

sales during some or all of the years at issue that did not file any Idaho corporate income tax returns.

The Tax Commission's Income Tax Audit Division selected each of the above listed companies for audit. The primary issue under review was whether [Redacted] and its more than 50% owned subsidiaries were engaged in a unitary business. After conducting a field audit, the audit staff determined that [Redacted] and all of its more than 50% owned foreign and domestic subsidiaries were engaged in a unitary business during each of the years under review. The tax liability of those unitary companies that conducted some part of their business operations in Idaho was then recomputed as required under Idaho Code § 63-3027(j). In other words, the Idaho income tax owed by the Idaho nexus corporations included in the unitary group was computed under the worldwide unitary combined reporting method. A Notice of Deficiency Determination was then issued setting forth this audit finding, along with the other audit adjustments made in computing the tax owed by the Idaho[Redacted]affiliates.

[Redacted] has not contested the finding that it is engaged in a unitary business, or the makeup of the proposed unitary group. Rather, [Redacted] protested the amount of the combined group sales factor denominator which did not include reimbursed costs from cost plus fixed fee contracts, and the inclusion of certain costs associated with an unfinished [Redacted] project in the Idaho property factor numerator of one of its affiliates. After receiving the letter of protest, the audit staff has agreed that the sales factor denominator should be increased to include the reimbursed costs from the cost plus fixed fee contracts. A revised tax deficiency calculation was faxed to the taxpayer's representative on May 14, 2003, showing the recomputed tax deficiency after making the requested change to the sales factor denominator. The Notice of Deficiency

Determination that is the subject matter of this protest will be modified to incorporate the revised sales factor denominator amount set out in the worksheet faxed to the taxpayer's representative.

The only issue remaining in this administrative protest is the disputed property factor numerator relating to the unfinished [Redacted] clean-up project that was contracted by [Redacted].

2. The [Redacted].

During the 1960s and 1970s [Redacted] was buried at what is known as the [Redacted]. Included within the [Redacted]

Beginning in the 1970s, there was concern that the [Redacted] at the [Redacted] might someday leak into the Snake River aquifer, which would create a tremendous public health and environmental disaster. During the late 1980s and early 1990s plans were made to "remediate" the potential hazard associated with the [Redacted]. In 1991 the Department of Energy, [Redacted]

[Redacted] was divided into three phases. In Phase I, potential subcontractors would perform a Proof-of-Process test to determine if their proposed remediation process could remove the [Redacted] Brief in Support, p. 7. "For Phase II, a subcontractor would be selected based on Phase I results and a review of technical and cost proposals. The selected subcontractor would complete the design and construct retrieval and treatment facilities." Id. Phase III was to be the performance of the "Full Scale Operations" to remediate the [Redacted]

As discussed above, the first Phase [Redacted] was to hire a subcontractor capable of doing the work. Bids were sought from potential remediation subcontractors. Because it was not known how best to remove and treat [Redacted] two subcontractors [[Redacted]] were selected in November 1992 to conduct "Proof-of Process" tests to establish that their proposed

approaches [Redacted] Brief in Support, p. 2. The [Redacted] proposal to clean up [Redacted] consisted of the following steps:

[Redacted]
Id. at pp. 8 – 9.

During late 1993 and early 1994, [Redacted] was performing its Proof-of-Process tests. “This involved developing, fabricating, and operating pilot-scale demonstration equipment and systems and performing laboratory analyses to assess [Redacted]’ system for effectiveness.” Id. at p. 14. [Redacted] successfully completed the Proof-of-Process tests and was, therefore, eligible to compete for the [Redacted] Id. On August 26, 1994, [Redacted] was awarded the [Redacted] remediation subcontract. In its final form, the subcontract “called for [Redacted] to remediate [Redacted] at a firm fixed-price of \$179 million.” Id. at p. 16. According to the subcontract, the following deadlines were established for completion of Phase II and Phase III of the project:

- | | | |
|-----|----------------------------------|--------------------|
| (1) | Begin Staging and Installation | January 1, 1995 |
| (2) | Initiate Limited Production Test | August 15, 1996 |
| (3) | Complete Limited Production Test | December 13, 1996 |
| (4) | [Redacted] | February 13, 1998 |
| (5) | Remove All Equipment/Facilities | February 13, 1999. |

Id. at p. 17. While not entirely clear, it appears that deadlines 1 – 3 above relate to Phase II of the project, and that deadlines 4 and 5 relate to Phase III.

Before the testing and remediation work could get underway, [Redacted] was required to prepare a Preliminary Safety Analysis Report (PSAR) and to submit it to the [Redacted] for approval. Id. at p. 26. The purpose of the PSAR was to define the safety parameters of the project. Because of the highly technical processes required to safely remove and neutralize the [Redacted] the safety concerns relating to the project proved to be daunting. Between February 1995 and November 1996 [Redacted] submitted at least two revised [Redacted]s to the

[Redacted] for approval. But the [Redacted] continued to reject the Reports and, as a result, the project stalled.

While the actual implementation of the testing and remediation work was put on hold during the period that [Redacted] was attempting to come up with a PSAR that would satisfy the [Redacted], the company “continued to perform all subcontract work that did not require technical direction, including limited construction work, security, and maintenance.” Id. at 40. By October 1997, [Redacted] had completed more than half of the construction and installation required to move forward with the project. According to LMAES:

[The] retrieval facility was more than 77% complete; its offsite (administrative and support) facilities were more than 82% complete; and its treatment facility was 40% complete and awaiting agreement with [the prime contractor] on the soil sorter. The melter was completed and was undergoing only factory acceptance testing. The Chemical Treatment System had been built. The dig face monitor and other assay systems were complete. By June 1, 1998, after more than three and a half years, [Redacted] had spent more than \$309 million in its attempt to perform the subcontract.

Id. at p. 40 – 41.

Ultimately the parties were never able to adequately resolve the safety issues as required before the testing and remediation work could begin. On June 1, 1998, the [Redacted] subcontract was terminated. At the time of the termination [Redacted] had been paid roughly \$56 million of the \$179 fixed fee contract. The company had also incurred over \$300 million in costs, much of which were accounted for as “inventory” on its books. The [Redacted] [Redacted] filed a counterclaim seeking to recover the money it has spent in performing the subcontract. This lawsuit is currently being heard in the United States District Court for the District of Idaho.

3. Issues Raised in this Administrative Protest.

As indicated above, [Redacted] booked much of its costs associated with the [Redacted] According to the separate [non-combined] Idaho corporate income tax returns filed by [Redacted] for 1996 through 1998, the company had year-ending inventory amounts as follows:

	<u>Idaho</u>	<u>Total</u>	<u>Idaho %age</u>
1996	\$47,771,252	\$51,124,904	93.4403%
1997	230,410,255	252,756,537	91.1590%
1998	255,699,517	266,441,534	95.9683%

Based on these inventory figures, along with its beginning of the year inventory amounts and its other real property and rental property, the company computed its Idaho property factor as follows:

	<u>Idaho</u>	<u>Total</u>	<u>Idaho %age</u>
1996	\$27,223,898	\$56,407,482	48.2629%
1997	139,302,874	171,044,164	81.4426%
1998	243,486,908	277,029,706	87.8920%

No audit adjustments were made to the Idaho property factor numerators set out in the [Redacted] 1996 through 1998 separate Idaho corporate income tax returns. On audit, those Idaho numerators were simply divided by the combined group's property factor denominator to determine the Idaho property percentage to be used in the combined report apportionment calculations.

While there was no audit adjustment made to the Idaho property factor numerator reported by [Redacted] for the 1996 through 1998 taxable years, the taxpayer has protested the inclusion of the "inventory" in the property factor computation. More specifically, the taxpayer has raised the following issues in this administrative protest:

- Should the inventory and other property listed by [Redacted] on its 1996 through 1998 separate Idaho corporate income tax returns be included in the Idaho property factor calculation since much of that property represented construction in progress?
- Alternatively, given the circumstances surrounding the unfinished [Redacted] should the Idaho property factor calculation for [Redacted] be modified under authority of Idaho Code § 63-3027(s), which allows for the use of an alternative apportionment method if the standard method does not "fairly represent the extent of the taxpayer's business activity in this state"?
- Does the amount of property included in the Idaho property factor numerator include property that was not actually located in Idaho during the years at issue?

The Tax Commission will address each of these issues in turn.

ANALYSIS

1. **The Idaho Property Factor Should Be Modified as Required Under Idaho Income Tax Administrative Rule 580.01.a and MTC Special Industry Regulation IV.18(d)(4)(iv).**

Idaho Code § 63-3027 sets forth the procedure for determining what portion of a multistate corporation's income is apportioned or allocated to Idaho. Business income is apportioned to Idaho based on a fraction, the numerator of which is the "property factor" plus the "payroll factor" plus two times the "sales factor," and the denominator of which is four. Idaho Code § 63-3027(i). The property factor is the average value of the taxpayer's real and tangible personal property owned or rented and used in Idaho during the tax period divided by the average of all such property owned or rented and used by the taxpayer everywhere during the tax period. Idaho Code § 63-3027(k). Idaho Income Tax Administrative Rule 465.01 goes on to provide that:

a. Property shall be included in the property factor if it is used, is available for use, or capable of being used during the taxable year in the regular course of the taxpayer's trade or business. Property held as reserves or standby facilities or property held as a reserve source of materials shall be included in the factor. For example, a plant temporarily idle or raw material reserves not currently being processed are includable in the factor.

b. Property or equipment under construction during the taxable year, except inventorable goods in process, shall be excluded from the factor until the property is used in the regular course of the taxpayer's trade or business.

c. If the property is partially used in the regular course of the taxpayer's trade or business while under construction, the value of the property shall be included in the property factor to the extent used.

d. Property used in the regular course of the taxpayer's trade or business shall remain in the property factor until it is permanently withdrawn by an identifiable event such as its sale, abandonment, or any event or circumstance that renders the

property incapable of being used in the regular course of the taxpayer's trade or business.

Income Tax Administrative Rule 465.01, IDAPA 35.01.01.465.01 (2002).

The first issue raised in this protest is whether the property listed by [Redacted] on its 1996 through 1998 separate entity Idaho corporate income tax returns is properly included in the property factor computation. Per Income Tax Administrative Rule 465.01.b, property is not included in the property factor computation to the extent it is "under construction." Based on the facts set forth above, it is likely that most, if not all, of the [Redacted] "inventory" at issue in this protest was "under construction" and would not be included in the property factor under Rule 465.01.b. While the term "under construction" is not defined, giving the term its plain everyday meaning it would in all likelihood include the property that [Redacted] booked as "inventory" that related to the construction[Redacted] However, for the reasons discussed below, the Tax Commission finds that Rule 465.01.b does not apply.

Income Tax Administrative Rule 465 sets out the general rule to be applied in determining whether specific property should be included in the property factor computation. That general rule applies unless there is a more specific rule on point; which in the present case there is. In 1981 the Idaho State Tax Commission adopted a "special industry" rule that applies to construction contractors. See former Idaho Income Tax Regulation 24,4.18.i (1982). That special industry rule is now set out in Income Tax Administrative Rule 580.01.a, IDAPA 35.01.01.580.01.a (incorporating by reference MTC Regulation IV.18.(d)). Under this special industry rule, construction in progress is included in the property factor computation "to the extent that such costs exceed progress billings." MTC Regulation IV.18(d)(4)(iv)(A).¹ More specifically, the Rule provides as follows:

¹ A copy of MTC Regulation IV.18(d) is available on-line at <http://www.mtc.gov/news&vws/Publications.htm>.

(A) The average value of the taxpayer's cost (including materials and labor) of construction in progress, to the extent that such costs exceed progress billings (accrued or received, depending on whether the taxpayer is on the accrual or cash basis for keeping its accounts) shall be included in the denominator of the property factor. The value of any such construction costs attributable to construction projects in this state shall be included in the numerator of the property factor.

The Tax Commission's audit staff accepted the Idaho property factor information set out on the 1996 through 1998 separate entity Idaho corporate income tax returns filed by [Redacted]. On those returns [Redacted] did not treat the "inventory" as construction in progress and did not apply the special industry rule set out in MTC Regulation IV.18(d)(4)(iv). If the MTC Regulation is applied, the Idaho property factor for [Redacted] drops slightly for each of the 1996, 1997, and 1998 taxable years. A worksheet setting forth the recomputed Idaho property factor is attached to this Decision as Appendix 1. In making this recomputation the Tax Commission has assumed that all of the costs associated with the [Redacted] were actually construction in progress (CIP) costs. According to the "[Redacted] [Redacted] [Redacted]" incurred total costs of \$302,055,596 prior to the termination of the [Redacted] subcontract. Most, but not all, of these costs were booked as "inventory" by [Redacted] and included in the Idaho column of its separate entity Idaho property factor computation.² In recomputing the [Redacted] Idaho property percentage, the amount [Redacted] listed as "inventory" in the Idaho column of its 1996 through 1998 separate entity Idaho returns is backed out and the amount of the CIP in excess of progress billings is included. No change was made to any of the other amounts included in the Idaho property factor computation set out on the 1996 through 1998 separate entity Idaho corporate income tax returns filed by [Redacted].

The Commission finds that all of the costs associated with the [Redacted] including the property and equipment that was listed as “inventory” in the separate entity Idaho corporate income tax returns filed by [Redacted] are more accurately characterized as construction in progress. The Commission also finds that the Idaho property factor of [Redacted] should be computed in accordance with the long-term construction contractor special industry regulation set out in MTC Regulation IV.18(d)(4)(iv). The calculations necessary to recompute the Idaho property factor of [Redacted] in accordance with MTC Regulation IV.18.(d)(4)(iv) is set forth in Appendix 1. The Notice of Deficiency Determination dated December 20, 2002, will be modified to apply the property factor computation set out in Appendix 1.

2. No Additional Modifications to the Idaho Property Factor Computation are Required.

The second issue raised in this administrative protest is whether the Idaho property factor calculation should be modified under the authority of Idaho Code § 63-3027(s). That code section allows for the modification of the standard 3-factor apportionment formula if the standard formula does not “fairly represent the extent of the taxpayer’s business activity in this state.” According to the taxpayer, the [Redacted]project represents “unusual fact situations that are unique and nonrecurring” and, therefore, applying the standard property factor

[Redacted]as a deduction to the costs included as “inventory.” In any event, absent a detailed explanation of why the inventory figure is \$46,356,079 less than the total project costs, the Tax Commission will treat all \$302,055,596 associated with the [Redacted] as CIP costs.

computation will “produce incongruous results.” Letter of protest, p.2. Based on this assertion, the taxpayer requests that all of the “property values of [Redacted] be eliminated from the numerator.” Id.

The Tax Commission does not agree that elimination of all of the [Redacted] property values from the numerator would more fairly reflect the extent of the taxpayer’s business activity in this state. Rather, application of the special industry property factor computation set out in MTC Regulation IV.18(d)(4)(iv)(A) is adequate to more fairly represent the taxpayer’s Idaho business activity. By treating the “inventory” and other project costs as construction in progress and then applying the special industry rule applicable to long-term construction contractors, [Redacted] is being treated like any other long-term construction company that is engaged in business in this state. Further modification of the special industry property factor computation is not required.

There are two additional concerns worth noting relating to the taxpayer’s request to remove all of the [Redacted] and related property from the Idaho property factor computation. First, [Redacted] included this [Redacted] inventory in the Idaho property factor numerator in its originally filed separate-entity Idaho corporate income tax returns. It wasn’t until the Tax Commission’s audit staff determined that [Redacted] was part of the [Redacted] unitary group of companies that [Redacted] suggested that all of its property should be removed from the Idaho property factor computation. Whether the [Redacted] inventory and related property is properly included in the property factor computation should not turn on whether the taxpayer computes its Idaho income tax liability on a separate-entity basis or on a combined reporting basis. While it is certainly not improper for [Redacted] to request the removal of all of its property from the Idaho

property factor computation, there is a certain sense of inconsistency in [Redacted]' change in position regarding the tax treatment of its [Redacted] inventory.

The second concern the Tax Commission has with respect to the taxpayer's request to remove all the [Redacted] inventory and related property from the Idaho property factor computation is that [Redacted] has included this property in the property factor denominator of its [Redacted] (and possibly other states') tax returns. If the inventory is included in the property factor denominator in other state income tax returns filed by [REDACTED], as a matter of state-to-state consistency it should be included in the numerator of the state where the property was located or where the construction project took place. This lack of state-to-state consistency has the real potential of creating "nowhere income," which is one of the chief concerns of the Uniform Division of Income for Tax Purposes Act.

In the final analysis, the Tax Commission finds that [Redacted] has not met its burden of establishing that an additional modification to the special industry property factor computation is appropriate under the circumstances of this case. Nothing in the record convinces this Commission that application of the property factor computation set out in the long-term construction contractor special industry rule does not fairly represents the extent of [Redacted]' business activity in Idaho. As a result, the taxpayer's request to have all of the "property values of [Redacted] . . . eliminated from the numerator" is hereby denied.

3. Property Not Located in Idaho is Still Included in the Idaho Property Factor Numerator to the Extent it is Attributable to the [Redacted] Construction Project.

The final issue raised in this administrative protest is whether some of the property included in the Idaho property factor numerator was actually located outside of Idaho during the years at issue. The taxpayer asserts that a large portion of the "inventory" included in the Idaho numerator of the 1996 through 1998 [Redacted] separate entity Idaho corporate income tax

returns was not actually located in Idaho during any of those taxable years. In support of this assertion the taxpayer has provided numerous schedules, photographs, and inventory lists that helped to identify the type and location of the property and equipment attributable to the [Redacted] clean-up project, as well as an estimate of the cost of the [Redacted] property and equipment that was located outside of Idaho.

Idaho Code § 63-30327(k) provides that the numerator of the property factor is “the average value of the taxpayer’s real and tangible personal property owned or rented and used in this state during the tax period.” Normally property will be considered to be “used in this state” only if it is located in this state. See Warren, 1150 T.M., *Income Taxes: Principles of Formulary Apportionment*, ¶ 1150.05.D. However, pursuant to Idaho Income Tax Administrative Rule 580.01.a and MTC Regulation IV.18(d)(4)(iv)(A), the cost of property characterized as “construction in progress,” to the extent that the average CIP costs exceed progress billings, is considered to be used in this state if it is “attributable to [a] construction project[] in this state.” In other words, it is the location of the construction project, not the location of the CIP property, that determines whether the cost is included in the Idaho property factor numerator.

While not entirely clear, it appears that the primary purpose for attributing construction in progress to the property factor numerator of the state where the construction project is taking place is to more accurately reflect the extent of the taxpayers’ business activities relating to that construction contract. Otherwise, a construction contractor could simply store its construction in progress inventory in a state with a low or no income tax burden until the property is needed at the construction site. To the extent that construction in progress is to be taken into account in determining the extent of a construction contractor’s business activity, it seems entirely logical to attribute that CIP property to the state where the construction activity is taking place as opposed

to the place where the CIP inventory happens to be stored. In any event, it appears certain that the drafters of the MTC construction contractors special industry regulation felt that the location of the construction project, rather than the location of the CIP inventory, was a better measure of a construction contractor's business activities. Absent a showing that application of this special industry regulation does not fairly represent the extent of the taxpayer's Idaho business activity during the years at issue, the Tax Commission has no alternative but to apply the property factor regulation as written. C.f. *In re Appeal of The O.K. Earl Corporation*, Cal. SBE 4/6/77 (1977 WL 3861) (construction contractors special industry regulation was applied where the taxpayer was unable to establish that application of the regulation was unreasonable).

In the present case, the Commission is unable to find that application of the property factor computation set out in the construction contractors special industry regulation results in an inequitable or unreasonable result. As discussed above, [Redacted] included 100% of its [Redacted] "inventory" in the Idaho property factor numerator in its originally filed separate-entity Idaho corporate income tax returns. In so doing, it is safe to assume that none of this construction in progress "inventory" was included in the numerator of the state where the property was located. Thus, it could be argued that [Redacted] has implicitly recognized that it is equitable to include all of the inventory attributable to the [Redacted] project in the Idaho numerator. At a minimum, it is fair to point out that the argument [Redacted] is advancing in this administrative protest – to exclude the property from the Idaho numerator to the extent it was not located in Idaho – is not consistent with how it reported this CIP inventory in those states where the property was located.

There is no dispute that all of the property that made up the CIP inventory at issue in this case was earmarked for use in the [Redacted] construction project in Idaho. Otherwise

[Redacted] would not have capitalized the property as “inventory” and would not have included it in the Idaho property factor numerator in its originally filed separate-entity returns. Under the express language of Income Tax Administrative Rule 580.01.a and MTC Regulation IV.18(d)(4)(iv), this CIP inventory in excess of progress billings is to be included in the Idaho property factor numerator. Given the fact that [Redacted] has not included any of this CIP inventory in the property factor numerator of any other state, the Tax Commission can find no justification for disregarding this regulatory requirement in this case.

To summarize, because the Tax Commission has determined that the “inventory” and other costs associated with [Redacted] project are more accurately characterized as construction in progress, and because the Commission has determined that it is appropriate to apply the long-term construction contractor special industry rule in computing the Idaho property factor of [Redacted], all of the excess CIP attributable to the [Redacted] project is to be included in the Idaho numerator. The taxpayer’s request to subtract the estimated amount of the CIP not located in Idaho from the Idaho numerator is denied.

ORDER

WHEREFORE, the Notice of Deficiency Determination dated December 30, 2002, is MODIFIED in accordance with the foregoing analysis, and as so Modified is hereby APPROVED, AFFIRMED AND MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayer pay the following taxes, penalty and interest:

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
1996	\$155,391	-0-	\$75,480	\$230,871
1997	318,418	-0-	126,929	445,347
1998	362,159	-0-	116,437	<u>478,596</u>
			TOTAL	<u>\$1,154,814</u>

Interest is calculated through October 31, 2003, and will continue to accrue at the rate set forth in Idaho Code § 63-3045(6) until paid.

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the taxpayer's right to appeal this decision is enclosed with this decision.

DATED this _____ day of _____, 2003.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that I have on this ____ day of _____, 2003, served a copy of the within and foregoing decision by sending the same by United States mail in an envelope addressed to:

[Redacted]
