ILLEGAL AUDIT SETTLEMENTS OF THE IDAHO TAX COMMISSION

<u>SECOND</u> (supplemental) report to Governor Otter, Attorney General Lawrence Wasden & The Idaho Legislature

By: Idaho Tax Commission Auditor Stan Howland

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This is a follow-up to my initial report dated May 27, 2008. I am writing this report to provide additional information on several of the specific cases referred to in the initial report. This information was not originally included due to its size, but it should provide a clearer understanding of the problems associated with the compromise process. In addition, as a result of the substantial response to the original report from employees at the Tax Commission, I am expanding on concerns raised in my initial report, raising further issues, and offering additional suggestions for your review.

First, I wish to advise that I make these reports in the spirit of my desire to improve the workings of the Tax Commission and for no other reason. I made my first report public only for the reason that the legislative audit of several years ago did not result in any improvement in procedures or the adherence to Idaho tax law. There was considerable effort made to attack the credibility and reasoning of the two legislative auditors and minimal emphasis placed upon addressing the problems.

I emphasize that in the interest of brevity, I have not detailed every issue which should be addressed, and the ones I have addressed have been abbreviated with considerable important detail remaining for discussion. Accordingly, I welcome the opportunity to appear personally with any legislators or legislative committees who might seek information.

Since my report of May 27th, I have been contacted by numerous current Tax Commission personnel, as well as former employees from both within and without Idaho. Not only have they supported the positions stated in my initial report, but they have brought other significant concerns which exist in other areas of the Tax Commission in which I am not involved, as well as my own. Although I have been aware of many employee complaints in other areas of the Tax Commission for many years, I did not address them in my original report. This was done as I feel strongly that the accusation of illegalities demands extensive proof and should never be based upon rumor or third party information.

In this supplemental report I am reporting general areas of concerns that I have been made aware of in the past two weeks. I want to emphasize, I am NOT making accusations that illegal compromises are being made in other areas in the Commission, nor do I have any documented evidence to support any of the complaints that I have received. However, the extent of the contacts that I have received from employees working in the sales tax area, and the consistency of the information provided to me, are concerning. I believe that if there are problems in other areas of the Commission similar to those that I reported in my initial report, they should be considered in the review of the Commission's procedures.

The primary concerns that have been expressed to me are:

Compromise of Sales Tax Audits

Many employees have contacted me asserting that compromises are improperly being used in the settlement of sales tax audits. I have been told by reliable sources that the compromise rate of these cases far exceeds 50%.

The sales tax auditors are not allowed to participate in the post-protest informal conferences, and in most cases are never contacted about case resolution after the protests are received. A number of employees have stated to me that this is causing substantial problems as it is absolutely necessary to rebut incorrect statements made by taxpayers during informal conferences. This is necessary as taxpayer's incorrect statements influence the Commission in the settlement of cases.

These concerns have come to me from current and prior employees in the sales tax area, and from those in management and non-management positions. These concerns should be addressed.

Delegation of Compromise Authority

A number of years ago the Commission adopted a policy/procedure that allows Division Administrators, Bureau Chiefs, and Audit Supervisors to compromise audit cases with limitations of $30,000, $10,000, and $5,000 respectively. The only guidance offered in the Delegation of Authority directive is that these employees may accept settlement offers, and they may reject any offer "which is not reasonably based on the grounds for compromise set out in Administration & Enforcement Rule 500." This delegation results in a lack of consistency and control over the audit process and further weakens the level of internal control at the Commission. This delegation of compromise authority was strongly opposed by a deputy attorney general when it was initiated for the reasons expressed above. This individual maintained that it blurred the line between the audit and appeals functions, and that it was highly improper.

This expansion of compromise authority is indicative of the Commission's unwillingness to operate under a strict set of internal controls. Not only does the Commission fail to apply the restrictions of Rule 500 when presented with cases under official protest, it allows many other individuals within the Tax Commission to interpret the restrictions of this rule without guidance. This not only allows deals to be made with taxpayers before protests are forwarded to the legal/policy department; it allows deals to be made in order to avoid protests. Any semblance of consistency, fairness, or equity in the application of Idaho tax laws does not currently exist at the Tax Commission due in part to this delegation of authority.

Commissioner Sign-Off Procedures

The response to the legislative auditor's report where the "so-called fix" is simply to have a second Commissioner sign off on C&Cs in excess of $50,000 is not a credible overview. The other three Commissioners do not have familiarity with the law involving multistate corporations, they do not have the benefit of a detailed written opinion before signing off, and they do not have detailed and direct discussions with the auditors to inform their opinions. Under the current policy, consultation with other Commissioners or employees is optional. No meeting or vote of the Commission is required to approve a compromise or closing agreement. Essentially the sign-offs are only courtesy sign-offs which inform a second Commissioner as to the dollar amount, but not as to the rationale or legality of the agreement.

The $50,000 limitation set by the Commissioners as a decision point that somehow enhances internal control serves to control nothing. Using a dollar amount to value the importance of a case has been used extensively by the Commission to support its use of C&Cs. The argument that the Commission cannot justify going to court over a small assessment specifically ignores the reality that the taxpayer is faced with the same decision, and ignores the fact that this is not a criteria for making such determination. The reality is that even if one incorrectly believes that the legal application of the law is dependent upon the size of the tax bill, the measurement of the potential current and future tax effect is not. Many "small" cases have substantial importance for subsequent tax years, and for other taxpayers. The use of any dollar amount to justify a C&C, or as an approval limit for additional Commissioners, only creates an illusion of legality and/or internal control.

Access to Legal Advice

The audit staff generally works independently of the Tax Policy and Legal departments throughout the audit process. However, at times it is necessary to obtain assistance or advice in order to insure that specific issues are being handled correctly. This occurs primarily in situations where new tax law is being addressed, recent court decisions must be considered, or consistency in the application of law is under question. Over the past couple of years some members of the Tax Policy and Legal departments have taken the position that working together with the audit staff violates the "independence" of the Commission. This has been actively and openly promoted by a tax policy employee that works as an appeals officer, as well as members of the legal staff. The audit staff has been told by one deputy attorney general that he has ONLY one client, and that client is the Commissioner. He does not represent the audit staff or any other members of the Tax Commission, or the general public. This leaves the audit staff without access to legal advice or to any information regarding protested cases.

Excluding the auditors at the Tax Commission from obtaining legal advice or information regarding protested cases has a negative impact on the auditor's ability to do their job. It has a negative impact on the entire operations of the Tax Commission. Complaints have been made by three Bureau Chiefs to a Division Administrator over the Commissions isolation of the legal staff. If the Commission's role in hearing appeals is to be defined as a totally "independent" function requiring a total separation between the audit and appeals functions, then many of the problems facing the audit staff will continue. The role of both the deputy attorneys general and the tax policy staff should be examined and then clearly defined. If necessary, the Tax Commission should be permitted to employ additional attorneys that will represent all employees at the Tax Commission and by doing so, represent the best interests of the citizens of Idaho.

Motive

The question has been raised as to why anyone working at the Commission would recommend or approve a compromise agreement that either violated state law or intentionally allowed a taxpayer to violate state law. I purposely did not discuss this issue in my first report or with the media as the reasoning underlying such behavior should be thoroughly investigated before being made public. However, as criticism of my report has been based in part on the assumption that this behavior could not exist, I feel that I should address motive in a general manner at this time.

Obtaining support for future re-appointment, abuse of authority, laziness, intimidation, concern over pay raises, lack of confidence, fear of having a litigation loss on one's record, and anti-auditor bias are all behaviors that have been seen at the Commission over the past 15 years. Other reasons may exist, but are not discussed in this report. It is important to recognize the existence of these problems if one is intent on improving the effectiveness and professionalism of the Tax Commission. Many of these behaviors would cease to exist if the public accountability provisions recommended in my initial report are adopted.

Motive is also important as it relates to the Commission's often spoken criticism of auditors as those that "see everything as black and white", insinuating that they are incapable of understanding or accepting compromises when deemed to be necessary. Auditors do operate in "black and white" as compared to many in the Commission for a very simple reason. They have only one motive when conducting an audit. They apply the law in a fair and equitable manner as determined by the strict interpretation of the law and consistency in its application. Fairness and equity cannot be determined or achieved by considering only a specific taxpayer's demands, without considering how it affects ALL taxpayers. This singular motive is not present in the Commission's treatment of many taxpayers as evidenced by the illegal compromises that have been made.

Any accusations that auditors do not recommend or agree with compromise agreements are totally false. They do, but only when done in accordance with Idaho law.

Attorney Expertise

The often cited reasons given by members of the Commission for settling cases with C&Cs are listed in my original report. I specifically addressed only the legality of these reasons when compared to the restrictions found in Idaho Administrative Rule 500. These reasons for compromises seldom square with reality, much less with legal constraints.

However, I will address one situation that may impact the Commissioner's decisions only because it has been raised by many other employees.

There is a perception that the Commission and its legal staff are not comfortable in court, which seriously undermines our ability to take a firm and proper stand when the facts and the law would require that we do so. This perception exists in part as the deputy attorneys general assigned to the Commission consistently argue (when recommending and/or justifying C&Cs) that all cases can be lost in court. Although the audit staff agrees with this assessment as nothing is impossible, the emphasis on this argument is far out of proportion to any discussion of success at trial. Adding to the perception are the well known comments made by an ex-deputy attorney general (assigned to the Commission many years ago) that his pay raises depend directly on his success at trial. Although many of the lawyers assigned to the Tax Commission are very bright and dedicated individuals, they often lack trial experience. They do not develop that expertise while employed with us because they seldom get to court.

I contacted an experienced trial attorney to see if he thought this was a legitimate concern. He said that it was. He advised me that both within and outside of government employment, attorneys who are not experienced in trial and who are timid about presenting a case in court, are greatly compromised in their ability to succeed.

This attorney offered a suggestion which would seem to make sense. The Commission could, on some of its major cases, engage an experienced trial lawyer on either a contingent fee or hybrid basis. He stated that a non-contingent basis could be very expensive to the state and probably not desirable. Such an arrangement would have the outside attorney working with one of the staff attorneys and with our auditors. This would provide us with an effective team on the cases, and in the process our staff attorneys would obtain valuable trial training.

CASE DETAIL

There are additional multistate cases that have been settled with C&Cs that I have not specifically identified in my reports. The Commission’s resolution of these cases should also be subject to an independent investigation.

The following is a more detailed analysis of several of the cases referred to in my initial report.

TAXPAYER #1

The issue in this case is not complex. However, my explanation and analysis of the taxpayer's claim for tax relief and the Commission's actions regarding such claim are complicated. I want to emphasis that the complications are only due to the taxpayer's apportionment distortion claim that has absolutely no merit or legal support. In order to explain a relatively simple case, I have had to interpret and critique these arguments put forth by someone with little knowledge of the subject matter. This was necessary as the Commission used these arguments to support its C&C. The taxpayer's claims should have been rejected outright by the Commission.

Case Overview

The taxpayer claimed nonbusiness income (NBI) treatment on the capital gain received from the sale of a line of business that had been part of its overall unitary business (and therefore treated as business related) for over 30 years. The tax returns were audited, and the auditors made adjustments to treat this gain as business income which must be apportioned using the standard apportionment method detailed in the Idaho Income Tax Code. The taxpayer filed a written protest and an informal conference was held. The Commission then issued a written decision that upheld the audit report, which was followed by the taxpayer filing an appeal in district court. Approximately 2 months prior to the court date, the taxpayer made a settlement offer to the Commission. The taxpayer agreed that the income was properly classified as business income, but argued that the use of the standard apportionment method was distortive in this case, and that an alternative apportionment should be used. The Commission accepted the taxpayer's distortion argument, made adjustments to the taxpayer's final settlement offer, and then settled the case with a compromise and closing agreement (C&C). All discussion and determinations related to the taxpayer's distortion arguments, alternative apportionment arguments, and the C&C were specifically kept secret from the auditors.

Alternative apportionment is allowed by Idaho Income Tax Code Section 63-3027(s) if the standard allocation and apportionment provisions of Idaho Income Tax Code Section 63-3027(i) do not fairly represent the extent of the taxpayer's business activity in this state.

The taxpayer put forth extensive and confusing arguments to support its alternative apportionment position that create an impression of complexity that does not exist. These arguments have nothing to do with the realities of proper apportionment and the requirements of Idaho law. However, I must address these arguments as the Commission will use this false complexity to support its use of a C&C.

The taxpayer and the Commission have relied upon the writings of an expert witness hired by the taxpayer to testify in the court proceedings in support of its position. At first read, the expert witness's analysis is so far removed from the realities and legalities of formula apportionment that it would appear to have been written tongue-in-cheek. However, based upon the 20 year history of this company in receiving special tax deals from the Commission, and the specific details concerning this particular case, it became more apparent that it was written to simply muddy the waters that were flowing to a long anticipated and expected settlement by both parties. This analysis created a scenario that the Commission could again use to excuse this taxpayer from paying its full tax liability in Idaho, and it will help the taxpayer position itself in other states that are fighting the same issue.

Idaho Tax Commission Audit - 2000, 2001, & 2002 Tax Years

This taxpayer (Parent) is a global enterprise headquartered on the east coast that engages in a variety of different types of businesses, a few of which have activity in Idaho. The Company files its Idaho income tax returns on the water's-edge method. Under this method the total apportionable income reported to Idaho includes the income of all domestic companies that are unitary with each other.

The prime audit issue with this taxpayer is the tax treatment of a substantial amount of capital gain received in the 2001 tax year. In 1969 the taxpayer entered into "Business A" and has operated it as a division, unitary subsidiary, and a partnership since that time. During this audit period, this business was operated as a 100% owned partnership with 50% interests held by two affiliated members of the unitary group. Until 2001, the taxpayer treated business A for Idaho tax purposes as a unitary/operational line of business. At that time the taxpayer sold this business and reported a taxable gain of over $5 billion. The taxpayer claimed this amount as NBI on the Idaho tax return and removed it from apportionable income.

In August of 2004, Commission auditors initiated an audit of the 2000, 2001, and 2002 Idaho income tax returns filed by the taxpayer. The taxpayer refused to respond to the auditor's questions regarding the NBI claims on the tax returns, and denied the auditors the substantiation required by Idaho law. The taxpayer's representative told the audit staff that he does not respond to these questions regarding non-business income, because the responses generally were interpreted to not support the Company's position. He said (and kept his word) that he would not answer the auditor's questions; he would just protest the audit and make his case in the appeals process.

The audit staff gathered as much information as they could and re-classified the gain in question as business income to comply with Idaho law. The auditors imposed both the negligence and the substantial underpayment penalties due to the understatement of tax, and the taxpayer's failure to maintain and provide sufficient documentation to support the deductions claimed on its returns. This audit was concluded in May of 2005 with the issuance of a Notice of Deficiency Determination (NODD), which was later protested by the taxpayer. An informal conference was held in February of 2006.

In September of 2006, the first and last years of the audit (2000 and 2002) were settled with a C&C. This C&C incorporated a few revised adjustments that were agreed to by the audit staff, and it removed the negligence and tax understatement penalties which were <u>not</u> agreed to by the audit staff. The auditors were told by the deputy attorney general in charge of the case that the purpose of the C&C was to isolate the remaining 2001 tax year. This would narrow the overall litigation focus when argued in District Court. In November of 2006, the Commission issued a decision for the 2001 year. This decision upheld the auditor's disallowance of nonbusiness income treatment on capital gain reported from the sale of the taxpayer's "Business A". The Commission decision also abated the negligence penalty. This penalty abatement was <u>not</u> agreed to by the audit staff. At some point during 2007 the taxpayer filed in district court and a court date was eventually set for April of 2008.

In February of 2008, the Deputy Attorney General assigned to the case issued a statement (e-mail dated February 14th) that the 2001 tax year was being settled with a C&C. This statement made it clear that the Commission had accepted the taxpayer's new argument that standard apportionment was distortive in this particular case, and that an alternative apportionment method was agreed to. This alternative method was based on a written analysis presented by the previously referenced expert witness employed by the taxpayer. The Commission stated that some adjustments had been made to the proposed apportionment and both parties had arrived at a "mutually acceptable apportionment."

On February 14th, after receiving notification of the C&C, I sent the following request to the writer of the e-mail and the other employees that also received the original message.

> "It is my understanding from your e-mail that the settlement is based on a business income determination regarding the gains in question, but that a departure from standard apportionment is required as the sold entities have only partial Idaho factor and/or have losses in the state of Idaho. Based on Idaho law this position would therefore be that standard apportionment does not fairly represent the extent of the taxpayer's business with this set of facts. I do not agree with this settlement based on the limited information provided.
>
> I respectfully request a copy of the detailed alternative apportionment method allowed to (this taxpayer), and the basis for distortion that would result from standard apportionment."

My request was ignored. To this day I have never received a response, or the information requested. Because of this, I am unable to address the actual details of the final settlement, if there were any. Therefore, the following analysis, opinions, and conclusions are based upon the content of the Commission's e-mail referenced above, the analysis (referred to in the e-mail) written by the taxpayer's expert witness, and the information gathered during and subsequent to the audit. I have addressed both the distortion and the alternative apportionment claim made by the taxpayer.

TAXPAYER'S ISSUE #1 - DISTORTION

It is difficult to follow the expert witness's rationale as he throws out a variety of conclusions, but fails to offer any insight into how they are evenly remotely connected to proper apportionment. He goes to great lengths to convince the reader that distortion exists under this scenario, but he never identifies the distortion. After artificially creating this distortion, the expert witness then attempts to justify the use of an alternative apportionment method. The net result of his proposed alternative method, not surprisingly, results in zero tax being due the state of Idaho.

The following is an abbreviated list of the expert witness's "Summary of Conclusions" used to identify apportionment distortion, and my analysis of the validity of each claim:

<u>Expert's Conclusion #1 - All of (Parent's) Idaho businesses operated at a loss in 2001.</u>

This statement is only true if income is computed in a manner that violates Idaho Code Section 63-3027. However, true or not, it has no relevance to the determination or recognition of distortion. When taxable income is properly computed by including all of business income in apportionable income, the taxpayer's businesses all report a profit. The taxpayer is evidently trying to support its distortion argument by selectively removing operational income (partnership gain) from apportionable income to create a loss, and then claiming that mixing an operational loss with capital gain is somehow distortive.

The profit or loss of these businesses is not relevant to the determination of proper apportionment. If a <u>proper</u> filing resulted in a loss for all Idaho businesses, these losses would be apportioned in the same manner as that used when gains are reported. If the gain in this case were only $4.1 billion instead of $4.9 billion, Idaho apportionable would be positive if the gain were artificially removed. Under this scenario one would have to assume that the taxpayer would then recognize standard apportionment as being valid. This is nonsensical.

<u>Expert's Conclusion #2 - (Subsidiary #1) operated at a loss in the state of Idaho in 2001.</u>

This statement is false. Again, even if true, it would have no relevance to the determination or recognition of distortion. Subsidiary #1 is one of several unitary subsidiaries that operate in Idaho. This subsidiary operates in "Business B". Subsidiary #1 is unitary with the Parent group as claimed by the taxpayer on the original tax returns, and agreed to by the Commission. Under the unitary concept neither separate company income nor separate accounting for a business line is recognized under Idaho Code Section 63-3027. Subsidiary #1 operated at a substantial gain in Idaho when apportionable income is properly computed. The expert witness claims that Subsidiary #1 did incur a loss on the sale of the primary product line manufactured in this state. He evidenced his newly found loss by re-calculating the net income using non-approved separate accounting calculations. His computations used to arrive at this loss are based on assumptions and estimates that fall short of any verifiable standard of proof. More importantly, even if this separate accounting loss exists, it has nothing to do whatsoever with gauging the reasonableness of standard apportionment. Separate accounting is an improper filing method that hides the true profitability of a member of a unitary group. The expert witness attempts to defend his distortion claim using the same accounting method that was specifically eliminated by the unitary concept in order to properly apportion income.

This notion that separate accounting can be used to invalidate standard apportionment has been addressed by the Commission and by the courts before. As an example, <u>Idaho Tax Commission Decision Docket # 11649</u> holds that "Standard UDITPA is presumed to be applicable to apportion business income." In this case the taxpayer argued that separate accounting should be employed for freight discounts, because the discounts are expenses clearly identifiable with Idaho business operations and therefore should be allowed as a deduction under the alternative apportionment provisions of the Idaho Income Tax Code. The Commission determined that the taxpayer "has failed to establish the prerequisite for invoking alternative apportionment, namely that the standard UDITPA factors do not fairly represent the extent of the taxpayer's business activity in this state." The Commission decision held that "The mere fact that an expense is separately identifiable does not establish such distortion."

The folly of using separate accounting to argue apportionment distortion was directly addressed in Container Corp. of America v. Franchise Tax Bd. The taxpayer argued that applying the California three-factor apportionment formula to its foreign affiliates resulted in distortion as the foreign affiliates were significantly more profitable (due to lower foreign wage rates) than the rest of the company. The court stated "The problem with this argument is obvious; the profit figures relied on by appellant are based on precisely the sort of formal geographical accounting whose basic theoretical weaknesses justify resort to formula apportionment in the first place." This is similar to the expert witness's claim in this case that standard apportionment is distortive as Subsidiary #1 reported a separate accounting loss due to severe overproduction of inventory. He opines that somehow standard apportionment becomes distortive when separate accounting losses are combined with large gains to arrive at apportionable income. Not only has the taxpayer failed completely to show how standard apportionment is distortive, but the methodology offered has failed in previous state and court decisions.

Expert's Conclusion #3 - The gain from the sale of the "Business A" partnership was independent of the acquisition of subsidiary #1.

The expert witness makes numerous presumptions and determinations (most of which are incorrect) regarding the unitary theory and its application, in an attempt to create doubt that subsidiary #1 and "Business A" were ever unitary. This insinuation falls short of an actual claim as the restatement of either entity as non-unitary is not directly made. Evidently the expert witness believes that addressing a perceived "independent" relationship between the two businesses somehow weakens the inclusion of both in standard apportionment. Not only has the taxpayer never made the claim that this unitary relationship did not exist, it specifically advanced the unitary relationship through the filing of its original returns. The taxpayer treated "Business A" as part of its total unitary business since its purchase in 1969. The taxpayer treated subsidiary #1 as being unitary with the other Parent affiliates since 2000. Attempts to now create a doubt that this relationship was not fully consummated during the audit period are totally without merit, and clearly represent an attempt to simply confuse the reader.

Expert's Conclusion #4 - 90% of the standard apportionment formula produced an operating loss compared to 10% of this formula accounting for overall apportionment.

Again, this is only true if apportionment is done incorrectly. True or not, it has no relevance to the determination or recognition of distortion.

The expert witness claims that over 90% of the statutory formula used to produce the tax assessment is comprised of the factors that produced an operating loss, while the factors that comprised the $5 billion gain accounted for less than 10% of the overall apportionment. The expert witness compared the following two percentages to arrive at his conclusion. He first averaged each factor using standard apportionment (removing the gain from the sales factor) to arrive at an approximate 90% figure. This, according to the taxpayer, represents the factor applied by the Commission to an overall company net loss. The remaining 10% represents the percentage determined by applying the standard apportionment formula to only the sales factor (doubled), determined by dividing the gain by total receipts.

This is an exercise in denominator relationships that does not speak in any way to the proper or improper apportionment of income. One would be hard pressed to understand what it does speak to.

The expert witness goes into great detail to show that the smaller the gain, the larger the difference in percentages. The larger the gain, the smaller the differences until you reach a point where the reverse percentage relationship begins. Evidently the expert witness is suggesting that this difference reflects distortion if the overall factor (computed without the gain) is applied to an overall company net loss (without regard to the gain). That argument makes absolutely no sense. He also seems to be proposing that this is a rare or unique situation, and that it is a calculation that means something. He does not state this directly, for obvious reasons. This result, or something very similar, would occur in almost every situation, with all taxpayers, where gain is reported in low profit or loss years.

Auditor's analysis of the taxpayer's distortion claim.

The expert witness has gone to great lengths to create an illusion of distortion while totally failing to offer any evidence to support such a theory. He simply states that standard apportionment results in too much income being reported to Idaho, and that his alternative method is "more conceptually correct".

The taxpayer's claim that separate accounting somehow identifies distortion is absurd. The Supreme Court in Mobil, 445 U.S. at 438 stated "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." Because these contributions "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."

The party seeking to invoke equitable apportionment has the burden of proof to show that standard apportionment is distortive. Advocating a better formula is not enough; the party requesting alternative apportionment must demonstrate that standard apportionment results in a significant distortion of the taxpayer's business activity in the state. Idaho Tax Commission

Decision Docket # 19109. This taxpayer has not only failed to meet this burden of proof, but has put forth adjunct arguments that have absolutely no basis in fact or law. This failure to demonstrate that distortion exists by using standard apportionment invalidates the taxpayer's argument. Distortion does not exist in the case at hand. The taxpayer has failed to show that standard apportionment is not reasonable.

Removing the writer's substantial use of issue misdirection reveals the real position being put forth - the unitary filing method is distortive. This is verified by the taxpayer's solution to this distortion which is entirely based on a departure from this proper filing method. However, this in itself represents even more misdirection, as the real position of the taxpayer is that it simply does not want to pay any income tax to the state of Idaho.

The expert witness treats standard apportionment and the unitary method of reporting as something that can be altered or reversed at will, based solely upon the tax outcome. Apportionable income is comprised of all business income and receipts regardless of whether the net result is a gain or a loss. Any logical review of the taxpayer's claim, with consideration given to the restrictions found in Idaho law and case law, results in a total rejection of any and all distortion claims. What would be distortive would be to selectively remove income and receipts in order to attain a pre-determined result.

TAXPAYER'S ISSUE #2 - ALTERNATIVE APPORTIONMENT

The taxpayer claims that an alternative apportionment method is necessary to properly reflect income in Idaho. Alternative apportionment is allowed by Idaho Income Tax Code Section 63-3027(s) if the standard allocation and apportionment provisions of Idaho Income Tax Code Section 63-3027(i) do not fairly represent the extent of the taxpayer's business activity in this state.

Although it appears that the Commission did not accept all of the expert witnesses' relief proposals, it is important to review them as they provide stark evidence as to lack of legitimacy in the purported facts, conclusions, and recommendations of the taxpayer. Simply stated, the taxpayer wants two separate apportionment calculations made.

1. The capital gain would be removed from apportionable income and the receipts denominator, and then be apportioned by a two factor formula. The amount of gain that would be available for Idaho apportionment would not be the total gain reported by this entity. It would be based on the four general areas of purchase price allocation reported by the purchaser. Which of these areas to be used are dictated by the expert witness based on his assumptions of appropriateness to the business activities conducted in Idaho by "Business A". This results in a small gain to be reported to Idaho.

2. The remaining loss (after the removal of the capital gain) of this taxpayer would be apportioned using the standard apportionment method. This results in a loss to be reported to Idaho. It should be of no surprise that the taxpayer then nets the two

results in another inventive taxing scheme, and ends up with a net loss. The taxpayer therefore proposes that no tax should be paid to the state of Idaho in 2001.

Auditor's analysis of the taxpayer's alternative apportionment claim.

Although the taxpayer's net tax results were evidently adjusted somewhat by the Commission, it is quite obvious from the taxpayer's proposal that reasonableness is not a criteria for negotiating with the state of Idaho.

The taxpayer's methodology of measuring income not only apportions recognized business income as if it were non-business income, but it restricts this new concept to only gains received from the sale of a business that has a business activity within this state. If "Business A" had not reported any property, payroll, or sales within Idaho (which it did), then the apportionment system invented by the expert witness would not have apportioned any of the $5 billion gain to this state. This is in total conflict with the unitary filing method, the same method under which the taxpayer has been filing in Idaho for over 20 years. The connection to Idaho is not determined by each affiliates activity within the state, it is determined by the flow of value that establishes a unitary relationship. Most companies that report gain in situations similar to this entity have sold affiliates that do not have any activity within our state borders. This gain is subject to standard apportionment as the gain represents the sale of a unitary affiliate or the sale of operational assets. The taxpayer's alternative apportionment proposal is simply ludicrous.

A detailed analysis of standard and alternative apportionment is found in Idaho Tax Commission Decision Docket # 19109. This decision states in part "The party requesting alternative apportionment must demonstrate that standard apportionment results in a significant distortion of the taxpayer's business activity in the state; simply advocating a better method than the standard formula is not enough."

In 2004, the Idaho Supreme Court in Union Pacific v. Idaho State Tax Commission stated that "There is a strong presumption on favor of the normal three-factor apportionment and against the applicability of the relief provisions." The Court found that a departure from the standard apportionment formula should be avoided except where reasonableness requires a departure. Reasonableness was defined as being made up of three elements: (1) the division of income fairly represents business activity and if applied uniformly would result in taxation of no more or no less than 100 percent of the taxpayer's income; (2) the division of income does not create or foster lack of uniformity among UDIPTA jurisdictions; and (3) the division of income reflects the economic reality of the business activity engaged in by the taxpayer in the taxing state.

In the case at hand, all three elements of reasonableness are present when standard apportionment is applied. None of the three elements of reasonableness are present under the alternative apportionment proposal of the taxpayer:

- There is no evidence whatsoever to support a contention that standard apportionment would result in the taxation of any more or less than 100% of the taxpayer's income. The taxpayer did not make this claim.

- The division of income under the standard apportionment method is uniform among UDIPTA jurisdictions. Applying the alternative method based on the taxpayer's facts and arguments, is totally unheard of in applying the non-business provisions of the Idaho code, and would result in a complete lack of uniformity with all jurisdictions. The taxpayer did not claim that standard apportionment created a lack of uniformity among UDIPTA jurisdictions.

- The taxpayer offers absolutely no evidence to show that the standard apportionment method does not reflect its business activity in this state. If standard apportionment is an inaccurate reflection of business activity in this case, then the state of Idaho is guilty of incorrect determinations in similar non-business income situations spanning several decades. The taxpayer did claim that standard apportionment did not properly reflect the Idaho business activity of the Company in 2001, but failed to demonstrate the inaccurate result.

It is obvious that without a requirement for reasonableness, a uniform application of apportionment methods would not be possible. There has to be a standard for use in the measurement of income that allows the taxing authority to operate in a consistent manner. These standards must apply logical and legally to all entities, regardless of the location of their headquarters, or the location of the business that was sold. The taxpayer's apportionment theory in this case raises many questions that the Commission has failed to address, and that do not have answers that include reasonableness.

- Would we claim unreasonableness, and apply the taxpayer's alternative apportionment theory to a company headquartered in Idaho that reports a large gain from the sale of a non-Idaho unitary business that is properly classified as business income?

- Would we make such a case, based on separate accounting or operating losses, that the factors in other states would be distortive if we include this business income in the apportionable base?

- Would we then remove this business income and dream up a separate factor method to allocate the majority of the gain to Idaho? This is the reverse application of this taxpayer's theory on alternative apportionment.

- Is it legitimate to use standard apportionment to apportion the profit or loss on a line of business in operating years, but abandon this method when the business is sold and large gains are taxable?

The answer to the above questions is of course, no. This would violate the unitary filing method, the rules of standard apportionment and logic, and it would rightfully be rejected by the Commission.

SUMMARY – TAXPAYER #1

The year to year profitability of the majority of all large multi-state corporations varies substantially and is dependent upon many factors including organizational structuring, world economic changes, product liabilities, business practices, and many other factors that influence the global business environment. Many of these entities are constantly buying and selling business operations and reporting the gain received from such sales. Apportionable income of these corporations is determined through the use of the standard apportionment provisions of Idaho Code 63-3027. The profits and losses of these taxpayers are apportioned to Idaho resulting in a tax liability (or net operating loss that can be applied in other years) consistent with their profitability as reported to the Internal Revenue Service. To apply any form of alternative apportionment to this process in these situations would invalidate state and case law, and would remove all consistency, fairness, and equity from the Idaho taxing process. Standard apportionment would become obsolete and unworkable. This taxpayer is no different than any other corporation required to follow the standard apportionment provisions of the Idaho Code.

Apportionment distortion can exist in rare circumstances. Unique situations, double counting of activities, churning, and some tax accounting practices that have no substance, can lead to the need for an alternative apportionment method. However, claiming distortion whenever large gains are reported in low or no profit operational years has no basis in Idaho law. There is absolutely nothing unique or unusual about this taxpayer's tax reporting situation, nor is there anything remotely distortive about the results obtained from standard apportionment.

The Commission's path to a C&C is not at all clear in this case. The Commission agreed with the taxpayer that its distortion claim has validity, as evidenced by an e-mail sent to several Commission employees on February 14, 2008. The Commission stated that the taxpayer's argument has "merit", that "the parties arrived at a mutually acceptable apportionment", and that this alternative apportionment is "reasonable". This would lead one to believe that any doubt as to liability had been satisfied and a modified decision should be issued. A modified decision would not only clearly and openly reflect the Commission's position, but it would correct the first decision, which is still available to the public and audit staff as a precedent setting decision. Since the Commission opted to use a C&C, one must assume that it believes the tax liability resulting from the "reasonable" and "acceptable" alternative apportionment method is still in doubt. This assumption is based on the fact that there must be a doubt as to liability in order to settle a case with a C&C. However, it has been the Commission's practice for many years to use a C&C for reasons other than that allowed by Idaho Tax Commission Administrative and Enforcement Rule 500. Obviously the Commission was aware that if a decision had been issued, it would have been in direct conflict with all other Commission decisions regarding business income and the apportionment of such income.

The Tax Commission's Audit History with Taxpayer #1

The Tax Commission has audited this taxpayer seven (7) times dating back to the mid-eighties. Every tax year since 1983 has been audited. The Tax Commission has settled six (6) of these audits with a compromise and closing agreement (C&C). The Tax Commission not only allowed the taxpayer to pay less that the amount of tax due in 6 out of the past 7 years, it has reversed all understatement and negligence penalties properly imposed by the audit staff. A summary of the previous audits conducted on this particular taxpayer reveals that the taxpayer refused on each audit to comply with the substantiation rules adopted by the state of Idaho.

1983, 1984, & 1985 Tax Years. This audit was conducted in 1987. The auditors made various adjustments to apportionable income and to the apportionment factors. The taxpayer <u>refused to provide the auditors substantiation</u> for specific issues. The taxpayer protested the audit report. The Commission settled the audit with a C&C.

1986, 1987, & 1988 Tax Years. This audit was conducted in 1991. The auditors made various adjustments to apportionable income and to the apportionment factors. The taxpayer <u>refused to provide the auditors substantiation</u> for specific issues. The taxpayer protested the audit report. The Commission settled the audit with a C&C.

1989, 1990, & 1991 Tax Years. This audit was conducted in 1995. The taxpayer claimed NBI treatment on substantial amounts of capital gains, including amounts received from the sale of various businesses that were unitary or operationally tied to the Company's business. The taxpayer <u>refused to provide the auditors with substantiation</u> for NBI, specific factor items, and the investment tax credit. The auditors made various adjustments, most of which were based upon the taxpayer's refusal to provide documentation. The taxpayer protested the audit report.

The taxpayer told the audit staff that <u>they will claim every possible deduction on Idaho tax returns, even if in conflict with Idaho law, as they can always get a "deal" at the appeals level.</u> They stated that they did not make these claims in those states with a history of not providing them tax relief. The Commission settled the audit with a C&C.

1992, 1993, & 1994 Tax Years. This audit was protested and settled with a C&C. The taxpayer <u>refused to provide substantiation</u> for specific issues to the audit staff.

1995 & 1996 This audit was conducted in 1999. The taxpayer claimed NBI treatment on substantial amounts of capital gains, including that received from the sale of various businesses that were unitary or operationally tied to the Company's business. The taxpayer <u>refused to provide the auditors with substantiation</u> for NBI. The auditors made various adjustments, most of which were based upon the taxpayer's refusal to provide documentation. The taxpayer protested the audit report.

The Commission wrote a decision in 2000. This Commission decision upheld the audit because the taxpayer failed to respond to the deputy attorney general in charge of the case with anything more than "boilerplate" documentation. This deputy attorney general has since left the Tax Commission. The taxpayer paid the decision amount. It probably did not pursue a C&C after the Decision was issued due to the relatively small amount of tax liability.

1997, 1998, & 1999 Tax Years. This audit was conducted in 2002. The taxpayer claimed NBI treatment on substantial amounts of capital gains, including that received from the sale of various businesses that were unitary or operationally tied to the Company's business. The taxpayer refused to provide the auditors with substantiation for NBI. The auditors made various adjustments, most of which were based upon the <u>taxpayer's refusal to provide documentation</u>. The auditors imposed both the negligence and the substantial underpayment penalties due to taxpayer's failure to maintain and provide sufficient documentation to support the deductions claimed on its returns. The taxpayer protested the audit report. The audit staff agreed to one post-audit adjustment concerning Idaho sales. A modified report was issued.

The Commission wrote a decision in January of 2006 that upheld all but one of the NBI issues. This issue was the sale of various parcels of land that the taxpayer claimed were idle, and therefore should not be treated as business income. The Commission allowed the NBI treatment and stated in the decision that "While the record before us is not as detailed as we would like, we are unable to find any evidence within the file to refute the general statement that all of the land at issue was idle and was not used in the taxpayer's trade or business operations." This statement was made even though the audit staff asked the taxpayer for, and was refused, documentation on this issue. The Commission, for whatever reason, relieved the taxpayer of the burden of proof by accepting only verbal testimony. The Commission upheld the understatement penalty, but did not uphold the negligence penalty. This was done even though the Commission decision stated that "the penalty (negligence) was properly asserted", and that "the commission simply does not believe that the waiver of the substantial understatement penalty is warranted." The Commission, for whatever reason, determined that one penalty was enough. The taxpayer filed in District Court in October of 2006.

The Commission determined that the court action should be settled with a C&C. This was part of an overall settlement with this taxpayer that included two of the three years that were included in the subsequent audit. No reason was given to the audit staff for these concessions other than it was part of a cleanup that would make it easier to go to court on the 2001 tax year. A C&C was signed by the Commission. This compromise settlement allowed the taxpayer non-business income treatment on foreign exchange contracts, an issue that was specifically addressed and upheld in the original Commission decision. This reversal alone reduced the taxpayer's tax and interest liability by over $15,000. The C&C also removed the 10% underpayment penalty that had been imposed and upheld in the original Commission decision. Between the decision and the C&C, the Tax Commission removed a total of $16,000 in penalties that the auditors properly imposed on a taxpayer that had over a ten year history of filing incorrect returns and of refusing to cooperate and document their tax returns.

TAXPAYER #2

Case Overview

The taxpayer claimed nonbusiness income (NBI) treatment on the capital gain received from the sale of a line of business that had been part of its overall unitary business (and therefore treated as business related) for over 10 years. The taxpayer removed this income from apportionable income and it was therefore not apportioned to the state of Idaho. The tax returns were audited, and the auditors made adjustments to treat this gain as business income which must be apportioned using the standard apportionment method detailed in the Idaho Income Tax Code. The taxpayer filed a written protest and an informal conference was held. The Commission then issued a written decision that upheld the audit report. Approximately 4 months after this decision was issued, the taxpayer made a settlement offer to the Commission. The taxpayer argued that the income is question was nonbusiness income under a "liquidation exception" to the functional test. The Commission then settled the case with a C&C. All discussion and determinations related to the taxpayer's "liquidation exception" arguments and the C&C were specifically kept secret from the auditors.

Idaho Tax Commission Audit - 2001, 2002, & 2003 Tax Years

The taxpayer has two subsidiaries that have significant operations in Idaho and several others that have minimal activity within the state. In 1997 the taxpayer acquired 100% of the stock of two corporations that were operating in "Business A", a business that was also conducted by this taxpayer. From that point forward these entities were put into a "group" with existing affiliates that conducted the same type of business. All of these entities were included in the taxpayer's unitary worldwide business for Idaho tax reporting purposes. Until 2002, all of the income from these entities was treated by the taxpayer as business income and their property, payroll, and receipts were included in the worldwide apportionment factors. In August of 2002, the taxpayer sold these operations to a third party for approximately $1.59 billion. This sale resulted in a taxable gain of $821 million which was required to be reported to the Internal Revenue Service and included in Idaho apportionable income.

In August of 2005, Commission auditors initiated an audit of the 2001, 2002, and 2003 Idaho income tax returns filed by the taxpayer. The taxpayer refused to respond to the auditor's questions regarding the NBI claims on the tax returns, and denied the auditors the substantiation required by Idaho law. The audit staff classified the gain in question as business income. This audit was concluded in May of 2005 with the issuance of a Notice of Deficiency Determination (NODD), which was later protested by the taxpayer. An informal telephone hearing was held in August of 2006.

In July of 2007, the Commission issued a written decision for the audit years. This decision upheld the auditor's disallowance of nonbusiness income treatment on capital gain reported from the sale of the taxpayer's "Business A". The Commission found that "Business A" served an operational function to the taxpayer and that capital gain from its sale should properly be classified as business income. The Commission decision also upheld the substantial understatement of tax penalty imposed on the original NODD.

On November 5th of 2007, the auditors and various other management personnel received an e-mail message from the Commission stating that this taxpayer "has initiated settlement discussions with the Commission, as the time period for appealing the Commission's decision to District Court is drawing near…" This notification also stated that the taxpayer "now argues that even if unitary, the sale of (Business A) is nonbusiness income under a 'liquidation exception" to the functional test. The Commission has made a business decision to try and settle this case rather than engage in litigation and has approved the following counteroffer which has been sent to the taxpayer's representative."

This e-mail message was forwarded to me for review on the same day. I immediately responded to all recipients with my strong disagreement with this proposal. I advised them of the lack of a "liquidation exception" in Idaho law and referred them to many Idaho decisions that supported this position.

SUMMARY – TAXPAYER #2

In December of 2007 this case was settled with a C&C. It is quite obvious that the Tax Commission did not rely on a "doubt as to liability" to support their use of this method of settlement. This is evident as the "liquidation exception" argument not only has no basis in Idaho law, it is specifically addressed and rejected by Idaho Administrative Rule 333.04 and several previously published Tax Commission decisions. Rule 333.04 states that -

> "Income that is derived from infrequently occurring dispositions or transactions involving property, including transactions made in liquidation or the winding-up of business, is business income, if the property is or was used in the taxpayer's trade or business operations."

This clearly repudiates the taxpayer's arguments in this case as the property was used in the taxpayer's business since its purchase. In a published decision (Docket #16707), the Tax Commission stated –

> "In addition, the Commission disagrees with the taxpayer's contention that Idaho's version of the functional test contains a "divestiture of entire lines of business" exception." Finding – business income.

In Docket #18340 the Tax Commission states –

> "…the petitioner argues that there is an exception to the functional test relating to the 'divestiture of entire lines of business' citing various non-Idaho state court cases as authority for its position. While this is a relatively common argument, there is nothing in Idaho's statutory language or the Idaho Supreme Court's interpretation of that language to support such an exception."

There are other Tax Commission decisions that also address the same issue with the same result.

As Idaho law clearly has no “liquidation exception”, and as the Tax Commission wrote a decision upholding the unity and NBI question, a doubt as to liability <u>does not</u> exist.

The question that remains is under what authority did the Tax Commission follow its decision with a C&C? This authority does not exist. The only reasoning offered by the Tax Commission was that it made a “business decision” to try and settle the case. “Business decision” is not listed as grounds for a C&C under Rule 500. This reasoning is so vague that it is meaningless. The Tax Commission simply cut another “deal” with a large multi-state taxpayer that is in direct violation of Idaho Rule 500.

TAXPAYER #3

The taxpayer filed its 2006 Idaho tax return on May 14, 2007. This return reported an Idaho net operating loss (NOL) of $194,123. The taxpayer checked the box on line 37 of the tax return electing to forego the carryback of this loss. Checking this box requires the loss to be carried forward to years after 2006.

In late 2007, the taxpayer filed an amended to carry back the 2006 loss to the 2004 tax year. The auditor advised the taxpayer that the loss could not be carried back as the election to forego the carryback had been made on the original return. The taxpayer did not agree resulting in an audit report (NODD) being issued in January of 2008. This NODD denied the refund claim of the taxpayer.

The taxpayer's accountant called the Tax Commission's tax policy department on January 15, 2008. The taxpayer's controller followed up this call with a letter to the tax policy department dated January 16, 2008 in which he claimed that the box was checked due to clerical error, and he requested that the loss be allowed to be carried back.

The audit staff was notified in February of 2008 that the Commissioner had ordered the amended return to be approved and the requested refund to be paid in full. No reason was given.

IDAHO LAW

NOL Carryback / Carryforward Provisions.

Idaho NOLs incurred in taxable years beginning after January 1, 2000 are required to be carried back to the second preceding taxable year and if not absorbed, the remaining loss applied to the first preceding taxable year. Any loss not absorbed in these two years is carried forward and subtracted in the 20 succeeding years until absorbed - Idaho Income Tax Code Section 63-3022(c)(1) and Idaho Income Tax Administrative Rule 201.04.b.

Election to Forego the Carryback Provisions.

The carryback provisions do not apply <u>if</u> the taxpayer makes a valid election to forego this 2 year carryback period. If the election is made the taxpayer can carry the NOL forward to years following the loss year. - Idaho Income Tax Administrative Rule 201.04.c.

Valid Election

Idaho Income Tax Code Section 63-3022(c)(1) states in part "The election shall be made as under section 172(b)(3) of the Internal Revenue Code. An election under this subsection must be in the manner prescribed in the rules of the state tax commission and once made is <u>irrevocable</u>

for the year in which it is made. (Emphasis added.)

In order for this election to be valid the provisions of Idaho Income Tax Administrative Rule 201.05 must be met. These provisions require:

- The election must be made by the due date of the loss year return, including extensions.

- The election must be made by either attaching a copy of the federal election to forego the federal NOL carryback to the Idaho income tax return for the taxable year of the loss, or as otherwise provided in the Idaho return. "Otherwise provided in the Idaho return" is met if the taxpayer checks a "check off" box on line 37 of the Idaho return. If this box is checked, the taxpayer does not have to include a copy of the federal election. (The instructions located on line 37 state "If the corporation has an NOL and is electing to forego the carryback period, check here." The instruction booklet for the Idaho corporate return states "Check the box on line 37 if the corporation elects to forego the Idaho carryback period for a net operating loss. If you check this box, you don't need to attach a separate statement electing to forego the Idaho carryback period.)

- If the election is made on an amended or original return filed subsequent to the due date of the loss year return, it is considered untimely and the net operating loss must be carried forward. The instruction booklet for the Idaho corporate returns states "If you are filing an amended return, you can't change your election."

Idaho Decisions

In a Tax Commission decision (Docket #16426) the Commission stated clearly that the election to forego the carryback "once made is irrevocable for the year in which it is made." The Commission upheld the audit adjustment and stated in its conclusion that "the application of the statutory provision is mandatory and **not discretionary**." (Emphasis added.)

In a Tax Commission decision (Docket #17081), the taxpayer claimed that its failure to properly file the election was a "simple error" that occurred during the "extreme stress of dealing with the April 15th deadline." The Commission upheld the audit adjustment in this case stating clearly that the carryback of the loss "was *mandatory* absent an election by the taxpayer to forgo the carryback."

Conclusion

As specifically stated in the Idaho Income Tax Code, Idaho Income Tax Administrative Rules, and various Idaho Tax Commission decisions, the election to forego the carryback must be made with the original return and is irrevocable. If this election is not made, the carryback is mandatory.

The Commission allowed the taxpayer full relief based on a personal communication and ignored the standard protest procedures which would have supplied a resolution trail. The standard audit process does not incorporate any intervention from the Commissioner, or member of the legal or policy departments. Their involvement is limited to generic legal advice and/or policy questions until such time that a protest is put under their jurisdiction. This is done to insure the independence of the audit and the appeals processes. Once a protest is received in response to an audit, and the auditor has exhausted all avenues of resolution available to him or her, the case is sent to legal department for the appeals process. From that point forward the taxpayer can appeal the audit determination, present evidence and arguments, and the Commission will make a determination based upon the merits of these arguments and the merits of the auditor's case. If the taxpayer opts to not file a protest, the deficiency becomes due and payable.

In this case, the Commission ignored all legal and standard protest procedures and simply chose to relieve the taxpayer of its tax burden for reasons unknown. The Commission has allowed this taxpayer to directly violate Idaho law and in doing so has done the same.

TAXPAYER #4

This case is representative of the Commission's refusal to uphold penalties in the majority of protested cases, and the effect of these actions on subsequent years. The tax issue underlying the penalty in this case is a simple one. It is the taxpayer's refusal to file the water's edge election form required by Idaho law in order to file a tax return using this filing method. The water's-edge filing method can only be used if the taxpayer makes a proper election as required in Idaho Income Tax Code Section 63-3027B. Without a proper election taxpayers must file their tax returns on the worldwide filing method. Details of these two methods and the basis for a proper election are not discussed in this report as the taxpayer agrees with the Commission that it has yet to file the proper water's edge election.

<u>Case Overview</u>

The taxpayer filed its original 6/01, 6/02, and 6/03 tax returns on the water's-edge filing method. These returns were audited by commission auditors in 2004. A Notice of Deficiency (NODD) was issued in August of 2005 asserting tax, penalty, and interest liabilities in all three years. The two main adjustments were to disallow the taxpayer's classification of specific gains as nonbusiness income, and to change the taxpayer's Idaho filing method to the worldwide method.

The 5% negligence penalty was assessed for the taxpayer's continued use of the water's-edge filing method without filing the proper water's-edge election form. Idaho Income Tax Administrative Rule 644 allows the Commission to assert the negligence penalty (by rule reference) to taxpayers that fail to comply with the Idaho code and rules regarding water's-edge filings. Idaho Income Tax Administration and Enforcement Rule 410 requires the negligence penalty to be assessed where the taxpayer has exhibited disregard for the rules of the Commission. It lists specific examples of negligence that include the continuing to make errors in reporting income that have been brought to the taxpayer's attention in previous audit reports.

This continual disregard for filing a proper election was discussed in detail by the auditors in their audit narrative. The taxpayer protested the audit for the nonbusiness income issue but agreed to the change in the filing method.

In February of 2007 the Commission issued a written decision that upheld the penalty as assessed by the audit staff. This decision stated in part "The Tax Commission observes that the Petitioner continues to file on a water's-edge basis without filing the proper election, an issue that has been addressed with the Petitioner in previous audits. The Audit Division and the MTC (Multistate Tax Commission) also found Company D to be part of the Petitioner's unitary business in previous taxable years. Therefore, the Commission finds that waiver of the penalty is not warranted."

In April of 2007, the auditor was informed that a C&C had been issued that removed the negligence penalty from the total assessment. This C&C was not discussed with the auditors at any time before this notice, and no explanation was provided for the Commissions reversal of the penalty.

History

The audit staff disallowed the water's-edge filing method to the taxpayer in several prior audits.

- The taxpayer was put on notice in January of 1995 that a water's-edge election was required.
- Commission auditors again notified the taxpayer of this requirement in 1997 while conducting an audit.
- The MTC then conducted an audit of this taxpayer for the Idaho Tax Commission in 2001. The taxpayer was still filing incorrectly. Adjustments were made to correct the filing method and the taxpayer was again put on notice regarding the requirement to file the water's-edge election.
- The taxpayer not only continued to file incorrectly in this audit period (6/01, 6/02 & 6/03), but is currently under audit for subsequent years for the same issue.

Summary

This taxpayer has been filing its Idaho income tax returns on a water's-edge method for over fifteen (15) years. The audit staff has converted this taxpayer to a worldwide filing continuously over this time period. The taxpayer refuses to file the mandatory water's-edge election. The taxpayer recently told the audit staff that it refuses to file this election as a "matter of principle."

Idaho Administrative Rule 500 applies to penalties as well as tax. There must be a "doubt as to liability" before the penalty can be removed through a C&C agreement. The decision written by the Commission properly upheld the negligence penalty in this case because of the taxpayer's continual disregard for the rules of the state of Idaho. The Commission's subsequent reversal of this penalty through the use of a C&C is in direct violation of Rule 500.

The issue of compromising penalties has a long history with the Commission. In many instances the Commission intentionally ignores the grounds for, and the legality of, penalties imposed by the audit staff. The Commission often uses penalties as a bargaining device with which to obtain a tax settlement from a taxpayer. The Commission will offer the taxpayer relief of the penalty in exchange for a payment of the tax, or in most cases a payment of part of the tax. This is done regardless of the strength of the Commission's position on each case. In some areas, such as in protested audits conducted by the multistate audit staff, this "bargaining" is the norm instead of the exception.

However, this use of penalties is not restricted to just the multistate audit area. Using penalties as a bargaining chip is done throughout the Commission. Penalties are no longer used to encourage proper tax reporting, which has resulted in a substantial decrease in taxpayer compliance. The audit staff has discussed this penalty issue on numerous occasions with

Commission management, deputy attorneys general, and appeals personnel. The audit staff arguments have been ignored in almost all cases.

The Commission's long term refusal to promote and enforce compliance with Idaho tax law through the use of penalties is one factor in why almost all large multistate companies protest all corporate income tax audits regardless of issue. The Commission's refusal to properly apply penalties removes all incentives for taxpayers to comply with Idaho tax laws.