

March 10, 2025. Having reviewed all available information, the Tax Commission makes its decision on the penalties.

LAW AND ANALYSIS

In 1994, the Multistate Tax Commission (MTC) issued a recommended formula for the apportionment and allocation of net income of financial institutions (financial rule), and the Tax Commission adopted the MTC financial rule in Idaho Income Tax Administrative Rule 582. The financial rule contains variations from Idaho's standard apportionment methods set forth in Idaho Code section 63-3027. Variations that are particularly significant in this case are the inclusion of intangibles, i.e. loans, in the property factor and the apportionment of intangibles to a state where a loan has a preponderance of substantial contacts, i.e. solicitation, negotiation, investigation, approval, and administration, or SINAA. The MTC amended the financial rule in 2015¹, but Idaho has not adopted the amendments. Therefore, for Idaho purposes, the definition of "financial rule" is that adopted in 1994 (old financial rule)². The old financial rule does not provide clear guidance or a method to measure "preponderance" nor does it clarify whether preponderance should be determined in each activity or in all activities as a whole. It is also not clear whether each activity should be weighed equally or differently based on the nature of each activity and its involvements, e.g., volume, time, effort, complexity, resource, etc. Because of the ambiguity in the old financial rule, the preponderance of substantive contacts is not easily determinable.

During the hearing, Petitioner argued that the outdated provisions of the Idaho statute and rules regarding loan assignment are the root cause for the penalties. Petitioner requested the Tax

¹ The MTC's amendments in 2015 removed intangibles (loans) from the property factor calculation, which would eliminate the ambiguity in the old financial rule. However, Idaho has yet to adopt the 2015 amendment.

² When a financial institution lent a loan to a borrower in Idaho, if 3 or more activities out of the 5 activities occurred in another state, the old financial rule would require the financial institution to assign 100% of the loan to another state, instead of prorating the loan based on the number of activities, e.g., 60% (3 divided by 5 activities)

Commission waive both substantial understatement and negligence penalties as there was reasonable cause for the understatement, and they acted in good faith.

The substantial understatement penalty is set forth in Idaho Code section 63-3046(d).

- (1) If there is a substantial understatement of tax for any taxable year, there shall be added to the tax an amount equal to ten percent (10%) of the amount of any underpayment attributable to such understatement.
- (2) For purposes of this subsection, there is a substantial understatement of tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of:
 - (i) Ten percent (10%) of the tax required to be shown on the return for the taxable year, or
 - (ii) Five thousand dollars (\$5,000).
- (4) For purposes of paragraph (d)(2) of this section, the term "understatement" means the excess of:
 - (i) The amount of tax required to be shown on the return for the taxable year, over
 - (ii) The amount of the tax imposed which is shown on the return.

The computation of the amount of the understatement of tax and the determination that it is substantial are mechanical processes under subsections (2) and (4) of the quoted subsection. In the present case, the substantial understatement of Idaho loans resulted in a tax deficiency, which exceeded the threshold provided in Idaho Code section 63-3046(d)(2)(i) and (ii).

As for the negligence penalty, Idaho Code section 63-3046(a) states,

If any part of any deficiency is due to negligence or disregard of rules but without intent to defraud, five percent (5%) of the total amount of the deficiency (in addition to such deficiency) shall be assessed, collected and paid in the same manner as if it were a deficiency.

Tax Administration and Enforcement Rule 410.02., further clarifies that,

[a] five percent (5%) negligence penalty shall be imposed if the deficiency results from either negligence by the taxpayer or from disregard by the taxpayer or his agent of state or federal tax laws, rules of the Tax Commission, or Treasury Regulations. Example of situations that justify the negligence penalty include the following:

a. Taxpayer continues to make errors in reporting income, sales or assets, or claims erroneous deductions, exemptions, or credits even though these mistakes have been called to his attention in previous audit reports.

Idaho Code section 63-3046(d)(7) is applicable not just to the substantial understatement penalty but also to the negligence penalty, and states:

[t]he state tax commission may waive all or any part of the addition to tax provided by this section 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.

Petitioner has been under review by the Bureau for many tax years and simultaneously handled multiple Idaho audits³. The primary issue in all cases is the assignment of loans to Idaho based on the preponderance of substantive contacts following the old financial rule⁴. Petitioner's position has always been that the preponderance of substantive contacts did not occur in Idaho and therefore they are not required to assign any of their loans to Idaho. However, because of the ambiguity in the old financial rule, Petitioner recognizes that their business activities in Idaho may not be fairly represented. Therefore, to account for the flaws caused by the outdated provision, Petitioner, in prior audits, agreed to assign twenty percent (20%) of their loans to Idaho borrowers.

³ The audit for tax years 2008 through 2010 (2008-2010 audit) started in November 2011 and resolved in January 2015. By the time the 2008-2010 audit resolved, Petitioner had already filed their 2013 Idaho return. The audit for tax years 2013 through 2015 (2013-2015 audit) started in September 2016. The Bureau conducted a field audit in May 2017 and received an executed waiver in June 2017. After the Bureau followed up with Petitioner about information request in October 2017, there was no contact with Petitioner until July 2018. Petitioner timely filed their 2016-2018 returns, with the last return 2018 received on October 15, 2019. The 2013-2015 audit resolved in April 2021. As Petitioner confirmed during the informal hearing, the Bureau did not instruct Petitioner to file amended returns for tax years 2016-2018 based on the resolution of the 2013-2015 audit. The current audit for tax years 2016 through 2018 (2016-2018 audit) started in November 2019, which is before resolving the 2013-2015 audit. Petitioner started corresponding to the Bureau's 2016-2018 information request in March 2021, one month before the 2013-2015 audit had resolved. It is unrealistic to expect Petitioner to amend their 2016-2018 returns when the Bureau had already started reviewing them.

⁴ The old financial rule is as the MTC established in 1994. Idaho has not adopted the MTC's 2015 amendments.

The Tax Commission finds that Petitioner applied their best effort to effectuate an equitable apportionment of their income by applying an alternative method⁵ despite the ambiguity in the old financial rule. The Tax Commission finds that there was reasonable cause for the understatement (or part thereof) and that Petitioner acted in good faith. Therefore, the Tax Commission modifies the Notice to abate the penalties.

CONCLUSION

The Tax Commission abates the 5% negligence penalty and the 10% understatement penalty. The Notice added interest to the tax due amount, and the Tax Commission finds the addition appropriate in accordance with Idaho Code section 63-3045. The Tax Commission applies the payments received from Petitioner to this decision.

THEREFORE, the Tax Commission FURTHER MODIFIES the Notice dated August 14, 2024, directed to Petitioner.

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2016	\$567,241	\$0	\$142,463	\$709,704
2017	386,728	0	84,413	471,141
2018	793,724	0	139,369	933,093
			Less: Payment Received	(2,113,938)
			Total Due	<u>\$0</u>

An explanation of Petitioner's right to appeal this decision is enclosed.

DATED this _____ day of _____ 2025.

IDAHO STATE TAX COMMISSION

⁵ Idaho Code section 63-3027(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: (4) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____, 2025,
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:



Receipt No.
