

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of)
[Redacted]) DOCKET NO. 20243
Petitioners.) DECISION
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_____)

PROCEDURAL BACKGROUND

On March 20, 2007, the Income Tax Audit Division of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] (hereinafter referred to collectively as “[Redacted]”) asserting a proposed deficiency of \$200,580 for the taxable years ended December 31, 2003, December 31, 2004, and December 31, 2005. On May 22, 2007, [Redacted] filed a timely appeal and petition for redetermination with the Audit Division. In its protest, [Redacted] stated that additional information would be submitted to the Audit Division for its consideration. After waiting several months, and contacting [Redacted], who did not respond, the Audit Division forwarded the protest to the Legal/Tax Policy Division for a hearing.

At [Redacted]’s request, a hearing was held by means of telephone on April 8, 2008. Prior to the hearing, [Redacted] submitted additional information in the form of a position paper. The new information was discussed with the Commissioner at the hearing. Following the hearing, the information was then forwarded to the Audit Division for its review and comment.

The Audit Division commented on the new information and, in so doing, provided the Commission with a report [Redacted] had filed with the United States Bankruptcy Court. The Commission communicated the Audit Division’s comments, with references to the bankruptcy report, to [Redacted] and asked [Redacted] to respond by the end of August 2008. The Auditor assigned to this case also contacted [Redacted] in an attempt to resolve an issue related to certain

intercompany eliminations [Redacted] reported on the returns filed with Idaho. To date, [Redacted] has not responded to the Audit Division's comments regarding the information submitted as part of the hearing, nor has [Redacted] contacted the Auditor to resolve the intercompany eliminations.

The Tax Commission considers this matter to be fully submitted and ready for a decision. The Tax Commission has reviewed the file, including all of the information submitted by [Redacted] and the Audit Division, and now issues its decision. For the reasons discussed below, the deficiency proposed by the Audit Division is affirmed in part and reversed in part.

SUMMARY OF FACTS

A. Background of Company

During the years in question, [Redacted] dealt in first and second home mortgages. The company conducted business in 36 states. [Redacted] originated and purchased loans through a network of independent mortgage brokers and correspondent lenders.

Correspondent lenders sold already-originated loans to the [Redacted]. The loans were originated, funded, and closed pursuant to [Redacted] specifications.

Independent brokers found potential borrowers. The borrower and broker completed a loan application which was then submitted to an [Redacted] account executive. The account executive forwarded the applications to account managers who reviewed the application for completeness. If additional information was needed, the account manager would contact the broker to request the needed information. Once the application was completed, the account manager forwarded the loan application to the company's underwriters. The underwriters made the initial determination of approval or denial of a loan application, subject to review and

modification by a regional or divisional manager. Upon approval, the loan package was sent to a local title company or agent for closing the loan.

One of the subsidiaries, [Redacted], founded in 1995, became heavily involved in subprime lending. In 2004, the corporation restructured as a [Redacted]. The goal was to improve the credit rating of the entity by obtaining more conventional loans. Even though [Redacted] obtained such loans, the Securities Exchange Commission (SEC) required [Redacted] to restate its financial statements for the first three quarters of 2006. The SEC was primarily concerned about accounting errors regarding the company's accounting of repurchase losses.

On March 13, 2007, the New York Stock Exchange delisted [Redacted] from the exchange and suspended all trading of shares in [Redacted]. As a result, [Redacted] has lost most of its liquidity. With the high rate of default on the subprime loans, [Redacted] can no longer finance new loans. These issues coupled with the recent industry-wide subprime mortgage crisis caused the company to falter and file a Chapter 11 bankruptcy in April of 2007.

B. The Audit

During the initial audit, [Redacted] failed to provide a majority of the information requested by the audit staff; in part, because the company filed a Chapter 11 bankruptcy. Matters were further complicated as the audit was conducted at the offices of [Redacted] professional accountants, rather than at the company's business office. In its protest, [Redacted] recognized the lack of substantiation during the audit and, in its protest, stated that for each issue protested "we will provide information to support our position." As discussed above, [Redacted] provided some additional information at the hearing, but has not provided all of the information requested by the Tax Commission.

1. Income Adjustments

The auditors visited the [Redacted] headquarters of the outside accounting firm, [Redacted], during the week of February 19, 2007. The audit staff adjusted the federal taxable income reported on the Idaho income tax return to match the taxable income reported on the federal return. Specifically for the 2005 taxable year, the staff disallowed a claimed deduction for Excess Inclusion Income, adding the income back to apportionable income. For the 2003 and 2004 taxable years, the audit staff disallowed intercompany eliminations that the company could not substantiate.

2. Filing Method

The tax returns [Redacted] filed with Idaho were inconsistent in that some years appeared to be filed on a worldwide basis while other years appeared to be reported on a water's-edge basis. The audit staff determined [Redacted] had not filed a proper water's-edge election and changed all returns to conform to a worldwide combined reporting method. As a result, the audit staff included the foreign income of [Redacted].

3. State Tax Add Back

Idaho Code 63-3022 requires taxpayers to add to federal taxable income, all state and local taxes paid and measured by net income. The audit staff increased the state tax add back reported by [Redacted]. The amount of state taxes added back by [Redacted] was less than the amount of state and local taxes the company reported on its federal return. Staff adjusted the Idaho state tax add back to match the federal return.

4. Apportionment Formula

a. The property factor numerator

The staff did not have enough information to determine precisely which loans should be assigned to Idaho for purposes of the property factor. Therefore, the auditors looked at the

ratio of Idaho sales to worldwide sales. Staff applied that ratio to the worldwide property of the company to determine the dollar amount of loans that should be assigned to Idaho in the property factor numerator.

b. The sales factor numerator

The audit staff accepted the sales as reported for the taxable years 2003 and 2004. However, there was an 18 percent decrease in Idaho loans reported to Idaho for the taxable year 2005, while the overall sales of the company increased by 41 percent. Staff felt that the securitization of loans with the new [REDACTED] had diverted loans from Idaho. Absent the taxpayer providing any other explanation or substantiation, the staff adjusted the sales numerator to include interest, service fees and gains associated with all loans secured by Idaho real property.

c. The payroll factor numerator

The staff adjusted only the 2003 tax year numerator reported by [Redacted]. The Idaho payroll reported by [Redacted] in the numerator was not consistent with the amount of wages and payroll reported to the Idaho Department of Labor. Staff increased the Idaho numerator to reflect the Department of Labor figures.

d. Sales factor, property factor and payroll denominators

Because [Redacted] could not produce the requested information and documentation, staff used the everywhere property and sales reported in the company's annual reports and 10-K's rather than the denominators reported on the Idaho returns. However, staff did not adjust the everywhere payroll shown on the Idaho returns.

e. Penalty

The auditors proposed a 10 percent substantial underpayment penalty pursuant to Idaho Code § 63-3046(d).

ISSUES PROTESTED

In the written protest filed with the Audit Division, [Redacted] protested the following audit adjustments:

1. The inclusion of "Excess Inclusion Income" in Idaho apportionable income for the taxable year 2005;
2. Disallowing intercompany eliminations claimed for the taxable years 2003 and 2004;
3. The increase in the state tax add back reported by [Redacted]; and
4. All audit adjustments made to the apportionment factors.

AGREED ISSUES

In its protest dated May 22, 2007, [Redacted] stated that it would "provide additional information to support our position." [Redacted] then asked the auditor for an additional 60 days in which to provide the necessary documentation and information.

[Redacted] did not provide the information to the auditor, but, as referenced above, [Redacted] submitted a position paper for discussion at the informal conference. In its position paper, [Redacted] agreed with several of the audit adjustments. Specifically, [Redacted] agreed with the following audit adjustments:

1. The state tax add-back;
2. The increase of federal taxable income for the taxable year 2005 based on excess inclusion income;
3. The inclusion of foreign income from [Redacted] (filing status); and
4. The payroll adjustment made to the 2003 payroll numerator for Idaho.

Additionally, the Tax Commission notes that in its position paper [Redacted] did not contest the 2005 adjustment to the sales numerator. The Tax Commission assumes that [Redacted] agrees with that particular adjustment. To the extent that [Redacted] does not agree with the

adjustment, the Commission finds [Redacted] has failed to meet its burden of proof on that issue, and therefore, affirms the adjustment made by the Audit Division.

ISSUES REMAINING FOR DECISION

Four issues remain to be resolved at this time, and therefore, will be addressed below.

[Redacted] continues to protest:

1. The adjustment to the sales factor denominators for the taxable years 2003 through 2005;
2. The 2003 payroll denominator;
3. The disallowance of intercompany eliminations;
4. The adjustment to the property factor numerators for the taxable years 2003 through 2005; and,
5. Imposition of the penalty.

DISCUSSION

A. THE ADJUSTMENT TO THE SALES FACTOR DENOMINATORS FOR THE TAXABLE YEARS 2003 THROUGH 2005

Staff used the everywhere property and sales reported in the company's annual reports and 10-K's rather than the denominators reported on the Idaho returns. In response, [Redacted] indicated that the sales reported on the Idaho returns were based on the federal returns filed with the Internal Revenue Service. [Redacted] asserts that since Idaho bases its income tax on the federal income tax pursuant to Idaho Code § 63-3002, the sales reported on the returns should be used. Additionally, the sales reported on the Idaho returns are consistent with returns [Redacted] filed in other states.

At the informal conference, the Commission asked [Redacted] about the difference in sales reported for financial purposes and sales reported on the tax returns. [Redacted] noted that, first of all, the differences were relatively small. In the year 2003, sales reported for book purposes amounted to \$976,003,986, while the company reported sales in the amount of

\$1,076,597,495 on its tax returns. In 2004, sales reported for book purposes amounted to \$1,732,605,352, while the company reported sales in the amount of \$2,048,903,112 on its tax returns. In 2005, sales reported for book purposes amounted to \$2,443,136,717, while the company reported sales in the amount of \$2,546,360,589 on its tax returns. When all is said and done, the tax impact of the change is \$9,914 for 2003, \$7,729 for 2004, and \$221 for 2005. Second, [Redacted] notes that different standards govern the accounting of loans and sales of loans as between book accounting and tax reporting.

The audit staff looked to the annual reports of the company because [Redacted] did not provide sufficient information during the audit. An examination of annual reports (including reports filed with the Securities and Exchange Commission) is entirely appropriate in such a circumstance.

However, absent a larger discrepancy between [Redacted] financial accounting and its tax reporting, the Commission does not find sufficient justification to depart from the federal and state tax return information provided by [Redacted]. The Tax Commission recognizes that there often is a difference between book accounting and tax reporting, especially in the area of loans and loan sales. Given the relatively minor difference between the reporting methods, the Tax Commission cannot conclude that the difference indicates any error on the part of [Redacted]. The audit adjustments of the sales factor denominators are reversed.

B. THE 2003 PAYROLL DENOMINATOR

Originally, [Redacted] protested the payroll numerator adjustment made by the audit staff. In its subsequent position paper, [Redacted] withdrew its protest of that issue and noted that the staff was correct in adjusting the numerator to correspond with the amount of payroll reported to the Idaho Department of Labor for unemployment purposes.

[Redacted] then raised a new issue. The denominator reported on the 2003 tax return also was not consistent with the amount of payroll reported for unemployment purposes. For taxable years 2004 and 2005, [Redacted] reported the denominator based on reports filed for Federal Unemployment Tax Act (FUTA) purposes. In this regard, [Redacted] asked that the total payroll (denominator) be increased to \$364,102,093 based on the annual FUTA wages. [Redacted] included copies of the 2003 FUTA reports with its request.

The audit staff agreed that it would be consistent to use the FUTA wages. FUTA wages were used to determine the payroll factor denominator for taxable years 2004 and 2005. The Tax Commission agrees that consistency, both with other years and the adjustment made by the staff to the numerator, requires use of the pertinent unemployment data. The payroll denominator for 2003 will be increased as [Redacted] requested. As a result, the tax deficiency for taxable year 2003 is reduced by \$26,299.

C. THE DISALLOWANCE OF INTERCOMPANY ELIMINATIONS

At the informal conference [Redacted] provided a one-page general schedule of the intercompany eliminations the company took into account when determining its apportionable income. The company provided a breakdown of the eliminations (deductions) by category. However, [Redacted] failed to explain why each category qualified as an intercompany elimination, nor did [Redacted] provide any underlying documentation supporting the eliminations.

At the request of the Commissioner, the auditor contacted [Redacted] after the informal conference to ask for additional information. Also, in a letter dated July 22, 2008, the Commission invited [Redacted] to provide additional information that would support the intercompany eliminations schedule. [Redacted] failed to respond to either.

[Redacted] has not met its burden of proof. The audit adjustment disallowing the intercompany eliminations is upheld.

D. THE ADJUSTMENT TO THE PROPERTY FACTOR NUMERATORS FOR THE TAXABLE YEARS 2003 THROUGH 2005

1. Unitary Business and Apportionment of Income Background

Prior to the advent of the unitary business concept in the early 1900s, most states generally determined the amount of income earned within their borders by applying separate accounting principles to each separate business entity. However, by the early part of the twentieth century, with the growing size and complexity of multistate businesses, the separate accounting method of measuring taxable income proved to be unsatisfactory. Because large corporations typically do business through networks of interlocking subsidiaries and divisions, enabling the enterprise to shift income, expenses, property, payroll, and sales among its various subsidiaries and divisions at will, the states sought a way to more accurately account for and tax the in-state income of these multistate (and often multi-entity) business enterprises.

To avoid the shift of income, expenses, property, payroll, and sales among the entities at will, the Courts developed what has become known as the “unitary business” doctrine. The unitary business doctrine treats a group of commonly owned businesses as a single business for purposes of allocation and apportionment, if the businesses are tied together operationally under constitutional standards developed in Supreme Court case law. *See, e.g., Allied-Signal, Inc. v. Director, Division of Taxes, 504 U.S. 768, 781-783, 112 S.Ct. 2251, 2260-2261 (1992); Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 179-180, 103 S.Ct. 2933, 2947-2948 (1983).* If a corporate business is unitary, then all of the subsidiaries and divisions

are lumped together, and the total income of the unitary business is allocated and apportioned to the various states in which the unitary business has activities, using the combined factors of the unitary business. *See* Idaho Code § 63-3027(t); Container Corp., *supra*.

As stated by the U.S. Supreme Court: “The principal virtue of the unitary business principle of taxation is that it does a better job of accounting for the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise than, for example, geographical or transactional accounting.” Allied-Signal, Inc. v. Director, Div. of Taxes, 504 U.S. 768, 783, 112 S.Ct. 2251, 2261 (1992) (citations and internal quotations omitted).

When a single corporation, or a "unitary" group of corporations, does business across state lines, each state may impose income tax only on that portion of the income earned within its borders. To that end, the income of the unitary business is divided among the states in which the business operates. As described by the Idaho Supreme Court:

The Act contains rules for determining the portion of a corporation’s total income from a multistate business which is attributable to this state and therefore subject to Idaho’s income tax. In general, UDITPA 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, while nonbusiness income is allocated to a specific jurisdiction.

American Smelting & Ref’g Co. v. Idaho St. Tax Comm., 99 Idaho 924, 927, 592 P.2d 39, 42 (1979) (citations to statute omitted), *rev’d on other grounds*, ASARCO Inc. v. Idaho State Tax Commission, 458 U.S. 307 (1982). The instant case involves business income generated or by the loans [Redacted] and affiliates originated or purchased.

Business income is apportioned among the states in which the unitary business operates. Each state uses one or more ratios to divide or "apportion" the business income to determine the

amount of income subject to each state’s income tax. The most commonly used formula is found in the Uniform Division of Income for Tax Purposes Act (UDITPA), which Idaho and many other states have adopted either in whole or with modifications. Idaho’s apportionment formula is set out in Idaho Code § 63-3027 (i), which states that “[a]ll business income shall be apportioned to this state . . . by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus two (2) times the sales factor, and the denominator of which is four (4). . . .” Id. The property factor is computed by dividing the taxpayer’s property located in Idaho by its property located everywhere. Idaho Code § 63-3027(k). Likewise, the payroll factor is calculated by dividing the taxpayer’s Idaho payroll by its payroll everywhere. Idaho Code § 63-3027(n). And finally, the sales factor is derived by dividing the company’s Idaho sales by its sales everywhere. Idaho Code § 63-3027(p). Set out as a mathematical formula, the Idaho apportionment formula is represented by the following equation:

$$\frac{\left(\frac{\text{Idaho property}}{\text{Total property}} + \frac{\text{Idaho payroll}}{\text{Total payroll}} + 2 \times \frac{\text{Idaho sales}}{\text{Total sales}} \right)}{4}$$

The result of the above equation is then multiplied by the corporation’s total business income to arrive at the portion of the business income apportioned to Idaho.

The three-factor apportionment formula, by means of the location of a business’s property, payroll, and sales, approximates the extent of the business activity in a given state. *See generally, Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159, 164 – 169

(1983)(discussing the unitary business principle in light of the California combined reporting requirement). Most states that impose a tax on corporate income use some variation of the three-factor apportionment formula. Many states, including Idaho, have modified the traditional three-factor formula so that the sales factor is double weighted.

Idaho's apportionment statute also recognizes there are instances in which the standard apportionment formula does not accurately reflect the extent of the unitary group's business activity in the state of Idaho. For instance, under the standard application of UDITPA, the apportionment formula excludes from the property factor all values associated with intangible properties, such as loans and credit card receivables. Since loans and credit card receivables often are the primary source of income for a financial institution, the standard apportionment would not accurately reflect the financial institution's business activity in the state if the intangibles were excluded.

2. Apportionment and Allocation of the Income of Financial Institutions

Pursuant to that authority to modify the statutory formula, the Idaho State Tax Commission has adopted a set of "special industry regulations." See Idaho Income Tax Administrative Rule 580.01, IDAPA 35.01.01.580.01 (setting forth special industry rules adopted by the State Tax Commission). Among the special industry regulations adopted by the Idaho State Tax Commission is the "Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions." The formula was recommended by the Multistate Tax Commission (MTC) after several years of hearing in which states and industry participated. Idaho made several additions and minor modifications to the Recommended Formula. These additions and modifications are set out in Idaho Income Tax Administrative Rule 582. A copy of Rule 582, along with a copy of the MTC Recommended Formula, is attached to this Decision as Appendix A.

Under the Recommended Formula loans are included in the apportionment factors. For property factor purposes, loans and credit card receivables are placed in the numerator of the state with which it has a preponderance of its substantive contacts. This has the effect of apportioning part of the income of the unitary business to that state.

A similar sourcing rule applies to the sales factor. The interest from loans secured by real property (*i.e.* mortgage or home equity loans) is sourced to the state in which the real property is located. Fees received for servicing loans secured by real property also is sourced to the state in which the real property is located. Again, by virtue of these sourcing rules, the state in which the real property is located will receive and tax a portion of the business income of the financial institution or group of institutions.

[Redacted] is not contesting the application of the rule regarding the sales factor. The only issue that needs to be addressed in the context of the Recommended Formula is the adjustment the Audit Division made to property factor numerator that [Redacted] reported to Idaho for each of the taxable years in question.

4. The Property Factor of the Recommended Formula

The Financial Institution attribution rules relating to the property factor are found in Section 4 of the Recommended Formula. The Recommended Formula property factor includes the average value of loans and credit card receivables. Loans are valued at their outstanding principal balance and are treated as being located at the “regular place of business with which [the loan] has a preponderance of substantive contact.” Recommended Formula, § 4(g)(1)(A). Thus, if the preponderance of substantive contact regarding a specific loan takes place at an Idaho branch or office, the loan is treated as being located within Idaho.

In determining where a loan has a preponderance of substantive contacts, “the facts and circumstances regarding the loan at issue shall be reviewed on a case-by-case basis and consideration shall be given to such activities as the solicitation, investigation, negotiation, approval and administration [SINAA] of the loan.” *Id.* at § 4(g)(3). *See also* § 4(h) (credit card receivables shall be treated as loans and shall be subject to the provisions of § 4(g)).

On the returns originally filed with Idaho, [Redacted] assigned its loans based on the location of the cost center or processing center that managed the loan. In its position paper, [Redacted] suggested that this sourcing of loans still fits the SINAA criteria because most of the activities surrounding its loans were conducted at locations outside of Idaho. [Redacted] concedes that often the independent brokers solicit the loans and conduct the initial investigation (gathering materials and information to complete the loan application).

[Redacted] states however, that account executives and account managers process the loan applications by verifying the applicant’s monthly obligations and credit rating. The account executives and account managers are located at processing centers, none of which are in the state of Idaho. Hence, [Redacted] concludes that a majority of the investigation occurs outside of Idaho. [Redacted] applies a similar rationale for negotiation, approval and administration of the loans. [Redacted] asserts the majority of SINAA activities occur at processing or business centers outside of Idaho.

The audit staff disputes both the qualitative and quantitative aspects of [Redacted] analysis. The audit staff’s analysis was based on staff’s examination of the Final Report of [Redacted], Bankruptcy Court Examiner regarding the Chapter 11 bankruptcy filed by an [Redacted] affiliate in Delaware.

Based on its examination of the report, the audit staff concluded the solicitation of certain loans incurred in Idaho. [Redacted] had multiple independent brokers and lenders in the state of Idaho. In addition, [Redacted] had its own mortgage brokers, sales managers, software engineers, and account representatives in Idaho. In addition, one [Redacted] affiliate had offices in the state with multiple personnel, from administration to clerical. The brokers and lenders entered into agreements with [Redacted]. Independent and in-house brokers located in Idaho found potential borrowers. After identifying the customer, the brokers and lenders assisted the borrower in completing loan applications, gathering necessary documentation, and serving as the liaison between the company and the borrower until the loan was closed.

Staff also concluded investigation primarily incurred in Idaho regarding certain loans. Appraisals were a key part of the underwriting process at [Redacted]. The actual appraisal was completed in the state of Idaho and submitted to [Redacted] for review. The review appraisers were responsible for reviewing and determining the acceptability of the outside appraisals that were attached to loan applications provided by the brokers. Regional managers, who had lending authority and were located outside of Idaho, could override the internal appraiser's decision, but this would be the exception rather than the rule. After underwriter approval, the loan was sent to a closing agent in Idaho (escrow or title) for a title search.

The negotiation of the loans is not as easy to attribute to a particular state. For instance, the account executives or managers at the processing centers are responsible for the loan terms. Since the broker or lender located in Idaho is the liaison between the borrower (also in Idaho) and [Redacted], an important portion of the negotiation happens in the state of Idaho. In short, it appears that the negotiation activity appears to take place both in Idaho and at the state in which

the processing center is located. There is not enough evidence to say where the greater amount of the activity takes place.

Approval also appears to occur both in Idaho and at processing or regional business centers. Underwriters approve the loans, but subject to conditions. If the files are not complete, it is up to the Idaho broker or lender in Idaho to contact and work with the borrower and obtain all necessary documentation to gain final approval. In addition, the Idaho escrow or title company is responsible for all of the necessary research (such as title searches, encumbrances, liens, and subordination).

Administration is conducted primarily outside of Idaho. Once the loan is approved, the closing is conducted at an escrow or title company in Idaho, where all the necessary documentation is gathered and executed and the funds are transferred. However, after funding, the servicing of the loans appears to be outside the state, although certain collection activities may occur in Idaho.

Of the two analyses, the Commission finds the audit staff's analysis to be the better analysis [Redacted] makes a blanket analysis based on the location of the cost centers. Rather than identifying and analyzing the particular location that each loan (or a representative sample of loans) was solicited, investigated, negotiation, approved, and administered, it appears that [Redacted] simply attributed the loans according to the location of its cost or processing centers.

The Tax Commission does not believe that this is the type of analysis the drafters of the Recommended Formula had in mind. The specific language of the Formula provides that the preponderance of substantive contacts is determined based on the place where such activity as solicitation, investigation, negotiation, approval and administration of the loan occurs. Recommended Formula, § 4(g)(3).

The formula states that all of the facts and circumstances of each loan shall be analyzed. [Redacted] analysis has the potential of skewing the results by putting more emphasis on administrative activities (which will be ongoing during the life of the loan) and less emphasis on the activities of the borrower and broker associated with solicitation, investigation, negotiation, and approval of the loan.

Under the Recommended Formula the facts and circumstances of each loan must be analyzed to determine the amount of weight to be placed on each factor. Even loans of the same type (such as residential home loans) may have different circumstances.

For instance, one customer in Idaho may see an advertisement in a local newspaper for home loans offered at an attractive interest rate. The customer may then visit the local financial institution, speak with a loan officer, fill out an application, and submit additional information to the loan officer. The local loan officer may then submit the application to an out-of-state location where the application is scored based on a pre-determined set of credit criteria. If the score is satisfactory, the local officer will notify the customer who then may visit the local office again to sign the necessary loan papers. Sometimes the closing occurs at a title company and the loan officer is present at the closing. Following the closing of the loan, the administration may occur at yet a different location. In this circumstance, the preponderance of substantive contacts may well be at the local level.

Conversely, a customer that initiates contact with a financial institution by means of the internet, and then applies for the loan by means of the internet, may present a different circumstance in which the preponderance of the substantive contacts would be outside the borrower's home state.

Additionally, an analysis for determining factors such as solicitation, investigation, negotiation, approval, and administration; requires not only a determination as to where the principal activity of each factor occurs, but also how much weight to give to each of the factors. If a customer visits a local office to initiate the loan process and to submit information to a local loan officer, the Commission may be inclined to give substantial weight to the solicitation and investigation factors. If the approval of that same loan amounts to nothing more than an automatic scoring under predetermined criteria, the Commission may be inclined to give that factor little weight.

The fact that the financial industry has become highly computerized and automated adds another layer of complexity in weighing the factors. Financial institutions send notices and letters to customers on a programmed or automatic basis. Customers engage in on-line banking or withdraw money from their accounts at ATMs. Financial institutions now are run on the backbone of large computer systems. The computer system can be thought of as a centralized mainframe located in a particular place or as a network that is located in a variety of places. It would skew the results of a SINAA analysis to say that all automated functions occur at a central location. Also, it would be difficult, if not impossible, to prorate those computerized functions to a specific loan or type of loan.

[Redacted] simply has not presented the Tax Commission with the necessary information, either at the audit level or the appeals level, to fully analyze the solicitation, investigation, negotiation, approval and administration factors. Finding that the audit staff has presented a more fully developed analysis of the SINAA factors, the Commission upholds the Audit Division's adjustments to the Idaho property numerator.

E. IMPOSITION OF THE PENALTY

With respect to the substantial understatement penalty, [Redacted] simply asks that the penalty be reevaluated and recalculated after the Commission has reviewed and adopted the changes proposed by [Redacted]. The substantial understatement penalty is set out in Idaho Code § 63-3046(d). Subsection (d)(7) provides that “[t]he state tax commission may waive all or any part of the [substantial understatement penalty] on a showing by the taxpayer that there was reasonable cause for the understatement (or part thereof) and that the taxpayer acted in good faith.” Idaho Code § 63-3046(d)(7). The Tax Commission is unable to find that the understatement in Idaho tax during the years under audit was based on reasonable cause or that the taxpayer acted in good faith. Of those adjustments that were protested, the taxpayer provided very little documentation to substantiate its position. In the final analysis, the Commission simply does not believe that waiver of the substantial understatement penalty is warranted under the circumstances.

CONCLUSION

WHEREFORE, the Notice of Deficiency Determination dated March 20, 2007, is hereby MODIFIED and as so Modified is APPROVED, AFFIRMED, AND MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayer pay the following tax, penalty, and interest:

<u>PERIOD</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2003	56,855	5,686	17,215	79,756
2004	47,324	4,732	11,495	63,551
2005	<u>10,741</u>	<u>1,074</u>	<u>1,965</u>	<u>13,780</u>
Subtotals	114,920	11,492	30,675	
		TOTAL AMOUNT DUE:		<u>\$157,087</u>

Interest is calculated through December 31, 2008, and will continue to accrue at the rate set forth in Idaho Code § 63-3045(6) until paid.

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

An explanation of the taxpayer's right to appeal this decision is enclosed. As set forth in the enclosed explanation the taxpayer must deposit with the Tax Commission 20 percent of the total amount due in order to appeal this decision. The twenty percent deposit in this case amounts to \$ 31,417 and will be held as security for the payment of taxes until the appeal is finally determined.

DATED this ____ day of _____, 2008.

IDAHO STATE TAX COMMISSION

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of _____, 2008, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[REDACTED]

Receipt No.