BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of	)	
	)	DOCKET NO. 17740
[Redacted].,	)	
	)	DECISION
Petitioner.	)	
	)	

On August 29, 2003, the Income Tax Audit Division of the Idaho State Tax Commission issued a Notice of Deficiency Determination to [Redacted] (hereinafter referred to collectively as "taxpayer"), denying a claimed refund for the 1997 through 1999 taxable years and asserting additional corporate income tax and interest in the amount of $21,975 for the 1997, 2000 and 2001 taxable years. On October 31, 2003, the taxpayer filed a timely appeal and petition for redetermination. An informal hearing was held via telephone on April 27, 2004. The Tax Commission, having reviewed the file, hereby issues its decision.

I.

SUMMARY OF FACTS

[Redacted] provides "claims management" services to insurance companies and self-insured entities. It bills itself as "the world's largest independent provider of claims management solutions . . . with a global network of more than 700 offices in 67 countries. Major service lines include workers' compensation claims administration and healthcare management services, property and casualty claims management, class action services, and risk management information services." [Redacted] (accessed 2/12/04). The company is headquartered in [Redacted]. According to its website, the company has at least two offices in Idaho. [Redacted] (accessed 2/12/04).

[Redacted] filed amended Idaho corporate income tax returns for the 1997 through 1999 taxable years. On each of these amended returns, the company adjusted the Idaho sales factor by recharacterizing virtually all of the sales that had originally been included in the Idaho numerator as non-Idaho sales. According to the company, the sales factor was adjusted to correctly reflect where a greater portion of the income-producing activity took place. The amended returns were selected for audit, along with the company's 2000 and 2001 Idaho corporate income tax returns. The audit staff disallowed the amended returns and made further adjustments to the 1997, 2000, and 2001 Idaho returns, resulting in a tax deficiency as follows:

Year	Tax	Penalty	Interest	Total
1997	$7,695	$-0-	$3,069	$10,764
1998	*Claimed refund of $3,913 disallowed. No other adjustments made*			
1999	*Claimed refund of $5,294 disallowed. No other adjustments made*			
2000	4,971	-0-	837	5,808
2001	4,950	-0-	453	5,403
TOTALS	17,616	-0-	4,359	21,975

II.

ISSUE

The issue raised in this protest centers on whether certain sales revenue from risk management and related services should be included in the Idaho sales factor numerator. This determination turns on whether a greater proportion of the income-producing activity giving rise to the service revenue took place in Idaho. The audit staff contends that the taxpayer has not provided sufficient documentation to support the recharacterization from "Idaho sales" to "non-Idaho sales" as set out in the amended 1997 through 1999 returns, or to establish that the audit adjustments made to the 1997, 2000, and 2001 returns are incorrect. The taxpayer, on the other hand, contends that it has supplied all the information and documentation that is readily available and that the additional information requested by the audit staff is too burdensome to compile or produce.

III.

OPINION

Under the Idaho Income Tax Act, business income of a corporation is apportioned to the state of Idaho based on that corporation's Idaho apportionment factor. Idaho Code § 63-3027. The Idaho apportionment factor is made up of the property factor, the payroll factor, and the sales factor. Idaho Code § 63-3027(k), (n), and (p). The Idaho sales factor is computed by dividing the corporation's sales taking place within Idaho by its total sales everywhere. Idaho Code § 63-3027(p). With respect to the sale of services and "nontangible" property, the sale is treated as taking place within Idaho if "a greater proportion of the income-producing activity is performed" in Idaho than in any other state. Idaho Code § 63-3027(r)(2). The location of the income-producing activity is determined by the costs of performance. *Id.*

The "income-producing activity" test set out in Idaho Code § 63-3027(r)(2) is one of the most troublesome aspects of the UDITPA statute. *See, e.g.* Hellerstein & Hellerstein, State Taxation, ¶ 9.18[3][a] (3rd ed.) ("For service providers that do the bulk of their work in a single state, the UDITPA [income-producing activity] rule will produce substantially the same results as the traditional rule of attributing receipts to a state on the basis of the ratio of expenditure of time or costs incurred in the state. However, where the services involve the expenditure of substantial amounts of time or costs in more than one state, the UDITPA rule often produces capricious and inequitable results.") Under the UDITPA "income-producing activity" test, which has been adopted in Idaho, the sales of other than tangible property are included in the Idaho numerator if the greater proportion of the "income producing activity . . . based on costs of performance" took place in this state. Where the income producing activity giving rise to the income has taken place in more than one state, the determination of which state should include the income in its sales factor numerator can be quite demanding. *Id.* ("Indeed, the difficulty and expense of tracing costs-of-performance on a state-by-state basis, especially when records of such costs are not maintained in the ordinary course of the taxpayer's business, can be overwhelming."). As will be discussed in greater detail below, the present protest highlights the difficulty a multistate service business can run into in trying to establish where the greater portion of its income-producing activity takes place.

Although the UDITPA "income-producing activity" test is by no means perfect, it remains the test set out in the Idaho statutes. Unless and until the Idaho Legislature implements a new test, taxpayers providing services within this state must comply with the current test. In addition, this Commission has the duty to enforce the tax laws of this state as written; and has the duty to audit taxpayers to determine if they are complying with the mandates of the Idaho tax laws. Thus, while we empathize with the potentially burdensome record-keeping required to prove whether the majority of income-producing activity took place within or without Idaho, such record-keeping is nonetheless required in order to clearly establish the source of income derived from services.

In an effort to provide some useful guidance in determining whether income from services should be included in the Idaho numerator, the Idaho State Tax Commission has adopted an administrative rule further defining the term "income-producing activity." According to Idaho Income Tax Administrative Rule 550.02, "[t]he term income producing activity applies to each separate item of income and means the transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of obtaining gains or profits." IDAPA 35.01.01.550.02. *See also* Idaho Income Tax Administrative Rule 550.03, IDAPA 35.01.01.550.03 ("Costs of performance are the direct costs determined according to generally accepted accounting principles and accepted conditions or practices of the taxpayer's trade or business."). Under Idaho law, the focus of the "income-producing activity" inquiry is on the direct costs associated with the generation of the income in the taxpayer's regular course of business. Indirect costs relating to the generation of the income, such as compensation paid to officers and directors and other general and administrative costs, are not considered.

In addition to promulgating an administrative rule further defining the meaning of the term "income-producing activity," the Tax Commission has also adopted an administrative rule dealing specifically with the performance of personal services. According to Idaho Income Tax Administrative Rule 550.05.d, IDAPA 35.01.01.550.05.d:

> d. Gross receipts for the performance of personal services are attributable to Idaho to the extent the services are performed in Idaho. If services relating to a single item of income are performed within and without Idaho, they are attributable to Idaho only if a greater portion of the services were performed in Idaho, based on costs of performance. Usually if services are performed within and without Idaho, they constitute a separate income producing activity. In this case the gross receipts attributable to Idaho are measured by the ratio that the time spent in performing the services in Idaho bears to the total time spent in performing the services everywhere. Time spent in performing services includes the time spent in performing a contract or other obligation that generates the gross receipts. This computation does not include personal service not directly connected with the performance of the contract or other obligation, as for example, time spent in negotiating the contract.

Id.

In the past it appears that [Redacted] treated the gross receipts from its business operations in a manner consistent with Idaho Income Tax Administrative Rule 550.05.d. If the income related to services performed by an employee assigned to one of the taxpayer's Idaho offices, the income was included in the Idaho numerator. If the income related to services performed by an employee assigned to an office outside of Idaho, the income was not included in the Idaho numerator. The presumption being that if the services were performed by an employee assigned to one of the taxpayer's Idaho offices, the majority of the time spent in performing the services likely took place in Idaho. Given the nature of the taxpayer's business operations, this treatment appears to be entirely reasonable. However, in 2000 the taxpayer began looking more closely at where its income-producing activity was taking place, resulting in the conclusion that much of the income-producing activity formerly attributed to Idaho was actually taking place at the home office in [Redacted]. According to the letter of protest:

> [Redacted] provides the [described] services throughout the world. . . . These services are complex and often involve multiple steps. To complete a specific service for a particular client, [Redacted] generally must utilize the personnel, computer systems and other facilities from more than one of its 400 U.S. offices. Additionally, [Redacted] offices are actively involved in the initial reporting and assignment of essentially all domestic claims . . .
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> [Redacted] maintains Idaho offices primarily to handle the insurance and risk management needs of its multi-state and multi-national clients that arise in Idaho. Most of the assignments handled by the Idaho offices come from referrals from within the [Redacted] network. In providing services, the Idaho offices rely on other [Redacted] offices in other states for provider bill auditing, utilization review, direct repair network . . . etc. To underscore the Idaho offices' dependence on other [Redacted] offices, [Redacted]has only 16 Idaho employees as compared to approximately 8,000 worldwide.
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> . . . . [Redacted]'s trade or business, i.e., its income producing activity, is the provision of comprehensive and integrated insurance and risk management related services . . . This income producing activity is performed both inside and outside of Idaho. The attached schedules summarize [Redacted]'s U.S. unitary costs of performance for the years 1997-2001. Based on costs of performance, the greater proportion of [Redacted]'s income producing activity does not occur in Idaho.

Letter of protest, pp. 4 – 5.

The Tax Commission's audit staff does not necessarily disagree with [Redacted]'s analysis. Rather, the audit staff has asked for detailed records showing the **direct costs** associated with each item of income generated by or through the Idaho offices. The information provided by the taxpayer with its letter of protest was not specific enough for the audit staff to analyze and come to its own conclusions about where the income-producing activity takes place. In effect, the audit staff's position in this protest is that [Redacted] has provided insufficient documentation to support its position.

During the informal conference, it was agreed that [Redacted] would try to provide sufficient documentation to address the audit staff's concerns. Several weeks after the conclusion of the informal conference the Commission's audit staff sent the taxpayer a detailed request for "information to substantiate [[Redacted]'s] claim that under the requirements of cost of performance [Redacted] does not have Idaho Sales." Letter from [Redacted] dated May 21, 2004. The request for additional information required [Redacted] to provide the following:

1. Access to Idaho employees familiar with the claims approval process, for both medical and casualty claims, from the time the claim is received until the case is closed.

2. A list of all Idaho jobs, by job number, date or whatever method is used to track the work process. The list should include the name of the insurer, name of the claimant and the work performed.

3. Schedules of the Idaho office/location expenses, for each year. Please provide detail of the expenses by account, e.g. wages (broken down by employee classification), office supplies, postage, data processing, rent, utilities, repairs, maintenance, depreciation, etc.

4. If [Redacted] employees from outside Idaho performed services in Idaho, provide a list of these employees, their job classification and the percentage of time spent in Idaho.

5. Schedules showing Idaho sales for [Redacted]'s internal book reporting purposes. Are these sales assigned [to] Idaho by location of the services performed or location of the client? Please explain.

6. Does [Redacted]'s Idaho office report to a regional office(s)? If yes, provide names [of] the office managers in the regional office(s).

7. Provide access to billing invoices for work performed in Idaho during the audit period (1997-2001).

8. Provide access to employee time sheets showing employee time billed to specific jobs.

9. Provide a copy of a billing schedule that shows how customers are billed for the work performed in Idaho.

Id. In response the representative for [Redacted] submitted a letter stating that the requested information was either unavailable, irrelevant, or too burdensome to compile. Letter from [Redacted] dated June 8, 2004. Quoting at length from that letter:

> Recently, [Redacted] received an information request from [Redacted] regarding its ongoing cost of performance issue. . . . As you can see, this request is rather exhaustive and will require a significant effort to answer. Furthermore, considering how [Redacted] manages its operations, responding to this information request is especially burdensome. [Redacted] conducts its U.S. operations through more than 400 branches, 3 to 5 (depending upon the year) of which are in Idaho. Obviously, to manage its numerous branches efficiently and effectively, certain data and information are either transferred from or otherwise made available by the branches to [Redacted] headquarters. However, the level of detail of financial information needed to manage the branches does not reach the detail that [Redacted] is requesting.
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> Regarding the items that [Redacted] has asked for, it will be difficult for [Redacted] to comply with the respective items for the following reasons:
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> **Item 1:** Only certain employees in the Idaho branches are familiar with the entire claims handling process. [Redacted] will need to arrange their schedules in order to make them available to meet with auditors.
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> **Item 2:** Jobs are identified by a combination of branch and file number. For example, each branch would start with file number 00001 and go through 99999. [Redacted] does not maintain a listing of "Idaho jobs". To obtain this information, a search of all Idaho employees in the payroll system would have to be performed. Once each Idaho employee was known, the billing system could be searched for all the billings done by each employee. The billing system would not necessarily have all the data requested by [Redacted] (name of insurer, name of claimant, and the work performed) so other systems would have to be searched to attempt to comply with this request.
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> **Item 3:** [Redacted] can provide the standard branch income statements that are prepared for the branches in the normal course of business.

However, these income statements do not have the detail that [Redacted] seeks. For example, wages are not broken down by employee classification. Special reports would have to be requested from the payroll system. [Redacted] is currently converting from one payroll system to another. Because all of the payroll management and IT personnel are working overtime to implement the new system, a request for special payroll reports at this time would be unduly burdensome.

Item 4: [Redacted] does not track where each employee performs his assignments. Accordingly, there is no way to determine which employees from outside Idaho may be performing services in Idaho or how to provide the requested information.

Item 5: For book purposes, cases are assigned to the closest servicing office. Providing detailed schedules of book revenue for the Idaho office would be very time consuming because of the high-volume, low-dollar amount of the billing and because of the complexities of the book revenue accounting, e.g. for book purposes, revenue is recognized at estimated collectible amounts in unbilled revenue at the time services are rendered; out-of-pocket costs that are incurred in administering a claim are passed on by [Redacted] to its clients and are excluded from revenues and recorded as a reduction to cost of services provided; and deferred revenues represent the estimated unearned portion of fees derived from certain fixed-rate claim service agreements.

Item 6: [Redacted]'s Idaho offices report to a regional office. However, the regional structure changed several time during the audit period as business units were restructured to better meet the needs of [Redacted]'s clients at the time.

Item 7: As noted in Items 4 and 5, [Redacted] does not track where work is performed. Instead, [Redacted] tracks which office handles the work. If, for example, a [Redacted] office is closer to property damaged in Idaho, the claim could be assigned to the [Redacted] office and would be considered in the [Redacted] office's book revenues. It would be a major undertaking to go into the billing system and reprint every invoice for the 1997-2001 audit period for every Idaho branch. Some invoices are sent from the branches and some are sent from [Redacted]'s head office. In addition, some of the invoices sent from the head office are combined to cover multiple jobs in multiple states.

Item 8: [Redacted] does not maintain "employee time sheets". A significant portion of [Redacted]'s business is done on a "flat rate" basis and no time is charged to the file. If the client arrangements call for "time and expense" billing, time is charged to the file but such data would have to be obtained from the billing system on a case-by-case basis.

> **Item 9:** [Redacted] does not have a billing schedule for each state. Most of its clients are national accounts and billing arrangements are made on a client basis. The only way [Redacted] could comply with this request would be to search the billing system for all the client numbers served by the Idaho branches during the audit period and then produce the billing arrangement for each client. During the audit period, the Idaho branches would have worked on hundreds and probably thousands of clients.
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> In general, none of the requested information is readily available. To comply with the requests would require significant time and expense.

Letter from [Redacted] dated June 8, 2004, pp. 1 – 2.

The taxpayer's representative has done an excellent job of specifying why the information requests submitted by the audit staff would be burdensome to comply with. Thus, we are not dealing with a situation where a taxpayer has made a general, yet ultimately unsupported, claim that complying with an audit request is unduly burdensome. In reviewing the representative's June 8 letter, we concede that he has made some valid points. As a result, we are faced with a difficult dilemma. On the one hand, the audit staff is entitled to request and review information relevant to determining whether the taxpayer's claim is correct. On the other hand, the taxpayer has provided a very specific explanation of the difficulty associated with answering the audit staff's requests. Neither side is clearly wrong.

Based on the record currently before this Commission, we are unable to make any definitive findings one way or the other on the ultimate question of fact presented in this protest. It may be true, as asserted by [Redacted], that the greater proportion of the taxpayer's income-producing activity takes place at the [Redacted], headquarters. However, the record as it now stands does not clearly support that finding. The schedules and spreadsheets provided by the taxpayer's representative simply summarize the "cost of performance" data based on the taxpayer's claim that the majority of the income-producing activity takes place in [Redacted].

There is no supporting documentation and it appears that the data used by [Redacted] may have been skewed by the inclusion of general administrative expenses that are not directly related to the income generated from the Idaho branch offices. In short, there is no convincing evidence that the majority of the income-producing activity, measured only by direct costs, takes place in [Redacted].

This protest ultimately comes down to the burden of proof. It is well established in Idaho that a Notice of Deficiency Determination issued by the Tax Commission's audit staff is presumed to be correct and that the taxpayer bears the burden of establishing that the deficiency determination is factually or legally incorrect. See Albertson's Inc. v. State, Dept. of Revenue, 106 Idaho 810, 814 (1984) (a determination of the State Tax Commission is presumed to be correct); Parsons v. Idaho State Tax Commission, 110 Idaho 572, 574-575 n.2 (Ct. App. 1986) (a State Tax Commission deficiency notice is presumed to be correct and the burden is on the taxpayer to show that the deficiency is erroneous). While we find this to be a close case, in the end we are not convinced that [Redacted] has met its burden of establishing that the Notice of Deficiency Determination is incorrect.

WHEREFORE, the Notice of Deficiency Determination dated August 29, 2003, is hereby APPROVED, AFFIRMED AND MADE FINAL.

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

YEAR	TAX	PENALTY	INTEREST	TOTAL
1997	$7,695	$-0-	$3,635	$11,330
1998	*Claimed refund of $3,913 disallowed.*			
1999	*Claimed refund of $5,294 disallowed.*			
2000	4,971	-0-	1,202	6,173
2001	4,950	-0-	817	5,767

TOTALS	$17,616	$-0-	$5,654	$23,270

Interest is calculated through January 31, 2005, and will continue to accrue at the rate set forth in Idaho Code § 63-3045(6) until paid.

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

An explanation of the taxpayer's right to appeal this decision is enclosed with this decision.

DATED this ______ day of ____________________, 2005.

IDAHO STATE TAX COMMISSION

____
COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ____ day of __________________, 2005, 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]
[Redacted]
[Redacted]
[Redacted]

Receipt No.

[Redacted]
[Redacted]
[Redacted]

[REDACTED]

____