BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of [Redacted] Petitioner.	)	DOCKET NO. 0-917-374-976 and 1-141-524-480 DECISION

Idaho State Tax Commission's Income Tax Audit staff (Audit) determined that [Redacted] (Petitioner)[1] had underreported its income tax liability for the tax years ending January 31, 2010 through January 31, 2015. Audit asserts that Petitioner owes additional income tax and interest for the six-year period totaling $230,734.

In December 2013, Audit conducted a field audit of Petitioner's books and records for tax years ending January 31, 2010, through January 31, 2012, that resulted in the issuance of a Notice of Deficiency Determination (First Notice) dated November 6, 2015. In the First Notice, Audit determined that Petitioner owed additional tax and interest totaling $395,195. Petitioner filed a timely petition for redetermination on December 8, 2015 (First Petition). On August 30, 2016, Audit modified the First Notice by decreasing the total amount sought from $395,195 to $107,050. On October 7, 2016, Audit further modified the First Notice by decreasing the amount sought from $107,050 to $101,097.

In July 2016, Audit conducted a field audit of Petitioner's books and records for tax years ending January 31, 2013, through January 31, 2015, that resulted in the issuance of a Notice of Deficiency Determination (Second Notice) dated November 4, 2016. In the Second Notice, Audit determined that Petitioner owed additional tax and interest totaling $129,637. Petitioner filed a

[1] Unless otherwise stated, "Petitioner" refers to the corporations identified on schedules 1100 attached to Audit's Notice of Deficiency Determination dated November 6, 2015, and November 4, 2016.

timely petition for redetermination of the Second Notice on January 4, 2017.

Petitioner requested that the Idaho State Tax Commission (the Commission) combine Petitioner's two petitions at the Appeals level. For purposes of the remainder of this decision, "Notice" refers to the first and second notices collectively and "Petition" refers to the first and second petitions collectively. Unless otherwise indicated, all Idaho Code section references are to the Idaho code relating to the tax years in issue and all Idaho rule references are to the Idaho Department of Administration's 2017 version of the Idaho Income Tax Administrative rules.

I. AUDIT ADJUSTMENTS AND ISSUES

Audit adjusted Petitioner's returns in a number of ways. Audit's adjustments include the following:

Jurisdiction to Tax: Audit asserted Idaho had jurisdiction to tax [Redacted] [2]

Apportionable Income or Loss: Audit adjusted Petitioner's apportionable income by adjusting the federal net operating loss addback, bonus depreciation, foreign income, intercompany dividends, I.R.C. section 78 gross-up, and the state income tax addback. Additionally, Audit included within its calculations federal audit adjustments.

Apportionment Formula: Audit adjusted Petitioner's property factor calculation by removing subrents and including certain foreign assets. Audit adjusted Petitioner's payroll factor calculation by removing compensation related to stock options. Audit adjusted Petitioner's sales factor calculation by including or excluding receipts relating to interest, dividends, subrents, vendor income, and incentive payments.

Idaho Credits: Audit adjusted Petitioner's calculation of the Idaho investment tax credit.

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[2] During the redetermination period, [Redacted] changed its name to [Redacted]
The federal employer identification number remained the same.

Permanent Building Fund Tax: Audit asserted that the additional corporations it found subject to Idaho's jurisdiction to tax were required to pay the additional ten dollar ($10) tax; commonly referred to as the Permanent Building Fund (PBF) tax.[3]

After the issuance of the Notice, all of the adjustments relating to apportionable income, the property factor adjustment for foreign assets, the payroll factor adjustment, the adjustment to Idaho investment tax credit, and the jurisdictional issue (which also resolved the sales factor issue) relating to [Redacted] have been resolved.[4] The issues remaining are:

1. Does [Redacted] have an Idaho filing requirement?
2. If [Redacted] is required to file, what receipts, if any, are assigned to the Idaho sales factor numerator?
3. Are rental income and rent expense relating to the [Redacted] subleases business income?
4. Are vendor income and incentive payments relevant in Idaho sales factor?
5. Does [Redacted] have an Idaho filing requirement and if so, what amount of receipts, if any, are assigned to Idaho sales factor numerator?
6. Does [Redacted] have an Idaho filing requirement, and if so, what amount of receipts, if any, are assigned to Idaho sales factor numerator?
7. Does [Redacted] have receipts assigned to the Idaho sales factor numerator under Idaho Income Tax Administrative Rule 525.02.a?

[3] Idaho Code section 63-3082.

[4] By "resolved," the Commission means either that Petitioner did not protest the Audit adjustment, agreed with Audit, Audit agreed with Petitioner, or Petitioner protested the Audit adjustment and during the redetermination process did not seek a determination from the Commission on that issue. In addition, during the audit on tax years ending January 31, 2013, through January 31, 2015, Audit determined that Public Law 86-272 protects [Redacted] from Idaho taxation. Given that there is no discernable difference in facts and as part of narrowing down the protested issues in this docket, the Commission will apply Audit's finding to tax years ending January 31, 2010, through January 31, 2012.

Based upon the facts before the Commission coupled with the Commission's desire to narrow the focus of its decision, the Commission will not pursue issues 5, 6, and 7. With respect to issues 5 and 6, the facts before the Commission do not establish whether [Redacted] or [Redacted] have an Idaho filing requirement. Furthermore, the issue of an Idaho filing requirement for these entities is not an ongoing issue since Petitioner has sold its credit card business. With respect to issue 7, the interest described as part of the sale of tangible personal property in Rule 525.02.a is not applicable to the intangible receipts received by [Redacted] The Commission will now turn its attention to the remaining issues.

Issue One

Is [Redacted] subject to the Idaho corporate income tax, required to file an Idaho income tax return, and required to pay the PBF?

The Commission finds that [Redacted] is subject to the Idaho corporate income tax, required to file an Idaho corporate income tax return, and pay the PBF.

Issue Two

Should any of [Redacted] receipts be included within the Idaho sales factor?

The Commission finds that since Petitioner failed to provide an analysis of costs of performance on a transactional basis, Audit was correct in including receipts relating to Idaho customer credit card accounts in the Idaho sales factor numerator for [Redacted] .

Issue Three

Is the rental income from property subleased to [Redacted] business or nonbusiness income and if business income, what is the impact on the Idaho apportionment factor?

The Commission affirms Audit's treatment of the [Redacted] rental income as nonbusiness income. In addition, Audit correctly excluded the rent expense associated with the [Redacted] properties from apportionable income and correctly calculated Petitioner's Idaho apportionment percentage.

Issue Four

When calculating Petitioner's Idaho Sales Factor percentage, should vendor income and incentive payments be included or excluded?

The Commission affirms Audit's exclusion of vendor income receipts and incentive payment receipts from the sales factor.

II. GENERAL STATEMENT OF LAW

Every corporation which is transacting business in this state, authorized to transact business in this state or having income attributable to this state, unless exempt from the tax imposed in this chapter, is required to file an Idaho income tax return.[5] Subject only to the limitations of the constitutions of the United States and of the state of Idaho, the term "transacting business" shall include owning or leasing, whether as lessor or lessee, of any property, including real and personal property, located in this state, or engaging in or the transacting of any activity in this state, for the purpose of, or resulting in, economic or pecuniary gain or profit.[6] Nexus is determined on a corporation-by-corporation basis.[7]

Once it is determined that a corporation is transacting business within Idaho, a corporation transacting business within and without Idaho must determine what portion of its income is taxable in Idaho. Idaho, along with most states, only seeks to tax its fair share of a multi-state taxpayer's income. To avoid over taxing a taxpayer, most states use similar, standardized formulas to determine a taxpayer's in-state tax liability. This formula is a fraction composed of several parts

[5] Idaho Code section 63-3030(a)(3).
[6] Idaho Code section 63-3023.
[7] IDAPA 35.01.01.365.04.

called factors: the sales factor, property factor, and payroll factor.

These three factors all compare in-state activity against out-of-state activity. Specifically, the sales factor is a fraction, the numerator of which is the total sales of the taxpayer in Idaho during the tax period and the denominator of which is the total of everywhere sales during the tax period.[8] Sales means "all gross receipts of the taxpayer not allocated."[9] Likewise, the property factor is a fraction that compares Idaho property to everywhere property,[10] and the payroll factor compares Idaho payroll to everywhere payroll.[11] Taken together, these factors estimate a taxpayer's presence in the State of Idaho.

III. ISSUE ANALYSIS

Issue One – For tax years ending January 31, 2010, through January 31, 2014, the Commission finds that [Redacted] is subject to Idaho corporate income tax, required to file an Idaho corporate income tax return, and pay the PBF tax.

Petitioner explained why it thinks [Redacted] should not be subject to Idaho taxation and provided additional information on the activities engaged in by [Redacted] It argued in pertinent part:

> The Department stated that [Redacted] . . . had nexus based on the activities that [Redacted] employees are performing as agents on behalf of [Redacted] . . . The Department cited three cases, *Scripto Inc. v. Carson*, 362 U.S. 207, 80 S. Ct. 619 (1960), *Tyler Pipe Industries v. Washington Dept.* of *Revenue*, 483 U.S. 232 (1987), and *Borders Online, LLC v. California State Board of Equalization*, 129 Cal. App.4th 1179, 29 Cal Rptr.3d 176 (2005) as support for their assertion. In *Scripto,* the Court concluded that it was not necessary to have employees or property present in the state in order to create nexus. However, the case dealt with independent sales representatives doing work on behalf of the business and ultimately focused on the distinction of employees versus independent contractors. In *Tyler Pipe,* the Court again focused on whether the characterization of an independent contractor vs an employee mattered when determining nexus. The Court held that it did not matter, however the factual conclusions reached by the Court in both of the cases mentioned above have no bearing on whether or not [Redacted] . [had] nexus. All of

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[8] Idaho Code section 63-3027(p).
[9] Idaho Code section 63-3027(a)(5).
[10] Idaho Code section 63-3027(k).
[11] Idaho Code section 63-3027(n).

the employees who work in [Redacted] are not independent contractors. While [Redacted] employees physically accept a credit card application, they cannot issue [Redacted] as that decision is made in [Redacted] Similarly, although the [Redacted] employees physically handle the check for payments, they do not process the payments as that is also done out of state. Finally, it is important to note that *Quill Corp v. North Dakota*, 504 U.S. 298 (1992) was decided after both of the aforementioned cases, and upheld that a physical presence is required in order to determine nexus.

The Department also cited *Borders* as further support for the courts asserting nexus based on the activities of an affiliate. *Borders* was a California state case and because it was not argued and tried in Idaho, it is therefore unable to be used as authority in determining nexus for [Redacted] . . in Idaho.

Without case law in Idaho which supports the Department's assertion of affiliate nexus, the only remaining authority available is the Idaho Code. Idaho Code § 63-3025(1) states that a tax is imposed on the Idaho taxable income of a corporation which transacts or is authorized to transact business in Idaho, or which has income attributable to Idaho. Idaho Code § 63-3023 defines "transacting business" as

> " *owning* or *leasing* ... of *any property located in this state or engaging in or the transacting* of *any activity in this state for the purpose of or resulting in economic or pecuniary gain or profit."*

[Redacted] issues all [Redacted] from [Redacted] makes decisions on credit worthiness in [Redacted] and services all receivables related to the [Redacted] in [Redacted] or [Redacted] [Redacted] does not transact business in Idaho, nor do they have any income attributable to Idaho. Therefore, [Redacted] does not have nexus in Idaho.

Finally, the protection of P.L. (Public Law) 86-272 does not apply in this case, as the amounts at issue are related to the sales of services. P.L. 86-272 states in part

> *"No State shall have power to impose ... a net income tax on income derived within such state if by any person from interstate commerce if the only business activities within such state ... are ... the solicitation of orders by such person for* ***sales of tangible personal property*** *..."*
> *(emphasis added).*

The Department's argument that the aforementioned companies have nexus because the actions of [Redacted] employees exceed the protection of P.L. 86-272 is therefore invalid as P.L. 86-272 does not apply to sales of services. Furthermore, the actions of [Redacted] employees would create nexus for [Redacted] , not [Redacted] .[12]

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[12] Petitioner letter dated January 4, 2017, page 4.

Petitioner also provided the Commission with the following information regarding the activities engaged in by [Redacted]:

> [Redacted] is a federally chartered credit card bank which originates private label [Redacted] credit cards which are accepted at all [Redacted] locations. They are headquartered in [Redacted] with locations in [Redacted]. Their customers are located throughout the United States. [Redacted] receives all customer payments and receives all fees which are generated by the customers' activities. While the customer service desk at a [Redacted] provides a conduit for a customer to pay on their account, rather than mail the payment or pay online, the payment is not processed or credited to the customer's account in store. All payments are processed in [Redacted]
>
> Additionally [Redacted] do not have the authority to issue or deny credit, based on Federal banking laws. The cards are issued in [Redacted] by [Redacted] and that is also where the approval or denial of a customer's credit application happens. The decision is then transmitted back to the store. The [Redacted] employee can then see if the customer has been approved, but has no insight as to the reason for denial of credit, nor is the card issued from the store. The cards are mailed from the [Redacted] location within 7-10 business days of approval.
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> The [Redacted] customer service desk is not able to access a customer's credit card activity. A customer can go to customer service and return without a receipt, *with any* form *of payment except for cash* or *check.* This service is available for both [Redacted] users and someone who uses any other credit or debit card. Credit card activity is not accessed, rather a match is made between the credit card number and the item purchased or returned. The process for a [Redacted] is no different than the process for a Visa, American Express, or any other bank or financial institution and no additional information is available to the representative at the customer service desk for [Redacted] than any other credit or debit card.
>
> The assertion that from the customer's perspective, [Redacted] is the only entity involved with the credit card receivables is incorrect. [Redacted] employees service all receivables generated by the [Redacted] from its offices in [Redacted] These services include accepting payments, resolving credit disputes, issuing statements, producing credit cards, and collecting on delinquent accounts. [Redacted] customer service representatives also handle all calls regarding the application process and the decision to extend credit. None of these services are performed in Idaho.[13]

In summary, Petitioner made several arguments as to why Idaho should not impose an income tax on [Redacted] Chief among these reasons is that Quill requires physical presence and that

[13] Petitioner letter dated January 4, 2017, page 3.

the in-store [Redacted] employees that Audit claimed created nexus were not independent contractors but were instead fulltime employees of [Redacted] In addition, it challenged Audit's analysis of Public Law 86-272 (P.L. 86-272) and did not see how that statute could apply in this matter.[14]

Law and Analysis

Petitioner argues that since [Redacted] did not have physical presence in Idaho, it cannot be taxed by Idaho. Petitioner points to the Supreme Court decision in *Quill* and argues that a business must have physical presence in Idaho before Idaho can tax it.[15] While *Quill* does require a physical presence in a state to establish sales tax nexus, the Commission does not read *Quill* as requiring a physical presence for income tax nexus.

In 2005, the Commission published a decision setting forth its reading of the physical presence requirement as it relates to non-sales and use taxes.[16] The Commission concluded that the *Quill* physical presence test does not apply to non-sales and use tax cases, a corporation with no physical presence in a state could still be found to have substantial nexus with that state, and the nexus inquiry is not limited to just the company's "physical contacts" within the state.

In the present case, the [Redacted] employees in Idaho acted as agents of [Redacted] by providing literature and brochures for the [Redacted] promoting the [Redacted] providing and assisting with the credit card application process to obtain a [Redacted] and accepting payments on customer accounts. The actions conducted by the employees of the Idaho [Redacted] not only establish "physical presence" within Idaho for [Redacted] but also are significantly associated with [Redacted] ability to establish and maintain a market in Idaho for its [Redacted] [Redacted] is transacting

[14] The Commission agrees with Petitioner that P.L. 86-272 does not apply. P.L. 86-272 is concerned with the solicitation of sales of tangible personal property. [Red is not engaged in the sale of tangible personal property.
[15] *Quill Corp v. North Dakota*, 504 U.S. 298, 112 S.Ct 1904, 119 L.Ed.2d 91 (1992).
[16] See the Commission decision 17948 published in 2005 on the Commission's website under Governance, Decisions, docket 17948, starting on page 15.

business within Idaho through [Redacted] employees.

Petitioner indicates that [Redacted] cannot be transacting business in the state because the facts of this case do not resemble the facts of two Supreme Court cases, *Tyler Pipe*[17] and *Scripto*.[18] It argues that the ruling in these cases—that a state has jurisdiction to tax a business whose independent contractors engage in substantial business activities in the state—is not applicable since those decisions dealt with independent contractors not affiliated corporations relying on one another's employees. The Commission disagrees with Petitioners reading of *Tyler Pipe* and *Scripto*. The Commission finds that it does not matter if it is an employee or an independent contractor performing "substantial business activities" in a state. Rather, the critical issue is whether the substantial business activities have occurred in the taxing state on the taxpayer's behalf.[19] Which as noted above, [Redacted] employees engage in substantial business activities on [Redacted] behalf.

The Commission finds that, since [Redacted] is transacting business in Idaho, it is required to file an Idaho corporate income return and pay the PBF.

Issue Two – <u>For the tax years ending January 31, 2010 through January 31, 2014, the Commission finds that [Redacted] is required to report the receipts associated with Idaho customer credit cards accounts as Idaho receipts.</u>

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[17] *Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232, 107 S.Ct. 2810 (1987); *Scripto v. Carson*, 362 U.S. 207, 80 S.Ct. 619, 4 L.Ed.2d 660 (1960).

[18] *Scripto, Inc. v. Carson*, 362 U.S. 207, 80 S.Ct. 619, 4 L.Ed.2d 660 (1960).

[19] *Arco Bldg. Systems, Inc. v. Chumley*, 209 S.W.3d 63,74 (2006), citing *America Online, Inc. v. Johnson*, No. M2001–00927–COA–R3–CV, 2002 WL 1751434, (Tenn.Ct.App. July 30, 2002). See also *Tyler Pipe Indus., Inc. v. Wash. State Dep't of Revenue*, 483 U.S. 232, 250, 107 S.Ct. 2810, 2821 (1987) ("As the Washington Supreme Court determined, 'the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state . . . .'"). See also *State v. Quantex Mirosystems, Inc.*, 809 So.2d 246, 251 (La. Ct. App. 2001) ("the crucial factor governing nexus is whether the activities performed in the taxing state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in the taxing state."). See generally, Fatale, *State Tax Jurisdiction and the Mythical "Physical Presence" Constitutional Standard*, 54 Tax Lawyer 105, 109 (Fall 2000).

Because the income received by [Redacted] is from the intangible assets, for purposes of calculating Petitioner's sales factor, the location of the sales must be determined using the costs of performance analysis. The costs of performance analysis applies to gross receipts from sales other than the gross receipts from the sale of tangible personal property except for incidental interest income, service charges, carrying charges, or time-price differential charges considered an incidental part of sale of the tangible personal property.[20]

A gross receipt from the sale of tangible personal property is an "Idaho gross receipt" and included within the Idaho sales factor if the property is delivered or shipped to an Idaho purchaser.[21] While this method works for determining the proper assignment of a gross receipt from the sale of tangible personal property, to determine the proper assignment of a gross receipt generated by an intangible asset, a different approach is required. "Costs of performance" determines whether that gross receipt counts as an Idaho gross receipt. A gross receipt relating to an intangible is an Idaho gross receipt for purposes of the Idaho sales factor if "the income-producing activity" is performed wholly in Idaho or, if the income-producing activity occurs in more than one state and more of that activity occurs in Idaho than in any other state based on costs of performance.[22]

The term income producing activity refers to <u>each separate item of income</u> from transactions and activity engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of producing <u>that item of income</u>.[23] The activity includes transactions and

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[20] See the following example contained within IDAPA 35.01.01.525.02:

a. If a taxpayer manufactures and sells or purchases and resells goods or products, sales includes all gross receipts from sales of the goods or products held primarily for sale to customers in the ordinary course of the taxpayer's trade or business. . . .Gross receipts means gross sales, less returns and allowances and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to the sales.

[21] Idaho Code section 63-3027(q). Special rules apply to "throwback sales" and sales to the United States government.

[22] Idaho Code section 63-3027(r).

[23] IDAPA 35.01.01.550.02.

activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor.[24]

Costs of performance refers to the direct costs determined in a manner consistent with generally accepted accounting principles and according to accepted conditions or practices of the taxpayer's trade or business to perform the income producing activity that gives rise to the particular item of income.[25] Included in the taxpayer's costs of performance are taxpayer's payments to an agent or independent contractor for the performance of personal services and utilization of tangible and intangible property that give rise to the particular item of income.[26]

The Idaho Supreme Court in its *Cable One* decision identified three steps when assigning gross receipts from other than the sale of tangible personal property. The Court stated that "[t]he first step is identifying the "income-producing activity" that is at issue. . . . The next step is determining in which state Cable One's various activities occurred that produced the income. . . . The final step is to determine the costs of performing the income-producing activity in each state."[27] Thus, the Supreme Court gave us three distinct steps to follow: 1) identify the income producing activities, 2) determine where those activities occurred, and 3) identify the costs of performing those activities.

With respect to identifying the income-producing activity, the Idaho Supreme Court stated that:

> "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 profit." IDAPA 35.01.01.550.02 (2005) (emphasis added). Pursuant to that rule, the income producing activity is not the activity that produces income

[24] *Id.*
[25] IDAPA 35.01.01.550.03.
[26] *Id.*
[27] *Cable One, Inc. v. Idaho State Tax Comm'n*, 157 Idaho 436, 440, 337 P.3d 595, 599 (2014).

[Redacted]

> from Cable One's nineteen-state system. It is the activity that produces the item of income at issue here, which is the income received from providing internet services to customers located in Idaho. [28]

The Idaho District Court in *Cable One* noted that the term "direct costs" was not defined under Idaho law nor by any of the standard methods of accounting.[29] While the Idaho Courts have yet to rule on the meaning of the term "direct costs," the Oregon Supreme Court has. [30] The Oregon Supreme Court found that since the income-producing activities are the individual transactions, the "'direct costs' are only those incremental costs associated with each transaction."[31]

Like Oregon, Idaho's transaction approach to the costs of performance analysis requires an identification of each separate item of income down to the most granular level. After identification of the separate item of income, and where the activities take place, a taxpayer must identify the incremental direct costs and provide the Commission with its analysis of where the location of the incremental direct costs, associated with the individual transaction, took place.

Thus, in the present matter, the costs of performance analysis requires: 1) identifying the income producing activities, 2) determining where those activities occurred, and 3) identifying the costs of performing those activities. As for the last step, Petitioner must identify the *incremental* direct costs and provide the Commission with its analysis of where the incremental direct costs for each individual transaction took place.

In this matter, the most granular income in [Redacted] operation are <u>each</u> monthly payment received by [Redacted] from a credit card customer relating to that customer's [Redacted] These payments represent [Redacted] income. Each monthly payment from each customer is a separate item

[28] *Id.*
[29] *Cable One, Inc. vs Idaho State Tax Commission*, Idaho District Court Fourth Judicial District CV OC 2011 03406, Redacted Copy for Public Record, page 12, conclusions of law, item 9 (2013).
[30] *AT & T Corp. v. Dept. of Rev.*, 357 Or 691, 358 P.3d 973 (2015).
[31] *Id.* at 717, 986 (2015).

of income. [Redacted] income producing activities are the transaction and activity engaged in by [Redacted] to produce these payments from credit card customers. For [Redacted] these activities include processing payments through an electronic system, processing payments by mail, and allowing [Redacted] cardholders to make payments in [Redacted] with the help of [Redacted] employees. [Redacted] also has operational activities that are related to the income producing activities such as providing lines of credit to customers and providing customer support.

The next step is to determine where [Redacted] income producing activities occurred. For any given monthly credit-card payment, [Redacted] income producing activities could have occurred in Idaho-based [Redacted], in [Redacted] in other states, where [Redacted] out-of-state electronic payment processing center is based, where [Redacted] processes monthly payments sent by mail, and where [Redacted] operation activities occurred. As Petitioner has not given the Commission a costs of performance analysis, the Commission does not have precise details on where all of the income producing activities occurred. However, because [Redacted] uses in-state [Redacted] employees to process payments, some portion of the [Redacted] income producing activities occurred in Idaho.

The third step is to identify the incremental and direct costs of performing the income producing activity. The incremental and directs costs of producing any single monthly payment are the wage costs associated with a [Redacted] employee providing in-store assistance to customers making [Redacted] payments, the cost of processing that payment through the electronic payment system, or the cost of processing a payment by mail. While not quantified by [Redacted] paying a [Redacted] employee to provide in-store assistance is likely more costly than the others.

Because the costs of performance must be both incremental and direct, not all costs related to producing an item of income are counted. Specifically, operational costs—such as [Redacted] provision of lines of credit or providing customer service—are typically neither direct nor incremental costs. As such, operational costs are excluded from costs of performance unless the taxpayer can otherwise show that operational costs are direct and incremental.

While Petitioner has not provided a costs of performance study, at least some portion of [Redacted] payments are made in Idaho [Redacted]. For all monthly payments made in person in an Idaho [Redacted] the greatest costs of performing that income producing activity is paying the wage of the [Redacted] employee receiving and processing the payment. As such, that monthly payment is an "Idaho sale" and should be included in sales factor numerator.

Petitioner bears the burden of providing an actual costs of performance study showing the incremental direct costs incurred on a transaction-by-transaction basis. Without such a study, the Commission cannot determine the proper assignment of the gross receipt. Since Petitioner has not presented a detailed analysis of the incremental direct costs associated with each payment, the Commission affirms Audit's treatment of a portion of [Redacted] receipts as Idaho receipts.

The following table identifies the amount of interest and fee receipts Audit treated as Idaho receipts.[32]

Table 1: Tax Year	1/31/2010	1/31/2011	1/31/2012	1/31/2013	1/31/2014
Idaho Receipts	$6,425,525	$5,488,067	$4,202,406	$3,832,829	$1,608,822

Issue Three – <u>For tax years ending January 31, 2014, and January 31, 2015, the Commission affirms Audit's treatment of the [Redacted] rental income and related rental expense as nonbusiness income and the corresponding adjustments to the property and sales factor.</u>

For the tax year ending January 31, 2014 and January 31, 2015, the amount of [Redacted] rental income Audit treated as nonbusiness income was $75,000,000 and $4,000,000, respectively. In

[32] Audit multiplied [Redacted] reported interest and fee income from credit cards by Idaho accounts receivables over total accounts receivables to arrive at the Idaho gross receipts included within [Redacted] Idaho sales factor numerator. Since Petitioner sold its credit card operations, the nexus issue and factor issue ended with the tax year ending January 31, 2014.

addition, Audit used the $75,000,000 and $4,000,000, subrental amounts to estimate the amount of corresponding nonbusiness rent expense excluded from the calculation of apportionable income. Lastly, Audit removed from Petitioner's total everywhere receipts and total everywhere property capitalized rent the amounts shown in the following table: [33]

Table 2: Tax Year	1/31/2014	1/31/2015
Everywhere receipts	$75,000,000	$4,000,000
Everywhere property capitalized rent	$600,000,000	$32,000,000

Petitioner explains its reasoning for determining why the [Redacted] subrental income is business income and why its rent expense, when calculating the total everywhere rent component of the property factor denominator, should not be adjusted:

> The subrents at issue are related to an agreement between [Redacted] and [Redacted] which allowed [Redacted] to acquire leasehold interests for up to 220 [Redacted] operating locations for our expansion into Canada. For purposes of negotiation and ease of administration, [Redacted] purchased the leasehold interests under one agreement paid through two tranches. For example, with the first of the tranche payments, [Redacted] selected 105 locations and assumed these leases from [Redacted] As of the date of the tranche payments, [Redacted] was not able to immediately begin renovation and occupation of all store locations. However, they did immediately begin renovating and occupying a portion of the leased locations and set a strategic plan for the rollout of the renovation, occupation, and integration of all of these store locations into the new [Redacted] Canada business operations. A period of time was needed to allow for construction approvals, renovation planning, and the rollout of the renovations (we did not initiate the renovation of hundreds of stores simultaneously). In any interim period between the payment and the commencement of renovation on a particular store location, the leased properties continued to operate as [Redacted] stores. Accordingly, [Redacted] subleased these store locations from [Redacted] until such time as [Redacted] was able to begin renovation and take over occupancy of the location. Please refer to the [Redacted] press releases dated May 26, 2011 and October 28, 2013 in support of the facts outlined above (Attachments C and D).
>
> Our facts with respect to the subrents received from [Redacted] are nearly identical to the example provided in Idaho Admin. Rule § 35.01.01.485.02(b). In the example, the taxpayer rents a five story office building knowing that it currently can only use three floors, but will need to use the other two floors for future expansion of its

[33] For purposes of the property factor, capitalized rent was determined by multiplying the [Redacted] rental income by eight.

> business. Similarly, [Redacted] acquired the leasehold interests to 220 locations with the intention of renovating and occupying these store locations as we expanded our business across Canada. The taxpayer in the example subleased the two unoccupied floors to other businesses until it was able to expand its business to occupy the remaining floors. Similarly, [Redacted] subleased the store locations to [Redacted] until it was able to renovate and occupy all of the store locations. A portion of the [Redacted] locations were immediately renovated and occupied upon execution of the lease agreement. Furthermore, the subrents in this instance are even more conclusively business income than those provided in the example because [Redacted] had a strategic plan to incorporate the rented locations into our Canadian business operations and had already begun to execute on that plan. Whereas in the example, the taxpayer merely intended to use the other floors at some unspecified future date with no strategic plan for when and how this expansion would begin. Therefore, in accordance with the examples provided in the Idaho regulation, these subrents from [Redacted] are business income and should not be deducted from the rent paid. [34]

In its argument, Petitioner focused on the “business income” language of Rule 485. Petitioner points to its strategic plan to incorporate the rented locations into its business operations as evidence that the subrentals produced business income.

Based on its position that the subrental income is business income, Petitioner believes that the Rule 485 exception from reducing the value of rent expense for subrental income applies to Petitioner’s situation especially given Rule 485’s five (5) story office building example.

<u>Law and Analysis</u>

Audit determined that “the acquisition of the leasehold interests from [Redacted] and the subsequent subleasing from [Redacted] back to [Redacted] does not constitute business income and is not a normal course of business activity that is conducted by [Redacted] [35] Audit apparently was not convinced by Petitioner’s “intent to use the stores” argument as satisfying Idaho’s definition of business income.

Business income means income arising from transactions and activity in the regular course of the taxpayer’s trade or business and includes income from the acquisition, management, or

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[34] See Petitioner’s letter dated January 4, 2017, page 2.
[35] Audit Protest Summary write-up in response to Petitioner’s petition.

disposition of tangible and intangible property when such acquisition, management, or disposition constitutes integral or necessary parts of the taxpayer's trade or business operations.[36] The Idaho Supreme Court has not rendered an opinion if intent in and by itself is enough to fall within Idaho definition of business income.[37] However, in an Idaho district court case, the court doubted that intent with nothing more would be enough. The court concluded, "merely acquiring property does not produce business income unless the property is managed as part of the integrated business."[38] Later on in its decision, the court noted that:

> The Commission argues . . . that acquiring the stock . . . was part of Union Pacific's century-old plan to "monetize" its land grant assets, and argues the . . . acquisition was part of Union Pacific's trade or business. Thus, . . . the dividends are income related to that . . . "acquisition," and therefore taxable. The Court disagrees. Merely acquiring shares without more does not satisfy the functional test. If that were true, any stock investment would automatically become "business income" within the statute. That is why the statute requires that the acquisition must also be "integral" to the taxpayer's business.[39]

Accordingly, the Commission affirms Audit's finding that the sublease rental income is nonbusiness income. Since the [Redacted] subleased property generated nonbusiness income, the apportionable income excludes all deductions relating to the production of nonbusiness income.[40] Since the exact amount of rent expense Petitioner paid on the [Redacted] properties was unavailable, the Commission affirms Audit's use of rental income received from [Redacted] to approximate the amount of that expense. In addition, the Commission affirms Audit's reduction in the capitalized rent expense since the property factor excludes property used in connection with the production of

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[36] Idaho Code section 63-3027(a)(1).

[37] For example, had Petitioner shown that the [Redacted] subrental income generated working capital for Petitioner's unitary business; or, that the subleasing of the [Redacted] stores rose to the level of a separate trade or business that was part of Petitioner's unitary business, the rental income would be considered business income under Idaho law.

[38] *Union Pacific Corporation vs Idaho State Tax Commission*, Idaho District Court Fourth Judicial District Partial Summary Judgement Decision (Dividends) CV OC 9704812D (2012).

[39] *Id.*, footnote 9.

[40] IDAPA 35.01.01.335.01.

nonbusiness income.[41] Likewise, the Commission affirms Audit's exclusion of the [Redacted] rental income from the receipts factor since the receipts factor excludes nonbusiness income receipts.[42] Finally, since the Commission affirmed Audit's treatment of the [Redacted] rental income as nonbusiness income, the Commission need not rule on Petitioner's Rule 485 argument.

Issue Four – For tax years ending January 31, 2010, through January 31, 2015, the Commission affirms Audit's removal of vendor income receipts and incentive payment receipts from Petitioner's sales factor Idaho numerator and everywhere denominator.

Audit removed the following receipts from Petitioner's sales factor denominator:

Table 3:

Tax Years	1/31/2010	1/31/2011	1/31/2012
Idaho Sales:			
Incentive payment receipts	$0	$0	$0
Vendor rebates	$3,762,843	$3,397,709	$3,934,773
Total Everywhere:			
Incentive payment receipts	$0	$0	
Vendor rebates	$3,172,676,041	$3,420,042,819	$3,650,295,437

Table 4:

Tax Years	1/31/2013	1/31/2014	1/31/2015
Idaho Sales:			
Incentive payment receipts	$0	$0	$0
Vendor rebates	$4,071,841	$4,177,782	$4,346,035
Total Everywhere:			
Incentive payment receipts	$7,612,866	$8,161,221	$5,773,616
Vendor rebates	$3,996,693,963	$4,128,203,997	$4,035,047,271

Petitioner provides the following statement regarding the vendor income:

> Vendor Income is a stream of payments [Redacted] receives for services it performs for certain vendors. Examples of these services include promoting their item on the front page of a circular or placing the item on the endcap of an aisle. Due to Generally Accepted Accounting Principles, these payments are required to offset SG&A [Selling, General and Administrative Expenses] or Costs of Sales, for purposes of the annual 10-K filing, as noted in the Department's notice.

[41] IDAPA 35.01.01.460.02.

[42] IDAPA 35.01.01.525.01.

> The conclusions included in the Department's notice deviate significantly from the plain language of Idaho law. The generation of Vendor Income is a substantial component of the trade, business, transactions, and activity in the regular course of business conducted by [Redacted] These activities all meet the letter of this regulation. The location of the Vendor Income receipts on [Redacted] annual 10-K report does not change the fact that Vendor Income meets the above definitions of a gross receipt per Idaho law. Further, the generation of the receipts is based on the requirement that some level of activity is performed by [Redacted] for the vendors in order to generate the Vendor Income. These activities are performed in the regular course of business and accordingly the associated revenue should be treated as a gross receipt.[43]

To summarize, Petitioner recognizes that the vendor receipts offset costs of goods sold and expenses related to selling, general, and administrative expenses (SG&A). However, it argued that these offsets are receipts that are part of the taxpayer's ordinary trade or business and should be treated as a "gross receipt" and included in its sales factor calculations.

<u>Law and Analysis</u>

In determining a taxpayer's sales factor, Idaho's statute defines the word "sales" as all gross receipts of the taxpayer not allocated.[44] Gross receipts are the gross amounts realized, (the sum of money and the fair market value of other property or services received) on the sale or exchange of property, the performance of services, or the use of property or capital (including rents, royalties, interest and dividends) in a transaction that produces business income, in which the income or loss is recognized (or would be recognized if the transaction were in the United States) under the Internal Revenue Code.[45] Amounts realized on the sale or exchange of property are not reduced for the cost of goods sold or the basis of property sold.[46]

It is important to understand that "recognized" is a very specific term of art in the context of income tax law; the term refers to that portion of income received (i.e., "realized") that is

[43] Petitioner's January 4, 2017, letter, page 7.
[44] Idaho Code section 63-3027(a)(5).
[45] IDAPA 35.01.01.325.07.
[46] *Id*.

required by tax law to actually be included in the taxpayer's gross income.[47] A taxpayer can receive (i.e., "realize") income, but because of an exclusion in the tax code only part of it might be taxable and included as gross income; this amount to be included as gross income is the amount that is "recognized."[48] This is a fundamental income tax concept discussed in most income tax textbooks. Once such textbook explains the concept as follows:

> The amount realized from a sale or other disposition of property is the sum of any money received plus the fair market value of other property received.
> …
> Recognized gain is the amount of the realized gain included in the taxpayer's gross income. A recognized loss, on the other hand, is the amount of realized loss that is deductible for tax purposes. As a general rule, the entire amount of a realized gain or loss is recognized.
> …
> In certain cases, a realized gain or loss is not recognized upon the sale or other disposition of property.[49]

Under federal income tax regulations, trade discounts reduce the invoice price and vendor allowances decrease the cost of goods sold. For financial reporting purposes, the notes to Petitioner's financial statements state, "[v]endor income reduces either our inventory costs or SG&A expenses based on the provisions of the arrangement."

Looking outside of the state provides some additional guidance. For apportionment purposes, the definition of "gross receipts" under California law is nearly identical to Rule 325.07's definition.[50] Section 7595 of the California Franchise Tax Board (FTB) Multistate Audit Technique Manual (MATM) provided what is probably the most detailed analysis of "vendor allowances" and which appears consistent with the Commission's interpretation of a "gross

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[47] *See* 26 C.F.R. § 1.61–6(b) ("Certain realized gains or losses on the sale or exchange of property are not 'recognized,' that is, are not included in or deducted from gross income at the time the transaction occurs.")
[48] *Id.*
[49] James H. Boyd et al., *Individual Income Tax,* 14-3 - 14-7 (William H. Hoffman, Jr. et al. eds., 2000 edition).
[50] See California R&TC section 25120(f)(1) & (2).

receipt."[51]

Section 7595 of the MATM begins by noting that the federal Treasury Regulation section 1.471-3(b) provides the rules for trade discounts stating that trade discounts reduce the invoice price and that Treasury Regulation section 1.471-3(e) provides the rules for sales-based vendor allowances stating that these decrease the cost of goods sold (COGS). The FTB identified three basic scenarios; those that reduce Costs of Goods Sold, those that generate income, and those that are a contra-expense. Only the scenario that generates a separate item of income would result in a "gross receipt" for California sales factor purposes as follows:

> <u>Income:</u> The retailer immediately recognizes income when the allowance is received. This only occurs when the retailer is selling a product or a service back to the vendor that is separate from the product or service that the vendor is selling to the retailer. These are gross receipts for California sales factor purposes.
>
> Example: If a retailer purchases item X from a vendor for $50, then sells it to a customer for $100, normally the retailer would have a gross receipt of $100 and income of $50. If the retailer receives an allowance of $10 per item sold and that $10 is treated as a separate item of income, then the amount of total gross receipts increases from $100 to $110 when item X is sold. The sourcing for the $10 (service) would likely be different than that for the $100 (sale of tangible personal property). In addition, the total income would increase from $50 to $60 when the item X is sold to a customer due to the $10 allowance.

In addition, the FTB manual provides the California auditors with additional general guidelines to apply and specific examples involving the treatment of cooperative advertising, market research services, cash payment for required level of retailer purchases, payroll allowances, shelf space, marketing, merchandise display allowance, slotting fees, and short-term promotional price or "buy down."

In summary, the FTB guidance explains why vendor income is not a sale when calculating a taxpayer's sales factor; instead, vendor income is a reduction in COGS or a contra expense that

[51] See at https://www.ftb.ca.gov/aboutFTB/manuals/audit/matm/7595.pdf.

offsets Petitioner's SG&A expenses. The Commission agrees with the FTB that such receipts are not "gross receipts" for purposes of determining the sales factor.

For Petitioner to include its vendor income as a "gross receipt" in the Idaho sales factor, the vendor income transactions must be "a transaction that produces business income, in which the income or loss is recognized...under the Internal Revenue Code."[52]

The facts before the Commission reflect that Petitioner's receipt of "vendor income" does not generate taxable income (i.e., these amounts are not "recognized" under income tax law); they only result in an adjustment to Petitioner's COGS or SG&A expenses. Petitioner has other business transactions that produce "recognized" income that ends up being reduced somewhat by these adjustments to COGS and SG&A expenses. The adjustment to COGS or SG&A expenses ends up being part of the calculation to determine the amount of "recognized" gross income in these other income producing transactions, but the adjustment to COGS or SG&A expenses is not part of the "recognized" gross income.

The transactions giving rise to Petitioner's "vendor income" themselves did not produce "recognized" gross income under the Internal Revenue Code and therefore do not meet Idaho's definition of "gross receipts." As such, for purposes of apportionment, the Commission affirms Audit's treatment of the "vendor income" as falling outside of Idaho's definition of a gross receipt for purposes of the Idaho sales factor.

As for Petitioner's incentive payments, these payments appear to be reductions to the amount of rental expense or other expenses that Petitioner would incur at a physical location within a given state. Petitioner apparently reports such income as a reduction in its financial statement expenses (such as rent expense) and as a contra-expense for purposes of its federal income tax

[52] IDAPA 35.01.01.325.07.

return. As such, for purposes of apportionment, the Commission affirms Audit's treatment of the contra-expenses as falling outside of Idaho's definition of a gross receipt for purposes of the Idaho sales factor.

IV. Order

In **Table 5** below, the Commission eliminated the Notice's proposed additional corporate income tax and PBF for [Redacted] . Additionally, the Commission reduced the Notice's proposed additional corporate tax for [Red acte to just the $20 minimum tax plus the $10 PBF for tax year ending January 31, 2014. The Commission left unchanged the minimum tax and PBF on the other tax years as asserted by Audit.

Table 5 Tax Year	Notice Additional Tax Due	[R ed Tax+PBF	Tax+PBF	Tax+PBF	Tax+PBF	Decision Additional Tax Due
1/31/2010	($28,949)	($30)	($13,010)		($30)	($42,019)
1/31/2011	64,787	(30)	(12,875)		(324)	51,558
1/31/2012	50,624	(30)	(10,632)		(30)	39,932
1/31/2013	60,628	(30)	(8,565)			52,033
1/31/2014	54,651	(30)	(2,603)	(1,866)		50,152
1/31/2015	60	(30)				30
Totals	$201,801	($180)	($47,685)	($1,866)	($384)	$151,686

The Commission modifies and finalizes the First Notice and the Second Notice as set forth in this decision.

The Commission ORDERS that Petitioner pay the following tax and interest totaling $179,365, calculated as follows:

YEAR	TAX	INTEREST	TOTAL
01/31/10	($42,019)	($13,227)	($55,246)
01/31/11	51,558	13,840	65,398
01/31/12	39,932	9,119	49,051
01/31/13	52,033	9,997	62,030
01/31/14	50,152	7,946	58,098
01/31/15	30	4	34
		TOTAL DUE	$179,365

The Commission calculated the interest shown above through July 31, 2018.

The Commission now DEMANDS immediate payment of this amount.

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

DATED this ________ day of ________________________________ 2018.

IDAHO STATE TAX COMMISSION

____

COMMISSIONER

CERTIFICATE OF SERVICE

I hereby certify that on this ________ day of ______________________________ 2018, 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.

____