ILLEGAL AUDIT SETTLEMENTS OF THE IDAHO TAX COMMISSION

THIRD (supplemental) report to Governor Otter, Attorney General Lawrence Wasden & The Idaho Legislature

By: Idaho Tax Commission Auditor Stan Howland

June 15, 2008

This is a follow-up to my initial report dated May 27, 2008 and my second supplemental report dated June 15, 2008. I am writing this report to provide additional information regarding the internal control audit conducted by Legislative Services on the Idaho Tax Commission in 1996. I believe that it is essential to have a complete understanding of the findings, recommendations, and responses to this audit as it provides valuable insight into the illegal actions currently being conducted by the Tax Commission in its handling of audit protests.

Legislative Services issued two audit reports in 1996. The "original" report was issued to the Tax Commission for review and represented the findings of the two legislative auditors. The Tax Commission issued a response to these findings which is included in this report. This report was eventually destroyed and replaced by a "final" report. The Commission's response to the final report was received in October of 1996.

THE 1996 ORIGINAL LEGISLATIVE AUDIT REPORT

The following is my overview and explanation of the 1996 Internal Control Report issued by Legislative Services and presented to the Idaho Tax Commission. This "original" report provides a more in-depth analysis of the internal control problems at the Tax Commission than what was contained in the final report. It was also much more specific regarding statutes and rules that were violated by the Commission. The internal control problems, and the Commission's refusals to address them, have not changed since this 1996 first report was written.

In the spring of 1996 I received a telephone call from an auditor working for Legislative Services. He said that they had received a complaint that accused Commissioner Dewey Hammond of illegally settling protested audit cases of large multistate corporations. He told me that this informant had given him my name as someone that might assist in the investigation.

I met with this auditor in his office and told him that I would cooperate fully with his investigation. I met with him one more time and gave him a general overview and history of the Commission's actions regarding settlements since Mr. Hammond had been appointed. He asked me to collect information on as many compromised cases as I could and put together a master list that could be reviewed. The legislative auditor called me a few weeks later telling me that he had removed himself from the audit to satisfy the complaints of Commissioner Anne Barker. He told me that I would be contacted by two auditors that had been assigned the case.

I was later contacted by Tom Haddock and Anne Lang and asked if I would still assist in the investigation. I agreed. Over a period of several weeks I put together a list of cases that had been recently settled with compromise agreements. Eventually 13 cases were selected by the legislative auditors for review. I spent a number of evenings over the next few months with the two legislative auditors assisting them to understand multistate auditing and various audit issues that were found in the selected cases.

The attached document "State Tax Commission Response to Internal Control Report" is a draft completed by the two legislative auditors and presented to the Tax Commissioners. This copy of the draft includes the Commissioner's response to the audit findings as written by Lenard Wittlake, an attorney hired specifically to defend the Commission. Mr. Wittlake had previously worked as a deputy attorney general assigned to the Tax Commission and had been involved in several of the cases being investigated. He was working in the state of Washington at that time and was hired for several months at taxpayer's expense to return and defend the Commission.

The legislative auditors advised me that their original report stopped short of a finding of malfeasance. However, the report stated specifically that "The Commission's compromise files include instances where statutes or rules were not followed." This concerned me somewhat as I believed that statutes and rules were knowingly violated for specific purposes, which would clearly be malfeasance. However, the auditors said that it was their supervisor's philosophy on all audits to focus on working with the state agencies to improve performance rather than to focus on guilt. Although the auditors were careful in their explanation, it was clear to me that they also felt malfeasance was present at the Tax Commission, but were limited in what findings they could propose.

The legislative auditors gave me the draft report for review. I provided a brief response to a number of Mr. Wittlake's comments that I considered to be misleading and in some cases, totally untrue. I did not respond to everything in the report due to time constraints. My comments were in the form of notes to the legislative auditors to assist them in understanding Mr. Wittlake's inaccurate statements. I had planned additional work on the report to defend it in its entirety.

A short time later I was asked to meet with the legislative auditors and their supervisor, Larry Kirk. In this meeting Mr. Kirk advised that the report would eventually be presented to the Joint Finance-Appropriations Committee, and he was concerned that Legislative Services did not have the expertise to defend it due to the complexity of the issues. I advised him that it was absolutely necessary to present these findings, that the legislative auditors could easily defend it, and that I would testify before JFAC to rebut Mr.Wittlake's responses. Mr. Kirk was not prepared at that time to make a decision on how to proceed.

A week or two later I received a call from one of the auditors asking me to come to another meeting. Mr. Kirk was not present. The auditors showed me a letter signed by Attorney General Lance addressed to Mr. Kirk's manager. This letter was extremely critical of the legislative auditors stating that they did not have the credentials to examine or question the deputy attorneys' general and that they should be prohibited from doing so. Although I do not remember all of the details of the letter, it was clear that it was written to stop the ongoing

investigation. I asked for a copy of the letter but was informed that the legislative auditors would be fired if it became knowledge that they even showed it to me. However, they did tell me that it would be a permanent part of the file that would be saved. I was then informed that Mr. Kirk had torn up the proposed audit report and re-wrote the findings. This new report removed many of the auditor's findings and recommendations. It was substantially watered-down from the original report and fell far short of identifying the problems at the Tax Commission. Both legislative auditors were very upset with this process but could do nothing to stop it.

I have summarized the findings, recommendations, and responses of both legislative reports below. The detail behind the findings and responses of the original report are included in the body of the report which is attached to this document.

Summary Findings & Recommendations of the 1996 <u>ORIGINAL</u> Report:

<u>Finding #1.</u> More than one person should approve and sign compromise agreements.
Commission's Response – **Disagree**.

<u>Recommendation #1:</u>

1. Define and follow criteria for appropriate compromise.
   Commission's Response – **Not necessary.**

2. Require a case resolution form for every compromise.
   Commission's Response – **Not necessary.**

3. Discontinue delegating sole compromise authority to one individual.
   Commission's Response – **Disagree.**

<u>Finding #2</u>. The Commission's lack of records and procedures for compromised cases is a weakness in internal control and accountability.
Commission's Response – **Disagree.**

<u>Recommendation #2:</u>

1. Policies and procedures be followed and documentation from taxpayers be required.
   Commission's Response – **No change is necessary.**

2. The audit bureau calculate the effect of compromises prior to finalization.
   Commission's Response – **No change is necessary.**

3. Copies of all decisions, compromises, and closure forms be distributed to audit staff.
   Commission's Response – **No change is necessary.**

4. A history file should be kept for all audits.
   Commission's Response – **No, the Commission objects to providing anyone the dollar amount compromised on any case.**

5. The Commission date & sign all information (notes, correspondence, calculations, etc.) and include in legal files.
   Commission's Response – **Do not understand the relevance of this recommendation.**

6. The Commission make public the total dollar amount compromised (by tax type) each year.
   Commission's Response – **No.**

Finding #3. Idaho statutes or rules were not followed. Seven specific cases were cited.
Commission's response – **Denied, no statutes or rules were violated.**

Recommendation #3. The Commission should comply with statutes and rules and should recommend changes to such law if it feels it necessary.
Commission's response – **No change is necessary, it does comply.**

THE 1996 FINAL LEGISLATIVE AUDIT REPORT

The final report was titled "Idaho State Tax Commission - Multi-State Corporate Tax Compromise and Close Agreements". I have not included a copy of the final legislative audit report as it available through Legislative Services, and has been made available to the general public by the media.

Summary Findings & Recommendations of the 1996 FINAL Report:

Finding #1. Sole Authority Is An Inherent Control Weakness.
Commission's Response – **Disagreed that an internal control weakness exists, but admits there may be a "perception" problem.**

Recommendation #1: Require that a second Commissioner sign off on all compromises above a certain dollar amount.
Commission's Response – **Agreed, this simply formalizes an existing "team" approach already in use.**

Finding #2. Documentation Should Be Improved.
Commission's Response – **Disagreed that this was a problem (other than some organizational problems.)**

Recommendation #2: A listing of suggestions include 1) obtaining and placing requested information, written elections, documentation in the files, 2) maintain and keeping a case

resolution and closure form, 3) maintain an audit history file for each audit that includes specific information, and 4) sign and date all notes, correspondence, calculations, and other information placed in the legal and audit files.
Commission Response – **Debated most of the recommendations and agreed to "maintain adequate records and documentation."**

It should be noted again that due to the audit philosophy of Legislative Services management in 1996, the audit findings were substantially watered-down from the findings of the auditors. The Commission was extremely uncooperative and combative during the legislative audit, and refused to accept the vast majority of audit findings. The only recommendation of note agreed to by the Commission was the second Commissioner sign-off procedure which does not enhance internal control unless accompanied by third party review, and /or public notification. It is very concerning that a small group of public officials responsible for overseeing the tax revenues collected from, and for, the citizens of this state can isolate themselves from all accountability for their actions and refuse to cooperate with a legislative audit.

The findings in both legislative reports and the Commission's response to such findings are history. Nothing can be done about the Commission's illegal settlements made through 1996. However, it is important to review the history of Commission audits to show that procedures and behaviors have not changed. The Commissioners previously refused to accept any oversight or adopt any internal controls as recommended by this legislative audit, and continue to do so today. Because the problems at the Tax Commission were not dealt with at that time, the honest taxpayers in this state continue to subsidize a number of large corporations that receive the special tax breaks detailed in my original report.

Attached to this overview is a copy of the original (first) report that was presented to the Commission. The responses from Mr. Wittlake are in bold. I have inserted my comments made at the time in blue.

Stan Howland

State Tax Commission Response to Internal Control Report

(Original report presented to the Idaho State Tax Commission in summer of 1996)

State Tax Commission Response
to Internal Control Report Introduction

(Page 1 through 12 were written by Lenard Wittlake, representing the Idaho Tax Commission. Responses (in blue) written by Stan Howland)

Introduction

The Legislative Audit staff submitted a draft Internal Control Report to the Commission on June 13, 1996 which focuses on the settlement of multi-state corporate income tax cases. This response presents a brief overview of the Tax Commission's perspective and specific comments on statements in the report. The comments in this response are generally limited to the items and procedures mentioned in the report and should not be construed as encompassing the entire scope of Commission activities.

Settlement is one method of deciding a tax dispute. The process necessarily involves the review of tax accounting information as well as careful analysis of legal issues and consideration of the best interests of the state. Good business judgment is necessary to coalesce these various disciplines in the exercise of sound discretion to resolve a dispute. It is the interplay of legal issues and the proper resolution thereof that causes the major disagreement between the Tax Commission and the Legislative Audit staff on this project.

Overview

In the summer of 1993, a relatively new Idaho State Tax Commission was faced with a dilemma caused by a large backlog of protested tax cases (see Figure 1) and the imminent implementation of the Taxpayer Bill of Rights on January 1, 1994. The Commission had to take action to resolve disputes, provide tax certainty to the taxpayers, reach agreements, close cases, and deliver revenue to the State. The system could not tolerate such a large volume of accounts receivable tied up in the legal process, accompanied by angry and frustrated taxpayers, and potentially more litigation than the Commission could absorb.

Litigation regarding tax disputes is only justified when it is absolutely necessary for the most-crucial events or circumstances, to define tax issues, or to purposefully set precedent.

This statement sets the stage for the Commission's support of its widespread usage of compromise agreements. Its tone is that litigation is something that should almost always be avoided and then outlines the few rare situations that it would come into play. The audit staff believes that litigation is necessary to uphold the Idaho statutes. If a taxpayer clearly violates an Idaho statute, and absent any unusual circumstances, our position should be litigated.

The Commissioner and the Deputy AGs have advised the audit staff on many occasions that litigation must be avoided if there is any possibility of losing. With few exceptions this has

been the policy of the Commission since the appointment of Commissioner Hammond. The precedent that desperately needs to be set is that the state of Idaho will require adherence to all income tax laws. The majority of large corporate taxpayers know this is not currently the case and protest most audits. The Commission's compromise policy has insured a steady stream of protests from a rapidly growing number of taxpayers. It has also insured that the number of tax returns filed incorrectly will increase as the reputation of the Idaho Tax Commission spreads.

Unwarranted litigation raises the State's and the taxpayers' legal costs, postpones answers to tax questions, and runs the risk of calamitous judicial precedent.

Taxpayer protests in the corporate income tax area involve complex issues of law and fact. To provide a meaningful, independent, and timely review of the issues, the delegated commissioner employs a team approach. Attachment 1 is an example of this procedure.

The commissioner uses the team approach only when it is to his benefit. He totally ignores any advice that does not support his program of compromising audit findings. He is very adept at securing advice that supports his positions. He will actually badger and harass individuals until they agree with him. Those individuals that will not be coerced in this manner are never included on the "team" again.

The Commission believes a taxpayer deserves such a review of his unique facts and circumstances. The principles guiding the Commission's approach to petitions filed for redetermination are based on a common sense construction of the appeals statutes at Idaho Code §§63-3045, 3045B, and 3049.

A full review requires specialized knowledge in the particular tax field involved; a thorough analysis of the facts of each case; and the experience base, coupled with advice of counsel, upon which to apply a doubt-as-to-liability analysis to the taxpayer's specific facts and circumstances.

Why does Idaho Income Tax Administrative Rule 112 require that a liability can only be compromised based on one of three stated grounds? If the Commission were given unconditional authority to compromise any case, these three grounds for compromise would not be necessary. They were established to put some restrictions or controls over the authority to compromise. Using "doubt as to liability" as a catchall to justify any compromise is to have no limitations at all.

Where doubt as to liability exists, the Commissioners believe that settlement negotiations are not only proper, but required. A doubt-as-to-liability analysis is part of the law, not contrary to it. This includes the expectation of the taxpayer to receive a fair and equitable settlement when the taxpayer can show a distinct possibility of prevailing in court. Risk of litigation is a major consideration. Given limited resources, the Commission chooses not to expose the State or the

taxpayer to protracted, expensive, and uncertain litigation.'[1] Taxpayers deserve a prompt response to their protests, one that provides tax certainty to them on an efficient and timely basis.

Idaho Income Tax Administrative Rule 112 states that "The State Tax Commission may compromise . . ." The term "may" represents the authority or permission to do an act, but not an obligation or requirement to do it. If the Tax Commission were required to compromise when a doubt-as-to-liability existed, the rule would use the word "shall" which does represent an obligation to do the act. "May" is discretionary; "shall" is not. There is no authority in the statutes or rules that would support the Commission's statement referenced above. This is simply another reason to justify compromising a case. Settlement negotiations may be proper in cases where a doubt as to liability exists. However, litigation may be the best approach in some of these cases. Equity and long-term tax consequences may require a legislative and/or judicial resolution to an issue.

The Commission's records show that since January 1, 1994, 312 cases have been resolved by the issuance of precedent-setting decisions, and 328 cases have been settled through the issuance of compromise agreements. As shown in Figure 1, old cases are being resolved. In 1994, over forty percent of the settled corporate income tax cases involved audits that were ten years old or older. In 1995, twenty-five percent of the corporate income tax settlements involved audits that were ten years old or older.

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[1] Litigation can be a very *lengthy* process. The Burlington Northern / Union Pacific case was in court for 8 years, including two appeals to the Idaho Supreme Court. The TTX case was on appeal for 6 years, with 1½ years waiting for a Supreme Court decision. Litigation can be a [1] Litigation can be a very *lengthy* process. The Burlington Northern / Union Pacific case was in court for 8 years, including two appeals to the Idaho Supreme Court. The TTX case was on appeal for 6 years, with 1½ years waiting for a Supreme Court decision. Litigation can be a very *expensive* process. The Potlatch boiler litigation included expert witnesses and several depositions, including a deposition of the Chief Operating Officer in San Francisco. The results of litigation can be *uncertain.* In Burlington Northern / Union Pacific the apparently "victorious" taxpayer asked the court to reconsider the case. The court did not adopt either parties' argument. After remand to District Court the parties argued about the meaning of the Supreme Court ruling and the case was again appealed to the Supreme Court.

These are misleading and incorrect statements. The author is trying to show that almost 50% of the cases completed since 1/1/94 were done so by written decision and that this represents some sort of high level of efficiency. First, these referenced cases do not represent the focus of the legislative audit. The legislative audit is concerned with one Commissioner and one type of audit. The Commission's compromise percentage on corporate multi-state cases was closer to 80%. This raises additional questions. Does the 50% Commission wide decision rate represent efficient protest management, or does it represent potential serious problems in the Commission's resolution of audit cases? Even if one illogically assumes that a 50% compromise rate is optimum, then how is the 80% multi-state compromise rate explained or defended?

The Commission is trying to support their massive giveaway program by painting a picture of a huge backlog of old cases that could only be cleaned up by negotiating compromises. 40% of the settled cases in 1994 and 25% of those in 1995 were not 10 years old. This is simply untrue. It is possible that some of these cases included tax years that were that old at those percentages. This would be normal and expected, and caused by several reasons. Any case in protest almost always includes a tax year that is 6 years old. Example; the 1990 tax year is filed in October of 1991, selected for audit in 1993, started in 1994, and completed in 1995. Even with minimal delays, this tax year would not show up as a logged protest until 1996.

The Commission has administered the laws according to the statutory mandate that process and procedure before the Commission be as summary and simple as it reasonably may be and, so far as possible, in accordance with equity. Idaho Code § 63-514. There is also the mandate to construe statutes "with a view to effect their objects and to promote justice." Idaho Code § 73-102.

How is justice promoted when large multi-state corporations are continually allowed to pay less than their determined tax? Would the average citizens of Idaho who pays their full tax feel that justice is being promoted if they knew the extent and frequency of these settlements? If you know how to play the game, you win. The current system has gotten so out of hand that a taxpayer (one involved in negotiating with the Commission) has compared it to buying a used car.

The negotiation of cases criticized by the Legislative Audit staff occurred during a time in which the corporate tax law in Idaho was in a constant state of flux and substantial uncertainty.

This is not true. From 1990 to 1994 there were numerous changes brought about by court decisions and legislative changes. The majority of the cases in question were negotiated after that time. The corporate tax law in Idaho has never been in substantial uncertainty. Not one of the audit changes involved in these cases was due to uncertainty in Idaho law.

Idaho had administered the worldwide combination method of filing for unitary corporate groups for over 20 years when the court declared in J.R. Simplot Co. v. State Tax Commission that there

was no such method under Idaho law.[2] A temporary regulation was issued and immediate - rework of every outstanding corporate deficiency was undertaken. Converting corporate tax calculations from the worldwide method to the Simplot domestic method consumed substantial audit resources.

This is an absurd exaggeration, if not an outright untruth. The majority of corporate deficiencies were not affected. The only conversions causing extra work were for those corporations that were either under audit or had unresolved protests, and were on a worldwide filing method. The worldwide filers that were not yet audited created no extra work as this conversion would be routinely dealt with on audit. The majority of audits at that time dealt with other issues and were not affected.

Then the 1993 legislature passed taxpayer sponsored House Bill 404 to reinstate the worldwide method retroactively for all open cases and change the water's edge combination. Outstanding corporate deficiencies were again reworked and converted, at the taxpayer's election, to the HB 404 worldwide method.

This process was complicated by the fact that HB 404 worldwide was not exactly like the worldwide method that the Commission had administered for 20 years. In 1994 the legislature passed House Bill 832 which made some changes to the HB 404 provisions. Final regulations on the "new" statutory worldwide method were issued in June of 1994. The corporate tax auditors, legal and appeals staff, and Commissioner now must be familiar with pre-Simplot worldwide combinations, statutory worldwide combinations, Simplot domestic combinations, pre-1993 water's edge combinations, and post-1992 water's edge combinations.

In addition, the Commission was litigating investment tax credit (ITC) issues with Burlington Northern Railroad and Union Pacific railroad. The court changed the ITC formula. Legislation immediately followed to reinstate (with some changes) the prior formula. Also, another pending court case resulted in legislation that reversed over 10 years of ITC application to corporate unitary groups.

The Commission was also litigating fundamental issues such as nexus in TTX and corporate deductions in Potlatch Corp. and Extended Systems. Inc. These cases were decided in 1996. Court cases reversing long-standing tax practice and legislative changes have created an environment of substantial uncertainty in Idaho corporate tax law. The changes were major and rapid, with a dramatic effect on tax administration.'[3] Finally, in 1993 the Taxpayer Bill of Rights

[2] The worldwide method was a result of Idaho's adoption in 1965 of the Uniform Division of Income for Tax Purposes Act (UDITPA) codified in Idaho Code §63-3027. It is clear that the Commission cannot necessarily expect a uniform interpretation of uniform laws.

[3] Idaho Code § 63-3029B, the investment tax credit statute, has been amended every year

was passed which mandated resolution of most tax protests within 180 days of the date the case is fully submitted for review. It was a mandate to clear the backlog of protests.

All of this was imposed on an overloaded audit, appeals, and legal staff at the Commission. At one time one individual handling protests had over 170 cases. Others handled over 120 cases each for months at a time. The backlog was part of the impetus for the Taxpayer Bill of Rights. The Commission started a process of resolving old cases and clearing out the backlog. It was utterly impossible to litigate every case, regardless of merit. The number of pending protest cases was reduced from over 1000 in late 1992 to under 500 in late 1995. See Figure 1. The personnel handling these appeals are the same persons that the audit staff ask for legal and policy guidance on new and existing laws. With 12 people to handle over 1000 cases, not much time was left over to advise the audit staff on the meaning of the latest court case or new statute. These are also the same people that develop new legislation and administrative rules.

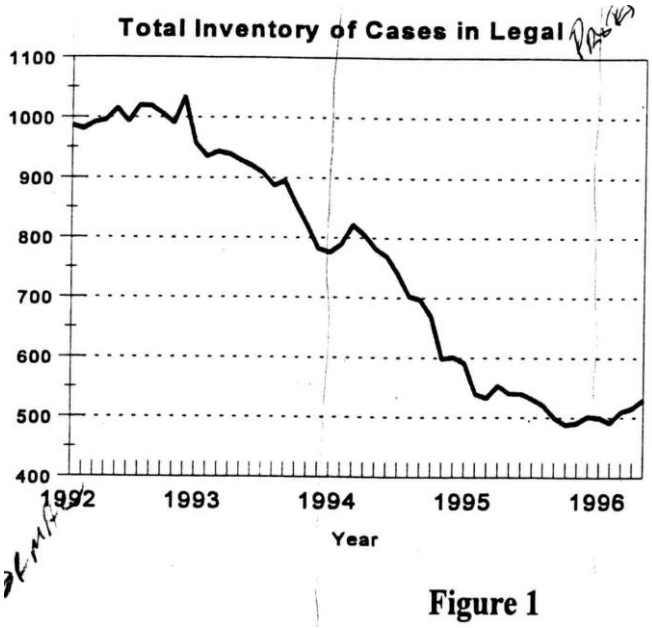

Figure 1

Even so, Idaho's settlement process is extraordinarily productive. For example, in 1995 the Commission's settlement process resulted in roughly sixty cents on the dollar collected.

Where is the support for the sixty cents on the dollar? If statistical information was requested and not provided by the Tax Commission that would verify statements now made by the Tax Commission, the audit report needs to indicate clearly that this information was requested and denied. The Commission intentionally misleads the reader by comparing settlement statistics of the IRS Offers-in Compromise program to total undocumented settlement figures for the state of Idaho. A reference is then made to "corporate" income tax cases. The comparative figures used for both the state and IRS include compromises of ALL cases (includes cases compromised for collectability and hardship reasons) which cannot be compared to corporate cases restricted to doubt-as-to-liability grounds. If the Commission did prove that they collected sixty cents on the dollar on corporate cases, would this be an example of productivity? Writing off 40% of the tax deficiencies deemed due by the Audit Bureau is hardly extraordinarily productive.

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from 1992 through 1996. House Bill 132 in 1995 (the Idaho source income bill) made substantial revisions throughout the Income Tax Act.

If new facts and information presented by the taxpayer following the audit are taken into consideration, the settlements produce approximately eighty cents on the dollar.

On the Commission's protest list, several of the cases in question were listed as cases where additional information was received from the taxpayer. This is untrue. The final legislative report should state clearly that many of the statements made by the Commission are erroneous and have not been supported by any factual documentation.

This 60-80% settlement success can be compared to similar statistics for the Internal Revenue Service which show 16% collected nationally, and 13% collected in Idaho through Offers-in-Compromise received from October 1, 1994 through September 30, 1995. Since January 1, 1994, over $8.6 million has been received by the State from the corporate income tax cases that were in backlog but subsequently settled. This represents optimum present value for the State, and a timely response delivered to the taxpayer.

The Commission again compares apples and oranges in an attempt to confuse the reader. The Offers-in-Compromise program (IRS) includes collectability cases which cause the vast majority of all compromises. Doubt-as-to-liability is the only issue at hand.

How much was written off? The audit staff believes that close to $20 million was owed on these cases. Exact figures are unavailable as the Commission has denied the auditors access to the legal and audit files. Allowing a handful of corporations special tax treatment by writing off over $10 million dollars in legitimate tax deficiencies does not represent "optimum present value for the State."

In summary, effective management requires prioritization of scarce resources, cost effective decisions, balance and fairness to achieve the goals of the agency's strategic plan.

Legislative Auditor's Internal Control Report

The report states three underlying concerns: (1) the authority vested in each commissioner to settle cases, (2) apparently undocumented settlement decisions and (3) noncompliance with tax statutes. Each of these concerns are refuted in section II of this response.

A few employees of the Commission brought the issue of corporate income tax settlements to the attention of the Legislative auditors.

The final legislative report should show the Commission's attitude toward this audit. The audit report should reflect the reluctance of some employees in providing statements, and the reversal of statements, when in the presence of the Commissioner due to fear of losing their jobs. The report should indicate that auditors were instructed to report each meeting with a legislative auditor and that auditors were denied access to their own workpaper files during the process. The report should indicate the refusal of the Commission to provide information that they later gathered for their own support. The report should reflect the Commission's cavalier attitude that

they are above reproach. The report should acknowledge previous attempts by auditors to tighten internal controls and the failure of the Commission to address these issues.

From the total population of corporate tax settlements, legislative auditors selected 39 corporate income tax cases for review. Of this total, 13 were selected for detailed examination. A total of $7.9 million was received by the State from the 39 cases, of which approximately $6.0 million was produced from the smaller list of 13 cases. While primarily involving corporate income tax, two of the 13 cases also include settlement of several prolonged sales tax audits with two of the respective taxpayers. The resolutions of the sales tax issues were integral to the compromise agreements, and are included in the enclosed analyses.

These 13 cases were not randomly selected by the legislative auditors. Rather it appears that these cases were selected in order to prove that "excessive tax reductions" were being granted. No such thing happened. Therefore, no such proof exists.

For the 13 selected cases, settlements represent a recovery rate four to five times higher than that experienced by the Internal Revenue Service over a comparable time period. On average, the amount compromised by the Commission is less than the amount compromised by the taxpayers. Of approximately $8.4 million at issue, the Commission received nearly $6 million. As part of these agreements the taxpayers gave up claims of $7.7 million and the Commission gave up claims of $2.7 million, including carryforward items, thereby avoiding costly and protracted litigation with uncertain results. Every settlement entered into has been in the best interests of the state of Idaho. They are the result of listening to the taxpayers, forming multi-faceted focus teams, rolling up sleeves to understand and to respond to taxpayer-specific facts and attributes, providing a truly independent review, seeking cost effective solutions, and applying criteria for settlement. This is what good government is all about.

As to the question regarding authority to settle, the report recommends that such authority not be delegated to a single individual or that some review and approval occur before larger cases are settled. Idaho Code § 63-3048 states that the commission or its delegate is authorized to reach agreements with taxpayers regarding their tax liability. Such agreements are conclusive and not subject to review. This authority has been unchanged since the Income Tax Act was enacted in 1959. Now the legislative auditor, representing the legislature, says such authority should not be allowed. It appears to the tax commission that there is a difference of opinion between the legislature and the legislative auditor. The tax commission intends to continue administering the tax laws according to the statutes passed by the legislature.

It is crucial to recognize that tax audits have a different focus and objective than financial audits. Financial audits are to express an opinion on the fairness of financial statements. Tax

audits are to determine compliance with tax law and may focus only on a few entries on the tax return. It is rare to audit the entire tax return from major corporations. In fact, such an undertaking for a multinational company is impossible for the Tax Commission staff. It is necessary and common practice to work from federal tax returns and taxpayer schedules without tracing every number to underlying accounting documents. Some original accounting documents are examined, some summary schedules are examined, some items are based on oral representations, all subject to the auditor's professional judgment. Later, during the protest resolution process, settlements are entered on some cases because calculating a precise tax number requires an unreasonable amount of resources. The exact amount is unknown and reasonable estimates are used.

Absolutely untrue. Calculating a precise number is a very simple operation. On each and every one of the 13 cases exact tax liabilities were given to the Commission. There was never an occasion when the exact amount was either difficult to obtain, or unknown.

Tax law provides for such reasonable estimates. See generally, Cohan v. Commissioner, 39 F.2d 540 (1930). A recent Tax Court opinion stated: "If a claimed deduction is not adequately sustained, we are permitted to estimate expenses when we are convinced from the record that the taxpayer has incurred such expenses." See T.C. Memo 1995- 497. Reasoned estimates are a part of the body of law guiding a Commissioner in the quasi- judicial function of deciding a protest.

The four tax commissioners fulfill an *executive* function by directing the operations of the agency, a *quasi-legislative* function by promulgating rules, and a *quasi-judicial* function by deciding protested audits. As part of its function of deciding protests, the commission or its delegate is authorized to reach an agreement "with any person relating to the liability of such person ... in respect of any tax under this act" and such agreement is not subject to review. Idaho Code § 63-3048.[4]

It is wrong that auditing standards designed to test internal accounting controls are being applied to a quasi-judicial function. Such is not normally the case. **A** proper understanding of the commission's quasi-judicial function is essential to reviewing compliance with laws and regulations. The only proper inquiry is whether there was an abuse of discretion by a commissioner. There is nothing here that a court could find to be an abuse of discretion. As

[4] The legislature has stated that an agreement between the commission and taxpayer is final. Idaho Code §63-3048(b)(2) states: "In any suit, action or proceeding ,such agreement, or any determination, assessment, collection, payment abatement, refund, or credit made in accordance therewith, shall not be annulled, modified, set aside, or disregarded." Therefore, the legislature has stated that the quasi-judicial function, when exercised to reach such agreement, is not reviewable by the courts except to determine whether the officer has exceeded his jurisdiction. Idaho Code § 7-202.

discussed later, courts encourage settlements.

Is the Tax Commission trying to dictate what can and cannot be questioned by the legislative auditor? Can they set the rules for which functions or decisions can be subject to review by others? They continue to convey the message that they are above reproach.

The audit report contains several misstatements and observations presented in a misleading manner. Auditors usually review internal control to help establish audit scope. In this anomalous case, the auditors performed an internal control review after finishing field work on the financial compliance, and for a different period.

The statement is irrelevant as the fact remains that the internal controls are not in place regardless of whether the internal controls were reviewed first, or through the review of the cases.

While the report claims to be an adjunct to the financial compliance audit, the substance of the review is clearly a performance audit. The substance of the report seems to be merely a disagreement with the Commission's handling of certain protests.

Moreover, several audit "findings" and recommendations are identical to statements made by tax commission staff in the recent past and appear to come directly from the anonymous staff members mentioned in the report. These items have been the subject of vigorous debate within the commission just a year ago. All of the recommendations have been considered previously by the Commission and the Deputy Attorneys General assigned to the Commission. Some are already in place, some are under development, and others have been rejected.

The “statements made by tax commission staff” were suggestions provided by the audit staff at the request of the Commissioners approximately one year ago. They have heard absolutely nothing in response to any of the recommendations. Which suggestions were adopted? Which ones are under development? If some were rejected, were the Commissioners going to tell anyone?

The audit staff also recommended to the Communications Committee (currently inactive) that controls needed to be established for situations when a Commissioner should excuse himself from a case due to a conflict of interest or even the appearance of a conflict of interest. The Commission never acted on this concern. Apparently they are above excusing themselves from any case.

Conclusion

Even if reduced to writing, subjective legal advice remains subjective. Administrators are nevertheless entitled, even expected, to rely on such professional legal advice in making

decisions about whether to settle a given case. Idaho Code §§ 67-1401, 1406. Internal controls within the Commission cannot constrain the Deputy Attorneys' General professional and ethical obligation to give their best assessment of the Commission's litigation risks.

Internal controls would not constrain this obligation. Rather, they would ensure that the best assessment of litigation risks was received from the AGs. The assessment of the litigation risks needs to be based on thorough analysis, not just an oral statement by an AG that the Commission could lose with no objective facts provided as to how that assessment was reached. Litigation risk is only one factor that should be considered. According to Attachment 1 provided by the Commission, also considered must be the precedential value of a decision, the importance of deciding legal or factual issues, and the long-term effect of a written decision.

Justice is not the same as expressing an opinion on the fairness of financial statements. Justice in the law is difficult to measure or audit. An auditor's professional tools are ill suited to the task to which the legislative auditors have tried to put them. That is why the legislative auditor's recommendations ultimately lead only to the illusion of internal control over what is really a subjective judgment based on experience and entrusted by law to the sound discretion of the Commissioners.

This report evinces no dialog with taxpayers that are outside parties with an interest in the process at the Commission. Neither does the report give credence to the explanations provided by Commissioners, counsel, other auditors, and tax policy staff. The report expresses only one view. Therefore, it is biased and does not reflect an understanding of the negotiation process.

In closing, tax cases and the Commission's perspective are not generally favored by the courts. The Commission's litigation record bears this out.

The Commission seems to be saying that the only reason we lose cases is that the courts don't like us. First of all, we have won a number of cases. The lost cases take on much more importance because they are constantly used by the Commission to justify entering into more compromises. On rare occasion we have lost cases due to poorly written statutes. If a statute is poorly written, it should only justify one compromise. The law should then be changed so that additional compromises are not necessary. This seldom happens at the Commission. We have been compromising the same issues for years. On the majority of these issues, the Commission refuses to advise the Legislature of the problem stating that they are easily handled on a case-by-case basis (compromise).

It is highly probable that that poor preparation and representation may have been partially responsible for losing some of the cases. The Commission's response to the Legislative Report paints a picture of unquestioned intelligence and integrity of all Deputy AGs. This certainly is not the case at the Tax Commission. A review of the Simplot and TTX decisions will reveal possible inadequate legal representation provided to the Commission by the Deputy AGs.

Turning to judicial remedies must, therefore, be carefully deliberated. Bad cases make bad law.

Bad law at least is applied to all taxpayers in the same situation equally. Bad law established through case law can be corrected through legislation. One example of bad case law corrected through legislation is Burlington Northern/Union Pacific

It is clear that settlements are the favored remedy.

Favored by whom? It is common knowledge that the courts favor settlements because of their backlog of cases. Attorneys favor settlements for a variety of reasons. Would taxpayers favor settlements if they knew that others were being held to a different standard than they are? The statement that settlements are the favored remedy is ludicrous. The favored remedy by those that have to pay the tax of others, is the correct remedy.

Settlements are contemplated and approved by law. Settlements are actively encouraged by the courts. Fair settlements are, as substantiated on several occasions, what legislative leadership expects.

CASE EXAMPLE

Once a proper protest is filed by the taxpayer, the following is a typical example of how a case would be handled:

-The case is assigned to a deputy attorney general and/or tax policy specialist. A "legal file" is opened which contains copies of selected parts of the audit file.

-Generally, a summary is prepared for the commissioner with oversight.

-Commissioner is presented the summary and entire file for review, including NOD, audit narrative, taxpayer's protest, all notes and research performed.

-Commissioner forms team including some or all of the following personnel for an independent analysis of case:

- -tax policy specialist
- -deputy attorney general assigned to the agency (I.C.§ 63-3066)
- -bureau chief or manager
- -audit personnel
- -deputy attorney general from central office litigation staff.

-Informal conference held at taxpayer's request. (Rule 109.02(b); I.C.§ 63-3045(2)).

-Following the informal conference, further assignments for research/analysis are made to include hazards of litigation, comparative strength of conflicting legal positions, factual issues and susceptibility of proof, long term effect of a decision either way, precedential value of a decision, importance of deciding legal or factual issues, and other critical results of the proceeding.

-Recommendations, even if disparate, are given to the commissioner.

-On major cases (monetarily or precedent setting) oversight commissioner advises other commissioners and seeks their analysis, concerns, and reaction.

-After gathering all information and recommendations, commissioner elects to (a) issue decision or (b) settle the case (Rule 112.01 and I.C.§ 63-3048).

-If (a), the order drafting assignment is made and the decision is routed for comment, then signed and sent to the taxpayer (I.C.§ 63-3045B).

-If (b), the taxpayer is contacted and negotiations commence.

-Throughout negotiation, the commissioner continually seeks advice from members of the team concerning issues within their expertise.

-Once agreement is reached, a compromise agreement is prepared and sent to the taxpayer who then signs the document and returns it with a check for the settlement amount (I.C.§ 63-3048).

-If the settlement negotiations reach an impasse, and a deadlock occurs, STC reverts back to option (a) and a decision is issued (I.C.§ 63-3045B)

SECTION II

AUDIT AUTHORIZATION	Reported to the Joint Finance-Appropriations Committee as directed by the Legislative Council of the Idaho Legislature as authorized by Section 67-429, Idaho Code.
ASSIGNED STAFF	Thomas Haddock, CPA Anne Lang ,CPA, CGFM
ADMINISTRATION AND TECHNICAL REVIEW	Larry Kirk, CPA, Supervisor, Legislative Audits Ray Ineck, CGFM
GRAPHIC LOGISTICS	Rande Trueax

Note: in the following pages, the text of the draft Internal Control Report is shown in standard type; the comments from the Commission are indented and shown in bold type, with a different font.

(June 11, 2008 – My comments written in 1996 in response to the comments of the Tax Commission are in 'blue". My comments were provided only to the legislative auditors – Stan Howland)

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INTRODUCTION: INTERNAL CONTROL

Our audits are conducted in accordance with *Government Auditing Standards.* These standards require that we consider internal control and perform tests of compliance with laws and regulations.

Internal control is defined as a process--effected by an entity's management and staff--designed to provide reasonable assurance regarding the achievement of the entity's objectives. Objectives vary from organization to organization but generally include compliance with applicable laws, accurate financial reporting, and efficient operations. Statement on Auditing Standard (SAS) No. 78 provides five interrelated components of internal control: (1) Control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. (2) Risk assessment is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed. (3) Control activities are the policies and procedures that help ensure that management directives are carried out. (4) Information and communication are the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities. (5) Monitoring is a process that assesses the quality of internal control performance over time.

We evaluated the Commission's internal control components regarding compromise and close agreements of multi-state corporate tax protests. The following describes the Commission's policies . and procedures for settling tax protests and our findings and recommendations.

> **Statements on Auditing Standards (SAS) mentioned in this report are intended specifically for internal accounting controls relevant to financial statement preparation. The Commission could find no reference to these standards being designed to analyze and evaluate the quasi-judicial function of deciding tax protests.**

AUTHORITY AND PROCEDURES USED TO COMPROMISE AND CLOSE TAX PROTESTS

The Commission receives its authority to compromise tax liabilities from the Legislature in IDAHO CODE. That authority is broad and conclusive:

> **"63-3048. Adjusted or compromised cases -Closing agreements. -**(a) The state tax commission or its delegate is authorized to enter into an agreement in writing with any person relating to the liability of such person, or of the person for whom he is acting, in respect of any tax under this act for any taxable period ending prior to the date of the agreement. (b) Such agreement shall be final and conclusive and, except upon a showing of fraud or malfeasance, or misrepresentation of a material fact: (1) The case shall not be reopened as to matters agreed upon or the agreement modified by any officer, employee, or agent of the state. (2) In any suit, action, proceeding, such agreement, or any determination, assessment, collection, payment abatement,

refund, or credit made in accordance therewith, shall not be annulled, modified, set aside, or disregarded. [1959, ch. 299, § 48, p. 613.]"

The Commission may also compromise penalties:

> **"633047. Compromised cases**. -The state tax commission or its delegate may compromise any penalty arising under the provisions of this act instead of commencing suit thereon and may compromise any such cases with the consent of the attorney general after suit thereon has been commenced. Where any penalty case is compromised the state tax commission shall keep on file in its office reasons for the settlement of any case by compromise. [1959, ch. 299, § 48, p. 613.]"

The Idaho Income Tax Rules published by the Commission under the Idaho Administrative Procedure Act (IDAPA) further define their statutory authority to compromise. By IDAPA rule 35.01.112, the Commission has established three reasons for compromise: Doubt as to liability; Doubt as to collectability; or Extreme hardship of the taxpayer. This rule also adds that compromises are not allowed if the liability has been established by a valid judgement or is certain.

> **The Commission is not "they" or "their".**
>
> **The section on authority has omitted Idaho Code § 63-506(b)which requires that the "commission shall delegate to each member of the commission responsibility for administration and control of one or more departments of taxation and responsibility for the functions of that department" This statement was recodified in 1996, effective in 1997 as Idaho Code § 63-102(3), stating the "commission shall delegate to each member of the commission responsibility for administration and control of one (1) or more taxes and responsibility for that tax." Additionally, Idaho Code § 63-103 allows in 1997 "the state tax commission may delegate any other function, responsibility or duty imposed upon the commission to one or more commissioners or deputy commissioners." Sole authority to settle cases is clearly in line with the legislative mandate to the Commission.**

The Commission delegates its responsibilities and duties to each of the four Commissioners. Each Commissioner is responsible for administering one or more types of taxation and administrative functions of the Commission. For the types of taxation under their control, each Commissioner has been delegated absolute authority to decide the final tax liability of taxpayers without review by anyone else, for example another Commissioner. Authority to compromise and close up to $20,000 is also delegated by the Commissioners to certain staff.

When the Commission determines a taxpayer is deficient, the Commission mails a Notice of Deficiency Determination (NODD) to the taxpayer. The NODD provides the tax, penalty, and interest due by tax period and is accompanied by a written narrative and calculations explaining the reason for and amount of the deficiency. Taxpayers may pay or protest the deficiency determination.

The Commission may withdraw an NODD when a taxpayer provides support to validate the amount of tax paid or the Commission determines it has made an error in issuing the NODD.

Beginning January 1, 1994, with the passage of the Idaho Taxpayer's Bill of Rights, a taxpayer who disagrees with an NODD has 63 days to file a written protest. The taxpayer then has the option of requesting a decision or an informal hearing to justify and support the reasons for protest. Similarly, the Taxpayer's Bill of Rights requires the Commission to resolve tax protests within 180 days of the informal hearing or a written request for a decision. The NODD becomes null and void if the protest is not resolved within the 180-day period. Prior to 1994 and the passage of the Taxpayer's Bill of Rights, taxpayers had to file a written protest with the Commission or a complaint with the District Court within 30 days. Then the Commission was unlimited on the time taken to resolve the protested matter.

The Commission may resolve a protest by issuing a decision or by compromising the tax amount and closing the case. Commission decisions can affirm, modify, or withdraw the deficiency determination. Decisions are public and set precedence to guide taxpayers and future actions of the Commission and its staff. Compromise and close agreements are confidential and reduce or write off the amount of the tax assessed and close the identified tax

Compromise and closing agreements have been used to close cases while collecting 100% of the proposed deficiency. They do not necessarily "reduce or write-off" deficiencies.

On a few cases the Commission used a compromise and closing agreement to close a case while upholding the entire audit deficiency. It should not have been done and was done against strong recommendations of the audit staff. It was done because the attorney did not want to spend the extra time to write the decision. The precedent setting advantage of a decision was lost because of this procedure. The compromise agreement was a lie as no compromise was reached. A compromise and closing agreement should never be used to close a case that does not fit the strict rules allowing for the use of a compromise.

Moreover, the terminology used of "tax assessed" is legally erroneous. A Notice of Deficiency (NOD) is not an assessment it is the tax auditor's proposal as to the correct tax adjustment. The stated deficiency is not a tax at all until an assessment occurs. When the taxpayer and Commissioner agree as to the correct liability, that is the correct tax amount and the state has been well served by good public administration.

This is technically correct to a point, but misleading. Rarely is the compromise dollar amount referred to as a correct tax amount. It is an agreed-to amount because the Commission determines that the correct amount cannot be accurately determined. The agree-to amount is only correct if the compromise rules were correctly and legally followed.

An agreement by the Commissioner may be a correction of an excessive deficiency notice, not a tax reduction. Furthermore, a closing agreement does not necessarily "close the identified tax periods" but rather it closes the "matters agreed upon." These matters may be selected issues, not the tax period, leaving other issues for decision and litigation. Therefore, it has happened that there is a Compromise and Closing Agreement, a Decision, and a court judgment all in the same case. The last sentence in the above paragraph is an example of the bias built in to the report.

ADMINISTRATION OF MULTI-STATE CORPORATE TAX LAWS

Administration of tax laws governing multi-state corporations has been expressed by the Commission as complex and difficult. We were told that each corporation has unique facts and circumstances which has discouraged the Commission from issuing precedent-setting decisions. Attorneys for the Commission maintain that compromise agreements, that do not set precedence for other taxpayers, do not diminish equity because all taxpayers are given the opportunity to assert their rights through the protest process. Risk of litigation was expressed as one of their primary concerns. They explained that unfavorable court decisions could affect other states or may result in substantial General Fund losses because taxpayers would amend returns and request refunds. Additionally, many of these large corporations have an extensive legal staff and litigation budget as compared to the Commission's four in-house attorneys and small litigation budget. The Commission also believes that external influences should be appreciated. For example, an attorney for the Commission stated that on one case the Idaho Supreme Court asked what steps were taken to settle matters prior to litigation. Furthermore, the Commission said they had a backlog of protest cases requiring settlement at January 1, 1994, when the Taxpayer's Bill of Rights became effective. Finally, the Commission informed us that by design, they do not maintain summary or detailed records of compromised cases because, as explained by another Commission attorney, they are a governmental entity where attorney-client privilege is weakened and the public records law may create additional refund exposure.

The "attorneys for the Commission," "the Commission's four in-house attorneys" and "another Commission attorney" are Deputy Attorneys General.

The second sentence is misleading. Merely having unique facts and circumstances does not discourage precedent setting decisions. Even if one person made that statement in response to interrogation, that is only <u>one small part</u> of the analysis and decision of whether to settle a case. Litigation analysis is important. The last sentence implies that the Commission does not keep records because it does not want to pay valid refunds. Such is <u>not</u> the case!

Such <u>is</u> the case. The attorneys have told the audit staff on numerous occasions that using compromise and closing agreements reduces the chances of additional refund liabilities being incurred for other taxpayers. This is their prime argument against using decisions. They maintain that by not keeping records or identifying the issue in question, other taxpayers will not be able to find out about the compromise. They cannot then claim refunds for the same issue.

The concern is that legal analysis includes opinions of what might happen in court and could cause unnecessary litigation exposure. An example is the 1993 repeal of Idaho Code § 63-3022(f). This was a little used deduction that the Commission advised the legislature <u>may</u> be unconstitutional. Bringing attention to it caused protests based on that paragraph that for years had been uncontested.

This section of the report is written in a tone of unbelief, especially when compared to the findings and recommendations later in the report. Points stated here are given no

credence in the report. There is an element of truth here that is presented with just enough twist to misguide the impressions of the reader. Perhaps the greater offense is the explanation that has been left out of this section. See section I of this response for a discussion of procedure and for an explanation of philosophy on how protests are handled.

According to Commission records, during the period of our review (January 1994 to May 1996), the Commission compromised 74 multi-state corporate tax protests and issued 19 precedent-setting decisions. The Commission informed us that a coalition of corporations, called the Committee On State Taxation, exists to record, monitor, and report each state's position for compromising specific tax issues. Although for each Commission decision there may be a risk of litigation, we found that of the 19 decisions issued during the period of our review, none resulted in a court decision, and of the two appealed to the Board of Tax Appeals, one was dismissed and the other was decided in favor of the Commission. One decision was appealed to District Court but was compromised prior to a court decision being rendered.

It appears the Legislative Audit staff is advocating more litigation.

The Legislative Audit staff is advocating the proper use of the compromise and closing option. If used only when legal, the result will be more decisions written. Based on prior history and common sense, this will decrease the amount of litigation. The point being made is that simply issuing a decision does not guarantee that the decision will be appealed.

That none of the 19 decisions issued resulted in a court decision testifies to Tax Commission success, not failure. A wise litigator endeavors to pick battles that can be won. It would have been foolhardy for the Tax Commission to litigate rather than settle the 74 cases.

The Commission is misleading the reader by offering only two alternatives with constant results. The proper alternative (totally ignored by the Commission) is the writing of a decision. This will NOT automatically result in litigation. Based on any common sense interpretation of the rules allowing compromises, this method of settlement would be allowable in less than 5% percent of the multistate corporate cases. The three reasons for a compromise simply do not exist with the vast majority of these type cases. Yet, the Commission has construed one of these reasons, doubt as to liability, so loosely that all cases can be settled by compromise. A litigator that defends only on this basis is neither wise, nor honest.

Since the Commission keeps confidential the tax issues compromised, taxpayers who do not protest are not afforded the opportunity for tax reduction based on the same issues.

All taxpayers are offered the same "opportunities."

This statement is absolutely without truth and is totally ridiculous. The only taxpayers that receive a discount on their tax liability are those that are audited, and that file a protest. All audited taxpayers that do not protest the assessment, and those that are not audited, are not given the same benefit that was given to the taxpayer involved in the compromise. The real truth is that the taxpayer who protests an audit will almost always get a reduction in the amount of tax that he owes. All others pay the full amount of what they owe.

This comment seems to indicate a belief that all taxpayers are affected in the same way by disputes about applying the tax law to one taxpayer's facts. Furthermore, all taxpayers that receive a deficiency notice also receive notice of their right to contest the deficiency. It is axiomatic that those who do not exercise their right to appeal lose such right. Finally, even if tax issues compromised were not confidential, it would still be the case that those who do not protest are not entitled to an adjustment.

As of July 1, 1995, under the consolidation of the Attorney General's duties brought about by amendments to Section 67-1401, Idaho Code, additional attorney support may now be available to the Commission for litigating tax protests, but the opportunity to litigate may be limited by the small size of the Commission's litigation budget resulting in limits on their ability to hire expert witnesses and to conduct depositions.

The Commission must pay for additional litigation support. Given the litigation budget of $30,000 for an entire year with fact intensive cases requiring extensive discovery, the statement by the legislature is clear: litigate advisedly. The Commission agrees with the Attorney General's recent comment that "neither the Commission nor the Attorney General's Office possess the substantial resources that would be required to litigate a significant percentage of the contested cases." It is notable that in one particular case a Supreme Court Justice expressed concern about not settling cases and pressed the Deputy as to why the case had not been settled; The Idaho judiciary actively encourages settlement rather than litigation. Attorneys and judges know that litigation is very time consuming, expensive and often results in little guidance and dissatisfactory results for both sides. This is reflected in the advice given the commissioners.

AUDIT SCOPE AND METHODOLOGY

Based on the specific concerns brought to our attention by members of the Commission's staff, we limited our review to multi-state corporate tax protests that were compromised and closed since January 1994. Multi-state corporate taxpayers earn income in Idaho and other states and (or) foreign countries. Field or desk audits are completed by the Commission's audit staff. For effective and efficient use of audit staff, field audits are normally conducted once every three years, cover three tax years, and are primarily reserved for the corporations paying the most tax. This results in about 50 corporations consistently receiving field audits. These 50 or so corporations pay 60% to 70% of all Idaho corporate income tax collected each year.

A field audit generally consists of one or two auditors spending one to two weeks visiting the taxpayer, gathering information and making a preliminary analysis. The data is then reviewed more thoroughly back at the Commission's offices in Idaho. Eventually a Notice of Deficiency or Overassessment (NOD) is sent to the taxpayer. There is an important point to note here: it is impossible to completely audit a multinational, multibillion dollar enterprise in a couple weeks on-site. Therefore, adjustments to the NOD are neither unusual nor an indication of auditor ineptness.

Audits are never completed after the on-site filed work. These trips are for initial data gathering

and only begin the audit process. The author knows this but is intentionally painting another false picture. Through this paragraph the Commission is trying to leave the impression that the audit is not really completed when the protest is reviewed. Again, this is totally false. The NOD represents months of auditor field work, office work, consultation, supervisor and/or manager involvement, and a very strict review process. This review process is done either by Tax Audit Supervisors or the Audit Bureau Chief. The Bureau Chief was aware of all 13 cases in question and he totally approved and agreed with all audit findings. It is the exception, not the rule, when a legal and legitimate correction must be made to the audit report.

We developed a list of 39 corporate case files for review. A corporate case file may include more than one tax protest. For example, a corporate case file for one compromise included four separate tax protests of the corporation. This list of 39 corporate case files resulted from the specific concern that were brought to our attention and interviews with staff. We selected l3 of the 39 corporate case files based on our understanding of the issues involved and the dollar amount compromised. Twelve of these corporations had received field audits. We reviewed the notes and correspondence in the case files and interviewed the Commissioners and staff regarding each of the 13 cases, which included 23 of the Commission's 74 tax protests listed as compromised from January 1994 to May 1996.

These 13 hand-picked cases represent some of the most complicated and controversial income tax cases handled by the Commission. These are cases where reasonable minds can differ about the application of the law to the taxpayer. That is why taxpayers appeal and that is why the Commission has authority to settle cases.

This is absolutely false and shows the extent that the Commission will go to cover up its actions. These 13 cases are standard routine audit cases. They are no more complicated or controversial than any other cases that we handle on a daily basis. The only reason that they are in this report is because they protested their audit deficiency notice and received a special deal. We have many cases that are just as complicated or more, but they paid their tax due. Many of the issues in question on these 13 cases are actually extremely simple. Some are simply a matter of the taxpayer refusing to provide records to support their claim. The Commission is attempting to support their compromises by inflating the complexity of these cases.

Finding #1: Internal control would be improved by having more than one person approve and Sign compromise agreements.

Generally Accepted Auditing Standards (SAS No. 53) explains that the delegation of sole authority increases the risk of material errors or irregularities because it enables one person the opportunity to circumvent all other controls. This standard directs auditors to consider certain risk factors including: management decisions dominated by a single person; lack of documentation for major transactions; and whether significant difficult-to-audit transactions are present. Segregation of duties is essential as stated in SAS No. 78 "...to reduce the opportunity that would allow any one person to be in a position to both perpetrate and conceal errors or irregularities in the normal course of his or her duties."

Under current statutes and policies, each Commissioner is delegated sole authority for compromising tax protests for the types of taxation under their control. This is not to say Commissioners have not discussed cases with other Commissioners or staff, but the decision to compromise is the individual Commissioner's and there is no further review or sign off.

The Commission disagrees that top management needs "further review or sign off." The legislature has provided the current structure. If the legislature wants further review or sign off, the Tax Commission will certainly work with whatever requirements are codified. Until then, the Commission will continue applying its philosophy of service, equity, and value according to the statutory mandate that practice and procedure be as summary and simple as reasonably may be. Idaho Code § 63-514. The procedure for protest resolution, by design, does not create an evidentiary record for later appeal. The intent is for an inexpensive process for taxpayers to obtain a review of their NOD. Also, as to every case reviewed here, there was extensive discussion between the Commissioner and staff and, on some cases, another Commissioner. No decisions were made in a vacuum.

The delegation of this authority places each ,Commissioner in a defenseless position, providing little or no protection from accusations of impropriety. Also, due to the confidentiality of tax records and the lack of documentation discussed below, a defense against impropriety is difficult. Each Commissioner's authority to issue refunds or reduce taxes does not have a dollar value limit and could involve millions of dollars of tax liability.

As to accusations of impropriety, the delegation of authority does not automatically make the Commissioner guilty until proven innocent. It is not authority that creates a defenseless position. The Commission received evidence justifying settlement of every case questioned by this report.

This is absolutely not true. Where is this evidence? Verbal testimony is self serving and not allowable except in specific circumstances. Written substantiation was never provided on the majority of the 13 cases.

Moreover, during the protest resolution process the Commissioner does not reduce taxes. Rather, the Commissioner determines the tax liability.

Again, this may be correct, but is very misleading. In reality, the audit staff determines the tax liability. If the audit is paid, the Commissioner never sees the result or is even aware of the audit. If the audit is protested, the Commissioner determines if any part of the complaint is valid. If the NOD is correct then the Commissioner does indeed reduce taxes if he/she lowers the amount on such document.

There is no tax until there is an assessment. During the protest process the Commission is prohibited from making an assessment. Idaho Code § 63-3045(1)(c).

Management's attitude, awareness, and actions may have a pervasive effect on internal control. For this reason, we are required to consider both the substance of controls and their collective effect because controls may be established but not acted upon. From our review of thirteen cases we noted the following:

A. In eight out of the 13 cases reviewed, documentation was not required to support $5.9 billion in deductions and exclusions and $1 million in credits. These. deductions, exclusions, and credits had been disallowed by the Commission's staff prior to the corporation's protest because

requested or required documentation was not provided. The Commission receives its authority to require taxpayer substantiation from Section 63-3042, Idaho Code.

First, a commissioner needs <u>evidence</u> to decide a tax protest. According to Government Auditing Standards, evidence may be categorized as physical, documentary, testimonial, and analytical. <u>Documentary evidence is only one type of evidence</u> that may be available. The Commission received sufficient, competent evidence for every case noted herein.

The Commission is trying to justify its failure to require the taxpayers to provide the written substantiation requested by the audit staff. The only way they can do this is by taking the position that verbal testimony is sufficient. The evidence rule of Government Auditing Standards has nothing to do with the substantiation rules of the Internal Revenue Code or the Idaho Code. Tax law is based on physical substantiation. Without this requirement the tax system would not work. This has been proven by the results of this Legislative audit. The verbal testimony offered and accepted by the Commissioner was previously rejected by the auditors as required by their job. Why do the arguments of the taxpayer have more value when heard by the Commissioner?

Second, the $5.9 billion must be stated in terms of Idaho tax impact. The correct figure is $2.6 million, not billion. A preapportionment deduction or exclusion is <u>not</u> an Idaho deduction. This section of the report will not be understood by a layman unfamiliar with formulary apportionment and unitary enterprises. It is misleading, inflammatory, and a flagrant violation of complete, accurate, objective reporting requirements.

The reference used by the legislature auditors is appropriate. What is misleading is the fact that the Commission will not allow the report to show the actual difference between the tax and interest due per the audit and the tax and interest determined in the settlement. If the Commission's position is so honorable and correct, why is this information kept a secret?

As to the allegedly undocumented $1 million in credits, only $40,000 was an estimate. Again, reasoned estimates are part of tax law. See p. 6 of Section I of this Response. Other amounts were based on documentation or legal analysis. However, $880,000 is the difference between two proposals on one case and the Commission does not understand how this amount is included as an undocumented credit.

B. In one compromise, it was agreed not to audit two years scheduled for audit. Chief legal counsel for the Commission was unable to recall any other case in which the Commission agreed not to audit future tax years.

The statement about future tax years is erroneous. The years were <u>past</u> tax years. The settlement statute specifically prohibits a compromise for future tax years.

Technically, the Commission wins the play on words but loses in contributing to a sensible discussion. In reality, all follow-up years to an on-going or completed audit, are considered future years. This technical argument does not change what happened - the Commissioner barred the audit staff from auditing two tax years on a taxpayer that had a long history of filing incorrect tax returns.

Moreover, this is no different than simply deciding not to select for audit any taxpayer.

This argument is nonsensical and should be embarrassing to the Commission. There is a huge difference in a Commissioner barring the audit staff from audit returns, and the audit staff opting not to conduct an audit. The decision not to audit is made by the audit staff based on an experienced review of the tax returns and the history of the taxpayer. It is reversible at any time. The Commission's decision was not based on an informed review of the returns as a Commissioner has no expertise in selecting audits. Not "selecting" is an everyday determination and defensible. Not "allowing" has only happened this one time and is not defensible in any matter whatsoever.

Scheduling an audit is not an irreversible action. Furthermore, it should be noted that under this settlement the taxpayer filed amended returns for these two years and remitted an additional $56,000.

What did the taxpayer owe? Did he owe $56,000? Or did he owe $156,000? Or $1.56M? We will never know because the Commissioner froze these two years for audit. This same taxpayer settled the same audit years with Montana. Part of their agreement was to file amended returns for the same two years. The difference is that Montana did not close these years to audit. A Montana auditor has told the Idaho audit staff that the two returns were not filed correctly and they are going to audit the taxpayer. What are the chances that the taxpayer filed correctly in Idaho? This agreement was reached with a taxpayer that has filed incorrectly in Idaho for over ten years. There have been three prior audits conducted on this taxpayer. Even after these audits, the taxpayer continued to file incorrectly over this time span. This taxpayer refused to provide a variety of important substantiation to the audit staff. This is not the type of taxpayer you would trust to file a correct tax return knowing it would not be audited.

The Commission agrees that this was an unusual situation, but believes that it should be analyzed in context of the larger picture of which it was a pan This case included a court action of which the Commission retained 100% of the deficiency, a second protested audit of which the Commission collected most of the deficiency, and the additional cash noted here with no further litigation or audit expense. Finally, the taxpayer had recently been sold and the issues were nonrecurring items.

In another corporation's field audit, two years of investment tax credit, totaling $1.5 million, was calculated by determining the percentage that was allowed in another audited year. Documentation for $1.5 million was not reviewed.

Documentation was reviewed sufficient for the auditor to conclude that an appropriate amount was reflected. Sampling projections are common in the audit industry.

The audit staff uses sampling techniques on a few of their audits. This case did not qualify for a sampling technique in any way whatsoever. The technique becomes even more suspect when the history of the taxpayer is analyzed. This is simply a case of a special deal cut for a particular taxpayer. It was initiated by the Commissioner and carried out by the auditor. This so called sampling technique has never been used before and is not used by any other auditor at the Tax Commission.

Evidence existed that the taxpayer was entitled to a credit.

Credits are a matter of legislative grace. They are to be construed strictly against the taxpayer.

The taxpayer must provide documentation to show that a credit has been earned and then substantiate the exact amount of allowable credit. These requirements were established by the Legislature, enforced by the audit staff, and disregarded by the Commissioner.

It is a matter of the auditor's professional judgment. The amounts of credit allowed and disallowed were comparable to the commission experience in the prior audit.

Idaho is not unique in allowing compromises. Other states have compromise provisions. Some of these states have recognized the control problems related to compromises and have implemented control procedures. For example, California, New Mexico, and Wyoming have independent officials outside their taxation and revenue agency approve or sign compromise agreements. As an additional control, the compromise agreements of Wyoming and California become public record.

There is insufficient information in the report to draw conclusions about other state practices as compared to Idaho. For example, New Mexico statute (unlike the Idaho statute) requires Attorney General approval for settlement. The settlement procedures require a memorandum written by legal counsel setting out the pros and cons of a case and a proposed settlement. According to contacts in the New Mexico Taxation and Revenue Department, in practice, when a case involves "touchy issues," these memoranda express them in only vague and general terms. Further, the legal analysis is available only to the attorney preparing it, the department's Chief Legal Counsel, the Secretary of the Department, and the Attorney General's Office. An auditor conducting a follow-up audit will have the settlement agreement as part of his preparation, but not the legal analysis prepared for the Secretary. In other words, the New Mexico practice does not serve an internal accounting control function. It has no post settlement decision purpose. Wyoming has a Board of Equalization that hears (and settles) tax appeals. This Board is separate from the Department of Revenue. Also, the Department of Audit is separate from both the Board and Dept. of Revenue. The structure is entirely different than Idaho's. California has authorized settlements only a few years ago.

Recommendation #1: **We recommend the Commission improve controls by defining and following criteria for appropriate compromise; requiring a case resolution form for every compromise; and by not delegating sole authority to compromise to one individual.**

First, the Commission has defined and followed criteria for appropriate compromise. No additional work is necessary. Second, the Commission has considered a closing form for every case and the issue vigorously debated just one year ago by the audit, legal, and tax policy staff. The Commission has decided not to develop an additional form beyond the Decision or Compromise and Closing Agreement. No additional work is necessary. Third, sole authority has been delegated to facilitate the protest review process in conformance with the Open Meeting Law and confidentiality of taxpayers' information. If the legislature wants taxpayer information made public it will so indicate. Currently, unauthorized disclosure is a felony. The Tax Commission does not intend to change its current practice without legislative direction. No additional work is necessary.

For example, controls would be improved by the Commission:

1. Expanding its rules to explain when a compromise may be appropriate and when a compromise is not appropriate. For example, the State of Washington has developed rules under which settlements are not appropriate. According to these rules, settlements are not appropriate when: the issue the taxpayer is protesting is being litigated by the Department; the taxpayer's argument is that the law is unconstitutional; the taxpayer challenges a longstanding Departmental policy or rule that the Department will not change unless the policy or rule is declared invalid by a court; or the taxpayer presents issues that have no basis upon which relief for the taxpayer can be granted or given. Similarly, the State of Washington's rules provide that a settlement may be appropriate when the issue is nonrecurring, there is uncertainty of the outcome of an appeal if it were presented to a court, or conflict exists between precedents.

   The Tax Commission considers its current rule to be just as helpful and explanatory as the above language. There is no more certainty under the above guidelines than under the Commission's guidelines. Any compromise is ultimately up to the decision maker. Also, the Tax Commission has a statutory mandate for practice and procedure to be summary and simple. Expanding rules create more complexity in the law, not simplification.

   Expanding a rule does not create more complexity in the law. A rule's purpose is to bring clarity to the statute that it interprets. Idaho Income Tax Administrative Rule 112 provides limitations for when a compromise is warranted. If doubt-as-to-liability could be used for any case, there would be no reason to include the other two limitations. There would be no reason to include this information at all in a rule if limitations were not intended. Adding further information in the rule would clarify this issue, not create complexity.

   The reason for the proposal has nothing to do with simplification. The rules need to be expanded or better explained so as to avoid abuse. It was never intended that all protested cases contain doubt as to liability and therefore should be settled by compromise. The current system has been severely abused by the Commissioner and the Deputy AGs. Simplification is never desired at the cost of integrity.

2. Maintaining and keeping as a part of the legal file a case resolution and closure form. This form should include, besides taxpayer identification and Commission personnel associated with the case, the following information:

   A. An explanation of the issue being compromised with a summary of the positions held by the taxpayer and Commission.
   B. An explanation of why the issue is being compromised and that the compromise is in accordance with the Commission's rules.
   C. An analysis completed by the audit bureau of the potential audit consequences and tax effect of this settlement for the taxpayer in subsequent years.
   D. A calculation showing the amount of tax, interest, and penalty due at the compromise date.
   E. Signatures indicating the form has been reviewed and approved by the same Commissioners that sign the Compromise and Close agreement.

This idea was presented by the audit staff over a year ago. After full discussion the commission decided against such a form. Cases are discussed before any settlement decisions are made. The closing agreement itself contains language regarding why the case is settled. The issues and positions are not always detailed because it is usually very poor litigation strategy to disclose the details of an attorney's analysis of your case. The attorney-client privilege exists to allow disputing parties to not do what the legislative auditors suggest here. As a practical matter, most of what is suggested is done and it would be useful to know the impact on carryover tax attributes. However, in some cases, time spent analyzing potential audit consequences would be meaningless speculation about impacts which may never materialize. The Commission disagrees that an additional form is necessary.

The Commissioners and Deputy AGs are quite clear that they do not want any trail or record of their actions on protested cases. They did not provide one good reason for not accepting the audit recommendations. They want total unchecked and unquestioned authority to do as they please.

3. Examining and considering any oversight procedures that would avoid delegating sole authority to compromise substantial tax protests to any individual, such as:

   A. Requiring two commissioners to sign for any compromise exceeding a certain dollar amount.
   B. Requiring a majority of commissioners to sign for any compromise exceeding a certain dollar amount.

The Commission does not agree. The statutory authority has been unchanged since 1959. Single Commissioner settlements have been done for many years. Tax law is technical in nature, requiring specialization for competency. Having a second commissioner who is not an expert in that area of tax law approve an agreement is merely the illusion of control. Most settlements are the result of legal analysis where, as the State of Washington says "there is uncertainty of the outcome of an appeal if it were presented to a court." Such questions are a matter of legal opinion which the legislative audit function is not designed to evaluate.

This leaves the legislature with three choices. 1) Leave the system alone and put 100% of the authority and responsibility in the hands of one individual. This power is absolute and cannot be challenged according to the Commission. Total authority for millions of taxpayer's dollars rests in the hands of one individual. This system would fail any general auditing standards as there is no internal control. 2) Require that all settlements be approved by a third party. The Commission has already pointed out the foolishness of having the settlements be approved by another commissioner. 3) Make all decisions and compromises public information. This would add a substantial amount of accountability.

Finding #2: <u>The Commission's lack of records and procedures for compromised tax cases is a weakness in Internal Control and Accountability.</u>

By definition, records are an essential component of internal control. Therefore, a lack of records is a

weakness because the structure of internal control is incomplete. SAS No. 60 asserts that a lack of records could be a material weakness.

> **The Tax Commission possesses records for every case handled. One taxpayer's cases span 1974 - 1992 tax years with pro- in progress for 10 years. With personnel turnover it is difficult to determine all relevant facts, issues and activities undertaken. The Tax Commission agrees that records are essential and that complete and accurate files are essential. The Tax Commission will endeavor to maintain complete and accurate case files. A new audit review and tracking system (ART) has been under development since February 1995. Also, in accordance with the State Tax Commission Strategic Plan, FY 1997 - 2000, at page 13, the Tax Commission agrees to work toward the objective of improving the agency's document management processes.**

The Commission informed us that by design they do not maintain summary or detailed records of compromised tax cases.

> **The Tax Commission does maintain records on each and every case. However, it is important to realize that the Commission is subject to the Public Records Law, private litigants are not. Commission records may be subject to discovery in situations where private records are not. Corporate tax issues tend to be fact intensive. Obviously, each taxpayer will have slightly different facts even for the same legal issue. It is unwise to create unnecessary exposure for the state by pretending that all taxpayers have the same facts and, therefore, the same tax obligations. Documenting every negotiation statement has a greater potential downside than the positive effect it might have for management.**
>
> This is a continuation of the cover-my-trail philosophy discussed above. They want everything to be kept a secret and refuse to keep any sort of record of their actions. Why? There is never a reason for secrecy if one complies with the law.

When we asked for a schedule of compromises including tax, interest, and penalty, the Commission had to develop the data.

> **Developing the data is the purpose of maintaining a database. The Tax Commission should not be faulted just because it did not have the precise report predesigned for the legislative auditors.**
>
> Once again, back to Idaho Code Section 63-3047. For the compromise of penalties, the statute states "Where any penalty case is compromised the state tax commission shall keep on file in its office reasons for the settlement of any case by compromise." One would assume this report would be readily available. The Tax Commission had to generate a report by going back through every case. I'm sure the reason for compromising each penalty was not listed in each case but later determined only due to the legislative audit.

Although we did not audit the data, we found multi-state tax protests compromised that were not on their list.

Upon inquiry the legislative auditor listed 15 such protests. After examination, the Tax Commission agrees that two cases should have been on the list. The case resolution entry was not properly completed in the case management system. In accordance with the Tax Commission Strategic Plan, FY 1997 - 2000, at page 13, the Tax Commission agrees that staff training is an important strategy to achieve the objective of properly utilizing information resources. As to the other 13 cases, they were either misclassified by the legislative auditor, still open, included on the list, or included with other docket numbers. One case was a settlement by a Division Administrator, not the Commissioner. The legislative auditor was clearly informed that the list would only include Commissioner settlements. Some docket numbers are listed several times by the legislative auditor. It should be noted that docket numbers are more useful as tools than as data. The important data are taxpayer identification numbers (TIN) and tax years and whether a tax year is open or closed for a particular taxpayer.

Other information we requested regarding multi-state corporate tax deficiencies, protests, and compromises was not available and was deemed too difficult to develop. Since the Commission does not keep these records, we are unable to report the total amount of tax, interest, and penalty compromised since January 1994. The total amount compromised on the 13 cases we reviewed is about $7 million dollars. This estimate does not include the effect of the compromises on subsequent tax years.

The total amount "compromised" on the 13 cases, if such a number has any relevance, is $2.7 million.

This is totally false. One of the cases alone is close to that amount. The correct figure will be more than twice that amount. The actual number can only be obtained if the Commission will release the files which are currently locked up. Why wouldn't the amount compromised be relevant?

Also, the report does not inform the reader that taxpayers conceded $7.7 million on these cases.

The number cannot be verified due to the Commission's refusal to provide the records. This statement is extremely misleading. The Commission claims that the taxpayer conceded millions of dollars. The taxpayer conceded nothing. The taxpayer owed that money by law. In the majority of these cases there were many issues other than the one selected for compromise. The payment of these issues cannot be described as a concession by the taxpayer.

To say that an amount is *compromised* is to suggest that it was the correct number to begin with.

It is the correct number at that time. The audit staff follows the provisions of Idaho tax law. They are very experienced professionals and their work goes through a thorough review process. They have no motive but to find the right answer. The taxpayers in question do not share that motive. Many other taxpayers simply pay the amount billed. Would the Commission accept the money from these companies if it felt that the auditor's numbers were not correct?

Taxpayers protest because they believe the auditor does not have the correct amount to

begin with. In most cases it is not clear what is the correct tax.

This is simply not true. Many taxpayers protest because they know that the Commission will compromise the correct amount of tax as determined by the audit staff. In almost all cases it is absolutely clear what the correct tax is. The Commission is trying to deceive the reader into believing that determining the correct tax due of a taxpayer is an extremely complex process that only the Commissioner and the Deputy AGs can accomplish. They are trying to convince the reader that the auditor's numbers are simply a starting point from which the Commission can begin. This entire argument is misleading and inaccurate.

A protest settlement for less than the NOD amount is not a tax reduction, but is a tax determination. It may very well be a correction of an excessive NOD or, more likely, an agreement to reach finality for a tax year where acquisition of conclusive evidence is unreasonably expensive.

The settlement is a tax reduction if the NOD is correct. The Commission's argument regarding the cost of acquiring conclusive evidence is baffling, to say the least. Unreasonably expensive for whom? The burden of proof is always on the taxpayer. They are required by law to substantiate all income and deductions. We incur no cost by requiring the taxpayer to provide conclusive evidence. Again, this statement is misleading to the reader and is based on no facts whatsoever.

Records are needed to demonstrate consistent and uniform application of the law and unbiased treatment of taxpayers. Additionally, records may provide a defense against alleged improprieties as well as inhibit the opportunity for malfeasance. Adequate records would also help the Commission and the Attorney General's Office identify rules or statutes that need to be clarified or modified, and training issues for staff guidance.

During our review of 13 cases we noted that controls were weak or absent at the senior management level. Specifically, we noted the following:

A. Compromise agreements are sometimes not reviewed by the Commission's staff prior to being finalized. In one instance, this lead to a tax benefit of $23,000 more than requested on the original unaudited return. **[The original return may have been wrong. Again, the settlement was based on legal advice and doubt as to liability.]** In another compromise agreement, the Commission gave the corporation 89% of a protested issue without documentation from the corporation and before the dollar value of the compromise had been calculated by the Commission's staff. This compromise resulted in a $1.3 million refund to the corporation.

The representation here is erroneous. The Tax Commission did not give 89% of a protested issue without documentation from the corporation.

The Commission has now elevated the term misleading to new heights. It is true that the taxpayer did provide tax treaties, contracts, etc to the Commission and these records are on file. However, what the Commission fails to address is that these records do not support the taxpayer's contention of nexus in foreign countries. The Commission has documentation, just not the kind necessary to verify the taxpayer's claim.

The issue dealt with sales in foreign countries, called *throwback sales* in the corporate

tax arena. Determination of such issues turns on tax treaties, contracts, agents, and procedures in addition to amount of sales. The Tax Commission obtained, reviewed, and filed such information. It remains available for legislative audit review. As to settling an issue before calculating the tax effect, that simply proves that the settlement was based on principle, not principal.

The settlement was based on cutting a deal, not on principle. The Commissioner had no idea of what he was doing and got outfoxed by the taxpayer. As for principle vs. principal, if the Commissioner is interested only in principle, then why does he require all auditors to prepare detailed reports of the tax consequences of each and every protested issue before the protest is sent to legal? If the Commissioner is interested only in principle, they why does he start every protest hearing with a statement that we are gathered here to settle the case without going to court. He never states that we are here to obtain the truth.

It is also notable that $46.8 million of property had been misclassified. Correcting this error turned a deficiency into a refund. Also, this case was settled by offset against old sales tax cases. The state collected $600,000 and closed several old protests.

In a third example, the Commission wrote the corporation and explained it would not allow the corporation to deduct $2.2 billion because such a deduction was not allowed by the Internal Revenue Code. The Commission entered into a compromise agreement and allowed the corporation to deduct $273 million it had specifically told the corporation it would not allow.

The letter to the corporation clearly states that it is a proposal, lays out the proposed resolution of the case, and asks for the taxpayer's feedback on the proposal. To represent the letter and Commission action as above is blatantly misleading.

Not so - it is very accurate. The Commission is trying to draw the attention away from its actions on this case. The fact is that the taxpayer was allowed $273 million in federal deductions that are not allowed by the Internal Revenue Code.

Shouldn't all proposals be initiated by the Taxpayer? Rule 112 states that offers of compromise shall be submitted in writing and shall be accompanied by a remittance in the amount of the offer being made. It is not the Tax Commission who should offer the proposal -- it is the taxpayer.

Furthermore, the reference to $2.2 billion is, again, not an Idaho deduction. To state it as such, without explaining formulary apportionment is misleading and inflammatory.

If the Commission really wants the accurate numbers to be given, all they have to do is release the files to the audit staff. We can compute the actual Idaho tax effect, with interest, for each and every case. The Commission refuses to do this but complains that these figures are not used by the legislative auditors.

The amounts stated are for the entire unitary group, not just the part that does business in Idaho. The Idaho tax effect of the above issue is about $116,000.

Finally, the Commission's records on these examples are adequate. The examples given here are not examples of inadequate records but, rather, are disagreements with the

Commissioner's final decision on the cases.

B. Compromises can also make auditing subsequent years difficult. In four cases involving five compromises, investment tax credit of $3.8 million was allowed as a specific dollar amount or as a percentage of assets rather than identifying the specific assets to which the credit relates. Without identification of the actual qualified property, Commission auditors may not be able to determine if investment tax credit recapture provisions are followed when assets are later disposed of or sold.

This statement regarding the $3.8 million is erroneous. Several items are traceable to specific assets allowed for specific reasons. Moreover, $1.1 million is tax paid in one case and must be a misclassification of numbers by the legislative auditors. There was a concession of $10,000 on one case based on questioned documents to reach a settlement and collect over $379,000.

This $10,000 concession was not based on any request of the taxpayer. It was not based on any documents, records, or issues. It was simply a gift initiated by a deputy attorney general witnessed by the audit Bureau Chief, and approved by the Commissioner. This individual's only explanation for his offer was this would insure that the taxpayer would not raise a throwback sales issue. This was nonsensical. The auditor had made an adjustment to these sales and the adjustment was agreed-to by the taxpayer. This issue was never protested or raised by the taxpayer. Again, this concession was a gift and we do not know the reason why.

This deputy attorney general was involved in numerous compromise and closing agreements while assigned to the Tax Commission. Although this individual is not longer assigned to the Commission, he still retains contact and influence with the Commission.

On another case there was an allowance of $936,000 for specific assets for which the Commission has ample evidence and advice of counsel. In one case sampling was used by the audit staff in allowing nearly $1.5 million of credit. This is the same case noted under finding # 1(B). Sampling is a legitimate audit technique. The credit allowed in this audit was comparable to the prior audit. The state was well served.

However, the Commission does agree that care must be taken to consider tax attributes, such as carryover items, when cases are settled.

Members of the Tax Commission's staff expressed feelings of frustration because they felt laws and rules were not being applied equally to all corporations because corporations who do not protest are not afforded a tax reduction based on the same issues.

This comment assumes that the law reaches the same result for different taxpayers with similar facts. Such may not be the case. Consider that ASARCO v. Idaho State Tax Commission was decided in 1982. Fourteen years later states and taxpayers are still arguing over nonbusiness dividends, interest and capital gain income, which were the issues in ASARCO. The point is that these issues are not black and white. The Commissioner too looks for absolutes in a sea of uncertainties and ultimate must rely on the advice of staff and counsel. Therefore, corporations who do not protest may not be entitled to an adjustment of the deficiency.

Additionally, members of the Commission's staff believe had they calculated the effect of the proposed compromise prior to the final agreement, some of the compromises may have been revised (or reconsidered).

These findings are speculation, not fact The Commission strives to administer the tax laws fairly while recognizing that reasoned flexibility has long been part of tax law, not contrary to it. See e.g., Pacific Fruit Express Co. v. McColgan, 67 Cal.App.2d 93, 99, 153 P.2d 607 (Cal.App. 1 Dist., NOV. 30, 1944).

Recommendation #2: <u>We recommend the Commission improve control procedures and recordkeeping. Specifically. we recommend:</u>

1. The Commission follow established policies and procedures and require documentation be provided by the taxpayer. Although there may be instances in which documentation cannot be provided, this would be the exception and not the rule, especially for large dollar issues and multi-state corporate taxpayers.

   The Commission agrees that established policies and procedures should be followed. Documentation is important and instances in which it cannot be provided are, and always have been, the exception and not the rule. No change is necessary.

2. The audit bureau calculate the effect of the compromise prior to it being finalized to ensure it represents the intent of the Commission.

   The intent of the Commission is based on fair administration of tax law, not on collecting a certain amount from each taxpayer. However, the Commissioner and legal/appeals staff routinely ask the audit staff to calculate the tax effect of protested issues. No change is necessary.

   Why are auditors required to provide tax and interest estimates on all issues <u>before</u> protested cases are sent to legal? This process clearly reveals that the Commission's goal is not to find the right legal answer. The intent of the legislative audit proposal is to have the audit bureau calculate the effect of a compromise after it has been proposed and before it is finalized. This has nothing to do with collecting specific amounts of revenue. It is meant to keep the Commissioner and the deputy attorneys general from overlooking critical tax issues as they did in one referenced case, and to insure that the effects on all taxpayers are considered.

3. The Commission distribute copies of all decisions and compromise resolution and closure forms to all pertinent members of audit, legal, policy, and appeals staff. This will provide timely and relevant information to staff for consistent administration of the tax laws.

   The Commission agrees that timely and relevant information is essential for staff to properly perform their duties. All decisions and compromise agreements are, and always have been, available to whoever needs them. Decisions and agreements are, and have been, routinely copied to the audit files. No change in procedure is necessary. However, the Commission will continue its development efforts to make decisions available on-line to any staff that find them useful.

4. The Commission maintain records detailing deficiency determinations, protests, compromises, and decisions. Specifically, we recommend the Commission consider keeping an audit history for each audit showing all significant action from the initial audit work to the final resolution of the case. This record should be a separate tracking system of all audits and should be accessible by audit, legal, policy, appeals, and any other affected staff of the Commission. Besides the basic taxpayer identification information, the history file should include at a minimum:

   A. The name of the auditors and other staff associated with the case.
   B. The date of the NODD and amounts of tax, penalty, and interest for each year.
   C. The protest or payment date.
   D. The primary and secondary tax issue(s) protested.
   E. The final resolution date and method (Commission decision, court decision, or compromise and close agreement).
   F. The total amount compromised (tax, penalty, and interest).
   G. The compromise payment date.

   The Commission is currently developing an audit review and tracking system, a project that started before this audit. The Commission intends to continue development as planned. The Commission does maintain the detailed and summary records that it considers prudent to maintain and is constantly working to upgrade its information processing capability within its appropriated budget. The Commission disagrees with item F above because such an amount does not convey useful information. 'It does not say whether the NOD was excessive as a provisional or whether the taxpayer provided more evidence or whether other issues are being litigated or contested. It is a number that is too easily misused. It assumes that the starting is the "right answer" when, in fact, such right answer may be unascertainable except by use of estimates and negotiation.

   The Commission has again refused to record or report any information that will show how much money was compromised. The Commission hides behind a variety of excuses and accusations. If nothing else comes out of this audit, the Commission should be required to provide this number on each compromised audit.

5. The Commission date and sign all notes, correspondence, calculations, and other information placed in the legal and audit files.

   The Commission agrees that proper workpapers are essential. However, it is not at all clear in this report how this recommendation relates to the stated concern of equal application of the law to taxpayers. Neither is it clear how any of this affects the agency's financial statements.

6. The Commission make public the total amount of tax, penalty, and interest compromised each year by tax type.

   If the Governor or legislature wants such information the Commission will provide the

information. Until there is a need for such information, the Commission intends to continue its collection efforts. It seems obvious that such information could be used out of context, and inappropriately by taxpayers to influence negotiations.

Finding #3: The Commission's compromise files include instances where statutes or rules were not followed.

Statement on Auditing Standards No. 63 states "*...material instances of noncompliance* are failures to follow requirements, or violation of prohibitions, contained in statutes, regulations, contracts, or grants that cause the auditor to conclude that the aggregation of the misstatements (that is, the auditor's best estimate of the total misstatement) resulting from those failures or violations is material to the financial statements."

The Commission reiterates that its financial statements have not been affected as demonstrated by the recently completed financial audit. This section of the report constitutes disagreement over legal advice given to the Commission, an area outside the expertise of legislative auditors. Moreover, the Commission must be able to make budgetary decisions and allocate its appropriated budget in a way to maximize its efforts for the benefit of the state. On occasion that means settling rather than litigating. Settling a case does not constitute noncompliance with tax law.

In reviewing the files, we noted several areas where we believe statutes or rules may not have been followed:

A. **SECTION 63-3072(c), IDAHO CODE. Credits and refunds.**-This statute did not allow the Commission to issue a refund after three years unless the refund was due to adjustments made by a federal audit. The Commission refunded one corporation $460,819 on amended returns that were filed beyond the three year period allowed by statute and that were not a result of a federal audit.

The Commission did not violate this statute. This example was part of a settlement covering 19 tax years, closing several protested income and sales tax audits. The cases had been in process for over 10 years. The "amended returns" were simply part of the negotiation process. They were information submitted by the taxpayer to facilitate settlement. Once a protest is filed, the tax year is not closed until the protest is finalized. These protests were finalized by the compromise and closing agreement. This statute does not prohibit the Commission from entering into a settlement agreement.

B. SECTION 63-3048, IDAHO CODE. Adjusted or compromised cases. -This statute does not allow the Commission to reopen any case settled by compromise. The Commission compromised three corporate tax years on September 9, 1994. These years were later reopened and recompromised June 6, 1995, allowing additional investment tax credit of $60,098.

The Commission did not violate this statute. The legislative auditor has misread the documents. Any compromise and closing agreement only closes the matters agreed upon. While the general case is that the entire tax year is closed, such was not the case here. The issues settled on June 6, 1995 were not settled in the September 9, 1994

agreement.

The Commission either violated this statute, or the applicable law established by the Idaho Supreme Court. The law in effect at the time was from this taxpayer's Idaho Supreme Court decision. This decision specifically did not allow for the method granted by the Commission. To argue that the computation method allowed by the Supreme Court somehow qualified as an alternative method is a farce. The Supreme Court looked very closely at this method and said it was not allowable in prior years. It certainly did not intend for it to be allowed in any following year without any change in facts. The taxpayer did not provide any change of facts. The Commission states that they chose to follow the advice of its legal counsel. Choosing this path resulted in the violation of Idaho law.

C. **SECTION 63-3029B, IDAHO CODE. Income tax credit for capital investment.** -This statute was amended and approved April 2, 1992 and was retroactively effective only to January 1, 1992. The amendment introduced a second allowable method to compute certain eligible property for investment tax credit. The Commission allowed one corporation to use the new method for tax year 1991, before the amendment's retroactive effective date.

The Commission did not violate this statute. The legislative audit staff has taken a short memo to the file, written by a Deputy Attorney General, out of the context in which it was written. The Commission allowed one corporation to use an alternative method when the Idaho Supreme Court and statute both mandated such alternative to clearly reflect business activity of the assets in Idaho. Even if the alternative is the same or similar to the new statute, it is not noncompliance with the current statute. Moreover, the new statute was simply codifying what the Commission had required before this case was litigated. Therefore, the new statute was a return to what the Commission had asserted as the right answer. This was explained to the legislative auditors during the audit whereupon a legislative auditor (who is not an attorney) simply disagreed with an experienced Deputy Attorney General about the meaning and import of the recent Supreme Court case. The Commission has chosen to follow the advice of its legal counsel.

D. **SECTION 63-3045, IDAHO CODE. Notice of redetermination or deficiency. -Interest.** This statute requires the Commission to assess and collect interest on deficiencies until paid. We reviewed four cases where interest was not assessed and collected up to the point of the corporation's payment.

The Commission did not violate this statute. A case may be settled for a dollar amount. As a practical matter, the amount may be agreed upon a week before the document is signed and payment remitted. As a legal matter, the amount is not set until the documents are signed. In any case, the interest is "a part of the tax" as stated in Idaho Code § 63-3045(6) (a). It is possible to calculate an amount to be due in the future. This point is trivial and is erroneous as a matter of law.

Interest is not considered the same as tax. Interest may be collected along with the tax but it is not treated as a tax anywhere in the Idaho or Internal Revenue Code. This is yet another misleading statement made by the Commission.

E. Three of the cases we reviewed allowed corporations, within their compromise agreements, to take categories of deductions that are not allowed by state and federal statutes and (or) the Internal Revenue Code.

The Commission did not violate any statutes or rules. The Commission agrees that it settled one issue that, based on a later Supreme Court decision, need not have been settled. That one issue was .0081 of the deficiency and was settled at 50% for a $4,095 concession on a million dollar case. The Commission collected over $975,000 instead of holding up the entire case over a minor issue.

The Commission claims that they did not violate Idaho law by allowing the taxpayer to deduct 50% of two items that were not allowable deductions per Idaho law. Idaho law says these were not allowable deductions and the audit staff has not allowed them to other taxpayers. Another taxpayer appealed to the Idaho Supreme Court on this issue, and the Commission argued the case the same day that it allowed the deduction to this taxpayer. It is very disturbing that the Commission maintains they are not in violation of anything. It is also interesting that the Commission goes to such lengths to show that the dollar amount was very small. They obviously feel that the dollar amount of the issue is important in determining whether or not to compromise. Yet, in a prior response, the Commission stated that settlements were based on principle, not principal. If that is the case, the dollar amount of an issue would never be considered in resolving a case.

However, note that the Commission has the authority to reach an agreement with any taxpayer for any tax in any year prior to the date of the agreement. Idaho Code § 63-3048. The compromise statute is part of the tax law. The law is to be read as a whole, not as a collection of unrelated parts. None of the noted settlements are instances of noncompliance. Here the legislative auditors are simply disagreeing with legal advice.

F. **SECTION 63-3027, IDAHO CODE. Computing taxable income of corporations.-** This statute provides a statutory formula for apportioning business income of multi-state corporations. **IDAHO CODE SECTION 63-3029B Income tax credit for capital investment (3)(c)** states that the formula contained in 63-3027 is required for the determination of certain qualified property for the investment tax credit, absent any showing that the formula did not accurately reflect the corporations' business activity in Idaho.

Two of the cases we reviewed allowed a nonstatutory method for the computation of qualified property for investment tax credit. The Commission's files did not contain documentation showing how the alternate method used more accurately reflected the corporations' business in Idaho. The Commission was also unable to provide an explanation supporting the corporations' contention that the alternate methods more accurately reflected their business in Idaho.

The Commission did not violate these statutes. One of the noted cases is a repeat of item C above. The other case has different facts but the principles of the settlement are the same. Idaho Code § 63-3027(s) allows alternative formulas. Such formula does not constitute a "nonstatutory method."

Neither the Idaho Supreme Court, nor the statute, says that an alternative method can be allowed to reflect the business activity of the assets in Idaho. The statute states "If the allocation and

apportionment provisions of this section do not fairly represent the extent of the taxpayer's business activity in this state. . ." Either the standard apportionment formula fairly represents the extent of the taxpayer's business activity in Idaho or it does not. But if it does not, then the alternative method should also be used as the measure to compute its income attributable to Idaho. The taxpayer did not argue for this alternative in computing income nor did the Commission require it as it would have resulted in more income being taxed by Idaho.

G. **SECTION 63-3045B, IDAHO CODE. Final decisions of the commission. --(7)** "...A decision shall serve as precedent for the tax commission in future protest determinations unless information excised, court decisions, changes in the Idaho Code, or changes in applicable administrative rules overrule, supersede, modify, distinguish, or otherwise make inapplicable the written decision of the tax commission."

The Commission entered into compromise agreements with two corporations shortly after writing precedent-setting decisions requiring those same corporations to pay the full amount of the audit assessment. We noted other .compromises in which the Commission did not follow precedence when it agreed to compromise tax issues. In one compromise in which the Commission allowed the corporation an additional deduction, not only was there a precedent-setting decision not allowing the deduction, but there were no provisions in the Idaho Code allowing for the deduction.

The Commission did not violate this statute. Every case noted here was settled based on doubt as to liability. A doubt-as-to-liability analysis is based primarily on legal advice that includes a legal opinion on the statutes, rules, and case law. The legislative audit staff has misconstrued the meaning and import of this section. Decisions are precedential "in future protest determinations" and the Commission treats them as such. However, this statute, as all tax statutes, must be read together with the authority to determine tax liability and close cases. This statute broadens the body of tax law in Idaho to include these Decisions as well as statutes, rules, and court cases. However, Supreme Court decisions do not prohibit settlements between litigants. Likewise, this statute does not remove the authority to close cases under Idaho Code § 63-3048. In fact, failure to recognize a taxpayer's meritorious argument could result in the Commission paying the taxpayer's attorney's fees. Idaho Code § 12-117.

The Commission responds that they are not bound by precedent setting decisions if they choose to settle a case based on doubt-as-to-liability. The Commission states very clearly that Supreme Court decisions or Idaho statutes do not have to be followed if it determines that there is a doubt-as-to-liability. This is the most telling response of the Commission's response to the Legislative Audit. This shows the extent to which a handful of individuals have determined that they are accountable to no one. They have put themselves above the law.

Rule 112 - No tax will be compromised if the liability has been established by a valid judgment or is certain, and there is no doubt as to the ability of the taxpayer to pay or the state to collect the amounts owing. If the Supreme Court has ruled on the issue, wouldn't it be certain removing the argument that the case could be compromised based on a doubt-as-to-liability?

There is nothing amiss with settling a case at any time, before or after litigation has commenced. Civil litigation is routinely settled by the parties without waiting for a

court judgment. The noted instances are nothing more than disagreement with the commissioner as to whether a particular case should have been settled, a question given by the legislature to the sound discretion of the Commissioner. As noted in section I of this response, the Commissioner applies a reasoned approach to evaluate cases based on a full discussion of available evidence and legal advice.

Recommendation #3: <u>We recommend that the Commission re-examine its policies and procedures to ensure that its administration of the tax laws is in compliance with statutes and rules. If the Commission believes that the tax laws need to be amended to properly administer the tax code or to properly compromise questions of tax liability, the Commission should recommend appropriate statutory amendments through the legislative process.</u>

The Commission agrees that compliance with statutes and rules is of utmost importance. Furthermore, the Commission annually brings its suggestions for legislative action to the Governor's Office. The Commission will continue its tradition of working diligently to uphold and administer the tax laws, collecting that which is due. No change in procedure is necessary.

The general tenor of the report suggests that the legislative auditors believe that the provisions of Idaho's income tax laws relating to multi-state corporations have a greater degree of certainty than actually exists. The Commission must exercise judgment when applying the law. The legislative audit staff has reviewed 13 hand-picked, controversial cases for review. These are cases where there is a legitimate difference of opinion about what the law requires. That is the reason the statutory authority for settlement exists. If every disagreement was litigated, the costs of tax administration would be much higher for government and taxpayers alike. Neither is it reasonable or appropriate to try to change the law to fit every circumstance which might arise. Formulary apportionment for unitary corporate groups is complex tax law. Trying to anticipate every conceivable fact pattern would result in chaos.

Leading commentators agree on the need for flexibility in prescribing apportionment methods. "Flexibility is recognized not only as a desirable but an essential feature of any workable system for the of allocation income, whereas a single, rigid statutory formula would doubtless be productive of injustice in particular cases, and lead to unconstitutional results as to certain corporations, since it would be impossible to make it adaptable to different types of business."

> ***State Taxation*, by Prof. Walter Hellerstein, Warren Gorham Lamont, ¶ 10.01 [1], n. 9 © 1993.**

The Commission welcomes outside review of its operations. It has participated fully in the legislative auditor's research regarding compromise and closing agreements for multi-state corporations. This Report does not recognize the amount of successful work involved with all tax protests, decision and settlements, which may leave the reader to conclude there are "problems" after looking at only 13 of the most complicated cases from over 500 pending protests. The Commission strongly disputes any such conclusion.