



STATE OF IDAHO
OFFICE OF THE ATTORNEY GENERAL
LAWRENCE G. WASDEN

July 15, 2008

Senator Brent Hill
1010 S. 2nd E.
Rexburg, Idaho 83440

Senator Kate Kelly
P.O. Box 654
Boise, Idaho 83701

Re: Response to Inquiries

Dear Senators Hill and Kelly:

Senator Kelly's June 18, 2008, letter asks the Attorney General to review the allegations by State Tax Commission auditor Stan Howland about settlements of corporate income tax audits. Her inquiry is limited to the question of whether the settlements constitute any illegality by the Tax Commission. Senator Hill has asked the Attorney General for a similar review of whether the State Tax Commissioners have illegally settled corporate income tax liabilities. We conclude that they have not.

Question:

Did the State Tax Commission have authority to enter into the settlements with taxpayers that are the subject of Stan Howland's complaint, either before or during litigation, over amounts of corporate income tax liability owed to the state of Idaho?

Summary of Conclusions:

Our review of the allegations made by Mr. Howland does not disclose any illegal activity by the State Tax Commission. As a matter of law, the Commission's discretion in regard to settlements is less constrained than Mr. Howland's complaint suggests. A review of the specific cases he discusses shows that the Commission acted well within its legal authority in each case. Further, the confidentiality of the settlements is mandated by statute. The settlement processes, though not open to public review, are not conducted in secret, and in fact, are reviewed by auditors, tax commissioners, tax policy specialists, and commission attorneys, as deemed appropriate.

The Commission is entitled, when evaluating a potential settlement with a specific taxpayer, to consider and weigh contested factual conclusions about that taxpayer, ambiguities in the state of the law either facially or as applied to a specific taxpayer's

case, the potential objective and subjective hazards and costs associated with administrative dispute resolutions and litigation, and make judgments about the best interests of the state in the use of the resources allocated to the Commission by the legislature, among other factors. Additionally, in these cases, the degree of doubt about the Commission's ability to successfully establish each taxpayer's liability for the taxes originally asserted after the audits is substantially greater than Mr. Howland acknowledges.

In two of the cases of which Mr. Howland complains, the Commission's actions did not change the corporation's tax liability; the Commission's actions simply eliminated a penalty and changed the year a deduction could be claimed. In one case, the Commission permitted the taxpayer to correct a clerical mistake involving checking a box on the tax form. This allowed the taxpayer to move a deduction from one year to the next and did not effect its tax obligation. In another case, the Commission collected the entire \$105,045 of tax and interest asserted. It only abated a \$3,400 negligence penalty because it concluded that the tax payer was not negligent. That decision was well within the Commission's discretion.

The other cases all involve the application of a notoriously difficult provision of the Uniform Division of Income for Tax Purposes Act¹ defining the term "business income." Published professional literature and case law, both in Idaho and in other states in which this Uniform Act provision applies, demonstrates the difficulties and the unpredictability of results for particular taxpayers. A leading legal scholar in the field, Walter Hellerstein, has suggested the distinction between business and non-business income be abolished, in part, because there is no policy objective for it aside from its relationship with U.S. Supreme Court apportionment jurisprudence.²

Analysis:

Overview of the Commission's Administrative Appeal Process.

It is useful to understand how the State Tax Commission reviews taxpayer protests of audited tax deficiencies. The relevant statutory authority outlining this process is set out in Idaho Code §§ 63-3044 through 63-3049.³ A longer description of this process is included as an attachment to this letter. The statute, Idaho Code § 63-3045, provides, in part:

¹ Section 63-3027(a) – (s), Idaho Code.

² See, Hellerstein, *The Business-Non Business Distinction and the case for its Abolition* State Tax Notes, August 22, 2001.

³ These reviews are not "contested cases" within the meaning of the Administrative Procedures Act and, therefore, the procedures are not governed by that Act. Idaho Code § 63-107.

(2) Following a protest, the taxpayer has the right to a hearing. The purpose of the hearing is to discuss the deficiency determination and the taxpayer's protest with a commissioner or duly authorized representative of the commission. The meeting shall be held informally and evidence shall be freely admitted regardless of the rules of evidence.

(3) Any hearing conducted under the provisions of this section may be conducted, in whole or in part, by telephone, television, or other electronic means, if each participant in the hearing has an opportunity to participate in the entire proceeding while it is taking place.

(4) A taxpayer has the right to be represented by, or be accompanied by, any person of his choice in any proceeding before the tax commission. If the taxpayer is not present at a proceeding, the representative of that taxpayer must be designated in writing by the taxpayer as shall be prescribed in administrative rules or in any manner acceptable to the tax commission.

Several points need emphasis. The process is informal. Its purpose is to allow the taxpayer to discuss the matter with the individual (usually a Tax Commissioner) who will make a decision about his protest. These hearings, and the procedures associated with them, are the taxpayer's last chance to make his case before he must make a payment in order to receive further review in a court. Idaho Code § 63-3049 requires that before proceeding in court, "the taxpayer shall secure the payment of the tax or deficiency as assessed by depositing cash with the tax commission in an amount equal to twenty percent (20%) of the amount asserted." Fundamental notions of fairness and basic due process require that before a taxpayer may be deprived of property, any such review must be independent.

The State Tax Commission's Authority to Settle Disputed Tax Liabilities

The general rule is that a tax administration agency may settle cases if it acts within statutory authority from the legislature. This is the generally recognized rule throughout the country. *Matter of Joint Diseases North General Hosp.*, 148 A.D.2d 873, 539 N.Y.S.2d 511 (3d Dep't 1989) (Department had not exceeded its authority in agreeing to compromise tax liability of a nonprofit hospital); *People ex rel. Devine v. Murphy*, 181 Ill. 2d 522, 230 Ill. Dec. 220, 693 N.E.2d 349 (1998) (merits of settlement of tax objection under Property Tax Code are generally not subject to examination by trial court); *Grundon Holding Corp. v. Board of Review of Polk County*, 237 N.W.2d 755 (Iowa 1976); *State ex rel. Property Appraisal Dept. v. Sierra Life Ins. Co.*, 90 N.M. 268, 562 P.2d 829 (1977); *City of Cleveland v. Limbach*, 40 Ohio St. 3d 295, 533 N.E.2d 336 (1988). The authority is not unlimited. Actions amounting to fraud or bad faith are not within an agency's authority. *People ex rel. Devine, supra*.

In Idaho, there are several statutory sources that either expressly or impliedly grant the State Tax Commission authority to exercise its discretion to settle tax liabilities. The first and most prominent of these provisions is found in Idaho Code §§ 63-3047 and 63-3048, specifically authorizing compromise of tax liabilities arising under the Income Tax Act.

63-3047. 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 case 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.

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, [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.

Exercising its rulemaking authority under the Idaho Administrative Procedures Act, Chapter 53, Title 67, Idaho Code, and the Idaho Income Tax Act, (Idaho Code § 63-3039), the State Tax Commission has promulgated an administrative rule addressing the circumstances under which it will exercise its authority under these two code sections. The Commission's Administration and Enforcement Rule 500, (IDAPA 35.02.01.500), provides:

500. ADJUSTED OR COMPROMISED CASES -- CLOSING AGREEMENTS (RULE 500).

Sections 63-3047 and 63-3048, Idaho Code.

(3-20-97)

01. Grounds for Compromise. The Tax Commission may compromise the tax liability, penalties, or both, of a case if one (1) or more of the following circumstances exist:

(3-20-97)

a. Doubt as to liability;

(3-20-97)

b. Doubt as to collectability; or (3-20-97)

c. Extreme hardship of the taxpayer. (3-20-97)

02. Final Judgments. The Tax Commission may not compromise the tax liability if the liability has been established by a final judgment of a court, and no doubt exists as to the taxpayer's ability to pay or the state's ability to collect the amounts owing. (3-20-97)

What is "doubt as to liability"?

The judiciary has the ultimate responsibility to construe tax statutes and determine tax liability. *J.R. Simplot Co, Inc. v. Idaho State Tax Com'n*, 120 Idaho 849, 820 P.2d 1206 (1991). "Doubt as to liability" ultimately means whether the Tax Commission's assessment can be sustained in court if challenged. Because tax law is not always clear, determining what a court will do can be challenging. It appears to me that Mr. Howland in his criticisms against the Tax Commission's settlements has failed to take this factor into account. The Tax Commission has litigated cases in court and won. Unfortunately, the Tax Commission has also litigated cases in court and lost. For example, the State Tax Commission, convinced it was correct, litigated the case of *Lockheed Martin Corp. v. Idaho State Tax Commission*, 142 Idaho 790, 134 P.3d 641 (2006). Stan Howland was the tax auditor in that case and was equally convinced that the State Tax Commission's position was correct. Unfortunately, neither the district judge nor any of the five justices of the Idaho Supreme Court agreed with the State Tax Commission or the position taken by its auditor. Fortunately, the court did conclude "that the Tax Commission's appeal was not so lacking in merit that Lockheed is entitled to an award of attorney's fees." *Id.* at 797.

The point is that doubt differs for individuals who view a case from diverse perspectives. Auditors, Tax Commissioners, and Judges evaluate cases in different ways.

Auditors play an important role in evaluating whether tax liability exists. However, it is the Tax Commissioners who have ultimate responsibility, which is imposed by statute, for evaluating the facts, applying the law and making reasoned judgments concerning whether tax liabilities should be settled or should be tried in court. Even if this responsibility was not imposed by law on the Tax Commissioners, the Commissioners are still in the best position to make a judgment about whether to litigate a disputed tax liability. They have the opportunity to independently review a tax auditor's findings and are in a unique position to understand the law, how it applies to a case and the likelihood of succeeding on a claim in court. So long as Tax Commissioners do not abuse the discretion the law vests in them (an issue discussed below), they do not violate the law by making settlements with which others may disagree.

It is apparent from claims made recently by Mr. Howland, that he and the Commissioners differ on whether there was significant doubt about the taxpayers'

liability in those cases cited by Mr. Howland. Because it is correct that Tax Commissioners do not have the power to simply excuse taxes for unlawful reasons, it is necessary to evaluate this claim. This task is simplified a bit by the fact that, with one exception, all of the cases involve the application of the same statutory provision. That is the provisions of the Uniform Division of Tax Purposes Act (UDITPA, Section 63-3027(a) – (s), Idaho Code) defining the terms “business income” and “non-business income.” Further, these cases all involve, not income from business operations, but gain on the sale of a subsidiary, a line of business, interests in limited partnerships or similar transactions.

The classification of income as business or non-business income is fundamental in state corporate income taxation in Idaho and other states because it distinguishes income that may be taxed, in part, from income that usually may not be taxed. The definition, as enacted in Idaho, Idaho Code § 63-3027, is:

(1) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitutes integral or necessary parts of the taxpayer's trade or business operations. Gains or losses and dividend and interest income from stock and securities of any foreign or domestic corporation shall be presumed to be income from intangible property, the acquisition, management, or disposition of which constitutes an integral part of the taxpayer's trade or business; such presumption may only be overcome by clear and convincing evidence to the contrary.

All income that is not business income is “non-business” income. Idaho Code § 63-3027(4).

Because it is based on a uniform state law, there is at least some form of this distinction in the statutes and rules of almost every state imposing a corporate income tax. That means it is possible to judge the difficulties that underlay the statute by examining the extensive reported case law, in Idaho and elsewhere, about it.

The understanding of the statutory distinction is strongly influenced by the Constitutional jurisprudence developed by the U.S. Supreme Court governing what income a state may apportion for state income tax purposes and what it may not. This is because, when construing the meaning of a statute, a meaning that makes it constitutional is preferred over one that does not because the legislature is presumed to have intended to enact a constitutional law. *Hindman v. Oregon Short Line R. Co.*, 32 Idaho 133, 178 P.2d. 837 (1918).

Thus, the overarching constitutional requirements have influenced many courts' interpretation and application of the statutory definition. In *State Dep't of Revenue v. OSG Bulk Ships, Inc.*, 961 P.2d 399, 411-412 (Alaska 1998), for example, the court declared, "In our view it is unwise to construe . . . , 'business income' and 'nonbusiness income,' without reference to the constitutional standard which has been established by decisions of the United States Supreme Court." See also discussion in "The 'Business Income' Definition: Compound Predicate or Constitutional Imperative?" M. Wethekam and B. Browdy 7 St. & Loc. Tax Law. 1 (2002), spotlighting the analytical intersection between the income classification system found in state statutes and regulations and its origins in the Supreme Court's Commerce Clause and Due Process Clause cases.

In a case from Idaho, the United States Supreme Court observed that the Idaho State Tax Commission's assertion that income should be considered a part of the taxpayer's unitary business (and therefore apportionable) because property was acquired, managed, or disposed for purposes relating or contributing to the taxpayer's business would destroy the very concept of limiting apportionment to a taxpayer's unitary business. See, *ASARCO v. Idaho State Tax Commission*, 458 U.S. 307, 102 S. Ct. 3103 (1982). As a result, the constitutional prerequisite that apportionable income must result from the taxpayer's unitary business operations (For a recent example, see *Meadwestvaco Corp. v. Illinois Department of Revenue*, ___ U.S. ___, 128 S. Ct. 1498, (April 15, 2008)) is inherently a part of the statutory standard.

In addition to the superimposed constitutional aspects of the business income determination, the cases show that the business income versus non-business income classification turns on more than a formalistic set of rules. Courts have also pointed out the grammatical difficulties of the statutory language resulting from a misplaced modifier or a compound predicate and have reached differing conclusions about its meaning. *Hoechst Celanese Corp. v. Franchise Tax Bd.*, 22 P.3d 324, 332-33 (Cal. 2001); *Kroger Co. v. Dep't of Revenue*, 673 N.E.2d 710, 713-14 (Ill. App. Ct. 1996). For example, courts consider how many like assets the taxpayer has bought or sold since its corporate inception. Compare *Atlantic Richfield Co. v. Colorado*, 601 P.2d 628, 632 (Colo. 1979) (holding gain from the sale of income-producing assets was business income where the taxpayer "regularly engaged" in major acquisitions and dispositions of property, consisting of 15 purchases and 11 sales of property over a 21-year period) with *Firststar Corp. v. Comm'r of Revenue*, 575 N.W.2d 835, 839 (Minn. 1998) (holding gain from a bank's sale of its corporate headquarters was nonapportionable in that the sale was a "once-in-a-corporate lifetime" transaction). Courts consider the "conditions of ownership" of an income-producing asset. See *Texaco-Cities Serv. Pipeline Co. v. McGaw*, 695 N.E.2d 481 (Ill. 1998) (stating that the determination of whether gain from the sale of a petroleum company's pipeline assets was apportionable to Illinois turned on the "conditions of ownership" of the property sold).

A review of cases similar to those that Mr. Howland cites as examples of Commission settlements in cases in which there is no doubt as to liability, demonstrates

the extent of judicial uncertainty about these issues. The following cases involve actual or hypothetical liquidations⁴ or partial liquidations of a business. Where the sale proceeds have not been reinvested in the business, courts (with the exception of the California courts) often have held, under the UDITPA definitions of business and nonbusiness income or similar language, that the sale proceeds were nonbusiness income. The examples include:

- 1975 - *McVean & Barlow, Inc. v. New Mexico Bureau of Revenue*, 543 P.2d 489 (N.M. Ct. App. 1975).
- 1994 - *Laurel Pipe Line Co. v. Commonwealth of Pennsylvania*, 642 A.2d 472 (Pa. 1994)
- 1998 -
 - *Texaco-Cities Service Pipeline Co. v. McGaw*, 695 N.E.2d 481 (Ill. 1998). (Although a business income, finding it acknowledges the liquidation exception.)
 - *Polaroid Corp. v. Offerman*, 349 N.C. 290, 507 S.E.2d 284 (1998), *cert. denied*, 526 U.S. 1098, 143 L. Ed. 2d 671 (1999) see Footnote 3 – “North Carolina's definition of business income is slightly broader than the definition found under the Uniform Act. Specifically, North Carolina's definition reads "acquisition, management, and/or disposition of the property," as opposed to the definition in UDITPA, which uses the conjunction "and" rather than "and/or."⁵ Moreover, North Carolina's definition utilizes the term "corporation" instead of "taxpayer." These distinctions are irrelevant to the case sub judice.”
- 2001 -
 - *May Department Stores Co. v. Indiana Department of State Revenue*, 749 N.E.2d 651 (2001).
 - *Kemppel v. Zaino*, 746 N.E.2d 1073 (Ohio 2001).
 - *Lenox, Inc. v. Tolson*, 548 S.E.2d 513 (N.C. 2001).
- 2002 - *Blessing/White, Inc. v. Illinois Department of Revenue*, 768 N.E.2d 332 (Ill. App. Ct. 2002).
- 2003 - Conn. Dep't of Revenue Servs., Ruling 2003-3 (July , 2003).

⁴ “Hypothetical liquidations” refers to a transaction in which taxpayers elect under Internal Revenue Code § 338 to treat a sale of stock as an asset sale.

⁵ The *Polaroid* is of particular interest because North Carolina, like Idaho, modified the UDITPA definition by changing the “and” in UDITPA. In Idaho, the “and” was changed to “or.” In North Carolina it was changed to “and/or.” Note that in spite of this change, in both *Polaroid* and in the 2001 *Lennox* case below, the Court held the income to be not apportionable.

- 2004 -
 - *American States Insurance Co. v. Hamer*, 816 N.E.2d 659 (Ill. App. Ct. 2004), (specifically dealt with a Section 338(h)(10) election).
 - *Canteen Corp. v. Commonwealth of Pennsylvania*, 818 A.2d 594 (Pa. Commw. Ct. 2003), aff'd, 854 A.2d 440 (Pa. 2004) (specifically dealt with a Section 338(h)(10) election. Gain must be characterized as non-business income despite the existence of a regulation that would have treated such gain as business income).
- 2007 -
 - *ABB C-E Nuclear Power, Inc. v. Director of Revenue*, 215 S.W.3d 85 (Mo. Sup. Ct.) finding sale proceeds constitute non-business income under the liquidation exception.
 - *Chambers v. Utah State Tax Comm'n*, Case no 050402915 (Utah Tax Ct.)
 - *Nicor, Inc. v. Illinois Dept. of Rev.* Docket No. 05 L 01306, Circuit Ct. of Cook County, Illinois, holding as a matter of law, the deemed sales of assets pursuant to an Internal Revenue Code § 338(h)(10) election constituted non-business income.
 - *McKesson Water Products Company v. Director, Division of Taxation*, Docket No. 00156-2004 (Tax Court of New Jersey).

The point of this discussion about the law relating to business income for income tax apportionment purposes is not to assert the correctness or incorrectness of any conclusion in a particular case. It is to demonstrate the extreme volatility and uncertainty of the state of the law addressing the kinds of cases that Mr. Howland uses as examples of his allegations that the State Tax Commission settled cases in which there is no significant doubt about the corporations liability.

The forgoing discussion addresses the reasons for doubt as to liability in five of the six cases that are addressed in Mr. Howland's complaint and in the Commission's response. These five cases are all business or non-business income cases involving gain from the sale of subsidiaries, lines of business, interests in partnerships, or similar assets. The remaining case (identified in both as "Taxpayer 3") involves a different issue. It involves a taxpayer that checked a box on its tax return electing to make a net operating carry back election. The factual circumstances indicate the box was checked by mistake. Taxpayer's have the right, upon the presentation of evidence showing a clerical mistake, to have a tax agency correct the error. *Woodward v. Board of Equalization of Ada County*, 114 Idaho 882, 761 P.2d 1234 (1988) (The Board of Tax Appeals erred when it

refused to consider evidence of a clerical error and correct the tax rolls accordingly). The *Woodward* case suggests that the Commission may have erred had it acted as Mr. Howland suggests and not permitted the taxpayer to amend its return to correct a clerical mistake.

When the ability of the Commission to enforce an asserted tax liability is in doubt, the Commission has appropriate discretion to enter into reasonable settlements. Whether the Commission has exercised its discretion in a lawful manner is not a question of whether other reasonable minds may disagree with the settlement. The question is whether the Commission abused its discretion in making the particular settlement. Whether a governmental decision maker acted properly in exercising its discretion is determined by application of a three-part analysis. That is: (1) whether the decision maker correctly perceived the issue as one of discretion; (2) whether the decision was within the outer boundaries of its discretion and consistent with the legal standards applicable to the specific choices available to it; and (3) whether the decision is reached by an exercise of reason. *Bradley v. Washington Group Intern.* 141 Idaho 655, 115 P.3d 746 (2005). (Holding that the Idaho Industrial Commission abused its discretion by refusing to award reasonable attorney fees.)

A review of the examples Mr. Howland discusses, the Commission's response thereto, and the forgoing discussion about the difficulties in the statutes involved easily indicate that the Commission has not abused its discretion in making the questioned settlements. They are therefore not unlawful.

Other Statutory Authority for the Commission to Settle Cases.

Having concluded that the Commission has acted within the scope of the legislative authority granted in Idaho Code §§ 63-3047 and 63-3048 to settle tax cases as that authority is interpreted in the Commission's Rule 500, some additional comment is nevertheless necessary to fully address Mr. Howland's allegations of illegality. There are at least three other statutes implicated when the Tax Commission made the kind of decisions the example cases illustrate. Note that the Commission's Rule 500 is expressly promulgated under the authority of Idaho Code §§ 63-3047 and 63-3048 and does not directly implicate the Commission's authority to settle cases under other statutory provisions.

Penalties

In one of the example cases (identified as "Taxpayer 4"), the Commission collected the full amount of tax and interest asserted in the audit, but abated the associated penalty. As noted above, the case falls well within the doubt as to liability standard for settlements. However, the reduction or abatement of penalties implicates an additional statutory basis for the Commission's action that differs from the doubt as to liability standard. The penalty arises under Idaho Code § 63-3046(a):

63-3046. Penalties and Additions to the Tax in Case of

Deficiency. (a) If any part of any deficiency is due to negligence or disregard of rules but without intent to defraud, five percent (5%) of the total amount of the deficiency (in addition to such deficiency) shall be assessed, collected and paid in the same manner as if it were a deficiency.

The Tax Commission's administrative Rule 410 (IDAPA 35.02.01.410) in regard to this statute provides, in part:

410. NEGLIGENCE PENALTIES (RULE 410).

Section 63-3046(a), Idaho Code.

(3-20-97)

01. Negligence Defined. Negligence is the breach of a duty or obligation, recognized by law, that requires conformance to a certain standard of conduct.

(3-20-97)

02. Imposition of Penalty. A five percent (5%) negligence penalty shall be imposed if the deficiency results from either negligence by the taxpayer or from disregard by the taxpayer or his agent of state or federal tax laws, rules of the Tax Commission, or Treasury Regulations. . . .

A determination of whether a taxpayer's assertion of a particular disputable legal position is negligent or in disregard of rules is an analysis that is independent from whether there is doubt as to liability. A position may be reasonable though ultimately determined to be in error. That is essentially the Idaho Supreme Court's conclusion in the *Lockheed* case (*supra*) when it decided that the Commission's assertion about Lockheed's tax liability was erroneous, but not unreasonable. That is the converse of Taxpayer 4's situation. Thus, a settlement abating penalty, even though all of the tax was paid, is not evidence of an illegal settlement.

Implied authority under Idaho Code §§ 63-105(6) and 63-3049.

The State Tax Commission has the power and duty to engage in litigation. The statutory basis is found in both Idaho Code § 63-105(6) (the Commission's "power to sue and be sued") and Idaho Code § 63-3049 (appeals of State Tax Commission decisions). This authority carries with it implied powers naturally associated with litigation. *Bingham County Com'n v. Interstate Elec. Co., a Div. of the L.E. Myers Co.* 105 Idaho 36, 665 P.2d 1046 (1983). Many courts have recognized that the power to sue or be sued carries with it the ordinary powers to manage litigation – including the power to exercise proper discretion to settle cases, including tax cases. *See, e.g., State ex rel. St. Louis Shipbuilding & Steel Co. v. Smith* 356 Mo. 25, 201 S.W. 2nd 153 (1947) (power to compromise interest and penalty in a disputed sales tax case). *Multnomah County v. Title Guarantee & Trust Co.* 46 Or. 523, 80 P. 409 (1905) (county commissioners can settle

pending controversies as to the validity of tax certificates held by the county and the rights of the respective parties thereunder).

The Tax Commission is constrained by its legislative appropriation.

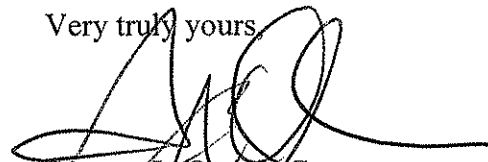
The State Tax Commission is constitutionally and statutorily restrained by the extent of its appropriation. It must manage its affairs, including auditing, resolution of protested disputes, and litigation in a manner that stays within its appropriation. It must exercise judgments necessary to keep the cost of all of its administration and enforcement activities within its budgeted limits. This requires trade-offs and can mean that some violations go unenforced. By analogy, this is not unlike other common enforcement activities – police cannot catch every speeder; prosecutors cannot bring to trial every criminal charge. Indeed, the Tax Commission’s audit staff cannot audit and adjust every tax return that may contain errors. The Commissioners and their managers must judge when it is best for the overall interest of the state to use its limited resources for enforcement and when it is better to settle. In regard to litigation, this discretion rests with the Commissioners – not their staff. Good stewardship of the resources entrusted to the Commission, and the extent to which the resources are available to support enforcement and litigation, are proper factors for Commissioners to consider when deciding to settle disputed tax liabilities.

Conclusion:

Each of the example cases fall easily within the scope of the State Tax Commission’s discretion to settle cases, and there is a reasoned consideration for the settlement of each of them. The Commission has not acted in a way that can be characterized as “illegal.”

We have limited our analysis to the question you asked that we answer and leave to policy makers the other concern in Senator Kelly’s letter. We appreciate the opportunity to address the questions raised by your inquiries. Please let me know if you have any additional questions you would like us to address.

Very truly yours,



STEVEN L. OLSEN, CHIEF
CIVIL LITIGATION DIVISION
Deputy Attorney General

SLO/rm
Enclosure

Attachment
The Commission's Administrative Appeal Process.

The administrative appeal process begins when one of the bureaus or divisions within the Tax Commission determines that there is a tax "deficiency." Idaho Code § 63-3044. In the context of this memorandum, a proposed tax deficiency usually results from an audit conducted by the Tax Commission's Income Tax Audit Division. If the Audit Division finds the amount of tax due under the applicable Idaho statutes is more than the amount of tax shown due on the taxpayers return, then the Audit Division will determine that a deficiency exists. Idaho Code § 63-3044(a).

Once the Audit Division determines a deficiency exists, the next step is to notify the taxpayer of the deficiency and to give that taxpayer the right to challenge the Division's determination. Idaho Code § 63-3045(1)(a). Notification is done through a Notice of Deficiency Determination. The Notice of Deficiency Determination serves three primary functions: (1) it informs the taxpayer: of the amount of taxes, penalty, and interest that the Commission claims is still owing; (2) advises the taxpayer of the reasons for the deficiency determination; and (3) provides the taxpayer with a written explanation of that taxpayer's right to appeal. *Id.*

The taxpayer is given sixty-three days from the date the Notice of Deficiency Determination was mailed to file a written protest with the Tax Commission. If a valid protest is filed within the sixty-three day time period, the Tax Commission is required to send a letter acknowledging that a valid protest has been filed. Idaho Code § 63-3045B(3). This acknowledgment letter must be sent within fourteen days from the receipt of the letter of protest. *Id.*

In order to be valid, the protest (statutorily referred to as a "petition for redetermination") must be timely filed and it must meet the minimum requirements set out in Idaho Tax Commission Administration and Enforcement Rule 320.01 (IDAPA 35.02.01.320.01). *See*, Idaho Code § 63-3045(1)(b). According to that Tax Commission administrative rule, the protest must contain the following information to be perfected:

- a. Name, address, and pertinent identification number;
- b. The period to which the deficiency relates;
- c. The specific item or items in the Notice of Deficiency to which the taxpayer objects; and
- d. The factual or legal basis for the objections made.

Id. If the written protest does not meet these minimum requirements, the protest is not "perfected." The Tax Commission must then notify the taxpayer that the protest was invalid and inform the taxpayer of the corrective action that is necessary to perfect the protest. Idaho Code § 63-3045(1)(b). The taxpayer has twenty-eight (28) days from the date of the notice to perfect the protest. *Id.*

If the taxpayer fails to file a protest with the Tax Commission – or fails to perfect the protest – within the time allowed, the taxpayer’s right to challenge the deficiency determination lapses, and the amount asserted in that deficiency becomes assessed and subject to collection action. Idaho Code §§ 63-3045(5), 63-3045B(1), 63-3045B(2); Tax Commission Administration and Enforcement Rule 320.04. See also *State Tax Com’n v. Western Electronics, Inc.*, 99 Idaho 226, 227, 580 P.2d 72, 73 (1978).

If, on the other hand, the taxpayer files a perfected protest, the taxpayer is given the opportunity to have a hearing before a Tax Commissioner, or the Commissioner’s designee, to explain the factual and/or legal basis for the protest. Idaho Code § 63-3045(2). At that point, the matter is transferred from the Audit Division to the Commissioner with oversight of the tax at issue⁶ (in this case corporate income tax). In many instances, especially in corporate income tax cases, the Commissioner is assisted by a Policy Specialist of the Commission or a Deputy Attorney General from the Office of the Attorney General. These persons are independent of the Audit Division, and they have experience with the issues involved in the case.

The hearing with the Commissioner is informal. Idaho Code § 63-3045(2) provides that “the meeting shall be held informally and evidence shall be freely admitted regardless of the rules of evidence.” Similarly, Idaho Code § 63-107 states that “Processes and procedures before the state tax commission shall be as summary and simple as reasonably may be, and, as far as possible, in accordance with the rules of equity.”

The informal hearing is the taxpayer’s opportunity to explain to a Commissioner, on a personal level, why the deficiency proposed by the Audit Division should be “redetermined.”

Because the hearing is informal, it provides both parties an efficient and economic means of resolving issues before resorting to a more formal hearing before the Idaho Board of Tax Appeals or an Idaho district court.

The Tax Commission’s conduct in assessing and collecting a tax deficiency is governed by the Taxpayer Bill of Rights which protects a taxpayer’s right to a due and fair process of the law. In line with the Taxpayer Bill of Rights, the Commissioners of the Tax Commission conduct the redetermination hearing independent of the Audit Division. The role of the Commissioner is to examine the audit in the context of the taxpayer’s explanations. Unless there is a need to have an auditor explain a specific audit adjustment, members of the Audit Division are not present at the informal hearing. However, if the taxpayer presents new information, the Commissioner may forward that information to the Audit Division and ask the Division to comment.

⁶ By statute, individual Tax Commissioners are assigned “responsibility for policy management and oversight of one (1) or more of the taxes collected and/or activities supervised or administered by the commission.” Idaho Code § 63-102(3).

After the informal hearing is held, the Commissioner is given 180 days to issue its final decision regarding the protest. Idaho Code § 63-3045B(3)(b). If the taxpayer does not request an informal hearing before a Commissioner, that taxpayer can still start the 180-day time limitation by making a written request for a final decision. If the Tax Commission fails to issue its final decision within the 180-day period, “the notice of deficiency shall be null and void *ab initio*, with prejudice.” Idaho Code § 63-3045B(5). In this manner, a taxpayer is ensured of receiving a timely response to the request for a redetermination.

A decision of the Commissioner may uphold, reverse, or modify the deficiency determined by the Audit Division. The internal process for issuing a decision requires review by several persons. The Commissioner and Deputy Attorney General or Tax Policy Specialist begins by drafting a proposed decision. The proposed decision is proof read and then circulated to the manager of the Tax Policy group, the Audit Division Administrator, the Bureau Chief of the Income Tax Audit Bureau, and the other three Commissioners of the Idaho State Tax Commission. The Commissioner charged with the redetermination will consider comments made by any of the reviewers before the decision is issued. Once the internal review is complete, the decision is finalized by the Commissioner and mailed to the taxpayer. Idaho Code § 63-3045B(6).

Within 120 days of mailing a decision to the taxpayer, the Commission makes the decision available to the public for inspection and copying in compliance with Idaho’s Public Records Requests laws. However, to protect a taxpayer’s confidentiality, the decision must be redacted by removing any information that discloses the identity of the taxpayer or proprietary information (for instance trade secrets) the taxpayer identifies and requests to have removed from the published decision. Idaho Code § 63-3045B(6). The taxpayer’s request to redact specific information from the decision must be in writing within 91 days after the date of the Tax Commission’s decision.

If the taxpayer still does not agree with the determination of the State Tax Commission, that taxpayer has the right to appeal the final decision to district court or to the Idaho Board of Tax Appeals. Idaho Code § 63-3049. To appeal to the Idaho Board of Tax Appeals, the taxpayer is required to file an appeal with the Board within 91 days of the receipt of notice of the final decision. *Id.*⁷ Corporate income tax decisions generally are appealed to an Idaho district court. To appeal to the district court, the taxpayer must file a complaint “within ninety-one (91) days after the receipt of notice of the decision of the state tax commission.” Idaho Code § 63-3049(a). In either case, the taxpayer is also required to pay – or post a bond equal to – at least 20% of the amount asserted as due in the final decision. Idaho Code § 63-3049(b).

If no appeal is taken to either the district court or to the Idaho Board of Tax Appeals within the 91-day time period set out in Idaho Code § 63-3049(a), the taxpayer

⁷ An appeal to the Idaho Board of Tax Appeals is not allowed in the case of a sales or use tax deficiency in excess of \$25,000, or in the case of a corporate income tax deficiency in excess of \$25,000. Idaho Code § 63-3049(a) (last sentence).

loses his right to judicial review of the final decision of the Idaho State Tax Commission. Idaho Code § 63-3049; *Conley v. Looney*, 117 Idaho 627, 630, 790 P.2d 920, 923 (Ct. App. 1989). The amount asserted in that final decision then “hardens” into a due and owing tax assessment. See Idaho Tax Commission Administration and Enforcement Rule 300.02 (IDAPA 35.02.01.300.02).

If the taxpayer files an appeal, then the rules and procedures governing that body will apply. Any information filed by the taxpayer loses its confidentiality protection unless the taxpayer specifically requests the district court or the Board to issue a protective order for the purpose of sealing the information and keeping the information out of the public view.

Settlements are an alternative to issuing a decision, or litigating an issue once it is issued. Idaho Code § 63-3047 grants the Tax Commission the authority to abate penalties assessed to the taxpayer, and Idaho Code § 63-3048 provides that the Tax Commission may adjust or compromise a deficiency. The compromises must be in writing and signed by the parties. Once the parties enter into a settlement agreement, the agreement closes the tax years at issue. In contrast to a decision, a settlement is not an admission or concession by either party regarding the issues involved in the case.

But like a decision, a compromise contains confidential information. Idaho Code § 63-3076 prohibits the Tax Commission, or any person of the Tax Commission, from disclosing to the public any tax return or tax information. “Tax return” and “tax information” are broadly defined in the statute to include information contained on a taxpayer’s return, including the taxpayer’s identity and the nature of the taxpayer’s income or deductions, the status of any assessment or refund of a taxpayer, the status of any investigation into a taxpayer’s liability, any information collected by the Tax Commission with respect to a taxpayer’s liability, or any other information furnished by or on behalf of a taxpayer. Because a compromise agreement contains confidential information, it is not made available to the public.

The internal review of a proposed compromise agreement is similar to the procedure used for reviewing a proposed decision. The Commissioner and Deputy Attorney General or Tax Policy Specialist begin by drafting a summary of the compromise offered by the taxpayer and a proposed compromise agreement. The documents show: (1) the specific issues involved in the case; (2) the updated amount of deficiency in dispute; (3) an explanation of why a compromise may be appropriate; and (4) the tax affect of the compromise proposed by the taxpayer. The compromise documents are circulated to the Audit Division Administrator, the Bureau Chief of the Income Tax Audit Bureau, and the other three Commissioners of the Idaho State Tax Commission. Any person who has an objection to the proposed compromise, or a suggestion for an alternative compromise, may submit comments. Additionally, if the amount in dispute is more than \$50,000, then the Commissioner with oversight of the tax type and one additional Commissioner must sign the agreement. Once a compromise agreement is approved, the Tax Commission sends the agreement to the taxpayer. The taxpayer then signs the agreement and, together with the required payment, returns the

agreement to the Tax Commission. If the agreement is properly executed without modification, the Commissioner(s) sign the agreement and accept the payment submitted by the taxpayer. A copy of the fully-executed agreement is provided to the taxpayer and the case is closed.