BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of [Redacted], Petitioner.	)))))))	 DOCKET NO. 18147 DECISION

On March 19, 2004, the Income Tax Audit Division of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] (hereinafter the "Petitioner"), asserting additional corporate income tax and interest in the amount of $88,301 (after a credit for previous payments) for the 1998 through 2000 taxable years. On May 25, 2004, the Petitioner filed a petition for redetermination of the deficiency. The Petitioner requested an informal conference before the Commission.

The Audit Division (Division) contacted the Petitioner to discuss the issues raised in the petition for redetermination. The Division and the Petitioner resolved several issues and on July 8, 2004, the Division issued a modified Notice of Deficiency Determination. The Division reduced the asserted deficiency to $85,741.

On November 3, 2004, the Tax Commission conducted an informal conference to discuss the issues not resolved at the audit level. The Petitioner's representatives participated by means of telephone. Staff from the Audit Division appeared in person.

Issues Protested

The Petitioner stated three issues remained for discussion at the informal conference.

1. More of the interest expense should be allocated to business income;
2. Interest on the deficiency regarding the excess value insurance program should be recalculated to correctly account for a previous payment; and,

3. The income of two foreign reinsurance companies should not be included in the apportionable income of the combined group because to do so discriminates against the Idaho taxpayers of the combined group in violation of the Commerce Clause of the United States Constitution.

Holding

The Tax Commission considered the comments made at the informal conference and reviewed the information submitted by both the Petitioner and the Audit Division. Based on its review the Tax Commission further modifies the Notice of Deficiency Determination.

The Commission agrees to the modifications that the Petitioner requested in the first and second issues. Therefore, the Tax Commission further modifies the Notice of Deficiency Determination as it relates to: (1) the allocation of interest expense; and (2) the calculation of interest on the excess value insurance deficiency.

The Tax Commission affirms the Audit Division regarding the third issue. The Tax Commission finds the affiliated corporations are "captive" reinsurance companies that do not pay a premium tax. As a result, they are not exempt insurance companies for income tax purposes. Pursuant to the Tax Commission's Administrative Rule 600, the income of the affiliated insurance companies should be included in the income of the combined group.

The Tax Commission further finds that including the affiliated foreign insurance companies in the combined group does not violate the Commerce Clause of the United States Constitution. The Petitioner failed to present any evidence to support its claim that including the affiliated companies in the combined group results in discrimination that unduly burdens foreign commerce. To the contrary, it appears to the Commission that foreign reinsurance companies are treated the same as domestic reinsurance companies. Neither foreign nor domestic reinsurance companies pay the premium tax. As a result, reinsurance companies are included in the combined group without distinction between domestic and foreign reinsurance companies.

Facts

[Redacted] is the world's largest express [Redacted] company, and provider of specialized transportation services. Its primary business is the delivery of packages and documents in the United States and over 200 other countries. The company that operates in Idaho is [Redacted]. The other major [Redacted] entity, [Redacted] provides service to [Redacted] and 13 other northeast states. [Redacted] provides services to the rest of the United States.

When an Idaho customer calls [Redacted] the call is routed through [Redacted], which is a call center in [Redacted]. [Redacted] then arranges for ground transportation to pick up [Redacted]. The ground unit delivers [Redacted] to either a rail center or an air hub. If sent by air, the [Redacted]. The large hub then sends the [Redacted] to a smaller hub where ground transportation picks up [Redacted] and delivers it.

An unrelated third party insures the [Redacted]. The insurance includes coverage for packages, property, and other risks located in Idaho. Two affiliated [Redacted] "reinsure" the [Redacted] under an arrangement with the original third-party insurer for a share of the premiums or losses incurred by the third-party insurer.

The affiliated companies are "captive" companies. A typical captive company is domiciled in [Redacted] or other foreign country to obtain an exemption from income tax on its investment. The company provides insurance to affiliated corporations (members of the unitary group), but the company does not underwrite insurance policies for third parties. *See* Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir.), *cert. denied,* 454 U.S. 965, 102 S.Ct. 506, 70 L.Ed.2d 381 (1981), *aff'g* 71 T.C. 400 (1978). Thus, they are "captive" to, and serve only, their own family of corporations.

The two affiliated companies in this case provide services only to affiliated companies. The companies reinsure approximately 98% of the risk insured by third-party insurers. Both of the affiliated companies were incorporated under the laws of Bermuda and elected domestic insurance company treatment for income tax purposes under the provisions of § 953 of the Internal Revenue Code.

The Petitioner filed world wide combined returns for the taxable years in question, treating the group of affiliated corporations as a single unitary business. The Petitioner excluded the income of the two reinsurance companies from the apportionable income of the combined group. For each of the years at issue, the Petitioner excluded income ranging from approximately $260 million to $289 million.

The Audit Division determined the income of the reinsurance companies should be included in the apportionable income of the combined group. At the Petitioner's request, the Division included the attributes of the two companies in the denominators of the apportionment formula. The Audit Division made other adjustments and issued a Notice of Deficiency Determination, and later, a modified Notice of Deficiency Determination, as described above.

Law and Analysis

Statutes and Administrative Rules

1. Insurance Statutes

Chapter 4 of Title 41 of the Idaho Code imposes the Idaho premium tax. Idaho Code § 41-402 requires authorized insurers to file statements with, and pay a premium tax to, the Department of Insurance.

Idaho Code section 41-405 states the premium tax paid by an insurer shall relieve the insurer from the payment of other state taxes.

41-405. PREMIUM TAX IN LIEU OF OTHER TAXES – LOCAL TAXES PROHIBITED.

(1) Payment to the director by an insurer of the tax upon its premiums as in this chapter required, shall be in lieu of all other taxes upon premiums, taxes upon income, franchise or other taxes measured by income, and upon the personal property of the insurer and the shares of stock or assets thereof; provided, that all real property, if any, of the insurer shall be listed, assessed and taxed the same as real property of like character of individuals.

In short, Idaho Code 41-405 exempts from Idaho corporate tax those insurance companies that pay the Idaho premium tax to the Department of Insurance.

2. <u>Income Tax Statute and Rules regarding Combined Reporting.</u>

Idaho Code section 63-3027 governs the computation of Idaho taxable income of a multistate or unitary corporation. The statutes provides in relevant part:

> **63-3027. COMPUTING IDAHO TAXABLE INCOME OF MULTISTATE OR UNITARY CORPORATIONS**. The Idaho taxable income of any multistate or unitary corporation transacting business both within and without this state shall be computed in accordance with the rules set forth in this section:
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> (t) For purposes of this section and sections 63-3027B through 63-3027E, Idaho Code, the income of two (2) or more corporations, wherever incorporated, the voting stock of which is more than fifty percent (50%) owned directly or indirectly by a common owner or owners, <u>when necessary to accurately reflect income, shall be allocated or apportioned as if the group of corporations were a single corporation, in which event</u>:
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> (1) <u>The Idaho taxable income of any corporation subject to taxation in this state shall be determined by use of a combined report which includes the income, determined under subparagraph (2) of this subsection, of all corporations which are members of a unitary business</u>, allocated and apportioned using apportionment factors for all corporations included in the combined report and methods set out in this section. The use of a combined report does not disregard the separate corporate identities of the members of the unitary group. Each corporation which is transacting business in this state is responsible for its apportioned share of the combined business income plus its nonbusiness income or loss allocated to Idaho, minus its net operating loss carryover or carryback.

Idaho Code section 63-3027(t). While the statute directs the filing of a combined return when "necessary," the statute does not provide criteria for determining the necessity.

Under its administrative authority the Tax Commission promulgated administrative rules that set out the criteria for determining if and when a combined report may be necessary. The Tax Commission's initial regulation setting out the mechanism for determining whether a combined report is necessary to accurately reflect income was officially promulgated as a regulation in 1989 and remained in existence until 1996.[1] *See* Tax Commission Administrative Regulation 27,4.19.a (1990), IDAPA 35.01.01.27,4.19.a (1990). The rule did not expressly address the issue of whether or not exempt insurance companies should be included in the combined group. However, as judicially noticed in the case of AIA Services Corp. v. Idaho State Tax Commission, 136 Idaho 184, 30 P.3d 962 (2001), the effect of the regulation was to exclude exempt insurance companies from the combined group.

In 1997, the Tax Commission adopted a new administrative rule, Rule 600.05. That rule specifically excluded exempt insurance companies from the combined report and provides in part:

> **600.ENTITIES INCLUDED IN A COMBINED REPORT (RULE 600).**
> Section 63-3027(t), Idaho Code.
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> **01. Combined Report**. Each corporation that is a member of a unitary business transacting business within and without Idaho shall allocate and apportion its income to Idaho using a combined report pursuant to Rules 360 through 369 of these rules. See Rules 340 through 344 of these rules for the principles for determining the existence of a unitary business.
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> * * * *
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> **05. Insurance Companies**. Pursuant to Section 41-405, Idaho Code, an insurance company subject to the premium tax may not be included in a combined group.

Tax Commission Administrative Rule 600.05 (1997), IDAPA 35.01.01.600.05 (1997). Although it has been recodified, that administrative rule is still in effect today. *See* Tax Commission

[1] In 1993 the Idaho Legislature required all administrative agencies to begin referring to administrative pronouncements as "Rules" rather than as "Regulations." As a result, in 1993 the Regulation was reissued and renumbered as Tax Commission Administrative Rule 76.

Administrative Rule 600.06 (1999), IDAPA 35.01.01.600.06 (1999). Administrative Rule 600 applies in this case because the taxable years at issue are 1998, 1999, and 2000.

Audit Division's Position

The Petitioner conceded that the two reinsurance companies do not pay a premium tax to Idaho or any other state. As a result, the Audit Division found that pursuant to Idaho Code section 41-405, the insurance companies were not exempt insurance companies. The Division determined that Administrative Rule 600 required that the income of the two foreign affiliates should be included in the apportionable income of the combined group.

Petitioner's Position

The Petitioner asserts the two reinsurance companies should be excluded from the combined group even though they do not pay a premium tax.

> While they [the two affiliated insurance companies] do not actually pay a premium tax in Idaho, this is a consequence solely of their lack of nexus. If this lack of nexus made a difference to the application of Idaho Code § 41-405, the result would be that only insurance companies lacking nexus with Idaho would pay Idaho's income tax while those having nexus would be exempt. Such unequal treatment of foreign non-nexus insurance companies would discriminate against foreign commerce in violation of the Commerce Clause of the United States Constitution. Thus, Idaho Code § 41-405 must be interpreted to apply to non-nexus as well as nexus insurance companies and neither [affiliated insurance company] . . . may be included in the . . . combined group.

Petition for Redetermination at p. 5. In essence, the Petitioner argues Idaho is discriminating against the combined group because it is treating the reinsurance companies differently than other companies based solely on their foreign status.

Analysis

1. The Unitary Business and Combined Reporting.

The Petitioner argues that the failure to exclude foreign "non-nexus" insurance companies from the combined group violates the foreign commerce clause. To avoid any confusion, the Tax

Commission notes Idaho has not imposed, and is not seeking to impose, an income or premiums tax on the affiliated companies. [2] The Petitioner's use of the term "non-nexus" in relation to the two affiliated companies refers to the imposition of the Idaho premium tax by the Department of Insurance and not the imposition of the Idaho income tax by the Tax Commission.

Simply including a corporation in the combined report does not result in the taxation of that particular corporation. The unitary business concept -- as refined through the requirement of "combined reporting" -- treats a group of commonly owned businesses as a single unit for purposes of allocating and apportioning the income of that enterprise among the various states where it conducts its business operations. *See generally*, Container Corp., 463 U.S. 159, 164 – 169, 103 S.Ct. 2933, 2940 – 2942 (discussing the unitary business principle in light of the California combined reporting requirement). As stated by the U.S. Supreme Court: "The principal virtue of the unitary business principle of taxation is that it does a better job of accounting for the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise than, for example, geographical or transactional accounting." Allied-Signal, Inc. v. Director, Div. of Taxes, 504 U.S. 768, 783, 112 S.Ct. 2251, 2261 (1992) (citations and internal quotations omitted).

Idaho modified the Uniform Division of Income for Tax Purposes Act (UDITPA) allocation and apportionment provisions to require "combined reporting" of the income of certain affiliated corporations. Idaho Code § 63-3027(t). As explained by the Idaho Supreme Court, combined reporting is a refinement of the UDITPA apportionment principle.

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[2] States are not precluded from directly taxing foreign insurance companies. The Commerce Clause does not apply to a state's taxation of insurance companies. In Prudential Insurance Co. v. Benjamin, 328 U.S. 408, 66 S.Ct. 1142, 90 L.Ed. 1342 (1946), the Supreme Court held that the McCarran-Ferguson Act barred a dormant Commerce Clause challenge of a state tax levied on out-of-state insurance companies, noting that Congress in enacting the Act "clearly put the full weight of its power behind existing and future state legislation to sustain it from any attack under the commerce clause ...." *Id.* at 431, 66 S.Ct. 1142.

> The combined reporting provision of subsection (s) [now I.C. § 63-3027(t)] is a further refinement of the basic apportionment principle. Its purpose is to permit application of the UDITPA formula to a single business enterprise which is conducted by means of separately incorporated entities. In an economic sense such a business is no different than a similar business composed of a single corporation with several separate divisions. For tax reporting purposes such businesses should be treated the same.

Albertson's Inc., 106 Idaho at 814-815, 683 P.2d at 850-851. In a recent case, the Idaho Supreme Court affirmed the principle it articulated in Albertson's.

> AIA Services also cites *Albertson's, Inc. v. State, Dept. of Revenue*, 106 Idaho 810, 683 P.2d 846 (1984), for the proposition that all members of a unitary group are required to file a combined return. In *Albertson's,* the issue was "whether it is appropriate to treat the income of a Texas corporation which is a wholly-owned subsidiary of Albertson's, Inc. as income of the parent corporation, subject to apportionment under the Idaho version of the Uniform Division of Income for Tax Purposes Act (UDITPA)." *Id.* at 811, 683 P.2d at 847. . . . The Court concluded that the "result thus reached [by combining the unitary group] is exactly what Albertson's would have paid in Idaho taxes had the subsidiary never been formed." *Id.* at 818, 683 P.2d at 854.

AIA Services, Inc., 136 Idaho at 187, 30 P.3d at 966. The purpose of combined reporting is to more accurately reflect the income of the unitary group.

Including an exempt corporation in the income of the combined group does not cause the subsequent apportionment of income to be distorted. For example, an exempt insurance subsidiary could be included in the combined report. Including the income of an exempt insurance company in the combined group's income is permissible so long as the group's Idaho apportionment factor is calculated by including the exempt insurance company's total payroll, property and sales in the combined group's denominator, but excluding its Idaho payroll, property and sales in the group's numerator. See, e.g., State v. Penn Independent Corporation, 1999 WL 1062130 (Or. Tax. 1999). This does not result in the taxation of the exempt insurance

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At the informal conference the Petitioner agreed Idaho was not taxing the affiliated companies and therefore the McCarran-Ferguson Act was not relevant.

company's income because while the combined group's preapportionment income tax base is larger, its Idaho apportionment factor is smaller. Id.

While it is permissible to compute the business income of a combined group by including an exempt unitary insurance subsidiary, it is not the method Idaho chose. Through its administrative rule the Tax Commission chose to exclude exempt insurance companies from the combined group computation.

2. The Petitioner's Constitutional Claim

Although the Petitioner frames the issue as one of statutory interpretation, the Petitioner's disagreement is with the Tax Commission's administrative rule that excludes exempt insurance companies from the combined group while including "foreign non-nexus insurance companies." Thus, the Petitioner's constitutional challenge goes to the Tax Commission's administrative rule not the exemption statute.

The Petitioner makes a discrimination claim. The Tax Commission does not find any discrimination in this case and notes that the underlying premise of the Petitioner's claim is flawed.

The underlying premise of the Petitioner's claim is: "While they [the two affiliated insurance companies] do not actually pay a premium tax in Idaho, this is a consequence solely of their lack of nexus." It is not because of a lack of nexus that the affiliated companies are not required to pay the Idaho premium tax. The affiliated companies do not pay the Idaho premium tax because they "reinsure" other insurance companies rather than directly insure risks located in Idaho. "Reinsurance" usually involves a procedure referred to as a "fronting arrangement." In a fronting arrangement, a reinsurer who is not licensed in Idaho makes arrangements with an insurance company that is licensed in Idaho. The licensed company underwrites the insurance and, in turn, the unlicensed "reinsurer" insures the licensed company.

The failure of the reinsurer to pay its obligations does not relieve the licensed company from its obligations to pay Idaho claims. The licensed (fronting) company is the company responsible for the payment of the premium tax on Idaho premiums, to maintain an adequate reserve, and to pay all Idaho claims, regardless of any arrangement the licensed company may have with a reinsuring company. Under Idaho Code § 41-402, the licensed insurer pays an Idaho premium because it is the "authorized insurer" writing Idaho risks.

Thus, contrary to what the Petitioner asserts the premium tax is imposed on the insurance company that: (1) is authorized to write insurance in Idaho, (2) receives premiums for Idaho risks, and (3) is required to satisfy Idaho claims. In contrast, the reinsurer is not required to apply for and receive authorization because the state of Idaho will look to the "fronting company" to satisfy Idaho claims. This is the reason the reinsurer is not required to pay the premium tax.

It does not matter whether a reinsurance company is an Idaho company, a company domiciled in another state, or a company created under the laws of a foreign country. The premium tax is imposed on only an "authorized" licensed insurer. A reinsurance company involved in a fronting arrangement, regardless of whether it has a domestic or foreign domicile is not subject to the Idaho premium tax.[3]

Whenever a domestic or foreign insurance company fails to pay the premium tax it will be included in the combined return. The Tax Commission fails to see how including the affiliated insurance companies in the combined report causes any discrimination. The provisions of the administrative rule affords the Petitioner the same treatment as any other unitary taxpayer with affiliates who reinsure members of the unitary group.

[3] A foreign insurance company could choose not to enter into a fronting arrangement and apply for authorization. However, if a foreign insurance company directly insured risks located in Idaho, the company would be required to seek certification and

3. Under both Federal and California Law the Affiliates are Not Insurance Companies.

The Tax Commission notes that the treatment of the two affiliated companies in this case is consistent with the treatment afforded by California, another combined reporting state. California has some unique constitutional and statutory provisions which generally excludes an insurance company from the combined group, if the insurance company pays either a domestic or foreign premium tax. *See* Legal Ruling 385, 1975 WL 3290 (California Franchise Tax Board, March 28, 1975).

California nonetheless combines "captive" companies that insure only the risks of their affiliated companies. *See* Appeal of Clougherty Packing Co., 90A-1424-JV, 1994 WL 396902 (California Board of Equalization, July 1, 1994)(not precedent). California's policy is informed by the federal courts' disallowance of deductions claimed by a domestic parent for premiums paid to a captive company.

A typical captive company is domiciled in Bermuda or other foreign country to obtain an exemption from income tax on its investment. Because the captive insures only affiliated companies, the federal courts have reasoned that the captive insurance company is no different than self-insurance in which the parent or affiliated corporation would place money in a reserve for claims. There is no effective shifting of risks and the captive company therefore is not an "insurance company" for income tax purposes. *See* Clougherty Packing Co. v. Commissioner of Internal Revenue Service, 811 F.2d 1297, 59 A.F.T.R.2d 87-668, 87-1 USTC P 9204 (9th

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authorization, and in turn, be subject to the Idaho premium tax and other Idaho regulatory requirements relevant to insurance companies.

Cir.(Cal.) (1987) *citing* Carnation Co. v. Commissioner, 640 F.2d 1010 (9th Cir.), *cert. denied*, 454 U.S. 965, 102 S.Ct. 506, 70 L.Ed.2d 381 (1981), *aff'g* 71 T.C. 400 (1978).

The federal court's ruling in Clougherty influenced the subsequent decision of the California Board of Equalization when the Clougherty and its affiliated reinsurer appeared before the Board. The Board of Equalization found:

> The respondent relies heavily upon Clougherty Packing Company v. Commissioner, 811 F.2d 1297 (9th Cir.1987), where the appellate court, affirming a decision of the Tax Court [84 T.C. 948 (1985)], sustained the position of the IRS in denying as a deduction the reinsurance premiums paid to LIC. The court held such premiums to really be for self-insurance and thus not deductible. In its holding the court states:
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> > ... an insurance agreement between parent and captive does not shift the parent's risk of loss and is not an agreement for 'insurance.' Premiums paid by the parent to the captive, whether directly or through an unrelated insurer, may not be deducted by the parent as insurance premiums.
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> (Clougherty Packing Company v. Commissioner, supra, 811 F.2d at 1307.) From this decision respondent suggests that LIC was not an insurance company and, therefore, the "in lieu" provisions relating to insurance companies do not apply.

> Respondent also argues that by using LIC's income only in the apportionment base, it is not taxing LIC but only determining the correct amount of income to be apportioned to California.
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> It is correct that a combined report only asserts a tax against California taxpayers even though the income and factors of non-California taxpayers may be utilized in determining the unitary business income fairly attributable to this state. An exception to this general rule is provided for in respondent's Legal Ruling No. 385, dated April 1, 1975 (CCH 205-232), which holds that insurance companies should not be included in a combined report nor should their income or factors be considered, even if it is otherwise a part of the unitary business. However, this legal ruling also provides that in order for an insurance company's income to be excluded from the combined report, the company must establish that it regularly engaged in an insurance business and was so licensed by the state where it operated.

Appeal of Clougherty Packing Co., 90A-1424-JV, 1994 WL 396902 at pp. 2-3. While the California Board's decision is not binding legal precedent, the Tax Commission finds the rational expressed in the opinion to be persuasive.

The two affiliated insurance companies at issue in this case appear to be analogous to the reinsurance company at issue in the California case. They are captive companies domiciled in Bermuda and the Petitioner stated the companies reinsure approximately 98% of the risk insured by third-party insurers, but the companies do not insure non-affiliated companies. As a result, the companies would be included in the combined group under the standards articulated by California and the federal court because the affiliated companies would not be insurance companies for income tax purposes.

Conclusion

WHEREFORE, the Notice of Deficiency Determination dated March 19, 2004, and modified by the Audit Division on July 8, 2004, is hereby further MODIFIED and, as so modified, is hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayer pay the following tax and interest:

YEAR	TAX	INTEREST	TOTAL
1998	$44,528	$14,195	$ 58,723
1999	$14,059	$ 4,867	$ 18,926
2000	$51,302	$13,673	$ 64,975
		SUBTOTAL	$142,624
	(LESS PAYMENTS RECEIVED)		($ 55,573)
	TOTAL AMOUNT DUE		$ 87,501

Interest is calculated through June 30, 2005.

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. As set forth in the enclosed explanation you must deposit with the Tax Commission twenty percent (20%) of the total amount due in order to appeal this decision. The twenty percent deposit in this case is $17,500 and will be held as security for the payment of taxes until the appeal is resolved.

DATED this ________ day of __________________________, 2005.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of ________________, 2005, 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]

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