BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of [Redacted], Petitioners.	))))))	DOCKET NO. 21623 DECISION

PROCEDURAL BACKGROUND

The Income Tax Audit Division (Division) issued a Notice of Deficiency Determination (NODD) dated October 15, 2008, to [Redacted] (Petitioners) for the taxable year ending June 30, 2004. The deficiency determined by the Division totaled $91,767 which included tax and interest.

The Petitioners submitted a protest of the proposed deficiency on December 17, 2008. The Petitioners requested a conference with a Commissioner to discuss the deficiency proposed by the Division. On June 4, 2009, the undersigned Commissioner conducted a conference at the offices of the Tax Commission (Commission) in Boise, Idaho. The Petitioners' Director of Taxes and outside legal counsel attended the conference. The Petitioners submitted additional information on June 10, 2009, detailing the events and operations of the Petitioners' Idaho businesses.

On June 30, 2009, the Petitioners submitted an asset schedule related to the amount of depreciation claimed on the income tax returns the Petitioners filed with Idaho. The Division had adjusted the claimed depreciation to account for the differences between federal and Idaho treatment of bonus depreciation. However, after reviewing the asset schedule submitted by the Petitioners, the Division agreed to reverse the audit adjustment.

With the submission of the audit schedule and the resolution of the depreciation issue, the Commission considered this matter fully submitted as of June 30, 2009. The Tax Commission has reviewed the information contained in the file and submitted during the protest. The Tax Commission being fully advised, now issues a decision on the protest.

ISSUES

The Petitioners originally protested four issues. The Petitioners asserted the Division erred when its auditors:

(1) disallowed the water's-edge filing method used by the Petitioners;

(2) excluded only 80 percent of foreign dividends in the combined group's apportionable income;

(3) failed to adequately adjust the apportionment formula to account for the foreign dividends included in apportionable income; and

(4) disallowed a portion of the depreciation the Petitioners claimed on their returns.

As discussed above, issue number four is resolved in the Petitioners' favor. The Tax Commission accepts the depreciation amounts the Petitioners reported.

At the conference in this matter, the parties also resolved the first issue. Although the Petitioners did not file a formal water's-edge election, the Petitioners and the Commission have followed water's-edge treatment for the Petitioners in the past. As a result, although not required, the auditor accepted the water's-edge method of reporting used by the Petitioners and did not convert the Petitioners to a worldwide filing basis. For the purposes of this decision, the matter is deemed to be resolved and will not be addressed.

HOLDING

Based on the asset schedules submitted by the Petitioners and the Division's acceptance of those schedules, the audit adjustment of the depreciation reported by the Petitioners is reversed. Accordingly, the deficiency asserted by the Division in the NODD is reduced.

However, the Commission affirms that part of the deficiency related to certain deemed dividends from foreign affiliates. The Commission agrees with the Division that the governing water's-edge statute is clear. The Petitioners may exclude 80 percent of the deemed dividends from the apportionable income reportable to Idaho but may not exclude 100 percent of the deemed dividends.

Contrary to the Petitioners' arguments, the Commission does not find that the water's-edge statute unconstitutionally discriminates against taxpayers choosing the water's-edge election for tax reporting purposes. It is true that under worldwide reporting, the deemed dividends reported by the foreign subsidiaries would be eliminated in their entirety as an intercompany transaction. However, the Petitioners' argument overlooks the fact that the income would be reported in the first instance by the related company that pays the foreign dividend. Thus, other taxpayers would report 100 percent of the income of subsidiaries that are part of their unitary business.

DISCUSSION

A. COMBINED REPORTING

1. Statutory Authority for Combined Reporting.

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

> **63-3027. COMPUTING IDAHO TAXABLE INCOME OF MULTISTATE OR UNITARY CORPORATIONS**. The Idaho taxable income of any multistate or unitary corporation transacting business both within and without this state shall be computed in accordance with the rules set forth in this section:
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> (t) For purposes of this section and sections 63-3027B through 63-3027E, Idaho Code, the income of two (2) or more corporations, wherever incorporated, the voting stock of which is more than fifty percent (50%) owned directly or indirectly by a common owner or owners, when necessary to accurately reflect

income, shall be allocated or apportioned as if the group of corporations were a single corporation, in which event:

> (1) 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, 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) (emphasis added). *See* American Smelting & Ref'g Co. v. Idaho St. Tax Comm'n, 99 Idaho 924, 928, 592 P.2d 39 (1979), vacated and remanded, 445 U.S. 939 (1980), reinstated on remand, 102 Idaho 38, 624 P.2d 946 (1981), rev'd on other grounds sub nom. ASARCO Inc. v. Idaho St. Tax Comm'n, 458 U.S. 307 (1982).

2. Worldwide Combined Reporting.

Controlled foreign subsidiaries are included in a taxpayer's pre-apportioned taxable income even though the subsidiaries were not included on the parent's federal consolidated return. Idaho Code section 63-3027(t)(2) states in relevant part:

> (2) The income of a corporation to be included in a combined report shall be determined as follows:
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> (i) for a corporation incorporated in the United States or included in a consolidated federal corporation income tax return, the income to be included in the combined report shall be the taxable income for the corporation after making appropriate adjustments under the provisions of section 63-3022, Idaho Code;
>
> (ii) for a corporation incorporated outside the United States, but not included in [a consolidated federal income tax return], the income to be included in the combined report shall be the net income before income taxes of such corporation . . . .

Id. (Emphasis added.)

3. Water’s-Edge Election as the Exception to the Worldwide Reporting Requirement.

Taxpayers are provided the option of filing a unitary combination on a water’s-edge basis rather than a worldwide basis. A water’s-edge basis is the equivalent of domestic combined reporting, that is to say that only the domestic corporations within the unitary group that report federal taxable income are included on the combined group.

Idaho Code section 63-3027B provides that, a "qualified taxpayer" may elect to determine its income from Idaho sources using a water's-edge election. A "qualified taxpayer" is a corporation that makes a water’s-edge election on the Idaho income tax return filed with the Idaho State Tax Commission. Additionally, the taxpayer must file consent to the reasonable production of documents with the return. *See* Idaho Code section 63-2027B(b)(3). The consent remains in effect as long as the water's-edge election is in effect.

One of the documents that must be produced is the “domestic disclosure spreadsheet” showing a breakdown of how income is reported to each state in which the taxpayer has a presence. Idaho Code section 63-3027E. If a taxpayer fails to produce the required document, the water’s-edge election may be disregarded, even if the taxpayer is an otherwise “qualified taxpayer.” The relevant statute states:

> (c) A water's-edge election may be disregarded, and the income of the taxpayer determined without regard to the provisions of this section pursuant to those conditions which may be required by the state tax commission under subsection (b) of section 63-3027C, Idaho Code, if any corporation fails to comply with:
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> (1) The domestic disclosure spreadsheet filing requirements defined in section 63-3027E, Idaho Code; . . .

Idaho Code section 63-3027B(c)(1). If a taxpayer fails to make a water’s-edge election or fails to comply with the conditions of the election, the taxpayer may be required to report under the default method, which is the worldwide combined reporting method.

B. WATER'S-EDGE EXCLUSION OF FOREIGN DIVIDENDS

1. The Statutory Mechanics of the Foreign Dividends Exclusion.

The water's-edge statutes specifically address dividends received from foreign corporations.

> **63-3027C. ELECTION IS BINDING -- TREATMENT OF DIVIDENDS.** (a) A water's-edge election shall be made in the original return for a year and shall be binding for all years thereafter, except as follows:
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> * * *
>
> (c) For purposes of this section:
> (1) Dividends received from payors incorporated outside the fifty (50) states and District of Columbia, to the extent taxable, shall be treated as income subject to apportionment**.**
> (2) The income of corporations filing elections under section 936 of the Internal Revenue Code shall be deemed dividends received from payors incorporated outside the fifty (50) states and District of Columbia.
> (3) Eighty-five per cent (85%) of all dividends described in subsection (c)(1) or (c)(2) of this section shall be excluded from income subject to apportionment.

If a domestic spreadsheet is not filed, a type of penalty is imposed under Idaho Code section 63-3027C(c)3; the dividend exclusion is reduced from 85 percent to 80 percent. In this case, because the Petitioners have not filed a domestic spreadsheet, the Petitioners must exclude only 80 percent of the dividends received from foreign subsidiaries.

2. How Petitioners Reported Foreign Dividends.

Many of the Petitioners' foreign subsidiaries were converted to disregarded entities or partnerships for [Redacted]. Pursuant to the Internal Revenue Code (IRC) section 332, the conversions were treated as liquidations. As liquidations, the Petitioners are deemed to receive the earnings and profits of each liquidated entity in a "deemed dividend." IRC section 367. It is the deemed dividends from the conversions that are at issue.

a. <u>The uncontested foreign dividends</u>.

The Petitioners reported a total of $196,379,058 of foreign dividends on their federal return. For Idaho income tax purposes, the Petitioners determined that $14,207,023 of the dividends came from foreign corporations that were not liquidated under IRC section 332. On its Idaho return, the Petitioners correctly reported a dividend exclusion of $11,365,618. As discussed above, Idaho statutes allow water's-edge filers to exclude from apportionable income 80 percent of the dividends received from controlled foreign corporations when the combined group has not filed a domestic spreadsheet. Because $14,207,023 of the dividends fell under the usual category of dividends, it deducted 80 percent of those dividends from apportionable income.

b. <u>The contested dividends.</u>

However, the remaining $182,172,035 of dividends represented deemed dividends of earnings and profits from the liquidated or converted foreign entities. The Petitioners deducted from apportionable income 100 percent of the deemed dividends received from the liquidated foreign entities ($182,172,035). The Petitioners asserted the dividends representing earnings and profits did not fall under the usual dividend treatment. The Petitioners do not cite any specific Idaho authority that would permit such treatment or the exclusion of the entire amount received from the liquidated entities, but instead argue the 80 percent exclusion discriminates and is in violation of the United States Constitution.

The Division examined the issue and determined the dividends received from the liquidated entities should be treated in the same manner as other dividends received from controlled foreign corporations. Accordingly, the staff reversed the $182,172,035 "earnings and profits" exclusion claimed by the Petitioners and instead allowed an exclusion of 80 percent of that amount. In other words, the Division allowed an additional dividends exclusion of $145,737,628 rather than the $182,172,035 exclusion reported by the Petitioners. It is the difference between the two exclusions for the deemed dividends, $36,434,407, that lies in dispute between the Petitioners and the Division.

C. ALLEGED DISCRIMINATION REGARDING TAXATION OF FOREIGN DIVIDENDS.

1. Statutes and Rules Governing Deemed Dividends.

The Petitioners allege that if a corporation filing on the worldwide combined method received earnings and profits from a subsidiary, the earnings and profits would be excluded from apportionable income. The Petitioners are partially correct in this statement.

The Commission has examined deemed dividends in the context of a dividend issued 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 IRC section 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 section 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. <u>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</u>.

Idaho Code section 63-3002 (emphasis added). There is no provision in the Idaho Code which would prohibit treating the IRC section 1248 "deemed dividend" as a dividend for state income tax purposes.

However, if the sold foreign subsidiary has been part of a worldwide combined group reporting to Idaho, the dividend may be excluded because the earnings and profits contained in the dividend have already been subject to tax. Idaho Income Tax Rule 365.07 provides:

> **365. USE OF THE COMBINED REPORT (RULE 365).**
> Section 63-3027, Idaho Code. (3-20-97)
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> * * *
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> **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. <u>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.</u> 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 35.01.01.365.07 (emphasis added). When the dividend is from foreign earnings previously included in the combined report of a worldwide filer, it is appropriate to exclude the deemed dividend.

The deemed dividend in this case is analogous to the IRC section 1248 dividend. In this particular instance, the Petitioners do not file on a worldwide basis, nor have they shown that the earnings and profits contained in the deemed dividend were included previously in reported income subject to apportionment. Because the Petitioners file on a water's-edge basis, the assumption is that the controlled foreign corporations have not been included in the combined report filed with Idaho, and hence their accumulated earnings and profits have not been subject to Idaho income tax in the past.

2. The Constitutional Claim.

The Petitioners assert that the different treatment between worldwide filers and water's-edge filers violates the Commerce Clause of the United States Constitution. In support of its position, the Petitioners cite the United Supreme Court decision in Kraft General Foods, Inc. v. Iowa Dept. of Revenue, 505 U.S. 71 (1992).

In Kraft General Foods, Inc., the Supreme Court held that Iowa's income tax law, which included dividends from foreign subsidiaries in a corporation's tax base but excluded dividends from domestic subsidiaries, discriminated against foreign commerce in violation of the Foreign Commerce Clause. Iowa taxed the income of a corporation on a single-entity basis. Since the state used the federal definition of taxable income with certain modifications, dividends from domestic subsidiaries, but not dividends from foreign subsidiaries, were deductible from a corporation's Iowa income. Stating that the payment of dividends by a foreign subsidiary to a domestic corporation constituted foreign commerce, the Court said that the Iowa tax burdened foreign commerce even though a taxpayer could avoid the tax by conducting its foreign operations through domestic subsidiaries.

This case does not present Kraft circumstances. First, this case involves combined, not separate, reporting. Second, the foreign dividends in question are not fully included in apportionable income. As discussed above, 80 percent of the foreign dividends were excluded from apportionable income. Third, as evidenced by the Commission's administrative rule, even domestic dividends received by a company will be eliminated only to the extent the dividends represent previously taxed earnings and profits. In this case, the dividends received by the water's-edge filers do not represent previously taxed earnings and profits.

However, the most significant distinction is found in the case of Fujitsu IT Holdings, Inc. v. Franchise Tax Bd., 120 Cal. App. 4th 459, 15 Cal. Rptr. 3d 473 (1st Dist. 2004), review denied, (Oct. 20, 2004). In Fujitsu the court held that the disparate California franchise tax treatment of dividends received by a water's edge combined group from foreign and domestic subsidiaries did not discriminate against foreign commerce in violation of the Foreign Commerce Clause. California statutes provided that dividends received by a water's-edge group from a foreign subsidiary, to the extent not eliminated by another provision, were 75 percent deductible. Similar dividends received from a domestic subsidiary were 100 percent deductible or excludible through various provisions.

Holding that this treatment was not discriminatory, the court explained that the different treatment did not depend on whether the dividends were paid by a foreign or domestic subsidiary, but rather on whether or not the income from which they were paid had been included in the water's-edge combined report. If a subsidiary's dividend was paid from income that had been fully included in the combined report, whether the subsidiary was foreign or domestic, the dividend was eliminated under California law which provided for full elimination of intercompany dividends paid from income of a unitary group.

The court reasoned that, while the domestic dividends were eliminated, the income from which they were paid was included 100 percent on the combined report and was subject to apportionment and taxation. Similarly, foreign source dividends paid from income included on the combined report were eliminated in exactly the same manner. It was only when a foreign subsidiary's income had been excluded from the combined report by the water's-edge election that dividends paid by it were not eliminated. However, if the subsidiary's dividend was paid from income that had not been included on the combined report, it was nevertheless eligible for the 75 percent deduction.

As discussed above, Idaho law is similar to that of California. While the dividends paid by a subsidiary may be eliminated under Idaho law, if the company paying the dividend is part of the combined group, the income from which the dividends are paid will nonetheless be fully included in apportionable income.

In this case, only 20 percent of the dividend is included in apportionable income when a subsidiary is not part of the combined group pursuant to a water's-edge election. The Tax Commission does not perceive any state caused discrimination in the Petitioners' choice of electing water's-edge treatment.

D. PETITIONERS' REQUEST TO ADJUST THE APPORTIONMENT FORMULA IF THE LIQUIDATION DIVIDENDS ARE INCLUDED IN APPORTIONABLE INCOME.

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. The most commonly used formula for dividing the income is found in the Uniform Division of Income for Tax Purposes Act (UDITPA).

Idaho and many other states have adopted UDITPA either in whole or with modifications. Idaho Code section 63-3027(i) states that "[a]ll business [apportionable] 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 taxpayer’s property located in Idaho by its property located everywhere. Idaho Code section 63-3027(k). Likewise, the payroll factor is calculated by dividing the taxpayer’s Idaho payroll by its payroll everywhere. Idaho Code section 63-3027(n). And finally, the sales factor is derived by dividing the taxpayer’s Idaho sales by its sales everywhere. Idaho Code section 63-3027(p). Many states, including Idaho, have modified the traditional three-factor formula so that the sales factor is double weighted. The result of the above equation is then multiplied by the taxpayer’s total business income to arrive at the portion of the business income apportioned to Idaho.

The three-factor apportionment formula, by means of the location of a business’s property, payroll, and sales, approximates the extent of the business activity in a given state. Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983). Most states that impose a tax on corporate income use some variation of the three-factor apportionment formula.

Under the standard apportionment formula set forth in Idaho Code section 63-3027, only those taxpayers subject to the Idaho tax would have their property, payroll, and sales included in the apportionment formula. Companies not included in the reporting group are not included in the apportionment factor, despite the fact that such companies may pay dividends to the reporting group.

However, the Commission recognizes that in a water’s-edge situation, there may frequently be instances in which dividends from non-reporting subsidiaries will be included in the reporting group’s apportionable income. Idaho Income Tax Rule 641 gives factor representation to such dividends by including the dividends in the sales factor computation. In this specific case, the auditor determined that 20 percent of the deemed dividends should be included in apportionable income. Pursuant to Idaho Income Tax Rule 641, the auditor included the same 20 percent of foreign dividends in the denominator of the sales factors. This had the effect of diluting the sales factor and decreased the amount of income apportioned to Idaho pursuant to the sales factor.

The Petitioners ask the Commission to modify the apportionment formula further by including in the apportionment formula the total payroll, property, and sales of the foreign subsidiaries that occurred during the past several years. The Petitioners reasoned that such payroll, property, and sales were used over a number of years to generate the total earnings and profits that were distributed in the form of a deemed dividend.

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. *See* Idaho Code section 63-3027(s). The party asserting an alternative apportionment bears the burden of showing that the proposed 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 requesting party (which may be either the Tax Commission or a taxpayer) must demonstrate that the apportionment currently used does not fairly reflect the taxpayer's business activity in the state; simply advocating a better method of apportionment 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).

The Petitioners have not met their burden for requesting an alternative apportionment. In this case, the total earnings and profits have not been included in apportionable income, so the proposed alternative apportionment is not warranted. Only 20 percent of the deemed dividends were included in apportionable income. Moreover, the foreign subsidiaries which paid the dividends are not included in the combined group. As discussed previously, reporting taxpayers often receive dividends from non-reporting companies. Under standard apportionment, the non-reporting companies paying the dividends are not included in the apportionment formula. If the Petitioners reported on a worldwide combined basis, which included the foreign subsidiaries then it would be appropriate to include all of the factors of the foreign subsidiaries.

The Division included the 20 percent of dividends in the sales factors. Simply put, the Petitioners have not demonstrated that the apportionment used in the audit fails to fairly reflect the Petitioners' business activity in Idaho.

CONCLUSION

WHEREFORE, the Notice of Deficiency Determination referenced above is hereby MODIFIED, and as modified, is MADE FINAL by this Decision.

IT IS ORDERED and THIS DOES ORDER that the Petitioners pay the following tax and interest.

PERIOD	TAX	INTEREST	TOTAL
06/30/04	$71,971	$24,060	$96,031

Interest is calculated through March 26, 2009, and will continue to accrue at the rate set forth in Idaho Code section 63-3045(6) until paid.

DEMAND for immediate payment of the foregoing amount is hereby made and given. An explanation of the Petitioners' right to appeal this decision is enclosed. As set forth in the enclosed explanation, the Petitioners must deposit with the Tax Commission 20 percent (20%) of the total amount due in order to appeal this decision. The 20 percent deposit in this case is $19,206.20 and will be held as security for the payment of taxes until the appeal is resolved.

DATED this ____ day of ____________________, 2009.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of __________________, 2009, 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.

COPY MAILED TO:
[REDACTED]

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