

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)
) DOCKET NO. 21664
[Redacted], [Redacted])
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Petitioners.) DECISION
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BACKGROUND

The Income Tax Audit Division (Division) of the Idaho State Tax Commission audited the returns filed by The [Redacted]; and The [Redacted](Petitioners). The Division subsequently issued a Notice of Deficiency Determination (NODD) dated November 13, 2008, [Redacted]. Among other adjustments made to the returns [Redacted], the Division determined [Redacted] should be included in the group returns filed [Redacted]. For the years in question, the [Redacted] had filed separate returns with Idaho.

The [Redacted] filed a written protest of the NODD on January 13, 2009. The [Redacted] paid the audit adjustments proposed by the Division except those adjustments specifically related [Redacted] and the penalties asserted by the Division.

Because the other audit adjustments of the group returns were satisfied, the Division issued a separate NODD [Redacted] on January 20, 2009. The NODD issued [Redacted] concerned the taxable years ending December 31, 2004 through December 31, 2006. The deficiency determined by the Division totaled \$276,570 which included tax, penalty and interest.

The [Redacted] submitted a written protest of the proposed deficiency on March 17, 2009, stating that it should not be included in the group return filed [Redacted]. As with The [Redacted], the [Redacted] requested an informal conference before the Tax Commission to discuss the proposed deficiency.

The undersigned Commissioner conducted a telephone conference on April 28, 2009. The Tax Commission has reviewed the Audit Division file and the information submitted by the Petitioners during the protest period. The Tax Commission now issues this decision.

ISSUE

Must the [Redacted] be included in the group [Redacted] which files a combined return for Idaho income tax purposes when the [Redacted] files a separate return for federal income tax purposes?

HOLDING

The [Redacted] must be included in the combined group. The federal tax code which governs how corporations file tax returns for federal income tax purposes does not apply in this circumstance. The combining of corporations for state income tax purposes is governed by a specific Idaho statute. Also, if the [Redacted] were not included in the combined group, a significant amount of the Idaho business activity of the group would not be reflected in the group report.

DISCUSSION

I. INTRODUCTION

The [Redacted] (Company) is one of the largest [Redacted] retailers in the United States. [Redacted]. [Redacted]. [Redacted]. The Company employs approximately 290,000 full-time and part-time employees.

Not all persons who work at the Company stores are directly employed by the Company. Some of the Company stores lease their employees [Redacted]. The [Redacted] was expressly created for leasing employees [Redacted]. The Company and thirteen of its subsidiaries were the original members/owners [Redacted]. The bylaws [Redacted] provide: (1) the [Redacted] must

be operated for the benefit of its members; (2) members agree to purchase a minimum percentage of employee services [Redacted]; (3) no member may transfer its membership [Redacted]; (4) members are entitled to receive patronage distributions [Redacted]; and (5) after setting aside reasonable reserves, all remaining net earnings [Redacted] are allocated to the Members based on the value of business transacted by each Member during the year.

In short, the [Redacted] provides the Company and its subsidiaries an alternative to directly employing its staff. They lease employees [Redacted] for consideration, but then receive back a portion [Redacted] earning in the form of distributions (patronage dividends) [Redacted].

The Company and many of its subsidiaries file a consolidated return for [Redacted] income tax purposes rather than filing separate returns. However, the [Redacted] is not part of the Petitioner's consolidated group. Under federal law, [Redacted] is taxed differently than other corporations. Accordingly, the [Redacted] files a separate [Redacted] return in accordance with Internal Revenue Code (IRC) § 1382.

The Company and the Cooperative maintain that Idaho must follow the federal law for the filing of income tax returns. The Petitioners cite Idaho Code § 63-3002 which declares in part:

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 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", . . .

The Petitioners assert that, by virtue of this statute, Idaho has incorporated the separate filing provisions for cooperatives as found in IRC § 1382.

II. IDAHO HAS NOT INCORPORATED THE SEPARATE FILING PROVISIONS OF SECTION 1382 OF THE INTERNAL REVENUE CODE.

Idaho models its state income tax on the provisions of the federal tax code. However, Idaho has not incorporated all of the provisions of the Internal Revenue Code. Idaho Code § 63-3002 in its entirety 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). *See also* Lockheed Martin Corporation v. Idaho State Tax Commission, 142 Idaho 790, 134 P.3d 641 (2006) (Federal tax law did not apply when the subject was governed by a specific state tax statute).

In this instance, the matter is governed by a specific Idaho tax statute. Idaho Code § 63-3027 governs the computation of Idaho taxable income of a multistate corporation or unitary business. 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:

- (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)

he 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 § 63-3027(t) (emphasis added). Under the unitary business principle, separately incorporated entities are treated as a single business when they work in coordination and conduct what essentially is a single business enterprise. *See generally, Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 164 – 169 (1983). The Idaho Supreme Court has interpreted Idaho Code § 63-3027(t) to require combined reporting by a unitary business. *Albertson's, Inc. v. State, Dept. of Rev.*, 106 Idaho 810, 683 P.2d 846 (1984).

The Petitioners do not contest that the [Redacted] is part of the Company's unitary business. They simply argue the federal reporting provisions governed. That argument is in error. By operation of Idaho Code § 63-3027(t), and the court's interpretation of that statutory provision, the [Redacted] must be included in the combined group that reports to Idaho.

III. THE SIGNIFICANCE OF COMBINING THE COOPERATIVE IN THE REPORTING GROUP

Including [Redacted] in the combined group of entities reporting to Idaho does not increase the total amount of income the group reported to Idaho. The taxable income reported [Redacted] is zero for each year at issue. Although [Redacted] receives income each year from its members

(through activities such as leasing employees to the related members), the income is offset by corresponding deductions, including the patronage dividends paid back to the members out of the [Redacted] annual profits.

However, while including [Redacted] in the combined group does not increase the total amount of income reported to Idaho, it is significant in how the total income of the combined group is apportioned among the states in which the group operates. When a unitary business conducts business across state lines, each state may tax only an apportioned share of the business income.

In 1965, Idaho adopted with slight modification the Uniform Division of Income for Tax Purposes Act (UDITPA). 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 business operates. Each state uses one or more ratios to divide or "apportion" the business income to determine the amount of income subject to tax. 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).

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.

Idaho further modified UDITPA to require "combined reporting" of certain affiliated corporations.

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. As referenced above, combined reporting incorporates the unitary business principle.

As stated by the U.S. Supreme Court: "The principal virtue of the unitary business principle of taxation is that it does a better job of accounting for the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise than, for example, geographical or transactional accounting." Allied-Signal, Inc. v. Director, Div. of Taxes, 504 U.S. 768, 783, 112 S.Ct. 2251, 2261 (1992) (citations and internal quotations omitted). The three-factor apportionment formula, by means of the location of a business's

property, payroll, and sales, approximates the extent of business activity in a given state. Container Corp., supra.

The significance of including [Redacted] in the combined group is directly connected to the payroll factor of the apportionment formula. [Redacted] operate in several locations throughout Idaho. [Redacted]. [Redacted]. These two entities lease nearly all of their employees [Redacted] for the Idaho operations.

Because they lease their employees [Redacted], [Redacted] assign only a small amount of the payroll factor to the state of Idaho. The employees who operate [Redacted] in Idaho are not included in the payroll factor of the companies. Instead, the Cooperative with no reportable income includes the employees in its payroll factor. This is not a fair reflection of the income resulting from business activity occurring in Idaho. These employees operate the Idaho stores that are part of the combined group. As a result, the Cooperative must be included in the combined group so that the Cooperative's payroll factor is also included and reported to Idaho.

The Tax Commission finds the plain language of the Idaho Code § 63-3027, as well as the policy underlying the statute, requires that the [Redacted] be included in the combined group that reports to Idaho.

IV. PENALTIES

The Division asserted a substantial underpayment penalty for each of the taxable years at issue. 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.” Idaho Code § 63-3046(d)(7).

The Petitioners ask that the penalties be abated. The Petitioners maintain that “There is no negligence associated with the proposed deficiency, but rather a possible misinterpretation of the laws of Idaho and a possible incorrect contention by Idaho with respect to certain corporate relationships” The Petitioners conclude they have acted in good faith in this matter.

As discussed above, the Tax Commission finds that the Petitioners, not the Division, misinterpreted the laws of Idaho. The Tax Commission does not find that those laws are ambiguous. Nor have the Petitioners shown that the Division misunderstood the relationship between the combined group of Company affiliates and [Redacted]. Additionally, the Tax Commission notes the Petitioners were on notice concerning this specific issue. The Division and the Petitioners discussed the Cooperative and employees leased [Redacted] in the previous audit cycle. The Tax Commission simply does not believe that waiver of the penalties is warranted under these circumstances. Therefore, the Tax Commission upholds the penalties asserted by the Audit Division.

CONCLUSION

WHEREFORE, the Notice of Deficiency Determination referenced above is hereby APPROVED, AFFIRMED, and MADE FINAL by this Decision.

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

| <u>YEAR END</u> | <u>TAX</u> | <u>INTEREST</u> | <u>PENALTY</u> | <u>TOTAL</u> |
|-----------------|------------|-----------------|------------------|------------------|
| 12/31/2004 | \$ 32,411 | \$ 9,578 | \$ 3,241 | \$ 45,230 |
| 12/31/2005 | 82,080 | 19,302 | 8,208 | 109,590 |
| 12/31/2006 | 102,748 | 17,715 | 10,275 | <u>130,738</u> |
| | | | TOTAL AMOUNT DUE | <u>\$285,558</u> |

The previous payment of \$118, 096 is applied to the liability of [Redacted] Company and Subsidiaries.

Interest is calculated through January 20, 2010, and will continue to accrue at the rate set forth in Idaho Code § 63-3045(6) until paid. This decision does not address or incorporate amended returns or federal adjustments filed by the Petitioner.

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 twenty percent deposit in this case amounts to \$57,112 and will be held as security for the payment of taxes until the appeal is finally determined.

DATED this ____ day of _____ 2009.

IDAHO STATE TAX COMMISSION

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.
