

11-2010  
TAX TYPE: INCOME  
TAX YEAR: 2006, 2007, AND 2008  
DATE SIGNED: 3-2-2012  
COMMISSIONERS: M. JOHNSON, D. DIXON, M. CRAGUN  
EXCUSED: B. JOHNSON  
GUIDING DECISION

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BEFORE THE UTAH STATE TAX COMMISSION

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TAXPAYER-1  
TAXPAYER-2

Petitioner,

v.

AUDITING DIVISION OF THE  
UTAH STATE TAX COMMISSION

Respondent.

**INITIAL HEARING ORDER**

Appeal No. 11-2010  
Account No. #####  
Tax Type: Income Tax  
Tax Year: 2006, 2007 and 2008  
  
Judge: Nielson-Larios

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**Presiding:**

Aimee Nielson-Larios, Administrative Judge

**Appearances:**

For Petitioner: TAXPAYER-1, by telephone  
For Respondent: RESPONDENT REPRESENTATIVE- 1, Assistant Attorney General, in person  
**RESPONDENT REPRESENTATIVE-2, Auditing Division, in person**

STATEMENT OF THE CASE

This matter came before the Commission for an Initial Hearing in accordance with Utah Code Ann. §59-1-502.5, on November 29, 2011. On April 20, 2011, Respondent (the "Division") issued Notices of Deficiency and Estimated Income Tax ("Statutory Notices") to Petitioner (the "Taxpayer"), in which the Division imposed tax, interest, and penalty as a result of a non-filing audit, as follows:

<u>Year</u>	<u>Tax</u>	<u>Penalties</u>	<u>Interest</u>	<u>Total</u>
2006	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$
2007	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$
2008	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$	\$\$\$\$\$

Interest has continued to accrue.

The Taxpayer, a resident of STATE-1, was a member of COMPANY. The Division treated all of the Taxpayer's member income reported by COMPANY on Schedule K-1 forms as Utah source income.

The Taxpayer disagrees with this allocation, and argues that all such income from COMPANY should be STATE-1source income.<sup>1</sup>

APPLICABLE LAW

Utah Code § 59-1-1417 (2011) provides, “In a proceeding before the commission, the burden of proof is on the petitioner . . .”

For 2006-2007, a tax is imposed on the income of individuals who are non-residents of the State of Utah, as set forth below in Utah Code § 59-10-116(2) (2006-2007), stating in pertinent part:

- (2) [A] tax is imposed on a nonresident individual in an amount equal to the product of the nonresident individual’s:
  - (a) unapportioned state tax; and
  - (b) **state income tax percentage** . . .

(Emphasis added.)

Utah Code § 59-10-116(1) (2006) defines the terms “unapportioned state tax” and “state income tax percentage,” as follows:

- (1) For purposes of this section:

.....

- (c) “state income tax percentage” means a percentage equal to a nonresident individual’s federal adjusted gross income for the taxable year **received from Utah sources, as determined under Section 59-10-117**, divided by the difference between:
  - (i) the nonresident individual’s total federal adjusted gross income for that taxable year; and
  - (ii) if the nonresident individual described in Subsection (1)(c)(i) is a servicemember, the compensation the servicemember receives for military service if the servicemember is serving in compliance with military orders; and
- (d) “unapportioned state tax” means the product of the:
  - (i) difference between:
    - (A) a nonresident individual’s federal taxable income, as defined in Section 59-10-111, with the modifications, subtractions, and adjustments provided in Section 59-10-114; and
    - (B) if the nonresident individual described in Subsection (1)(d)(i)(A) is a servicemember, compensation the servicemember receives for military service if the servicemember is serving in compliance with military orders; and
  - (ii) tax rate imposed under Section 59-10-104.

(Emphasis added.)

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<sup>1</sup> The parties did not present arguments on whether a waiver of penalties might be appropriate based on reasonable causes such as those provided in Utah Admin. Code R861-1A-42, available online at <http://tax.UTAH.gov/commission/effective/r861-01a-042.pdf>. Thus, this order does not address any such waiver request.

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Utah Code § 59-10-116(1) (2007) has minor wording changes but is substantively the same as § 59-10-116(1) (2006).

For 2008, Utah Code § 59-10-116(1) (2008) imposes a tax on a nonresident individual and provides a calculation similar to that found in § 59-10-116(2) (2006-2007), stating the follows:

- (1) [A] tax is imposed on a nonresident individual in an amount equal to the product of the:
  - (a) **nonresident individual's state taxable income**; and
  - (b) percentage listed in Subsection 59-10-104(2).

(Emphasis added.)

Utah Code § 59-10-103(1)(w) (2008) defines state taxable income as follows, in part:

"Taxable income" or "state taxable income":

....

- (ii) for a nonresident individual, is an amount calculated by:
  - (A) determining the nonresident individual's adjusted gross income for the taxable year, after making the:
    - (I) additions and subtractions required by Section 59-10-114; and
    - (II) adjustments required by Section 59-10-115; and
  - (B) calculating the portion of the amount determined under Subsection (1)(w)(ii)(A) that is **derived from Utah sources in accordance with Section 59-10-117**;

(Emphasis added.)

Federal adjusted gross income derived from Utah sources is defined in Utah Code § 59-10-117 (2006), below in pertinent part:

- (1) For the purpose of Section 59-10-116, federal adjusted gross income derived from Utah sources shall include those items includable in federal "adjusted gross income" (as defined by Section 62 of the Internal Revenue Code) attributable to or resulting from:

....

- (b) the **carrying on of a business . . . in this state**.

....

- (2) For the purposes of Subsection (1):

....

- (g) A **nonresident partner's distributive share** of partnership income, gain, loss, and deduction **derived from or connected with Utah sources** shall be determined under Section 59-10-303.

(Emphasis added.)

Utah Code § 59-10-117 (2007) has minor wording changes but is substantively the same as § 59-10-117 for 2006. Utah Code § 59-10-117 (2008) is similar to § 59-10-117 (2006-2007), but for 2008, subsection (2)(g) references Utah Code § 59-10-1405 (2008) instead of Utah Code § 59-10-303 (2006-2007).

Utah Code § 59-10-303 (2006-2007) states:

- (1) In determining the adjusted gross income of a nonresident partner of any partnership, there shall **be included only that part derived from or connected with sources in this state** of the partner's distributive share of items of partnership income, gain, loss, and deduction entering into his federal adjusted gross income, as such part is determined under rules prescribed by the commission in accordance with the general rules in Section 59-10-116.  
.....
- (4) The commission may, on application, authorize the use of such other methods of determining a nonresident partner's portion of partnership items derived from or connected with sources in this state, and the modifications related thereto, as may be appropriate and equitable, on such terms and conditions as it may require.  
.....

(Emphasis added.)

Utah Code § 59-10-1405 (2008) states:

- (1) Subject to Subsection (2), the adjusted gross income of a nonresident taxpayer shall **be adjusted by only that portion of the taxpayer's distributive share of an item of income, gain, loss, or deduction of a pass-through entity derived from or connected with sources in this state.**  
.....
- [(5)] (b) For purposes of Subsection (5)(a), the commission may authorize the use of one or more methods, other than a method described in Subsections (1) through (4), if:
  - (i) the commission finds that the use of the method is appropriate and equitable; and
  - (ii) the taxpayer applies to the commission.  
.....

(Emphasis added.)

Utah Code § 59-10-118 (2006-2007) states in part:

- (1) As used in this section unless the context otherwise requires:
  - (a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.  
.....
- (2) **Any taxpayer having business income which is taxable both within and without this state, shall allocate and apportion his net income as provided in this section.**  
.....
- (8) **All business 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 the sales factor, and the denominator of which is three.**

....

- (17) If the allocation and apportionment provisions of this chapter do not fairly represent the extent of the taxpayer's business activity in this state, the taxpayer may petition for or the commission may require, in respect of all or any part of the taxpayer's business activity, if reasonable:
- (a) separate accounting;
  - (b) the exclusion of any one or more of the factors;
  - (c) the inclusion of one or more additional factors which will fairly represent the taxpayer's business activity in this state; or
  - (d) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

(Emphasis added.)

Utah Code § 59-10-118 (2008) has changes to its wording but is substantively the same as § 59-10-118 for 2006-2007; the Utah Code for 2008 still requires the allocation of business income according to the property, payroll, and sales factors.

Utah Code § 59-10-115 (2011) provides for adjustments for double taxation, stating in part:

- (1) The commission shall allow an adjustment to adjusted gross income of a resident or nonresident individual if the resident or nonresident individual would otherwise:
  - (a) receive a double tax benefit under this part; or
  - (b) suffer a double tax detriment under this part.

....

#### DISCUSSION

According to the Operating Agreement, a COMPANY formed in 2006 under the STATE-1, COMPANY Act with a designated office and principal place of business that was originally in CITY-3, STATE-1. The Operating Agreement allowed the Managing Member to change the location of the office and/or place of business in the future.

Based the Operating Agreement, the Taxpayer argues that COMPANY is a STATE-1 company with STATE-1 income. The Taxpayer said he claimed the Schedule K-1 income reported by COMPANY on his STATE-1 individual income tax returns for the 2006-2008 tax years and he submitted copies of those returns for this appeal. The Taxpayer said it is unfair to require him to pay tax to Utah when he has already paid tax on the same income to STATE-1. He said he cannot get a refund from STATE-1 for the 2006 tax year because the STATE-1 statute of limitations has run and he also does not want to cause the 2006 tax year to be reopened for STATE-1 because he entered into a tax settlement for that year.

The Division did not challenge the Taxpayer's claim to have reported COMPANY income to the state of STATE-1. However, the Division disagrees that COMPANY income is STATE-1 source income. The Division explained that COMPANY was registered in Utah as a foreign COMPANY; that it was authorized to do business in Utah; that it listed its registered agent and primary place of business as

located at, ADDRESS, in CITY, Utah; that it reported W-2 income paid to two individuals in Utah-- NAME, a manager, in CITY-1, Utah, and NAME-1, a bookkeeper, in CITY-2, Utah; and that it filed Utah tax returns without apportioning its income to other states.

On the Schedule K-1 (Form 1065) forms issued by COMPANY to the Taxpayer for the 2007 and 2008 tax years, COMPANY reported its address as ADDRESS, in CITY, Utah, and it reported in Box 1 ordinary business income of \$\$\$\$\$ for 2007 and \$\$\$\$\$ for 2008. The Schedule K-1 forms did not include additional information separating the ordinary business income by state. No interest, dividend, or other type of income was reported on the Schedule K-1 forms. No Schedule K-1 form for the 2006 tax year was submitted. The Schedule K-1 forms for 2007 and 2008 show COMPANY tax year to be a calendar year, not a fiscal one.

At the hearing, the Taxpayer speculated that COMPANY incorrectly reported its income as source income instead of STATE-1 source income because Utah had a lower tax rate than STATE-1. The Taxpayer said he requested that COMPANY amend its returns, but COMPANY refused. The Taxpayer contends that much of COMPANY income was not Utah source income, and he submitted a document titled "COMPANY, Loans by State, DATE, YEAR," which included graphs breaking out the loans by state. The Taxpayer said he received this document from NAME-3. According to the document, on March 31, 2008, %%% percent of COMPANY loan balances were from Utah loans, %%% percent from STATE-1 loans, and the remaining percentages were from other states.

The Division stated that COMPANY filed a Utah TC-65 and did not apportion income to other states using a Schedule B and that by not including a Schedule B, COMPANY reported all of its income as Utah source income. The Division asserts that it correctly apportioned all of the Taxpayer's Schedule K-1 income from COMPANY to Utah based on COMPANY reporting of the income. The Division also contends that if COMPANY incorrectly reported its income, any correction must be first made at the partnership/company level because such a change would affect the other members of COMPANY. The Division discussed the procedure provided in the Internal Revenue Code for corrections at the partnership level for federal income tax purposes. The Division noted that in the Taxpayer's case, the Taxpayer requested COMPANY make a correction but COMPANY refused. Lastly, the Division asserted that even if the Taxpayer has shown that COMPANY incorrectly apportioned its income, the Taxpayer has not shown what a correct apportionment would be.

As a final argument, the Taxpayer contends that Utah should not require him to pay Utah income tax on COMPANY income amounts for 2006, 2007, and 2008, because such tax would just be refunded

in subsequent years. The Taxpayer explained that COMPANY is now generating losses which would cause the prior years' taxes to be refundable.

After reviewing the facts, the Taxpayer has not shown the Schedule K-1 income from COMPANY to be STATE-1 source income. COMPANY was registered in Utah; it could legally do business in Utah; and it had ASSETS in Utah. It filed a Utah return that showed all of its income as Utah source income, and it refused to amend its return when the Taxpayer's requested such. The Division's audit assessments are supported by the Utah TC-65 returns filed by COMPANY.

Although the document titled, "COMPANY Loans by State, DATE, YEAR," raises a question as to whether all of the income of COMPANY was Utah source income, the document has limited usefulness in this appeal. First, the document's origins are questionable; we do not know who created it, how it was created, what underlying data was used, or if the underlying data was correct. Furthermore, even if the document's information is correct, such information only applies to DATE, YEAR and is too limited to calculate an apportionment based on the three factor formula required by the Utah Code. The Taxpayer has not met his burden of proof to prevail on an allocation different from the ones used by the Division in its audits.

Furthermore, the Taxpayer's request for relief under the Utah Code for double taxation should also be denied. Although, the Taxpayer claims STATE-1 taxed him on COMPANY income, he has not shown that he correctly reported the income to STATE-1. Based on the facts presented, COMPANY income is Utah source income, not STATE-1 source income.

Lastly, the Taxpayer's claim of future losses from COMPANY is not sufficient for him to avoid the Division's audit assessments for the 2006, 2007, and 2008 tax years. If the Taxpayer is entitled to refunds in later years for the Utah taxes assessed for the 2006, 2007, and 2008 tax years, he should file Utah tax returns for the later years to claim his refunds.

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Aimee Nielson-Larios  
Administrative Law Judge

#### DECISION AND ORDER

Based on the foregoing, the Commission sustains the Division's audits for the 2006-2008 tax years. It is so ordered.

This decision does not limit a party's right to a Formal Hearing. However, this Decision and Order will become the Final Decision and Order of the Commission unless any party to this case files a written request within thirty (30) days of the date of this decision to proceed to a Formal Hearing. Such a

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request shall be mailed to the address listed below and must include the Petitioner's name, address, and appeal number:

Utah State Tax Commission  
Appeals Division  
210 North 1950 West  
Salt Lake City, Utah 84134

Failure to request a Formal Hearing will preclude any further appeal rights in this matter.

DATED this \_\_\_\_\_ day of \_\_\_\_\_, 2012.

R. Bruce Johnson  
Commission Chair

Marc B. Johnson  
Commissioner

D'Arcy Dixon Pignanelli  
Commissioner

Michael J. Cragun  
Commissioner