

**BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO**

In the Matter of the Protest of )  
 )  
[Redacted] Petitioners. ) DOCKET NO. 18612  
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 ) DECISION  
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On December 14, 2004, the Income Tax Audit Division of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted]. (taxpayer), asserting additional income tax, penalty, and interest in the amount of \$144,980 for the 2001 through 2003 taxable years. On February 15, 2005, the taxpayer filed a timely appeal and petition for redetermination. An informal hearing was held on July 26, 2005. The Tax Commission, having reviewed the file, hereby issues its decision.

**I.**

**SUMMARY OF FACTS**

[Redacted] operates a number of retail home improvement warehouses throughout the western United States, including at least two in Idaho. [Redacted] is a wholly owned subsidiary of [Redacted]. (“[Redacted]” or “parent”). [Redacted] filed Idaho corporate income tax returns for the fiscal years ending 2/2/2001, 2/1/2002, and 1/31/2003 on the worldwide combined reporting basis. The combined group was made up of [Redacted] and all of its more than 50 percent owned subsidiaries, with the exception of a wholly owned insurance subsidiary called [Redacted]. (“[Redacted].”). “[Redacted]. was incorporated on October 2, 2002, under the laws of [Redacted] to provide insurance coverage, such as workers’ compensation, auto liability, and general liability, to [Redacted]-affiliated companies.” Letter of protest, p. 2. [Redacted]. did not pay any Idaho premium tax for the 1/31/2003 taxable year.

The audit staff adjusted the [Redacted] 1/31/2003 Idaho return to include [Redacted]. in the Idaho combined report. The audit staff also made some adjustments to the Idaho apportionment factor and to the Idaho investment tax credit for all three years under audit. However, [Redacted] is not protesting these other audit adjustments. The 10 percent substantial understatement penalty was asserted for the 2/1/2002 and 1/31/2003 taxable years.

## **II.**

### **ISSUES**

[Redacted] is protesting the following two audit adjustments:

1. Inclusion of [Redacted]. in the Idaho combined group report.<sup>1</sup> [Redacted] asserts that the inclusion of [Redacted] in the combined group report is contrary to Idaho law and, if upheld, would violate the Commerce Clause. Thus, there are two sub-issues to be analyzed:
  - a. Does Idaho law permit a unitary insurance subsidiary that does not pay Idaho premium tax to be included in the combined group report?
  - b. If yes, does the inclusion of [Redacted]. in the combined group report violate the Commerce Clause in light of the Tax Commission administrative rule that excludes from the combined group report insurance subsidiaries that pay the Idaho premium tax?
2. Imposition of the 10 percent substantial understatement penalty.

We will address each of these issues in turn.

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<sup>1</sup> This issue only relates to the 1/31/2003 taxable year. The amount of Idaho tax at issue with respect to this issue is only \$2,280.

### III.

#### OPINION

##### A. Inclusion of Unitary Insurance Subsidiary in the Combined Group Report.

###### 1. Statutory Analysis.

Idaho Code § 41-405(1) provides that payment of the Idaho premium tax “shall be in lieu of all other taxes upon . . . income, franchise or other taxes measured by income . . . .” Thus, insurance companies that are subject to, and actually pay, the Idaho premium tax are exempt from the Idaho income tax. However, that does not necessarily mean that an exempt insurance company cannot be included in a combined group calculation relating to a subsidiary corporation that has an Idaho income tax filing requirement. Including an exempt subsidiary in the combined group calculation is not equivalent to taxing the income of that exempt company. *C.f. Barclays Bank PLC v. Franchise Tax Board*, 512 U.S. 298, 311 n. 10, 114 S.Ct. 2268, 2277 n. 10 (1994) (“Formulary apportionment of the income of a multijurisdictional (but unitary) business enterprise, if fairly done, taxes only the income generated within a State.”) (citation and internal quotations omitted). In this respect, an exempt insurance subsidiary is no different than a subsidiary exempt from Idaho income taxation by Public Law 86-272. So long as the payroll, property, and sales of the exempt subsidiary are included in the combined group denominators, there is no inherent or theoretical reason why the income of the exempt subsidiary cannot be included in the combined group total apportionable income that is then apportioned to Idaho on the return filed by an Idaho-nexus taxpayer. *See State v. Penn Independent Corporation*, 1999 WL 1062130 (Or. Tax. 1999).

While it is permissible to include an exempt insurance subsidiary in the combined group calculation relating to an Idaho-nexus taxpayer, the Idaho State Tax Commission has a longstanding policy of excluding exempt insurance companies from the combined group. The policy is currently set out in Income Tax Administrative Rule 600.06, IDAPA 35.01.01.600.06, which provides that “[p]ursuant to Section 41-405, Idaho Code, an insurance company subject to the premium tax may not be included in a combined group.” The rationale for this policy seems to be based in large part on the fact that [Redacted] excludes exempt insurance subsidiaries from the [Redacted] combined group report.<sup>2</sup>

[Redacted] argues that the term “subject to the premium tax” as used in Rule 600.06 should be read broadly to include insurance companies that don’t actually pay any Idaho premium tax but would pay the tax if they actually conducted business in Idaho. In effect, the taxpayer asserts that Rule 600.06 should be read to exclude all insurance companies from the combined group calculation, not just those insurance companies that actually pay the Idaho premium tax.

A similar argument was recently addressed by this Commission in the decision issued in docket # 18147. In that decision we held that two unitary “reinsurance” subsidiaries were not **exempt** insurance companies under Idaho Code § 41-405(1) and, therefore, were not excluded

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<sup>2</sup> According to the California Franchise Tax Board, a unitary insurance subsidiary may not be included in the combined report of a unitary business because an insurance company is not a “taxpayer” as defined by California’s tax statutes. See FTB Legal Ruling 385 (3/28/75). Under California’s combined reporting statute, only “taxpayers” are to be included in the combined report; and since insurance companies do not meet the statutory definition of a “taxpayer,” they cannot be included. *Id.* However, the rationale and analysis followed in California for excluding insurance companies from the combined report does not apply under Idaho law. Idaho Code § 63-3027(t) [authorizing combined reporting] does not limit the makeup of the combined group only to “taxpayers.” Rather, Idaho Code § 63-3027(t)(1) specifies that “all corporations which are members of a unitary business” are to be included in the combined group “when necessary to accurately reflect income.”

from the combined group report under Rule 600.06.<sup>3</sup> The decision in docket # 18147 turned in large part on the fact that the unitary “reinsurance” subsidiaries were not the type of insurance company that would be subject to the Idaho premium tax because they did not provide **direct** insurance coverage. The present protest involves a “direct” insurance company ([Redacted].) as opposed to a “reinsurance” company, so the holding in docket # 18147 is not controlling. However, the statutory and regulatory analysis set out in that decision does carry great weight.

Applying that same analysis to the facts of this protest (i.e., applying the analysis to a “direct” insurance subsidiary) clearly supports the audit staff’s position that [Redacted] should be included in the combined group calculation. First, Rule 600.06 only applies to insurance companies that are exempt from Idaho income tax by virtue of Idaho Code § 41-405. Next, Idaho Code § 41-405(1) only exempts from the Idaho income tax those insurance companies that actually pay the Idaho premium tax to the Department of Insurance. Therefore, Rule 600.06 does not apply to an insurance company (whether it be a “direct” insurer or a “reinsurer”) that pays no Idaho premium tax. Since it is undisputed that [Redacted]. paid no Idaho premium tax during the 1/31/2003 taxable year, Rule 600.06 does not apply. Because Rule 600.06 does not apply, there is no reason why [Redacted]. should be excluded from the combined group report.

We find that inclusion of [Redacted]. in the combined report filed by [Redacted] is not prohibited by Idaho Code § 41-405 or by Income Tax Administrative Rule 600.06. We further find that the analysis set out in the decision issued in docket # 18147 supports inclusion of [Redacted] and other “direct” insurance subsidiaries in the combined group calculation. So long as the insurance subsidiary is a member of the unitary group of an Idaho nexus taxpayer, that

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<sup>3</sup> A redacted version of this decision is available to the public at <http://tax.idaho.gov/Decisions05/Corporation/0518147.pdf>.

subsidiary should be included in the combined group report. We now turn to the constitutional question raised in this protest.

## **2. Constitutional Analysis.**

[Redacted] argues that the Commission's policy of excluding insurance subsidiaries that pay the Idaho premium tax, but not excluding insurance subsidiaries that do not pay the tax, is discriminatory and violates the Commerce Clause. According to the taxpayer, the policy violates the Commerce Clause because it discriminates against interstate commerce by providing a "preference for companies whose affiliates pay Idaho premium tax." Letter of protest, p. 6.

The principal flaw with the taxpayer's Commerce Clause argument is that the inclusion of an exempt or non-nexus unitary subsidiary in the combined group calculation does not necessarily result in a higher tax liability for the Idaho nexus taxpayer. For example, if a unitary insurance subsidiary has a net operating loss, inclusion of that subsidiary in the combined group calculation would reduce the Idaho tax liability of the Idaho nexus taxpayer. Likewise, if a unitary insurance subsidiary has significant payroll, property, or sales that are included in the combined group apportionment denominator, the Idaho tax liability of the Idaho nexus taxpayer might be less if the insurance subsidiary is included in the combined group calculation. Thus, the inclusion of an insurance subsidiary does not necessarily result in a higher Idaho tax burden. This fact is amply supported by the arguments raised in AIA Services Corp. v. Idaho State Tax Com'n, 136 Idaho 184, 30 P.3d 962 (2001). In that case, the taxpayer (AIA Services) wanted to have its exempt insurance subsidiary included in the combined group report and argued to the Idaho Supreme Court that the Commission's policy of excluding exempt insurance subsidiaries violated the Commerce Clause. While the Idaho Supreme Court did not address AIA Services' Commerce Clause argument due to the fact that the company failed to raise the issue below, the

case does point out that the Commission's policy does not necessarily favor those "companies whose affiliates pay Idaho premium tax." AIA Services wanted to have its exempt insurance subsidiary included in the Idaho combined group report because it would have resulted in a tax savings.

[Redacted] has not met its burden of establishing that the Idaho policy relating to exempt insurance subsidiaries discriminates against interstate commerce by granting preferential treatment to in-state activity. In addition, even if the policy was discriminatory, the remedy would be to invalidate Rule 600.06, not to expand that rule to cover "non-exempt" insurance subsidiaries. *See, e.g., K-Mart Corp. v. Idaho State Tax Com'n*, 111 Idaho 719, 722, 727 P.2d 1147, 1150 (1986) ("Statutes control interpretive regulations. To the extent a regulation is unconstitutional, it is inconsistent with the constitutional statute it purports to interpret and is, therefore, of no effect to the extent of such inconsistency."). We therefore reject the taxpayer's assertion that Rule 600.06 must be read to exclude all insurance subsidiaries from the combined group return.

## **B. Imposition of the Substantial Understatement Penalty.**

The audit staff asserted the 10 percent substantial understatement penalty to the tax deficiency computed for the 2/02 and 1/03 taxable periods. [Redacted] asserts that the penalty should be waived. All but a very small amount of the penalty relates to audit adjustments that are not being protested.

### **1. Penalty attributable to protested audit adjustment.**

The penalty as it relates to the inclusion of [Redacted]. in the 1/31/2003 combined group report is only \$228 [10% of \$2,280]. [Redacted] asserts that it acted in good faith and with reasonable cause in not including [Redacted] in the combined group calculation. We agree.

Although we have rejected the substantive arguments presented by [Redacted] in this protest, we recognize that the underlying legal issues are complex. In addition, at the time [Redacted] filed its 1/31/2003 Idaho combined group return, it did not have the benefit of the analysis set out in the administrative decision issued by the Tax Commission in docket # 18147. As a result, we find that there was reasonable cause for the position taken by [Redacted] and that the company acted in good faith when it excluded its wholly owned insurance subsidiary from the Idaho combined group calculation. Therefore, pursuant to Idaho Code § 63-3046(d)(7), the Commission hereby waives the portion of the substantial understatement penalty that is attributable to the inclusion of [Redacted] in the combined group calculation.

**2. Penalty attributable to the conceded audit adjustments.**

With respect to the remainder of the substantial understatement penalty, [Redacted] essentially asks for leniency. According to the letter of protest: “The Commission has the discretion to abate penalties when the taxpayer does not dispute additional amounts owed. . . . [[Redacted] did not challenge the deficiencies the Commission assessed that were unrelated to the inclusion of [Redacted]. in [the] combined group. However, [Redacted] has always been a dutiful and responsive Idaho taxpayer and it filed its returns in good faith. Therefore, [Redacted] respectfully requests the Commission use its discretionary authority to abate these other penalties unrelated to [Redacted].’s status.” Letter of protest, pp. 12 – 13.

The Idaho income tax calculated on the 2/1/2002 and 1/31/2003 returns was understated by more than \$10,000 in each year. As a result, imposition of the penalty was clearly warranted. While this Commission appreciates the fact that [Redacted] did not raise every conceivable issue in this protest, there appears to be no legitimate justification for waiving the penalty under the

circumstances. As a result, we affirm the portion of the substantial understatement penalty that is attributable to the conceded audit adjustments.

WHEREFORE, the Notice of Deficiency Determination dated December 14, 2004, is hereby MODIFIED, and as so Modified is APPROVED, AFFIRMED AND MADE FINAL.

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

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2/2/2001	\$3,968	\$-0-	\$1,092	\$5,060
2/1/2002	43,129	4,313	8,581	56,023
1/31/2003	71,434	6,915	9,743	<u>88,092</u>
			TOTAL	<u>\$149,175</u>

Interest is calculated through September 30, 2005, 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 \_\_\_\_\_, 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]

Receipt No.

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