

The Petitioners assigned the [Redacted] revenue [Redacted] under a cost of performance analysis. However, the Division determined the cost of performance analysis used by the Petitioners was inappropriate in that it included indirect costs, such as licensing fees for instructional materials and management costs. When these particular costs are excluded from the cost of performance analysis, the greater cost of performance for providing the Idaho [Redacted] services occurs in Idaho rather than [Redacted].

HOLDING

The Tax Commission affirms the deficiency proposed by the Division. The purpose of the cost of performance test is to assign sales revenues to the principal place where the income-producing activity occurs. In this case, the principle place of the sale [Redacted] in Idaho where the [Redacted] services are provided, not [Redacted] where a variety of general administrative costs are incurred. Including the type of indirect costs advocated by the Petitioners skews the results and frustrates the purpose of the cost of performance test.

DISCUSSION

A. THE APPORTIONMENT OF BUSINESS INCOME.

1. The Apportionment Formula.

When a single corporation, or a “unitary group” of corporations, does business across state lines, each state may impose income tax only on that portion of the income earned within its borders. To that end, the income of the unitary business is divided among the states in which the business operates. The most commonly used formula for dividing the income is found in the Uniform Division of Income for Tax Purposes Act (UDITPA).

Idaho and many other states have adopted UDITPA either in whole or with modifications. Idaho Code § 63-3027 (i) states that “[a]ll business [apportionable] income shall

be apportioned to this state . . . by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus two (2) times the sales factor, and the denominator of which is four (4). . . .” Id. The property factor is computed by dividing the petitioner’s property located in Idaho by its property located everywhere. Idaho Code § 63-3027(k). Likewise, the payroll factor is calculated by dividing the petitioner’s Idaho payroll by its payroll everywhere. Idaho Code § 63-3027(n). And finally, the sales factor is derived by dividing the company’s Idaho sales by its sales everywhere. Idaho Code § 63-3027(p). Many states, including Idaho, have modified the traditional three-factor formula so that the sales factor is double weighted.

The three-factor apportionment formula, by means of the location of a business’s property, payroll, and sales, approximates the extent of the business activity in a given state. Container Corp. of America v. Franchise Tax Bd., 463 U.S. 159 (1983). Most states that impose a tax on corporate income use some variation of the three-factor apportionment formula.

2. The Sales Factor of the Apportionment Formula.

Generally, gross receipts are included in the sales factor denominator. *See* Idaho Code § 63-3027(p). The statute provides that, for numerator purposes, the sales of tangible property will be assigned to the state in which the property is located. Sales other than sales of tangible personal property (intangible property and services) are more difficult to source to a particular state. Sales other than sales of tangible personal property, such as the [Redacted] services at issue, are sourced to the state in which the income-producing activity is performed. *See* Idaho Code § 63-3027(r).

To provide guidance in determining whether income from sales other than sales of tangible personal property should be included in the Idaho numerator, the Tax Commission has

adopted an administrative rule 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.

The Tax Commission has also adopted an administrative rule dealing specifically with the performance of personal services.

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.

Idaho Income Tax Administrative Rule 550.05.d. (IDAPA 35.01.01.550.05.d.).

In the past, the Petitioners treated the [Redacted] receipts from its [Redacted] operations in a manner consistent with Idaho Income Tax Administrative Rule 550.05.d. The [Redacted] income related to services performed by an employee assigned [Redacted] was included in the Idaho numerator. The presumption being that if the services were performed by employees [Redacted] assigned [Redacted], the majority of the time spent in performing the services likely took place in Idaho. Given the nature of the Petitioners’ [Redacted] services, this treatment appears to be entirely reasonable.

However, in 2004 the Petitioners re-examined its costs and concluded the income-producing activity formerly attributed to Idaho should be reassigned. According to the letter of protest:

[Petitioner] is a leading provider of technology-oriented postsecondary degree programs in the United States. [Petitioner] is headquartered in Indiana and operates over 85 institutes in approximately 33 states [The Petitioner's] wholly-owned subsidiary . . . [Redacted] develops in Indiana the curricula utilized by the institutes. [Redacted] licenses the use of the curricula to [Petitioner] as well as unrelated third parties. [Redacted] also performs the administrative, accounting, legal and executive duties in Indiana for the [Petitioner's] campuses operated in the United States.

* * *

. . . It was determined based upon this review that [the Petitioner's] tuition revenue would not be included in the Idaho sales factor numerator under Idaho Code Section 63-3027(r) as the greater portion of the costs incurred in generating the tuition revenue are not incurred in Idaho. . . .

Letter of Protest at p. 3. Based on its new cost analysis in 2004, the Petitioners submitted refund claims for the then previous years of 2001 through 2003 and filed their 2004 through 2006 returns with the Idaho tuition removed from the Idaho sales factor.

The primary reason the [Redacted] was reassigned outside of Idaho was the inclusion of the licensing and management fees in the cost analysis. On audit, the Division determined that licensing and management fees were indirect costs that should not be included in the analysis. The Petitioners contend that these costs are direct costs that should appropriately be considered in cost of performance analysis. Both the Division and the Petitioners recognize that if these costs are not included in the analysis, a greater proportion of the remaining costs will be costs incurred in Idaho.

B. THE COST OF PERFORMANCE APPLIED IN THIS CASE.

It is not clear where the Petitioners have assigned the [Redacted] income. The Petitioners imply they assigned the income to the headquarters state [Redacted], where licensing and management costs are incurred. However, at the conference, the Petitioners also stated that [Redacted] does not employ a cost of performance test and that [Redacted] does not tax the [Redacted] income. This supports the Division's position that the Petitioners have not assigned [Redacted] to any state for apportionment purposes.

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. *See Idaho Income Tax Rule 550.05.d. (IDAPA 35.01.01.0550.05.d.)* (A cost of performance 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.)

For purposes of the cost of performance test, direct costs are determined according to generally accepted accounting principles and the accepted conditions or practices of the taxpayer's trade or business. Idaho Income Tax Administrative Rule 550.03 (IDAPA 35.01.01.550.03). While the Tax Commission recognizes that licensing and management costs often are considered by [Redacted] institutions in cost accounting, especially for purposes of grants, such costs are not considered direct costs according to generally accepted accounting principles.

Moreover, the Tax Commission finds that interpreting the cost of performance provisions of Idaho Code § 63-3027(r) in a manner as to include such indirect costs would defeat the

purpose of the statute. The general philosophy of the UDITPA sales factor is that gross receipts should be sourced to the “market state.” That is to say the sales are sourced to the state in which the property or services are consumed. Ultimately, it is the place where the sales activity occurs that should govern where the income is assigned. In this case, [Redacted] services were provided to Idaho [Redacted] [Redacted] in exchange [Redacted]. The services were consumed by Idaho customers and, consistent with the sales factor provided in the statute, the income received from those services should be sourced to Idaho.

The Petitioners’ approach to the cost of performance would tend to source the gross receipts to the states where the Petitioners have the majority of its payroll and property. The UDITPA apportionment formula has separate factors to account for a taxpayer’s property and payroll. Duplicating the effect in the sales factor would only serve to under-emphasizing the impact of the customer base on the overall profitability of a taxpayer’s multistate business.

Additionally, the curricular licensing fees imposed by an affiliated company would appropriately be eliminated from the analysis as an intercompany transaction. In common with other states employing unitary combined reporting, Idaho eliminates transactions within the combined group when computing both income and apportionment factors. As to income, *see, e.g., American Smelting & Ref’g Co. v. Idaho St. Tax Comm.*, 99 Idaho 924 at 928 (1979) (dividends within unitary group not income to Petitioners), *rev’d on other grounds sub nom. ASARCO, Inc. v. Idaho St. Tax Comm.*, 458 U.S. 307 (1982). As to factors, IDAPA 35.01.01.450 provides, in part, as follows:

02. Intercompany transactions. All intercompany transactions must be eliminated in the computation of the numerators and the denominators of the apportionment factors of the combined group. The apportionment factor computation may not include property, payroll, or receipts of any affiliated corporation except those whose income is included in the combined report.

IDAPA 35.01.01.600 provides in part:

04. Intercompany transactions. If a return is filed on a combined basis, the intercompany transactions shall be eliminated to the extent necessary to reflect combined income and to properly compute the apportionment factor.

The Petitioners filed as a unitary business using a combined return. To fairly reflect the Petitioners' Idaho sales, the intercompany licensing fees should be eliminated.

Applying the cost of performance in the manner suggested by the Petitioners would not fairly reflect the Petitioners' business activity in Idaho. As a result, even if the Petitioners' interpretation of the cost of performance was accepted, this would be an instance that would require an alternative apportionment. An alternative apportionment is warranted when (1) the standard apportionment provisions do not fairly represent the extent of [Redacted]'s business taking place in this state, and (2) the proposed alternative apportionment formula is reasonable. Union Pacific v. Idaho State Tax Commission, 139 Idaho 572, 575, 83 P.3d 116, 119 (2004). The Tax Commission finds that it is reasonable to assign the sales receipts from education activities occurring on the Idaho campus to the state of Idaho for tax purposes.

C. THE PENALTIES ARE UPHELD.

The Division asserted both a 5 percent negligence penalty and a 10 percent substantial understatement penalty. The negligence penalty was asserted due because the Petitioners' inclusion of the licensing fees and management costs were contrary to established Idaho statutes, administrative rules, and Tax Commission decisions. The substantial understatement penalty was asserted because the underpayment of tax exceeded the \$10,000 threshold in certain taxable years.

[Redacted]assert that neither penalty is warranted. The Petitioners believe they have adequately supported their position with legal authority, albeit with legal authority from states other than Idaho.

After careful consideration, the Tax Commission has decided to uphold the negligence penalty. The Tax Commission finds the Petitioners' position is contrary to several administrative rules. 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." Idaho Code § 63-3046(d)(7). The Tax Commission will not question the good faith of the Petitioners, but must have doubt about the reasonableness of their position. It simply is not reasonable to assign [Redacted] earned from services performed in Idaho to the state [Redacted] based on the costs discussed above.

CONCLUSION

WHEREFORE, the Notice of Deficiency Determination referenced above is hereby AFFIRMED, APPROVED, and MADE FINAL by this decision.

IT IS ORDERED and THIS DOES ORDER that the Petitioners' requests for REFUNDS are DENIED except as allowed in the Notice of Deficiency Determination and the Petitioners are

directed to PAY the following tax, penalty, and interest:

<u>PERIOD</u>	<u>REFUND CLAIMED</u>	<u>REFUND ALLOWED</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2001	\$(16,076)	\$(168)			\$ (81)	\$ (249)
2002	(24,556)	(64)			(26)	(90)
2003	(26,538)	0	237	12	88	337
2004			40,404	6,060	12,508	58,972
2005			37,030	5,555	9,230	51,815
2006			55,237	8,286	10,304	<u>73,827</u>
						TOTAL AMOUNT DUE: <u>\$184,612</u>

Interest is calculated through May 3, 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 taxpayer's right to appeal this decision is enclosed. As set forth in the enclosed explanation, the taxpayer must deposit with the Tax Commission 20 percent (20%) of the total amount due in order to appeal this decision. The 20 percent deposit in this case amounts to \$36,922.40 and will be held as security for the payment of taxes until the appeal is finally determined.

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.

Copies mailed to:

[Redacted]

[Redacted]
