BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of [Redacted], Petitioner.	))))))	DOCKET NOS. 18719 and 19549 DECISION

PROTEST SUMMARY

The Income Tax Audit Division of the Idaho State Tax Commission issued a Notice of Deficiency Determination dated February 25, 2004, to [Redacted]. (Petitioner) for the taxable years 1997 through 2000. The Audit Division disallowed a refund claim for the taxable year 1998 and asserted a total deficiency of $367,949 for the taxable years in question.

The Petitioner submitted a timely protest of the proposed deficiency and requested an informal conference before the Tax Commission. The Tax Commission assigned the matter as Docket No. 18719 and conducted an informal conference on September 20, 2005. Representatives of the Petitioner appeared in person.

The Petitioner submitted additional information in support of its protest after the conference, including adjustments to its federal returns. The Audit Division examined the federal adjustments and issued a modified Notice of Deficiency Determination to reflect the federal changes. The federal adjustments reduced the proposed deficiency to $356,490 for the taxable years 1997 through 2000.

While Docket No. 18719 was pending before the Tax Commission, the Audit Division issued a Notice of Deficiency Determination for the subsequent audit cycle which included the taxable years 2001 through 2003. In a Notice of Deficiency Determination dated April 14, 2006, the Audit Division determined a deficiency of $1,005,228. After issuing the notice, the Audit Division discovered a data entry error and issued a revised Notice of Deficiency Determination on May 2, 2006. The revised Notice of Deficiency Determination asserted a deficiency of $1,602,444 for the taxable years 2001 through 2003.

The Petitioner timely filed a written protest of the revised Notice of Deficiency Determination and requested an informal conference. The Tax Commission assigned this matter as Docket No. 19549. At the Petitioner's request, the Tax Commission combined the two dockets and conducted an informal conference on October 30, 2006. The Petitioner's representative participated by means of telephone and members of the audit staff appeared in person.

SUMMARY OF FACTS

The Notice of Deficiency Determination regarding the taxable years 1997 through 2000 originated from a follow-up audit of a federal adjustment concerning the taxable year 1997. The audit focused on the determination of apportionable business income, the apportionment factors, the allocation of non-business income, and the amount of investment tax credit claimed. The primary issue protested by the Petitioner is how to account for the activities of the financial arm of [Redacted] in the sales and property factors of the apportionment formula.

[Redacted] was established in [Redacted] as a wholly-owned subsidiary of the Petitioner. [Redacted] was established for the purpose of [Redacted]. [Redacted] is a [Redacted] corporation and has no physical sharing of office space, equipment, or property with the Petitioner. [Redacted] does not manage the Petitioner's [Redacted] business because the Petitioner had its own [Redacted] company during this audit cycle. [Redacted] and the Petitioner's [Redacted] company are separate businesses and do not perform interrelated operations. Rather, [Redacted] was created "to take over the same financial function performed for [the Petitioner] by banks."

The Audit Division eliminated the transactions between the Petitioner and [Redacted] from the sales and property factors of the apportionment formula because the transactions were intercompany transactions. In its protest, the Petitioner maintains that [Redacted] should be treated as a "financial institution." Under the Petitioner's theory, the interest [Redacted] receives from loans to the Petitioner and its affiliates would be included in the sales denominator of the apportionment formula and the intangible assets of [Redacted] would be included in the property denominator of the apportionment formula. The proposed adjustments would dilute the existing apportionment formula meaning that less of the Petitioner's business income would be apportioned to Idaho.

The Petitioner recognizes that the Tax Commission addressed the same issue in a previous decision. In its decision in Docket No. 13185, the Tax Commission rejected the alternative apportionment that the Petitioner again proposes in this matter. However, the Petitioner states that the Idaho Supreme Court's decision in Union Pacific v. Idaho State Tax Commission., 139 Idaho 572, 83 P.3d 116, 120 (2004), sets forth a new standard for alternative apportionment and requires the Tax Commission to re-examine the issue.

During the years in question, the Petitioner also held a majority interest in [Redacted]. In 1997 the Petitioner sold 80 percent of its stock for $104,689,581. The Petitioner originally reported the sales as an Internal Revenue Code (IRC) section 1248 dividend. As a 1248 dividend, the income was eliminated from apportionable income as an intercompany transaction. The Audit Division agreed with the elimination as the dividend represented previously taxed earnings and profits.

During the audit, the Petitioner determined the sale of stock should not have been treated as a dividend for state tax purposes. Instead, the Petitioner recalculated the basis of stock and amended its state return to claim a loss on the sale of $170,577,358. The Petitioner asked that its apportionable income be reduced by the amount of the loss. The Audit Division denied the requested deduction.

The Audit Division also disallowed a portion of the Investment Tax Credit (ITC) claimed by the Petitioner due to a lack of documentation. The Petitioner could not document specific items with a receipt or invoice demonstrating the purpose and use of the property.

During the subsequent audit cycle, the taxable years 2001 through 2003, the parties addressed the same issues addressed in Docket No. 18719 (the impact of [Redacted] on the apportionment factors, the treatment of the 1248 dividend that was recognized when the Petitioner sold its remaining interest in [Redacted], and documentation of the claimed ITC). Additionally, the parties discussed how to treat the sale of the Petitioner's [Redacted] company and the sale of [Redacted].

The Petitioner sold its [Redacted] business in November 2003. The Petitioner sold its business to another large [Redacted] company for [Redacted], generating an overall gain of approximately [Redacted]. The Petitioner stated it used the proceeds to repurchase company stock, repay outstanding short-term borrowing, and otherwise retire outstanding debt. The Petitioner had managed the credit card receivables which consisted primarily of the Petitioner's proprietary (namesake) [Redacted] account balances. The proprietary [Redacted] were generated from purchases of the Petitioner's goods and services from the Petitioner's stores, catalogues, and websites. The [Redacted] balances were generated from the same sources, plus goods and receivables purchased from sellers other than the Petitioner. The [Redacted] segment also sold and delivered [Redacted].

The sale of the [Redacted] business was structured in part as a stock sale and in part as an asset sale. The asset sale included certain “Customer Use” intangibles, use of trademarks, and licenses. The Petitioner reported the [Redacted] gain for state tax purposes as follows: (1) [Redacted]business income resulting from the sale of the [Redacted] which would be apportioned among the various states in which Petitioner conducted its unitary business; (2) [Redacted] as non-business income resulting from the sale of the co-branded [Redacted] balances because customers purchased products from sellers other than the Petitioner with their [Redacted]; and (3) [Redacted] as non-business income resulting from the sale of intangible assets.

The Audit Division asked for, but did not receive, documentation showing how the Petitioner determined the values for these three categories. Absent such documentation, the Audit Division treated the entire gain as business income. Additionally, the Audit Division removed the [Redacted] intangibles from both the property and sales denominator reported by the Petitioner.

The other item of non-business income addressed in the subsequent audit concerned the sale of [Redacted]. On November 2, 1998, [Redacted] acquired a minority interest in [Redacted]. The Petitioner did not include [Redacted] in its unitary returns filed for the taxable year 1998 and thereafter. During the 2002 taxable year, the Petitioner sold all of its interest in [Redacted]. The Audit Division treated the sale of stock as business income. The Petitioner maintains that because [Redacted] was not part of the unitary group, the Audit Division could not treat the gain as business income.

In addition the Audit Division included certain affiliated insurance companies in the combined group and adjusted the payroll factor reported by the Petitioner. The additional issues are discussed in more detail below.

ISSUES

The Petitioner asserts the following issues in its protest of the deficiencies determined by the Audit Division:

1. The receipts of [Redacted] should be included in the denominator of the sales factor for apportionment purposes and the intangibles (such as commercial paper) of [Redacted] should be included in the property factor for apportionment purposes under the alternative apportionment standard articulated in Union Pacific v. Idaho State Tax Commission., 139 Idaho 572, 83 P.3d 116, 120 (2004);

2. The Petitioner's reporting of the sale of its credit card and financial products business should be upheld;

3. The Petitioner's reporting of the sale of [Redacted] should be upheld;

4. The loss on the [Redacted] stock should be treated as a net loss reducing apportionable income rather than as a 1248 dividend under IRC section 1248;

5. The Petitioner's affiliated insurance companies should not be included in the combined group;

6. A portion of the disallowed ITC should be allowed because the nature of the property at issue can be determined by reviewing the seller's websites;

7. The Tax Commission should accept the payroll it reported on its state tax return rather than the payroll it reported to the Idaho Department of Labor; and

8. The Tax Commission should abate all penalties.

DISCUSSION

1. THE PETITIONER HAS NOT SHOWN ANY REASON TO DEPART FROM THE COMMISSION'S PREVIOUS DECISION AND HAS NOT MET ITS BURDEN OF PROOF REGARDING ALTERNATIVE APPORTIONMENT FOR THE CREDIT ACCEPTANCE COMPANY.

As stated above, the Tax Commission previously addressed this issue in Docket No. 13185. For the sake of convenience, the Commission repeats that analysis here and then explains why the analysis still is relevant under the Idaho Supreme Court's holding in Union Pacific v. Idaho State Tax Commission., 139 Idaho 572, 83 P.3d 116, 120 (2004).

The Petitioner is a publicly traded, national retailer with stores in Idaho. Petitioner owns 100 percent of the stock of [Redacted]. [Redacted] has 10 employees who work in an office in [Redacted], which office is not shared with any office of the Petitioner.

To meet the capital requirements of the Petitioner's business, the Petitioner borrows on a short-term basis from [Redacted], giving notes to [Redacted]. At the end of [Redacted], 97 percent of [Redacted]'s assets consisted of notes of the Petitioner. The size of [Redacted]'s holdings of the Petitioner's notes is set by the Petitioner's funding requirements. The Petitioner also sells commercial customer receivables[1] to [Redacted] at par. At the end of [Redacted], less than one percent of [Redacted]'s assets consisted of receivables purchased from the Petitioner. [Redacted]'s remaining assets consisted of cash and equivalents (liquid investments with maturities of three months or less) and other assets.

[Redacted] issues import letters of credit to assist the Petitioner in buying imported merchandise. Petitioner normally reimburses [Redacted] on the same day [Redacted] pays drafts to the foreign vendors. If the Petitioner takes longer than a day to reimburse [Redacted], the

[1] The receivables mentioned here do not include revolving charge balances of Petitioner's retail customers.

Petitioner's obligation to reimburse [Redacted] is to be converted into a demand loan. [Redacted] also issues standby letters of credit to a retailing subsidiary of the Petitioner.[2]

[Redacted] goes to the public capital markets to obtain funds to lend to the Petitioner. [Redacted] issues [Redacted] paper, [Redacted] notes, and [Redacted] debt. [Redacted].[3] [Redacted]'s annual report is aimed at an audience of [Redacted]'s creditors, who are referred to in that report as customers.

In [Redacted], 97.5 percent of [Redacted]'s revenues consisted of interest paid by the Petitioner. The remainder of revenues came from interest on receivables bought from the Petitioner and earnings on invested cash. [Redacted]'s expenses are primarily interest on [Redacted]'s debts. In [Redacted], [Redacted]'s operating expenses other than interest were less than one percent of its total expenses.

Petitioner and [Redacted] set the interest rate on the Petitioner's borrowings so that [Redacted] "maintains an earnings to fixed charges ratio of at least 1.25." The Petitioner and [Redacted] also agreed that the Petitioner would make payments to [Redacted] in amounts sufficient to maintain [Redacted]'s fixed charge ratio at no less than 1.10. Certain syndicated creditors of [Redacted] have the right to veto any changes to the credit agreements between the Petitioner and [Redacted]. In [Redacted], for the benefit of [Redacted]'s creditors, the Petitioner also agreed to continue to own all of [Redacted]'s stock. In 1996, the Petitioner made large capital infusion into [Redacted]. [Redacted] became a co-guarantor of certain debt of one of the Petitioner's newly acquired retailing subsidiaries.

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[2] [Redacted] borrowed from a foreign finance company named after Petitioner. Petitioner took over payments on [Redacted] liability to this finance company.

[3] The protest states that if Petitioner borrowed directly and not through [Redacted], then all of the commercial paper would have to be registered with the Securities and Exchange Commission. Under the [Redacted] structure, most of [Redacted] debt instruments are exempt from registration.

The primary business advantage of using [Redacted] to borrow on behalf of the Petitioner, as opposed to direct borrowing by the Petitioner, is that banks would charge the Petitioner an interest rate that is approximately 1.25 times the interest rate that [Redacted] pays to its creditors. In other words, [Redacted] captures profit that would otherwise go to bank lenders. [Redacted] also indirectly reduces the Petitioner's borrowing costs, since the Petitioner owns 100 percent of [Redacted]'s shareholder's equity and retained earnings.

Another business advantage of the [Redacted] structure is that [Redacted]'s creditors do not compete with the Petitioner's trade creditors for priority of payment. The liquidity of [Redacted]'s assets enables [Redacted] to maintain a higher ratio of debt to equity than creditors would allow to the Petitioner.

Also, by maintaining the ratio of 1.25 as just described, [Redacted]'s debt instruments become eligible investments for banks, insurance companies, government organizations, and pension funds, under state laws governing such entities.

[Redacted] is highly profitable but has very small amounts of tangible assets and payroll that the Tax Commission's auditors included in the combined property and payroll factors. Almost all of [Redacted]'s revenues come from the Petitioner. The Tax Commission's auditors have eliminated these as intercompany sales in computing the combined sales factor.

The contention is that the standard apportionment formula applied in this manner improperly causes [Redacted]'s income to be apportioned to Idaho using the Petitioner's retailer factors. The protest argues that combination is only appropriate if the apportionment factors are computed by including (1) [Redacted]'s intangible property in the combined denominator of the property factor, and (2) interest income from the Petitioner to [Redacted] in the combined denominator of the sales factor. To reach this result, the Petitioner asks the Tax Commission to depart from the standard apportionment rule.

A. The Unitary Business and Combined Reporting.

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 percent 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. E.g., Albertson's, Inc. v. State, Dept. of Rev., 106 Idaho 810 (1984).

Unitary business is a concept of constitutional law under the Commerce and Due Process Clauses. 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 a "discrete business enterprise." Allied-Signal, Inc. v. Director, Div. of Tax., 504 U.S. 768, 772-773 (1992)(citations and internal quotation marks omitted); Albertson's, supra, 106 Idaho at 815 n.4.

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 tax reporting, such businesses should be treated the same. Combined reporting can be required only in the case of a unitary business. When the Tax Commission has found that a subsidiary is part of the Petitioner's unitary business, the Petitioner has the burden of proving that the finding is incorrect. Albertson's, supra, 106 Idaho at 814-815. Here, the auditors have so found, and the Petitioner has the burden of disproving the finding.

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 business is unitary. Edison Cal. Stores v. McColgan, 30 Cal. 2d 472, 481, 183 P.2d 16, 21 (1947), quoted at 106 Idaho at 815. Here, the Petitioner's mercantile operation that is present in Idaho depends upon [Redacted] for financing, and the mercantile operation contributes virtually all of [Redacted]'s income.

Another test asks "whether contributions to income result from functional integration, centralization of management, and economies of scale." F. W. Woolworth Co. v. Taxation & Rev. Dept., 458 U.S. 354, 364 (1982), quoted at 106 Idaho at 816. Here, [Redacted]'s main customer is the Petitioner, showing functional integration. [Redacted]'s letters of credit and guarantees provide economies of scale in financing the retail business. The interlocking directorates plus the credit agreements between the Petitioner and [Redacted] are evidence of central management.

The Tax Commission concludes that [Redacted] and the Petitioner are parts of a single unitary business under the Constitution. The Petitioner repays the principal with interest to [Redacted], which repays the principal and interest to the public. This two-way vertical flow supports the finding of unity. Cf. Container, supra, 463 U.S. at 178 ("The prerequisite to a constitutionally acceptable finding of unitary business is a flow of value, not a flow of goods.") and 180 ("Two of the factors relied on by the state court deserve particular mention. The first of these is the flow of capital resources from appellant to its subsidiaries through loans and loan guarantees. There is no indication that any of these capital transactions were conducted at arm's-length, and the resulting flow of value is obvious" (emphasis added)). There can be a flow of value in this sense even with arm's-length pricing of the loans. Cf. Exxon Corp. v. Wisconsin Dept. of Rev., 447 U.S. 207, 226 (1980)("[A]ppellant's internal accounting system is not binding on the State for tax purposes. The decision to assign wholesale market values to internal transfers of raw materials . . . does not change the unitary nature of appellant's business.")

In 1965, Idaho adopted with slight modification the Uniform Division of Income for Tax Purposes Act (UDITPA), Idaho Code § 63-3027. The Act contains a formula for determining the portion of a corporation's total income from a multistate business which is attributable to Idaho and therefore subject to Idaho's income tax.

When a single corporation, or a "unitary" group of corporations, does business across state lines, each state may impose income tax only on that portion of the income earned within its borders. To that end, the income of the unitary business is divided among the states in which the business operates. As described by the Idaho Supreme Court:

> The Act contains rules for determining the portion of a corporation's total income from a multistate business which is attributable to this state and therefore subject to Idaho's income tax. In general, UDITPA divides a multistate corporation's income into two groups: business income and non-business income. Business income is apportioned according to a three factor formula, while nonbusiness income is allocated to a specific jurisdiction.

American Smelting & Ref'g Co. v. Idaho St. Tax Comm., 99 Idaho 924, 927, 592 P.2d 39, 42 (1979) (citations to statute omitted), *rev'd on other grounds*, ASARCO Inc. v. Idaho State Tax Commission, 458 U.S. 307 (1982). Nonbusiness income is allocated and attributed to a particular state under specific "allocation" rules. *See* Idaho Code § 63-3027(d – (h) (rules relating to the allocation of nonbusiness income).

Business income is apportioned among the states in which the unitary business operates. Each state uses one or more ratios to divide or "apportion" the business income to determine the amount of income subject to each state's income tax. The most commonly used formula is found in UDITPA, which Idaho and many other states have adopted either in whole or with modifications. Idaho's apportionment formula is set out in Idaho Code § 63-3027 (i), which states that "[a]ll business income shall be apportioned to this state . . . by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus two (2) times the sales factor, and the denominator of which is four (4). . . ." Id. The property factor is computed by dividing the Petitioner's property located in Idaho by its property located everywhere. Idaho Code § 63-3027(k). Likewise, the payroll factor is calculated by dividing the Petitioner's Idaho payroll by its payroll everywhere. Idaho Code § 63-3027(n). And finally, the sales factor is derived by dividing the company's Idaho sales by its sales everywhere. Idaho Code § 63-3027(p). Set out as a mathematical formula, the Idaho apportionment formula is represented by the following equation:

$$\frac{\left(\dfrac{\text{Idaho property}}{\text{Total property}} + \dfrac{\text{Idaho payroll}}{\text{Total payroll}} + \left(2 \times \dfrac{\text{Idaho sales}}{\text{Total sales}}\right)\right)}{4}$$

The result of the above equation is then multiplied by the corporation's total business income to arrive at the portion of the business income apportioned to Idaho.

The three-factor apportionment formula, by means the location of a business's property, payroll, and sales, approximates the extent of the business activity in a given state. Container Corp., supra.. Most states that impose a tax on corporate income use some variation of the three-factor apportionment formula. Many states, including Idaho, have modified the traditional three-factor formula so that the sales factor is double weighted.

B. Intercompany Loans and Interest Should Be Eliminated from the Denominators of the Apportionment Factors

In common with other states employing unitary combined reporting, Idaho practice is to eliminate transactions within the combined group when computing both income and apportionment factors. As to income, *see, e.g.*, American Smelting & Ref'g Co. v. Idaho St. Tax Comm., 99 Idaho 924 at 928(1979)(dividends within unitary group not income to Petitioner), *rev'd on other grounds sub nom.* ASARCO, Inc. v. Idaho St. Tax Comm., 458 U.S. 307 (1982). As to factors, IDAPA 35.01.01.450 provides in part as follows:

> 02. Intercompany transactions. All intercompany transactions must be eliminated in the computation of the numerators and the denominators of the apportionment factors of the combined group. The apportionment factor computation may not include property, payroll, or receipts of any affiliated corporation except those whose income is included in the combined report.

IDAPA 35.01.01.600 provides in part:

> 04. Intercompany transactions. If a return is filed on a combined basis, the intercompany transactions shall be eliminated to the extent necessary to reflect combined income and to properly compute the apportionment factor.

Treating Petitioner and [Redacted] as part of a single, unitary business, it is only the combined net income that is to be apportioned. And in computing the denominators of the apportionment factors, only the combined net sales, property, and payroll should be included, eliminating intercompany sales, property, and payroll.

Specifically as to inclusion of [Redacted]'s loans receivable as intangible assets in the combined property denominator, this is forbidden by the standard apportionment formula. Idaho Code § 63-3027(k) provides (emphasis added):

> The property factor is a fraction, ... the denominator of which is the average value of all the Petitioner's <u>real and tangible personal</u> property owned or rented and used during the tax period.

Since loans are intangible, the standard apportionment formula makes no provision to include them in the property factor.

C. <u>The Petitioner has not Met its Burden for Alternative Apportionment.</u>

The United States Supreme Court stated that "the Constitution imposes no single [apportionment] formula on States … and … the Court [has] declined to undertake the essentially legislative task of establishing a single constitutionally mandated method of taxation." <u>Goldberg v. Sweet</u>, 488 U.S. 252, 261 (1989). A "margin of error [is] inherent in any method of attributing income among the components of a unitary business." <u>Container Corp.,</u> 463 U.S. at 184. Such a formula need not "identify the precise geographic source of a corporation's profits." <u>Moorman Mfg. Co. v. Bair</u>, 437 U.S. 267, 273 (1978). Rather, a state is required to strive for a "'rough approximation' of the corporate income that is 'reasonably related to the activities conducted within the taxing state.'" <u>Exxon Corp. v. Wisconsin Dept. of Revenue</u>, 447 U.S. 207, 223 (1980), *quoting* <u>Moorman Mfg. Co.</u>, 437 U.S. at 273. Under the standards articulated by the Supreme Court, once the unitary relationship has been established, states are given wide latitude in developing a formula that can be used to apportion the business income of the combined group.

Although states are given wide latitude in fashioning their respective apportionment formula under the United States Constitution, Idaho's apportionment statute recognizes that there are instances in which the standard apportionment formula does not accurately reflect the extent of the unitary group's business activity in the state of Idaho. Idaho Code § 63-3027(s) provides that:

> **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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> require, in respect to all or any part of the Petitioner's business activity, if reasonable:
> (1) Separate accounting, provided that only that portion of general expenses clearly identifiable with Idaho business operations shall be allowed as a deduction;
> (2) The exclusion of any one (1) or more of the factors;
> (3) The inclusion of one (1) or more additional factors which will fairly represent the Petitioner's business activity in this state; or
> (4) The employment of any other method to effectuate an equitable allocation and apportionment of the Petitioner's income.

These provisions are often referred to as "alternative apportionment." When standard apportionment fails to accurately reflect the business activity that occurs in Idaho, an alternative apportionment formula may be determined.

If reasonable, the Petitioner may petition for "[t]he employment of any other method to effectuate an equitable allocation and apportionment of the Petitioner's income." [Redacted]'s loans to Petitioner may be included in the combined property factor, if at all, only under this section.

In its previous decision, the Tax Commission found that the Petitioner could not include the [Redacted] attributes in the sales and property factor under alternative apportionment after the Petitioner failed to meet its burden. In regard to the burden of proof required, the Tax Commission found:

> The Idaho Supreme Court has held that the party invoking alternative apportionment has the burden of proof as to the standard formula's unfairness. <u>Burlington Northern, Inc. v. Idaho St. Tax Comm.,</u> 126

> Idaho 645 (1995). Under the U.S. Constitution, the Petitioner has the burden to demonstrate that "there is no rational relationship between the income attributed to the state and the intrastate values of the enterprise," and that "the income apportioned to [the taxing state] is out of all appropriate proportion to the business transacted in the state." Container, supra, 463 U.S. at 180-181 (citations and internal quotation marks omitted).

Tax Commission Decision in Docket No. 13185 at p.10. The Tax Commission also found that what the Petitioner must prove is that standard apportionment "does not fairly represent the extent of the taxpayer's business activity in this state." Id.

The Petitioner implies that the Idaho Supreme Court has established a new standard for alternative apportionment in the recent case of Union Pacific v. Idaho State Tax Commission and the Tax Commission must re-examine the issue in light of the new standard. The Idaho Supreme Court indeed recently examined the alternative apportionment provisions and stated that "There is a very strong presumption in favor of the normal three-factor apportionment and against the applicability of the relief provisions." Union Pacific v. Idaho State Tax Commission., 139 Idaho 572, 576, 83 P.3d 116, 120 (2004), *citing* Roger Dean Enterprises, Inc. v. State, 387 So.2d 358, 363 (Fla., 1980). The party asserting alternative apportionment bears the burden of showing that the alternative apportionment is appropriate. Union Pacific, 139 Idaho at 576, 83 P.3d at 120 *citing* Burlington Northern, Inc. v. Idaho State Tax Comm'n, 121 Idaho 808, 828 P.2d 837 (1992).

The Idaho Supreme Court adopted the ruling of the New Hampshire court regarding the standard of proof required for alternative apportionment.

As stated by the New Hampshire Supreme Court:

> The alternative formula is the exception, and the party who wants to use an alternative formula accordingly has the burden of

> showing that the alternative is appropriate. Merely because the use of an alternative form of computation produces a higher business activity attributable to New Hampshire, is not in and of itself a sufficient reason for deviating from the legislatively mandated formula.

Union Pacific, 139 Idaho at 576, 83 P.3d at 120, *citing* St. Johnsbury Trucking Co., Inc. v. State, 118 N.H. 209, 385 A.2d 215, 217 (1978). The Court further articulated that departure from the standard apportionment formula should be avoided except where reasonableness requires a departure. Union Pacific, 139 Idaho at 577, 83 P.3d at 121, *citing* Pierce, The Uniform Division of Income for State Tax Purposes, 35 TAXES 747, 781 (1957). The Court then identified what grounds of "reasonableness" would support a deviation from the standard apportionment formula.

> "Reasonableness" has been defined as being made up of three elements: (1) the division of income fairly represents business activity and if applied uniformly would result in taxation of no more or no less than 100 percent of the Petitioner's income; (2) the division of income does not create or foster lack of uniformity among UDITPA jurisdictions; and (3) the division of income reflects the economic reality of the business activity engaged in by the Petitioner in the taxing state.

Union Pacific, 139 Idaho at 577, 83 P.3d at 121, *citing* Twentieth Century-Fox Film Corp. v. Dep't of Revenue, 299 Or. 220, 700 P.2d 1035 (1985). In sum, the party requesting alternative apportionment must demonstrate that standard apportionment results in a sufficient distortion of the Petitioner's business activity in the state; simply advocating a better method than the standard formula is not enough. Union Pacific, 139 Idaho at 122, 83 P.3d at 578, *citing* Appeal of New York Football Giants, (Opinion on Pet. Rhg., Calif. St. Bd. of Equalization, June 28, 1979).

In the Union Pacific case, the Tax Commission was the party seeking alternative apportionment, and therefore the Tax Commission had the burden to prove its proposed apportionment was reasonable. The Tax Commission showed that the standard method of apportioning the income did not accurately reflect the extent of Union Pacific's business activity in Idaho and that the alternative apportionment proposed by the Tax Commission was reasonable.

The Petitioner's argument in this case is the same as it was in Docket No. 13185. The Petitioner again argues that Petitioner's mercantile apportionment factors should not be almost the entire basis for apportioning the large profits of [Redacted]. The Petitioner argues that [Redacted] earns its income from loans and not tangible property, so those loans should be reflected in the property factor. The Petitioner points to the Tax Commission's administrative rules that allow banks to include loans in their property factor.

The distinction between the bank cases and the present case is that [Redacted]'s loans are receivable not from third parties outside the unitary group but are receivable from the Petitioner itself. Viewing the unitary group as a single business, as the Tax Commission is required to do, [Redacted]'s profits are no more than a reduction of the group's interest expense payable to the public.

Setting up [Redacted]'s loans to the Petitioner as property in the factor would effectively convert the group's liability to the public into an asset of the group. In contrast, the bank cases involve loans by the unitary bank group <u>to</u> the public—an asset of the bank group. Assets go in the property factor; liabilities do not. The Tax Commission would not allow a bank's deposits (liabilities) in its property factor. The bank cases are not on point.

As in the previous docket, the Petitioner still has not demonstrated why it would be "reasonable" to depart from the standard apportionment formula, as the term "reasonable" has been defined by the Idaho Supreme Court. Without more explanation, the Tax Commission must conclude that alternative apportionment is not appropriate in this case.

2. THE GAIN REALIZED FROM THE SALE OF THE PETITIONER'S CREDIT CARD AND FINANCIAL PRODUCTS BUSINESS RESULTED IN BUSINESS INCOME AND UNDER STANDARD APPORTIONMENT THE INTANGIBLES OF THE CREDIT CARD BUSINESS MUST BE ELIMINATED.

A. The Gain as Business Income.

In a series of cases culminating in Allied-Signal, 504 U.S. 768 (1992), the United States Supreme Court provided an analytical framework for determining the constitutional restraints on state apportionment of income.[4] The Court held that it is not always necessary to find a unitary relationship exists before apportioning income for state taxation. The investment in a non-unitary business also can result in business income if the investment serves an operational purpose.

The Allied-Signal Court described two occurrences where apportionment of income from intangibles (such as the gain on the sale of Company D stock) will be consistent with the Due Process and Commerce Clause provisions of the United States Constitution. First, apportionment will be permitted if there is unity between the payor and the payee. That is, apportionment is permitted if the payor and the payee are engaged in the same unitary business.

The second occurrence upon which apportionment of income from intangibles will be permitted is if the capital transaction from which the income is derived "serves an operational function" as opposed to an "investment function." Id. at 788. "The essential question under the operational-function test is whether the intangible asset is part of the corporate taxpayer's own unitary business, not whether two separate corporations are engaged in a common enterprise." Walter Hellerstein, State Taxation of Corporate Income From Intangibles: Allied-Signal And Beyond, 48 Tax L. Rev. 739, 791 n.315 (1993).

[4] The alluded to cases are Mobil Oil Corp. v. Comm'r of Taxes, 445 U.S. 425, 100 S.Ct. 1223 (1980); ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 102 S.Ct. 3103 (1982); F.W. Woolworth Co. v. Taxation and Revenue Dept., 458 U.S. 354, 102 S.Ct. 3128 (1982); Container Corporation of America v. Franchise Tax Bd., 463 U.S. 159, 103 S.Ct. 2933 (1983); and Allied-Signal, Inc. v. Director, Div. of Taxation, 504 U.S. 768, 112 S.Ct. 2251 (1992).

The United States Supreme Court in Allied-Signal clearly indicated that a taxpayer can derive apportionable unitary income from an operational transaction even though there is no unity between the payor corporation and the payee corporation. It is this operational function test which was at issue in Allied-Signal that also is at issue in this protest with respect to the gain from the sale of the credit card and financial products business.

The Allied-Signal Court left this operational-function test largely undefined; however, it provided one practical example of operational unity. According to the Court, "a State may include within the apportionable income of a nondomiciliary corporation the interest earned on short-term deposits in a bank located in another state if that income forms part of the working capital of the corporation's unitary business, notwithstanding the absence of a unitary relationship between the corporation and the bank." Allied Signal, 504 U.S. at 787-788. Thus, income earned on the investment of idle working capital can constitutionally be apportioned among the various states in which the corporation conducts its unitary business operations.

The Court also gave another indication of the breadth of this operational-function test when it cited footnote 19 of Container Corporation. In footnote 19 of Container Corp., Justice Brennen, writing for the majority, stated that "[a]s we made clear in another context in *Corn Products Co. v. Commissioner*, 350 U.S. 46, 50-53, 76 S.Ct. 20, 23-24, 100 L.Ed. 29 (1955), capital transactions can serve either an investment function or an operational function." Container Corp. 463 U.S. at 180 n.19.

It is this distinction between investment and operational functions that is at the heart of the operational-function test set forth in Allied-Signal. In general terms, if a capital transaction serves an operational function, the income derived from the transaction will be treated as part of the corporation's unitary business and is subject to apportionment. Conversely, if the transaction serves an investment function, the income derived from the taxation cannot be taxed by a nondomicilary state unless (1) the investment transaction took place, at least in part, in that state, or (2) payor-payee unity exists.

Another important point that can be gleaned from the language in footnote 19 of Container Corp. is that transactions other than the short-term investment of idle working capital may meet the operational-function test. The fact that the Court cites with approval the Corn Products Co. v. Commissioner decision is key. As explained by Professor Hellerstein:

> In *Corn Products*, the Supreme Court held that a company engaged in converting corn into syrup and other products realized ordinary income and loss on the sale of corn futures even though such futures were not literally excluded from the "capital asset" definition under I.R.C. § 1221. Because the taxpayer's transactions in corn futures were designed to protect its manufacturing operations against increases in the cost of its principal raw material and to assure a ready source of supply of corn if needed, the Court held that the resulting profits and losses should be characterized consistently with Congress' perceived intent "that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss." *Corn Products*, 350 U.S. at 52.
>
> The case spawned the doctrine under which gain or loss from the sale of intangible assets, frequently stock in other corporations, was held to be ordinary gain or loss because the asset was "**bought and kept not for investment purposes, but only as an incident to the conduct of the taxpayer's business**." *John J. Grier Co. v. United States*, 328 F.2d 163, 165 (7th Cir. 1964). . . .
>
> Income from intangible assets falling under the Corn Products doctrine thus would be apportionable under the operational-function test. . . .

Hellerstein, State Taxation Of Corporate Income From Intangibles: Allied-Signal and Beyond, 48 Tax L. Rev. 739, 793-94 n.319 (1993) (emphasis added).

The operational versus passive investment distinction also is the fundamental factor in determining whether specific income is business or nonbusiness income under Idaho law. Under

Idaho tax law, business income is defined as all "income arising from transactions and activities in the regular course of the taxpayer's trade or business and includes income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitutes integral or necessary parts of the taxpayer's trade or business operations." Idaho Code § 63-3027(a)(1). Nonbusiness income is all income other than business income. Idaho Code § 63-3027(a)(4).

Idaho Code § 63-3027 sets forth two separate and independent definitions of the term "business income." Union Pacific v. Idaho State Tax Com'n., 136 Idaho 34, 28 P.3d 375 (2001). According to the Idaho Supreme Court, the first definition for business income is "income arising from transactions and activity in the regular course of the taxpayer's trade or business." Id. at 38 – 39, 28 P.3d at 379 – 380. This definition is referred to as the "transactional test."

The second definition of business income includes "income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitutes integral or necessary parts of the taxpayer's trade or business operations." Union Pacific, 136 Idaho at 38 – 39, 28 P.3d at 379 – 380. This definition is referred to as the "functional test."

The transactional test is concerned with income arising from the ordinary course of the taxpayer's trade or business operations. In contrast, the functional test is concerned with income derived from property that is utilized in or otherwise directly connected with the taxpayer's trade or business operations. Union Pacific, 136 Idaho at 38 – 39, 28 P.3d at 379 – 380.

There is no requirement under the functional test that the income arise from transactions and activities in the regular course of the taxpayer's trade or business. Union Pacific, 136 Idaho at 39, 28 P.3d at 380. The key determination is whether the property acquired, managed, or disposed of was directly connected with the taxpayer's business operations. American Smelting, 99 Idaho at 931, 592 P.2d at 46 ("business income includes . . . income from tangible and intangible property if that property has the requisite connection with the corporation's trade or business."). Property that is not directly connected to the taxpayer's trade or business operations, such as passive investment property, does not generate business income. As pointed out in the American Smelting case:

> In our view, in order for such income to be properly classified as business income there must be a more direct relationship between the underlying asset and the taxpayer's trade or business. The incidental benefits from investments in general, such as enhanced credit standing and additional revenue, are not, in and of themselves, sufficient to bring the investment within the class of property the acquisitions, management or disposition of which constitutes an integral part of the taxpayer's business operations. This view furthers the statutory policy of distinguishing that income which is truly derived from passive investments from income incidental to and connected with the taxpayer's business operations.

American Smelting, 99 Idaho at 933, 592 P.2d at 48. The important distinction under the functional test is whether the property was directly connected with the taxpayer's business activity or whether it was merely a passive investment.

Idaho statutes establish a strong presumption that income from stock or other securities is business income. Idaho Code § 63-3027(a)(1) ("Gains or losses and dividend and interest income from stock and securities of any foreign or domestic corporation shall be presumed to be income from intangible property, the acquisition, management, or disposition of which constitute an integral part of the taxpayer's trade or business; such presumption may only be overcome by clear and convincing evidence to the contrary."). Under Idaho law, there also is a general presumption that the business versus nonbusiness income determination of the Idaho State Tax Commission is correct, and the burden is on the taxpayer to establish that the Commission's determination is incorrect. Albertson's Inc. v. State, Dept. of Revenue, 106 Idaho 810, 814, 683 P.2d 846, 850 (1984).

The Tax Commission finds that the record contains very little evidence supporting the Petitioner's position. The Petitioner has made several statements regarding how it made a study to divide the gain between business income and nonbusiness income but has not provided the study or documentation to the Tax Commission for examination. In contrast the record before the Tax Commission evidences a strong operational tie to the Petitioner's retail business. While the Tax Commission certainly recognizes the arguments set out by the Petitioner's representative during this protest, without supporting documentation those arguments are not evidence.

B. The Credit Card Receivables Must be Excluded from the Property Factor for the Taxable Years 2001 through 2003.

As stated above with reference to [Redacted], intangible receivables or receipts cannot be included in the combined denominator. This is forbidden by the standard apportionment formula.

> The property factor is a fraction, ... the denominator of which is the average value of all the Petitioner's real and tangible personal property owned or rented and used during the tax period.

Idaho Code § 63-3027(k) (emphasis added). Since the credit card and financial products receivables are intangible, the standard apportionment formula makes no provision to include them in the property factor.

C. The Proceeds from the Sale of the Credit Card Business Must be Excluded from the Sales Factor for the Taxable Year 2003.

The Petitioner suggests that the proceeds from the sale of the credit card business could be included in the sales factor denominator; however, none of the intangible sales would be included in the Idaho numerator. Generally, gross receipts are included in the sales factor denominator. *See* Idaho Code § 63-3027(p). For sales of intangible property, the sales are sourced to the state in which the income-producing activity is performed. *See* Idaho Code § 63-3027(r). If the income-producing activity is performed both in and outside of Idaho, the sales are sourced to the state in which the greater amount of income-producing activity is performed, based on the costs of performance. *See* Idaho Code § 63-3027(r).

The Petitioner suggests all of the proceeds should be attributed to Illinois, the state where the negotiations for the sale presumably took place. The Petitioner has not submitted a cost of performance analysis or any other evidence to support its statement. Additionally, the costs of negotiations are not direct costs and cannot be used in a cost of performance analysis. *See* Idaho Income Tax Rule 550.05.d (IDAPA 35.01.01.0550.05.d)(A cost of performance computation does not include personal service not directly connected with the performance of the contract or other obligation, as for example, time spent in negotiating the contract).

Additionally, the Tax Commission is not convinced that the only income-producing activity related to the sale consisted of negotiations. The Petitioner represented the sale consisted of both a sale of assets (primarily account balances and certain intangible assets) and the sale of stock. It seems to the Tax Commission that as with any sale there is a multitude of steps in the sales process and several costs associated with each step. For instance, when purchasing property, even intangible property, the costs associated with the sale include research, property verification, and property valuations involved in the process.

Moreover, the Tax Commission is mindful that the sale was in fact the sale of a business segment, the credit card and financial products business, of the Petitioner. The sale was not simply a sale of a minority interest of stock held purely for investment purposes. The business that Petitioner sold conducted business in Idaho. Many of the accounts transferred as the result of this transaction were accounts of customers located in Idaho.

Based on the record before it, the Tax Commission concludes that the receipts of the sale cannot be assigned to the numerator of any particular state. The underlying concept of the apportionment formula is that the combined numerators of each factor must equal the denominator. *See* Idaho Income Tax Rule 450 (IDAPA 35.01.01.0450.01)(The denominator of each factor may not exceed the sum of the numerators of that factor). In particular, Idaho Income Tax Rule 530 provides:

> The denominator of the sales factor includes the total gross receipts derived by the taxpayer from transactions and activity in the regular course of its trade or business, except receipts excluded by Rules 525 through 559 and Rule 570 of these rules. The denominator may not exceed the sum of all the numerators.

IDAPA 35.01.01.0530. Because the sale proceeds are not properly assignable to the numerator of any particular state or group of states, if the gross proceeds of the sales were included in the sales denominator, the combined total of the sales numerators would be less than the sales denominator.

The Audit Division found the sale of the credit card and financial products business could not readily be attributed to any particular income-producing activity and therefore the sales could not be assigned to the numerator of the sales factor for any state. As a result, the Audit Division excluded the receipts from the denominator of the sales factor.

The Tax Commission finds the Audit Division properly applied Rule 570. The Tax Commission has adopted Rule 570, and the pertinent part of the rule states:

> **570. SPECIAL RULES -- SALES FACTOR (RULE 570).**
> **02. Gross Receipts From Intangibles**.
> * * * *
> **b.** If business income from intangible property cannot readily be attributed to any particular income producing activity of the taxpayer, the income cannot be assigned to the numerator of the sales factor for any state and shall be excluded from the denominator of the sales factor. For example, if business income in

> the form of dividends received on stock, royalties received on patents or copyrights, and interest received on bonds, debentures or government securities results from the mere holding of the intangible personal property by the taxpayer, the dividends, royalties and interest shall be excluded from the denominator of the sales factor.

IDAPA 35.01.01.570.02.b. The rule is specifically designed to avoid diluting the sales reported to apportioned states at the expense of over-reporting sales to a particular state, such as the state where the taxpayer is headquartered or a state in which the taxpayer has little or no income tax responsibility.

The Petitioner has not provided a cost of performance analysis and therefore has not met its burden of proof. The Tax Commission upholds the Audit Division on this issue.

3. THE SALE OF [Redacted] IS BUSINESS INCOME.

The Petitioner states that [Redacted] was not part of its unitary business and therefore the gain recognized from the sale of the non-unitary company is not business income. The Petitioner's argument fails to recognize the holding of Allied Signal discussed above.

The unitary relationship is not the only test to determine apportionable business income. To the extent the taxpayer can show that its ownership of stock of the dividend-paying corporation is a passive investment, the dividend income will be nonbusiness income under the Allied-Signal "operational function" test. If, on the other hand, the ownership of stock of the dividend-paying corporation serves an operational function, the dividends should be treated as business income. *See* Allied-Signal, 504 U.S. at 787m 112 S.Ct. at 2263.

Given the nature of [Redacted] unitary business, which includes the sale of automotive parts and servicing segment, it appears to the Tax Commission that ownership of [Redacted] as a non-unitary affiliate may serve an operational function rather than just an investment function. More to the point, [Redacted] has not convinced the Tax Commission that the ownership in this company was unrelated to its overall unitary business operations. *See* Allied-Signal, 504 U.S. at 787, 112 S.Ct. at 2263 ("It remains the case that [in] order to exclude certain income from the apportionment formula, the company must prove that the income was earned in the course of activities unrelated to those carried out in the taxing State.") (Internal quotations omitted). Thus, the Tax Commission finds that the proceeds received from the sale of [Redacted] is apportionable business income. Based on the information currently in the file, the Petitioner has not met the statutory burden required to overturn a business income determination by the Audit Division.

4. THE LOSS ON THE [Redacted] STOCK SHOULD BE TREATED AS A 1248 DIVIDEND UNDER IRC SECTION 1248.

During both audit cycles, the Petitioner reported gains realized from the sale of [Redacted] stock as a dividend pursuant to Internal Revenue Code (IRC) section 1248. Pursuant to IRC section 1248 the gain on a sale of the stock of a foreign corporation is a "deemed dividend" to the "extent of the earnings and profits of the foreign corporation attributable to such stock . . . accumulated in taxable years . . . beginning after December 31, 1962. The 1248 dividend is included in the parent's gross income.

The question that arises is whether or not the gain should be treated like a dividend for state income tax purposes. Idaho Code § 63-3002 states:

> **63-3002. DECLARATION OF INTENT**. **It is the intent of the legislature by the adoption of this act, insofar as possible to make the provisions of the Idaho act identical to the provisions of the Federal Internal Revenue Code relating to the measurement of taxable income, to the end that the taxable income reported each taxable year by a taxpayer to the internal revenue service shall be the identical sum reported to this state, subject only to modifications contained in the Idaho law;** to achieve this result by the application of the various provisions of the Federal Internal Revenue Code relating to the definition of income, exceptions therefrom, deductions (personal and otherwise), accounting methods**,** taxation of trusts, estates, partnerships and corporations, basis and other pertinent provisions to gross income as defined

> therein, resulting in an amount called "taxable income" in the Internal Revenue Code, and then to impose the provisions of this act thereon to derive a sum called "Idaho taxable income"; to impose a tax on residents of this state measured by Idaho taxable income wherever derived and on the Idaho taxable income of nonresidents which is the result of activity within or derived from sources within this state. **All of the foregoing is subject to modifications in Idaho law including, without limitation, modifications applicable to unitary groups of corporations, which include corporations incorporated outside the United States.**

Idaho Code § 63-3002 (emphasis added). In this case, the Tax Commission is not aware of, nor has the Petitioner pointed to, any provision in the Idaho Code which would prohibit treating the IRC 1248 "deemed dividend" as a dividend for taxpayers using the worldwide combined reporting method.

Rather, because it is treated as a dividend from previously taxed earning and profits, it may be appropriate to deduct the dividend from taxable income pursuant to Idaho Income Tax Rule 365.07.

> **365.USE OF THE COMBINED REPORT (RULE 365).**
> Section 63-3027, Idaho Code. (3-20-97)
>
> - * * *
>
> **07. Dividends and Other Intangible Income**. Dividends and other intangible income shall be included in income subject to apportionment to the extent they constitute business income received from companies not included in the combined report. **However, a dividend deduction and factor adjustments are allowed to the extent dividends received are paid from prior year earnings previously included in income subject to apportionment.** Part I, Subchapter C, Internal Revenue Code, is applied to determine the taxable year in which the earnings and profits were earned that paid the dividend. It is the taxpayer's responsibility to prove that the dividend, or a portion of it, was previously included in Idaho apportionable income. (4-6-05)

IDAPA 01.01.30.0365.07 (Emphasis supplied). Because the dividend is from earnings previously included in the combined report of a worldwide filer, the Tax Commission finds that it was appropriate for the Audit Division to deduct the 1248 deemed dividend in this instance.

The Petitioner originally deducted the deemed dividend but later recalculated its basis in the company stock to create a loss for state tax purposes that was not reported at the federal level. The Petitioner has not cited any authority for its recalculation or explained why Idaho should depart from the federal treatment of the dividend. Given the statute and administrative rule set forth above, the Tax Commission denies the loss deduction requested by the Petitioner.

5. THE PETITIONER'S AFFILIATED INSURANCE COMPANIES SHOULD BE INCLUDED IN THE COMBINED GROUP FOR TAXABLE YEARS 2001-2003.

For the taxable years 2001 through 2003, the Audit Division included several affiliated insurance companies in the Petitioner's combined group. The insurance companies do not pay the Idaho premiums tax.

A. <u>Insurance Statutes</u>

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 § 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.

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

Idaho Code § 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:
>
> (t)
>
> or 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>:
>
> (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.[5] *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 from the combined group those insurance companies that pay the Idaho premium tax. Tax Commission Income Tax Rule 600.05 (1997), IDAPA 35.01.01.600.05 (1997). That administrative rule was later recodified. *See* Tax Commission Administrative Rule 600.06 (1999), IDAPA 35.01.01.600.06 (1999).

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

The Petitioner asserts its affiliated insurance companies should be excluded from the combined group even though they do not pay a premium tax. The Petitioner asserts that, while the insurance companies do not actually pay a premium tax in Idaho, this is a consequence solely of their lack of nexus; that is to say they do not conduct business in Idaho. The Petitioner

[5] 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.

contends that including the insurance companies in the combined report overstates the income apportioned to Idaho and taxes the included insurance companies.

However, simply including a corporation in the combined report does not result in the taxation of that particular corporation. As discussed above, 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, 504 U.S. at 783, 112 S.Ct. at 2261 (citations and internal quotations omitted).

As explained by the Idaho Supreme Court, combined reporting is a refinement of the UDITPA apportionment principle.

> 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. *See also* 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). Thus for purposes of determining the income of the combined group, it is appropriate to include all of the members of the unitary business, including the affiliated insurance companies, in the combined group.

Additionally, including a nontaxable corporation in the income of the combined group does not cause the subsequent apportionment of income to be distorted. The Oregon Tax Court has held that the income of a nontaxable insurance company in the combined group's income was permissible so long as the group's states' 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 state payroll, property, and sales in the group's numerator. *See* State v. Penn Independent Corporation, 15 Ore. Tax 68 (1999). The insurance company was not taxed because, while the combined group's preapportionment income tax base is larger, its Idaho apportionment factor is smaller. Id.

Thus contrary to what the Petitioner asserts, the inclusion of the insurance companies does not necessarily overstate the income apportioned to Idaho. The Petitioner has not asserted any other grounds for excluding the insurance companies from the combined group. Accordingly, the Tax Commission upholds the Audit Division on this issue.

6. THE AUDIT DVISION CORRECTLY DISALLOWED A PORTION OF THE CLAIMED INVESTMENT TAX CREDIT.

In both audit cycles, the Petitioner claimed the Investment Tax Credit (ITC) for a variety of property. Idaho Code § 63-3029B provides that an asset must be "eligible for the federal investment tax credit, as defined in §§ 46(c) and 48 of the Internal Revenue Code" to qualify for the Idaho credit. By reference to the federal tax code, the Idaho statute set forth strict restrictions on what type of property qualifies for the credit. For instance, IRC § 48 provides that tangible personal property—not including a building and its structural components—used as an integral part of manufacturing qualifies for the federal investment credit. The statute also provides for a detailed substantiation of each property for which the credit is claimed.

The Petitioner did not provide a detailed breakdown of the property for which the credit was claimed. Instead, the Petitioner asked the audit staff to independently verify the type and property claimed by matching general descriptions to the vendors' websites. The Petitioner maintained that the websites would demonstrate that the property purchased could only be qualifying property.

The Tax Commission finds that this is not sufficient substantiation as required by the statute. It is a well-established rule of law that the burden is on the taxpayer to prove its entitlement to a credit or deduction.

7. THE PETITIONER HAS NOT EXPLAINED WHY THE PAYROLL IT REPORTED ON ITS STATE TAX RETURN DIFFERS FROM THE PAYROLL IT REPORTED TO THE IDAHO DEPARTMENT OF LABOR.

The Audit Division adjusted the payroll reported in the second audit cycle to conform with the payroll the Petitioner reported to the Department of Labor. At the October 30, 2006, conference in this matter, the Petitioner recognized that a difference existed between its internal records kept for purposes of the federal unemployment tax and the reports generated by the Idaho Department of Labor. The Petitioner could not explain why its internal database differed from the Department of Labor reports. Accordingly, the Tax Commission finds that the Petitioner has not met its burden and upholds the Audit Division on this issue.

8. THE PENALTIES ARE UPHELD.

The Audit Division asserted both a five percent negligence penalty for some taxable years and the 10 percent substantial understatement penalty concerning other taxable year. The negligence penalty was asserted due to [the Petitioner's] repeated failure to provide adequate documentation to support the nonbusiness income claimed on [its] return. The substantial understatement penalty was asserted because the underpayment of tax exceeded the $10,000 threshold in four years.

[Redacted]asserts that neither penalty is warranted. The Petitioner believes it has adequately supported its nonbusiness income positions and provided an adequate response to all requests from the audit team.

After careful consideration, the Tax Commission has decided to uphold the negligence penalty. The Tax Commission believes that the penalty was properly asserted (*see* IDAPA 35.02.01.410.02.k).

With respect to the substantial understatement penalty, the Petitioner simply asks that the penalty be reevaluated and recalculated. The substantial understatement penalty is set out in Idaho Code § 63-3046(d). Subsection (d)(7) provides that "[t]he state tax commission may waive all or any part of the [substantial understatement penalty] on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith." I.C. § 63-3046(d)(7). The Tax Commission is unable to find that the understatement in Idaho tax during the years under audit was based on reasonable cause or that the taxpayer acted in good faith. Much of the understatement of tax relates to audit adjustments that were not protested. Of those adjustments that were protested, the taxpayer provided very little documentation to substantiate its position. In the final analysis, the Commission simply does not believe that waiver of the substantial understatement penalty is warranted under the circumstances.

CONCLUSION

WHEREFORE, the Modified Notices of Deficiency referenced above, including refunds denied therein, are hereby APPROVED, AFFIRMED, AND MADE FINAL.

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

PERIOD	TAX (REFUND)	PENALTY	INTEREST	TOTAL
1997	$229,170	$34,376	$142,959	$ 406,505
1998	7,785	389	4,256	12,430
1999	12,795	640	6,064	19,499
2000	(44,536)	0	(17,539)	(62,075)
2001	182,519	18,252	57,801	258,572
2002	147,597	14,760	37,260	199,617
2003	945,609	94,561	188,598	1,228,768
		TOTAL	AMOUNT DUE	$2,063,316

Interest is calculated through July 11, 2007, 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. As set forth in the enclosed explanation, the taxpayer must deposit with the Tax Commission twenty percent (20%) of the total amount due in order to appeal this decision. The 20 percent deposit in this case amounts to $412,663 and will be held as security for the payment of taxes until the appeal is finally determined.

DATED this ____ day of ____________________, 2007.

IDAHO STATE TAX COMMISSION

____
COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of __________________, 2007, 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] Receipt No.

____