

**BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO**

In the Matter of the Protest of	)	
	)	DOCKET NO. 21735
[Redacted]	)	
	)	DECISION
Petitioner.	)	
	)	

On December 16, 2008, the Income Tax Audit Division (ITA) of the Idaho State Tax Commission (Commission) issued a Notice of Deficiency Determination (NODD) to [Redacted] (petitioner) asserting an Idaho income tax deficiency in the amount of \$221,389 for taxable year 2005. The petitioner filed a timely petition for redetermination and provided the ITA with additional information, which the ITA reviewed.

On December 22, 2009, the ITA modified its NODD changing the amount of Idaho income tax deficiency being asserted from \$221,389 to \$229,430. As modified, the amount of Idaho income tax was reduced slightly; however, the updating of the interest more than offset the decrease in the tax amount.

An informal conference was requested by the petitioner and was held on June 28, 2010.

The Tax Commission will use the modified tax deficiency amount as the starting point in its analysis of the petitioner’s administrative protest.

**I. ISSUE(S)**

[Redacted]

**II. IN GENERAL**

[Redacted]

<b>Table 1</b>	(A)	(B)	(C)
<b>Profit and Loss Report</b>	Direct	Allocation	Total
State	Local	From	Cost
	Costs	Corporate	P&L
Alabama	\$245,438	\$784,260	\$1,029,698

Arizona	366,764	1,717,666	2,084,430
Arkansas	123,020	421,694	544,714
Idaho	1,866,416	3,048,222	4,914,638
Iowa	216,980	322,801	539,781
Kansas	100,413	361,472	461,885
Mississippi	762,820	1,810,059	2,572,879
Missouri	267,463	441,272	708,735
Nebraska	148,177	194,563	342,740
New Mexico	66,009	486,083	552,092
North Dakota	372,171	788,181	1,160,352
Oklahoma	475,279	1,648,304	2,123,583
Tennessee	23,108	144,065	167,173
Texas	276,381	871,262	1,147,643
Total	<u>\$5,310,439</u>	<u>\$13,039,904</u>	<u>\$18,350,343</u>

Phoenix, AZ costs:

Administration	4,257,410
Other direct costs	<u>18,350,343</u>

[Redacted] \$40,958,096

[Redacted]

**Table 2 - Idaho Direct Cost Breakdown**

Idaho direct costs	\$1,866,416
Allocated costs:	
[Redacted]	1,488,489
[Redacted] costs	<u>1,559,733</u>
Total Idaho Costs	<u>\$4,914,638</u>

[Redacted]

**Table 3:**

Cost of Performance	(A) Internet Service Revenue	(B) Percent Of Service Revenue	(C) Allocation Phoenix Costs	(D) Direct Local Costs	(E) Total Direct Costs
State					
Alabama	\$ 3,657,008	3.51%	\$ 1,252,164	\$ 245,438	\$ 1,497,602
Arizona	11,463,418	11.01%	3,925,088	366,764	4,291,852
Arkansas	3,030,646	2.91%	1,037,697	123,020	1,160,717
Idaho	30,019,046	28.83%	10,278,556	1,866,416	12,144,972
Iowa	3,485,343	3.35%	1,193,385	216,980	1,410,365
Kansas	2,327,939	2.24%	797,089	100,413	897,502
Mississippi	16,235,083	15.59%	5,558,911	762,820	6,321,731
Missouri	2,813,211	2.70%	963,247	267,463	1,230,710
Nebraska	1,651,397	1.59%	565,440	148,177	713,617
New Mexico	2,695,599	2.59%	922,976	66,009	988,985

North Dakota	8,199,382	7.88%	2,807,478	372,171	3,179,649
Oklahoma	8,831,140	8.48%	3,023,793	475,279	3,499,072
Tennessee	878,471	0.84%	300,789	23,108	323,897
Texas	8,823,112	8.47%	3,021,044	276,381	3,297,425
Total	<u>\$104,110,795</u>		<u>\$35,647,657</u>	<u>\$5,310,439</u>	<u>\$40,958,096</u>

[Redacted]

### III. [Redacted] ANALYSIS

For a multistate corporation transacting business within Idaho, the allocation and apportionment provisions are found in Idaho Code section 63-3027.<sup>1</sup> The Idaho apportionment percentage is governed by Idaho Code sections 63-3027(i) through (s) and is used to determine the amount of business income apportioned to Idaho. The Idaho apportionment percentage typically consists of three percentages; a property factor percentage, a sales factor percentage, and a payroll factor percentage.<sup>2</sup>

The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer

<sup>1</sup> References to Idaho Code or Rules refer to the Idaho Code or Income Tax Administrative Rules in effect for the taxable year 2005 unless otherwise stated.

<sup>2</sup> Idaho Code section 63-3027(i).

everywhere during the tax period.<sup>3</sup> Idaho law defines “sales” as “all gross receipts of the taxpayer not allocated.”<sup>4</sup> Idaho Code sections 63-3027(q) and (r) govern the determination if a sale is a “sale of a taxpayer in Idaho[Redacted] Idaho Code section 63-3027(r) provides that sales, other than sales of tangible personal property, are in this state if: (1) the income-producing activity is performed in this state; or (2) the income producing activity is performed both in and outside this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance. “The 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.”<sup>5</sup> [Emphasis added.] The amount of income producing activity performed within Idaho is measured by the direct costs relating to that activity.<sup>6</sup>

Under the income producing activity test, “each separate item of income” must be independently analyzed to determine where the income producing activity, with respect to that item of income, took place.<sup>7</sup> It is this income producing activity “separate item of income” requirement that is a major part of the dispute between the petitioner and the ITA. The petitioner takes the position that the separate item of income requirement should be read broadly so as to apply at a level characterized as the stream of income flowing from its [Redacted] services. This position is described in the petitioner’s letter dated February 1, 2010, as follows:

[Redacted]

The ITA staff, on the other hand, basically views the income producing activity “separate item of income” requirement more narrowly so as to apply to the Idaho customers that gave rise

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<sup>3</sup> Idaho Code section 63-3027(p).

<sup>4</sup> Idaho Code section 63-3027(a)(5).

<sup>5</sup> Idaho Income Tax Administrative Rule 550.02, IDAPA 35.01.01.550.02.

<sup>6</sup> Idaho Income Tax Administrative Rule 550.03, IDAPA 35.01.01.550.03.

<sup>7</sup> Idaho Income Tax Administrative Rule 550.02, IDAPA 35.01.01.550.02.

to the income. This finding is set out in the ITA's explanation page attached to the NODD as follows:

[Redacted]

The argument over what constitutes an income producing activity "separate item of income" has been described by the Massachusetts courts as a "transactional" versus an "operational" argument. See Interface Group v. Commissioner of Rev., 72 Mass-App.Ct. 116, 918 N.E.2d 97 (2009); Boston Prof. Hockey Assoc., Inc. v. Commissioner of Rev., 443 Mass. 276, 820 N.E.2d 792 (2005). In Massachusetts, the courts apply the "operational" rather than the "transactional" approach.

In the case before the Commission, since the petitioner argues that the cost of performance analysis should be made based upon its "[Redacted] activity," the petitioner is basically arguing for an "operational" approach in determining the income producing activity "separate item of income." On the other hand, the ITA is essentially making a "transactional" argument by requiring the petitioner to identify those direct costs associated with the Idaho customers.

The Commission finds that the ITA "transactional" approach is more in line with Idaho's interpretation of the statutory language and is less susceptible to abuse and manipulation. The language contained within Idaho Income Tax Administrative Rule 550.05 dealing with special rules and examples supports a "transactional" interpretation. For example, Idaho Income Tax Administrative Rule 550.05.b. (the rental, lease, licensing or other use of tangible personal property in Idaho is a separate income producing activity from the rental, lease, licensing or other use of the same property while in another state); Idaho Income Administrative Rule 550.05.c. (A taxpayer owns ten (10) bulldozers. During the year, each bulldozer was in Idaho fifty (50) days. The receipts attributable to the use of each bulldozer in Idaho are separate

items of income); and, Idaho Income Tax Administrative Rule 550.05.e. (gross receipts from theatrical performances given in Idaho are separate items of income attributed to Idaho.)<sup>8</sup>

#### IV. FINDING

Determination of the scope and contours of the income producing activity “separate item of income” test is an issue of first impression in this state. Given the lack of any clear authority on point, the Commission accepts the “transactional” approach asserted by the ITA that the petitioner is required to provide sufficient detail on the direct costs associated with the Idaho customers and has failed to do so. To be clear, the petitioner may very well be correct that the Idaho [Redacted] revenue under a cost of performance analysis based upon direct costs should be assigned to [Redacted]; however, since detailed records showing the direct costs associated with **each item of income** generated by the petitioner’s Idaho internet customers has not been provided, the petitioner has not provided sufficient documentation to support a conclusion that more direct costs were incurred in another state than in Idaho with respect to the Idaho [Redacted] revenue. Furthermore, the Commission [Redacted] provided the Commission with sufficient detail on the direct costs associated with each Idaho customer; therefore, the petitioner would still not meet its burden of establishing that more direct costs were incurred in another state than in Idaho relating to the Idaho [Redacted] revenue. Even if the petitioner provides the required documentation, and it is shown that some or all of the Idaho [Redacted] revenue should be assigned to the [Redacted] numerator rather than the Idaho sales numerator, if the assignment of the Idaho service revenue to [Redacted] does not fairly represent the extent of the petitioner’s business activity within Idaho, the Commission reserves the right to require the petitioner to use an alternative apportionment method for taxable year 2005.

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<sup>8</sup> IDAPA 35.01.01.550.05.b through e.

As of the date of this decision, the petitioner has not provided information that would resolve this case in the petitioner's favor for taxable year 2005. It is the petitioner's burden of proving error on the part of the deficiency determination. Albertson's, Inc. v. State Dept. of Revenue, 106 Idaho 810, 814, (1984); Parsons v. Idaho State Tax Comm'n, 110 Idaho 572, 574 (Ct. App. 1986). Since the petitioner has not met this burden of proof showing that the NODD is incorrect, the Commission upholds the ITA's determination.

WHEREFORE, the Notice of Deficiency Determination dated December 16, 2008, as modified by the ITA on December 22, 2009, is hereby APPROVED, AFFIRMED, and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the petitioner pay the following taxes, penalty, and interest:

<u>PERIOD</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2005	\$ 185,505	\$0	\$52,389	\$237,894

Interest is calculated through December 31, 2010, and will continue to accrue at the rate set forth in Idaho Code § 63-3045(6) until paid.

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

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

DATED this \_\_\_\_\_ day of \_\_\_\_\_ 2010.

IDAHO STATE TAX COMMISSION

\_\_\_\_\_  
COMMISSIONER

**CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_\_ day of \_\_\_\_\_ 2010, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

Receipt No.

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