BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NOS. 19470, 21621,
[Redacted],	)	and 22469
	)	
Petitioner.	)	
	)	
	)	

<u>Procedural Background</u>

On March 20, 2006, the staff of the Income Tax Audit Bureau (Audit Bureau) of the Idaho State Tax Commission (Tax Commission) issued a Notice of Deficiency Determination to the Petitioner proposing a deficiency of taxes, penalty and interest in the amount of [redacted]. The proposed deficiency concerned the taxable periods ending December 31, 2001, December 31, 2002, and December 31, 2003.

On May 22, 2006, the Petitioner filed a timely protest and petition for redetermination. The protest filed by the Petitioner was docketed as Docket No. 19470. The matter was retained at the audit level for resolution of a related matter in another docket to make appropriate investment tax credit adjustments and net operating loss carrybacks and to exchange additional information concerning the audit.

On September 14, 2007, the Audit Bureau issued a summons to the Petitioner. The summons principally sought information about the various loans made by the Petitioner's [Redacted] business. The Petitioner responded to the summons and provided information during the period of June through September 2008.

While the protest was pending, the Petitioner also filed amended returns reporting federal adjustments to the income and deductions the Petitioner filed with the [Redacted]. These

[Redacted] adjustments resulted in adjustments to the Petitioner's Idaho income tax. As a result of the [Redacted] adjustments and other on-going audit adjustments, the Audit Bureau issued a revised audit report to the Petitioner on March 10, 2009. The Bureau proposed a deficiency of tax, penalty, and interest in the amount of $[Redacted]. The Petitioner filed a renewed Petition for Redetermination of the modified deficiency on April 30, 2009. The Petitioner supplemented its renewed Petition for Redetermination with additional information on May 8, 2009.

The Audit Bureau and the Petitioner could not resolve all of the remaining issues, so the matter was forwarded to the Commissioner for a hearing. At the Petitioner's request, the hearing was consolidated with two other dockets, namely Docket No. 21621 and Docket No. 22469.

In Docket No. 21621, the Audit Bureau issued to the Petitioner a Notice of Deficiency Determination dated October 9, 2008. The notice asserted a deficiency of $[Redacted] in tax, penalty, and interest for the taxable year ending December 31, 2004. A payment received on April 22, 2008, was credited against the proposed deficiency resulting in a proposed total due of $[Redacted]. On December 15, 2009, the Audit Bureau received a written protest of the proposed deficiency from the Petitioner. The Petitioner raised, substantially, the same issues that it raised in Docket No. 19470.

In Docket No. 22469, the Audit Bureau issued to the Petitioner a Notice of Deficiency Determination dated October 14, 2009. The notice asserted a deficiency of $[Redacted] in tax, penalty, and interest. The proposed deficiency included a credit for a previous payment of $[Redacted] the Petitioner made on April 15, 2009. The Petitioner filed a written protest of the proposed deficiency with the Audit Bureau on December 21, 2009. Again, the Petitioner raised common issues with those raised in previous dockets.

An informal conference was conducted on April 8, 2010, in which the consolidated dockets were considered together. The Tax Commission has reviewed the file, is advised of its contents, and hereby issues its decision MODIFYING the Notices of Deficiency Determination issued by the Audit Bureau.

Agreed Issues

The Petitioner raised issues in its Petitions for Redetermination filed with the Tax Commission. The Petitioner submitted additional information after it had filed the formal protests. The Audit Bureau has reviewed the information and agreed to make certain adjustments as summarized below.

1. Internal Revenue Code section 265 and 291 interest expense associated with federal tax-exempt interest is deducted for taxable years 2001 through 2003. This adjustment was effected in the modified audit report issued by the Audit Bureau.

2. The Audit Bureau agreed to recompute the intercompany dividend elimination for taxable year 2003 per the Petitioner's protest.

3. The calculation of interest expense associated with exempt income from [Redacted] will be adjusted as requested by the Petitioner for taxable years 2001-2003, 2004, 2005, and 2006.

4. Apportionable income interest from state and local obligations exempt from federal income tax was double counted in taxable year 2004. The Audit Bureau agrees to subtract $[Redacted] from apportionable income.

5. The Audit Bureau agreed to incorporate [Redacted] changes made by the [Redacted] for taxable year 2004.

6. Interest income from Idaho bonds will be removed from apportionable income for taxable years 2005 and 2006.

7. The Tax Commission and the Petitioner have agreed to address separately other issues concerning amended returns the Petitioner recently filed with the Audit Bureau. [Redacted]. That matter is docketed with the Tax Commission as Docket No. 22875.

Issues to be Addressed

The Petitioner raised the following issues in its written protest which now are addressed in this decision.

1. The Audit Bureau incorrectly applied the MTC Recommended Formula in determining whether or not certain loans should be included in the Petitioner's Idaho property factor and sales factor of the apportionment formula.

2. The Audit Bureau included loans in the apportionment formula of companies that did not have a connection with the state of Idaho.

3. Including the Petitioner's insurance affiliates in the combined group that reports to Idaho is contrary to Idaho Code § 41-405 and facially discriminates against interstate commerce in violation of the Commerce Clause of the United States Constitution.

4. Dividends received from the [Redacted] and from the [Redacted] are exempt from state taxation by federal law.

5. Taxing income from non-Idaho state and local obligations while exempting income from Idaho state and local obligations discriminates against the non-Idaho obligation in violation of the Commerce Clause of the United States Constitution.

6. The Audit Bureau's adjustment to the investment tax credit on moveable property was erroneous.

7. The penalties imposed by the Audit Bureau should be abated.

To the extent the Petitioner sought to raise additional issues during the protest period, those requests for adjustments are denied.

Background Facts

The Petitioner is a unitary banking business that operates in the state of Idaho and many other states. The [Redacted]. The Petitioner uses these funds to make [Redacted] and invest in securities and other interest-bearing assets. The loans and investment activities are directed to Idaho customers as well as customers in other states. Many of the members of the Petitioner's [Redacted] business are members of the [Redacted] and the [Redacted].

Law and Analysis

1. The MTC Recommended Formula

To understand this issue, 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 shifting 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. 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 [Redacted] made by the Petitioner and its 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).

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. In such instance, the taxpayer may request, or the Tax Commission may require, an alternative apportionment. Idaho Code § 63-3027(s). 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.

The Multistate Tax Commission (MTC) addressed the specific apportionment issues regarding financial institutions. After a decade of discussion with many states and representatives of financial institutions, the MTC promulgated a model regulation which has come to be referred to as the MTC Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions (Recommended Formula). Idaho adopted the Recommended Formula for taxable years beginning on or after January 1, 1998. *See* Idaho Income Tax Administrative Rule 580.01.g. IDAPA 35.01.01.580.01.g.

The Recommended Formula includes several significant modifications to the normal statutory apportionment computation. The primary modifications were to include certain intangible assets in the property factor calculation and to establish a set of rules for sourcing gross receipts from the various types of services and products offered by financial institutions for purposes of the sales factor. Both factors are at issue in this matter.

The Property Factor

The Recommended Formula property factor includes the average value of loans and credit card receivables. Loans are valued at their outstanding principal balance. They 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). If, for example, the preponderance of substantive contact regarding a specific loan takes place at an Idaho branch of a multistate bank, the loan is treated as being located within Idaho.

The primary issue in the above-referenced dockets is whether certain loans should be included in the Idaho property factor. The Petitioner asserts it properly followed the Recommended Formula in determining which loans were assigned to Idaho when it reported the loans on its returns. The Audit Bureau maintains the Petitioner failed to include all of the appropriate Idaho loans in the Idaho property factor.

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)). In short, the preponderance of substantive contacts is based on the place where the loan activity occurs.

The Petitioner agrees that the place of activity is the test and goes to some length to describe the process involved with the various types of loans, offered by its business. In general terms, the types of loans at issue include residential home loans, home equity loans, automobile loans, commercial loans, consumer loans, agricultural loans, student loans and credit card accounts. The Petitioner has provided a broad description of the internal process employed by its unitary business for each type of loan. Based on these process descriptions, the Petitioner represents that certain types of loans do not have substantive contacts with the state of Idaho because most of the solicitation, investigation, negotiation, approval, and administration of the loans occurs outside the state of Idaho.

This general analysis is appealing at first blush. For instance, it is not difficult to envision that most of the contacts for a student loan could occur outside of Idaho. The initial solicitation may or may not occur in Idaho. Some of the initial investigation may occur at the Financial Aid Office at the educational institution which gathers the initial information from the student. There probably is not much in the form of negotiation. Quite likely, approval and administration occur outside of Idaho. It would certainly make it easy to comply with, and to administer, the Recommended Formula under this type of analysis.

However, this is not the type of analysis required by the Recommended Formula. The Recommended Formula provides the preponderance of substantive contacts is an analysis that must be conducted on a “case-by-case basis.” There are reasons for examining each loan, rather than a broad-brush approach based on the general processes involved in the various loan categories. While a more generalized approach may be easier from both the perspective of the tax administrator and the taxpayer, it may not fairly reflect the extent of the financial institution’s business activity in the state of Idaho.

Even loans within the same category (such as residential home loans) may have different circumstances that require a different result. 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.

Thus, the generalized approach suggested by the Petitioner may not be representative of the Petitioner's loan activity in Idaho. The Recommended Formula requires that all of the circumstances be considered. The Petitioner has not presented any of the specific details of the loan's process, only generalized descriptions. Undoubtedly, the solicitation of certain loans occurred in Idaho. The Petitioner has various employees in Idaho including its own mortgage brokers, sales managers, software engineers, and account representatives. The Petitioner had offices in the state with multiple personnel, from administration to clerical. Also, appraisals are a key part of the underwriting process for most mortgages, and the actual appraisal for Idaho property probably was completed in the state of Idaho. After underwriter approval, a loan could be sent to a closing agent in Idaho (escrow or title) for a title search. It would seem that at least preliminary investigations occurred in Idaho regarding certain loans.

These types of activities were not mentioned by the Petitioner making the factual basis for an analysis incomplete. Moreover, 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 element occurs, but also a determination of how much weight to give to each of the elements.

If a customer visits a local office to initiate the loan process and submit information to a local loan officer, the person conducting the analysis may be inclined to give substantial weight to the solicitation and investigation factors. The negotiation of the loans generally is not easy to attribute to a particular state and often is a mix between local loan officers and designated personnel at an area service center. There often is not enough evidence to say where the greater amount of the negotiation activity takes place. In many instances, the approval and administration activities may not be given substantial weight, especially if the approval of that same loan amounts to nothing more than a computer scoring under predetermined criteria and the administration consists primarily of computerized notices.

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 as it undoubtedly supports a wide array of loans.

The difficulty of assigning loans based on computer programming became apparent in this case. The Petitioner references loans made on two computer systems or programs. For the purposes of this decision, the systems are referred to, respectively, as [Redacted] and [Redacted]. The Petitioner points out that, in many instances, the loan officer involved with the loans was located outside of Idaho, even when the customer was located in Idaho. Based on this representation, the Petitioner maintains the loans should be assigned to the property factor of the state in which the loan officer is located.

The audit staff disagreed with the Petitioner. The audit staff specifically referenced the loans entered on these computer systems in its audit narrative. On page 27 of the audit narrative, the auditor stated a majority of the loans on the [Redacted] system were assigned to states other than Idaho. The staff specifically noted the Petitioner did not include any pre-2001 loans which came into its possession as a result of a merger and acquisition of a small bank doing business in Idaho. The Petitioner refused to provide requested information regarding the pre-2001 loans, so the auditor included in the Idaho property factor all home equity loans with a borrower located in Idaho.

On page 29 of the audit narrative, the auditor states: "The loans reported on the original returns by the taxpayer at the ending of 2000 (beginning of 2001) are extremely low as compared to those at the end of the year. The prior auditor asked for loan verification and the taxpayer refused to provide this information. Therefore we have estimated the beginning 2001 [[Redacted]] loan amounts based on the amounts reported for the following years."

The Petitioner argues that the surrogate methods used by the Audit Bureau results in double counting certain loans or incorrectly assigning loans to Idaho that should not be assigned to Idaho. At this point, given the information available to it, the Tax Commission cannot say whether certain loans are double counted or should otherwise be excluded from the property factor determined by the Audit Bureau. There simply is not enough information to make a definitive determination.

The Petitioner recognizes this fact. The Petitioner cites the Recommended Formula and suggests that any doubt in this matter should be resolved in the Petitioner's favor. 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 in question to various places of business other than in the state of Idaho. However, the Petitioner has failed to demonstrate that (1) the assignment was consistent with federal and state regulatory requirements, (2) the loans were assigned to other states based on substantive contacts of the loan with the other states, and (3) the assignment was reported consistently with returns filed in other states. Accordingly, the Petitioner is not entitled to a presumption.

In any event, the Tax Commission finds that the Audit Bureau has provided sufficient information that would rebut the presumption if it applied. The Tax Commission recognized the impracticality of producing loan documents for each loan entered into by the Petitioner. However, the alternative suggested by the Petitioner is much too general in nature, as discussed above. It would seem that a sampling of the loan population could be produced, which would satisfy the Bureau's request for information.

In the absence of such information, the approach used by the Audit Bureau seems reasonable and supported by the Recommended Formula. The Petitioner asserts that the Audit Bureau has essentially used a "market approach" by assigning the loans to the place where the underlying property is located or, in the case of an unsecured loan, to the state where the customer is located.

The Petitioner argues that the Audit Bureau deviated from the Recommended Formula in applying this type of method. The Tax Commission is not persuaded. First, it is not entirely a "market approach." In the case of a secured loan, the customer may or may not be located in Idaho. Second, the fact that the securing property or customer is located in Idaho certainly gives the loan some connection with the state of Idaho. The Recommended Formula states that "consideration shall be given to such activities as the solicitation, investigation, negotiation, approval, and administration of the loan." The Recommended Formula does not limit the analysis of substantive contacts only to the elements of solicitation, investigation, negotiation, approval and administration of the loan. In cases in which sufficient information is not available, it is reasonable that other types of contact between the loan and the state should be considered.

Based on the foregoing, the Tax Commission upholds the property factor determined by the Audit Bureau.

The 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 straightforward, 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 of the Recommended Formula provide the receipts received by a financial institution for its loans 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 Bureau followed Section 3(d) of the Recommended Formula and attributed the receipts from the loan activities to the state where the customer or securing property was located.

The Petitioner maintains that this is inappropriate and that the loans should instead be sourced to the state where the loan officer is located or where the loan is otherwise “processed.” For the same reasons that the Tax Commission rejected this argument in terms of the property factor, the Tax Commission rejects the argument in the context of the sales factor. The language contained in the sales factor makes it clear that the auditor applied the methodology set forth in the Recommended Formula.

2. The Nexus Question

The Petitioner makes another argument concerning the assignment of the loans which extends beyond the provisions of the Recommended Formula. The Petitioner contends that some of the loans were made by affiliates that have no connection or “nexus” with the state of Idaho other than the sales of loans.

A state’s ability to tax a non-domiciliary company is limited by the Due Process Clause or the Commerce Clause. *See* U.S. Const. art. I, § 8, cl. 3 & amend. XIV, § 1. The U.S. Supreme Court held that the nexus requirements of the two constitutional clauses were distinct. Quill Corp. v. North Dakota, 504 U.S. 298, 313-14 (1992). After stating that “a corporation may have the ‘minimum contacts’ with a taxing State as required by the Due Process Clause, and yet lack the ‘substantial nexus’ with that State as required by the Commerce Clause,” id. at 313, the Court fashioned a bright-line test to determine the constitutional validity of sales and use taxes under the Commerce Clause. Id. at 314. To justify a sales and use tax, this bright-line test required a taxpayer’s physical presence in the taxing state. Id. at 315-17. Physical presence of the taxpayer within the taxing state is not a requirement under the Due Process test. “[I]f a foreign corporation purposefully avails itself of the benefits of an economic market in the forum

State, it may subject itself to the State's *in personam* jurisdiction even if it has no physical presence in the State." Id. at 307.

The gist of the Petitioner's argument is that the loans at issue were essentially made by affiliates that are analogous to the remote seller in Quill Corporation, and therefore, those particular affiliates of the Petitioner had are not subject to Idaho's income tax.

Commerce Clause Jurisprudence in State Taxation.

The Commerce Clause is an express grant to Congress to regulate commerce between the various states. *See* U.S. Const., art. I, § 8, cl. 3 ("The congress shall have power . . . [t]o regulate commerce . . . among the several states . . . ."). However, under the so-called "dormant" or "negative" Commerce Clause, the U.S. Supreme Court has determined that there are certain limits placed on state laws even when Congress has not affirmatively acted. In other words, the Commerce Clause, by its own force, provides certain limits on the ability of several states to impose laws that affect interstate commerce.

With respect to state tax laws, the United States Supreme Court, in Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977), established a four-part test that is used to determine the validity of a state tax under the dormant Commerce Clause. The first prong of the Complete Auto Transit four-part test requires that the state tax must be applied to a taxpayer or taxable activity that has a "substantial nexus" with the taxing state. The remaining three parts of the Complete Auto Transit test are that the tax must be fairly apportioned, must not discriminate against interstate commerce, and must be fairly related to the services provided by the state. Id. at 279.

While Complete Auto Transit sets out the current analysis used to determine if a state tax will be valid under the dormant Commerce Clause, it is important to note that the sweep of the

U.S. Supreme Court's dormant Commerce Clause jurisprudence has changed significantly over the years. Because the history of the U.S. Supreme Court's dormant Commerce Clause jurisprudence is important in understanding the purpose (and the limits) of the Court's holding in Quill, the Court's discussion of that history is set out at length below:

> Our interpretation of the "negative" or "dormant" Commerce Clause has evolved substantially over the years, particularly as that clause concerns limitations on state taxation powers. Our early cases, beginning with *Brown v. Maryland*, 12 Wheat. 419 (1827), swept broadly, and in *Leloup v. Port of Mobile*, 127 U.S. 640, 648 (1888), we declared that "no State has the right to lay a tax on interstate commerce in any form." We later narrowed that rule and distinguished between direct burdens on interstate commerce, which were prohibited, and indirect burdens, which generally were not. *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 256-258 (1938), and subsequent decisions rejected this formal, categorical analysis and adopted a "multiple-taxation doctrine" that focused not on whether a tax was "direct" or "indirect" but rather on whether a tax subjected interstate commerce to a risk of multiple taxation. However, in *Freeman v. Hewit*, 329 U.S. 249, 256 (1946), we embraced again the formal distinction between direct and indirect taxation, invalidating Indiana's imposition of a gross receipts tax on a particular transaction because that application would "impos[e] a direct tax on interstate sales." Most recently, in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 285 (1977), we renounced the *Freeman* approach as "attaching constitutional significance to a semantic difference." We expressly overruled one of *Freeman's* progeny, *Spector Motor Service, Inc. v. O'Connor*, 340 U.S. 602 (1951), which held that a tax on "the privilege of doing interstate business" was unconstitutional, while recognizing that a differently denominated tax with the same economic effect would not be unconstitutional. *Spector*, as we observed in *Railway Express Agency, inc. v. Virginia*, 358 U.S. 434, 441 (1959), created a situation in which "magic words or labels" could "disable an otherwise constitutional levy." *Complete Auto* emphasized the importance of looking past "the formal language of the tax statute [to] its practical effect," and set forth a four-part test that continued to govern the validity of state taxes under the Commerce Clause.

Quill at 309-310 (citations and footnotes omitted).

After discussing this history of the Court's dormant Commerce Clause jurisprudence, the U.S. Supreme Court then went on to determine that one of its prior cases, National Bellas Hess v. Illinois, 386 U.S. 753, 87 S.Ct. 1389 (1967), was consistent with the Court's current jurisprudence. In Bellas Hess, the state of Illinois had attempted to impose a sales and use tax collection responsibility on an out-of-state mail-order seller that had no physical presence within Illinois other than the use of the postal service or common carriers to deliver its products to its Illinois customers. In striking down the Illinois law, the Supreme Court held that it was impermissible for a state to "impose the duty of use tax collection and payment upon a seller whose only connection with customers in the State is by common carrier or the United States Mail." Bellas Hess, 386 U.S. at 758, 87 S.Ct. at 1392. As a result, for purposes of imposing a sales or use tax collection responsibility on an out-of-state seller, Bellas Hess established that something more than delivery via the U.S. mail or common carrier was necessary.

In effect, Bellas Hess established a safe-harbor rule for mail-order sellers. So long as the seller's only connection within the taxing state was the delivery of its products by common carrier or the U.S. mail, that seller would not be required to collect or remit sales or use tax on those sales. In Quill, the U.S. Supreme Court recognized and revitalized the safe harbor rule established in Bellas Hess. In so doing, the Court commented that "[l]ike other bright-line tests, the *Bellas Hess* rule appears artificial at its edges: Whether or not a State may compel a vendor to collect a sales or use tax may turn on the presence in the taxing State of a small sales force, plant, or office." Quill, 504 U.S. at 315, 112 S.Ct. at 1914. The Court then went on to hold:

> This artificiality, however, is more than offset by the benefits of a clear rule. Such a rule firmly establishes the boundaries of legitimate state authority to impose a duty to collect sales and use taxes and reduces litigation concerning those taxes. . . .
>
> Moreover, a bright-line rule in the area of sales and use taxes also encourages settled expectations and, in doing so, fosters investment by businesses and individuals. Indeed, it is not unlikely that the mail-order industry's dramatic growth over the last quarter-century is due in part to the bright-line exemption from state taxation created in *Bellas Hess.*

Id. at 315-316, 112 S.Ct. at 1915. After discussing the benefits of the bright-line rule established in Bellas Hess, the Court in Quill found that, because "the *Bellas Hess* rule has engendered substantial reliance and has become part of the basic framework of a sizable industry," it was unwise and unnecessary to overrule that case. Id. at 317, 112 S.Ct. at 1915-1916.

The Court also emphasized that Congress, through its affirmative Commerce Clause powers, was in a much better position to decide the continuing utility of the Bellas Hess safe harbor rule. Id. at 318, 112 S.Ct. at 1916. In any event, because the Bellas Hess safe harbor still applied, the opinion of the North Dakota Supreme Court (which had held that Bellas Hess was no longer good law) was overruled.

The Physical Presence Requirement Does Not Apply To State Income Taxes.

There has been a split among state courts regarding whether Quill's presence requirement was intended as a broad, Commerce Clause principle, applicable to all state taxes, or whether physical presence was limited to sales and use tax. *See* J.C. Penney Nat'l Bank v. Johnson, 19 S.W.3d 831, 839 (Tenn.Ct.App.1999) (requiring physical presence beyond sales and use tax to satisfy Commerce Clause); cf. Geoffrey, Inc. v. South Carolina Tax Comm'n, 437 S.E.2d 13, 18 n.4 (1993), *cert. denied*, 114 S.Ct. 550 (1993) (articulating the court's understanding that the physical-presence requirement is limited to sales and use tax under the Commerce Clause).

It appears that the majority of state courts recently have determined the nexus inquiry is not limited to just the company's physical contacts within the forum state. *See* West Virginia Tax Commissioner v. MBNA America Bank, N.A, 640 S.E.2d 226 (2006) (Credit card bank with no physical presence availed itself of economic forum in West Virginia and, therefore, was subject to state income tax.); Lanco, Inc. v. Director, Department of Revenue, 188 N.J. 380, 908 A.2d 176 (2006) (even though licensor had no physical presence in the state; licensor-derived income from intangible property designed to boost commercial activity within the state); A & F Trademark, Inc. v. Tolson, 167 N.C.App. 150, 605 S.E.2d 187, 193-96 (2004) (holding North

Carolina can impose corporate franchise and income taxes on companies not physically present in North Carolina); and K-Mart Properties, Inc. v. New Mexico Department of Revenue, 139 N.M. 177, 131 P.3d 27 (2001) citing Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E.2d (S.C. 1993), *cert. denied*, 114 S.Ct. 550 (1993) (use of an intangible trademark and trade name within the state was sufficient to create substantial nexus). Pursuant to this recent line of cases, all of the unitary business's activity, to the extent it is focused on creating and maintaining a market for its products and services within the state, are to be considered.

This concept of "in-state market exploitation" is not a novel response to Quill, but rather is the touchstone in the Supreme Court's other non-use tax cases. *See* Standard Press Steel Co. v. Dep't of Revenue, 419 U.S. 560, 562, 95 S.Ct. 706, 708 (1975) (Use of a single in-state employee "with a full-time job within the State, made possible the realization and continuance of valuable contractual relations between [the taxpayer] and Boeing."); Tyler Pipe Indus., Inc. v. Washington Dep't of Revenue, 483 U.S. 232, 250, 107 S.Ct. 2810, 2821 (1987) ("As the Washington Supreme Court determined, 'the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state . . . .'"); and State v. Quantex Mirosystems, Inc., 809 So.2d 246, 251 (La. Ct. App. 2001) ("the crucial factor governing nexus is whether the activities performed in the taxing state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in the taxing state."). *See, generally*, Fatale, State Tax Jurisdiction and the Mythical "Physical Presence" Constitutional Standard, 54 Tax Lawyer 105, 109 (Fall 2000).

From its context, it is clear that the Supreme Court's holding in Bellas Hess and Quill are limited only to sales and use tax collection cases. Neither of those cases purported to establish a safe-harbor nexus standard for income tax or other tax types. In fact, in Quill, the Court specifically stated that "concerning other types of taxes we have not adopted a similar bright-line, physical-presence requirement." Quill, 504 U.S. at 317.

This, coupled with the underlying policy considerations discussed above, leads the Tax Commission to find that the better interpretation of Quill is the one adopted by those states that limit the Supreme Court's holding to sales and use tax.

The Statutory Safe Harbor in Idaho

The statutory analysis is different. Before a non-Idaho corporation is required to comply with Idaho's income tax laws, that 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.

Idaho Code § 63-3023(b). (Emphasis added.) Relying on this statute, the Petitioner argues that certain affiliates, and the loans they make to Idaho customers, should be excluded from the Idaho tax because the affiliates do not directly own offices in the state.

However, the fact that an affiliate does not directly own an office is not the end of the analysis. There is no question that a corporation can be deemed to be transacting business in Idaho 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 is 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.)

As noted in the property factor discussion, the Petitioner has not provided a great deal of detail about the loans, only general descriptions about the overall loan process. However, it is apparent that the loan process involves many people, not just the loan officer or employees of processing centers located outside of Idaho.

The audit narratives and protest summaries are replete with instances in which the Audit Bureau determined that the affiliates used the offices and employees located in Idaho to conduct its business. At page 40 of the audit narrative for taxable years 2001 through 2003, the Audit Bureau states ". . . these loans are made through the entire . . . network [of the Petitioner], and are originated, assigned, transferred and reported in many complex transactions that enable the taxpayer to report them without applying any measurable criteria to the term 'office.'"

Given the interdependent nature of this particular unitary banking business and the lack of details provided by the Petitioner, the Tax Commission agrees with the conclusion reached by the Audit Bureau. Absent an explanation and additional information from the taxpayer regarding the various activities that occur in Idaho regarding loans and the various transactions that occur between related entities and third parties, the Tax Commission upholds the apportionment determination made by the Audit Bureau.

3. Including Insurance Affiliates in the Combined Group

Statutory Analysis

Idaho Code § 41-405(1) provides that payment of the Idaho premium tax "shall be in lieu of all other taxes upon . . . income, franchise or other taxes measured by income . . . ." Thus, insurance companies that are subject to, and actually pay, the Idaho premium tax are exempt from the Idaho income tax. However, that does not necessarily mean that an exempt insurance company cannot be included in a combined group calculation relating to a subsidiary corporation that has an Idaho income tax filing requirement. Including an exempt subsidiary in the combined group calculation is not equivalent to taxing the income of that exempt company. *Cf.* Barclays Bank PLC v. Franchise Tax Board, 512 U.S. 298, 311 n.10, 114 S.Ct. 2268, 2277 n.10 (1994) ("Formulary apportionment of the income of a multijurisdictional (but unitary) business enterprise, if fairly done, taxes only the income generated within a State.") (citation and internal quotations omitted). In this respect, an exempt insurance subsidiary is no different than a subsidiary exempt from Idaho income taxation by Public Law 86-272. So long as the payroll, property, and sales of the exempt subsidiary are included in the combined group denominators, there is no inherent or theoretical reason why the income of the exempt subsidiary cannot be included in the combined group total apportionable income that is then apportioned to Idaho on the return filed by an Idaho-nexus taxpayer. *See* State v. Penn Independent Corporation, 15 Or. Tax 68 (1999).

It is permissible to include an exempt insurance subsidiary in the combined group calculation relating to an Idaho-nexus taxpayer. In fact, that is the current practice of the Tax Commission. However, for the taxable years in question, the Tax Commission had a policy of excluding exempt insurance companies from the combined group. The policy was set forth in Income Tax Administrative Rule 600.06, IDAPA 35.01.01.600.06 (2000). The rule, at that time, read: "[p]ursuant to Section 41-405, Idaho Code, an insurance company subject to the premium tax may not be included in a combined group." The rationale for this policy seemed to be based, in part, on the fact that California excluded exempt insurance subsidiaries from the California combined group report.[1]

[Redacted] argues that it is "subject to the premium tax" as that term is used in Rule 600.06. Although the Petitioner does not actually pay a premium tax to the Idaho Department of Insurance for the activity it conducts, the Petitioner is contractually obligated to pay or reimburse the premiums tax which other insurance companies must pay. In effect, the Petitioner asks the Tax Commission to construe the statutory exemption and accompanying rule broadly.

The Tax Commission finds that such a broad interpretation is contrary to the rules of statutory construction. Tax exemptions are never presumed or extended by construction of a statute. Bistline v. Bassett, 47 Idaho 66, 272 Pac. 696 (1929); Sunset Memorial Gardens, Inc. v.

[1] According to the California Franchise Tax Board, a unitary insurance subsidiary may not be included in the combined report of a unitary business because an insurance company is not a "taxpayer" as defined by California's tax statutes. *See* FTB Legal Ruling 385 (3/28/75). Under California's combined reporting statute, only "taxpayers" are to be included in the combined report; and since insurance companies do not meet the statutory definition of a "taxpayer," they cannot be included. *Id.* However, the rationale and analysis followed in California for excluding insurance companies from the combined report does not apply under Idaho law. Idaho Code § 63-3027(t) [authorizing combined reporting] does

Idaho State Tax Commission, 80 Idaho 206, 327 P.2d 766 (1958); Ada County Assessor v. Roman Catholic Diocese of Boise, 123 Idaho 425, 849 P.2d 98 (1993). The terms of the statutory exemption must be so specific and certain as to leave no room for doubt. Appeal of Evangelical Lutheran Good Samaritan Society, 119 Idaho 126, 804 P.2d 299 (1990).

Because tax exemptions are a matter of legislative grace rather than a guaranteed right, the exemption must be strictly and narrowly construed against the taxpayer. Owyhee Motorcycle Club, Inc. v. Ada County, 123 Idaho 962, 855 P.2d 47 (1993). Tax exemption statutes must be given their ordinary meaning and will not be sustained unless within the spirit as well as letter of the law. Church of Latter-Day Saints v. Ada County, 123 Idaho 410, 849 P.2d 83 (1993). Where more than one interpretation of statutory term or phrase is possible, courts must choose the narrowest possible reasonable construction of the tax exemption statute. Church of Latter-Day Saints, 123 Idaho at 416-7, 849 P.2d at 89-90 (1993).

The Tax Commission finds that inclusion of [Redacted] in the combined report filed by the Petitioner is not prohibited by Idaho Code § 41-405 or by Income Tax Administrative Rule 600.06. The statute and rule do not contemplate exempting someone for paying a tax on another's behalf or reimbursing another when they pay the tax. We now turn to the constitutional question raised in this protest.

Constitutional Analysis

[Redacted] argues that the Tax Commission's policy of excluding insurance subsidiaries that pay the Idaho premium tax, but not excluding insurance subsidiaries that do not pay the tax, is discriminatory and violates the Commerce Clause. The Petitioner asserts the policy violates

not limit the makeup of the combined group only to "taxpayers." Rather, Idaho Code § 63-3027(t)(1) specifies that "all corporations which are members of a unitary business" are to be included in the combined group "when necessary to accurately reflect income."

the Commerce Clause because it discriminates against interstate commerce by providing a preference for companies whose affiliates pay Idaho premium tax.

The principal flaw with the Petitioner's Commerce Clause argument is that the inclusion of an exempt or non-nexus unitary subsidiary in the combined group calculation does not necessarily result in a higher tax liability for the Idaho-nexus taxpayer. For example, if a unitary insurance subsidiary has a net operating loss, inclusion of that subsidiary in the combined group calculation would reduce the Idaho tax liability of the Idaho-nexus taxpayer. Likewise, if a unitary insurance subsidiary has significant payroll, property, or sales that are included in the combined group apportionment denominator, the Idaho tax liability of the Idaho-nexus taxpayer might be less if the insurance subsidiary is included in the combined group calculation. Thus, the inclusion of an insurance subsidiary does not necessarily result in a higher Idaho tax burden. This fact is amply supported by the arguments raised in AIA Services Corp. v. Idaho State Tax Com'n, 136 Idaho 184, 30 P.3d 962 (2001). In that case, the taxpayer (AIA Services) wanted to have its exempt insurance subsidiary included in the combined group report and argued to the Idaho Supreme Court that the Tax Commission's policy of excluding exempt insurance subsidiaries violated the Commerce Clause. While the Idaho Supreme Court did not address AIA Services' Commerce Clause argument due to the fact that the company failed to raise the issue below, the case does point out that the Tax Commission's policy does not necessarily favor those "companies whose affiliates pay Idaho premium tax." AIA Services wanted to have its exempt insurance subsidiary included in the Idaho combined group report because it would have resulted in a tax savings.

[Redacted] has not met its burden of establishing that the Idaho policy relating to exempt insurance subsidiaries discriminates against interstate commerce by granting preferential treatment to in-state activity. In addition, even if the policy was discriminatory, the remedy would be to invalidate Rule 600.06, not to expand that rule to cover "non-exempt" insurance subsidiaries. *See, e.g.*, K-Mart Corp. v. Idaho State Tax Com'n, 111 Idaho 719, 722, 727 P.2d 1147, 1150 (1986) ("Statutes control interpretive regulations. To the extent a regulation is unconstitutional, it is inconsistent with the constitutional statute it purports to interpret and is, therefore, of no effect to the extent of such inconsistency."). The Tax Commission, therefore, rejects the Petitioner's Commerce Clause claims.

4. Taxing Dividends Received from the Federal Reserve Bank and the Federal Home Loan Bank

Dividends from the Federal Reserve Bank

The Federal Reserve System's booklet titled "The Federal Reserve System Purposes & Functions" describes the member bank structure as follows:

> [T]he nation's banks can be divided into three types according to which governmental body charters them and whether or not they are members of the Federal Reserve System. Those chartered by the federal government (through the Office of the Comptroller of the Currency in the Department of the Treasury) are national banks; by law, they are members of the Federal Reserve System. Banks chartered by the states are divided into those that are members of the Federal Reserve System (state member banks) and those that are not (state nonmember banks). State banks are not required to join the Federal Reserve System, but they may elect to become members if they meet the standards set by the Board of Governors.[2]
>
> * * * *
>
> A bank that is a member of the Federal Reserve System must, under the Federal Reserve Act, subscribe to the capital stock of the Reserve Bank of its District. The total amount of a member bank's subscription is equal to 6 percent of its current capital stock and surplus. Of this amount, one-half is capital paid in and one-half is subject to call by the Board of Governors. These shares, unlike ordinary stock in private banks or corporations, do not carry voting power to control the policies of the Reserve Banks. Member institutions are entitled by statute to a cumulative dividend of 6 percent per year on the value of their paid-in

[2] Chapter 1, Overview of the Federal Reserve System, page 13, Member Banks.

> stock. Holdings of Reserve Bank stock may not be transferred, nor may the shares be used as collateral for loans.[3]

Member banks of the Federal Reserve System are entitled by statute to an annual dividend of six percent on paid in capital[4]. In arriving at net business income subject to apportionment, the Petitioner subtracted dividends received on Federal Reserve Bank stock. The Tax Commission's Audit Bureau disallowed the Petitioner's deductions.

The Petitioner cited Idaho Code § 63-3022(g) as support for subtracting the Federal Reserve Bank dividends from Idaho taxable income because Idaho Code § 63-3022(g), in part, allows a subtraction for any income exempt from Idaho taxation under the provision of any law of the United States. The Petitioner asserts the dividends are exempt from state taxation as a matter of federal law.

In 1913, Congress created the Federal Reserve System under the Federal Reserve Act of 1913. Section 7, undesignated paragraph 3, of the Federal Reserve Bank Act of 1913 (currently 12 U.S.C.A. § 531) provides the following:

> Federal reserve banks, including the capital stock and surplus therein, and the income derived therefrom shall be exempt from Federal, State, and local taxation, except taxes upon real estate.

[3] Appendix A, Federal Reserve Bank Balance Sheet and Reserve Equation, page 117, Capital Accounts.
[4] 12 U.S.C. § 289

The Petitioner argues that 12 U.S.C. § 531 and its legislative history continue to exempt Federal Reserve Bank dividends from state and local taxation.

This argument ignores that Section 4 of the Public Debt Act of 1941, as amended in 1942, removed <u>any exemption for dividends under federal tax acts.</u> In 1941**,** Congress passed the Public Debt Act of 1941 and Section 4 of this Act reads, in part, as follows:

> Sec. 4. (a) Interest upon, and gain from the sale or other disposition of, obligations issued on or after the effective date of this Act by the United States or any agency or instrumentality thereof shall not have any exemption, as such, and loss from the sale or other disposition of such obligations shall not have any special treatment, as such, under Federal tax Acts now or hereafter enacted;…

In 1942**,** realizing they had overlooked the tax exemption privilege enjoyed by shares and other evidences of ownership issued by various agencies and instrumentalities of the United States, Congress corrected its oversight.

> Sec. 4. (a) Interest upon obligations, and dividends, earnings, or other income from shares, certificates, stock, or other evidence of ownership, and gain from the sale or other disposition of such obligations and evidences of ownership issued on or after the effective dated of the Public Debt Act of 1942 by the United States or any agency or instrumentality thereof shall not have any exemption, as such, and loss from the sale or other disposition of such obligations or evidences of ownership shall not have any special treatment, as such, under Federal tax Acts now or hereafter enacted; . . .

Section 6 of the Public Debt Act of 1942 amending Section 4 of the Public Debt Act of 1941.

In 1947**,** Congress further amended Section 4 of the Public Debt Act of 1941 to read, in part, as follows:

> Sec. 4. (a) Interest upon obligations, and dividends, earnings, or other income from shares, certificates, stock, or other evidences of ownership, and gain from the sale or other disposition of such obligations and evidences of ownership issued on or after the effective date of the Public Debt Act of 1942 by the United States or any agency or instrumentality thereof <u>shall not have any exemption, as such, and loss from the sale or other disposition of such obligations or evidences of ownership shall not have any special treatment</u>, as such, under the Internal Revenue Code, or laws amendatory or supplementary thereto;. . .

(Emphasis added.) In 1959, Congress codified Section 4 of the Public Debt Act of 1941 (including subsequent amendments) as 31 U.S.C. § 742a.

In 1982, numerous words were omitted as surplus while other words were replaced for clarity when 31 U.S.C. § 742a was revised and re-designated as 31 U.S.C. § 3124(b). 31 U.S.C. § 3124 provides in part:

> Sec. 3124 Exemption from taxation
>
> (a) Stocks and obligations of the United States Government are exempt from taxation by a State or political subdivision of a State. The exemption applies to each form of taxation that would require the obligation, the interest on the obligation, or both, to be considered in computing a tax, except -
>
> (1) a nondiscriminatory franchise tax or another nonproperty tax instead of a franchise tax, imposed on a corporation; and
>
> (2) an estate or inheritance tax.
>
> (b) <u>The tax status of</u> interest on obligations and <u>dividends</u>, earnings, or other income <u>from evidences of ownership issued by the Government</u> or an agency and the tax treatment of gain and loss from the disposition of those obligations and evidences of ownership <u>is decided under the Internal Revenue Code of 1986</u> (26 U.S.C. 1 et seq.). . :[5]

(Emphasis added.) The Internal Revenue Code, in its definition of gross income, does not provide for an exemption for dividends received on Federal Reserve Bank stock.

The Idaho income tax is specifically tied to the federal determination of income. Idaho Code § 63-3002 states the legislative intent to follow the federal treatment. It states in part:

> 63-3002. Declaration of intent. It is the intent of the legislature by the adoption of this act, insofar as possible to make the provisions of the Idaho act <u>identical to the provisions of the Federal Internal Revenue Code relating to the measurement of taxable income</u>, to the end that the taxable income reported each taxable year by a taxpayer to the internal revenue service shall be the identical sum reported to this state, subject only to modifications contained in the Idaho law; to achieve this result by the application of the various provisions of the Federal Internal Revenue Code relating to the definition of income,. . . and other pertinent provisions

[5] The wording of 31 U.S.C. § 3124 is substantially the same today as it was in 1982, the year in which 31 U.S.C. §§ 742 and 742a were revised and renumbered as 31 U.S.C. §§ 3124(a) and 3124(b), respectively.

> to gross income as defined therein, resulting in a final amount called "taxable income" in the Internal Revenue Code . . . . All of the foregoing is subject to modifications in Idaho law including, without limitation, modifications applicable to unitary groups of corporations, which include corporations incorporated outside the United States.

(Emphasis added.) Under Idaho income tax law, there is no specific modification that allows a taxpayer to subtract dividends received on Federal Reserve Bank stock.

By following the federal treatment, the plain language of 31 U.S.C. § 3124(b) provides that Idaho may impose a corporate franchise or income tax on the interest or other income received on the stock. The Petitioner argues that certain legislative history would suggest Congress only intended to remove the tax exemption for the federal income tax. However, the Tax Commission is not persuaded that out-of-context references to legislative history should change a clear reading of the plain language of the statute. While the process for drafting is often uncertain, the Tax Commission finds the federal statutes that resulted from that process to be clear. The Public Debt Act removed the exemption for Federal Reserve Bank dividends previously immune from federal, state, and local taxation under the Federal Reserve Bank Act of 1913. Since the exemption was removed, the dividends became subject to Idaho taxation.

Accordingly, the Tax Commission finds no federal law or Idaho law prohibiting Idaho's taxation of dividends paid on Federal Reserve Bank stock. The audit adjustment on this issue is upheld.

<u>Dividends from the Federal Home Loan Bank</u>

The related issue raised by the Petitioner is whether dividends paid to the taxpayer on stock in the Federal Home Loan Bank (FHLB) are taxable by Idaho. The Petitioner received substantial dividends on FHLB stock during the audit period.

A lending institution's eligibility for membership in the FHLB is set forth in 12 U.S.C. § 1424. The capitalization of the FHLB is set forth in 12 U.S.C. § 1426. Subsection (g) thereof provides: "(g) DIVIDENDS. All stock of any Federal Home Loan Bank shall share in dividend distributions without preference."

Taxation of the FHLB is addressed in 12 U.S.C. § 1433, which reads as follows:

> Any and all notes, debentures, bonds, and other such obligations issued by any bank, and consolidated Federal Home Loan Bank bonds and debentures, shall be exempt both as to principal and interest from all taxation (except surtaxes, estate, inheritance, and gift taxes) now or hereafter imposed by the United States, by any . . . State, county, municipality, or local taxing authority. The bank, including its franchise, its capital, reserves, and surplus, its advances, and its income, shall be exempt from all taxation now or hereafter imposed by the United States, . . . by any State, county, municipality, or local taxing authority; except that in [sic] any real property of the bank shall be subject to State . . . or local taxation to the same extent according to its value as other real property is taxed. ...

The language here, "all notes, debentures, bonds, and other such obligations," clearly refers only to debt instruments. Notes, debentures, and bonds are all debt instruments, and "such obligations" limits the "obligations" to similar instruments. Bell Fed. Sav. & Loan Assn. v. Wagner, 675 N.E.2d 135, 138 (Ill. App. 1996). This is confirmed by the exemption being limited to "principal and interest." The second sentence makes "the bank" (meaning the FHLB, not a member bank) and its assets and income exempt from state tax. Taxation of dividends paid by the FHLB would not be prohibited by that sentence since it is the member bank that is being taxed on its income, not the FHLB. Thus, by the terms of this section, dividends on FHLB stock are not exempt from state taxation

Moreover, the Public Debt Act discussed above (31 U.S.C. § 3124) would further limit the Petitioner's argument. In terms of this statutory structure, the taxpayer's contention raises a series of questions. The first issue is whether FHLB stock is a "stock . . . of the United States Government." The Tax Commission does not need to answer this question definitively because, even if the answer is yes, taxation of the dividends is not a tax on the stock. This is confirmed by subsection (b) of 31 U.S.C. § 3124, which refers specifically to "dividends . . . from evidences of ownership." When Congress meant to refer to dividends, it did so expressly. The absence of mention of dividends in subsection (a) must be regarded as intentional.

The next issue is whether the reference in subsection (a) to "interest" encompasses dividends. The answer is no, again because dividends and interest are separately referred to in subsection (b). "Interest" in subsection (a) does not include dividends.

The next issue is whether the FHLB stock is an "obligation" within the meaning of the second sentence of subsection (a). The answer must be no because stock and obligations are separately referred to in the first sentence of subsection (a). *See also* Smith v. Davis, 323 U.S. 111, 116 (1944) (obligation must bear interest); American Bank & Trust Co. v. Dallas County, 463 U.S. 855, 859 n.1 (1983); Memphis Bank & Trust Co. v. Garner, 459 U.S. 392, 397 (1983) (statute restates constitutional principle of intergovernmental immunity); First Nat'l Bank v. Bartow County, 470 U.S. 583, 593 (1985).

The Tax Commission, therefore, concludes that taxation of the dividends on FHLB stock in the hands of the taxpayer does not violate 31 U.S.C. § 3124. The Oklahoma Supreme Court reached the same result in Sooner Fed. Sav. & Loan Assn. v. Oklahoma Tax Comm., 662 P.2d 1366 (1982).

5. Taxing Income from Non-Idaho Obligations

This is one of the issues for which this matter was held in abeyance. In the case of Kentucky v. Davis, 553 U.S. 328 (2008), taxpayers filed a class action seeking declaratory judgment that the Commonwealth of Kentucky's income tax structure, exempting interest on bonds issued by Kentucky or its subdivisions from state income tax, but taxing interest income on bonds from other states and their subdivisions, violated the dormant Commerce Clause. The Petitioner raises the same claim as the taxpayers in Davis regarding Idaho's taxation of income from bond and other obligations.

The Court found that Kentucky's taxation of non-Kentucky obligations, while exempting Kentucky obligations, did not violate the Commerce Clause. The Court found that, in instances in which the state is a market participant, such as in the bond and obligation market at issue here, the state action falls under the "market-participation" exception to the dormant Commerce Clause limit on state regulation. Applying the Court's ruling to the instant case, the Tax Commission upholds the deficiency as it relates to this issue.

6. Investment Tax Credit on Moveable Property

The Petitioner claimed the Idaho investment tax credit regarding certain moveable property for the taxable periods at issue. Moveable property consists of property that can be moved from state to state, such as certain motor vehicles. The Tax Commission's Audit Bureau disallowed a portion of the Idaho investment tax credit claimed on the return as filed. The auditor felt the Petitioner failed to adequately substantiate the Idaho situs and use of the moveable property.

Idaho Code § 63-3029B allows an investment tax credit on certain "qualified property." The documentation requirement to substantiate the eligibility of "qualified property" is found in Idaho Income Tax Administrative Rule 716 (Rule 716).

> **716. IDAHO INVESTMENT TAX CREDIT -- RECORD-KEEPING REQUIREMENTS (RULE 716).** Section 63-3029B, Idaho Code. (3-20-97)
>
> 01. Information Required. Each taxpayer must retain and make available, on request, records for each item of property included in the computation of the investment tax credit claimed on an income tax return subject to examination. The records must include all of the following: (3-20-97)

a. A description of the property; (3-20-97)

b. The asset number assigned to the item of property, if applicable; (3-20-97)

c. The acquisition date and date placed in service; (3-20-97)

d. The basis of the property; (3-20-97)

e. The class of the property for recovery property or the estimated useful life for nonrecovery property; (3-20-97)

f. The designation as new or used property; (3-20-97)

g. <u>The location and utilization (the usage both in and outside Idaho) of the property;</u> (3-20-97)

h. The retirement, disposition, or date transferred out of Idaho, or date no longer used in Idaho, if applicable; and (3-20-97)

i. The reason for acquisition if acquired prior to January 1, 1995. (3-20-97)

02. Accounting Records Subject to Examination. Accounting records that may need to be examined to document acquisition, disposition, location, and utilization of assets include the following: (3-20-97)

a. Accounting documents that contain asset and account designations and descriptions. These documents include a chart of accounts, the accounting manual, controller's manual, or other documents containing this information. (3-20-97)

b. Asset location records including asset directories, asset registers, insurance records, property tax records, or similar asset inventory documents. (3-20-97)

c. Records verifying ownership including purchase contracts and cancelled checks. (3-20-97)

d. Invoices, shipping documents, and similar documents reflecting the transfer of assets in and out of Idaho. (3-20-97)

e. Purchase orders, authorizations for expenditures or other records that identify the reason for acquisition for property acquired prior to January 1, 1995. (3-20-97)

> f. Log books measuring the use of property used both in and outside Idaho. These logs must be maintained for each item of property on which investment tax credit is claimed. These logs should measure use of property in accordance with the most accurate method for measuring the extent of use in Idaho. For example, use in Idaho of trucks, trailers, locomotives, and railcars shall be calculated according to actual mileage in and outside Idaho. (3-20-97)
>
> g. A system that verifies that property on which the investment tax credit was claimed continues to maintain its status as Idaho qualifying property throughout the recapture period. (3-20-97)
>
> 03. Failure to Maintain Adequate Records. Failure to maintain any of the records required by this rule **may** result in the disallowance of the credit claimed. (3-20-97)
>
> 04. Unitary Taxpayers. Corporations claiming investment tax credit must provide a calculation of the credit earned and used by each member of the combined group. The schedule must clearly identify shared credit and the computation of any credit carryovers. (3-20-97)

(Emphasis added.) In its protest, the Petitioner states "The Idaho situs and use of the property in question can be substantiated. Uniform Commercial Code filings in Idaho and title certificates in Idaho are reasonably contemporaneous records which establish Idaho situs . . . and use . . . ." Thus, the Petitioner asks that the Tax Commission rely on indirect and circumstantial evidence to satisfy the Petitioner's documentary burdens.

After reviewing the file and the Petitioner's history of failing to maintain proper documentation, the Tax Commission does not believe the Petitioner's facts and circumstances warrant the relief sought. The Petitioner should have provided the required information to the auditor during the audit.

While the protest was pending, the Petitioner submitted additional information to the Tax Commission regarding the investment tax credit. This information was submitted to the Audit Bureau, and over the course of several months, the parties reached agreement on some of the investment tax credit issues. The Audit Bureau issued modified schedules for the credit, which contained adjustments in the Petitioner's favor. Those adjustments are hereby incorporated in this decision.

Additionally, the Petitioner made a convincing point regarding one of the issues related to the investment tax credit moveable property. The Petitioner leases certain moveable property to third parties. The Audit Bureau disallowed many of the claims for credit relating to the property finding that it was not used in Idaho to the extent reported in the returns. The Audit Bureau relied on fuels tax reports made by the lessee of the property (vehicles) to determine what percentage of the time the property was used in Idaho. The Petitioner argues that the credit should at least be based on the percentage of use indicated in the lease agreements. The Audit Bureau did not agree with the Petitioner and did not make the corresponding adjustment to the tax credit. However, the Tax Commission finds that the lease agreements provide adequate substantiation in this case and instructs the Audit Bureau to further modify the investment tax credit to reflect the Idaho usage stated in the lease agreements.

7. Penalties

The Audit Bureau asserted both the five percent negligence penalty and the 10 percent substantial understatement penalty. The negligence penalty was asserted due to (1) the Petitioner's failure to follow previous rulings of the Tax Commission, (2) inadequate record keeping practices of the Petitioner, and (3) the Petitioner's failure to provide substantiation for its claims. The substantial understatement penalty was asserted because the underpayment of tax exceeded the $10,000 threshold in all three years.

[Redacted]asserts that the negligence penalty is not warranted. The Petitioner believes it has provided adequate support for its various positions and has provided an adequate response to all other requests from the Audit Bureau. The Tax Commission finds the negligence penalty was correctly asserted. S*ee* IDAPA 35.02.01.410.02. The Petitioner has itself received a previous decision from the Tax Commission regarding the taxation of dividends received from the Federal Reserve Bank. Yet it continues to raise the issue without acknowledging the past decision of the Tax Commission. Similarly, the Tax Commission issued decisions in the past regarding the taxation of dividends from the Federal Home Loan Bank and including insurance affiliates in the combined group. The Tax Commission also is concerned with the lack of detail provided regarding the property factor determination for loans.

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). While some adjustments have been made after the Petitioner provided additional information during the protest, the bulk of the deficiency has not been addressed. The Petitioner has not explained why the information was not provided during the audit or why the Petitioner chose to disregard previous decisions of the Tax Commission. 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. In the final exercise of its discretion, the Tax Commission does not believe that waiver of the substantial understatement penalty is warranted under the circumstances.

WHEREFORE, the Notices of Deficiency Determination referenced above are hereby MODIFIED, and as modified are MADE FINAL.

IT IS ORDERED and this does order the Petitioner pay the following tax, penalty, and interest:

Year	Tax	Penalty	Interest	Total
12/31/2001	[Redacted]	[Redacted]	[Redacted]	[Redacted]
12/31/2002	[Redacted]	[Redacted]	[Redacted]	[Redacted]
12/31/2003	[Redacted]	[Redacted]	[Redacted]	[Redacted]
12/31/2004	[Redacted]	[Redacted]	[Redacted]	[Redacted]
12/31/2005	[Redacted]	[Redacted]	[Redacted]	[Redacted]
12/31/2006	[Redacted]	[Redacted]	[Redacted]	[Redacted]
				[Redacted]
	[Redacted]			[Redacted]
	[Redacted]			[Redacted]

Interest is calculated through October 1, 2010, 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 (20%) of the total amount due in order to appeal this decision. The 20 percent deposit, in this case, is $[Redacted] and will be held as security for the payment of the asserted deficiency until the appeal is resolved.

DATED this ________day of ____________________2010.

IDAHO STATE TAX COMMISSION

____

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of ________________ 2010, 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.
COURTESY COPIES SENT TO:

[REDACTED]

____