

# ILLEGAL AUDIT SETTLEMENTS OF THE IDAHO TAX COMMISSION

REPORT TO GOVERNOR OTTER, ATTORNEY GENERAL LAWRENCE WASDEN &

THE IDAHO LEGISLATURE

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## I. OVERVIEW

I have worked at the Idaho Tax Commission for 28 years and am currently employed as a corporate auditor in the Income Tax Audit Bureau. I have written this report to document violations of Idaho laws and rules committed by several employees at the Tax Commission. These violations have occurred in the process of resolving large corporation income tax audits that have been conducted by the audit staff. My concerns are shared by and may be verified by many of my colleagues.

Although most of the violations specifically addressed in this report have occurred in the past year, they represent only a small percentage of the total audit protests that have been illegally settled over a much longer period of time. For many years the Tax Commission has allowed many large corporations to pay less income tax than that required by Idaho law.

The process by which this has occurred is relatively straightforward: A corporation files an incorrect Idaho income tax return, it is corrected by the audit staff, the additional tax liability is protested by the taxpayer, and then a Tax Commissioner allows the taxpayer to pay only a percentage of what is really owed. The Commission relies upon various public disclosure laws, and the illegal use of resolution options to keep this information from the general public. This allows these companies to avoid paying millions of dollars of income tax that are properly due the state of Idaho, and to do so in complete secrecy.

Although the responsibility for the resolution of these cases rests primarily with the Commissioner who oversees the corporate audit section of the Tax Commission, responsibility also falls to a few individuals who are assigned each case in the appeals process and provide technical and legal advice to the Commissioner. This includes deputy attorneys general, tax policy staff, and select members of management. Throughout the remainder of this report, I use the term "Commission" to refer to this small group of individuals.

These special deals are available primarily to those companies that are aware of the Commission's willingness to compromise audited tax returns. The number of corporations receiving these "deals" has increased over the years to a point where most large corporations now automatically protest all audits in anticipation of receiving their "Idaho tax break".

The vast majority of individuals and corporations that earn income in Idaho pay the proper amount of income taxes to this state. The Commission's actions, which are in direct conflict with Idaho law, create inequities between these honest taxpayers and those who are intentionally filing incorrect tax returns in order to receive their special deals.

These violations of Idaho law are not new, nor have they gone unchallenged. Over an extended period of time many employees have confronted the Commission regarding its actions. These employees include division administrators, bureau chiefs, audit managers, and the audit staff. The Commission has totally ignored these individuals and their complaints.

The Commission's illegalities that are documented in this report were not caused by poorly written tax laws or legitimate differences of opinion in interpreting statutes or rules. The Commission has knowingly allowed taxpayers to circumvent the tax laws in this state, and in doing so has directly violated Idaho tax law.

This report identifies the Commission's code and rule violations and explains how this misuse of public funds goes undetected. I have documentation to support each complaint made in this report. This overview is followed by a more in-depth explanation of the audit and protest process, the methods used in cutting "deals" with specific taxpayers, and the history of these violations (including a prior legislative investigation). I have included recommendations that I believe will hold the Commission accountable to the taxpayers in this state, and will establish internal controls to prevent future violations of Idaho law. In Section X of this report I have provided a brief overview of several recent cases that were illegally settled by the Commission.

In order to assist the reader in understanding the process by which these cases were settled, it is important to first understand the audit protest options available to the Commission.

## II. AUDIT PROTESTS

The multistate corporate audit staff conducts numerous audits of large corporations that have business activity within the state of Idaho. The majority of these entities are headquartered outside this state. Each audit is conducted by an audit team which generally consists of two auditors. When the audit staff finds that corrections must be made to the tax returns under audit, they issue a Notice of Deficiency Determination (NODD) to the taxpayer. This NODD explains the adjustments and shows the amount of tax, penalty (if applicable), and interest due to the Commission. If the taxpayer disagrees with the audit results, it may file a written protest which is sent to the legal/policy department for resolution. Either a tax policy specialist or a deputy attorney general assigned to the Tax Commission will receive the case for further processing. Generally, this process entails scheduling an informal conference in which the taxpayer will argue that the audit staff was incorrect in their determinations. Following specific time lines, the Commission then will then resolve the protest.

### III. AUDIT PROTEST RESOLUTION OPTIONS

The Commission resolves the majority of all audit protests by either issuing a written decision or settling the case with a compromise and closing agreement (C&C). A written decision can uphold, modify, or cancel the audit findings. A C&C generally settles the case for a specified dollar amount without discussing any of the issues protested.

#### A. Written Decisions

If the Commission resolves a case by issuing a written decision, the taxpayer may pay the amount determined, or appeal to district court. This written decision serves as precedent for the Commission in future protest determinations. Written decisions are very detailed in their analysis of the issues and the applicability of the appropriate tax laws. They not only address the taxpayer's concerns on specific issues, but serve as a public pronouncement of the Commission's interpretation of various Idaho tax laws. These decisions are published and exhibited on the Tax Commission website. The taxpayer generally goes unidentified in these decisions as Idaho law currently allows them to remove all identifying information. The published decisions are often used by the audit staff and the general public in making determinations on similar tax issues.

#### B. Compromise and Closing Agreement (C&C)

C&Cs are authorized by Idaho Income Tax Code Sections 63-3047 and 63-3048. Idaho Tax Commission Administrative and Enforcement Rule 500.01 (Rule 500) was adopted to set out specific conditions that must exist in order for the Commission to use these agreements. These conditions are:

- Doubt as to liability;
- Doubt as to collectability; or
- Extreme hardship of the taxpayer.

The collectability and hardship grounds listed in Rule 500 are generally not found in most large corporate tax cases. They have not been cited by the Commission in the resolution of the cases at hand and are therefore not addressed in this report. That leaves "doubt as to liability" as the only ground for compromising the tax and/or penalty of most large multistate corporations.

### IV. THE COMMISSION'S USE OF SETTLEMENT OPTIONS

The Commission has settled the majority of all multistate corporate protests over the past 17 years with C&Cs. The Commission has settled almost all multistate corporate protests in the past year in this manner. Based on the provisions of Rule 500 and the extensive use of C&Cs by the Commission, it is obvious that the Commission finds a "doubt as to liability" in the majority

of all corporate audit cases. The Commission's intentional misuse of the "Doubt as to liability" restriction is the prime focus of this report.

#### A. Doubt as to Liability – Rule 500

If one believes that C&Cs are only used where there is a "doubt as to liability", one must also then believe that Idaho tax laws are either not competently written, or so archaic that they are unusable. Neither is true. The real truth is that there is not a "doubt as to liability" in the vast majority of these cases.

The Commission does not ask for, require, or accept any opinions regarding the existence of reasonable doubt from members of the audit staff on any case after protest. These determinations are made in secrecy by only a few individuals that are involved in the resolution of each case. This limitation on involvement eases the Commission's burden of accountability by limiting the debate. The Commission does not always accept its own previous determinations even though doubt as to liability was not raised or considered, as some of its written decisions are later followed with C&Cs. The Commission also uses C&Cs to settle cases with near identical issues to other cases supported by published written decisions.

The Commission's definition of "doubt as to liability" has evolved over the years to the point where it is so broad that it has lost its meaning and purpose. The standard definitions used by most tax specialists such as "a bona fide dispute as to the actual tax owed" or "the existence of a substantial reason that the taxpayer does not owe the tax," have not been accepted nor applied in a restrictive manner by the Commission. The definition of this phrase clearly varies as to the end result one is trying to achieve. If one's goal is to determine the correct legal answer to the application of a statute or rule, doubt is not difficult to define. However, if the goal is something other than finding the right legal answer, the definition can be easily expanded to the point where it becomes nonsensical. Such is the case with the Commission.

On numerous occasions various deputy attorneys' general have stated, in defense of their recommendations for the use of C&Cs, that there is doubt in every case as it is always possible that a judge will rule against the Commission. This view that "doubt as to liability" is ever-present in all tax situations gives the Commission the power to compromise any and all cases at will. This argument is based not only on the false premise that all taxpayers will appeal adverse decisions to court, but on an interpretation of Rule 500 that totally invalidates its restrictive provisions. This refusal to accept the Legislature's mandate for internal controls raises serious questions as to the Commission's willingness to enforce any Idaho tax laws.

The Commission's refusal to accept any restrictions to its power in the settlement of audits was openly admitted in a February 17, 2005 e-mail message sent by a deputy attorney general working at the Commission. An offer of compromise had been received from a taxpayer on a protested audit. The taxpayer had agreed to the auditor's determinations and offered to pay the total amount of tax and interest imposed on the issue under protest, if the Commission would

allow relief in another area that had not been initially protested. The relief sought would have placed the taxpayer in direct violation of another Idaho tax law. The Commission wanted to accept this offer as it “was not much money” to give away (approximately \$2,500). The auditor strongly advised the Commission to reject this offer as accepting it would place the Commission in violation of Rule 500. The deputy attorney general in charge of this case sought the advice of another deputy attorney general that was assigned to the Commission, but was not involved with this particular protest. The following is the actual summary opinion of this individual as included in the 2005 e-mail. I have used underline to emphasize specific phrases.

“While the audit staff will be on solid footing in applying the code and rules as written, there is still the possibility that the NODD will be compromised and settled at the protest level. Compromises happen. The fact is that there are times where the Commissioners feel that it is in the best interests of efficient and effective tax administration to compromise an NODD even where the facts are not in dispute and the audit staff applied the law correctly. The Commissioners must consider not only the risk that the Courts might disagree with our current interpretation of the law, but also factors such as the amount involved, allocation of legal resources, and litigation strategy (i.e., picking a good set of facts on which to litigate). Hopefully the audit staff understands that NODDs will get compromised even when the Commissioners believe the auditor correctly applied the law. The term "doubt as to liability" as used in Adm. & Enf. Rule 500.01 should not be read so restrictively as to prohibit the Commission from compromising cases even where the Commission believes the audit staff has correctly applied the law and that the Commission's position will more than likely prevail on appeal.”

The above opinion leaves no doubt as to the position of the Commission regarding limits of authority. The Commission holds itself above the law. Although the individual providing this opinion no longer works at the Commission, this e-mail was read and approved by individuals who are still here, and who are currently involved in the resolution of audit protests. In this particular case the auditor’s arguments were not only rejected, but he was ordered to refrain from any future challenges to the Commission’s use of Rule 500. The auditor refused to accept this directive.

The author of the e-mail in question states without hesitation that the correct application of Idaho law, as determined by both the audit staff and the Commission, does not require the Commission to then collect the amount of tax due. The author personally expands the grounds for compromise of Rule 500 to include “efficient & effective tax administration”, “the amount (dollar) involved”, “allocation of legal resources”, and “litigation strategy.” These invented reasons, combined with other often used Commission justifications such as “lack of litigation funds”, “attorney workload”, “hazards of litigation”, “constitutionality concerns”, “fear of being on the leading edge”, and “money in the hand” not only cannot be found in Rule 500, but when used, removed all internal controls from the decision making process at the Commission.

It should be noted that “auditor error” is not listed as a reason for compromise, as it is not used

by the Commission to justify a C&C. This is true as most audit errors are found and corrected before reaching the appeals level. If auditor errors are found in appeals they would be properly dealt with by issuing a written decision to correct the errors.

## B. Doubt as to Liability - Other Taxing Jurisdictions

Rule 500 is not unique to the state of Idaho. Many other states, and the Internal Revenue Service (IRS), employ language identical or similar to that found in this state. I have not researched the frequency or interpretation with which each state applies its similar rule or statute. I do not find it to be pertinent as the ethical and legal concerns of Idaho's application of Rule 500 should be independent of all others. However, as the Commission in the past has attempted to justify its actions by falsely claiming similar compromise practices employed by the IRS, I do find it important to refute this claim.

The majority of all compromises approved by IRS are not done under the "doubt as to liability" provisions of the Treasury Regulations. A review of the IRS Offer in Compromise (OIC) procedures, Treasury Regulation Section 301.7122-1(b), Internal Revenue Bulletin No. 1999-32, and provisions of the Internal Revenue Manual clearly show that exceptional circumstances must exist before a compromise of a tax liability may be made.

It is quite clear that regardless of the identical language used by both taxing authorities, the IRS compromise application and enforcement procedures are strikingly dissimilar to those employed by the Commission. The IRS places great burden upon the taxpayer to prove that a doubt as to liability exists, and accepts this argument rarely. On the other hand, the Commission routinely accepts this doubt based on little more than the taxpayer's self serving statements that generally fail all tests of reasonableness and legal standards of proof.

## V. CONFIDENTIALITY

The abuses present in the Commission's administration of the Idaho income tax statutes and rules are easily hidden within the state's framework of confidential tax enforcement. This secret environment is due in part to past legislation that considered the privacy of non-compliant taxpayers to be a priority at the expense of those that do comply. This legislated protection exists in both the written decisions and the C&Cs used by the Commission to resolve protested audits.

### A. Redacted Written Decisions

Idaho Code Section 3045B(6) requires that final written decisions of the Commission be made available for public inspection. These provisions also require the removal of the taxpayer's name, address, identification number, other identifying information, and any proprietary

information identified by the taxpayer.

Written decisions are published with the above listed information replaced with the word “redacted”. Many of these decisions are almost nonsensical and unreadable because of the taxpayer’s right to remove what information it deems to be proprietary. The public’s best interest is not well served by protecting those that file incorrect tax returns. Tax matters argued in our court systems are public information. Although Commission written decisions do not equate to court decisions, there is no justification whatsoever for not treating them in the same manner regarding public disclosure.

## B. Confidential Compromise & Closing Agreements

A C&C does not discuss any details of the issues in the case. It simply states that the two parties have a dispute and agree to end such dispute with a dollar settlement. The C&C requires the taxpayer to withdraw its protest and/or court complaint. These agreements are not published or made available to the general public in any way. These dollar settlements are the Commission’s best kept secret from the residents of this state.

Although the resolution of these cases is kept secret from the taxpayers in the state of Idaho, the taxpayers who are parties to these agreements often share the results with other members of the multistate corporate community. The primary avenue established for this sharing of information is the Council On State Taxation (COST). COST was formed in 1969 and is a powerful trade association consisting of over 600 multistate corporations engaged in interstate business.

Many COST representatives have been open with the audit staff in discussing various state tax reduction practices employed by the organization. These practices include sharing detailed records of all state protest determinations with other COST members, and sharing the frequency with which “deals” can be obtained from each state. This information has a direct effect upon the accuracy of original tax returns filed by COST members and the level of cooperation given to the staff when conducting audits. Many multistate companies refuse to provide legally required substantiation to the Idaho auditors, stating openly that they will protest the audit and get relief from the Commission.

## C. The Result of Confidentiality

The corporations which receive written decisions, or succeed in obtaining a C&C to resolve an audit, obviously benefit from the fact that the general public will not be allowed to see these results. It would not enhance the reputation of these large multistate companies, most of which are headquartered outside of Idaho, if the details of the Idaho tax settlements were made public.

The citizens of Idaho reap no direct benefit from the secrecy surrounding the resolution of tax audits. Members of the Commission have argued that public accountability for tax disputes

could have a negative effect on the business climate in Idaho as some entities may not invest in a state that does not guarantee privacy in its tax matters. This unfounded argument totally ignores the responsibility that state government has to the vast majority of taxpayers who comply with the tax laws. The real reason for such secrecy is to hide the actions of the Commission. There should be little debate on whether governmental secrecy is justified when it protects those who violate Idaho statutes and regulations.

## VI. FALSE PRECEDENTS

Idaho Code Section 3045B(7) states in part that “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.” A written decision establishes precedent that is commonly used by the taxpaying community for guidance on specific issues. The audit staff frequently refers taxpayers to these decisions in response to questions.

Over the past year the Commission has substantially accelerated its use of C&Cs on cases that were previously resolved with written decisions. Some of these C&Cs were written by the same individuals who wrote the original decisions. Without evidence that a reason for doubt was found at some point between the two written documents, one can only speculate as to the cause of this change of mind.

A published written decision is not withdrawn from public access when the case is subsequently settled with a C&C. Even if the Commission were to argue that a C&C somehow overrules, supersedes, modifies, distinguishes, or otherwise makes inapplicable a written decision, it would have to justify why it continues to publish false tax guidance on its website. The continued advertising of these written decisions (that have subsequently been compromised) as having precedential value is nothing more than a veiled form of deceit.

The Commission is fully aware that a process for eliminating false precedent is available. The Commission can properly follow a published decision with a published modified decision. This process does not remove the incorrect decision from the public eye, but at least it corrects the Commission’s position on the issue in question.

The Commission issues modified decisions rarely in protests settled with C&Cs due to the trap that it has created for itself. If it settles the case with a C&C and then simply withdraws the original decision, it is in direct violation of Idaho Code Section 3045B(7), which requires that all written decisions be made available for public inspection. On the other hand, if the Commission publishes a modified decision, it eliminates its option for a cash settlement and has now recorded for public scrutiny interpretations of Idaho law that are contrary to the findings in the original published decision.

When recently challenged on this deceptive practice, the Commission justified its behavior by stating that the original decisions were written primarily to pressure the taxpayer into paying more money when the Commission started its negotiations for the expected compromise settlement. This maneuvering for the purpose of cutting deals with public funds represents attitudes and behaviors that clearly represent something other than a desire to properly enforce the tax laws of this state.

## VII. HISTORY

The compromise practices employed today by the Commission are not new. The lack of internal control procedures has always existed, but the behaviors that exploited these problems have not. To have a full understanding of the current accountability problems, it is important to review what has happened in the past.

The blatant rebuke of executive, legislative, and judicial control over the collection of state taxes began approximately 17 years ago when a commissioner initiated an unprecedented expansion of the use of C&Cs to settle protested cases of multistate taxpayers. The Commission's rejection of all internal controls and the resulting abuses of authority eventually became the subject of an in-depth and lengthy financial compliance audit conducted by the Legislative Services Office in 1996. This compliance audit centered on the same problem that exists today, the illegal use of C&Cs to settle protested income tax audits.

The legislative auditors wrote an initial report that was extremely critical of the management of the Commission. However, this initial report became the victim of intervention from the Attorney General's office. The Attorney General wrote a letter to the management of Legislative Services in which he was highly critical of the qualifications and findings of the two legislative auditors. This letter was very clear in demanding that these two auditors be stopped from continuing their work. A short time later the initial audit report was withdrawn and a modified report was written by the auditors' bureau chief. This new report, although critical in its own right, covered up the detailed findings of the two legislative auditors. I believe that it is important to briefly review the highlights of this past compliance audit as the conclusions of both the legislative auditors and the Commission are key to what is happening today.

This modified report found an "inherent control weakness" in granting one commissioner sole authority to settle tax protests by the use of C&Cs. This audit stated in part "the delegation of sole authority to compromise millions of dollars of contingent tax liabilities creates the opportunity for malfeasance especially when those compromises are not subject to public disclosure. We know of no other position in state government where one individual has sole and complete authority, in confidential circumstances, to determine the outcome of millions of dollars of revenue to the State General Fund." This report went on to say that this system "has a control weakness because the final decision can be made by one person without review and is not public."

The Commission adamantly rejected this finding and supported its position with several inane and very troubling arguments. The Commission claimed that accountability did exist as evidenced by the commissioner confirmation process, limited commissioner terms, and the re-appointment process. Understandably it did not further develop its rationale that a review every 6 years somehow equates to internal control. The Commission also claimed that internal control existed as deputy attorneys general, tax policy specialists, and bureau chiefs were involved in many decisions. This evidently supposed that a lack of integrity ceases to exist when more than one individual is involved.

The Commission went to great lengths to create an illusion that the “real” world of case resolution was based on either costly and hazardous litigation, or C&Cs. The Commission argued that these C&Cs provided the means with which to avoid litigation and save the taxpayers in this state millions of dollars. However, the truth is that the C&Cs cost the state of Idaho millions of dollars. The Commission failed to address the use and effect of written decisions and led the reader to believe that all taxpayers will take their case to court if they receive an adverse decision. The opposite of this was true then, and is true now. Most taxpayers will not go to court if they know the Commission has resolve and will defend the laws of this state. This is exactly what occurred many years ago when written decisions were the primary method used to resolve protested cases.

In response to the legislative auditor’s findings the Commission directly displayed its perceived sovereignty by rejecting any claim that it is subject to internal control because “sole authority to settle cases is clearly in line with the legislative mandate to the Commission.” It claimed that internal controls are related to accounting and auditing standards and therefore cannot be applied to anyone fulfilling a quasi-judicial function, such as a commissioner. In other words, a commissioner’s decisions cannot be challenged as he/she is not subject to internal controls.

The legislative audit recommended that the Commission keep a C&C resolution form that includes in part; an explanation of the issue being compromised, why the issue is being compromised, that it is in accordance with Commission rules, potential audit consequences, and tax effect of the settlement. The Commission responded that it would consider this form, but that it had previously rejected this concept as “it creates additional work for no useful purpose.” This is yet another example of the Commission’s refusal to accept any form of oversight.

There were many more serious findings by the legislative auditors, and many more troubling responses by the Commission. The majority of the Commission’s responses were inaccurate and misleading, but they cannot be addressed in this report. The attitudes and positions taken by the Commission during this legislative audit remain today.

## VIII. SUMMARY

The legislature recognized many years ago that there would be unique and rare cases that were not adequately covered by existing tax laws or resolution procedures. In order to give the

Commission the ability to deal with such cases, it approved Rule 500 which authorized the Commission to use C&Cs. The legislature clearly recognized the potential abuse that could exist with the unrestricted use of compromises as it imposed specific grounds that must be met before cases could be settled in this manner.

Rule 500 was, and is, the only specific internal control system in place to prevent mismanagement in the area of audit protest resolution. Although this rule falls short of providing a full measure of accountability, it may have been somewhat successful over the years if it had been accompanied by some requirement for public reporting. However, the legislature does not require that C&Cs be published, which eventually led to the complete undermining of the restrictive provisions of Rule 500. The tax laws in and of themselves offer a perception of internal control under the public's assumption that they are fairly and consistently enforced. However, when the actual application of such laws is specifically kept hidden from the public, internal control ceases to exist.

Although the Commission maintains that a commissioner is not subject to financial internal controls, it claims that a type of internal control does exist as a commissioner involves several professionals in all settlement discussions and deliberations. This is a very misleading claim that was given some credence by the legislative audit report discussed earlier, and by several legislators in their public comments. However, obtaining agreement from a few close associates does not translate into internal control. The argument that several other high level employees are involved in making decisions is meaningless. The use of position, politics, experience, friendship, or manipulation to influence or obtain cooperation from a few other employees in order to obtain agreement as to final settlements is not uncommon. Several individuals in positions that could effectively influence and secure proper decisions simply do not have the fortitude to do so. It is easier to go along than to take risk.

The Tax Commission should be subject to the most stringent of internal control procedures that insure the integrity of the tax collection process. An internal control system has to be designed to control all individuals, regardless of their perceived integrity or their level of authority. This should include commissioners, tax policy personnel, managers, and deputy attorneys general. No internal control system can be dependent upon the private decisions made by a small group of specific individuals.

The end result of the Commission's refusal to follow Rule 500 is that the vast majority of large corporations that are audited by the audit bureau are treated differently than the hundreds of thousands of other taxpayers in this state. The Commission allows these companies to pay a reduced amount of tax based on nothing more than their demand which guarantees future noncompliance with the Idaho tax laws. The majority of the rest of the taxpayers in this state pay the correct amount of tax as established by Idaho law.

For the last 17 years, the past and present Commission has been in the "deal cutting" business when it comes to resolving large multistate corporate income tax audits. These deals have cost the taxpayers in this state millions of dollars. A manager employed at the Commission said

recently in a discussion about the Commission's wide-spread use of deal cutting "It has gone on so long that it has become institutionalized." This is so very accurate.

The Commission has always defended its compromise practices by trying to convince everyone that the world of Idaho corporate taxation is so complex that the correct amount of tax liability is seldom easy to determine. This is pure nonsense. The tax laws are indeed complex to those who do not work with them every day. This is not the case with large corporate taxpayers, auditors, and appeals staff. Regardless of the Commission's claims, the vast majority of the Income Tax Code and Rules are clear, concise, and simple. Although taxpayers try to complicate each and every protest in order to assist in obtaining a compromise, the issues in these cases are relatively easy to resolve.

The Commission also claims that audit determinations do not represent taxes due the state; they are only a beginning point that generally must be adjusted to arrive at the right answer. It is true that the proposed deficiencies are not due until assessed by either a written decision or a C&C. However, to claim that these audit deficiency amounts must be, or generally need to be, adjusted to arrive at the proper assessment is totally false. By the time the appeals section of the Commission receives a protested audit, this audit has been reviewed by other auditors, reviewers, and supervisors. Most of these individuals have much more experience dealing with these issues and with Idaho law, than those who are involved in the resolution process. In almost all cases the tax, penalty, and interest deficiency amounts proposed by the audit staff are correct.

It was widely recognized during the prior legislative audit that changes in the internal control system at the Commission needed to be made. Extreme concern over the Commission's refusal to accept internal controls was expressed by legislators as well as the legislative auditors. However, the vast majority of all recommendations made by the legislative auditors were ignored by the Commission. The failure of this investigation empowered the Commission to return to its practice of reaching secret "agreements" with the multistate corporate community. This practice continues today.

## IX. RECOMMENDATIONS

1. Legislation should be enacted which removes the ability of taxpayers to redact any information from published written decisions. These decisions should be published exactly as written. All modified decisions should also be written without redaction. All original decisions should be changed to include references to modified decisions when used.
2. Legislation should be enacted which mandates that all C&Cs be published without redaction. It should be required that each C&C include the detail of each specific issue that is deemed to create a doubt as to liability. The dollar settlement amounts of each compromised issue should be clearly shown. Any issues that are not in doubt should be addressed through a separate written decision, or should be specifically detailed as to tax

due and determination in the C&C.

3. A thorough investigation of the Commission should be initiated that examines the resolution of all multistate audits for the past several years. The reasons for the excessive and illegal use of C&Cs should be thoroughly examined. This investigation should not be conducted by Legislative Services unless it can be assured that it will be free of interference from the Attorney General's office. This is absolutely necessary as the recommendations and/or decisions made by deputy attorneys general assigned to the Commission and to the central office, may be subject to the investigation. Any involvement by the Attorney General would represent a clear conflict of interest.
4. Procedures should be initiated that will ensure that past and present Commission employees will have the right to not only provide testimony in the investigative process, but will have the opportunity to rebut the Commission's responses to this investigation. 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.
5. A thorough audit of the Commission should be initiated that examines all internal control procedures at the Commission. This audit should be conducted by an accounting firm or other independent third party outside of state government to insure the integrity of the findings. Comprehensive standards of internal control should be demanded, written, and enforced at the Commission to insure the proper management of public funds. These standards should include many of the recommendations found in the 1996 legislative audit report.
6. All C&Cs should be forwarded to a third party source for final approval. The audit staff should be required to review all proposed compromises and provide their input for consideration in the approval process.

When settling protested audits the Commission's goal should always be to simply find the right legal answer to the issues protested. This seldom happens. Instead, the Commission resolves a substantial amount of protests based on unidentified criteria which ignores the Idaho tax laws as enacted by the legislature. I expect the Commission to defend its protest resolution practices with the same intensity as that exhibited in its response to the legislative audit discussed above. I also expect the Commission to attack my integrity and purpose. I welcome and encourage a thorough investigation into the audit protest settlement practices employed by the Commission, and will willingly and openly defend the facts and opinions presented in this report. These facts and opinions will be supported by an independent audit.

## X. CASES

Following is a brief summary of several cases that have recently been illegally settled with

C&Cs or other suspect means. Docket numbers and additional details on each case are available for review, and will be revealed to such authorities as appropriate under Idaho law. There are many more cases that have been settled in this manner, or are in the process of being settled at the current time.

### Taxpayer #1

The taxpayer claimed nonbusiness income (NBI) treatment on the capital gain received from the sale of a line of business that had been part of its overall unitary business for over 30 years. By classifying this capital gain as NBI, the taxpayer avoids paying Idaho tax on any of this income as it is removed from the total apportionable income reported to this state. The Commission's corporate audit staff found this treatment to be incorrect. The Commission issued a written decision on this case which supported the auditor's position. The taxpayer filed a legal action in district court which prompted the Commission to then invalidate (privately - not publicly) its written and published decision by settling this case with a C&C. This settlement recognized the gain to be business income that must be reported to Idaho, but it accepted an alternative form of income apportionment. The exact method of apportionment is unknown as all discussions and determinations related to the C&C were specifically kept secret from the auditors.

This C&C cost the taxpayers in this state approximately \$220,000 in tax, penalty, and interest for just this one year. When Idaho law was properly applied by the audit staff, the taxpayer had a liability of a little over \$300,000 as of February 22, 2008. This amount was reduced by the Commission to approximately \$80,000 which represents an approximate 74% reduction in the tax, penalty, and interest. The tax assessed in the C&C equates to an approximate 2.2% corporate income tax rate instead of the 7.6% as established by the Idaho legislature.

This settlement was made in direct violation of Idaho Rule 500 as there was no "doubt as to liability" as required for the use of a C&C. The Commission has audited this company seven (7) times covering twenty (20) consecutive tax years. All but one of these audits was settled with a C&C. The taxpayer was totally uncooperative with the audit staff, and in most cases with the appeals officers in all 7 audits. Yet, the Commission has only once held this taxpayer to the tax laws adopted by the state of Idaho. This case is simply an extension of the many "deals" that have been allowed this company.

### Taxpayer #2

The taxpayer claimed NBI treatment on the capital gain received from the sale of a line of business that had been part of its overall unitary business (and therefore treated as business related) for over 10 years. The taxpayer refused to answer the auditor's questions regarding the claimed NBI. The auditor found this NBI treatment to be incorrect which was supported by the Commission in a written decision. The taxpayer then initiated settlement discussions which prompted the Commission to then invalidate its written and published decision by settling this

case with a C&C. All discussion and legal analysis related to the C&C were specifically kept secret from the auditors.

This C&C cost the taxpayers in this state approximately \$65,000 in tax, penalty, and interest for the 2002 tax year. The tax was lowered by 33% and the total penalty (\$13,255) was abated.

The Commission had no legal authority to follow its written decision with a C&C. The only reasoning offered by the Commission was that it made a “business decision” to try and settle the case in light of the taxpayer’s “liquidation exception” argument. This argument was made in private discussions that excluded the audit staff. There is no “liquidation exception” in Idaho law. This has been clearly stated in Commission decisions Docket No. 16707 & Docket No. 18340. “Business decision” is not listed as grounds for a C&C under Rule 500 for good reason. This reasoning is so vague that it is meaningless and would remove all legitimate internal control from the process. The Commission simply cut another “deal” with a large multi-state taxpayer: one that is in direct violation of Idaho Rule 500.

### Taxpayer #3

The taxpayer filed its original 2006 tax return and reported a net operating loss (NOL). Idaho law requires taxpayers to carry back NOLs to previous years, unless they file a specific election to forego the carryback. The loss can then be carried forward to future years. This election must be made on the original tax return filed in the loss year.

The taxpayer made the election to forego the carryback of the NOL. The taxpayer later filed an amended 2004 Idaho tax return to carry back this loss. The auditor disallowed this amended return as the election to carry back the loss is irrevocable and the loss must be carried forward to years subsequent to 2006. The taxpayer did not file a protest with the auditor. Instead, the taxpayer simply called the Commission’s tax policy group (and followed with a letter) claiming that it should be allowed to carry back the loss as the election was a clerical error. The Commissioner determined that the taxpayer should be allowed to carry back this loss and ordered the audit staff to void the audit report and issue the refund.

The Commission has allowed the taxpayer to violate Idaho Income Tax Code Section 63-3022(c)(1) and Idaho Income Tax Administrative Rule 201 by allowing the NOL to be carried back to a prior year. These provisions are mandatory and to my knowledge have never previously been waived. Numerous Commission decisions have been issued that uphold the provisions of the above referenced statute and rule.

Not only have specific tax statutes and rules been violated by both the taxpayer and the Commission, the Commission ignored the standard protest and appeals procedures. The Commission should have referred the personal telephone call and letter to the auditor for normal processing of a protest. Instead, the Commission circumvented these standard procedures resulting in the elimination of an appeals trail. This sets a very troublesome precedent.

#### Taxpayer #4

Corporate taxpayers must file their Idaho income tax returns on either a worldwide or a water's-edge filing method. The worldwide method is standard; the water's-edge method may be used if a specific election is made on the original tax return filed under this method.

This taxpayer has been filing its Idaho income tax returns on a water's-edge method for over fifteen (15) years. However, the taxpayer refuses to file the mandatory water's-edge election. The audit staff has converted this taxpayer to a worldwide filing continuously over this time period. The taxpayer recently told the audit staff that it refuses to file this election as a "matter of principle." The auditor imposed the negligence penalty on this taxpayer for its failure to file the election in the most recently completed audit. This penalty was upheld in the Commission's written decision. The Commission again followed a written published decision with an unpublished C&C which reached a different result.

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

The issue of compromising penalties has a long history with the Commission. In many instances the Commission intentionally ignores the grounds for, and the legality of, penalties imposed by the audit staff. The Commission often uses penalties as a bargaining device with which to obtain a tax settlement from a taxpayer. The Commission will offer the taxpayer relief of the penalty in exchange for a payment of the tax, or in most cases a payment of part of the tax. This is done regardless of the strength of the Commission's position on each case. In some areas, such as in protested audits conducted by the multistate audit staff, this "bargaining" is the norm instead of the exception. However, this behavior with penalties is not restricted just to the multistate audit area.

Whether penalties are imposed on violations to deter future similar behavior by taxpayers, or to simply fill a punishment role, can and will be debated by those who impose and uphold them. However, it is very clear, and easily documented, that penalty reversals provide incentives to taxpayers to NOT file correct tax returns in the future. The audit staff has discussed this penalty issue on numerous occasions with Commission management, policy, and appeals personnel. The audit staff arguments have been ignored in almost all cases.

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

### Taxpayer #5

The taxpayer claimed NBI treatment on capital gains, dividends, and other income received from various partnerships and other entities that were an integral part of its business. The auditor found this NBI treatment to be incorrect and issued an audit report that disallowed all claimed NBI. The taxpayer protested this audit report. The Commission settled this case with a C&C that treated 50% of the total income in question as nonbusiness income.

Idaho Code Section 63-3027 establishes two separate and independent definitions of business income. These two definitions are the “transactional test” and the “functional test.” All income in question clearly met both tests. There did not exist any “doubt as to liability” based on Idaho law and previous decisions written by the Commission. This C&C cost the taxpayers in this state approximately \$46,000 in tax and interest.

### Taxpayer #6

The taxpayer claimed NBI treatment on the ordinary and capital gain received from the sale of assets belonging to a line of business that was reported by the taxpayer as a division. In the 5 previous years this division was reported as a part of the taxpayer’s unitary worldwide business resulting in a reduction of the taxpayer’s Idaho tax liability.

The auditors found this NBI treatment to be incorrect and issued an audit report that disallowed this claimed NBI. The taxpayer protested this audit report. The Commission settled this case with a C&C that treated 50% of the income in question as nonbusiness income and reversed the understatement of tax penalty. This C&C was in direct violation of Idaho law as there did not exist a “doubt as to liability” as required by Rule 500.

This C&C cost the taxpayers in this state approximately \$680,000 in tax, penalty, and interest for the 2000 tax year.

Copies of this report have been delivered to each of the four Tax Commissioners.

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