BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 17558
[Redacted] Petitioners.	)	
	)	DECISION
	)	
	)	

On June 25, 2003, the Income Tax Audit Division of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] ("taxpayer") asserting an Idaho income tax deficiency in the amount of $1,031,910 for the 1998 through 2000 taxable years. On August 25, 2003, the taxpayer filed a timely appeal and petition for redetermination. An informal conference was requested by the taxpayer and was held on June 22, 2004.

[Redacted] Therefore, the Tax Commission will use the modified tax deficiency amount as the starting point in its analysis of the taxpayer's administrative protest.

I.

PROCEDURAL BACKGROUND AND STATEMENT OF THE ISSUES

[Redacted] (hereinafter referred to as "[Redacted]" or "taxpayer") is the parent corporation of a large unitary financial services business that provides a wide range of banking and nonbanking financial services throughout the United States and worldwide. The company is headquartered in [Redacted]. During the years at issue (1998 – 2000) [Redacted] operations were divided into four primary business segments: [Redacted] 2000 Annual Report, p. 7.

During the years at issue, the taxpayer had several subsidiaries that conducted business activity in Idaho. Each of these "Idaho nexus" subsidiaries reported their Idaho income tax liability on a group return that was prepared on a worldwide combined unitary basis. On these 1998 through 2000 Idaho combined group returns the taxpayer treated all of its more than 50% owned domestic and foreign subsidiaries as a single worldwide unitary group. Those Idaho combined group returns were selected for audit and there were a number of adjustments proposed by the Commission's audit staff. The taxpayer filed a timely protest and petition for redetermination, asserting that the audit staff erred with respect to certain of the audit adjustments. More specifically, the taxpayer has raised five issues to be decided in this administrative protest. Those issues are:

1. Whether the taxpayer meets the requirements for use of the "alternative method" allowed under Idaho Code § 63-3027(t)(2)(ii) in determining the amount of income earned by its non-consolidated unitary foreign subsidiaries.

2. Whether the taxpayer meets the requirements for use of the "alternative method" allowed under Idaho Code § 63-3027(t)(2)(ii) in determining the amount of income earned by its non-consolidated Foreign Sales Corporations [FSCs].

3. Whether the audit staff correctly disallowed a dividends paid deduction relating to dividends paid to the taxpayer by several unitary Real Estate Investment Trusts [REITs] and by a Regulated Investment Company [RIC].

4. Whether the audit staff correctly disallowed a dividends paid deduction relating to distributions made by two unitary REITs that were liquidated in 1998 pursuant to IRC § 332.

5. Whether the audit staff correctly concluded that two unitary "credit card" subsidiaries were transacting business in Idaho.

This Decision will address each of these issues in turn.

II.

ANALYSIS

A. Use of the "Alternative Method" Allowed Under Idaho Code § 63-3027(t)(2)(ii) to Determine the Amount of Income Earned by [Redacted] Non-Consolidated Unitary Foreign Subsidiaries.

The first issue raised in this protest is whether the taxpayer has met the requirements for using the alternative method of calculating the pre-apportionment business income earned by its non-consolidated unitary foreign subsidiaries. Idaho Code § 63-3027(t)(2)(ii) and related rules provide that a unitary foreign subsidiary that is not included in the federal consolidated return filed by its parent must include in the combined group pre-apportionment income its "net income before income taxes . . . [as] stated on the profit and loss statement of such corporation." The section then goes on to allow an alternative method "subject to reasonable substantiation and consistent application." Under the alternative method, the pre-apportionment business income of each non-consolidated foreign subsidiary is calculated on a tax accounting basis as opposed to a financial accounting basis.

During each of the years at issue the taxpayer owned a number of foreign subsidiaries that it included as part of its unitary group but which were not included on the parent's federal consolidated return. As a result, Idaho Code § 63-3027(t)(2)(ii) applies. That section states in relevant part:

> (2) The income of a corporation to be included in a combined report shall be determined as follows:
>
> . . . .
>
> (ii) for a corporation incorporated outside the United States, but not included in [a consolidated federal income tax return], the income to be included in the combined report shall be the net income before income taxes of such corporation stated on the profit and loss statements of such corporation which are included within the consolidated profit and loss statement prepared for the group of related corporations of which the corporation is a member, which statement is prepared for filing with the United States securities and exchange commission. . . . **In the alternative**, and subject to reasonable substantiation and consistent application by the group of related companies, adjustments may be made to the profit and loss statements of the corporation incorporated outside the United States, if necessary, to conform such statements to tax accounting standards as required by the Internal Revenue Code as if such corporation were incorporated in the United States and required to file a federal income tax return . . . .

Id. (bolding added for emphasis). Although this section is somewhat lengthy and difficult to digest, it sets out two methods for determining the amount of income earned by a non-consolidated foreign subsidiary that is to be included in the Idaho combined reporting calculation. The first method, which is the standard or "default" method, provides that the income to be included in the combined reporting calculation is the "net income before income taxes of such corporation stated on the profit and loss statements of such corporation." Net income calculated under this method is commonly referred to as "book" income. The second method provides that the income to be included in the combined report calculation is the net income that the foreign corporation would report to the IRS "if such corporation were incorporated in the United States and required to file a federal income tax return . . . ." This net income amount is commonly referred to as "tax" income.

As set out in the statute, a taxpayer may elect to use the alternative method of computing the pre-apportionment net income of its non-consolidated foreign subsidiaries so long as the taxpayer is able to show "reasonable substantiation and consistent application" of the alternative method calculations. Idaho Income Tax Administrative Rule 605.04 provides some additional guidance with respect to this "reasonable substantiation and consistent application" requirement:

> **04. Consistent Application Of Book To Tax Adjustments.** If adjustments are made to conform financial net income to tax accounting standards, all book to tax adjustments as required by the Internal Revenue Code for domestic corporations shall be made for each unitary foreign corporation included in the combined report and shall be consistently applied in each year for which the worldwide method applies. These adjustments are subject to the record-keeping requirements of the Internal Revenue Code and Treasury Regulations for domestic corporations.

IDAPA 35.01.01.605.04 (2004).

Boiled down to its essence, there are three things that a taxpayer must show under the statute and regulations in order to be allowed to apply the alternative method:

1. That in converting its financial net income to tax accounting standards, the taxpayer made "all book to tax adjustments as required by the Internal Revenue Code for domestic corporations";

2. That the taxpayer made these book to tax adjustments for all of its non-consolidated unitary foreign subsidiaries; and

3. That the taxpayer made these book to tax adjustments in each year for which the worldwide combined reporting method applies.

[Redacted] states that it meets these requirements and, as a result, it should be allowed to use the alternative method. As succinctly stated in the Protest Supplement filed on behalf of [Redacted]:

> Taxpayer owns many foreign subsidiaries and operates them as part of its worldwide unitary business. Federal Form 5471 is required to be completed for each controlling foreign corporation, including an annual computation of earnings and profits reconciled to book income. The pre-tax earnings and profits of each subsidiary (as computed under federal tax rules) was reported as the federal taxable income of each foreign subsidiary on the Idaho corporation income tax return.
>
> . . . .
>
> The Audit Report follows the general rule for foreign subsidiaries (by including book income) and not the alternative rule (allowing adjustment to taxable income). . . .
>
> Taxpayer meets the alternative rule and consistently filed its Idaho return on that basis. Pre-tax earnings and profits as reported on Form 5471 conforms net income before income taxes of each foreign subsidiary to tax accounting standards required by the Internal Revenue Code. Taxpayer therefore protests the inclusion of net income before income taxes in Idaho taxable income rather than pre-tax earnings and profits, as actually reported.

Protest Supplement, p. 1.

[Redacted] asserts that it meets all of the requirements for use of the alternative method. The audit staff disagrees. According to the audit staff, the taxpayer is simply using the amount reported as Earnings and Profits on federal Form 5471 and has not converted the "book" net income of its foreign subsidiaries into the "tax" net income that would be reported if the subs "were incorporated in the United States and required to file a federal income tax return." Thus, the question before this Commission is whether [Redacted] has provided sufficient substantiation that it has accurately converted its financial accounting net income to federal tax accounting net income.

It is well established that Earnings and Profits of a particular corporation are not necessarily equivalent to the book income reported by the entity as reported on its financial statements, or to the federal taxable income of that corporation reported on its federal income tax return. *See, e.g.*, 10 Mertens, Law of Federal Income Taxation, § 38C.04. ("earnings and profits bear no exact relation either to taxable income or to earnings as determined by normal corporate accounting practice."). There are a number of differences between the way Earnings and Profits are calculated and the way federal taxable income is calculated. *See Id.* at §§ 38C.26 – 38C.54. The treatment of depreciation expense and tax-exempt interest income are two primary examples. Thus, as a general matter, it is clear that E & P is not necessarily equivalent to book income or to federal taxable income. While there very well may be circumstances where the pre-tax E & P of a foreign subsidiary is equivalent to the federal taxable income that the subsidiary would have reported if it was a U.S. corporation and required to file a federal corporate income tax return, that would be the rare exception.

In the present case the taxpayer has asserted that the pre-tax E & P of its foreign subsidiaries as reported on the federal Form 5471 is equivalent to the federal taxable income each of those subsidiaries would report "if such corporation were incorporated in the United States and required to file a federal income tax return." During the informal conference the taxpayer's representative stated that the depreciation method used in calculating the E & P amounts was essentially equivalent to the depreciation method that these subsidiaries would use if they were U.S. corporations.[1] Likewise, the taxpayer's representative indicated that the E & P amounts it used in its alternative method calculation were the pre-tax E & P amounts listed on the federal Form 5471s, so there would be no material difference in the E & P calculations and the federal taxable income calculations relating to the treatment of federal income taxes.

As it turns out, the taxpayer's representative was not entirely correct when he indicated during the informal conference that the taxpayer had reported pre-tax E & P amounts on its Idaho combined group returns. In a letter dated October 15, 2004, the taxpayer's representative provided detailed schedules setting out the actual pre-tax E & P of the various foreign subsidiaries at issue, as well as several other corrections that were required under the taxpayer's proposed alternative method calculation. The schedules list the amount of taxable income as originally reported on the Idaho combined group returns and the amount of taxable income that should have been reported under [Redacted] proposed alternative method. These schedules show that [Redacted] over reported its foreign subsidiary taxable income under its proposed alternative method calculation by $179,655 on its 1998 Idaho return and underreported the foreign subsidiary taxable income under its proposed alternative method by $146,763,369 in 1999 and $328,133,147 in 2000. [Redacted] concedes that these adjustments to its proposed alternative method calculation are necessary to correct errors made on its originally filed Idaho combined group returns. *See* letter dated October 15, 2004, p. 3.

As indicated above, it may be possible that the pre-tax E & P of [Redacted] foreign subsidiaries as reported on the federal Form 5471 is equivalent to the federal taxable income that would be reported by those subsidiaries if they were taxed as U.S. domestic subsidiaries. The

[1] This statement does not appear on its face to be unreasonable given the language in I.R.C. § 312(k)(4) which allows a foreign corporation that has less than 20% of its gross income from U.S. sources to use a depreciation method other than the straight-line method in computing its Earnings and Profits.

issue, however, is whether [Redacted] has adequately substantiated its claim in the present case. According to the plain language of the statute, use of the alternative method is permitted only where there is "reasonable substantiation" that the taxpayer has made the adjustments necessary to convert the book income of its foreign subsidiaries into the amount that would be reported under "tax accounting standards as required by the Internal Revenue Code as if such corporation were incorporated in the United States and required to file a federal income tax return." The Commission's administrative rule goes on to require that this substantiation must be accomplished through a showing that "all book to tax adjustments as required by the Internal Revenue Code for domestic corporations" have been made. IDAPA 35.01.01.605.04. Thus, under a strict reading of the Commission's administrative rule, a taxpayer can substantiate its alternative method calculation only by producing books and records detailing that all book to tax adjustments as required by the Internal Revenue Code have been made. That did not occur in the present audit. When the Commission's audit staff requested the workpapers showing the book to tax adjustments made to convert the book income into the amounts listed as federal taxable income on the Idaho returns, the taxpayer's tax representative was unable to provide those workpapers.[2] Instead, the Commission's auditors were provided with the complete set of federal Forms 5471 and an explanation that the E & P amounts listed on the federal Forms 5471 were used as the basis for the book to tax calculation. Upon review, the audit staff found that neither the book income, nor the earnings and profits, listed on those federal Forms 5471 corresponded directly to the amount of federal taxable income reported on the Idaho returns. More importantly, the federal Forms 5471 contained no detail of the adjustments made by the taxpayer

[2] Apparently this request was made orally as there is no written request for these workpapers in the audit file. In any event, the taxpayer has not disputed that this request was made and that it was unable to provide the workpapers setting out its book to tax adjustments.

in converting the foreign book income into taxable income reported under the tax accounting standards required under the Internal Revenue Code for domestic corporations. Based on the taxpayer's inability to produce workpapers detailing the book to tax adjustments, the Commission's audit staff disallowed the taxpayer's alternative calculation for lack of reasonable substantiation.

The taxpayer has presented a colorable argument that the E & P amounts listed on the federal Forms 5471 are equivalent to the federal taxable income these subsidiaries would report if they were domestic corporations. From the record before us we cannot disprove this claim. The taxpayer's representative states that the depreciation method and other accounting practices used in calculating the E & P amounts was essentially equivalent to the depreciation and accounting methods that these subsidiaries would use if they were U.S. corporations; and the audit staff made no attempt to review the E & P calculations to determine whether they were in fact equivalent to the federal taxable income computed under tax accounting standards for domestic corporations. Rather, the audit staff determined that since no workpapers were produced showing the book to tax adjustments, as required by the Commission's administrative rule, the taxpayer was not allowed to use its proposed alternative method. As a result, we are unable to tell for certain whether the corrected E & P amounts provided by the taxpayer are equivalent to the tax accounting amounts these subsidiaries would report if they were domestic subs.

Based on the language of Income Tax Administrative Rule 605.04, the audit staff was correct to disallow the taxpayer's proposed alternative method. Since no workpapers were provided at the audit detailing the book to tax adjustments, the taxpayer did not meet the substantiation requirements set out in the administrative rule. It is, in essence, irrelevant whether the E & P amounts listed on the federal Forms 5471 accurately reflect the pre-apportionment business income of each non-consolidated foreign subsidiary calculated on a tax accounting basis. Absent proof that all book to tax adjustments as required by the Internal Revenue Corporation for domestic corporations have been made for each unitary foreign subsidiary, the alternative method is simply unavailable. The Commission is constrained to follow its own administrative rules, and given the language of Rule 605.04 the taxpayer's alternative method calculation must be rejected.

B. Use of the "Alternative Method" Allowed Under Idaho Code § 63-3027(t)(2)(ii) to Determine the Amount of Income Earned by [Redacted] Non-Consolidated Foreign Sales Corporations [FSCs].

The next issue raised in this protest is very similar to the issue discussed above, except that it relates to income earned by foreign sales corporations [FSCs]. During the years at issue [Redacted] owned a number of FSCs that were not included on the taxpayer's federal consolidated corporate income tax return. Each of these FSCs filed a separate federal Form 1120-FSC with the Internal Revenue Service in which the FSC reported its taxable income and exempt income under the special rules set out in IRC §§ 921 – 927 and related Treasury Regulations. The calculation of taxable and exempt income under these federal FSC provisions is relatively complex. *See generally*, 12 Mertens, The Law of Federal Income Taxation, §§ 45F.15 – 45F.26. In any event, because the income earned by the foreign sales corporations was not included in the federal consolidated return filed by [Redacted], the amount of the FSCs' income to be included in the Idaho combined group return is to be calculated under Idaho Code § 63-3027(t)(2)(ii). On audit, the Commission's audit staff was unable to reconcile the amount of FSC income reported on the Idaho combined report with the book income of these FSCs as shown on Schedule M-1 of the federal Form 1120-FSC. As a result, the audit staff made an adjustment to the taxpayer's Idaho returns to include the book income of these FSCs in the pre-apportionment tax base as required by the default rule set out in Idaho Code § 63-3027(t)(2)(ii).

The Protest Supplement filed on behalf of [Redacted] contains only a very cursory explanation for why the taxpayer feels this audit adjustment should be reversed. According to that Supplement:

> The Audit Report again follows the general rule under §63-3027(t)(2)(ii) for foreign subsidiaries (by including book income) and not the alternative rule (allowing adjustments to taxable income). Again, no explanation is offered as to why the alternative rule was not used.

> Taxpayer hereby repeats the same objections as above (relating to Unitary Foreign Subsidiaries) with the additional point that Taxpayer's FSCs filed Form 1120-FSC which includes conforming adjustments from net income to *actual federal taxable income.*

Protest Supplement, pp. 2 – 3. After the conclusion of the informal conference, the taxpayer's representative provided further clarification regarding the alternative method calculation that was used to report the amount of pre-apportionment income of the FSC.

> Our FSCs can earn two types of income – foreign trade income ("FTI") and nonforeign trade income ("non-FTI"). Foreign trade income of our FSCs is the net income attributable to the lease of export property (typically aircraft) for use by the lessee outside of the U.S. Nonforeign trade income is any other taxable income of the FSC; for our FSCs this is typically interest, of which there is generally not very much.
>
> Of FTI, 30% is exempt and 70% is nonexempt. Exempt FTI appears on Form 1120-FSC as the difference between exempt FTI (schedule B, line 10) and deductions attributable to exempt FTI (schedule G, line 17). . . .
>
> Nonexempt FTI appears on schedule B, line 15. . . .
>
> Non-FTI (if any) of our FSCs appears on schedule F, line 19. . . .
>
> Income of FSCs is shown in this fractured manner because of the different way the various buckets of income are taxed. If the buckets were all added together, poured into one big bucket, the total would be equal to the taxable income of that corporation if it weren't a FSC.

Letter from [Redacted] dated November 5, 2004.

It is beyond dispute that the amount reported as federal taxable income by a qualifying FSC is not equivalent to the amount the corporation would report as its federal taxable income if such corporation was incorporated in the U.S. and required to file a federal income tax return. The primary purpose behind the federal FSC provisions is to provide special tax treatment to those corporations that qualify. For example, a FSC is allowed special tax treatment on its "exempt foreign trade income." 12 Mertens at §§ 45F.19 – 45F.20. Numerous other special rules apply to qualifying FSCs. *Id.* at § 45F.19; 45F.21 – 45F.26. Given the significant differences in the way a FSC calculates its taxable and tax-exempt income versus the way a domestic U.S. corporation calculates its federal taxable income, simply picking a number off of the federal Form 1120-FSC return is not sufficient to meet the alternative method for determining the amount of income to report on the Idaho combined report. However, in the present protest the taxpayer argues that if you add together (1) the exempt foreign trade income, (2) the nonexempt foreign trade income, and (3) the nonforeign trade income, you arrive at an amount equal to the federal taxable income of the corporation under tax accounting standards if it were taxed as a U.S. domestic corporation.

Once again, the Commission does not necessarily disagree with the theory advanced by the taxpayer in this protest. It may well be true in certain circumstances that the amount of foreign trade income and nonforeign trade income shown on the 1120-FSC return, when added together, is equivalent to the federal taxable income that would be reported by the subsidiary if it were taxed as a U.S. domestic subsidiary. But we are unconvinced that this simple technique of adding several numbers from the 1120-FSC return <u>necessarily</u> equates to the tax accounting figure contemplated by the statute. We have seen no proof that adding these foreign and nonforeign trade income amounts together will inevitably equal the "tax" net income that would be reported if the subs "were incorporated in the United States and required to file a federal income tax return."

In any event, the taxpayer has not met the strict substantiation requirements set out in Rule 605.04. Absent proof that all book to tax adjustments as required by the Internal Revenue Code for domestic corporations have been made for each unitary FSC, the alternative method is simply not allowable. While we acknowledge that the administrative rule may be unduly restrictive in the type of proof required to substantiate the alternative method calculation, we are nevertheless constrained to apply the rule as currently written. The audit adjustment relating to the pre-apportionment FSC income is upheld.

C. Treatment of Dividends Paid by Several Unitary Real Estate Investment Trusts [REITs] and by a Regulated Investment Company [RIC].

The third issue raised in this protest involves the treatment of dividend income paid to [Redacted] from several unitary Real Estate Investment Trusts [REITs] and by a unitary Regulated Investment Company. Under federal law REITs and RICs are allowed a deduction equal to 100% of the dividends paid out during the taxable year. IRC § 561. Thus, if a REIT or RIC pays out 100% of its net income as dividends, it will have no federal taxable income for the taxable year. Since Idaho uses federal taxable income as the starting point for determining Idaho taxable income, and since there is no adjustment allowed or required under Idaho Code § 63-3022 relating to this federal dividends paid deduction, a REIT/RIC that pays out 100% of its net income as dividends will have no Idaho taxable income. *C.f.* Potlatch Corp. v. Idaho State Tax Com'n, 128 Idaho 387, 389, 913 P.2d 1157, 1159 (1996) ("Idaho taxable income is the same as federal taxable income, except that it is 'adjusted' according to the subsections of I.C. § 63-3022.").

Consistent with IRC § 561, the taxpayer did not include any of the income earned by its unitary REITs/RIC in the Idaho combined report pre-apportionment tax base. However, there is no federal or Idaho provision that exempts the dividend income from being taxed in the hands of the recipient. In fact, the purpose of the REIT and RIC dividend paid deduction is to treat income earned by these types of entities and paid out in dividends in a manner similar to the pass-through treatment afforded Subchapter S corporations. The recipient of the dividend income is taxed on that income, not the REIT or RIC that paid the dividend. Thus, to the extent the dividends are paid to a unitary parent, that dividend income is included in the combined group pre-apportionment tax base.

During the audit it was not clear whether the dividends paid by the REITs/RIC were included in the pre-apportionment tax base of [Redacted] and Subsidiaries. The taxpayer's representative originally explained to the audit staff that the dividend income that was received from its REITs and RIC had been eliminated from the combined group's pre-apportionment tax base as an intercompany elimination. Based on this understanding that the dividend income had been eliminated in computing the group's pre-apportionment tax base, the audit staff added that REIT/RIC income back into the tax base. [Redacted] protested this audit adjustment and initially argued that it was entirely proper to exclude the dividends received from its unitary REITs/RIC as an intercompany elimination. However, in a letter dated December 2, 2004, the taxpayer's representative explained that the dividend income had not been eliminated as originally thought. Rather, most of that dividend income had been included in the pre-apportionment tax base in the originally filed Idaho returns. Because the dividend income was included in the Idaho combined return calculation as required, the audit adjustment that was made to add the REIT/RIC income back into the combined group pre-apportionment tax base essentially added that income into the tax base a second time. The taxpayer's representative now urges the Commission to reverse that audit adjustment so that the REIT/RIC income is not counted twice.

The Commission has reviewed the materials provided by the [Redacted] tax representative with the December 2, 2004, letter and agrees that the dividend income was, for the most part, included in the combined group calculation on the originally filed returns. In addition, the Commission's audit staff has reviewed the adjustments proposed by the [Redacted] tax representative for correctly including the dividend income from the unitary REITs/RIC into the

Idaho combined group tax base and concurs with those adjustments. The adjustments proposed by [Redacted] appear to include the dividend income paid by the REITs/RIC in the pre-apportionment tax base once, and only once. As a result, the Commission hereby accepts the proposed adjustments set out in the letter of December 2, 2004, from the [Redacted] tax rep. The Notice of Deficiency Determination will be modified accordingly.

D. Treatment of IRC § 332 Liquidating Distributions made prior to the Effective Date of IRC § 332(c).

The next issue in this protest involves the federal and Idaho tax treatment of a distribution made in a complete liquidation of two of [Redacted] REIT subsidiaries. Subject to certain restrictions, IRC § 332(a) provides that a parent corporation recognizes no gain or loss from the receipt of property distributed to that parent corporation in a complete liquidation of an 80% or more directly owned subsidiary. In order to qualify for this nonrecognition treatment, the parent corporation must own at least 80% of the outstanding voting stock of the subsidiary at the time the plan of liquidation is adopted, and the final liquidating distribution must occur either within a single taxable year or within three years from the close of the taxable year in which the first distribution was made. IRC § 332(b). If the requirements of this nonrecognition provision are met, the property distributed to the parent retains the same basis as it had in the hands of the liquidating subsidiary. IRC § 334(b).

In 1998 [Redacted] received a liquidating distribution from two of its unitary REITs, [Redacted] Because the distributions qualified for the dividend paid deduction allowed to REITs under IRC § 561, none of the income from which the distributions were made was included as Idaho taxable income on the combined group report. In addition, under IRC § 332(a), none of the money or property paid to the parent in the liquidating distribution was treated as income of the parent. Thus, not only did the income earned by the REITs escape tax as a result of the federal dividend paid deduction, but none of the money or property distributed to the parent was included in the parent's federal taxable income.

In what appears to be an effort by Congress to close the "liquidating REIT" tax loophole being used by [Redacted] in this protest, there is a special rule set out in IRC § 332 that relates to liquidating distributions from REITs and RICs. IRC § 332(c) provides as follows:

> **(c) Deductible liquidating distributions of regulated investment companies and real estate investment trusts.** If a corporation receives a distribution from a regulated investment company or a real estate investment trust which is considered under subsection (b) as being in complete liquidation of such company or trust, then, notwithstanding any other provision of this chapter, such corporation shall recognize and treat as a dividend from such company or trust an amount equal to the deduction for dividends paid allowable to such company or trust by reason of such distribution.

The gist of this subsection is that the amount paid in a complete liquidation of a REIT is treated as a dividend to the shareholder to the extent the REIT claimed the amount as a deduction in computing its federal taxable income. Under the express terms of this exception, the distribution received by [Redacted] would be treated as a dividend from a unitary subsidiary and would be included in [Redacted] pre-apportionment tax base just like any other dividend received from a unitary REIT subsidiary. However, as pointed out in the Protest Supplement filed by [Redacted], the federal Public Law that created IRC § 332(c) specifically states that it "shall apply to distributions after May 21, 1998." *See* P.L. 105-277, § 3001(c). The liquidations at issue in this protest were both made on or before May 21, 1998. As a result, the exception set out in IRC § 332(c) does not apply to either of the liquidating distributions at issue in this protest.

Because the exception set out in IRC § 332(c) does not apply, the taxpayer correctly treated the distribution it received from its two liquidating REITs as a tax-free distribution. The audit adjustment relating to this liquidating distribution is hereby reversed.

E. Whether Two Unitary "Credit Card Bank" Subsidiaries were Transacting Business in Idaho.

[Redacted] has two unitary subsidiaries, [Redacted], that conduct the majority of the credit card business activity of the [Redacted] unitary group. During the years at issue neither of these two "Credit Card Banks" had an actual office in Idaho and, therefore, each appeared to meet the safe-harbor provision of Idaho Code § 63-3023(b). Under that safe harbor provision, corporations that do not "maintain an office in this state" are not treated as "transacting business" in Idaho even though they conduct certain financial activity within this state. However, the audit staff asserts that there was sufficient activity relating to these credit card subsidiaries that was taking place at [Redacted] bank branches located in Idaho to qualify as "maintaining an office in this state." [Redacted], on the other hand, contends that the credit card related services that can be obtained or utilized at the local bank branches is *de minimis* and is not sufficient to qualify as "maintaining an office" under the Idaho statute.

Before a non-Idaho corporation is required to comply with Idaho's income tax laws, that corporation must be "transacting business" in this state. Transacting business is defined in Idaho Code § 63-3023(a) to include the "owning or leasing . . . of any property, including real and personal property, located in this state, or engaging in or the transacting of any activity in this state[] for the purpose of or resulting in economic or pecuniary gain or profit." Idaho Code § 63-3023(a). Idaho Code § 63-3023(b) goes on to provide a "safe harbor" exception that applies to corporations conducting certain limited financial activities within Idaho. That subsection provides:

> (b) Notwithstanding the provisions of subsection (a) [defining "transacting business"] . . . , any corporation, bank, trust company . . . or other corporation . . . existing under the laws of any state or territory of the United States other than the state of Idaho . . ., **which does not maintain an office within the state of Idaho for any purpose** shall not be deemed to be transacting business within the state of Idaho during any taxable year by reason of carrying on in this state any one (1) or more of the following activities:
>
> > (1) Creating, acquiring or purchasing of loans . . . .
> >
> > (2) Collecting and servicing of loans in any manner whatsoever and the making of credit investigations and physical inspections and approval of real or personal property securing any loans or proposing to secure any loans;
> >
> > (3) Soliciting of applications for loans which are sent outside this state for approval; and
> >
> > (4) Filing of security interests; maintaining or defending any action or suit; holding, selling, assigning, transferring, collecting or enforcing any loans, or foreclosing or other disposition thereof, including acquiring title to property securing such loans by foreclosure, deed in lieu of foreclosure, or otherwise, as a result of default under the terms of the mortgage, deed of trust or other security instruments . . . or the holding, protecting and maintaining of said property so acquired or the disposition thereof.

Idaho Code § 63-3023(b). (Bolding added for emphasis).

With respect to the two credit card subsidiaries in question, it is the audit staff's position that each maintains an office in Idaho, which would take the subsidiary out of the protection of the statutory safe-harbor and would also clearly establish nexus for constitutional purposes. According to the Audit Narrative:

> We believe that [the credit card subsidiaries] do maintain an office in the state as they are using the facilities and employees of [Redacted] to conduct their business within the state. Applications for credit cards, phone lines for additional information, payments on account, inquiries into balances and problems, taking pictures for credit cards – can all be done at the local [Redacted] branch offices. We believe this qualifies as "maintaining an office" within the state.

Audit Narrative, p. 5.

The audit staff has raised an interesting "representative nexus" issue. The question that must be decided is whether the activities of the [Redacted] employees, taking place at [Redacted] branches in Idaho, are sufficient to bring the credit card subsidiaries outside of the safe harbor set out in Idaho Code § 63-3023(b). From a theoretical standpoint, there is no question that a subsidiary can be deemed to be maintaining an office in Idaho by virtue of utilizing employees or facilities of an affiliated corporation. But while we agree with the audit staff that it is possible for a corporation to be maintaining an office in Idaho based on the activity being conducted on behalf of that corporation by its affiliates or representatives, the activity being conducted on behalf of the corporation must be more than just *de minimis*. Thus, the question here is whether the facts set out in the audit report constitute **sufficient activity** on behalf of the credit card subsidiaries to be treated as "maintaining an office in this state for any purpose."

The Protest Supplement provided by the taxpayer's representative describes the activities taking place at the local Idaho bank branches as follows:

> **Applications for credit cards—**Credit card applications are indeed available at [Redacted] branch offices but [Redacted] branch employees do nothing more than provide the applications to interested customers. Interested applicants must fill the form out and submit the form to the [Redacted] operation in [Redacted]. [Redacted] employees in [Redacted]investigate the applicant and approve (or deny) the application.
>
> **Phone lines for additional information—**A phone is available in every [Redacted] branch for a customer to use to contact a [Redacted] call center. There is nothing special about the calls made from the [Redacted] branch. The same call could be made toll free from any phone in the United States. Automated responses are provided for balance or payment inquiries. Any other credit card related inquiry must be passed off to a special credit card call center. This credit card call center is not located in Idaho.
>
> **Payments on account—**[Redacted] branch employees can take credit card payments and post them to a cardholder's account. The posting is a memo

> posting only, which means that the payment is posted to the cardholder's account immediately on the [Redacted]teller system. But the transaction is not permanently posted to the credit cardholder's account on the credit card system until processing that evening, when electronic records of the transactions are transferred and permanently posted to the credit card systems. This differs from payments sent directly to the credit card center in [Redacted]. Payments received in [Redacted] are posted immediately and are immediately applied to the cardholder's account balance.
>
> **Inquiries into balances and problems—**[Redacted] branch employees in Idaho can view account balance, payment amount, and payment due dates for Northwest region cardholders who are also banking customers. For all other cardholders, the [Redacted] branch employee cannot pull up any information. The [Redacted] branch employees can do nothing beyond viewing these three items. For more information, a credit cardholder would be directed to the call center.
>
> **Taking pictures for credit cards—**A cardholder customer who would like their picture on their credit card can come into any [Redacted] branch and have a Polaroid picture taken. The picture is then sent to Phoenix where it is scanned into a database. This database is then accessed and the image printed on the card. Having the customer's picture on the credit card is a security measure that mainly benefits the [Redacted] and not the customer. Furthermore, the camera equipment was placed in the [Redacted]branch in the first place so that pictures could be taken and imprinted on the customer's [Redacted] *debit card*. The debit card provides card access to a customer's [Redacted] checking account and is not a [Redacted] product.

Protest Supplement, pp. 6 – 7.

Based on the explanations provided in the Protest Supplement, the Commission finds that the activities conducted on behalf of the credit card subsidiaries at the bank branch offices in Idaho are *de minimis* and, therefore, insufficient to take the credit card companies out of the Idaho Code § 63-3023(b) safe harbor provision. While this is a relatively close case, without more significant in-state activity being conducted on behalf of the two credit card subsidiaries, there is simply insufficient evidence to find that these subsidiaries are engaged in business activity that goes beyond that allowed under the Idaho safe harbor. As a result, neither of these corporations has an Idaho corporate income tax filing requirement during the years at issue. The audit determination to the contrary is reversed.

F. Additional Corrections to 2000 Tax Liability.

One final issue needs to be addressed in this decision. In a letter dated November 23, 2004, the representative for [Redacted] informed the Commission of some additional corrections that [Redacted] felt were needed with respect to the 2000 Idaho combined group return. In a letter dated December 2, 2004, the Commission's delegated representative agreed to make some, but not all, of the suggested corrections. Each of those letters is hereby incorporated by reference into this decision, and those corrections that the parties have agreed to will be included in the tax deficiency calculation set out below.

IV.

CONCLUSION

To summarize, we agree with the taxpayer with respect to issues number 3, 4, and 5, but we uphold the audit staff with respect to issues number 1 and 2. The Notice of Deficiency Determination, as modified to incorporate [Redacted] relating to the 1998 and 1999 taxable years and the agreed-to corrections relating to the 2000 taxable year, will be adjusted accordingly. A schedule showing the recomputed tax and interest amounts is attached to this Decision as Appendix A.

WHEREFORE, the Notice of Deficiency Determination dated June 25, 2003, 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:

PERIOD	TAX	PENALTY	INTEREST	TOTAL
1998	$ 74,844	-0-	$29,180	$104,024
1999	167,311	-0-	53,010	220,321
2000	280,843	-0-	66,556	347,399
			TOTAL AMOUNT DUE	$671,744

Interest is calculated through December 31, 2004, 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 ____________________, 2004.

IDAHO STATE TAX COMMISSION

____

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of __________________, 2004, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]
[Redacted]
[Redacted]

Receipt No.

____