

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Combined Protest of)
[Redacted]) DOCKET Nos.
Petitioners.) 17975, 17976, 17977, and
) 17978
)
) DECISION
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On January 9, 2004, the Income Tax Audit Division of the Idaho State Tax Commission issued Notices of Deficiency Determination to [Redacted] subsidiaries of [Redacted]. Those [Redacted] subsidiaries are [Redacted]. In those Notices of Deficiency Determination the Income Tax Audit Division made modifications to the 1995 through 1999 Idaho corporate income tax liability and Idaho net operating loss carryforward of each of the [Redacted] subsidiaries. On March 11, 2004, each of the [Redacted] subsidiaries filed a timely appeal and petition for redetermination. Those petitions have been combined for purposes of this administrative review.

An informal conference was held via telephone on September 24, 2004. The Tax Commission, having reviewed the file, hereby issues its decision upholding the four Notices of Deficiency Determination that have been combined for purposes of this administrative review.

I.

SUMMARY OF FACTS

The Notices of Deficiency Determination that are the subject matter of this combined protest were issued to [Redacted] subsidiaries [Redacted]. [Redacted] is the parent company of a diversified [Redacted] in the United States. [Redacted] is a [Redacted] company, with its operating activities being conducted through various subsidiaries and partnerships. [Redacted]

division conducts its operations primarily through a limited partnership [Redacted]. This partnership is owned by [Redacted] subsidiaries [Redacted]. During the years at issue, [Redacted] conducted part of its [Redacted] business in Idaho. As a result, each of the [Redacted] partners had an Idaho corporate income tax filing requirement. The income and apportionment factors of [Redacted] were passed through to the various partners based on the specific partner's ownership percentage. The pass-through income and factors were then used in the calculation of each partner's Idaho corporate income tax liability.

In September 2000 the Idaho State Tax Commission authorized the Multistate Tax Commission (MTC) to conduct an audit of [Redacted]. The audit was conducted under the MTC Joint Audit Program on behalf of a number of participating states. The primary purpose of the audit was to determine whether [Redacted] and its more than 50% owned subsidiaries were engaged in a single unitary business. The Notices of Deficiency Determination at issue in this combined protest were all based on the recommendations set out in the Audit Report issued by the MTC. In that Report, the MTC audit staff determined that [Redacted] and its more than 50% owned subsidiaries were part of a unitary business enterprise and computed the recommended Idaho tax deficiency on a unitary combined reporting basis. [Redacted] is not contesting this unitary finding.

In addition to recommending that [Redacted] and its more than 50% owned subsidiaries be treated as a unitary business, the MTC audit staff also recommended that the participating states use alternative apportionment to determine the sales factor of the [Redacted] that are engaged in the [Redacted] segment of [Redacted] business. [Redacted] maintains that the sales factor relating to the receipts from its [Redacted] business operations should be determined based

[Redacted] (1989). [Redacted]The Tax Commission’s audit staff has accepted the MTC recommendations and issued Notices of Deficiency Determination to the [Redacted] that were partners in [Redacted] using the “[Redacted]” described above. [Redacted] filed a timely protest of all [Redacted] Notices of Deficiency Determination, asserting that the requirements for alternative apportionment have not been met and that the standard apportionment formula should be applied.

II.

ISSUE

The only issue raised in this administrative protest is whether the alternative “[Redacted]” apportionment method recommended by the Multistate Tax Commission auditors should be used to determine the Idaho sales factor of [Redacted].

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 intangible 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, sales of services 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. Hellerstein & Hellerstein, *supra*. (“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.”). [Redacted].

During the years at issue in this combined protest, [Redacted]business was conducted primarily through [Redacted] As discussed above, [Redacted] is owned by [Redacted] In 1995, 1996, and 1997 each of the [Redacted] partners filed separate entity Idaho returns in which they computed the sales factor “based on the [Redacted].” [Redacted] However, sometime around 1998 [Redacted]Based on this Study, [Redacted] partners filed amended Idaho corporate income tax returns for 1995 through 1997 claiming a refund of tax. ([Redacted]). In those amended returns, the taxpayers revised their Idaho sales factor by including significantly less gross

receipts in the Idaho numerator. Each of the [Redacted] [Redacted]partners then filed their original 1998 and 1999 Idaho returns using the cost of performance methodology [Redacted].

As noted above, the 1995 through 1999 Idaho returns filed by the [Redacted] partners were audited by the MTC as part of a Joint Audit. At the conclusion of the MTC Joint Audit, the MTC audit staff determined that the cost of performance methodology used by the [Redacted] partners did not fairly represent the extent of the taxpayers' business activity in any of the participating states. Thus, the MTC audit staff recommended an alternative apportionment methodology based on the criteria set [Redacted]. As set out on page 29 of the MTC Audit Report:

It is clear to the MTC that the "allocation and apportionment provisions of Article IV do not fairly represent the extent" of [Redacted] business activity [Redacted] in the participating states. Since [Redacted] purports to be following the provisions in UDITPA for the attribution of its [Redacted] . . . , an alternative method needs to be applied to fairly attribute [Redacted]revenue. The [standard sales factor apportionment provisions] ([Redacted]) are not doing justice to the uniform distribution of revenue regarding [Redacted].

. . . .

[Redacted]For the reasons above . . . the MTC concludes that the Cost of Performance method simply does not work with a sufficient degree of accuracy to fairly represent the extent of the Taxpayer's business in each states.

[Redacted]. The Idaho State Tax Commission's audit staff accepted this recommendation and issued deficiency notices to the [Redacted] partners using the alternative "[Redacted]" sales factor method.[Redacted]

The taxpayers have not provided much in the way of argument or legal analysis in their letters of protest. The crux of the taxpayers' argument is simply that alternative apportionment is not warranted and that the standard method should be applied.

Because the state is asserting that alternative apportionment is warranted in this case, the state bears the burden of proving (1) that the standard apportionment provisions do not fairly represent the extent of [Redacted]'s business taking place in this state, and (2) that the proposed alternative apportionment formula is reasonable. Union Pacific v. Idaho State Tax Commission, 139 Idaho 572, 575, 83 P.3d 116, 119 (2004) (Union Pacific II). It is the first of these two requirements that is at issue in this protest. As pointed out by the Idaho Supreme Court in Union Pacific II:

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. See I.C. § 63-3027(s). The party asserting alternative apportionment bears the burden of showing that alternative apportionment is appropriate. *Burlington Northern, Inc. v. Idaho State Tax Comm'n*, 121 Idaho 808, 828 (1992).

Id. Thus, it is not sufficient to show that the [Redacted]method is “better” or that the [Redacted]method “more accurately” reflects [Redacted] activity in Idaho. Rather, the first requirement that must be met is a showing that the standard formula does not accurately reflect the taxpayer's business activity in this state. Moreover, the Commission's own Administrative Rules provide that departure from the standard formula is “permitted only in limited and specific cases . . . when unusual fact situations that ordinarily are unique and nonrecurring produce incongruous results” Income Tax Administrative Rule 560.01, IDAPA 35.01.01.560.01 (2004).

After careful consideration, we find that alternative apportionment is warranted in this case. There are essentially three factors we find to be most significant in this determination. First, sourcing the gross receipts from [Redacted], does not appear on its face to fairly reflect the contribution of the “market state” to the overall profitability of the business. There is no doubt

that the location of the income-producing property and the location of the company's employees are important in the generation of income [Redacted]; but the contribution to the profitability of the business from its property is reflected in the property factor and the contribution to the profitability of the business from its employees is reflected in the payroll factor. To make the sales factor so dependent on where the property and/or employees are located (as opposed to where the customers are located) over-emphasizes the contribution of the property and employees and under-emphasizes the contribution of the customer or the market. In fairness to [Redacted], this problem [under-emphasizing the contribution of the customer or market] is caused in large part by the specific language of the UDITPA statute as it pertains to sales from other than tangible property. More to the point, the UDITPA statute does not specifically address how sales from services should be accounted for in the sales factor numerator. *See Hellerstein & Hellerstein at ¶ 9.18[3][a]* (“UDITPA contains no provision dealing explicitly with the attribution of receipts from services for sales factor purposes. As a consequence, receipts from services are subject to UDITPA’s general rule for attributing all receipts other than receipts from the sale of tangible personal property.”) (Footnotes omitted).

Because the drafters of UDITPA apparently made little effort to craft a formula designed to emphasize the contribution of the “market state” when dealing with gross receipts from services, it is not all that surprising that the statutory formula occasionally leads to incongruous or inequitable results. But this systematic weakness in the standard apportionment formula as it applies to sales of services also makes it more likely that alternative apportionment will be needed to correct any inequities resulting from the mechanical application of the standard formula. The facts of this protest represent a paradigm situation where alternative apportionment is needed.

The second significant factor is the overall effect the application of the standard formula has on the Idaho sales factor calculation. While the actual tax amounts at issue in this case are not all that significant, the impact on the Idaho sales factor is material. [Redacted] See Union Pacific II, 139 Idaho at 577, 83 P.3d at 121 (“Distortion in one factor . . . does not necessarily result in unfair reflection of the business activity in the state; the other two factors may well mitigate the distortive effect of the third, so that, ultimately, the taxpayer’s business activity in the state is fairly represented through the combination of the three factors in the apportionment formula.”). Thus, application of alternative apportionment is warranted.

The final factor we find significant is the possibility that the cost of performance method used by [Redacted]

Taken as a whole, we agree with the MTC audit staff that the standard apportionment formula, [Redacted], does not fairly reflect the extent of [Redacted] business activity taking place in this state. As a result, we uphold the use of the alternative “[Redacted]” apportionment method utilized by the MTC audit staff. The Notices of Deficiency Determination issued to the [Redacted] partners of [Redacted] are, therefore, sustained.

IV.

CONCLUSION

WHEREFORE, the Notices of Deficiency Determination dated January 9, 2004, are hereby APPROVED, AFFIRMED AND MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that refunds of tax and interest be issued to the [Redacted] taxpayers affected by this combined protest as follows:

[Redacted] Interest is calculated through February 28, 2005, and will continue to accrue at the rate set forth in Idaho Code § 63-3045(6) until paid.

An explanation of the taxpayers' 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.