BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of [Redacted]Petitioners.	))))))	DOCKET NO. 18614 DECISION

On December 16, 2004, the Income Tax Audit Division of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] (collectively "taxpayer"). The Notice of Deficiency Determination reduced a refund claim for the 1/29/2000 taxable year from $8,000 to $5,365, disallowed a $4,388 refund claim for the 2/03/2001 taxable year, and asserted an Idaho income tax deficiency for the 2/03/2001 through 2/01/2003 taxable years in the total amount of $16,929. After adding interest and applying the refund allowed for the 1/29/2000 taxable year, the total amount asserted in the Notice of Deficiency Determination was $12,913.

On February 14, 2005, the taxpayer filed a timely appeal and petition for redetermination. An informal conference was requested by the taxpayer and was held on September 13, 2005. The Tax Commission, having reviewed the file, hereby issues its decision upholding the December 16, 2004, Notice of Deficiency Determination.

FACTS AND PROCEDURAL HISTORY

This is a "forced combination" case. The primary issue in this protest is whether [Redacted]. was part of a unitary business being conducted by [Redacted] during 2000 through 2003. [Redacted] is a leading [Redacted] wholesaler and retailer. According to the company's 2000 Annual Report:

> [Redacted] is uniquely positioned in the [Redacted] industry as we operate both retail and wholesale businesses. Seventy-three percent of our revenues come from our [Redacted] retail stores. Through our wholesale division we delivered 60 million [Redacted] in fiscal 2000 to all channels of distribution -- from better-grade department stores to the most successful mass merchants.

2000 Annual Report, p. 1. The 2000 Annual Report goes on to describe the affiliated group's overall business operations as follows:

> [Redacted]. (the "Company"), founded in 1878, is a [Redacted] retailer and wholesaler. . . .
>
> The Company provides a broad offering of branded, licensed and private label [Redacted]. [Redacted] is sold at a variety of price points through multiple distribution channels both domestically and internationally. The Company currently operates 1,406 retail [Redacted] stores in the United States and Canada primarily under the [Redacted] names. In addition, through its Wholesale divisions, the Company designs, sources and markets [Redacted] to retail stores domestically and internationally, including department stores, mass merchandisers and specialty [Redacted] stores. In fiscal 2000, approximately 73% of the Company's sales were at retail, compared to 70% in 1999 and 68% in 1998.

2000 Annual Report, p. 39.

[Redacted], which is a wholly owned subsidiary of [Redacted], is the retail arm of the [Redacted] group of companies. [Redacted] operates primarily through its two retail store brands; [Redacted]. While these retail [Redacted] chains sell [Redacted] and related products that are manufactured by unrelated third parties, a significant portion of their retail sales are of products acquired through the [Redacted] wholesale operating unit. *See* Letter of protest, p. 1 ("The purchases made by [Redacted] from [Redacted]. are arms lengths transactions and for the most recent year available represented only 27.7% of all of [Redacted].'s purchases.").

During the years at issue [Redacted] operated seven retail stores within Idaho. [Redacted] filed separate entity Idaho corporate income tax returns for the 1/29/2000 through

2/01/2003 taxable periods. In August, 2004, the Tax Commission began an audit of [Redacted] to determine whether the company should be filing its 2000 through 2003 Idaho returns on a combined reporting basis. The audit staff determined that there was sufficient indicia of a unitary business to require [Redacted] to file on a combined reporting basis. The tax liability of [Redacted] was then recalculated on a worldwide combined reporting basis, and the Notice of Deficiency Determination that is the subject matter of this protest was issued.

ISSUES PROTESTED

The taxpayer has raised two issues in this administrative protest. Those issues are:

1. Whether [Redacted] is engaged in a unitary business with [Redacted] and the other members of the [Redacted] unitary group.

2. If [Redacted] is a member of the [Redacted] unitary group, whether [Redacted] can compute its Idaho income tax liability on a "water's edge" combined reporting basis.

ANALYSIS

A. [Redacted] is a Member of the [Redacted] Unitary Group.

The primary issue raised in this administrative protest is whether [Redacted] should compute its Idaho income tax liability on a separate entity basis or on a combined reporting basis. Combined reporting is required only if [Redacted] is part of a unitary business. In the present protest, the Tax Commission's audit staff has determined that [Redacted] is a member of a unitary business that consists of [Redacted] and all of its more than 50% owned subsidiaries.

Idaho Code § 63-3027(t) provides that two or more corporations may be considered a single corporation for income tax purposes, provided more than 50% of the voting stock of each of them is owned directly or indirectly by a common owner or owners, and such treatment is necessary to accurately reflect income. The Idaho Supreme Court has interpreted this statute to require combined reporting by a unitary business. *See, e.g., Albertson's, Inc. v. State, Dept. of Revenue,*

106 Idaho 810, 683 P.2d 846 (1984). A "unitary business" is a concept of constitutional law under the Commerce and Due Process Clauses of the United States Constitution. A state may tax the multistate income of a nondomiciliary corporation if there is both a "minimal connection" between the interstate activities and the taxing state and a rational relationship between the income attributed to the taxing state and the in-state value of the corporate business. A state need not attempt to isolate the in-state income producing activities from the rest of the business. The state may tax an apportioned share of the multistate business if the business is unitary. But the state may not tax the business's income that is "derived from unrelated business activity" or derived from a "discrete business enterprise." *Allied-Signal, Inc. v. Director, Div. of Tax.*, 504 U.S. 768, 772-773, 112 S.Ct. 2251, 2255 (1992) (citations and internal quotation marks omitted). *See also, Albertson's, supra,* at 815 n.4, 683 P.2d at 851 n.4.

In 1965, Idaho adopted with slight modification the Uniform Division of Income for Tax Purposes Act (UDITPA). The Act contains a statutory mechanism for determining the portion of a multistate corporation's total income that is attributable to Idaho and subject to Idaho's income tax. *See* Idaho Code § 63-3027. Under this statutory mechanism, business income is apportioned among the various states where the business operates pursuant to a specified formula, while non-business income is allocated to a particular state based on specified allocation rules. Combined reporting is a refinement of the apportionment principle. Its purpose is to permit application of the UDITPA apportionment formula to a single business enterprise that is conducted by means of separately incorporated entities. In an economic sense, such a business is no different from a similar business composed of a single corporation with several separate divisions. For income tax reporting purposes, such businesses should be treated the same. Combined reporting can be required only in the case of a unitary business.

A number of states, including Idaho, have enacted rules or regulations that establish a presumption of unity upon a finding that the taxpayer is (1) engaged in the same type of business as the parent; (2) is part of a vertically integrated business enterprise; or (3) is a member of a group of corporations that has strong centralized management. More specifically, Idaho Income Tax Administrative Rule 340.02 provides as follows:

> **02. Single Trade Or Business.** The following factors indicate a single trade or business, and the presence of any of these factors creates a strong presumption that the activities of the corporation or affiliated group constitute a single trade or business:
>
> **a.** Same Type of Business. A corporation or affiliated group is generally engaged in a single trade or business if all its activities are in the same general line. For example, a taxpayer operating a chain of retail grocery stores is almost always engaged in a single trade or business.
>
> **b.** Steps in a Vertical Process. A corporation or affiliated group is almost always engaged in a single trade or business if its various divisions or affiliates are engaged in different steps in a large, vertically structured enterprise. For example, a taxpayer that explores for and mines copper ores and fabricates the refined copper into consumer products is engaged in a single trade or business, regardless of the fact that the various steps in the process are operated substantially independent of each other with only general supervision from the enterprise's executive offices.
>
> **c.** Strong Centralized Management. A corporation or affiliated group is considered one (1) trade or business if there is a strong central management, coupled with the existence of centralized departments for functions such as financing, advertising, research, or purchasing. For example, a corporation or affiliated group is considered one trade or business if the central executive officers are normally involved in the operations of the divisions or affiliates and centralized offices perform the normal matters for the divisions or affiliates that a truly independent business would perform for itself, such as accounting, personnel, insurance, legal, purchasing, advertising, or financing.

IDAPA 35.01.01.340.02. (2005). To be sure, a finding of unity can be made even where none of these three presumptions set out in Rule 340.02 are present. Likewise, the presumptions set out in the administrative rule are rebuttable, so a taxpayer can still prove lack of unity even if one of the presumptions is met. But, as a general matter, a finding of unity is likely where one of the administrative presumptions is met, and it will be the rare case where a taxpayer is able to overcome the presumption.

It is worth noting that in *Container Corp. of America v. Franchise Tax Bd.*, the U.S. Supreme Court indicated that it was not troubled by the use of an administrative rule that provided that affiliated companies in the same line of business are presumed to be unitary. According to the Court in *Container Corp.*:

> Appellant also argues that the state court erred in endorsing an administrative presumption that corporations engaged in the same line of business are unitary. This presumption affected the state court's reasoning, but only as one element among many. Moreover, considering the limited use to which it was put, we find the "presumption" . . . to be reasonable. . . . When a corporation invests in a subsidiary that engages in the same line of work as itself, it becomes much more likely that one function of the investment is to make better use – either through economies of scale or through operational integration or sharing of expertise – of the parent's existing business-related resources.

Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 178, 103 S.Ct. 2933, 2947 (1983). In effect, the Supreme Court has recognized that the use of an administrative presumption, if reasonable on its face and supported by other evidence of unity, is a useful tool in making the unitary determination.

As indicated above, the Tax Commission's audit staff has determined that [Redacted] and all of its more than 50% owned subsidiaries (including [Redacted]) were engaged in a single unitary business during the 2000 through 2003 taxable years. The audit report provides only a summary of

the facts relied upon by the audit staff. The substance of the audit staff's findings are set out in the Notice of Deficiency Determination as follows:

> Information obtained during the course of the audit substantiates the presence of a substantial interrelationship between and among [Redacted] and its directly and indirectly held subsidiaries both domestic and foreign. This relationship produced a substantial flow of value for the companies which make up the [Redacted] organization. In Container Corporation of America v. Franchise Tax Board, the United States Supreme Court stated, "The prerequisite to a constitutionally acceptable finding of unitary business is a flow of values,…" Included in our findings that a substantial flow of value is present are (1) the exercise of control by [Redacted] over its subsidiary companies, (2) centralization of management, (3) flow of goods, (4) intercompany financing, (5) technical assistance to subsidiaries, and (6) supervision and general guidance.
>
> . . . .
>
> In view of the elements present in the [Redacted] organization the auditors have determined that [Redacted] and its subsidiaries conduct a unitary business on a worldwide basis.

Notice of Deficiency Determination, Explanation of Items, p. 1 - 2.

[Redacted] contends that while it "may participate in the same primary business" as its parent, it is sufficiently independent from the operations of its parent to fall outside of the [Redacted] unitary group. Letter of protest, p. 1. As stated in the letter of protest:

> [Redacted]. is commercially domiciled in [Redacted], separate from the other members of the affiliated group. [Redacted]. has it own management team including a president and vice presidents, Buying, Customer Service, Finance, Human Resources, Information Systems, Marketing, Merchandising, Real Estate, Retail Operations and Store Planning departments.
>
> The purchases made by [Redacted]. from [Redacted]. are arms lengths transactions and for the most recent year available represented only 27.7% of all of [Redacted].'s purchases. . . .
>
> As stated earlier, [Redacted]. operates independently from [Redacted]., however there are some technical services that [Redacted]. provides to [Redacted]. These services include income

> tax, internal audit and some legal services. [Redacted]. is charged a fee for each service that it is provided. These charges are based on the actual cost of the department and the amount of time spent. This results in a cost that is reasonable to what it would cost them to obtain these services on their own.
>
> [Redacted] and subsidiaries obtains financing from an outside party as a single borrower. The expense of the borrowing is distributed to each member company based on each company's invested capital (total assets - current liabilities). This method results in [Redacted][*sic*] recognition of an expense that is reasonable to what it would cost to obtain outside financing separately. [Redacted]., with it's [*sic*] strong balance sheet, would be able to obtain financing on it's [*sic*] own.
>
> [Redacted]. is a wholesaler of [Redacted], headquarters of the affiliated group and is commercially domiciled in [Redacted]. [Redacted]. is just one of the numerous customers. The sales made to [Redacted]. were 39% of total sales for the most recent year available. [Redacted] is the parent company, so it has shareholder oversight over the subsidiaries, including [Redacted] however the management and control of the operations are conducted independently by each operating subsidiary.

Letter of protest, pp. 1 - 2.

Clearly [Redacted] operates with considerable autonomy and has a number of departments and staff functions that are operated separately from the other members of the [Redacted] unitary group. However, in the final analysis, we find that there is a sufficient interrelationship between [Redacted] and the other members of the [Redacted] group of companies to support a finding of unity.

Among the tests of unity is whether "the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state[; if it does], the operations are unitary." *Edison California Stores v. McColgan,* 30 Cal. 2d 472, 481, 183 P.2d 16, 21 (1947). *See also, Albertson's Inc. v. State, Dept. of Rev.*, 106 Idaho 810, 815, 683 P.2d 846, 851 (1984) (quoting with approval from *Edison California Stores*.). [Redacted] is a

wholly owned subsidiary of [Redacted]; it is in the same general line of business as the other members of the unitary group; it's business operations are part of a vertical process (the retailing arm of the [Redacted] group [Redacted] business); there are at least a moderate amount of intercompany transactions (39% of [Redacted] sales, and 27.7% of [Redacted]'s purchases, are intercompany); and [Redacted] benefits from some common staff functions such as common accounting, legal services, and financing. Taken together, we find that the retail operations conducted by [Redacted] contribute to, and benefit from, the wholesale operations conducted by [Redacted] and its other affiliates. More to the point, we do not believe that the taxpayer has met its burden of proving that it is a "discrete business enterprise," separate and apart from the other members of the [Redacted] unitary group. Accordingly, the Tax Commission finds that [Redacted] was engaged in a unitary business in 2000 through 2003, and it was therefore required to compute its Idaho income tax liability on a combined reporting basis.

B. [Redacted] did not make a Timely Water's Edge Election.

The taxpayer next argues that if it is required to file on a combined reporting basis, it should be allowed to elect "water's edge" treatment. Under the water's edge combined reporting method, only those unitary subsidiaries that file federal income tax returns (either separately or as part of a federal consolidated return) are included in the unitary group. *See* Idaho Code § 63-3027B(a). This is in contrast to the "worldwide" combined reporting method, which includes all unitary subsidiaries, whether domestic or foreign, in the combined group calculation. In order to get the benefit of the water's edge reporting method, a taxpayer must make a timely election. More specifically, Idaho Code § 63-3027C(a) provides in part that "[a] water's edge election shall be made in the original return for a year and shall be binding for all years thereafter," with exceptions not relevant here.

[Redacted] did not make the election "in the original return" filed for any of the taxable years at issue in this protest. However, [Redacted] correctly points out that since it filed its Idaho returns on a separate entity basis, it really had no opportunity to make the election on its original return. Thus, according to the taxpayer, it ought to be allowed the opportunity to make the election upon the Tax Commission's determination that it is part of a unitary group that should be filing on a combined reporting basis.

In the abstract, we agree. It does seem unfair that the water's edge election is not available to [Redacted] under the circumstances presented in this administrative protest. However, the statute as currently written is clear on its face and our duty is to administer the tax laws of this state as written. *See Idaho State Tax Com'n v. Stang*, 135 Idaho 800, 802, 25 P.3d 113, 115 (2001); *Potlatch Corp. v. Idaho State Tax Com'n*, 128 Idaho 387, 389, 913 P.2d 1157, 1159 (1996). The water's edge election is a privilege granted by a very detailed and specific statute, the terms of which must be strictly complied with. Any modification to the specific requirements of the election must be made by the Idaho Legislature, not by this Commission. *Herndon v. West*, 87 Idaho 335, 339, 393 P.2d 35, __ (1964).

The taxpayer's request to file a belated water's edge election for each of the years at issue in this protest is denied. As a matter of statutory law, it is simply not relevant that the original return filed by the taxpayer was based on its belief that it was not required to file a combined group return. By filing on a separate entity basis, the taxpayer took the risk that its filing method would be challenged on audit. While this may seem harsh, the remedy lies with the Idaho Legislature.

CONCLUSION

WHEREFORE, the Notice of Deficiency Determination dated December 16, 2004, is hereby APPROVED, AFFIRMED AND MADE FINAL.

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

Year	Refund Claimed	Refund Allowed	Tax	Penalty	Interest	Total
1/29/00	$ (8,000)	$ (5,365)	$ -0-	$ -0-	$ (1,256)	$ (6,621)
2/03/01	(4,388)	-0-	4,606	-0-	1,313	5,919
2/02/02			30	-0-	7	37
2/01/03			12,293	-0-	1,800	14,093
				TOTAL DUE		$ 13,428

Interest is calculated through November 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

_____
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]
[REDACTED]
[REDACTED]

Receipt No.