BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of [Redacted] Petitioner.	DOCKET NO. 20555 DECISION

On July 16, 2007, the Income Tax Audit Division of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] asserting a proposed deficiency of $306,738 for the taxable years December 31, 2002, March 28, 2003, and December 31, 2003. On September 4, 2007, [Redacted] filed a timely appeal and petition for redetermination. An informal conference was held via telephone on February 6, 2007.

At the conclusion of the informal conference, the parties agreed to hold this matter in abeyance while [Redacted] submitted additional information to the Commission for its consideration. Subsequent to the informal conference, [Redacted] submitted information pertaining to: (1) the definition and role of an interest-only strip in the loan securitization process; (2) who bears risk of default for a securitized loan; (3) the typical type of unrelated third-party investors who invest in trusts holding securitized loans; (4) copies of agreements entered into during the securitization of loans; (5) a statement that the loans at issue were included in the denominators of the reported apportionment factors; (6) a statement that apportionment does not require that the numerators of the apportionment formula must equal the denominators; and (7) a statement that all of the loans at issue consisted of home equity loans and mortgages which were structured as secured financings and not as securitized sales pursuant to Statement Financial Accounting Standards No. 140 (SFAS No. 140).

The Tax Commission received the last of the above information on April 7, 2008. On the same date, the Commission advised [Redacted] that this matter was deemed fully submitted and ready for a decision. The Tax Commission has reviewed the file, including all of the information submitted by [Redacted], and now issues its decision concerning the [Redacted] request for a redetermination of the deficiency proposed by the Income Tax Audit Division. For the reasons discussed below, the Tax Commission affirms the proposed deficiency.

SUMMARY OF PROTEST

Affiliates [Redacted] issued [Redacted] loans. Many of these loans were loans secured by Idaho real property. Had [Redacted] followed its usual practice, the loans that were secured by real property located in Idaho would have been sourced to Idaho for apportionment purposes.

However, the [Redacted] affiliates did not retain the loans. Instead, the affiliates transferred the loans to related [Redacted] to be securitized. [Redacted] states that the transfer of the loans to the [Redacted] for securitization removes the loans from Idaho apportionment numerators because the loans are no longer owned by the affiliates. Instead, each [Redacted] Company is deemed to own the loans. [Redacted] asserts that pursuant to Idaho Code § 63-2023(b), the [Redacted] Companies do not transact business and, therefore, are not subject to Idaho income tax. [Redacted] suggests that because the [Redacted] Companies are not subject to Idaho income tax, the loans secured by Idaho real property should be excluded from the Idaho apportionment numerators.

Following the audit, [Redacted] also concluded the affiliates had incorrectly sourced other loans when filing their return with the Idaho Tax Commission. These were loans that were not transferred to a [Redacted] Company. [Redacted] stated that many of the loans sourced to

Idaho for the taxable years in question should be removed, entitling [Redacted] to a refund rather than the deficiency asserted by the Audit Division.

SUMMARY OF FACTS

1. The Company

[Redacted] [Redacted]2. [Redacted] Financing

[Redacted]There are two types of transactions [Redacted].

[Redacted].

The payment by investors is used to pay [Redacted] for the transferred loans. Repayment of the debt issued by the trust is secured by the transferred loans. The transactions are structured as [Redacted].

The transactions are not treated [Redacted]. Therefore, the loans and the underlying debt of the trust remain on [Redacted]. [Redacted] does not recognize a gain in a secured financing transaction. Because the receivables and the debt remain on [Redacted], revenues and expenses are reported consistently with their own balance sheet portfolio.

[Redacted] retains certain interests in the sold receivables. For instance, the [Redacted] affiliate that sold the loan continues to service the loan (for a fee) on behalf of the trust. [Redacted] collects finance charges and fees from [Redacted] customers every month regarding the securitized loans. These collections are primarily used to pay investors for their regular interests, and credit losses, and to pay [Redacted] servicing fees. [Redacted] also retains a residual interest in the trust, which means it has the right to any excess cash flow remaining after such payments are made to investors.

As of [Redacted], securitizations structured as sales represented 21 percent and secured financings represented 5 percent of the funding associated with [Redacted] managed portfolio.

As of [Redacted], securitizations structured as sales represented 23 percent and secured financings represented 7 percent of the funding associated with [Redacted] managed portfolio. The securitization revenue reported by [Redacted] was [Redacted] and [Redacted].

3. The Audit

[Redacted] filed its Idaho tax return on a worldwide combined basis. The Tax Commission's auditors visited the [Redacted] during April 24 through April 28, 2006. The audit staff adjusted the foreign income reported by [Redacted], disallowed some deductions for interest on [Redacted] and [Redacted] obligations, and included in the combined group those insurance companies that did not pay an Idaho premium tax. [Redacted] does not protest these adjustments.

However, during the audit, the auditors noted that loans secured by real estate had been transferred from [Redacted] The auditors found that the [Redacted] affiliates, which originated the loans, continued to service the loans and received interest from the loans in the form of a service fee. [Redacted].

The auditors also noted certain loans would have been assigned to Idaho for apportionment purposes absent the secured financing. [Redacted], the auditors stated the transfer of the loans to a related special purpose entity was not a "material change" of the loans (Explanation attached to the Division's Notice of Deficiency Determination). [Redacted].

ISSUES

In the Petition for Redetermination filed with the Tax Commission, [Redacted] presented the following grounds of protest to the adjustments of the Audit Division:

[Redacted]

During the informal conference conducted in this matter, [Redacted]

In its Petition, [Redacted]

1. [Redacted] incorrectly assigned loans and other receivables in their original return based on customer sourcing and therefore the property factor should be adjusted to remove those receivables from the property factor numerator.

This would entitle [Redacted] to reduce the proposed deficiency or, if it prevailed on the other audit issues, receive a refund.

DISCUSSION

[Redacted]

Before a non-Idaho corporation is required to comply with Idaho's income tax laws, the corporation must be "transacting business" in this state. Transacting business is defined in Idaho Code § 63-3023(a) to include the "owning or leasing . . . of any property, including real and personal property, located in this state, or engaging in or the transacting of any activity in this state for the purpose of or resulting in economic or pecuniary gain or profit." Idaho Code § 63-3023(a).

Idaho Code § 63-3023(b) goes on to provide a "safe harbor" exception that applies to corporations conducting certain limited financial activities within Idaho. That subsection provides:

> (b) Notwithstanding the provisions of subsection (a) [defining "transacting business"] . . . , any corporation, bank, trust company . . . or other corporation . . . existing under the laws of any state or territory of the United States other than the state of Idaho . . ., **which does not maintain an office within the state of Idaho for any purpose** shall not be deemed to be transacting business within the state of Idaho during any taxable year by reason of carrying on in this state any one (1) or more of the following activities:
>
> (1) Creating, acquiring or purchasing of loans . . . .
>
> (2) Collecting and servicing of loans in any manner whatsoever and the making of credit investigations and physical inspections and approval of real or personal property securing any loans or proposing to secure any loans;

> (3) Soliciting of applications for loans which are sent outside this state for approval; and
>
> (4) Filing of security interests; maintaining or defending any action or suit; holding, selling, assigning, transferring, collecting or enforcing any loans, or foreclosing or other disposition thereof, including acquiring title to property securing such loans by foreclosure, deed in lieu of foreclosure, or otherwise, as a result of default under the terms of the mortgage, deed of trust or other security instruments . . . or the holding, protecting and maintaining of said property so acquired or the disposition thereof. (Emphasis added.)

Idaho Code § 63-3023(b). (Bolding added for emphasis). If the [Redacted] simply carry on loan activities without maintaining an office in Idaho, they fall within the safe harbor. On the other hand, if the [Redacted] maintain an office in Idaho they would be taken out of the protection of the safe harbor and would be subject to Idaho's tax.

This audit raises a "representative nexus" issue. A corporation can be deemed to be transacting business in a state by virtue of utilizing employees or facilities of an employee or third-party agent. *See* National Geographic Society v. California Board of Equalization, 430 U.S. 551, 561-62 (1977) (Maintenance of two offices in the state and solicitation by employees of advertising copy totaling $1,000,000 sufficient to create nexus); Scripto, Inc. v. Carson, 362 U.S. 207, 212-3 (1960) (Ten independent contractors "conducting continuous local solicitation in [the state] and forwarding the resulting orders..." to the taxpayer created nexus).

The question that must be decided is whether the activities of [Redacted] outside of the [Redacted]. It must be noted that while it is possible for a corporation to be maintaining an office in Idaho, based on the activity being conducted on behalf of that corporation by its affiliates or representatives, the activity being conducted on behalf of the corporation must be more than just *de minimis*.

The record establishes that while a [Redacted], the [Redacted] then subcontracts with the originators of the loans to conduct the actual servicing. The [Redacted] affiliates collect finance charges and fees from [Redacted] customers every month regarding the securitized loans. The loan customer continues to interact with the [Redacted] affiliates and pay the loan in the same manner both before and after the secured financing.

The [Redacted] do not have contact with [Redacted] customers. The affiliates forward the finance charges and fees to the [Redacted]. The [Redacted] affiliates then receive its service fee from the collection. In short, the [Redacted] transact business in Idaho through the [Redacted] affiliates that originated the loans. Those affiliates, such as [Redacted]. Based on this, the Commission finds the activities conducted on behalf of the [Redacted] at the affiliated offices in Idaho exceed the *de minimis* exception and take the [Redacted] provision.

Accordingly, the ground asserted in the protest which asks the Commission to reverse the Audit Division’s adjustment to the property factor is denied. There are, however, other issues not raised in the protest that must be addressed.

B. THE AUDIT DIVISION DID NOT ASSERT A DEFICIENCY AGAINST THE SPECIAL PURPOSE COMPANIES. RATHER, THE AUDIT DIVISION ATTRIBUTED THE LOANS TO THE [Redacted] THAT ORIGINATED THE LOANS.

[Redacted] protested the deficiency proposed by the audit staff, stating Idaho could not impose a tax on the [Redacted]; however, the Audit Division did not assert that the [Redacted] were subject to tax. Rather, the Audit Division maintained that under the Recommended Formula, the loans should be attributed to the [Redacted] affiliates apportioning the business income of the [Redacted] combined group. To understand the Audit Division's position, a brief explanation of the unitary business concept and apportionment of income is necessary.

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.*, <u>Allied-Signal, Inc. v.</u>

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.of America v. Franchise Tax Board, 463 U.S. 159 (1983).

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 by the loans of the [Redacted] affiliates.

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:

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

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.

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 hearings 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 (for example, 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.

There are two issues that need to be addressed in the context of the Recommended Formula as it applies to this case. The first is the adjustment the Audit Division made to the property factor that [Redacted] reported to Idaho. The second is the adjustment the Audit Division made to the sales factor that [Redacted] reported to Idaho.

1. Property Factor.

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 [Redacted] 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 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 loans to the Idaho property numerator based on customer sourcing principles. Thus, if the loan was a loan secured by Idaho real property, the loan was assigned to the Idaho property factor. Absent the transfer of loans to a [Redacted] Company, the loans secured by Idaho real property would have been assigned to Idaho.

The Audit Division concluded the loans should have been assigned to Idaho on the original return because the [Redacted] Company simply is a conduit for the securitization process. Section 4(i) of the Recommended Formula indicates that a loan should be assigned to the state in which the loan has a preponderance of its substantive contacts and should remain assigned to that state absent any change of material fact.

[Redacted] has taken the position that although it would have assigned certain loans to Idaho, the transfer of loans secured by Idaho real property essentially was a material change in fact. The Tax Commission disagrees.

[Redacted] provided to the [Redacted] between several [Redacted]. This agreement is a secured financing agreement for loans secured by real estate. The agreement provides that each

[Redacted] affiliate will receive a cash payment (principal of the loan plus a premium) in exchange for the loans. Additionally, the affiliate continues to service the loan, and now receives a fee for that service. The service fee is paid from the interest collected monthly from [Redacted] customers. Thus, the affiliates receive cash upfront for selling the loans to a [Redacted] Company; use the proceeds to make new loans, perhaps at a higher interest rate; and in the meantime, the affiliates continue to receive interest from the transferred loans, although now in the form of a servicing fee.

The transfer of the loans to the related [Redacted] Company is not a sale for either book or tax purposes. The loans remain on [Redacted] balance sheets, and there is no gain reported. Had the loans been sold, they would have been removed from the balance sheet, and the gain realized from the sale would have been included in apportionable income. Also, the net gain would have been included in the sales factor. See Section 3(f) of the Recommended Formula – Net gains from the sale of loans. This means a portion of the gain would have been attributed to Idaho.

In short, a secured financing is exactly what the name implies. It is not a substantive sale of the loans. Rather, a secured financing is a vehicle to provide funding to the [Redacted], similar to issuing commercial paper or obtaining a loan using the loans in question as collateral. The principal and interest underlying loans are used to pay the debt incurred in the financing. As stated in [Redacted] annual reports to the SEL, a secured financing is preferred because it is more cost effective than other means of financing.

Based on these facts and circumstances surrounding the loans, the Commission concludes that the intercompany transfer of the loans to a related "[Redacted] Company" does not amount to a material change that would justify excluding the loans from the Idaho numerator. The audit adjustment made under the authority of Section 4(i) of the Recommended Formula is affirmed.

2. Sales Factor

The sales factor attribution rules for Financial Institutions are set out in Section 3 of the Recommended Formula. Section 3(b) through 3(m) sets out some very specific attribution rules relating to a wide variety of income and fees. "Sourcing for some items is straight forward, while other items involve more complicated procedures. Generally, receipts may be grouped as attributable to various categories of financial business activities such as loans, credit cards, leases, services, and investment and money management." Plant, *A Practical View of the MTC Apportionment Formula for Financial Institutions*, Vol. 5, No. 4, Journal of Multistate Taxation, 148, 151 (Sept /Oct. 1995).

By and large, these specific attribution rules provide that the receipt should be included in the numerator of the state where the property securing the loan is located, where the borrower is located, or where the transaction that created the income took place. Thus, for the most part, the Recommended Formula applicable to Financial Institutions follows the general philosophy of UDITPA that gross receipts should be sourced to the "market state."

The Audit Division relied on Section 3(d) which sets out the attribution rules relating to interest from loans secured by real property and provides that the interest is included in the numerator of the sales factor of the state where the real property is located. This is how [Redacted] reports the interest from other loans. Because the loans in question were transferred to [Redacted] Companies, [Redacted] excluded the interest from the Idaho sales factor.

In contrast to the property factor portion of the Recommended Formula, the sales factor does not contain a provision for keeping the state assignment of interest "absent any material change of fact." Section 3(d)(2) of the Recommended Formula states that for sales factor purposes, "The determination of whether the real property securing a loan is located within this state shall be made as of the time the original agreement was made and any and all subsequent substitutions of collateral shall be disregarded." While this provision addresses one particular change in fact, that is, a substitution of collateral, it does not address other changes in the loan, such as the loan itself being used in a subsequent securitization.

However, Section 3 of the Recommended Formula contains specific provisions for the sourcing of loan servicing fees.

> (k) **Loan servicing fees**.
>
> (1) (A)The numerator of the receipts factor includes loan servicing fees derived from loans secured by real property multiplied by a fraction the numerator of which is the amount included in the numerator of the receipts factor pursuant to subsection (d) of this section and the denominator of which is the total amount of interest and fees or penalties in the nature of interest from loans secured by real property.
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> (B) The numerator of the receipts factor includes loan servicing fees derived from loans not secured by real property multiplied by a fraction the numerator of which is the amount included in the numerator of the receipts factor pursuant to subsection (e) of this section and the denominator of which is the total amount of interest and fees or penalties in the nature of interest from loans not secured by real property.
>
> (2) In circumstances in which the taxpayer receives loan servicing fees for servicing either the secured or the unsecured loans of another, the numerator of the receipts factor shall include such fees if the borrower is located in this state.

The record demonstrates that a portion of the interest collected from the mortgages was passed through from the [Redacted] Companies in the form of service fees paid to [Redacted] affiliates. Because the loans are now held by a related trust, it appears the applicable provision is section 2. Because the [Redacted] affiliates receive servicing fees for loans owned by the trust, the servicing fees should be included in the Idaho numerator of the affiliates.

The Commission recognizes that the [Redacted] Companies may not have passed through all of the interest from the loans in question to the [Redacted] affiliates. At least in theory, a portion of the finance charges collected from the loans was passed on to third-party investors who held securities issued by the trust.

At first blush, this would suggest a possible distortion of the sales factor occurred when the Audit Division included the entire amount of mortgage interest received by the [Redacted] Companies in the Idaho numerator. However, as both [Redacted] and the Audit Division noted, the sales denominator includes the full value of the loans at issue. Because the interest received by the [Redacted] Companies was not included in the numerator of the sales factor, there is some question as to whether or not the full value of the loans should be included in the denominator. By including the full amount of interest from the loans, there is at least consistency between the numerator and denominator of the sales factor.

Also, the Tax Commission remains troubled by the fact that the gain (premium) realized by the affiliates on the transfer of the loans to the [Redacted] Companies was not recognized as a gain for tax purposes and, subsequently, was not reported in the sales factor. Had the transfer of the loans been recognized as a sale, then the net gain, as well as the service fee, would have been included in the sales denominator.

In any event, a potential distortion in the sales factor does not necessarily rise to a level that demands a different method of apportionment. To argue for a different method of apportioning of multistate or unitary corporation's income, it is necessary to establish that the application of the three factors (sales, payroll, and property) does not fairly represent business activity, not merely that one factor fails to meet this standard. It must be established that statutory apportionment does not adequately reflect business activity, not merely that the currently-employed factor does not adequately reflect income earned in the state. Union Pacific v. Idaho State Tax Commission, 139 Idaho 572, 83 P.3d 116 (2004).

Moreover, it would be appropriate to include the [Redacted] Companies in the nexus group subject to Idaho tax, and there would be no question that it was appropriate to include the entire amount of interest from the Idaho loans in the sales numerator. As discussed above, the representative activities of the [Redacted] affiliates brought the [Redacted] Companies out of the safe harbor of Idaho Code § 63-3023(b). Also, absent any evidence regarding how much interest from the mortgages may have been distributed to investors during the particular years at issue or how the other factors of the apportionment formula either mitigate or exacerbate the problem, the Tax Commission finds that the inclusion of the interest income is not distortive. The Audit Division's adjustment of the sales numerator is affirmed.

C. [Redacted] FAILED TO REBUT THE PRESUMPTION IN FAVOR OF THE ORIGINAL ASSIGNMENT OF LOANS.

Following the audit, [Redacted] concluded the affiliates incorrectly sourced other loans when filing their return with the Idaho Tax Commission. These were loans that were not transferred to a [Redacted] Company. [Redacted] stated that many of the loans sourced to Idaho for the taxable years in question should be removed from the property factor as reported on the Idaho returns, with the result of either reducing the deficiency or providing [Redacted]with a refund.

Section 4 of the Recommended Formula provides that once a loan is properly assigned by a financial institution, the assignment is presumed correct.

(g) **Location of loans**

(1) (A) A loan is considered to be located within this state if it is properly assigned to a regular place of business of the taxpayer within this state.

(B) A loan is properly assigned to the regular place of business with which it has a preponderance of substantive contacts. A loan assigned by the taxpayer to a regular place of business without the state shall be presumed to have been properly assigned if—

(i) the taxpayer has assigned, in the regular course of its business, such loan on its records to a regular place of business consistent with Federal or state regulatory requirements;

(ii) such assignment on its records is based upon substantive contacts of the loan to such regular place of business; and

(iii) the taxpayer uses said records reflecting assignment of loans for the filing of all state and local tax returns for which an assignment of loans to a regular place of business is required.

(C) The presumption of proper assignment of a loan provided in subparagraph (B) of paragraph (1) of this subsection may be rebutted upon a showing by the [State Tax Administrator], supported by a preponderance of the evidence, that the preponderance of substantive contacts regarding such loan did not occur at the regular place of business to which it was assigned on the taxpayer's records. When such presumption has been rebutted, the loan shall then be located within this state if (i) the taxpayer had a regular place of business within this state at the time the loan was made; and (ii) the taxpayer fails to show, by a preponderance of the evidence, that the preponderance of substantive contacts regarding such loan did not occur within this state.

In its original return, [Redacted] assigned the loans to Idaho. The Tax Commission assumes the assignment was consistent with federal and state regulatory requirements. [Redacted] stated it assigned the loans to Idaho because [Redacted] had offices in Idaho, solicitation for the loans occurred in Idaho, and the loans were secured by Idaho real property. Thus, the assignment was based on substantive contacts of the loan with the state of Idaho. The Tax Commission further assumes that the assignment was also reported consistently with returns filed in other states.

To change the assignment of loans, [Redacted] bears the burden of overcoming the original presumption. [Redacted] must demonstrate that the preponderance of substantive contact occurred with a different state and that the loans will be assigned to that state. Additionally, [Redacted] must show that the change in assignment will be reported consistently "for the filing of all state and local tax returns for which an assignment of loans to a regular place of business is required."

In its Petition for Redetermination, [Redacted] provided an analysis of the general type of contacts that most [Redacted] loans have with other states. In later correspondence, [Redacted] stated it had used a "cost of performance" type analysis to determine where the contacts occurred. In other words, rather than identifying and analyzing the particular location that each loan (or a representative sample of loans) was solicited, investigated, negotiated, approved, and administered, [Redacted] analyzed the **cost** incurred in making and administering the loan.

After a review of [Redacted] analysis, the Tax Commission is not convinced that the findings of that study are supported by the facts and circumstances regarding the loans. The Tax Commission does not believe that a "cost of performance" type of analysis is what 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). It is the place where the activity occurs, not the costs associated with the activity that controls. The term "cost of performance" is not used anywhere within section 4(g) of the Recommended Formula.

[Redacted] has not disclosed the type of cost it analyzed. However, the cost of performance approach used by [Redacted] has the potential of skewing the results by putting more emphasis on administrative costs (which will be ongoing during the life of the loan) and less emphasis on costs associated with solicitation, investigation, negotiation, and approval of the loan.

The Tax Commission finds that under the Recommended Formula the facts and circumstances of the loans must be analyzed to determine the amount of weight to be placed on each element. Even loans of the same type (such as residential home loans) may have different circumstances. 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.

If the Tax Commission were inclined to accept a cost of performance type of analysis for determining factors such as solicitation, investigation, negotiation, approval, and administration; the Commission would need to determine, not only 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.

Another complexity in the weighting of the substantive contacts is the fact that the financial industry has become highly computerized and automated. Financial institutions send notices and letters to customers on a programmed or automatic basis. Customers engage in online banking and withdraw money from their accounts at ATMs. Financial institutions now are run on the backbone of large computer systems. However, those computer systems do more than simply manage accounts. The system also is used to manage payroll, track employee performance, evaluate cash flows, and conduct numerous other intra-business activities of the financial institution. The expense and administration of the computer system is a sunk cost. It would be difficult, if not impossible, to pro rate those costs to a specific loan or type of loan. As stated above, a cost of performance analysis that included such administrative costs could skew the results of the analysis.

The Tax Commission simply does not have the necessary information in front of it to analyze the solicitation, investigation, negotiation, approval, and administration factors. Moreover, the Tax Commission notes that a "substantive contacts" analysis is not limited only to these factors. The Recommended Formula provides that a determination of "substantive contacts" of loans "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 of the loan." The Recommended Formula does exclude other factors from consideration.

The Commission concludes that [Redacted] properly assigned the loans on its original return. In addition to solicitation occurring in Idaho, the loans in question were secured by Idaho real property, assigned to Idaho on [Redacted] regular business records, and assigned to Idaho when [Redacted] filed returns with states other than Idaho. [Redacted] request to remove the loans from the Idaho property factor and to receive a refund is denied.

D. Imposition of the Substantial Understatement Penalty

The Audit Division asserted the 10 percent substantial understatement penalty to the proposed tax deficiency. [Redacted] requests the Tax Commission abate the proposed penalty because "The underlying legal issues are complex and even if the Tax Commission rejects [Redacted] arguments, the penalties should be abated because [Redacted] acted in good faith and with reasonable cause in the preparation and filing of its Idaho corporate income tax return for the periods at issue." (Petition for Redetermination at p.8.)

The Tax Commission agrees. Although the Tax Commission has rejected the substantive arguments presented by [Redacted] in this protest, it recognizes that the underlying legal issues are complex. In addition, at the time [REDACTED] filed its Idaho combined group return, it did not have the benefit of the analysis set out in administrative decisions issued by the Tax Commission. The Tax Commission finds, there was reasonable cause for the position taken by [Redacted] and that the company acted in good faith when it excluded securitized loans from the property factor, and the interest of the loans from the sales factor. Therefore, pursuant to Idaho Code § 63-3046(d)(7), the Commission hereby waives the substantial understatement penalty.

CONCLUSION

WHEREFORE, the Notice of Deficiency Determination issued July 16, 2007, is hereby AFFIRMED and made FINAL.

IT IS ORDERED and THIS DOES ORDER that the Petitioner's REQUEST FOR REFUND concerning the taxable years at issue is DENIED.

IT IS FURTHER ORDERED AND THIS DOES ORDER that the Petitioner pays the following tax, penalty, and interest:

YEAR	TAX	PENALTY	INTEREST	TOTALS
12/31/02	$ 115,311	$ - 0 -	$39,015	$154,326
03/28/03	11,787	- 0 -	3,794	15,581
12/31/03	101,589	- 0 -	28,992	130,581
TOTAL DUE	$ 228,687	$ - 0 -	$ 71,081	$300,488

Interest is calculated through October 1, 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 Petitioner's right to appeal this decision is enclosed. As set forth in the enclosed explanation, the Petitioner must deposit with the Tax Commission 20 percent of the total amount due in order to appeal this decision. The 20 percent deposit in this case amounts to $60,098 and will be held as security for the payment of tax 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.

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