, secondary or resale market for them during the period in question. Therefore, although they may have had maturities of 14 1/2

months rather than the 12-month limit imposed by Sperry and Hutchison for short-term investments, they much more closely resemble short-term investments and are clearly distinguishable from the long-term investments proscribed from taxation by Sperry and Hutchison.

The Court is persuaded that the District was justified in taxing petitioner's interest income. The short-term investments made by NBI were clearly done as an interim measure before the proceeds were invested in its business. The Court's holding in ASARCO and F.W. Woolworth, that a nondomiciary state may tax the interest income of a unitary business, was based on facts quite different from those present in the case at bar. There, the Supreme Court found that an insufficient connection existed between the investments of certain subsidiaries and the companies' primary business operations; neither the principal or the interest on the investments in these subsidiaries was shown to have been used in the businesses. The Supreme Court expressly noted, as stated by the respondent, that its opinion did not address whether a taxing authority could include income of the type described in ASARCO's brief to the Court, i.e., income earned on the temporary deposit of working capital funds, such as exist in the present case.

The Court concurs with the District that reliance on ASARCO and F.W. Woolworth is misplaced. The investments at issue differ substantially from those in ASARCO. Because the interest income arose from the proceeds of stock and debentures issued in NBI's regular course of business, and because the company intended to and did use the income directly in the business, the investment income may be characterized as business income under D.C. Code §47-441, Art. IV(1)(a). Petitioner may not be shielded from

legitimate taxation by simply holding the proceeds received from its issuance of stock and debentures for one year before using them for obvious business purposes. The elements of the "functional test" as set forth in District of Columbia v. Pierce Associates, Inc. have been met and NBI's interest income was properly included in its apportionable tax base.

Furthermore, the Court is not convinced (notwithstanding Sperry & Hutchison) that petitioners stripped coupon investments should be considered "long-term" because they had a 14 1/2 month maturation period. The stripped coupons were not simply held by NBI as an investment. NBI intended from the outset that proceeds raised from issuance of stock and debentures would be placed in short-term investments and then used for business purposes. Its prospectuses, published for would-be investors indicated that the intent of the stock offerings was to raise money for many business improvements, not merely for general long-term investments. The Court finds that, notwithstanding the longer maturity of the stripped coupons, the interest income from them, as well as the other investments at issue, are includable in NBI's apportionable tax base.

Wherefore, it is this 29th day of October, 1986,

ORDERED that Respondent's Motion for Summary Judgment is hereby GRANTED; and it is

FURTHER ORDERED that Petitioner's Motion for Summary Judgment is hereby denied.

JUDGE, IRALINE G. BARNES

cc:

McGee Grigsby, Esq.
Latham, Watkins & Hills
New Hampshire Ave., N.W.
Suite 1200
Washington, D.C. 20036

Katherine V. Kelley
Asst. Corporation Counsel, DC
1133 North Capitol Street, NE
Room 238
Washington, D.C. 20002

Melvin James
Finance Officer DC

B. Blanfield
10-30-86