

BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO

In the Matter of the Protest of

████████████████████

Petitioner.

DOCKET NO. 1-806-308-352

DECISION

████████████████████ and its subsidiaries (Petitioner) protested the Notice of Deficiency Determination (Notice) dated November 29, 2023, issued by the Income Tax Audit Bureau (Bureau). Petitioner disagreed with the Bureau’s adjustments to their apportionment factor. The Idaho State Tax Commission (Tax Commission) reviewed the matter and for the reasons stated below modifies the Notice.

BACKGROUND

Petitioner is a technology company based in ██████████ and provides “Platforms”, i.e. apps and services such as ██████████ and ██████████. The Multistate Tax Commission (MTC) conducted an audit of Petitioner’s Idaho corporation income tax returns for tax years 2018 through 2020. Upon completion of the audit, the MTC provided their findings to the Tax Commission, recommending the Bureau adjust Petitioner’s apportionable income and apportionment factor.

The Bureau adjusted Petitioner’s apportionable income and apportionment factor as the MTC recommended, added a ten percent (10%) penalty for substantial understatement and a five percent (5%) penalty for negligence, and sent Petitioner a Notice¹. Petitioner’s representative protested the Notice, disagreeing with the Bureau’s adjustments to the apportionment factor,

¹ Petitioner did not protest the apportionable income adjustment; therefore, the Tax Commission will not address it further in this decision.

specifically the sales numerator, and the imposition of penalties. The Bureau acknowledged the protest and sent the matter to the Tax Commission's Appeals Unit (Appeals) for administrative review.

Appeals reviewed the case and sent Petitioner and their representative a letter explaining the options available for redetermining a Notice. The representative responded and requested an informal hearing, which was held on April 2, 2025. After the hearing, Appeals requested additional information, which the representative provided. Having reviewed the file, the Tax Commission hereby issues its final decision.

ISSUES

There are two issues on appeal. One is the sales numerator regarding Petitioner's sourcing of sales other than sales of tangible property, which are the sales of services, specifically advertising revenues, and the other is the imposition of the penalties.

LAW AND ANALYSIS

Sales numerator

Idaho Code section 63-3027(r) Sales, other than sales of tangible property, are in this state, if:

(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.** (emphasis added)

Idaho Income Tax Administrative Rule IDAPA 35.01.01.550., provides in pertinent part,

01. In General. ... gross receipts are attributed to Idaho if, with respect to a particular item of income, the income producing activity is performed within and without Idaho but **the greater part of the income producing activity is performed in Idaho, based on costs of performance.** (emphasis added)

02. Income Producing Activity. The term income producing activity applies to **each separate item of income** and means the transactions and activity engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose

of producing that item of income. The activity includes transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor. (emphasis added)

03. Costs of Performance Costs of performance are the direct costs^[2] 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. Included in the taxpayer's cost 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.

To determine the amount of Petitioner's advertising revenue attributable to Idaho, the Tax Commission must review the following: (1) each separate income item, (2) income producing activities for each separate income item everywhere³ and in Idaho, (3) amount of direct costs that are traceable to, and associated with, each separate income item earned by performing the income producing activities, (4) where the preponderance of the costs of performance occurred, and (5) whether the preponderance of the costs of performance effectuates an equitable apportionment.

Income item

The representative explained in the protest that Petitioner's primary source of revenue was from "the sale of advertising placements to marketers (i.e., advertising agencies and other businesses that buy advertisements on [Petitioner]'s Platforms⁴, hereinafter referred to as 'Advertisers')". Therefore, the Tax Commission finds the income item in this case is the

² The term "direct costs" generally refers to expenses that can be directly attributed to a specific income item. In the context of tax law and accounting, direct costs are often discussed in relation to production costs. **Direct Production Costs:** Direct production costs are those that can be specifically identified with or traced to a given cost object in an economically feasible way. These include the material forming an integral part of the product and the labor directly involved in the fabrication of the product. **Direct Labor Costs:** Direct labor costs include the costs of labor that can be identified or associated with particular units or groups of units of specific property produced. This includes full-time and part-time employees, contract employees, and independent contractors.

³ Petitioner's filing method was worldwide.

⁴ Platforms are apps and services [REDACTED].

advertising revenue Petitioner receives from selling advertising placements⁵ to Advertisers. “Each separate income item⁶” means the advertising revenue charged to each customer on an invoice or on a contract for each sale Petitioner made to earn advertising revenue.

Income producing activities

IDAPA 35.01.01.550.02., provides that an income producing activity applies to “each separate item of income”, which means that the Tax Commission must independently analyze “each separate item of income” to determine where the income producing activities, with respect to the particular item of income, took place. The MTC Article IV, Section 17, as originally established in the 1960s⁷, explains the income producing activities are “transactions and activity directly engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of producing that item of income.” IDAPA 35.01.01.550.02.a.i. states that income producing activities includes,

The rendering of personal services by employees or by an agent or independent contractor acting on behalf of the taxpayer or the use of tangible and intangible property by the taxpayer or by an agent or independent contractor acting on behalf of the taxpayer in performing a service; ...

Petitioner’s Form 10-K, filed with the U.S. Securities and Exchange Commission, explains that they generate advertising revenue by displaying advertisements (ad products) on Platforms. The 10-K further explains that there are two types of advertisement: impression-based ads, and action-based ads. Petitioner recognizes revenue when a user on a Platform watches the impression-

⁵ Advertising placement means the specific location and format where an advertisement appears on a website, app, social media platform, or other online space. The placement of an advertisement significantly impacts its visibility, access rate and overall effectiveness.

⁶ IDAPA 35.01.01.550.02.

⁷ The MTC amended the model regulation in 2015, changing from the costs of performance method to the market-based sourcing method. Idaho adopted the market-based sourcing method for tax years beginning on and after January 1, 2022. The costs of performance method is as recommended by the MTC in the 1960s, plus the changes in 2009 to add clarification: “or by an agent or independent contractor acting on behalf of the taxpayer” to Idaho Rule IDAPA 35.01.01.550.02.a.i.

based ad. As for the action-based ads, Petitioner recognizes revenue when a user takes the actions the advertisement intended, e.g., purchasing a product or service marketed on the ads.

The MTC determined that Petitioner's income producing activities happened on users' computers when users click ads or purchase product/service marketed on ads. Petitioner argued that the MTC ignored their costs of performance and income producing activities and endeavored to "achieve a market-based sourcing^[8] result under a cost of performance regime".

It is true that Petitioner does not recognize advertising revenues if users do not click the ads or purchase products/services marketed on the ads. However, before users can click the ads, Petitioner must make the ads available for users to click on the Platforms. The users of Platforms are not employees of Petitioner, nor are they independent contractors acting on behalf of Petitioner. To make the ads available for users, Petitioner built Platforms, operated their data centers and technical infrastructure, employed their operations teams, etc., and these activities, which gave rise to the advertising revenue, should not be ignored when determining their income producing activities.

Petitioner had no facilities, i.e., data centers, servers, etc., in Idaho for tax years 2018 through 2020. However, Petitioner employed contractors to perform advertising services on their behalf in Idaho⁹, and these independent contractors were an integral part of Petitioner's income producing activities.

Direct costs

Petitioner's 10-K explains their cost of revenue, which is the direct costs, as:

⁸ Idaho adopted the market-based sourcing method for tax years starting on and after January 1, 2022; therefore, it is not applicable to this case.

⁹ Petitioner had employees in Idaho, but their Idaho employees' wages were for research & development, general admin, etc, which are recorded as a separate line item from the cost of revenue on the 10-K.

Our cost of revenue consists primarily of expenses associated with the delivery and distribution of our products. These include expenses related to the operation of our data centers and technical infrastructure, such as facility and server equipment depreciation, salaries, benefits, and share-based compensation for employees on our operations teams, and energy and bandwidth costs. Cost of revenue also includes costs associated with partner arrangements, including traffic acquisition and content costs, credit card and other transaction fees related to processing customer transactions, and cost of consumer hardware devices sold.

As for Idaho, the direct cost is the amount paid to the independent contractors located in Idaho.

Costs of performance

In determining the sales apportionable to Idaho, the Tax Commission must review where the costs of performance¹⁰ occurred with respect to its income producing activities for each separate item of advertising revenue. If the preponderance of the costs of performance did not occur in Idaho, the income should be sourced to a state other than Idaho. However, since the MTC's model regulation¹¹ adopted by Idaho was established in the 1960s¹², it is questionable whether Idaho statute and rules regarding costs of performance are applicable in this e-commerce era. The MTC amended the model regulation in 2015, changing the recommended sourcing method from the costs of performance to "market-based sourcing". However, despite legislative efforts, tax years beginning on and after January 1, 2022, is when Idaho adopted the market-based sourcing method.

¹⁰ Provisions in the Idaho statute and rules regarding the costs of performance give a state all sales or no sales, "all-or-nothing", as they require a taxpayer to source each income item to a state where the preponderance of the costs of performance occurred.

¹¹ The Multistate Tax Compact, Article IV, Section 17.

¹² In the late 1960s, most of the service sales were based on personal or professional services, such as pre-internet lawyers, accountants, and engineers, and determining where the preponderance costs of performance took place would have been relatively simple.

It is clear that the cost of performance method is outdated and does not fairly reflect Petitioner's business activities in Idaho. However, Idaho statute and rules for the market-based sourcing method are not effective for the years under review. Therefore, the Tax Commission explores alternative apportionment to fairly represent Petitioner's business activity in Idaho.

Alternative apportionment

Idaho Code section 63-3027(s) states,

If the allocation and apportionment provisions of this section do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the state tax commission may require, in respect to all or any part of the taxpayer's business activity, if reasonable:

- (4) The employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

To determine a fair representation of Petitioner's business activities in Idaho, Appeals reviewed the alternative apportionment method. In a prior audit, the Bureau used alternative apportionment, prorating the advertising revenues based on the percentage of Idaho direct costs to the total cost of revenue (pro-rata). The Tax Commission found that prorating the advertising revenues based on an Idaho direct cost % results in an equitable apportionment of Petitioner's income for the years under review. Therefore, the Tax Commission modifies the Notice to source the advertising revenue based on the Idaho direct cost %.

Penalty abatement

During the hearing, the representative argued that the method Petitioner used to determine the cost of performance (all-or-nothing) is correct. The representative explained in the protest that "[t]he party asserting alternative apportionment bears the burden of showing that alternative apportionment is appropriate." *Union Pacific Corp. v. Idaho State Tax Comm'n*, 139 Idaho 572, 575 (2004) and argued that the Bureau did not meet the burden. The representative further argued

that the outdated provisions in the Idaho statute and rules regarding the cost of performance method are the root cause for the penalties. The representative requested the Tax Commission waive both substantial understatement and negligence penalties as there was reasonable cause for the understatement, and they acted in good faith.

The substantial understatement penalty is set forth in Idaho Code section 63-3046(d).

- (1) If there is a substantial understatement of tax for any taxable year, there shall be added to the tax an amount equal to ten percent (10%) of the amount of any underpayment attributable to such understatement.
- (2) For purposes of this subsection, there is a substantial understatement of tax for any taxable year if the amount of the understatement for the taxable year exceeds the greater of:
 - (i) Ten percent (10%) of the tax required to be shown on the return for the taxable year, or
 - (ii) Five thousand dollars (\$5,000).
- (4) For purposes of paragraph (d)(2) of this section, the term "understatement" means the excess of:
 - (i) The amount of tax required to be shown on the return for the taxable year, over
 - (ii) The amount of the tax imposed which is shown on the return.

The computation of the amount of the understatement of tax and the determination that it is substantial are mechanical processes under subsections (2) and (4) of the quoted subsection. In the present case, the substantial understatement of Idaho loans resulted in a tax deficiency, which exceeded the threshold provided in Idaho Code section 63-3046(d)(2)(i) and (ii).

As for the negligence penalty, Idaho Code section 63-3046(a) states,

If any part of any deficiency is due to negligence or disregard of rules but without intent to defraud, five percent (5%) of the total amount of the deficiency (in addition to such deficiency) shall be assessed, collected and paid in the same manner as if it were a deficiency.

Tax Administration and Enforcement Rule IDAPA 35.02.01.410.02., further clarifies that,

[a] five percent (5%) negligence penalty shall be imposed if the deficiency results from either negligence by the taxpayer or from disregard by the taxpayer or his agent of state or federal tax laws, rules of the Tax Commission, or Treasury

Regulations. Example of situations that justify the negligence penalty include the following:

- a. Taxpayer continues to make errors in reporting income, sales or assets, or claims erroneous deductions, exemptions, or credits even though these mistakes have been called to his attention in previous audit reports.

Idaho Code section 63-3046(d)(7) is applicable not just to the substantial understatement penalty but also to the negligence penalty, states:

[t]he state tax commission may waive all or any part of the addition to tax provided by this section 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.

The Bureau audited Petitioner in prior tax years regarding their sourcing of the advertising revenue based on the cost of performance method. In the prior audit, the Bureau applied alternative apportionment and Petitioner agreed with the Bureau's determination. Petitioner's position has always been that the preponderance costs of performance did not occur in Idaho and therefore they are not required to source the advertising revenue to Idaho. However, because of the outdated provisions in Idaho statute and rules, Petitioner recognizes that their business activities in Idaho may not be fairly represented. Therefore, to account for the flaws caused by the outdated provision, Petitioner, in a prior audit, agreed to source a proportion of the advertising revenues to Idaho based on the Idaho direct cost percentage. At the conclusion of the hearing, Petitioner and the representative agreed to collectively work with Appeals and find an alternative method to effectuate an equitable apportionment of their income in the same manner as agreed in the prior audit. Based on Appeals' further review and analysis, the Tax Commission finds that there was reasonable cause for the understatement (or part thereof) and that Petitioner acted in good faith. Therefore, the Tax Commission modifies the Notice to abate the penalties.

CONCLUSION

The Tax Commission found that the “all or nothing” cost of performance method does not fairly represent Petitioner’s business activities in Idaho and determined that the alternative method, prorating the advertising revenue based on the Idaho direct cost %, is appropriate. The Tax Commission modifies the Notice for the sales numerator. The Tax Commission also found that there was reasonable cause for the understatement (or part thereof) and that Petitioner acted in good faith. Therefore, the Tax Commission abates the 5% negligence penalty and the 10% substantial understatement penalty.

The Notice added interest to the tax due amount, and the Tax Commission finds the addition appropriate in accordance with Idaho Code section 63-3045.

THEREFORE, the Tax Commission MODIFIES the Notice dated August 28, 2024, directed to Petitioner.

<u>YEAR</u>	<u>TAX</u>	<u>PENALTY</u>	<u>INTEREST</u>	<u>TOTAL</u>
2018	\$105,686	\$0	\$20,153	\$125,839
2019	147,724	0	20,204	167,928
2020	48,158	0	5,259	53,417
			TOTAL DUE	<u>\$347,184</u>

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

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

DATED this _____ day of _____ 2025.

IDAHO STATE TAX COMMISSION

CERTIFICATE OF SERVICE

I hereby certify that on this _____ day of _____, 2025,
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:

Receipt No.

[REDACTED]

[REDACTED]