

IDAHO STATE TAX COMMISSION RESPONSE TO AUDITOR HOWLAND'S COMPLAINT

This responds to State Tax Commission Auditor Howland's allegations that the Commission illegally allows large multi-state corporations to "pay less income tax than required by state law" through misuse of compromise and closing agreements. The Commission, and the individuals involved, reject as completely untrue any allegation that cases are illegally or inappropriately compromised.

OVERVIEW

Compromise and closing agreements are one method of resolving contested tax matters with taxpayers. They are available in appropriate situations to all taxpayers for many different types of taxes. Compromise and closing agreements are specifically authorized by statute.

A contested tax matter often begins with the Commission's Audit Division issuing a Notice of Deficiency Determination (NODD) to a taxpayer. Often these NODDs result from an audit conducted by Commission staff. If the NODD asserts that a tax liability is owed, the taxpayer has the right to appeal the NODD to the Commissioner who oversees the tax type at issue. This appeal is known as a protest. The taxpayer may elect to meet with a Commissioner or designee in an informal hearing, have a telephonic hearing, or simply provide written material in support of his protest. The taxpayer's protest is usually resolved in one of two ways. Either an appealable decision is issued or the taxpayer and Commission reach a compromise. A compromise is made effective through a compromise and closing agreement.

When a taxpayer protests an NODD, it is important that the protest process offer an impartial review. Moreover, it must be seen to offer an impartial review. It is difficult to have an impartial review, and impossible to be seen to have one, when the auditor sits in judgment on his own NODD. That is why auditor involvement is minimized at the protest level. Protests are heard either by Commissioners or their designees.

PREVIOUS AUDIT OF COMPROMISE AND CLOSING AGREEMENTS

We traveled this road before. Some Commission staff complained of improper use of compromise and closing agreements over a decade ago. This resulted in a 1996 Legislative Audit performed by the Legislative Services Office that issued a report entitled "Multi-State Corporate Tax Compromise and Close Agreements." The 1996 audit found no evidence of wrong-doing, but did make two basic quality control recommendations. First, the legislative audit recommended that a single commissioner not have sole authority to decide large compromises. This recommendation was adopted in 1996. Attached is a copy of the procedures adopted in 1996. Second, the audit expressed concern that Commission files contained inadequate documentation to explain the compromise and closing agreements. Documentation has been improved. A compromise and closing form is attached.

WHY COMPROMISE AND CLOSING AGREEMENTS ARE USED

Compromise and closing agreements are efficient. The 1996 Legislative Audit notes that in January, 1994 the Commission had a backlog of approximately 800 cases. Many of these simply languished for lack of resources to attend to them. This was a disservice to all concerned, especially the taxpayer. Use of compromise and closing agreements is largely responsible for reducing the backlog to the point where cases are now dealt with promptly.

Compromise and closing agreements have no precedential value and so are useful in preserving legal issues. Issue preservation is important when the Commission believes its position is correct, but the law is unsettled. There may be an uncertain federal constitutional issue involved or perhaps there is no Idaho case law on a certain point and other state courts are split. There is certainly doubt as to liability in these instances and Idaho simply does not have the resources to litigate all issues. A compromise now preserves the issue for another time when the law may be more settled.

The alternative to using a compromise and closing agreement is for the Commission to issue a written decision. In the multi-state corporate tax arena, a written decision almost always results in multi-year litigation.

MR. HOWLAND'S COMPLAINT

Specifics of Mr. Howland's complaint are best addressed by analyzing the cases he mentions in his complaint. Such analysis is in the following section. A few general comments are nevertheless in order.

What Mr. Howland deplors as unjustifiable secrecy, others regard as laudable confidentiality designed to protect privacy. Note, too, that many individuals in the Commission review compromise and closing agreements. In this way, taxpayer confidentiality is protected while minimizing the risk of error or malfeasance.

Mr. Howland also states that it is illegal to settle most cases because there is no doubt as to liability. This is rarely the case. Even when the Commissioners, legal staff and tax policy specialists concur wholeheartedly that the auditor is correct, courts decide who is right and who is not. The fact is that tax law, especially multi-state corporate tax law, is neither simple nor black and white. The Commission has defended written decisions not only to the Idaho Supreme Court, but all the way to the United States Supreme Court. If tax law was simple and clear, this would not be necessary.

ANALYSIS OF CASES NOTED IN MR. HOWLAND'S COMPLAINT

The following summaries provide additional information regarding the examples of compromises contained in Mr. Howland's document. Although specific taxpayers were not named, the Tax Commission identified the cases based on the facts provided by Mr. Howland.

Taxpayer #1

The business that was sold was a partnership located in a state other than Idaho. Other than selling certain products in Idaho, the partnership did not have a presence in Idaho (no property and no payroll). The companies of the unitary business that operated in Idaho operated at a loss. The Audit Division attributed the gain realized on the sale of the partnership to the unitary group and used the apportionment factors of the group to apportion part of the income to Idaho.

On appeal to the district court, the taxpayer hired an expert witness who conducted a study of how the gain from the sale of the partnership should be apportioned among the states. The expert witness noted the Tax Commission was taxing the gain of the out-of-state partnership based on the apportionment factors of in-state loss companies. The expert concluded that it was distortive to tax the out-of-state gain based on the property, payroll, and sales factors of the companies located in Idaho incurring losses.

The Company maintained such an apportionment did not fairly reflect the partnership's business activity in Idaho. The Idaho Supreme Court recognized the ultimate goal in apportioning income is to accurately reflect the taxpayer's business activity in the state of Idaho. Union Pacific v. Idaho State Tax Commission, 139 Idaho 572, 83 P.3d 116 (2004). Moreover, the Due Process and Commerce Clauses forbid the states from taxing extraterritorial values that are not associated with the in-state activities of the business. Container Corp. of America v. Franchise Tax Bd., 463 U. S. 159, 164 (1983)

The taxpayer had not made this argument during the audit or the administrative appeal. Based on the factual analysis of the expert's report and the court holdings set forth above, the Commission found merit in the taxpayer's new position. The taxpayer initially requested an overall refund based on the alternative apportionment. The Tax Commission negotiated a more acceptable method of alternative apportionment and compromised the case.

The auditor was correct that the alternative apportionment reduced the deficiency significantly (the Tax Commission declines to provide specific numbers of the compromise because of the potential for disclosure of tax information in violation of Idaho Code § 63-3076). However, the Commissioner, Audit Division Administrator, and Deputy Attorney General assigned to the case believed the apportionment agreed to during the compromise was a more accurate apportionment than the apportionment used in the audit.

Taxpayer #2

The auditor identifies the issue as whether or not a liquidation exception to business income exists under Idaho's statutory definition of business income. Essentially, the liquidation exception is that the sale of assets of a business is not business income even though those same assets formerly generated business income. The rationale is that the liquidation of the business (sale of its assets) is not a usual business event, and therefore the gain from the sale is not business income subject to apportionment.

In this particular case, the taxpayer sold an entire line of business and argued the relevant Idaho statute should be interpreted to include a liquidation exception. The taxpayer treated the gain from the sale as nonbusiness income and did not apportion any of the gain to Idaho. The Tax Commission was not prepared to concede to the taxpayer's interpretation, and therefore issued a decision upholding the audit determination.

After the decision was issued the taxpayer offered to compromise. The Tax Commission entertained a compromise because it was aware that several states recently lost this issue in their high courts. While the rulings of other state courts are not binding, such rulings are persuasive. To date, the Idaho courts have not ruled on the issue, and therefore it is an open question in Idaho.

Additionally, the Tax Commission became aware that the taxpayer was eligible to receive a newly enacted credit.

Based on these facts, the Tax Commission accepted a compromise in which it received about 67 percent of the deficiency proposed by the audit staff, and the taxpayer agreed to forego any right to claim the credit.

Taxpayer #3

This was a case where a taxpayer did not elect to forego the Net Operating Loss (NOL) carryback at the federal level. However, the taxpayer mistakenly made the election on its Idaho return, which is a check-the-box type of election.

Within a very short period of time of filing its original return, the taxpayer filed an amended return with the Tax Commission carrying back an NOL from a subsequent year to the year in question. The taxpayer carried back the NOL based on its assumption that it had not elected to forego the carryback on its Idaho return. The audit staff followed the check-the-box on the original Idaho return and disallowed the NOL carryback.

When the taxpayer received notice from the Audit Division of the disallowance, the taxpayer realized it had made a clerical error when it completed the original Idaho return. The taxpayer immediately contacted the Tax Commission to ask if the error could be corrected. The taxpayer stated it never intended to forego the carryback for either federal or Idaho taxes.

The taxpayer's statement was accepted by the Commissioner with oversight of the corporate income tax. The Commissioner found the taxpayer's statement to be credible because: (1) there was a short period of time between the filing of the original return and the amended return which claimed the NOL carryback; (2) the taxpayer had not elected to forego the carryback at the federal level; and (3) the taxpayer notified the Commission of the error as soon as it became aware of the error.

The matter was not lodged as a formal administrative appeal. The Tax Commission follows the policy contained in Idaho Code section 63-107 which states that "Process 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." This was a case of a clerical error which the Commission addressed as simply as possible. The Commission withdrew the NODD and allowed the taxpayer to carryback the NOL.

The tax impact regarding this issue is minimal. There is no question that the NOL is deductible. If it is not carried back and deducted in the year in question, the NOL will simply be deducted in a subsequent year.

Taxpayer #4

In this case, the taxpayer sold a subsidiary and reported the gain from the sale as nonbusiness income with none of the gain apportioned to Idaho. The audit staff reclassified the gain as business income and apportioned part of the gain to Idaho.

The taxpayer protested the resulting deficiency proposed by the audit staff on the following grounds: 1. Idaho lacked the requisite jurisdiction to tax the gain because the Petitioner was not in a unitary relationship with its subsidiary; 2. pursuant to the United States Supreme Court's holding in Allied Signal, Idaho could not apportion the gain because the taxpayer's investment in the subsidiary did not have an operational purpose but rather was a passive investment; and 3. the stock gain is nonbusiness income that should be allocated to the Petitioner's state of domicile because the sale of the stock failed both the transactional and functional test used to determine business income as set forth in Idaho Code § 63-3027.

What income of a multistate corporation constitutes business income subject to apportionment is an issue that both taxpayers and states have struggled with since ASARCO Inc. v. Idaho State Tax Commission, 458 U.S. 307 (1982). In ASARCO the United States Supreme Court rejected Idaho's business income determination. Since ASARCO, states and taxpayers have been to the United States Supreme Court several times with various interpretations and definitions of business income, including the Mead case from Illinois decided by the Supreme Court this year. States and taxpayers are now at odds over the meaning of the Court's recent ruling.

In short, whether the gain derived from the sale of a business constitutes business income subject to apportionment is an issue of law that is not settled. The Idaho courts have not addressed the issue. Other state courts have split on the issue.

The taxpayer offered a compromise and asked only that the penalty be waived in exchange for not moving toward litigation. This was equivalent to a reduction of about 3.5 percent of the total liability asserted in the Commission's decision. A 3.5 percent reduction was less than a conservative estimate of the risk of litigating this matter in district court.

Moreover, the Commission found the taxpayer was not unreasonable in its reporting position and the taxpayer had not acted in bad faith. The taxpayer pointed out that although its subsidiary had been included in the unitary group in the past years, it was because the Tax Commission required its inclusion in previous audits.

Accordingly, the Tax Commission waived the penalty and collected the entire amount of tax and interest assessed in the Tax Commission's decision. The amount with penalty was \$109,045. After waiving the penalty, the Tax Commission collected \$105,211.

Taxpayer #5

This case involved a taxpayer who held minority interests in various limited partnerships. The taxpayer reported the income as nonbusiness income. The audit staff attributed the income from these minority interests to the taxpayer as business income.

Again, this is the business vs. nonbusiness income issue that has been largely left unresolved by the United States Supreme Court's ruling. This particular fact pattern presented an additional difficulty. Under the Court's rulings, income is business income subject to apportionment among the states if: (1) the income is generated by a subsidiary that is part of the unitary group; or (2) the income is generated by assets that serve an operational function (as opposed to a passive investment) for the unitary business.

In this case, the limited partnerships could not be part of the unitary business. Idaho Code § 63-3027(t) indicates that only businesses in which the taxpayer owns more than 50 percent can be considered as part of the unitary business. Here the taxpayer owned less than 50 percent of each limited partnership. Additionally, the statute addresses only corporations, not partnerships, as part of the unitary business.

The taxpayer indicated that its minority interests in the limited partnerships were not operational assets but instead only passive investments, therefore failing the second test for business income. The investments were hedges that might prove useful as the taxpayer's market expanded. However, a restructuring in the operations of the industry, as well as the taxpayer, had rendered these investments less likely for future use. The taxpayer argued accordingly that its gain on the sale of its limited partnership interests constituted nonbusiness income because the interests were not used, and would not be used, as an operational part of the taxpayer's business.

Based on these facts and the state of the law regarding business income, the Tax Commission compromised the case. The compromise was approximately 50 percent of the deficiency proposed by the audit staff.

Taxpayer #6

Discussion of this case presents problems. The dollar amounts involved are large enough that they tend to be identifying information. Nevertheless, several points can be made. First, despite Mr. Howland's assertions to the contrary, liability was certainly in doubt. Second, Mr. Howland's estimate of the "cost" to the state in lost tax, penalty and interest is wildly overstated. Mr. Howland appears not to have considered a very large tax payment made prior to the compromise and closing agreement. This prior tax payment was in addition to the amount the company agreed to pay in the compromise and closing agreement. The third point, discussed below, explains why waiver of penalty was appropriate.

This is another business versus nonbusiness income case, but with a unique twist. The taxpayer is a unitary business that does business in Idaho. The taxpayer acquired a company which became a division of the unitary business. This fact was conceded. Thus the unitary test for business income was satisfied.

Nonetheless, the taxpayer treated part of a gain from the later sale of the division as nonbusiness income. The taxpayer stated that it had purchased the company for far less than its original value. Thus, when the taxpayer purchased the company it already had a "built-in" appreciation that was not a result of the operations of the taxpayer's business. Because the built-in appreciation was not part of the taxpayer's business, the taxpayer reasoned it should not be characterized as business income subject to apportionment.

This is a relatively novel theory. To the Tax Commission's knowledge, it had not been raised before in Idaho or any other state. However, the taxpayer presented the same case to an administrative appeal board in the state of Maine. Maine adopted the taxpayer's approach and determined that the built-in appreciation (or gain) was nonbusiness income because it existed before the company became part of the taxpayer's unitary business.

Additionally, the Tax Commission contacted the Montana Department of Revenue (MDOR) which was also addressing the issue with the taxpayer. The MDOR and taxpayer were involved in protected litigation. One piece of the litigation was headed to the Montana Supreme Court for resolution. That piece of the case was specific to Montana law and was not relevant to the Idaho issue. The case would not be decided in Montana until the Montana Supreme Court issued a ruling and then the remainder of the case proceeded through the appeal process.

Given these facts and the general state of uncertainty regarding the business income issue, the Tax Commission agreed to settle the case with the taxpayer.

The Tax Commission waived the understatement penalty pursuant to Idaho Code § 63-3046, which provides the penalty may be waived if the taxpayer shows there was reasonable cause for the understatement and that the taxpayer acted in good faith. Given the lack of authority to the contrary and a favorable ruling from Maine, the Tax Commission found the taxpayer acted reasonably and in good faith when it reported the built-in appreciation as nonbusiness income.

The Other Taxpayer Case

On page 5 of Mr. Howland's complaint, there is a reference to another case compromised by the Tax Commission. In that case, a subsidiary of a parent corporation acted as an investment entity. It invested in a series of partnerships in which a subsidiary owned a majority interest in some partnerships and minority interest in others. The subsidiary did not conduct its investment business in Idaho.

The extent of any activity in Idaho connected to the subsidiary was that the subsidiary was a limited partner in a partnership that conducted business in Idaho. The subsidiary sold its limited interest in this Idaho partnership and reported the gain as nonbusiness income.

The audit staff determined the subsidiary's income was business income apportionable to Idaho because the subsidiary was part of its parent's unitary business. The investment subsidiary protested the proposed deficiency, stating that: (1) it was not unitary with the parent; (2) its investment income was not business income that should be apportioned to Idaho; and (3) even if viewed as a limited partner of a partnership that conducts some business in Idaho, Idaho does not have the jurisdiction (nexus) to impose a tax on the limited partner.

The taxpayer offered a compromise to avoid litigation. The Commission accordingly evaluated its risks regarding the issues. The issue of whether the subsidiary was unitary or not with its parent represented little risk. However, there was a substantial risk of litigation regarding the issue of whether the income received by the subsidiary was business or nonbusiness income. The taxpayer took a reasonable position in reporting the sale of a limited partnership interest as nonbusiness income. By definition, a limited partner does not engage in the management of the partnership business. Additionally, while the audit staff had concluded that the subsidiary was part of the parent's unitary group, the staff had not conducted an analysis of whether the investment in the limited partnership served an operational purpose rather than an investment purpose.

In this case, the Tax Commission and taxpayer negotiated a compromise in which the taxpayer paid approximately 97.5 percent of the deficiency proposed by the audit staff. The deficiency proposed by the audit staff was \$101,215. The taxpayer paid \$98,650.

COMMENTS ON MR. HOWLAND'S SUGGESTED IMPROVEMENTS

Mr. Howland presents six suggestions that he believes will improve the present system. These recommendations show that Mr. Howland's complaints involve not just the Commission, but the public policy of the state as set forth by the Legislature. That policy is to protect taxpayer privacy by making taxpayer information confidential.

The first two suggestions eliminate confidentiality of taxpayers who protest an NODD. The first does away with the ability of the taxpayer to redact identifying information from the published decision. The second requires that compromise and closing agreements be published with details of each issue and with identifying information intact. This turns the compromise and closing agreement into a decision.

Note that the elimination of taxpayer confidentiality will result in the IRS no longer sharing information with the Commission. Many of the audits we do are developed with information that originated with the IRS.

The third recommendation calls for another investigation of the Commission's resolution of multi-state audits. Mr. Howland states that Legislative Services should not perform it unless it can be "free of interference from the Attorney General's office." In 1996, then Attorney General Lance wrote a letter to the head of Legislative Services critical of the non-attorney legislative auditors making legal judgments about particular cases. This is not "interference." It is a valid point made in an objective review of the legislative auditors' work.

Mr. Howland's fourth recommendation does not reflect the facts. He states, "In the prior legislative audit the employees were not allowed to respond to the many erroneous and misleading statements made by the Commission. This helped to keep the truth from being told and is partially responsible for the situation as it exists today." In fact, the legislative auditors interviewed many Commission employees, including auditors. The Commission could not have kept the legislative auditors from doing these interviews even if it wanted.

The fifth recommendation calls for an audit of all internal control procedures at the Commission. The 1996 legislative audit already reviewed internal control procedures. Mr. Howland suggests that any internal control procedures "include many of the recommendations found in the 1996 legislative audit report." The Commission already adopted many of these recommendations in 1996. See attachments.

Mr. Howland's last recommendation calls for audit staff to review all proposed compromises and "provide their input for consideration in the approval process." The auditor's input is the audit. It is the usual practice to send newly provided taxpayer information to the auditor for comment. Beyond this, to involve audit staff in the compromise and closing "approval process" is to involve the auditor in judging his own audit. This undermines, and will be seen to undermine, basic notions of fair play.

INTERNAL REVIEW OF PROCEDURES

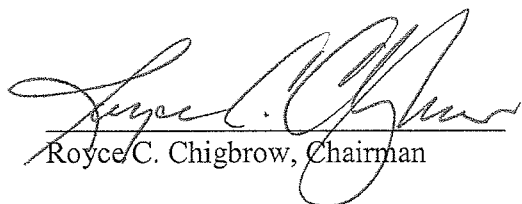
The Commission has again reviewed the procedures adopted in 1996. They work. They will continue to work. As recommended by the 1996 Legislative Audit, the Commission examines specific criteria when considering a compromise. A written form is prepared that shows: (1) the specific issues involved in the 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. These criteria are reviewed by more than one

Commissioner. The Commission is always open to suggestions that do not conflict with the statutory requirement for taxpayer confidentiality.

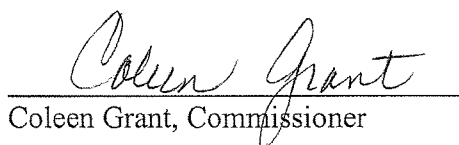
CONCLUSION

The fundamental disagreement between the Commission and Mr. Howland has to do with the complexity of tax law. Mr. Howland is of the opinion that it is really pretty simple and therefore any deviation from the amount of tax liability asserted on the audit staff's NODD and the amount finally collected is tantamount to giving away state money. Tax law, particularly multi-state corporate tax law, is actually quite complex. If it was not, there would not be so many CPAs and tax attorneys making good livings dealing with it. Courts would not split on contested issues. Reasonable, honest people can and do have legitimate differences of opinion concerning tax law. Taking complicated issues to court is never without risk. Compromise and closing agreements provide an efficient means of dealing with complex, uncertain issues. They have not been misused.

Dated: 6/19/08


Royce C. Chigbrow, Chairman

Dated: 6-19-08


Coleen Grant, Commissioner

Dated: 6/19/08


Sam Haws, Commissioner

Dated: 6-19-08


Tom Katsilometes, Commissioner




Guideline for Review of Compromise & Close Agreements

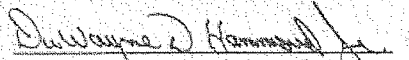
Once a Notice of Deficiency Determination (NODD) has been protested, if the *amount at issue** equals or exceeds \$50,000, and if the delegated commissioner determines the case should be settled, then the following procedure will apply:

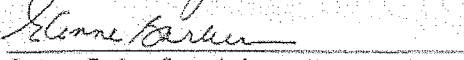
- The delegated commissioner, accompanied by a deputy attorney general, a tax policy representative assigned to the case and, when required, the bureau chief for the respective tax area, will meet with at least two other commissioners to explain the rationale for, and the parameters of, the proposed compromise.
- Following this meeting, any commissioner questioning the proposal, or any portion thereof, may place a memorandum detailing the questions and concerns in the case file. If these concerns are subsequently satisfied, the memorandum will be withdrawn from the file.
- Subsequent meetings may be held to satisfy any questions or concerns. A summary of the meeting(s) with the commissioners will be placed in the case file.
- If a tentative settlement is reached with the taxpayer, then the compromise and close document will be drafted and circulated to commissioners for review prior to the execution thereof by the taxpayer.
- Once the settlement agreement is signed by both parties and the final settlement amount is received, the case will be closed.
- If the *amount at issue* is less than \$50,000, the delegated commissioner has authority, without consultation with other commissioners, to propose settlement. However, the tentative agreement will be circulated to commissioners for review prior to the execution thereof by the taxpayer.
- At the discretion of the delegated commissioner, and regardless of the *amount at issue*, the above described procedure may be employed.

* The *amount at issue* is the net remaining amount of the NODD, after all additional information has been incorporated into the calculation, after updates for interest, and after reflecting any payments by the taxpayer in the interim, but it does not include penalty.


R. Michael Southcombe, Chairman


Colleen Grant, Commissioner


DuWayne D. Hammond, Commissioner
Effective Date: October 22, 1996


G. Anne Barker, Commissioner

<input type="checkbox"/> COMPROMISE & CLOSE AGREEMENT	<input type="checkbox"/> CLOSING AGREEMENT
NAME OF TAXPAYER: AUDIT PERIOD:	DATE: DOCKET #:
NODD AMOUNT (Decision if Issued)	NODD Updated to:
Tax Interest Penalty Total	Tax Interest Penalty Total
\$ _____	\$ _____
Informal Conference? No <input type="checkbox"/> Yes <input type="checkbox"/> Date: _____ New Information Received? No <input type="checkbox"/> Yes <input type="checkbox"/> From: _____ Deputy AG Assigned? No <input type="checkbox"/> Yes <input type="checkbox"/> Name: _____	
Taxpayer's Offer	Amount at Issue
Tax Interest Penalty Total	Tax Interest Penalty Total
_____	_____
Principal Issues Protested:	
Proposed Settlement Parameters:	From: _____
Tax Interest Penalty Total	To: _____
_____	Comments: _____
Reasons for Settlement:	
<input type="checkbox"/> Doubt as to Liability <input type="checkbox"/> Extreme Hardship <input type="checkbox"/> Doubt as to Collectibility	
Carryover Issues for Future Audits:	NO <input type="checkbox"/> YES <input type="checkbox"/>
Commissioner/Staff Attendance:	
Commissioner _____	Deputy AG: _____