BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 22105
[Redacted],	)	
	)	
Petitioner.	)	DECISION
	)	

Procedural Background

On May 28, 2009, the staff of the Income Tax Audit Bureau (Audit Bureau) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (NODD) to [Redacted] (Petitioner) proposing a deficiency of taxes, penalty, and interest in the amount of $[Redacted]. The proposed deficiency concerned the taxable periods ending December 31, 2004, December 31, 2005, and December 31, 2006.

On July 29, 2009, Petitioner filed a timely protest and petition for redetermination. A hearing rights letter dated November 5, 2009, was sent to Petitioner. Petitioner responded and requested a delay to obtain local counsel. An informal conference was scheduled for May 13, 2010.

Prior to the scheduled informal conference Petitioner, through counsel, sought to resolve some of the issues in the audit. The Audit Bureau staff examined additional supporting documentation during the field audit. Some issues were resolved, and a modified NODD dated April 27, 2010, was issued to Petitioner proposing a deficiency of taxes, penalty, and interest in the amount of $[Redacted]. The modified NODD was the result of construction loan adjustments. Petitioner, in a letter dated April 30, 2010, protested the modified NODD. An informal conference was held May 13, 2010. After the informal conference, Petitioner provided a significant amount of additional information to the Commission. Another informal conference

was held June 30, 2011. Thereafter, an [Redacted]audit concluded resulting in a decrease in income and a decrease in the amount of tax owed. The Tax Commission has reviewed the file, is advised of its contents, and hereby issues its decision AFFIRMING the modified NODD issued by the Audit Bureau on April 27, 2010, and further modified by [Redacted] audit.

Protested Issues

The main issues unresolved between Petitioner and the Audit Bureau after the June 30, 2011, informal conference are as follows:

1. Is [Redacted] a "financial institution" under IDAPA 35.01.01.582 (Income Tax Rule 582)?
2. If [Redacted] is not a financial institution, does mixing its gross receipts in the sales factor fraction with the net gains of the other entities in the combined group produce an incongruous result that does not fairly reflect Petitioner's business activity in Idaho?
3. Which loans should be assigned to Idaho for purposes of the property factor under the "SINAA" test?
4. Did [Redacted] have nexus in Idaho?
5. Should all proposed penalties be abated or removed?

Throughout the course of this audit and protest, Petitioner has raised other various arguments not specifically listed above, and the Commission has reviewed these additional arguments and finds them to be without merit.

Background Facts

1. [Redacted]

The following information is taken from the [Redacted] 2006 Form 10-K as filed with the Securities and Exchange Commission and gives a general overview of Petitioner.

[Redacted] is a registered bank holding company under the Bank Holding Company Act of 1956, as amended, and is a financial holding company under the provisions of the Gramm-Leach-Bailey Act.[1] Through its principal subsidiary, [Redacted] (Bank), a national banking association, and its other banking-related subsidiaries, Petitioner provides diversified financial services through four business segments: retail/commercial banking, mortgage banking, capital markets, and corporate.[2] The segments reflect the common activities and operations of aggregated business segments across the various delivery channels with the corporate segment providing essential support within Petitioner's organization.[3] The percentage of combined revenues (for this purpose, the sum of net interest income and noninterest income) ascribed to each segment is shown in the following chart:

	2006	2005	2004
Retail/Commercial Banking:	63%	56%	51%
Mortgage Banking	22%	28%	29%
Capital Markets (including the activity of [Redacted]	17%	15%	18%
Corporate	-2%	1%	2%
	100%	100%	100%

As a financial holding company, Petitioner coordinates the financial resources of the consolidated enterprise and maintains systems of financial, operational, and administrative

[1] 2006 Form 10-K, *available at* http://www.sec.gov/Archives/edgar/data/36966/000093041307001767/c46655_10-k.htm.
[2] *Id.*
[3] *Id.*

control intended to coordinate selected policies and activities.[4] Petitioner provided the following services through its subsidiaries:

- General banking services for consumers, businesses, financial institutions, and governments;
- Mortgage banking services;
- Through [Redacted] – sales, trading, and underwriting of bank-eligible securities and other fixed-income securities eligible for underwriting by financial subsidiaries; distribution of mortgage loans; advisory services; equity sales, trading, and research; and various investment banking services (includes the activities of [Redacted])
- Transaction processing – nationwide check clearing services and remittance processing;
- Trust, fiduciary, and agency services;
- Credit card products;
- Discount brokerage and full-service brokerage;
- Venture capital;
- Equipment finance;
- Investment and financial advisory services;
- Mutual fund sales as agent;
- Retail and commercial insurance sales as agent;
- Private mortgage reinsurance;
- Services related to health savings accounts.[5]

[Redacted] is the parent holding company of Petitioner's unitary banking business.[6] [Redacted] ([Redacted]) is the principal subsidiary of [Redacted].[7] [Redacted] is a direct subsidiary of [Redacted].[8]

[4] 2006 Form 10-K, *available at* http://www.sec.gov/Archives/edgar/data/36966/000093041307001767/c46655_10-k.htm.
[5] *Id.*
[6] Id.
[7] Id.
[8] 2006 Form 10-K, Exhibit 21, *available at* http://www.sec.gov/Archives/edgar/data/36966/000093041307001767/c46655_ex21.htm.

Law and Analysis

1. The Formula for the Apportionment and Allocation of Net Income of Financial Institutions

a. The apportionment of a financial institution's business income.

In 1994, the Multistate Tax Commission (MTC) issued a model provision for apportioning the income of financial institutions.[9] The MTC recommended that states adopt the provisions by statute or regulation.[10] This proposed financial institution apportionment formula came about through much discussion and input from financial institution industry representatives and various representatives from taxing states.[11]

The Commission adopted the MTC's "Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions" (Recommended Formula) in Income Tax Administrative Rule 582.[12]

The model provision for apportioning the income of financial institutions contains variations from Idaho's standard apportionment methods set forth in Idaho Code section 63-3027. A variation that is particularly significant in this case is the difference of including "net gains" versus "gross receipts" in the sales factor of the apportionment formula. Idaho uses a three-factor apportionment formula (with sales being double weighted) to determine a proportionate part of the business income of a unitary business, which Idaho will tax.[13] Under the standard apportionment method of Idaho Code section 63-3027, the sales factor (which is a fraction equal to Idaho sales divided by sales everywhere) uses a measurement of "gross

[9] Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions, *available at* http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FormulaforApportionmentofNetIncomeFinInst.pdf.
[10] Alan H. Friedman, *Final Report of Hearing Officer Regarding Proposed Multistate Tax Commission Formula for the Uniform Apportionment of Net Income From Financial Institutions*, pg 11 (April 28, 1994), *available at* http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/Final%20HO%20Rpt%20FinInst.pdf.
[11] *Id.* at 5.
[12] IDAPA 35.01.01.582.
[13] Idaho Code § 63-3027(i)(1).

receipts."[14] Under the apportionment method for financial institutions adopted by Income Tax Rule 582, the sales factor (referred to as the "receipts factor" in the financial institution apportionment provisions) uses a measure of "net gains" for most categories.[15] The difference between the measure of gross receipts versus net gains can be very significant. For example, if a person purchased an item for $99 and then sold the item for $100, generally speaking, the gross receipt of the sale would be $100, whereas the net gain of the sale would only be $1.

In this case, the difference between including [Redacted] gross receipts ($[Redacted]) in Petitioner's sales factor, as opposed to including [Redacted] net gains ($[Redacted]), drastically stuffed the sales denominator, which significantly diminished the sales factor and resulted in a calculation which greatly reduced Petitioner's Idaho tax liability for the taxable years at issue.

b. Defining a "financial institution."

The MTC's "Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions" has an "Appendix A" which is titled "Definition of Financial Institution."[16] The MTC model definition of "financial institution" was given as a starting point for states to decide how they wanted to define financial institutions. [17]

Some states have adopted the MTC's definition of financial institution, or a similar version, while some other states have used their own unique definitions.[18] Idaho's definition is a mix. Subsection 03 of Idaho Income Tax Rule 582 very closely mirrors the MTC's definition saying that the entities identified in the list are "Presumed to Be Financial Institutions." While

[14] Idaho Code § 63-3027(a)(5) & (p).
[15] Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions, § 3, *available at* http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FormulaforApportionmentofNetIncomeFinInst.pdf.
[16] Recommended Formula for the Apportionment and Allocation of Net Income of Financial Institutions, Appendix A, *available at* http://www.mtc.gov/uploadedFiles/Multistate_Tax_Commission/Uniformity/Uniformity_Projects/A_-_Z/FormulaforApportionmentofNetIncomeFinInst.pdf.
[17] *Id.*
[18] Examples of some of the states that have adopted definitions very close to the MTC's are Arkansas, Colorado, Oregon, Utah, and Washington. Whereas, examples of some of the states that have their own unique definitions are Alabama, Alaska, California, Hawaii, Kansas, and Minnesota.

subsection 02 of Rule 582 provides a detailed definition of "financial institution" which mirrors California's definition of a "financial corporation" found in California Administrative Code title 18, section 23183.

2. [Redacted] **is a Financial Institution Under Idaho Income Tax Rule 582**

The first question is whether the financial institution rules apply to [Redacted] and its subsidiaries. Petitioner has agreed that under the MTC rules adopted by Idaho Income Tax Rule 582, [Redacted] are financial institutions.[19] However, Petitioner maintains that [Redacted] is not a financial institution under Idaho Income Tax Rule 582. Petitioner also argues that as a non-financial institution, the standard apportionment provisions of Idaho Code section 63-3027 apply and that [Redacted] "gross receipts" should be used in the sales factor mixed in with the "net gains" of the rest of the entities in Petitioner's combined Idaho tax return.

a[Redacted] is presumed to be a financial institution.

[Redacted] is presumed to be a financial institution under Income Tax Rule 582. Idaho Income Tax Rule section 582.03 provides a list of entities presumed to be "financial institutions." Included in this list is "[a]ny corporation whose voting stock is more than fifty percent (50%) owned, directly or indirectly, by any person or business entity described in subsections 582.03.a. through 582.03.f." [Redacted] is a national bank as described in subsection 582.03.b. [Redacted] is a direct subsidiary of [Redacted]. Thus, [Redacted] is presumed to be a financial institution by Idaho Income Tax Rule section 582.03.g.

Petitioner has argued that the presumption is rebutted by showing that [Redacted] does not fit the definition of financial institution provided in Idaho Income Tax Rule section 582.02.

[Redacted]

Petitioner's arguments have focused on parsing the definition in Income Tax Rule 582.02 and arguing that each of the four parts of that definition does not apply to [Redacted].

The Commission holds that once an entity is presumed to be a financial institution by Idaho Income Tax Rule section 582.03, the only way to be excluded is by way of Idaho Income Tax Rule section 582.04. Idaho Income Tax Rule section 582.04 states:

> **04. Exclusion from Rule.** The Tax Commission is authorized to exclude any person from the application of Subsection 582.01 upon such person proving, by clear and convincing evidence, that the income-producing activity of such person is not in substantial competition with those persons described in Subsections 582.03.a. through 582.03.f. and 582.03.h.

The Idaho Supreme Court has explained that clear and convincing evidence is "evidence indicating that the thing to be proved is highly probable or reasonably certain."[20] The Idaho Civil Jury Instructions (IDJI) provide a description of the clear and convincing evidence burden of proof. IDJI 1.20.2 states:

> When I say a party has the burden of proof on a proposition by clear and convincing evidence, I mean you must be persuaded that it is highly probable that such proposition is true. This is a higher burden than the general burden that the proposition is more probably true than not true.

b. Petitioner has not shown by clear and convincing evidence that [Redacted] is not in substantial competition with those persons described in Idaho Income Tax Rule sections 582.03.a. through 582.03.f. and 582.03.h.

Petitioner has failed to provide clear and convincing evidence to prove that [Redacted] is not in substantial competition with entities described in Idaho Income Tax Rule sections 582.03.a. through 582.03.f. and 582.03.h. To the contrary, available facts indicate to the Commission that [Redacted] is in substantial competition with entities described in Idaho Income Tax Rule sections 582.03.a. through 582.03.f. and 582.03.h. In particular, it appears to the

[20] *Idaho Dept. of Health & Welfare v. Doe*, 150 Idaho 752, 250 P.3d 803, (2011).

Commission that [Redacted] is in substantial competition with bank holding companies described in 582.03.a.

Petitioner's "substantial competition" arguments have focused solely on whether [Redacted] is in substantial competition with the business of national banks, which they have discussed as they have parsed and argued the four parts of the definition in Income Tax Rule 582.02.[21] Petitioner has stated that "[Redacted]."

Regardless of whether or not [Redacted] is in "substantial competition with the business of national banks," it appears to the Commission that [Redacted] is in substantial competition with bank holding companies described in 582.03.a. and, therefore cannot remove itself from the 582.03.g. presumption by way of 582.04. Since the Gramm-Leach-Bliley Act of 1999, a bank holding company can elect to be treated as a "financial holding company" which is then allowed to engage in securities broker dealer activities. 12 USC 1841(p) defines "Financial Holding Company," stating, "For purposes of this chapter, the term 'financial holding company' means a bank holding company that meets the requirements of section 1843(l)(1) of this title." 12 USC 1843(k)(1) provides that a financial holding company "may engage in any activity, and may acquire and retain the shares of any company engaged in any activity" that is "financial in nature." 12 USC 1843(k)(4) lists activities that are financial in nature and includes "underwriting, dealing in, or making a market in securities." The Federal Reserve website explains:

> A bank holding company or a foreign bank that elects to become or be treated as a financial holding company pursuant to provisions of the Gramm-Leach-Bliley Act that amended section 4(k)(4)(E) of the Bank Holding Company Act, may engage in securities underwriting, dealing, or market-making activities. The financial holding company must notify the Board within thirty days after commencing these activities.[22]

[21] [Redacted].
[22] [Redacted].

Most of the bank holding companies of the largest commercial banks have elected to be "financial holding companies." [Redacted] banks and each has elected to be treated as a "financial holding company."[23] Each of these bank holding companies directly or indirectly holds a securities broker dealer subsidiary.

[Redacted] appears to be in substantial competition with bank holding companies described in Idaho Income Tax Rule section 582.03.a. [Redacted] is a registered broker dealer that engages in "underwriting, dealing in, or making a market in securities." Bank holding companies that elect to be treated as financial holding companies can engage in "underwriting, dealing in, or making a market in securities." As discussed above, most of the bank holding companies of the largest commercial banks have elected to be treated as financial holding companies so that they can engage in the types of activities that Petitioner states that [Redacted] engages in. Thus, because [Redacted] is a broker dealer, it appears to be in substantial competition with bank holding companies described in Income Tax Rule section 582.03.a.

In conclusion, [Redacted] is presumed to be a financial institution under Idaho Income Tax Rule section 582.03.g. Petitioner has not rebutted the presumption because Petitioner has failed to provide clear and convincing evidence to prove that [Redacted] is not in substantial competition with entities described in Idaho Income Tax Rule sections 582.03.a. through 582.03.f. and 582.03.h. Further, available facts indicate to the Commission that [Redacted] is in substantial competition with bank holding companies described in Income Tax Rule 582.03.a.

3. Even if [Redacted] **did not fit the Idaho definition of financial institution, mixing its gross receipts in the sales factor fraction with the net gains of the other entities in the combined group produces an incongruous result that does not fairly reflect Petitioner's business activity in Idaho.**

a. Alternative apportionment under Idaho Code section 63-3027(s).

[23] [Redacted].

Idaho Code section 63-3027(s) provides:

> (s) If the allocation and apportionment provisions of this section do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the state tax commission may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> (1) Separate accounting, provided that only that portion of general expenses clearly identifiable with Idaho business operations shall be allowed as a deduction;
>
> (2) The exclusion of any one (1) or more of the factors;
>
> (3) The inclusion of one (1) or more additional factors which will fairly represent the taxpayer's business activity in this state; or
>
> (4) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

The application of Idaho Code section 63-3027(s) was the central issue in the Union Pacific Corp. v Idaho State Tax Commission case in the Idaho Supreme Court.[24] The court stated:

> Idaho Code Section 63-3027(s) provides that the Tax Commission may require alternative apportionment (a) if the allocation and apportionment provisions of the statute do not fairly represent the extent of the taxpayer's business and (b) if the alternative apportionment is reasonable. Before the statutory apportionment can be rejected in favor of an alternative apportionment, either the Commission or the taxpayer must show that the three-part formula does not accurately reflect the taxpayer's business in the State. The party asserting alternative apportionment bears the burden of showing that alternative apportionment is appropriate.[25]

In Union Pacific, the Idaho Supreme Court held that it was permissible to apply an alternative apportionment formula that excluded the corporation's sales of accounts receivable from the sales factor denominator.[26] The corporation's reporting system included accounts receivable from freight sales under the accrual accounting method but then also included the sales of those same accounts receivable under the cash accounting method.[27] The Idaho Supreme Court held "the mixing of the two accounting systems to represent but one group of

[24] Union Pacific Corp. v Idaho State Tax Commission, 139 Idaho 572, 83 P.3d 116 (2004).
[25] *Id.* at 575 (citations omitted).
[26] *Id.* at 577.
[27] *Id.* at 574.

sales is the unusual fact situation that led to incongruous results" in the application of the standard formula and supported the use of alternative apportionment.[28] The court found that the Commission had "met its burden of showing the appropriateness of an alternative apportionment."[29] The court concluded "the apportionment urged by the Commission to delete the proceeds of the sale of the accounts receivable is a reasonable alternative."[30]

b. Mixing a method that measures the "gross receipts" of [Redacted] with a method that measures only the "net gains" of the rest of the entities in the group creates an unusual fact situation that leads to incongruous results in apportioning Petitioner's income.

Petitioner's sales factor computation that mixes [Redacted] gross receipts with the net gains of the rest of the group produces a result that does not fairly reflect Petitioner's business activity in Idaho. The difference between the measure of gross receipts versus the measure of net gains can be very significant. For example, in this case, [Redacted] 2006 gross receipts were $[Redacted], whereas [Redacted] net gains were only $[Redacted]. When using the measure of [Redacted] net gains, the total everywhere receipts of Petitioner's combined group (i.e., the denominator of the sales factor) is $[Redacted] for taxable year 2006. Whereas, under Petitioner's method, using the measure of [Redacted] gross receipts, the total everywhere receipts is dramatically larger, totaling $[Redacted]. The amended return method creates a strange factual scenario where [Redacted] represents 99.8 percent ($[Redacted]) of the Petitioner's combined group sales factor.

The apportionment method used by Petitioner suggests that in taxable year 2006 [Redacted] produced 99.8 percent of the sales for the entire group of entities in the combined group, but looking at Petitioner's federal taxable income shows that [Redacted] only brought in 3.6 percent of the total income of the group. The total income of the combined group reported

[28] *Id.* at 576 – 577.
[29] *Id.* at 577.
[30] *Id.* at 577.

on the federal 1120 forms for all of the entities in Petitioners combined group for taxable year 2006 was $[Redacted]; the portion of that total income that came from [Redacted] was $[Redacted]. The mixed method employed by Petitioner creates a strange factual scenario that does not fairly represent Petitioner's business activities in Idaho; it causes the sales attributes of [Redacted] to be severely over-weighted in the sales factor such that the sales contributions of all the other entities are dwarfed.

The purpose of the sales factor is to represent the markets for a taxpayer's goods or services.[31] Petitioner's apportionment method, which severely overweights the sales attributes of [Redacted], cannot fairly represent its business activities in Idaho. [Redacted] did not have any sales activities in Idaho, its [Redacted] percent dominance of the sales factor obliterates the representation of the other entities in the group making it impossible for the sales activities in Idaho to be fairly represented.

The reasonable alternative to Petitioner's mixed apportionment method would be to apply the financial institution apportionment rules to [Redacted]. All the other entities in the combined group are using the measure of net gains for the sales factor; using the measure of [Redacted] net gains would avoid the strange results of Petitioner's mixed method and would fairly reflect Petitioner's business activity in Idaho.

4. The Audit Bureau Correctly Adjusted Loans in the Property Factor

a. Overview of loan assignment.

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

[31] *See generally* Altman & Keesling, *Allocation of Income in State Taxation*, 126-128 (2d ed. 1950); J. Hellerstein & W. Hellerstein, *State Taxation I: Corporate Income and Franchise Taxes*, ¶ 8.06 [2] (2d ed. 1993 & Supp. 1996/1997).

substantive contact."[32] If, for example, the preponderance of substantive contacts regarding a specific loan takes place at an Idaho branch of a multistate bank, 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."[33] In short, the preponderance of substantive contacts is based on the place where the loan activity occurs.

Petitioner is asking that several types of loans be removed from the property factor numerator categorically rather than applying the "SINAA" factors on a "case-by-case" basis. The SINAA factor analysis is applied to individual loans rather than entire categories of loans; the rule instructs to look at "the loan at issue" on a "case-by-case" basis. The SINAA factors are summarized as follows:

1. Solicitation: Either active (Taxpayer initiates contact) or passive (customer initiates contact).
2. Investigation: Procedure whereby Taxpayer's employees determine creditworthiness as well as degree of risk.
3. Negotiation: Procedure whereby Taxpayer's employees determine terms of agreement (i.e., amount, duration, interest rate, frequency of repayment, currency denomination and security required).
4. Approval: Procedure whereby Taxpayer's employees or Board of Directors make final determination whether to enter into the agreement. If Board makes final determination, such activity is located at Taxpayer's commercial domicile.
5. Administration: Process of managing the account i.e., bookkeeping, collecting the payments, corresponding with customers, reporting to management regarding the status of the agreement and proceeding against the borrower or the security interest if the borrower is in default. Such activity is located at the regular place of business which oversees this activity.

[32] Recommended Formula, § 4(g)(1)(A).
[33] 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)).

The loans in question include several different types of loans. Some loans were installment loans and Home Equity Lines of Credit (HELOC). Others were one-time close (OTC) loans or construction loans that have all the terms negotiated in advance. The borrower has a two-year period within which to draw down funds. At the end of the construction period, the outstanding principal balance automatically becomes fixed and amortizable at the interest rate set in the beginning. Others were [Redacted].

Another significant type of loan in question in this matter was Petitioner's residential mortgage loans referred to as warehouse loans. Retail warehouse loans were done in-house by [Redacted] and wholesale warehouse loans were those which Petitioner claimed were purchased from independent loan brokers to be resold in the secondary market. Petitioner provided the following business description on a prospectus filed with the SEC:

[Redacted].

In this case, Petitioner does not agree with the Audit Bureau regarding assignment of the loans in the property factor to Idaho under the SINAA test. Petitioner categorizes the loans into three groups:

1. Loans held by the Bank (Bank loans). These loans included home equity loans, credit card receivables, installment loans, and other miscellaneous bank loans.

2. Loans held by [Redacted] but originated by an independent third party (wholesale loans). The wholesale loans included construction loans (also known as One-Time Close or OTC loans) and warehouse loans. Warehouse loans were first mortgage loans suitable for being sold in a pool to an agency such as Fannie Mae or Freddie Mac. Typically, warehouse loans were only owned for periods of ninety days or less, but a substantial volume was typically on hand at any point in time.

3. Loans both originated by and held by [Redacted] itself (retail loans). These retail loans included warehouse loans and construction loans, such as OTC loans, home builder finance loan and commercial real estate.

Petitioner argues that the Audit Bureau incorrectly grouped all of these loans into one category for purposes of the SINAA analysis and especially for purposes of retail loans vs. wholesale loans.

b. The assignment of loans in the property factor.

Loan balances were provided by Petitioner only in response to the Commission's summons, although numerous requests for this same information had been made before the summons was issued. Originally, inadequate information was provided to the Commission. Some detailed information by loan was provided such as the address, location of collateral, zip code, loan number, and "outstanding balance" at year-end. In the end, the Audit Bureau only included (in the numerator of the property factor) loans with borrower addresses and locations of collateral in Idaho.

As stated earlier, the Recommended Formula provides that loans should be assigned to the state with the "preponderance of substantive contacts" and that the analysis should 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.

The Recommended Formula requires that all of the circumstances be considered. 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.

Section 4(g)(1)(B) of the Recommended Formula provides that a loan is presumed to be "properly assigned" if certain requirements are met.

> (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.

Petitioner assigned the loans in question to various places of business other than the state of Idaho; Petitioner has not satisfied the three requirements that would cause their assignment to be presumed correct. The only information provided to the Audit Bureau was the loan data that Petitioner supplied in response to the summons. Petitioner gave no rationale for their assignment of specific loans; Petitioner did not demonstrate that the loans had been assigned based on

substantive contacts of the loans. Petitioner initially said that they could not provide the 51-state apportionment data that the Audit Bureau needed. Petitioner asserted that they did not keep records in that format and did not need to because each state's laws are different. Eventually, Petitioner did provide a report showing a state-by-state breakdown. Petitioner has not satisfied the three requirements of section 4(g)(1)(B) of the Recommended Formula and, therefore, is not entitled to the "properly assigned" presumption.

In any event, the Commission finds that the Audit Bureau has submitted information discussed in this decision that would rebut the presumption if it applied. The Audit Bureau has presented actual facts regarding the processing of loans that shows the loans are placed correctly in Idaho. The Audit Bureau also believes that all of the loans would fall into similar fact patterns. The information provided by Petitioner, that shows the addreses of various loan customers and location of the related collateral in Idaho, is further proof that these loans belong in Idaho.

For instance, information indicates that the Idaho offices of [Redacted] performed all the stages of the warehouse retail or residential mortgage loans. Petitioner had [Redacted] Idaho locations in 2006. According to payroll tax records filed with the Commission, it had [Redacted] employees in Idaho during 2006. Loan officers, underwriters, and clerical staff were all employed in Idaho. These employees accepted payments for either mortgage loans or home equity lines. SINAA activities in Idaho were identified as follows:

1. Solicitation: [Redacted] engaged in aggressive advertising and promotion locally in Idaho.

2. Investigation: The credit check of the borrower and the appraisal of the collateral were all done in Idaho.

3. Negotiation: Terms and loan to value amounts were negotiated by the local office.

4. Approval: The local Idaho offices had underwriters who had approval authority for "in house" loans. Only the independent broker loans had to be sent to [Redacted], Idaho for approval.

5. Administration: The local offices did some of the administration work. They accepted payments at their offices and corresponded with customers.

Petitioner claims that "In some cases, [Redacted] employees may have passed along a solicitation to an Idaho customer in the course of [Redacted] doing business with that customer." This statement minimizes the activities of both [Redacted] and the Bank. One of Petitioner's arguments is the fact that they try to sell the loans as quickly as possible. By their own admission, in the majority of cases, they are simply transferring these loans to another [Redacted].

The Audit Bureau's investigation found that the Idaho offices of [Redacted] performed all the stages of the home loan business. There were loan officers, underwriters, and clerical staff employed in Idaho. These employees accepted payments for either mortgage loans or home equity lines (HELOC). SINAA activities in Idaho were further identified by the Audit Bureau as follows:

1. Solicitation: [Redacted] engaged in aggressive advertising and promotion locally in Idaho. [Redacted] engaged in radio advertisement and saturation mailing promotions. [Redacted] had a complete structure for loan, mortgage, and real estate sales located in Idaho.

2. Investigation: The credit check of the borrower and the appraisal of the collateral were all done in Idaho. The brokers and lenders assisted the borrowers in completing loan applications. Required documents, such as proof of employment, tax returns, and bank statements, were submitted to the local Idaho office.

3. Negotiation: Terms and loan-to-value amounts were negotiated by the local Idaho office. The policies may have been established in general in [Redacted], however, this is a test of where the preponderance of substantive contact with the borrowers took place, which was in Idaho. The local employee screened loan packages for qualification. The Idaho loan officer communicated the loan-to-value limit and communicated that information to local real estate agents, builders, and other borrowers in Idaho.

4. Approval: The local Idaho underwriters were given approval authority for "in house" loans. Inquiries with the [Redacted] loan officer indicated that underwriters existed in each Idaho office, and only the loans originated by the independent broker loans or wholesale loans had to be sent to [Redacted], Idaho, for approval. Petitioner was also making SBA loans up through 2006 and would be most likely a [Redacted] loan. No loan balances were given for that type of loan, and the Audit Bureau made no estimates for SBA loans.

5. Administration: The local Idaho office did administration. It accepted payments and corresponded with customers. The employee structure indicates that administration would be done in Idaho during the loan origination process. Servicing may have been transferred out of Idaho after origination. Section 4 (i) indicates that the period for which properly assigned loans remain indicates that, absent any change in material facts, the loan remains assigned to Idaho for the length of the original term of the loan.

Again, according to the Petitioner's website, it had [Redacted] locations in taxable year 2006, and according to Idaho payroll tax records, it had [Redacted] employees assigned to Idaho during taxable year 2006. The significant number of employees in Idaho, which included high level employees, suggests that a large part of the SINAA activities would take place in Idaho.

According to tax and payroll documents filed with or available to the Commission, [Redacted] employees working in Idaho during taxable years 2004 through 2006 had the following job titles:

[Redacted]

[Redacted]The following was a written response to an inquiry with a loan officer in the [Redacted], Idaho, office about their local process. This correspondence was specifically requested in connection with the refinance of a [Redacted] that was originated through an independent broker. The protest letter denies this process takes place in Idaho.

> "Your approval will take 48 hours and the underwriting is done here locally ([Redacted]) when they are manual underwrites, but in this case your file will be underwritten in my office by our underwriter. Only when I broker loans do we have to wait until their underwriting gets to our files. Most lenders like US

> Bank have centralized underwriting, and this takes forever and that is why we feel that we are better since we can underwrite and fund from our office."

Petitioner has argued that because wholesale loans submitted by an independent broker had to be sent to the main office out of state for approval that a SINAA analysis would source these loans to that state. However, Petitioner's argument only relates to the "approval" factor; the solicitation, investigation, and negotiation would have been conducted in Idaho by the independent brokers. The Audit Bureau additionally supports placing these loans in Idaho because:

1. First, the loan applications from independent brokers were submitted to the local Idaho office to be controlled and managed by the Idaho loan officer.

2. The Idaho loan officer did the initial work to verify the completeness of the file, the credit report and all the documents required by [Redacted] prior to sending out for any underwriting.

3. The approval was made at a central Idaho location, [Redacted], and then communicated back to the [Redacted], location.

4. The Idaho employee was the main "contact" for both the borrower and the loan broker

5. The Idaho loan officer communicated with the escrow and title company to close the transaction.

The Commission's July 7, 2008, Summons asked for a detailed explanation of the Idaho business activities of [Redacted]. The Petitioner's written response was:

> "The Idaho business activities of [Redacted] are related to originating, selling and servicing single-family mortgage loans and providing related mortgage banking services for investors and customers."

It appears from this answer that the preponderance of the warehouse retail loan, warehouse wholesale, [Redacted], and installment loan solicitation, investigation, negotiation, approval, and administration was in Idaho. The warehouse retail loans were underwritten in

[Redacted], Idaho. The fact that the loans were held for re-sale to other investors is not seen as material.

The "one-time close" loans have intense lender involvement through the entire construction phase at their location which was in Idaho.

The Audit Bureau was conservative in the assignment of loans and did not attempt to include other categories of loans that probably could have been. For example, Petitioner had reported interest income received by the Bank from commercial loans. Yet, these loans were not included in the property factor numerator by Petitioner or the Audit Bureau. There were other similar indicators suggesting the existence of Idaho loans that were not included in the property factor numerator. The Audit Bureau was reasonable and conservative by only including loans that had a customer address and collateral in Idaho in the information summonsed from Petitioner.

The Commission upholds the adjustments made by the Audit Bureau regarding the inclusion of loans in the property factor.

c. Assignment of credit card receivables in the property factor.

For purposes of determining the location of credit card receivables, credit card receivables are treated as loans and are subject to the provisions of subsection (g) of section 4 regarding the Property Factor in the MTC Recommended Formula for Financial Institutions.

The Audit Bureau's October 7, 2008, summons asked for a detailed explanation of the Idaho business activities of [Redacted]. Petitioner's response was:

> The Idaho business activities of [Redacted] are related to originating, selling and servicing single-family mortgage loans and providing related mortgage banking services for investors and customers.

The Audit Bureau also asked about the unsecured loan (i.e., credit card loan) balances for Idaho borrowers. Petitioner's response was:

> We have mortgage loan offices in Idaho. These offices make loans that are secured by real estate. There is a minimal amount of credit card interest in Idaho that has been listed in our receipts factor.

The Audit Bureau estimated the receivable balance of unsecured loans (credit card loans) by using an estimated average interest rate of 10 percent. The amount of interest income, identified as being from Idaho sources was, divided by 10 percent to arrive at the estimated receivable balance at the end of each year.

Without the exact numbers to detail loan by loan under SINAA standards, this is a reasonable amount. The Commission, however, makes it clear that the rule calls for specific loan by loan information.

5. The Bank's presence in Idaho.

Petitioner argues that it had no Bank personnel in Idaho and, therefore, no nexus. The Bank did not have any official "[Redacted]" retail offices in Idaho. However, based upon income tax returns, W-2s, and other information filed with or available to the Commission, it appears the Bank did have personnel in Idaho conducting business. Numerous Bank employees operated at several of the [Redacted] offices, providing a wide variety of services. Additionally, a loan officer at the [Redacted], Idaho, branch indicated that SBA loans as well as unsecured business lines of credit were made in Idaho at [Redacted] locations through taxable year 2006.

In reviewing the income tax returns of Bank employees, the following job titles for the Bank during the years 2004 through 2006 existed in Idaho:

a. [Redacted].

The Bank holds themselves out to the public as doing business under any of the subsidiary names interchangeably as reported in their Form 10-K filed with the SEC. The list of names used by [Redacted] included [Redacted] among others. Loans made by a lender through an office using a different name or through the office of an affiliate are included in Petitioner's property factor. Again, the contacts with the borrower in originating the loans would have taken place in Idaho. The Commission upholds the adjustments by the Audit Bureau in the property factor.

6. Penalties

The Audit Bureau asserted both the 5 percent negligence penalty and the 10 percent substantial understatement penalty. The negligence penalty was asserted due to Petitioner's failure to provide substantiation for its claims.[34] The substantial understatement penalty was asserted because the underpayment of tax exceeded 10 percent of the tax required to be shown in all three years.[35]

Petitioner asserts that the negligence penalty is not warranted. Petitioner believes it is unreasonable for the Audit Bureau to request a 51-state breakdown. Petitioner argues that such a report would be impossible to produce in a comprehensible format. The Commission finds the negligence penalty was correctly asserted.[36] Most of the Audit Bureau's requests for information were not answered by Petitioner. The 51-state breakdown was just one of many requests. This type of report had been provided in an earlier audit cycle.

[34] Idaho Tax Commission Administration and Enforcement Rule 410.02.k. and 410.02.l.
[35] *See* Idaho Code § 63-3046(d).
[36] *See* IDAPA 35.02.01.410.02.

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."[37] While some adjustments have been made after Petitioner provided additional information during the protest, the bulk of the deficiency remains and is based on aggressive positions taken by Petitioner. The Commission is unable to find that Petitioner had reasonable cause for the understatement. The Commission does not believe that waiver of the substantial understatement penalty is warranted under the circumstances.

THEREFORE, the Modified Notice of Deficiency Determination dated April 27, 2010, referenced above is hereby AFFIRMED (as modified by the IRS audit changes) and MADE FINAL.

[37] Idaho Code § 63-3046(d)(7).

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

YEAR	TAX	PENALTY	INTEREST	TOTAL
12/31/2004	[Redacted]	[Redacted]	[Redacted]	[Redacted]
12/31/2005	[Redacted]	[Redacted]	[Redacted]	[Redacted]
12/31/2006	[Redacted]	[Redacted]	[Redacted]	[Redacted]
			[Redacted]	[Redacted]

Interest is calculated through February 16, 2012, 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 Petitioner's right to appeal this decision is enclosed. As set forth in the enclosed explanation, Petitioner must deposit with the Commission 20 percent of the total amount due in order to appeal this decision.

DATED this _____ day of _____ 2011.

IDAHO STATE TAX COMMISSION

_____

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____ 2011, 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.

_____