BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 19399
[Redacted]	)	
Petitioner.	)	DECISION
	)	
	)	

I. PROTEST SUMMARY

On March 2, 2006, the Idaho State Tax Commission's (Commission) Income Tax Audit Bureau (Bureau) issued a Notice of Deficiency Determination (NODD) to [Redacted] (Petitioner) proposing additional income tax, penalty, and interest for the taxable years September 30, 2000; September 30, 2001; September 30, 2002; and September 30, 2003, in the total amount of $786,692. The Petitioner filed a timely protest and petition for redetermination. An informal hearing was held on January 4, 2007. After the informal hearing, the Bureau issued a Modified Notice of Deficiency Determination dated February 28, 2007, modifying its March 2, 2006, NODD. In the Modified NODD the Bureau proposed additional income tax and interest but not penalties for the aforementioned tax years totaling $1,044,296 in lieu of the previous amount of $786,692. On June 6, 2007, a second informal hearing was held on the Modified NODD. The Tax Commission, having reviewed the file, hereby issues its decision.

II. ISSUES

During the redetermination process a number of minor issues were agreed to and included in the Modified NODD leaving but one issue remaining. The remaining issue involves the impact on the Idaho receipts factor and Idaho property factor for tax years September 30, 2001; September 30, 2002; and September 30, 2003, from the Petitioner's securitization of mortgage loans through the use of a real estate mortgage investment conduit (REMIC) whereby

Idaho single-family residential loans along with [Redacted] and [Redacted] loans were exchanged for REMIC certificates in March of 2001.

It is the Petitioner's position that, under the *MTC Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions* (the Financial Formula), which Idaho has adopted, the Financial Formula by definition does not treat an interest in a REMIC as a loan and thus the Petitioner properly excluded from the property factor (numerator and denominator) the loans transferred to the REMIC. The Petitioner also argues that the Financial Formula treats interest income received on a REMIC Certificate as a receipt received on an investment asset assignable for receipt factor purposes to a commercial domicile located outside of Idaho in a state that does not tax the Petitioner's net income.

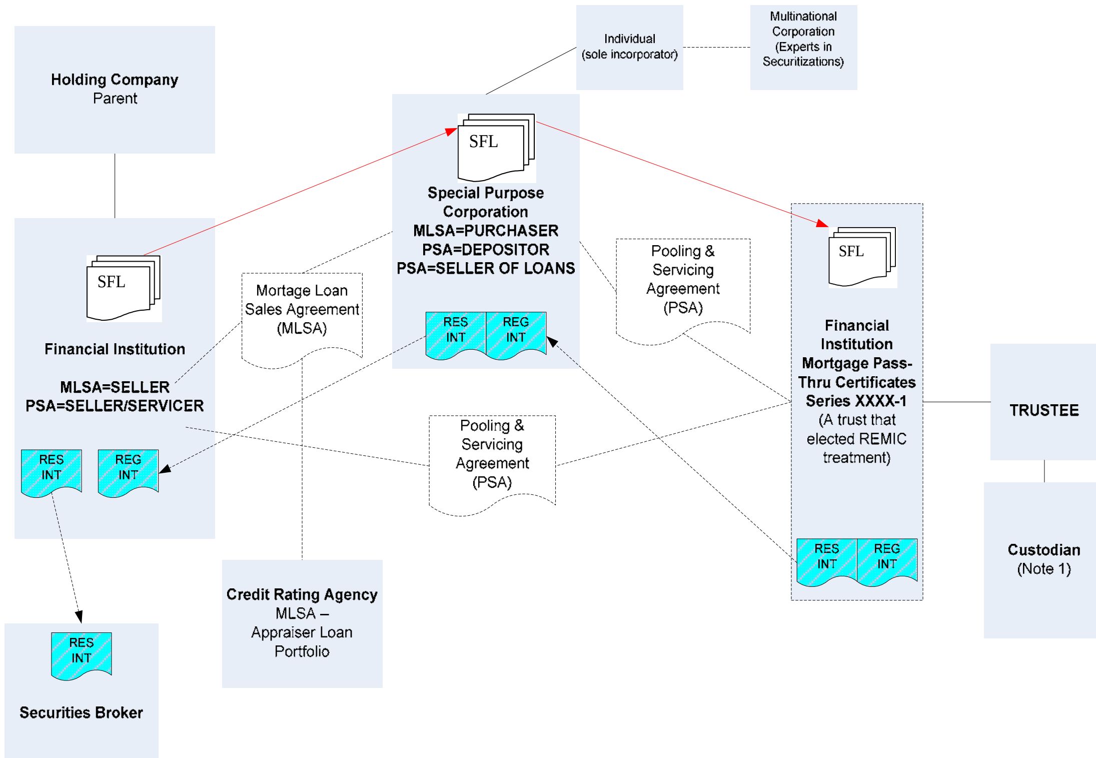
The Bureau in the Modified NODD argues that unless a material change has occurred the Financial Formula requires that the loans remain assigned to Idaho and included in the property factor and that interest from loans secured by Idaho real property is required to be included in the Idaho receipts numerator. Additionally, although the Bureau did not assert alternative apportionment when it issued the Modified NODD, the Bureau did include an analysis in the Modified NODD of what the result would be if alternative apportionment were invoked and concluded that the loans would be included in the property factor and the interest income on the Idaho loans included in the Idaho receipts numerator in order to fairly represent the extent of the Petitioner's business activity in Idaho.

The Petitioner previously argued that the Commission bears the burden of showing that alternative apportionment is appropriate, and the Commission has not met its burden; however, if the Commission imposes alternative apportionment, any interest incurred as a result of invoking the alternative apportionment provisions should be abated.

III. DISCUSSION OF FACTS

[Redacted] [Redacted].

Basically, from what the Commission can surmise from the documents obtained from the Petitioner, the process the Financial Institution engaged in when securitizing the [Redacted], [Redacted], and [Redacted] loans appears to be as follows:



Notes:
1. At some point in this process an Assignment of Mortgage was executed for each of the individual mortgages and held by Custodian (a subsidiary of the Trustee and currently known as XXXX) on behalf of the REMIC Trust.

Additional Legend:
SFL = Multistate Single Family Mortgage Loans
RES INT = Residual Interest Certificate
REG INT = Regular Interest Certificate

[Redacted] [Redacted] [Redacted]

The [Redacted] appears to be an unaffiliated third party. The Custodian is a subsidiary of the Trustee and may have acquired the "Assignment of Mortgage" for each of the individual mortgages at the outset of the process; however, the Petitioner had verbally indicated that the Custodian was holding the "Assignment of Mortgage" on behalf of the Trust (REMIC).

On March 1, 2001, The Financial Institution entered into a Mortgage Loan Sales Agreement (MLSA) with the [Redacted]. Per Section 1.01 of the MLSA, the Financial Institution was the seller and the [Redacted] was the purchaser. The Financial Institution transferred, assigned, set over, deposited with, and otherwise conveyed to the [Redacted], without recourse, all the right, title, and interest of the Financial Institution in and to the mortgage loans, including all interest and principal received on or with respect to the mortgage loans on or after the cut-off date (with some exceptions), liquidation proceeds, insurance proceeds, and any related accounts, the Financial Institution's rights in any collateral securing the mortgage loans and any and all proceeds of the foregoing.

Also on March 1, 2001, the Financial Institution, the [Redacted], and the Trustee entered into a Pooling and Service Agreement (PSA). Some of the more notable provisions of the PSA are

1. Section 1.01 –
    - Trust Fund - the corpus of the trust consisted of the mortgage loans, such assets as shall from time to time be identified as deposited in the collection account or the distribution account, property which is secured by a mortgage loan and which has been acquired by foreclosure or deed in lieu of foreclosure or otherwise, the primary insurance policies and any other required insurance policy, but not including any payment for processing fees.

- Voting Rights – one percent of the voting rights allocated to Residual Certificates and the remaining voting rights (99 percent) allocated to the Regular Certificates.

2. Section 2.01 -

- The [Redacted] transferred, assigned, set over, and otherwise conveys to the Trustee for the benefit of the certificateholders, without recourse, all the right, title, and interest of the [Redacted] in and to the mortgage loans, including all interest and principal received on or with respect to the mortgage loans, on or after the cut-off date (with some exceptions), liquidation proceeds, insurance proceeds, and any related accounts, the Financial Institution’s rights in any collateral securing the mortgage loans and any and all proceeds of the foregoing.
- The [Redacted] assigned to the Trustee all of its rights and interest under the Mortgage Loan Sale Agreement and delegates its obligations thereunder. The Trustee accepts such assignment and delegation and shall be entitled to exercise all rights of the [Redacted] under the Mortgage Loan Sale Agreement as if, for such purposes, it were the [Redacted]
- The [Redacted] has delivered or will cause to be delivered to the Trustee for the benefit of the certificateholders the original mortgage note and a duly executed Assignment of Mortgage.
- Recordation of Assignments of Mortgage shall not be required, except that in any state as to which the Financial Institution determines that recordation is

necessary to protect the Trustee's interest in the related mortgage loans or to perfect the Trustee's security interest in such mortgage loans.

- The [Redacted] and the Trustee intend that the assignment and transfer of the [Redacted]'s right, title, and interest in and to the mortgage loans constitute a sale of the mortgages, the mortgage certificates and related documents, conveying good title thereto free and clear of any liens and encumbrances, from the [Redacted] to the Trustee.

3. Section 2.02 - The Trustee shall retain possession and custody of each mortgage file. The Financial Institution shall deliver to the Trustee in the case of documents requiring recording, receipt thereof, the originals of such other documents or instruments constituting the mortgage file as come into the possession of the Financial Institution from time to time.
4. Sections 3.01 thru 3.21 - the Financial Institution is to provide the administration and servicing of the mortgage loans. These provisions are discussed in more detail below.
5. Section 4.05 – In the first federal income tax return of the Trust Fund for its short taxable year ending December 31, 2001, REMIC status shall be elected for such taxable year and all succeeding taxable years and the Financial Institution shall maintain or cause to be maintained records relating to the Trust Fund including the fair market value and adjusted basis of the Trust Fund property and assets as may be required by the Internal Revenue Code including the REMIC provisions and as may be necessary to prepare the returns, schedules, statements or information.

6. Section 4.06 – the Financial Institution is the initial “tax matters partner” under Subchapter C of Chapter 63 of Subtitle F of the Internal Revenue Code.
7. Section 4.08 – the Trustee is responsible to ensure the continuing treatment of the Trust Fund as a REMIC.
8. Section 9.01 – the Financial Institution is allowed to repurchase the mortgage loans at the point in time in which the Trust Fund mortgage loan principal balance is less than 15 percent of the original principal balance.

On page 2, Note D, of the Petitioner’s 10-Q filing for the quarter ended March 31, 2001, the Petitioner described the transaction as follows:

> . . . the Company completed the securitization of over 13,000 residential mortgage loans into a real estate mortgage investment conduit (“REMIC”). This transaction did not qualify as a sale under Statement of Financial Accounting Standards (“SFAS”) No. 125, therefore no gain or loss was realized. The Company is currently the holder of all of the securities issued by the REMIC. The result of this transaction was a transfer of securitized loans and related capitalized costs, deferred loan fees, and allowance for loan losses into a new line item on the balance sheet – securitized assets subject to repurchase, which continue to be accounted for in a manner similar to residential mortgage loans.

The dollar amount identified in the 10-Q filing as having been transferred to the REMIC was $1,388,196,742 which was determined by adding $1,397,643,742 of loan basis to $4,200,000 of deferred loan costs and reducing that amount by deferred loan fees of $11,447,000 and allowance for loan losses of $2,200,000. On page 5 of the 10-Q, the Petitioner listed the transaction under the “Non-Cash Operating Activities” section of the Petitioner’s Consolidated Statement of Cash Flow (Unaudited).

Per page 12 of the Petitioner’s Annual Report for 2001, since the terms of the transfer of the loans to the REMIC contain a call provision whereby the Petitioner can repurchase the loans when the outstanding balance of the pool declines to 15 percent or less of the original amount, the transfer did not qualify as a sale under generally accepted accounting principles (GAAP). Accordingly, for GAAP purposes the retained interests continue to be accounted for in a manner similar to loans and are identified by the Petitioner in its Annual Report balance sheet as securitized assets subject to repurchase.

Under Section 3.01 of the PSA, the Financial Institution would continue to administer and service the loans and protect the interest of the Trust Fund in the same manner as it protects its own interests in mortgage loans in its own portfolio. The Financial Institution has full power and authority, acting alone and/or through subservicers, to do or cause to be done any and all things that it may deem necessary or desirable in connection with servicing and administration including, but not limited to:

- Consent to the transfer of any mortgaged property and assumptions of mortgage certificates and related mortgages (but only in accordance with the PSA).
- Collect any insurance proceeds and other liquidation proceeds.
- Foreclose or otherwise convert the ownership of mortgage property securing any mortgage loan.
- Maintain at its own cost, a blanket fidelity bond and an errors and omissions insurance policy insuring the Financial Institution against losses resulting from dishonest or fraudulent acts committed by the Servicer's personnel, any employees of outside firms that provide data process services for the Servicer, and temporary contract employees or student interns.
- Maintain or cause the mortgagor to maintain on certain mortgages, without cost to the Trust Fund, a primary insurance policy insuring that portion of the mortgage loan in excess of a percentage in conformity with FNMA requirements. The

Financial Institution is obligated to pay to the Trustee the amount of any covered loss with respect to a covered mortgage loan; provided that the aggregate of such payments shall not exceed $1,000,000.

- Collect all payments due under each of the mortgage loan as well as ascertain and estimate taxes, assessments, fire and hazard insurance premiums, mortgage insurance premiums, etc.
- Establish a collections account in trust for the holders of the REMIC certificates.
- To the extent allowed under the mortgage agreement or current law, segregate and hold all funds collected and received pursuant to each mortgage loan which constitute escrow payments in trust separate and apart from any of its own funds and general assets.
- Withdraw from the collections account various expense reimbursements and its servicing compensation.
- Maintain for each mortgage loan fire and hazard insurance to the extent consistent with applicable guidelines of FNMA and FMHLC.

Not all of the rights and duties retained by the Financial Institution under the PSA are discussed above.

From the mortgagor's perspective, the Financial Institution was continuing to administer and service the mortgagor's loans as if no change in ownership had occurred. The mortgagor in all likelihood was simply unaware that the Financial Institution had securitized the loan.

PSA Sections 8.01 through Section 8.15 identifies the Trustee's responsibilities, which are substantially less than those of the Financial Institution. Additionally, per PSA Section 1.01, the Trustee is entitled to a fee with respect to each distribution date in an amount equal to the product of .003% per annum times the principal balance of the mortgage loans as of such date.

Per page 2 of the PSA, the certificates issued by the REMIC were in three main classes, the "A" certificates (regular interests), the “B” certificates (subordinate regular interests), and the "R" certificates (residual interests). The certificates are further divided as:

Class Designation	Initial Class Balance	Interest Rate
Class A1	$200,000,000.00	Note (2)
Class A2	$200,000,000.00	Note (2)
Class A3	$150,000,000.00	Note (2)
Class A4	$150,000,000.00	Note (2)
Class A5	$150,000,000.00	Note (2)
Class A6	$150,000,000.00	Note (2)
Class A7	$100,000,000.00	Note (2)
Class A8	$100,000,000.00	Note (2)
Class A9	$100,000,000.00	Note (2)
Class A10	$52,220,320.24	Note (2)
Class B	$45,423,421.61	Note (2)
Class R	$(1.00)	Note (1)
	$1,397,643,740.85	

- Note (1) – The Class R Certificate, a residual certificate, was issued without a class balance or an interest rate and was only entitled to a distribution of certain excess amounts as provided in the PSA.

- Note (2) – The Class A Certificate series and the Class B Certificate are regular interest certificates and were issued a per annum variable rate equal to the weighted average (by principal balance) of the net mortgage rates of the mortgage loans as of the first day of the related accrual period.

At some point shortly after the March 2001 securitization, the Financial Institution disposed of the Class R Residual Certificate to the Securities Broker; however, the Financial Institution retained 100 percent of the Class A and Class B Regular Interest Certificates during the tax years at issue. The details of the Financial Institution’s disposition of the Class R Residual Certificate are not known.

Basically, the end result of the aforementioned securitization transaction was that the Financial Institution swapped a substantial portion of its [Redacted], [Redacted], and [Redacted] residential mortgage loans for all of the Trust Fund REMIC certificates (Regular and Residual) in a non-cash transaction and for all intent and purposes retained ownership of the loan principal amounts, substantially all of the interest received on the mortgages, and continued to administer and service the loans in the same or similar manner to the way it did before the securitization.

B. Real Estate Mortgage Investment Conduit

Per 10 J *Mertens, Law of Federal Income Taxation* Section 40A:2, p. 1 (2006), the Tax Reform Act of 1986 created a mortgage-backed security, the real estate mortgage investment conduit (REMIC), thereby eliminating installment sales tax treatment of builder bonds. This Act added Sections 860A through 860G to the Code. These provisions were designed to add certainty to the treatment of the increasing trading of mortgages on secondary markets and packages using multiple class arrangements. The purpose of the REMIC was to have one vehicle for issuing multiple class mortgage-backed securities without a two-tiered taxation. The Technical and Miscellaneous Revenue Act of 1988 made several adjustments to the REMIC provisions. The REMIC's safe harbor period for holding substantially all its assets as qualified mortgages and permitted investments was reduced to three months after the start-up day from four months after the start-up day. The Act also established the 100 percent tax on the value of property contributed to a REMIC after the start-up day (a prohibited transaction). The Act created a tax on income from foreclosure property at a rate equal to the highest corporate income tax rate. The Act also created a tax on the transfer of residual interests to disqualified organizations.

To qualify as a REMIC, an entity must meet the requirements of IRC section 860D(a):

- First, the entity must make an election to be treated as a REMIC for the taxable year and all prior taxable years.
- All of the interests in a REMIC must be regular interests or residual interests. The REMIC must have one, and only one, class of residual interests.
- All distributions with respect to residual interests must be made on a pro rata basis.
- From the end of the third month after the start-up day, and at all times thereafter, substantially all of the entity's assets must consist of qualified mortgages and permitted investments.
- A regular interest must be issued on the start-up day, must have fixed terms, and must be designated as a regular interest. Additionally, a regular interest must unconditionally entitle the interest holder to receive a specified principal amount. Finally, the interest payments with respect to a regular interest, at or before maturity, must either be payable based on a fixed rate or a variable rate allowed by the IRS Treasury Regulations or must consist of a specified portion of the interest payments on qualified mortgages, without variance of such a portion during the period such interest is outstanding.
- The entity must have a taxable year that is the calendar year.
- The entity must have reasonable arrangements to ensure that the residual interests held in such an entity are not held by disqualified organizations and that the entity makes available any information necessary to collect the tax on the transfer of a residual interest to a disqualified organization.

A REMIC isn’t subject to federal income tax or treated as a corporation, partnership (except for certain reporting requirements), or trust for purposes of federal income taxation. IRC 860A(a). A REMIC calculates its federal taxable income in accordance with IRC section

860C(b)(1). Although REMICs are generally not subject to tax at the entity level since the REMIC's income is taxable to its interest holders in accordance with the REMIC provisions, REMICs are subject to

- a 100 percent tax on any net income derived from a prohibited transaction (IRC section 860F(a)(1)),
- a tax for each tax year on the net income from foreclosure property at the highest corporate income tax rate (IRC section 860G(c)(1)),
- a tax equal to 100 percent on any amounts contributed to a REMIC (with some exceptions) after its start-up date (IRC section 860G(d)), and
- if a residual interest is transferred to a disqualified organization, the transferor is subject to a tax equal to the present value of the total anticipated excess inclusions times the corporate income tax highest rate (IRC 860E(e)).

Additional REMIC provisions provide that:

- Regular interests in REMICs are treated as indebtedness of the REMIC; thus, the REMIC is entitled to a deduction for interest in arriving at the REMIC's federal taxable income. IRC sec 860C(b)(1)(A). In determining the federal income tax of any holder of a regular interest in a REMIC, the interest in the REMIC is treated as a debt instrument. IRC section 860B(a).
- A REMIC is not allowed IRC section 162 deductions since it is not treated as carrying on a trade or business. If a REMIC pays or incurs an ordinary and necessary operating expense, it must deduct it as an IRC section 212 expense. Treas. Reg. section 1.860C-2(b)(4).

- Generally, for purposes of procedure and administration, a REMIC is treated as a partnership. Any holder of a REMIC residual interest is treated as a general partner. However, the REMIC is not subject to the partnership provisions if there is no more than one holder of a residual interest at any time during the taxable year. IRC section 860F(e), Treas. Reg section 1.860F-4(a).
- A REMIC files federal form 1066 "U.S. Real Estate Mortgage Investment Conduit (REMIC) Income Tax Return" to report its calendar year activity, pay tax (if any), and report its federal taxable income. Idaho does not have a similar form. The Petitioner provided the Commission with a copy of the Trust Fund's Federal Form 1066 U.S. Real Estate Mortgage Investment Conduit (REMIC) Income Tax Return for tax years ending December 31, 2001; 2002; 2003; and 2004. The Trust Fund's taxable income for each of the years is as follows:

Calendar Year Ending	2001	2002	2003	2004
Taxable Interest	$70,764,673	$61,504,526	$24,059,425	$9,602,169
Interest Expense	(69,989,660)	(61,806,647)	(25,247,381)	(9,656,401)
OID Income Offset [1]	(4,643,867)	(5,640,727)	(4,204,340)	(829,684)
OID Expense Offset	5,698,240	8,162,360	6,514,354	1,233,360
Servicing Fees	(2,316,684)	(2,085,204)	(817,851)	(325,285)
Taxable Income	$ (487,298)	$ 134,308	$ 304,207	$ 24,159

- A REMIC files federal form 8811 "Information Return for Real Estate Mortgage Investment Conduits (REMICS) and Issuers of Collateralized Debt Obligations." A second form 8811 must be filed if in a subsequent year the information originally reported on the form 8811 changes. The IRS uses this form to report REMIC activity in

[1] OID stands for Original Issue Discount.

Publication 938 "Real Estate Mortgage Investment Conduits (REMICs) Reporting Information (And Other Collateralized Debt Obligations (CDOs)). The REMIC was reported in Publication 938 for June 2001. The telephone number listed for the REMIC in Publication 938 is that of the KPMG REMIC Investor Hotline.

C. Federal Income Tax Treatment

On its federal corporate income tax return for the tax years at issue, the Petitioner reported the following activity as a result of the securitization of the loans into the REMIC:

- Interest Income - Per the Bureau's Modified NODD schedule 1801, the Petitioner included in federal taxable income interest income from the REMIC of $54,372,471; $66,597,489; and $29,115,576 for tax years September 30, 2001; September 30, 2002; and September 30, 2003, respectively.
- Service Fee Income – Under the PSA, the Petitioner is entitled to servicing compensation and expense reimbursement for administering and servicing the mortgages; however, it is unclear from the file how much was reported in the federal income tax return or if the fee was reported as interest income or other income. Under Section 3.17 of the PSA, the servicing fee is to be paid out of the mortgage interest the Trust Fund receives from the mortgagors.
- An M-1 adjustment for income included in taxable income but not reported on books titled "REMIC Deferred Gain Amortization" and a separate M-1 adjustment for a deduction included in taxable income not on books for "REMIC Premium Amortization" was made as follows:

Tax Year ending	Sep-01	Sep-02	Sep-03	Total
Deferred Gain	$4,303,664	$9,435,311	$11,588,475	$25,327,450
Premium Expense	(2,466,583)	(5,461,802)	(6,703,279)	(14,631,664)
Net Gain	1,837,081	$3,973,509	$ 4,885,196	10,695,786
Federal Amended Return:				
Deferred Gain	118,338			118,338
Premium Expense	(68,539)			(68,539)
Adjusted Net Gain	$1,886,880			$10,745,585

The Bureau included a portion of the "net gain" in the Idaho receipts numerator using the same approach it used for the interest on loans secured by Idaho real property. See Schedule 1801 attached to the Modified NODD.

In taking a closer look at the calculation provided to the Petitioner by its tax advisor, KPMG, what the "total income" figure really represents in substance is the $12,620,537 of original deferred loan fees that the Financial Institution earned on the original loans (this is due to the fact that the $17,269,979 FMV increase in mortgage value over mortgage loan basis included in the sales price exactly offsets the premium expense being written off by the Financial Institution) as follows:

A. Gain or (loss) on Sale of Mortgages:	
Settle Date	March 22, 2001
Regular Interest FMV	$1,420,837,201.00
Tax Basis In Loans:	
Collateral Par	(1,397,643,741.85)
Deferred Fees on Loans	**12,620,537.29**
Accrued Interest on Loans	(5,923,479.93)
Deferred Gain	$ 29,890,516.51
B. FMV of Assets Received in Sale:	
FMV of Regular Interest	$1,414,913,721.00
Accounts Receivable - Interest	5,923,479.93
Total FMV of Regular Interest	$1,420,837,200.93

C. Calculation of Premium:	
Par of Regular Interest	$1,397,643,741.85
FMV of Regular Interest	1,414,913,721.00
Premium on Investment in Regular Interests	$ (17,269,979.15)

D. Netting Premium Against Deferred Gain:	
Premium on Investment in Regular Interests	$ (17,269,979.15)
Deferred Gain	29,890,516.51
Total Income	**$ 12,620,537.36**

The Petitioner did point out that the net increase in taxable income per year as a result of the M-1s for deferred gain and premium amortization is different than what the increase in taxable income from the amortization of the deferred loans fees would have been had the securitization not taken place.

The Bureau did not examine the steps taken in the formation of the REMIC or the impact the securitization had on the Petitioner's federal taxable income. The only issue raised by the Bureau relating to the securitization is the Petitioner's treatment of the securitization when determining its Idaho apportionment percentage.

D. Financial Formula And Prior Filings

The Petitioner argues that under the Financial Formula, an interest in a REMIC is excluded from the definition of a loan and thus excluded from the property factor and the interest the Financial Institution receives on its REMIC Regular Certificates is a receipt from an investment asset and, although included in the receipts factor, the interest received is assigned to the Financial Institution's commercial domicile outside of Idaho. *See MTC Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions*, Section 2(j), Section 3(m)(1), Section 3(m)(2)(A), and Section 3(o).[2] The Bureau countered in its Modified NODD that, in computing the Idaho property factor, unless a "material change" occurred, the loans transferred to the REMIC remain in the Petitioner's property factor under Section 4(i) and (4(g) of the Financial Formula. Furthermore, the Bureau argues that interest income on the loans secured by Idaho real property that were transferred to the REMIC remain an Idaho receipt per Section 3(d) of the Financial Formula.

Prior to the adoption of the Financial Formula, intangibles were not included in Idaho's standard apportion formula found in Idaho Code section 63-3027(i).[3] All of that changed upon Idaho's adoption of the Financial Formula, where under Section 4(a) of the Financial Formula certain intangibles (loans and credit card receivables) were specifically included in the property factor. Additionally, under Section 3(d) of the Financial Formula, interest, fees, and penalties in the nature of interest are assigned to a state based upon the location of the property rather than based upon cost of performance.

After the adoption of the Financial Formula, the Petitioner included loans in the everywhere property factor, and it would appear those loans that met the Financial Formula Section 4(g) criteria were assigned to Idaho's property factor numerator. After the securitization, those loans which were part of the March 2001 securitization which had previously been included in the property factor were now excluded from the property factor. Similarly the interest on the loans secured by Idaho real property which had been included in the Financial Institution's Idaho receipts numerator prior to the securitization were no longer assigned to Idaho's receipts numerator.

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[2] Representative's letter dated November 28, 2006.
[3] Unless otherwise noted, reference to Idaho Code and rules refers to the Idaho Code and rules in place for the years at issue.

IV. IDAHO LAW AND ANALYSIS

A. Idaho's version of UDITPA and Financial Organizations

In 1965 Idaho codified the majority of the Uniform Division of Income for Tax Purposes Act (UDITPA) provisions. Idaho Code section 63-3027.[4] Idaho Code section 63-3027 contains rules for determining the portion of a corporation's total income from a multistate business transacting business within and without this state and, therefore, subject to Idaho taxation. In general, Idaho Code section 63-3027 divides a multistate corporation's income into two groups: business income and non-business income. Business income is apportioned according to a three factor formula, Idaho Code section 63-3027(i); while non-business income is allocated to a specific jurisdiction, Idaho Code section 63-3027(d)-(h).

UDITPA's Section 2 specifically excluded financial organizations from the UDITPA provisions. Idaho's version of UDITPA did not contain a similar exception for financial organizations; however, Idaho did include a provision similar to the UDITPA Section 18 provision whereby a taxpayer may petition or the Commission may require an alternative apportionment method in those situations where the standard apportionment formula does not fairly represent the extent of the taxpayer's business activity in this state. That provision is currently found in Idaho Code section 63-3027(s).

B. Alternative Apportionment

The Tax Commission, under the authority of Idaho Code section 63-3027(s) adopted an alternative apportionment method that applies to "financial institutions" effective for taxable years beginning on or after January 1, 1998. *See* Income Tax Administrative Rules 580.01.g and 582.01, IDAPA 35.01.01.580.01.g and 35.01.01.582.01 (2006 Edition). Basically, Idaho, with

[4] 1965 Session Laws ch. 254, section 1, p 639.

limited modifications, adopted the Multistate Tax Commission's *Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions*.[5]

The United States Supreme Court stated that "the Constitution imposes no single [apportionment] formula on States . . . and . . . the Court [has] declined to undertake the essentially legislative task of establishing a single constitutionally mandated method of taxation." Goldberg v. Sweet, 488 U.S. 252, 261 (1989). A "margin of error [is] inherent in any method of attributing income among the components of a unitary business." Container Corporation of America v. Franchise Tax Board, 463 U.S. 159, 184, (1983). Such a formula need not "identify the precise geographic source of a corporation's profits." Moorman Mfg. Co. v. Bair, 437 U.S. 267, 273 (1978). Rather, a state is required to strive for a "'rough approximation' of the corporate income that is 'reasonably related to the activities conducted within the taxing state.'" Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207, 223 (1980), *quoting* Moorman Mfg. Co., 437 U.S. at 273. Under the standards articulated by the Supreme Court, states are given wide latitude in developing a formula that can be used to apportion the business income of the combined group.

The Financial Formula generally recognizes that financial organizations must depart from the standard apportionment formula to fairly reflect the business activity of a financial organization for apportionment purposes. For example, under the Financial Formula, certain intangibles are included in the apportionment property factor and interest income from loans secured by property are usually assigned in the receipts factor to the property's location rather than being excluded from the property factor or assigned based upon cost of performance, respectively. However, the drafters of the Financial Formula recognized there may be

[5] This MTC Financial Formula has been incorporated by reference into the Idaho Income Tax Administrative Rules. See IDAPA 35.01.01.580.g (2006) and IDAPA 35.01.01.582 (2006).

circumstances where the strict application of the Financial Formula to a financial organization may not fairly represent the extent of the taxpayer's business activity in a state; therefore, under Section 1(d) of the Financial Formula, the taxpayer could petition or the state could require modification of the Financial Formula. Section 1(d) of the Financial Formula, the language of which is nearly identical to Idaho Code section 63-3027(s), specifically provides, in pertinent part:

> If the allocation and apportionment provisions . . . do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the [Commission] may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
> (1) separate accounting,
> (2) the exclusion of any one or more of the factors;
> (3) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this State; or
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

The Idaho Supreme Court recently examined the alternative apportionment provisions and stated that, "There is a very strong presumption in favor of the normal three-factor apportionment and against the applicability of the relief provisions." Union Pacific v. Idaho State Tax Commission., 139 Idaho 572, 576, 83 P.3d 116, 120 (2004), citing Roger Dean Enterprises, Inc. v. State, 387 So.2d 358, 363 (Fla., 1980). The party asserting alternative apportionment bears the burden of showing that the alternative apportionment is appropriate. Union Pacific, 139 Idaho at 576, 83 P.3d at 120 citing Burlington Northern, Inc. v. Idaho State Tax Comm'n, 121 Idaho 808, 828 P.2d 837 (1992).

The Idaho Supreme Court adopted the ruling of the New Hampshire court regarding the standard of proof required for alternative apportionment.

As stated by the New Hampshire Supreme Court:

> The alternative formula is the exception, and the party who wants to use an alternative formula accordingly has the burden of

> showing that the alternative is appropriate. Merely because the use of an alternative form of computation produces a higher business activity attributable to New Hampshire, is not in and of itself a sufficient reason for deviating from the legislatively mandated formula.

Union Pacific, 139 Idaho at 576, 83 P.3d at 120, *citing* St. Johnsbury Trucking Co., Inc. v. State, 118 N.H. 209, 385 A.2d 215, 217 (1978). The Court further articulated that departure from the standard apportionment formula should be avoided except where reasonableness requires a departure. Union Pacific, 139 Idaho at 577, 83 P.3d at 121, *citing* Pierce, The Uniform Division of Income for State Tax Purposes, 35 TAXES 747, 781 (1957). The Court then identified what grounds of "reasonableness" would support a deviation from the standard apportionment formula.

> "Reasonableness" has been defined as being made up of three elements: (1) the division of income fairly represents business activity and if applied uniformly would result in taxation of no more or no less than 100 percent of the taxpayer's income; (2) the division of income does not create or foster lack of uniformity among UDITPA jurisdictions; and (3) the division of income reflects the economic reality of the business activity engaged in by the taxpayer in the taxing state.

Union Pacific, 139 Idaho at 577, 83 P.3d at 121, *citing* Twentieth Century-Fox Film Corp. v. Dep't of Revenue, 299 Or. 220, 700 P.2d 1035 (1985). In sum, the party requesting alternative apportionment must demonstrate that standard apportionment results in a sufficient distortion of the taxpayer's business activity in the state; simply advocating a better method than the standard formula is not enough. Union Pacific, 139 Idaho at 122, 83 P.3d at 578, *citing* Appeal of New York Football Giants, (Opinion on Pet. Rhg., Calif. St. Bd. of Equalization, June 28, 1979).

In the Union Pacific case, the Commission was the party seeking alternative apportionment, and therefore the Commission had the burden to prove its proposed apportionment was reasonable. The Commission showed that the standard method of apportioning the income did not accurately reflect the extent of Union Pacific's business activity in Idaho and that the alternative apportionment proposed by the Commission was reasonable. The Commission will apply the facts and circumstances of the present case to the approach articulated by Idaho's highest court.

The negative impact on Idaho taxable income or for that matter any of the Idaho apportionment factors as a result of the securitization of the loans is a far cry from the 250 percent difference resulting in "gross distortion" as discussed by the Court in Container, at 183-184 when referring to its earlier decision in Hans Rees Sons, Inc. v. North Carolina, 283 U.S. 123 (1931). However, gross distortion does not have to exist for the Commission to invoke alternative apportionment. Instead, the Commission must show that the Financial Formula apportionment, as applied by Petitioner, results in a sufficient distortion of the Petitioner's business activity in Idaho such as the Financial Formula does not fairly and accurately reflect the income of the business done within Idaho. Union Pacific, 139 Idaho at 122, 83 P.3d at 578.

As previously discussed, the Idaho Supreme Court articulated that a departure from a standard apportionment formula should be avoided except where reasonableness requires a departure. The Court defined reasonableness as being made up of three elements: (1) the division of income fairly represents business activity and if applied uniformly would result in taxation of no more or no less than 100 percent of the taxpayer's income; (2) the division of income does not create or foster lack of uniformity among UDITPA jurisdictions; and (3) the division of income reflects the economic reality of the business activity engaged in by the taxpayer in the taxing state.

The inclusion of the loans in the property factor (Idaho numerator and everywhere denominator) and interest on the loans secured by Idaho property in the Idaho receipts factor numerator, if applied uniformly, would not result in taxation of more than 100 percent of the Petitioner's income.

Since the UDITPA provisions are not applicable to financial organizations, the application of Idaho's alternative apportionment provisions does not create or foster lack of uniformity among UDITPA jurisdictions.

The last element set forth by the Court is that the division of income reflect the economic reality of the business activity in Idaho. The Financial Institution's primary business is the origination, retention, and servicing of residential mortgage loans and historically obtained its funds primarily through savings deposits and from the FHLB. Although the loan documents evidencing the mortgages were transferred to the REMIC or the Custodian (a subsidiary of the REMIC's Trustee) the Financial Institution, apparently as a result of the change in economic conditions brought on by the September 11, 2001, tragedy, found itself in a rather unusual and unique situation whereby the need for raising the additional funds from a source other than the FHLB no longer existed. As a result the Financial Institution retained control of the mortgages through the holding of the Regular Interest Certificates and through providing the same administration and services it had before the securitization. This unusual set of facts and circumstances lead the Petitioner to create a balance sheet item with the rather unique classification "securitized assets subject to repurchase."

During the tax years at issue, the Petitioner had a half-billion to over a billion dollars of other mortgage back securities (MBS) transactions, some of which were private issue REMIC certificates. The other MBS transactions were reflected in the Petitioner's Annual Reports primarily as "Available-For-Sale," in accordance with FASB 115. The securitization at issue represents an exception to the normal method in which the Financial Institution acquires and accounts for MBS transactions. The Bureau is not seeking to modify the Financial Formula to include those types of MBS or REMIC interests treated on the books of the Financial Institution as Available-For-Sale. The Bureau only seeks to include the loans with the book classification of "securitized assets subject to repurchase" as it was these loans in which the Financial Institution was the transferor of the loans, the holder of the Regular Certificates (entitling the Financial Institution to a return of the loan principal and substantially all of the interest on the loans) and the administrator and servicer of the loans it had originally created.

V. HOLDING

To allow loans to simply be swapped for REMIC certificates resulting in the omission of the swapped loans from the property factor and the interest on the loans secured by Idaho real property excluded from the Idaho receipts numerator results in sufficient distortion of the Financial Institution's business activity in Idaho thereby not fairly and accurately reflecting the economic reality of the business activity engaged in by the Financial Institution within Idaho. Therefore, the Commission holds that requiring that the loans be included in the property factor and the interest from the loans secured by Idaho real property (or a reasonable estimate thereof) be included in the Idaho receipts numerator is reasonable and necessary in order to fairly and accurately reflect the economic reality of the business activity engaged in by the Financial Institution within Idaho. Furthermore, Idaho law does not require the Commission to waive interest upon an assertion of alternative apportionment and since the Idaho Supreme Court has held that interest is imposed as a matter of law, the Commission upholds in total the interest that is owed on the tax deficiency. Union Pac. R. Co. v. State Tax Com'n, 105 Idaho 471, 476, 670 P.2d 878, 883 (1983).

WHEREFORE, the Notice of Deficiency Determination dated February 28, 2007, is hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the Petitioner pay the following tax and interest:

YEAR	TAX	INTEREST	TOTAL
September 30, 2000	$ 1,092	$ 468	$ 1,560
September 30, 2001	252,329	88,087	340,416
September 30, 2002	425,159	119,010	544,169
September 30, 2003	147,833	33,930	181,763
		TOTAL DUE	$1,067,908

Interest is calculated through September 28, 2007, and will continue to accrue at the rate set forth in Idaho Code section 63-3045(6) until paid.

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the Petitioner's right to appeal this decision is enclosed. As set forth in the enclosed explanation, the Petitioner must deposit with the Commission 20 percent of the total amount due in order to appeal this decision. The 20 percent deposit in this case amounts to $213,581.60 and will be held as security for the payment of taxes until the appeal is finally determined.

DATED this ____ day of ____________________, 2007.

IDAHO STATE TAX COMMISSION

____
COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that I have on this ____ day of ______________________, 2007, served a copy of the within and foregoing DECISION by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted] Receipt No.

[Redacted]

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