BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 22334
[Redacted],	)	
	)	
Petitioner.	)	DECISION
	)	

INTRODUCTION AND PROCEDURE

This is a multistate income tax matter regarding Idaho's taxation of [Redacted] (Taxpayer). The tax periods at issue are taxable years ending 12/31/2004, 12/31/2005, and 12/31/2006. The Income Tax Audit Bureau of the Idaho State Tax Commission issued the Notice of Deficiency Determination (NODD) in this matter to Taxpayer on August 26, 2009. Taxpayer protested the NODD on October 28, 2009. Thereafter, an informal conference was held by phone on May 11, 2010, and in person on March 23, 2011. Taxpayer provided additional information in August 2011, October 2011, and February 2012. This matter is ready for a decision regarding the tax asserted.

FINDINGS OF FACT

According to selected portions of Taxpayer's 2006 Form 10-K filed with the Securities and Exchange Commission (SEC), Taxpayer is one of the leading [Redacted] companies in the United States. As of December 31, 2006, it operated [Redacted]. The [Redacted], and these joint ventures are accounted for using the equity method. In addition, Taxpayer [Redacted]. [Redacted] of these [Redacted] centers are joint ventures in which an affiliate of Taxpayer is a partner. These joint ventures are accounted for using the equity method. During the relevant taxable years, Taxpayer's facilities were located in [Redacted].

Taxpayer owns and operates [Redacted] in Idaho: [Redacted]. [Redacted] is located in [Redacted] and is considered to be a [Redacted] for eastern Idaho. It is the largest full service center in that region with [Redacted]. [Redacted]. Through [Redacted].

Taxpayer is committed to the communities in which it serves by providing high quality, [Redacted] while complying fully with its ethics policy, governmental regulations, governmental guidelines, and industry standards. As a part of this strategy, management focuses on the following principle elements:

- [Redacted]

Taxpayer describes its operations by stating that it currently owns, manages, or operates [Redacted] and various other facilities. In addition to providing capital resources, its affiliates provide a variety of management services to their [Redacted], including [Redacted].

During the initial audit, Taxpayer declined to complete a unitary and non-business income questionnaire. The audit was completed to a large extent by relying upon information in the 2006 Form 10-K filed with the SEC. Additional information has been provided since the initial audit.

ISSUES

Taxpayer protested several issues asserted in the audit, and upon conclusion of the audit, three other issues were specifically added. The protested issues include the following:

1. Whether an [Redacted], should be included in the combined group,
2. Whether [Redacted] should be included in the combined group,
3. Whether Taxpayer should be able to change the timing of the receipt of taxable income according to IRC Section 367,

4. Whether a property factor adjustment for [Redacted] based on the apportionment rules for a financial institution is appropriate,
5. Whether a sales factor adjustment for secondment receipts is necessary;
6. Whether [Redacted] is entitled to an addition modification adjustment for federal tax exempt interest, and
7. Whether penalties should be applied.

UNITARY PRINCIPLES, ALLOCATION FORMULA, AND BUSINESS INCOME

To understand several of the issues in this case, a brief explanation of unitary business principles and apportionment of business income is necessary. Prior to the advent of the unitary business concept in the early 1900s, most states generally determined the amount of income earned within their borders by applying separate accounting principles to each separate business entity. However, by the early part of the twentieth century, with the growing size and complexity of multistate businesses, the separate accounting method of measuring taxable income proved to be unsatisfactory. Because large corporations typically do business through networks of interlocking subsidiaries and divisions, enabling the enterprise to shift income, expenses, property, payroll, and sales among its various subsidiaries and divisions at will, the states sought a way to more accurately account for and tax the in-state income of these multistate (and often multi-entity) business enterprises.

1. Unitary Business Principles

To avoid the shifting of income, expenses, property, payroll, and sales among the entities at will, the Courts developed what has become known as the “unitary business” doctrine. The unitary business doctrine treats a group of commonly owned businesses as a single business for purposes of allocation and apportionment if the businesses are tied together operationally under constitutional standards developed in Supreme Court case law.[1] Additionally, Idaho Code section 63-3027(t) requires that 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.

If a corporate business is unitary, then all of the subsidiaries and divisions are lumped together, and the total income of the unitary business is allocated and apportioned to the various states in which the unitary business has activities, using the combined factors of the unitary business.[2] 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."[3]

Whether two or more business entities constitute a unitary business is a factual determination that has spawned considerable litigation over the years. A primary reason for this is that there is no clearly established definition of what constitutes a unitary business. Rather,

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[1] *See, e.g.,* Allied-Signal, Inc. v. Director, Division of Taxes, 504 U.S. 768, 781-783, 112 S.Ct. 2251, 2260-2261 (1992); Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 179-180, 103 S.Ct. 2933, 2947-2948 (1983).
[2] *See* Idaho Code § 63-3027(t); Container Corp. of America v. Franchise Tax Board, 463 U.S. 159 (1983).
[3] Allied-Signal, Inc. v. Director, Div. of Taxes, 504 U.S. 768, 783, 112 S.Ct. 2251, 2261 (1992) (citations and internal quotations omitted).

courts have articulated several different definitions or standards that can be used to determine whether a group of commonly owned businesses are engaged in a single unitary enterprise.

Idaho Income Tax Administrative Rule 341 identifies the judicially accepted unitary tests. These are commonly referred to as the "three unities" test,[4] the "contribution – dependency" test,[5] and the "factors of profitability" test.[6] Unity can be established under any one (1) of the judicially acceptable tests and cannot be denied merely because another of those tests does not simultaneously apply.[7] Additionally, Idaho's Income Tax Administrative Rule 343 identifies three types of indicators of a unitary business: business activities that are in the same general line of business, business activities that are part of different steps in a vertically structured business, and business activities where there exists strong centralized management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing.[8]

Under the "three unities test," a business is unitary where there exists "(1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use in its centralized executive force and general system of operations."[9] In Butler Brothers, the taxpayer operated a wholesale dry goods and general merchandising business, purchasing from manufacturers and selling only to retailers. The taxpayer set up several wholesale distributing houses throughout the United States, including one in California. Each of these wholesale distributing houses maintained its own set of books and accounted for its own sales. In addition, each distributing house incurred direct

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[4] Butler Brothers v. McColgan, 111 P.2d 334, 336 (Cal. 1941).
[5] Edison California Stores, Inc. v. McColgan, 183 P.2d 16 (Cal. 1947).
[6] Mobil Oil Corp. v. Com'r of Taxes, 445 U.S. 425 (1980).
[7] Idaho Income Tax Administrative Rule 341.01, IDAPA 35.01.01.341.01 (2010)
[8] Idaho Income Tax Administrative Rule 343, IDAPA 35.01.01.343 (2005).
[9] Butler Brothers v. McColgan, 111 P.2d 334, 341 (Cal. 1941).

operating expenses which were charged against income; and each distributing house also claimed indirect expenses relating to the overall business enterprise such as executives' salaries, corporate overhead, and centralized advertising. These indirect expenses were allocated among the various distributing houses in accordance with recognized accounting principles. The taxpayer claimed it suffered an operating loss from its activities in California, even though the corporation recognized an overall profit by implementing this "separate accounting" approach. The California taxing authority denied the separate accounting approach and implemented an apportionment formula because the taxpayer's business was unitary.[10] The California Supreme Court upheld the apportionment method employed by the Franchise Tax Commissioner. In doing so, the California Supreme Court held that Butler Brothers was engaged in a single unitary business. Factors relied upon by the California Supreme Court to support its finding of unity were the presence of unity of ownership, unity of operation, and unity of use. These factors have since become known as the "three unities" test. While not expressly embracing the "three unities" test employed by the California Supreme Court, the U.S. Supreme Court went on to uphold the lower court's finding that Butler Brothers was engaged in a unitary business.[11]

Unity may also exist where 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…"[12] This test derived from the Edison case is known as the "contribution – dependency" test. In Edison, the taxpayer operated a chain of separately incorporated shoe stores nationwide. One subsidiary operated stores in California. The court found the fact that the taxpayer arranged the business through separate corporations rather than controlled branches was immaterial. Under

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[10] Butler Brothers v. McColgan, 111 P.2d 334, 336 (Cal. 1941).
[11] Butler Brothers v. McColgan, 315 U.S. 501, 62 S.Ct. 701 (1942).
[12] Edison California Stores, Inc. v. McColgan, 183 P.2d 16, 21 (Cal. 1947).

this test, if the businesses do not exhibit dependency or contribution, then businesses will be considered separate.[13] The Idaho Supreme Court cited this test with approval.[14]

Finally, unity may be found where the business exhibits "factors of profitability."[15] In Mobil Oil, Vermont asserted that dividends received by Mobil Oil from certain of its wholly or majority owned subsidiaries should be included as business income, a portion of which was attributable to the state of Vermont based on a statutory apportionment formula. In response, Mobil Oil pointed out that none of these subsidiaries conducted any business activity within Vermont. Thus, Mobil Oil employed a separate accounting which excluded the dividend income derived from business activities unrelated to Mobil Oil Corporation's Vermont activities. In rejecting Mobil Oil's argument and holding that the dividend income could constitutionally be included in the Vermont pre-apportionment tax base, the U.S. Supreme Court found that Mobil Oil had failed to establish that the subsidiaries in question were not part of its unitary petroleum operations. The Court opined that "separate accounting, while it purports to isolate portions of income received in various states, may fail to account for contributions to income resulting from functional integration, centralization of management, and economies of scale."[16] The Court then went on to state that "[b]ecause these factors of profitability [functional integration, centralized management, and economies of scale] arise from the operation of the business as a whole, it becomes misleading to characterize the income of the business as having a single identifiable 'source.' Although separate geographical accounting may be useful for internal auditing, for purposes of state taxation it is not constitutionally required."[17]

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[13] *See* Edison, 183 P.2d at 21.
[14] *See* Albertson's Inc. v. State, Dept. of Rev., 106 Idaho 810, 815 - 816, 683 P.2d 846, 851 - 852 (1984).
[15] Mobil Oil Corp. v. Com'r of Taxes of Vermont, 445 U.S. 425, 100 S.Ct. 1223 (1980).
[16] Id. at 438, 100 S.Ct. at 1232.
[17] Id.

The Mobil Oil "factors of profitability" has been cited with approval in subsequent U.S. Supreme Court cases as one permissible method of identifying a unitary business.[18] However, in Container Corp. of America v. Franchise Tax Bd., the Court made it clear that the overarching inquiry in determining whether two or more enterprises are engaged in a unitary business is the existence of a "sharing or exchange of value not capable of precise identification or measurement – beyond the mere flow of funds arising out of a passive investment or a distinct business operation – which renders formula apportionment a reasonable method of taxation."[19] Thus, a unitary business is not a passive investment and is not a distinct business operation. Where the facts and circumstances establish an interrelationship or flow of values that goes beyond a mere passive investment or a distinct business operation, it is likely that a unitary relationship exists.

There is no bright-line test that can be employed in determining whether two or more business entities are engaged in a unitary business. Even within the different unity tests, there is an unmistakable level of subjectivity. A decision maker will be presented with various facts that may weigh for or against a finding of unity. In many cases, reasonable people can disagree whether the weight of the evidence tips the scales in one direction or the other.[20] In spite of its problems and shortcomings, the unitary business principle is the backbone of modern state corporate income tax law. Formula apportionment, such as is required by Idaho Code § 63-3027, would not be possible absent the advent and development of the unitary business principle.[21]

i. Taxpayer Burden of Proof and Presumption of Unity

For constitutional purposes, the U.S. Supreme Court has consistently held that the burden is on Taxpayer to show that there is no unitary relationship between a parent and its subsidiary.

[18] *See, e.g.,* F.W. Woolworth Co. v. Taxation & Revenue, 458 U.S. 354, 364 - 370, 102 S.Ct. 3128, 3135 - 3138 (1982).
[19] Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 166, 103 S.Ct. 2933, 2940 (1983).
[20] Allied-Signal, Inc. v. Director, Division of Taxes, 504 U.S. 768, 785, 112 S.Ct. 2251, 2262 (1992).
[21] *See* Mobil Oil Corp. v. Com'r of Taxes of Vermont, 445 U.S. 425, 439, 100 S.Ct. 1223, 1232 (1980).

The state, in making a unitary finding, is simply attempting to tax income derived from activities of a unitary business carried on outside its borders.[22] In the present administrative protest, the burden is on Taxpayer to disprove the Commission's finding of a unitary business.

In addition to the general burden of proof that falls on a Taxpayer when contesting a finding of unity, there is an added "presumption" of unity that must be overcome in certain circumstances. Idaho's rules establish a presumption of unity upon a finding that Taxpayer is (1) engaged in the same type of business as the parent; (2) is part of a vertically integrated business enterprise; or (3) is a member of a group of corporations that has strong centralized management. More specifically, Idaho Income Tax Administrative Rule 340.02, as it existed for the years in question, provided as follows:

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

[22] *See, e.g.*, Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207, 223, 100 S.Ct. 2109, 2120 (1980); Mobil Oil Corp. v. Com'r of Taxes, 445 U.S. 425, 439, 100 S.Ct. 1223, 1232 (1980).

> officers are normally involved in the operations of the divisions or affiliates and centralized offices perform the normal matters for the divisions or affiliates that a truly independent business would perform for itself, such as accounting, personnel, insurance, legal, purchasing, advertising, or financing.[23]

A finding of unity can be made even where none of these three presumptions are present. The presumptions set out in the Idaho administrative rule are rebuttable. Taxpayer may still prove lack of unity even if one of the presumptions is met. However, as a general matter, a finding of unity will likely be upheld where one of the presumptions is met.

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

> Appellant also argues that the state court erred in endorsing an administrative presumption that corporations engaged in the same line of business are unitary. This presumption affected the state court's reasoning, but only as one element among many. Moreover, considering the limited use to which it was put, we find the "presumption" . . . to be reasonable. . . . When a corporation invests in a subsidiary that engages in the same line of work as itself, it becomes much more likely that one function of the investment is to make better use – either through economies of scale or through operational integration or sharing of expertise – of the parent's existing business-related resources.[24]

In effect, the U.S. Supreme Court recognizes that the use of an administrative presumption, if reasonable on its face and supported by other evidence of unity, is a useful tool in making the unitary determination.

2. Business and Nonbusiness 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

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[23] IDAPA 35.01.01.340.02. (2004).
[24] Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 178, 103 S.Ct. 2933, 2947 (1983).

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. [25]

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 the Uniform Division of Income for Tax Purposes Act (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 taxpayer's property located in Idaho by its property located everywhere. Idaho Code § 63-3027(k). Likewise, the payroll factor is calculated by dividing the taxpayer'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). This three-factor apportionment formula approximates the extent of the business activity in a given state.[26]

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[25] 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).
[26] *See generally*, Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159, 164-169 (1983).

Under Idaho's statutes and rules, business income means income that meets either the "transactional test" or the "functional test."[27] All other income that does not meet either test is nonbusiness income. Labels used by the taxpayer or others to characterize income (i.e., sales income, interest, rents, dividends, etc.) are of no use in analyzing whether income is business or nonbusiness.

The "transactional test" includes "income arising from transactions and activity in the regular course of Taxpayer's trade or business."[28]

The "functional test" means "income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitute integral or necessary parts of Taxpayer's trade or business operations."[29] In other words, the functional test is concerned with income derived from property that is utilized in or otherwise directly connected with taxpayer's trade or business operations. There is no requirement under the functional test that the income arise from transactions and activities in the regular course of Taxpayer's trade or business.[30] The key determination is whether the acquisition, management, or disposition of the property was directly connected with Taxpayer's business operations.[31] Under the functional test, property that is not directly connected to Taxpayer's trade or business operations, such as passive investment property, does not generate business income. As pointed out in American Smelting:

> 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 taxpayer's trade or business. The incidental benefits from investments in general,

[27] Union Pacific Corp. v. Idaho State Tax Comm'n, 136 Idaho 34, 38, 28 P.3d 375, 380 (2001).
[28] Id.
[29] Id. at 39, 28 P.3d at 380.
[30] Id.
[31] American Smelting and Refining C. v. Idaho State Tax Comm'n, 99 Idaho 924, 931, 592 P.2d 39, 46 (1979) ("business income includes . . . income from tangible and intangible property if that property has the requisite connection with the corporation's trade or business."). (Reversed on other grounds.) Idaho Income Tax Administrative Rule 333.01.

> 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 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 taxpayer's business operations.[32]

Thus, the important distinction under the functional test is whether the property was directly connected with and an integral part of Taxpayer's business activity or whether it was merely a passive investment.

[32] Id. at 933, 592 P.2d at 48.

ANALYSIS

I. INCLUSION OF [Redacted] IN THE COMBINED GROUP IS APPROPRIATE.

Taxpayer presented numerous issues relating to the inclusion of its [Redacted] in the unitary combined group.

[Redacted] was acquired in a series of mergers with [Redacted]. [Redacted]. It files annual reports to the Secretary of State of [Redacted]. The annual reports filed with [Redacted] shares its principal address with Taxpayer.

[Redacted] distinguishes itself as a [Redacted]."[33] Additionally, [Redacted]."[34]

It is undisputed [Redacted] for parties related to Taxpayer. [Redacted].[35]

1. [Redacted] is Unitary with Taxpayer

In its protest letter, Taxpayer asserted [Redacted] that is not part of the unitary group. As evidence for this, Taxpayer stated the following:

> [Redacted] is required to file Annual Statements with state departments of insurance, contract with actuaries, maintain restricted investments in stocks and bonds from which to pay claims, and must determine the selection and pricing of risks to be insured. [Redacted] maintains its own books and records. [Redacted] has its own directors, officers and employees, and separate payroll. Its employees, approximately [Redacted].[36]

Additionally, Taxpayer contends that regulatory controls specific to [Redacted] is unitary with Taxpayer. These regulatory controls require [Redacted] set aside investment assets sufficient to meet its reserves and thus restrict a "flow of funds" between [Redacted] and Taxpayer.

As discussed above, whether a subsidiary is included in the combined group depends on whether the subsidiary is unitary. The unitary analysis for the subsidiary uses the same three

33 [Redacted]
[34] Id.
[35] Protest Letter dated October 28, 2009, p. 2.
[36] Id. p. 3.

principles discussed above: the three unities test, the contribution – dependency test, and the factors of profitability test. Taxpayer and its insurance subsidiary demonstrate several of the principles indicating unity, including, but not limited to, the contribution and dependency test, and the factors of profitability test identified above.[37]

From the facts presented, it is clear Taxpayer and [Redacted] meet the contribution and dependency test. [Redacted]. Taxpayer is dependent on its [Redacted] purposes. The [Redacted] is dependent on Taxpayer to stay in business. The only examples of non-related parties that it [Redacted] that were prior subsidiaries spun off from Taxpayer. These parties would not be considered unrelated for any other business purposes.

Additionally, the facts show many factors of profitability including strong centralized management, elements of functional integration, and strong economies of scale. [Redacted] and Taxpayer share office space at their headquarters. There are a large number of intercompany transactions [Redacted] and Taxpayer. Taxpayer wholly owns [Redacted]. Taxpayer's management principles of leveraging its scale and its leading market position greatly contribute to [Redacted] overall success. Significant sales between the [Redacted] subsidiary and Taxpayer and affiliates show functional integration. In addition to these unitary characteristics, there also is a significant flow of value between [Redacted] and Taxpayer. By providing [Redacted] to Taxpayer's affiliates, [Redacted] helps control one of the largest and fastest growing [Redacted]. In turn, [Redacted] benefits from the large pool of business customers affiliated with or related to Taxpayer.

Taxpayer claimed [Redacted] is subjected to strict regulations specific to [Redacted] which preclude a unitary finding in spite of facts tending to show unity. While it is possible that [Redacted] regulations may affect unitary characteristics between a parent and subsidiary, a

[37] See, Idaho Income Tax Administrative Rules 340 through 344.

possible regulatory reason to act or not act in a unitary manner does not change the fact that Taxpayer benefits from the unitary relationship with [Redacted]. Taxpayer states that there is not a continuous flow of "funds" to [Redacted]. A flow of funds is not required to be unitary. As discussed above, there exists a continuous flow of value between Taxpayer and [Redacted]. By providing [Redacted] to Taxpayer's affiliates, [Redacted] helps control one of the largest and fastest growing costs in the [Redacted]. In turn, [Redacted] benefits from a large pool of business customers. Therefore, in this case, the [Redacted] will not control the unitary relationship between [Redacted] and Taxpayer.

The facts and circumstances in this case show a strong unitary relationship between Taxpayer and [Redacted]. Indeed, Taxpayer conceded in its protest letter that some unitary characteristics exist such as common ownership and centralized management.[38] For these reasons, audit appropriately determined that [Redacted] is unitary with Taxpayer.

2. Premium Tax Payment Made by Affiliates

Idaho Code § 41-402 requires authorized insurance providers to pay a premium tax with respect to gross direct premiums. Unauthorized insurance providers are not required to pay this tax. In the case of unauthorized insurance providers, Idaho Code §§ 41-1229 and 41-1233 imposes a premium tax on the broker or on the insured. During the taxable years at issue, the premium tax on authorized insurance providers varied from 2.75 percent for year 2004, 2.5 percent for year 2005, and 2.3 percent for year 2006.[39] The rate imposed on the insured for premiums issued by unauthorized insurance providers was 2.75 percent for all relevant taxable years.

[38] Id. p. 6.
[39] Idaho Code § 41-402(2).

[Redacted] provider in Idaho by choice. [Redacted].[40] Administratively, Taxpayer believes becoming an authorized insurance provider is more burdensome than operating in Idaho as an unauthorized provider.[41] Additionally, as an [Redacted] provider, [Redacted] is not directly responsible for paying the premium tax, thereby reducing [Redacted] costs. Rather, the [Redacted] in Idaho. Taxpayer admits [Redacted] did not pay the Idaho premium taxes. Instead, Taxpayer provided documents evidencing that the [Redacted] taxes were paid by or through its affiliates. Taxpayer argues that the payment by the affiliates (either an insured party or a broker) of the [Redacted] to Idaho is analogous to [Redacted] paying the [Redacted] tax. The applicable insurance provision in Idaho law reads as follows:

> **Idaho Code 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.

Idaho Code § 41-405 exempts a subsidiary insurance company's income from being included in the combined unitary group if that insurance company paid the Idaho premium tax. Idaho Code § 41-405 does not contemplate including affiliates (the insured and brokers) within that exemption. The exemption is specific to the "insurer." Similarly, it would be inappropriate to attribute the premiums paid by the affiliates because they are related parties. Each corporate identity must be honored. This is consistent with Idaho Income Tax Administrative Rule 365, Use of the Combined Report, which states in Subsection 365.01 the following:

> **01. In General.** Use of the combined report does not disregard the separate corporate identities of the members of the unitary group.

[40] Protest Letter Dated October 28, 2009, p.
[41] Id. at p. 5.

In conjunction with this argument, Taxpayer points to AIA Services Corp. v. Idaho State Tax Commission, 136 Idaho 184, 20 P.3d 962 (2001) to argue that [Redacted] income should not be included in the combined return. However, in that case, AIA directly paid premium taxes to Idaho and sought to have its insurance subsidiary included in the combined group. That case points out that the Commission's policy of including subsidiaries who do not pay the premium tax does not necessarily favor those affiliates that pay the premium tax and are otherwise excluded from the combined group. Taxpayer in this case does not pay any premium taxes to Idaho. AIA is differentiated on its facts from this matter.

Taxpayer also questions the constitutionality of including insurance companies that are not paying the Idaho premium tax while excluding companies that pay the Idaho premium tax. The argument is based upon the commerce clause. The Tax Commission previously addressed this argument in the decisions for Docket Nos. 18612 and 18147 and found no constitutional violation. To the extent applicable, the Tax Commission relies on those decisions for support of its position on this issue.

3. Alternative Apportionment for [Redacted] is Inappropriate

Taxpayer argued in the alternative, if [Redacted] is ultimately found to be unitary, then an alternative apportionment specific to [Redacted] income is appropriate. To support its position, Taxpayer asserted three possible alternative apportionment mechanisms: 1) apply the apportionment rules applicable to financial institutions, 2) include [Redacted] investment assets in the property factor, or 3) allow for the inclusion in the sales factor of gross proceeds on the sale of investments. The Tax Commission does not find any of those adjustments to have merit.

Taxpayer wants the individual subsidiary to be separated for audit purposes from the combined group and apply the financial apportionment rules. From the facts presented by

Taxpayer, the financial rules would not apply. Application of the financial rules in this case would most likely serve only to dilute the factors and result in further distortion.

Taxpayer did not offer any support for including [Redacted] investment assets in the property factor. Thus, the Commission finds Taxpayer did not meet its burden of proof and such adjustments will not be made.

Taxpayer also seeks to include the gross receipts of [Redacted] in the sales factor. For any taxpayer, gross receipts do not include return of principal. Idaho Income Tax Administrative Rule 325.07.a.i. states that gross receipts do not include repayment, maturity, or redemption of the principal of a loan, bond, or mutual fund or certificate of deposit or similar marketable instrument. Therefore, the gross receipts from the sales and trading of the insurance company investments, which are maintained as reserves for the risks it insures, are not included in the sales factor denominator. Including the gross receipts of [Redacted] in the sales factor could create a distortion and is not appropriate.

Additionally, Rule 570.03 reads "If a taxpayer holds liquid assets in connection with one or more treasury functions of the taxpayer, and the liquid assets produce business income when sold, exchanged or otherwise disposed, the overall net gain from those transactions for each treasury function for the tax period is included in the sales factor." [Redacted] holds liquid assets to provide a reserve for business contingencies and as required for the issuance of insurance policies. The net gain from these liquid assets has been included in the sales factor as required by Rule 570.03.

There is a very strong presumption in favor of using the normal three-factor apportionment and against the applicability of alternative apportionment.[42] Taxpayer bears the

[42] 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).

burden of proof to show including [Redacted] in the combined group does not fairly represent its business activity in Idaho or that the factors need to be computed using an alternate method. Taxpayer did not meet this burden.

4. Intercompany Transactions

Taxpayer argues that in the event the income of its insurance subsidiary is included in its combined return, its income should be eliminated as intercompany transactions according to Rule 600.04. Idaho Income Tax Administrative Rule 600.04 discusses intercompany transactions in the case of a combined report. It provides the following:

> **600. ENTITIES INCLUDED IN A COMBINED REPORT (RULE 600).** Section 63-3027(t), Idaho Code.
>
> …
>
> **04.** Intercompany Transactions. If a return is filed on a combined basis, the intercompany transactions shall be eliminated to the extent necessary to properly reflect combined income and to properly compute the apportionment factor.

In this audit, intercompany transactions were properly eliminated as shown by schedule 1850.

5. Business and Nonbusiness Income Analysis

In the event that [Redacted] is deemed unitary, Taxpayer argued alternatively that any income from [Redacted] should be deemed nonbusiness because insurance regulations require [Redacted] investment assets be kept separate from all other investment asset groups of Taxpayer.

Generally, all activities of a taxpayer that contribute to or depend on the operation of the taxpayer's unitary business will be considered business income because these activities constitute an integral part of the taxpayer's unitary business. Also, as discussed above, business income means income that meets either the "transactional test" or the "functional test."[43] All other income that does not meet either test is nonbusiness income.

[43] Union Pacific Corp. v. Idaho State Tax Comm'n, 136 Idaho 34, 38, 28 P.3d 375, 380 (2001).

[Redacted] income meets the requirements under the functional test and is appropriately classified as business income. The subsidiary is unitary with Taxpayer, and no plausible argument has been presented otherwise. [Redacted] activities contribute to Taxpayer's overall business activities and are interdependent with Taxpayer. [Redacted] primarily insures Taxpayer's subsidiaries and affiliates. Taxpayer is dependent on [Redacted] for insurance purposes. [Redacted] is dependent on Taxpayer to stay in business. The only examples of non-related parties that [Redacted] [Redacted] that were prior subsidiaries spun off from Taxpayer. Moreover, Taxpayer labeled [Redacted] as unitary on its worksheets and included it in the Idaho combined group for 2004 and 2005. The audit disallows the inclusion of [Redacted] gross receipts from investing activities in the denominator. From these facts, it is apparent [Redacted] is functionally integrated with Taxpayer because it is highly connected with Taxpayer and is an integral part of the Taxpayer's business activity. Thus, audit correctly classified [Redacted] income as business income.

II. [Redacted] **ARE UNITARY GROUP WITH TAXPAYER.**

Taxpayer requests that [Redacted] not be included in the combined group. These companies are all referred to as "[Redacted]" in the protest and will be referred to as the [Redacted] operations hereafter. Taxpayer included the [Redacted] operations in the Idaho unitary group beginning in 1994 when Taxpayer merged with [Redacted]. On its 1994 Idaho return, Taxpayer (then [Redacted]) filed using the combined method and included the [Redacted] claiming instant unity. A number of companies were excluded, so consideration was given to the attributes of unity, and Taxpayer determined the [Redacted]operations were unitary.

During the current audit cycle, audit issued a questionnaire addressing the subject of unity to Taxpayer during the field work, and reissued it by mail on June 11, 2008, but no response was received. For the relevant taxable years, Taxpayer made a simple change in its ownership structure by creating a new corporation and transferring the assets from an LLC to a corporation prior to the sale. One of the purposes of the change in ownership was to facilitate the sale. The LLC that held the [Redacted] operations was a disregarded entity and included in the consolidated [Redacted].

Taxpayer included the [Redacted] operations in their everywhere denominators for the entire time they were owned by Taxpayer. Taxpayer benefitted from a lower amount of state income tax in Idaho because of that treatment.

1. Facts Showing Unity for [Redacted]**Operations**

Idaho Code § 63-3027 and Idaho Income Tax Administrative Rules 340-344 define the principles of a combined group for income tax reporting and the principles for determining the existence of a unitary business. The [Redacted] subsidiaries meet all of the principles listed and several others. There are numerous indicators of unity. The 2006 Form 10-K filed with the [Redacted] operations as part of the [Redacted] group that Taxpayer operates. Taxpayer claims to provide a variety of management services to the [Redacted] operations' [Redacted] services.

The protest confirmed some of the aforementioned shared services such as auditing, Taxpayer's worldwide ethics manual, and construction planning. The protest also concedes [Redacted] employees take part in Taxpayer's stock options plan and that [Redacted] makes monthly reports to Taxpayer's other unitary affiliates. The protest acknowledged that [Redacted] received intercompany loans from Taxpayer affiliates in the past. As of November 2006, there were still outstanding loans to [Redacted] from Taxpayer's affiliates.

On page 32 of Taxpayer's 2006 Form 10-K, the properties of Taxpayer are listed. Included in this list are the [Redacted] operations. This page also notes that the headquarters of the unitary group are in one location in [Redacted]. On page 30 of Taxpayer's 10-Q for quarters ended September 30, 2006, and 2007, it is noted that "During the third quarter of 2007, we [Taxpayer] recognized gains on sales of facilities of $[Redacted], which included a gain of $[Redacted] on the sale of our [Redacted]."

The facts indicate that [Redacted] is unitary with Taxpayer. Taxpayer had more than 50 percent ownership in the [Redacted] operations. They are both in the same industry with the same operations. The [Redacted] were included in the consolidated federal returns for the entire time Taxpayer filed in Idaho. Taxpayer included the [Redacted] in their everywhere denominators for the entire time they were owned by Taxpayer and benefitted from a lower amount of Idaho state income tax. Taxpayer maintains one central headquarters in [Redacted]. Authority is delegated to local management, but ultimately all management decisions are made by Taxpayer's Board of Directors and the senior management in [Redacted]. The 2004 quality control award received for a system-wide quality control policy included the [Redacted]. Employment benefits and policies were system wide and included the [Redacted].

Taxpayer amended their returns months after the sale of the [Redacted] attempting to claim that Taxpayer and [Redacted] were not unitary. Unfortunately for Taxpayer, this transaction does not dictate whether unity exists, but instead, the clear history, including Taxpayer's own filings and records, prior to the transaction indicated that a unitary relationship existed.

III. IRC SECTION 367 GAIN

IRC Section 351 allows for the transfer of assets in exchange for stock in a fully controlled domestic corporation. Under this section, any gain realized on the appreciation of the asset value is deferred and the basis of the stock is established by the asset value. IRC § 367 is a special rule for outbound transfers of domestic assets for stock in a foreign corporation. Under IRC § 367, the gain is deferrable until a sale to an unrelated third party if it is held for at least 60 months. The transferor is required to file federal Form 8838 and must agree to report the gain and interest as of the date of the transfer, if the 60 month holding period is not met.

The enactment of IRC § 367 sought to counter a practice of multinational corporations taking advantage of the tax deferral of IRC § 351. IRC § 351 provides that the transfer of property by any person to a corporation for stock is not immediately taxable if, after the transaction, the transferor controls the corporation. Prior to the enactment of IRC § 367, domestic corporations were able to transfer assets to a foreign corporation in a non-taxable transaction. If the foreign corporation subsequently was sold, any gain was outside the reach of the IRS and thus defeated the spirit of IRC § 351. IRC § 367 required the transferring corporation to hold the stock received for a period of 60 months. If the acquired stock or assets were sold to a third party during the 60 month holding period, the realized gain was to be recognized <u>as of the date of sale or transfer</u> with interest from that date. Additionally, in order to be eligible to receive the non-taxable treatment under IRC § 351, the transferor must sign an agreement extending the statute of limitations for that issue only.

Taxpayer operated the [Redacted] since acquired in the 1994 merger with [Redacted]. [Redacted]. Effective January 1, 2006, [Redacted] elected to be treated as a separate corporation for federal income tax purposes. The effect of the election was that [Redacted] was treated as contributing the stock of [Redacted].

Taxpayer sold the new holding company in July 2007 (less than 60 months from the sale) thereby triggering the gain recognition under IRC § 367. Consequently, Taxpayer was compelled to amend its 2006 federal Form 1120 to reflect the realized gain in its federal taxable income. Taxpayer filed the amendment in December 2007. This amendment changed its 2006 tax liability to reflect the gain that otherwise would have been realized in that year. Thus, for tax purposes, Taxpayer realized and recognized the gain from the sale of the holding company in its taxable year for 2006.

Idaho conforms to IRC § 367 absent any statutory authority to the contrary. IRC section 367 is intended to prevent U.S. persons from avoiding U.S. tax by transferring appreciated property to a foreign corporation in a tax-free organization or reorganization and then selling the appreciated property to an unrelated party outside the tax jurisdiction of the United States. There is no Idaho statutory authority to reverse these transactions when computing Idaho taxable income. Taxpayer failed to hold the companies for the required time period and must report the gain.

1. Intercompany Dividends

Idaho Income Tax Administrative Rule 600.04 discusses intercompany transactions in the case of a combined report. It provides the following:

> **600. ENTITIES INCLUDED IN A COMBINED REPORT (RULE 600).** Section 63-3027(t), Idaho Code.
>
> …
>
> **04. Intercompany Transactions.** If a return is filed on a combined basis, the intercompany transactions shall be eliminated to the extent necessary to properly reflect combined income and to properly compute the apportionment factor.

The gain required to be recognized by IRC § 367 does not qualify for an intercompany elimination. The gain is required to be recognized because the stock was sold to an unrelated third party within five years of its original transfer to a related foreign corporation. Using intercompany eliminations as a means to exclude the gain from taxable income would effectively disregard the purpose of IRC § 367, which Idaho conforms to. As a result, the gain should not be deducted in computing Idaho taxable income.

This audit accounted for all intercompany dividends under IRC section 1248. If any other intercompany dividends existed, Taxpayer failed to provide any documentation to support this contention.

2. Business Income

Taxpayer suggests that the gain on the sale of the [Redacted] operations is nonbusiness income subject to allocation. Taxpayer did not make this claim on its 2006 amended Idaho Corporation Income Tax Return.

The gain from the sale of the [Redacted] operations will be treated as business income if the elements of the functional or transactional test are met. As discussed in greater detail above, the key determination under the functional test is whether the acquisition, management, or disposition of the property was directly connected with an integral part of a taxpayer's business operations.[44] The sale of a subsidiary which was previously included in a taxpayer's unitary group will meet the requirements of the functional test because the acquisition and management is directly connected with an integral part of a taxpayer's business operations.[45]

Prior to the sale, the [Redacted] operations were included in Taxpayer's unitary group by Taxpayer. As discussed above, the Commission believes the [Redacted] operations were appropriately included in the unitary group. As part of the unitary group, the acquisition and management of the [Redacted] operations constituted an integral part of Taxpayer's business activities. The disposition of the [Redacted] operations which were previously part of Taxpayer's unitary group meets the requirements under the functional test in determining business income

[44] American Smelting and Refining C. v. Idaho State Tax Comm'n, 99 Idaho 924, 931, 592 P.2d 39, 46 (1979) ("business income includes . . . income from tangible and intangible property if that property has the requisite connection with the corporation's trade or business."). (Reversed on other grounds.)
[45] Idaho Income Tax Administrative Rules 333 and 331.

because the acquisition and management of the [Redacted] operations was directly connected with and an integral part of Taxpayer's business operations.

IV. PROPERTY FACTOR ADJUSTMENT FOR A FINANCIAL INSTITUTION

Taxpayer presented proposed adjustments to the audited Idaho property factor to include the loan balances of [Redacted] financing entity [Redacted] consistent with Idaho Code § 63-3027(s). [Redacted] provides operating loans to [Redacted]. When a [Redacted] receives payments from operations in excess of the loans provided by [Redacted], that money is swept out of the subsidiary and into [Redacted]. Taxpayer seeks to include its accounts receivable balances in the property factor denominator similar to the method allowed in special industry rules applicable to financial institutions. Adjusting everywhere property as suggested by Taxpayer results in a reduction of over half of the taxes asserted in the NODD. The Commission does not find that these adjustments have merit.

The Idaho Income Tax Rule 582.04 defines "financial institution" to mean the following:

> **02. Definition of Financial Institution**. For purposes of Section 2(h) of the "Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions" the term financial institution means a person that predominantly deals in money or moneyed capital in substantial competition with the business of national banks.

[Redacted] will not be treated as a financial institution unless Taxpayer can prove by clear and convincing evidence that the income-producing activity of [Redacted] is in substantial competition with banks and other lending institutions.

"In substantial competition" is defined under Idaho Income Tax Rule 582.04.d. to include the following:

> **d.** In substantial competition means that a corporation and national banks both engage in seeking and securing in the same locality capital investment of the same class which are substantial in amount, even though the terms and conditions of the business transactions of the same class are not identical.

It is not apparent from the facts presented by Taxpayer whether more than 50 percent of [Redacted] income producing activity is in substantial competition with banks and other lending institutions. The only business [Redacted] does is intercompany. Therefore, Taxpayer cannot say that it is competing with banks and other lending institutions.

For these reasons, the special rules for "financial institutions" do not apply to [Redacted]. Application of the financial rules, in this case, would serve only to dilute the factors and result in further distortion.

V. SALES FACTOR ADJUSTMENT FOR SECONDMENT RECEIPTS

Taxpayer explained that for the periods at issue, it included certain fees earned under an employee leasing agreement in federal taxable income apportioned to Idaho. These fees are known as "secondment receipts." Taxpayer claims that it mistakenly omitted everywhere secondment receipts from the calculation of its Idaho sales factor for tax periods 12/04, 12/05, and 12/06. Taxpayer believes its sales factor for 12/04, 12/05 and 12/06 should be adjusted to include secondment receipts pursuant to Idaho Code section 63-3027. Taxpayer requests over $3 billion dollar adjustments for additional secondment receipts for each of these periods.

Taxpayer argues that it constructively operates a number of hospitals and other medical care facilities through partnership interests. As part of the overall structure, Taxpayer's subsidiary enters an Employee Leasing Agreement (ELA) with that partnership. Under the agreement, all former employees of a hospital or medical facility become employees of Taxpayer's subsidiary but perform all employment responsibilities on behalf of the partnership. The ELA provides that Taxpayer's subsidiary shall lease and furnish to the partnership all former employees of the facility. The agreement states that the employees "shall perform as employees of the corporation (Taxpayer's subsidiary) but on behalf of the partnership…" The partnership pays Taxpayer's subsidiary a fee under the ELA (secondment receipts) for certain enumerated services which amount to a dollar for dollar cost. Section 3 of the ELA provides:

> … Partnership shall pay (Taxpayer subsidiary), as consideration for the leasing of the employees to Partnership during each employee Group Pay Period, an amount equal to (Taxpayer's subsidiairy) Actual Payroll Costs (as hereinafter defined) and all other costs and expenses incurred by (Taxpayer's subsidiary) in performing its duties hereunder.

Employees are employed by Taxpayer's subsidiary to provide the ability for the employees to participate in all of Taxpayer's benefit plans. The employees participate in benefit plans at significantly reduced rates because of Taxpayer's vast purchasing power. If the employees were employees of the partnership, they could not contribute to various employee stock purchase plans, etc. Similarly, the partnership receives significant benefit because the employee costs are dollar for dollar.

Secondment receipts derived from ELAs are included in Taxpayer's subsidiary's federal taxable income and Idaho apportioned income. However, no secondment receipts were included in Taxpayer's combined unitary group's Idaho sales apportionment factor on the original tax returns. Accordingly, Taxpayer wishes to adjust its sales apportionment factors for 12/04, 12/05, and 12/06 to include the appropriate amount of secondment receipts.

Taxpayer did not provide any support for this issue other than a self-created description of its operating policy. Taxpayer describes a partnership structure, but did not name any particular partnership. The implication is that this is the uniform business practice adopted by the Taxpayer's management in order to operate the numerous LLCs, partnerships, and disregarded entities that are already in the unitary group. The dollar amounts are referenced as coming from "Federal 1120, Line 26, other deductions: reimbursed expenses". The definition of gross receipts does not include amounts for reimbursed expenses.

The auditors were provided limited information during this audit. Taxpayer provided additional information after the informal hearing. The information provided by Taxpayer merely demonstrates that secondment receipts are intercompany transactions, which if true, should be eliminated. Therefore, Taxpayer failed to meet its burden to justify an adjustment to account for these secondment receipts.

VI. ADJUSTMENT FOR FEDERAL TAX EXEMPT INCOME

Under IRC § 103, interest from state and local bonds are not included in federal taxable income. This interest is commonly referred to as "federal tax exempt interest." Idaho law uses federal taxable income as the starting point for calculating Idaho taxable income. This is subject to Idaho modification.[46] One such modification is contained in Idaho Code § 63-3022M which requires taxpayers to adjust taxable income to add all federal tax exempt interest to their Idaho taxable income:

> **63-3022M. Expenses and interest relating to tax exempt income.** For taxable years commencing on and after January 1, 1999:
> (1) Add interest and dividends received or accrued during the taxable year from foreign securities and from securities issued by states and other political subdivisions exempt from federal income tax under the Internal Revenue Code, less applicable amortization.

Idaho Code § 63-3022M(3)(b) also permits taxpayers to remove from the Idaho taxable income calculation any interest received from the state of Idaho, its cities, and political subdivisions to the extent it is exempt from tax under the IRC. In essence, Idaho requires interest received from other states' bonds to be included in a taxpayer's taxable income while it permits interest received from Idaho to be excluded.

The NODD included the interest income received by Taxpayer and its subsidiaries attributable to federal tax exempt interest. Taxpayer asserted two arguments against this

[46] Idaho Code §§63-3002 & 63-3011C.

adjustment. First, Taxpayer argues this income should be excluded entirely because it violates the commerce clause of the United States Constitution. Secondly, Taxpayer argues if the interest income is included, it is entitled to a 15 percent adjustment to reflect a loss deduction limitation imposed on its [Redacted].

1. Constitutional Challenge of Including Federal Tax Exempt Interest in Idaho Taxable Income

Idaho's inclusion of interest income received by Taxpayer from bonds of other states does not violate the commerce clause. The U.S. Supreme Court addressed this specific issue in Department of Revenue of Ky. v. Davis.[47] There, the state of Kentucky included interest income received from out-of-state municipal bonds in the taxpayer's tax base. The Court opined, with reference to municipal bonds, states are appropriately characterized as private when participating in the investment market. States act as any other debtor and are subject to the same disabilities of other borrowers. However, states must also assume an additional role in setting taxes and generating revenues. These dual roles (regulating taxes and participating in the market by issuing bonds) go hand in hand.[48] When a state acts as a market participant and regulator, the analysis under the commerce clause requires exceptional treatment and falls outside the scrutiny of the dormant commerce clause where the direct governmental activity benefits the public.[49] Kentucky treated income from municipal bonds just like income received from any other private issuer. By choosing to give preference to its own bonds by exempting that income from taxation, the state engaged in a permissive marketing technique.[50] Idaho's treatment of the income from

[47] Department of Revenue of Ky. v. Davis, 553 U.S. 328, 128 S.Ct. 1801 (2008).
[48] Id. at 1812.
[49] Id. at 1814.
[50] Id. at 1815.

municipal bonds is strikingly similar to Kentucky's. Thus, the inclusion of the income from municipal bonds of other states does not violate the commerce clause.

2. Taxpayer's Proposed Adjustment for 15 percent Incurred Losses Deduction Limitation

Taxpayer argued if the federal tax exempt income is included, it is entitled to an adjustment to the Idaho addition to reflect the loss deduction limitation imposed by IRC § 832(b). In essence, Taxpayer asserts the loss deduction limitation calculation imposed on its insurance subsidiary, [Redacted], effectively requires 15 percent of the federal tax exempt income to be included in its tax base in calculating federal taxable income which should be reflected in calculating Idaho taxable income.

Insurance companies create income through both investments and underwriting. The Internal Revenue Code recognizes the potential for these companies to receive a windfall if permitted to not include interest from tax exempt sources in taxable income and receive a deduction for losses incurred. Under IRC § 832(b)(5), the losses incurred deduction is limited to the computation of attributable to underwriting income. The losses incurred deduction described in IRC § 832 must be reduced by 15 percent of the sum of 1) tax exempt interest received, 2) the aggregate of deductions provided for in IRC §§ 243, 244, and 245, and 3) the increase for the taxable year in policy cash values of certain policies. In this regard, the federal tax exempt interest is only used as an arithmetic figure to reduce the losses incurred deduction. It does not follow that such a mathematical calculation would displace the rule under IRC § 103 that such interest is exempt from inclusion in taxable income.

As discussed above, Idaho Code § 63-3022M requires Taxpayer to adjust its taxable income to include all federal tax exempt interest. Taxpayer's argument that 15 percent of the federal tax exempt interest was already included is not convincing. Thus, audit appropriately added 100 percent of the federal tax exempt interest into Taxpayer's taxable income.

Additionally, Taxpayer proposes to modify the addition to reflect the 15 percent losses incurred reduction. In order to modify the adjustment as requested by Taxpayer, it must be permitted by the Idaho Code. Idaho Code does not contain such a modification. A similar situation was decided by the Idaho Supreme Court in Potlatch Corp. v. Idaho State Tax Com'n, 128 Idaho 387, 389, 913 P.2d 1157, 1159 (Idaho, 1996). Therein, the court held the following:

> In Bogner, the Court found I.C. § 63-3022(1) to be dispositive because it referred to "itemized deductions as defined" in various sections of the Internal Revenue Code, without requiring that the deductions be "allowed" as provided in I.R.C. § 63. In the present case, there is no subsection of I.C. § 63-3022 comparable to I.C. § 63-3022(1) that would allow Potlatch and ESI to adjust their federal taxable income defined in I.R.C. 63 by deducting the ESOP contributions and R & D expenses which were not allowed by Chapter 1 of the Internal Revenue Code. (citing Bogner v. State Dep't of Revenue & Taxation, 107 Idaho 854, 693 P.2d 1056 (1984).) (emphasis added)

Just as in the Potlatch decision, the modification for federal exempt interest cannot be allowed in this audit because there is no Idaho modification allowing the additional loss deduction reduction required by IRC section 832(b)(5)(B). Therefore, the inclusion of the federal tax exempt interest will not be adjusted to reflect the loss limitation deduction.

VII. PENALTY FOR THE 2006 TAXABLE YEAR

Taxpayer under reported their 2006 federal taxable income by approximately $[Redacted] without a valid legal basis to do so. Their misrepresentation materially affected their tax liability. When asked, Taxpayer failed to answer questions about unity and non-business income.

According to Idaho Code section 63-3046(a):

> If any part of any deficiency is due to negligence or disregard of rules but without intent to defraud, five percent (5%) of the total amount of the deficiency (in addition such

deficiency) shall be assessed, collected and paid in the same manner as if it were a deficiency.

Idaho State Tax Commission Administration and Enforcement Rule 410.02.k. provides for the imposition of the negligence penalty where Taxpayer fails to respond to requests to produce records substantiating items shown on the return. This would include claimed deductions. Idaho State Tax Commission Administration and Enforcement Rule 410.02.l. provides for the imposition of the negligence penalty where Taxpayer fails to make available the fifty-one state apportionment factor detail when requested. Taxpayer failed to provide substantiation for claimed deductions and the fifty-one state apportionment. For these reasons, penalties are appropriate.

CONCLUSION

It is well settled in Idaho that a Notice of Deficiency Determination issued by the Idaho State Tax Commission is presumed to be correct.[51] The burden is on Taxpayer to show that the tax deficiency is erroneous.[52] Taxpayer failed to meet this burden; the Commission finds that the amount shown due on the Notice of Deficiency Determination is true and correct.

Interest will continue to accrue pending payment of the tax liability pursuant to Idaho Code § 63-3045(6) and penalty to Taxpayer's tax deficiency. The Commission finds those additions appropriate as provided for in Idaho Code §§ 63-3045 and 63-3046.

THEREFORE, the Notice of Deficiency Determination dated August 26, 2009, is hereby APPROVED, AFFIRMED, and MADE FINAL.

[51] Albertson's Inc. v. State, Dept. of Revenue, 106 Idaho 810, 814 (1984); Parsons v. Idaho State Tax Commission, 110 Idaho 572, 574-575 n.2 (Ct. App. 1986).
[52] Id.

IT IS ORDERED and THIS DOES ORDER that Taxpayer pay the following tax, penalty, and interest (interest is calculated 91 days from June 29, 2012):

YEAR	TAX	PENALTY	INTEREST	TOTAL
12/31/2004	$ 98,168	$ 0	$39,504	$137,672
12/31/2005	145,413	0	49,745	195,158
12/31/2006	219,633	32,945	61,353	313,931
			TOTAL DUE	$646,761

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of Taxpayer's right to appeal this decision is enclosed.

DATED this ________ day of ___________________ 2012.

IDAHO STATE TAX COMMISSION

____

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ________ day of ___________________ 2012, 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.

____