

03-1149
Audit
Signed 05/05/2005

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER,	)	FINDINGS OF FACT,	
	)	CONCLUSIONS OF LAW,	
Petitioner,	)	AND FINAL DECISION	
)		
v.	)	Appeal No.	03-1149
	)	Parcel No.	#####
AUDITING DIVISION OF	)	Tax Period:	01/98 - 12/98
THE UTAH STATE TAX	)	Tax Type:	Corporate Franchise
COMMISSION,)		
	)	Judge:	Phan
Respondent.)		

Presiding:

Jane Phan, Administrative Law Judge

Appearances:

For Petitioner: PETITIONER REPRESENTATIVE 1, Attorney at Law
PETITIONER REPRESENTATIVE 2
PETITIONER REPRESENTATIVE 3
PETITIONER REPRESENTATIVE 4

For Respondent: RESPONDENT REPRESENTATIVE, Assistant Attorney General

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for a Formal Hearing on November 30, 2005. Petitioner submitted a Post Hearing Brief in this matter on February 11, 2005, and Respondent on February 18, 2005. Based upon the evidence and testimony presented, the Tax Commission hereby makes its:

FINDINGS OF FACT

1. The tax in question is corporate franchise tax.
2. The tax period at issue is January 1, 1998 through December 31, 1998.
3. The matter came before the Tax Commission on Petitioner's appeal of a refund denial for the tax year 1998. Petitioner had filed its original Utah 1998 return on a separate company basis. In 2001

an amended return was filed for tax year 1998, claiming a refund of \$\$\$\$ plus interest. Respondent denied the refund and this appeal of the denial was timely filed.

4. The difference between the original return and the amended return was that for the sales factor of the amended return Petitioner attributed no sales to Utah, while on the original return \$\$\$\$ had been reported as Utah sales. Petitioner claims that the reason for this was oversight on the part of Petitioner. In 1994, Petitioner acquired the assets, principally customer processing contracts, from COMPANY (COMPANY). Prior to the acquisition, these contracts called for the processing of card transaction for customers of COMPANY located throughout the United States, and such processing took place in Utah. Subsequent to the acquisition, the actual processing was moved from Utah to STATE 1, leaving only the debit card support function in Utah by 1995 and continuing through 1998. Petitioner explained that internal records relating to the processing of the former COMPANY customers continued to be generated as if these transactions were being processed in Utah. Most of the COMPANY receipts related to COMPANY customers located outside Utah. Petitioner's total receipts attributable to Utah based customers was only \$\$\$\$ out of the total \$\$\$\$ receipts claimed in Utah in error on the original return for tax year 1998.¹

5. When Petitioner prepared the amended 1998 return, Petitioner did not include the COMPANY receipts attributable to the non-Utah based customers, nor did it include the COMPANY Utah based customers in the numerator as it was the conclusion of Petitioner's tax preparer that the Utah facility performed no income producing activities.

6. After hearing the evidence at the hearing, Respondent acknowledged that the receipts relating to the COMPANY customers located outside Utah should not be included in the receipts attributable to Utah. If the non-Utah COMPANY sales were removed from the sales factor, but the receipts relating to the Utah COMPANY customers included, Petitioner's refund would be reduced to \$\$. Petitioner contends,

however, that its amended 1998 return was correct in indicating no sales attributable to Utah and the appropriate refund amount was the \$\$\$\$ claimed on the amended return.

7. PETITIONER (“PETITIONER”)² provides a variety of credit and debit card services to its customers who are banks, credit unions and other financial institutions.

8. During the period at issue PETITIONER’S customer base consisted of approximately 5,000 financial institutions of which less than 100 were principally located in Utah.

9. PETITIONER’S central data processing facility is located in CITY, STATE 1 where it processes credit and debit card transactions for its customers. Processing is done only at this STATE 1 facility. The level and types of services provided to its customers varies, but a typical card processing service would be one in which Petitioner posted the transaction details that allow for the settlement of fund transfers between the various parties and the posting of transactions to be used by the various financial institutions in sending credit card statements to the cardholders. A typical debit card transaction would be similar but not involve the posting of the transaction to a billing statement to be sent to the user of the debit card.

10. In addition to the data processing facility, Petitioner’s main customer support facility is in STATE 1, which is the support facility for the customers using Petitioner to process the credit card transactions. Petitioner also maintains a customer support facility in STATE 2 and Utah to provide support to its customers utilizing Petitioner’s service to process debit card transactions. The Utah facility comprised approximately 15,000 square feet and employed approximately 40-50 people. Approximately 1,100 people are employed at the STATE 1 facility. Petitioner’s building in STATE 1 comprised about 300,000 square feet.³

11. Although Petitioner’s invoices to its customers indicated various line items for specific services, without exception there was not a single invoice generated from the billing system containing

1 Respondent’s Exhibit 1.

2 Subsequent to the period at issue, after reorganization, Petitioner’s legal name was changed to (X)

any charge for the customer service function performed by the support facility located in Utah. Every line item reflected on the invoice with a specified charge resulted from services performed in STATE 1. The evidence and testimony indicated that the number of times a customer called the Utah office for support service was not reflected in the amount billed as Petitioner did not account for the service as a revenue generating activity. Instead it was accounted for as an expense only. Petitioner's representative acknowledged that the customer service aspect was a valuable part of the services offered.⁴ However, the facility located in Utah included only 1.3106% of the company's total operating costs.⁵ If only direct costs for providing the services were considered Utah's costs would be somewhere between 2% and 10% of Petitioner's direct costs.⁶

12. Although not separately invoiced the services performed at the Utah facility are a necessary part of Petitioner's service package. It is the Commission's conclusion that the services performed by Petitioner are, therefore, performed within and without the state. However, the evidence is clear that based on the cost of performance the greater portion of the income-producing activity is performed in STATE 1.

13. In conjunction with the other services, Petitioner also embossed and mailed the credit cards directly to the cardholders of Petitioner's customers. Petitioner either used a standard card stock that it supplied, or Petitioner's customers would supply a specialized card stock. Embossing was the process of encoding the names on the front of the plastic card stock and also the data that goes on the magnetic stripe on the back of the card. The embossing took place in either STATE 2 or STATE 1. Petitioner charged its customers for the embossing service as well as a small fee for the card stock if the cardstock had been used. Somewhere between 25% and 50% of the amounts charged for "embossing" related to transactions where Petitioner provided the card stock. The remaining 50%-75% of the amounts charged for "embossing" related

3 Testimony of (X) and (X).

4 Testimony of (X) and (X).

5 Petitioner's Exhibit 6

6 Testimony of (X).

to transactions where Petitioner's customers provided their own card stock. In those instances where Petitioner provided the card stock, it was not sold to Petitioner's customers in a for profit transaction. Rather, the cost of the plastic was simply passed through to the customer. Of the approximately 25% to 50% of the embossing transactions that involved a reimbursement for the generic plastic, only one-third of the fee related to the reimbursement of the cost of the plastic card. Two-thirds related to the service of embossing and encoding the cards.⁷ From the invoices of the Utah Customers provided by Petitioner in this matter⁸ and compiled by Petitioner in its posthearing filing the total embossing receipts related to the Utah customers was \$\$\$\$ and based on the estimated percentages provided at the hearing this would equate to \$\$\$\$ for the actual plastic cards provided to Utah customers.⁹

14. Petitioner's Utah apportionment percentage on its amended 1998 return was 3.3338%.¹⁰ If the Respondent were to prevail on the position that the receipts from all Petitioner's Utah based customers should be included in the Utah sales factor, after correction for the fact that many of the sales attributed to Utah on the original return were done so in error as part of COMPANY'S receipts, the allocation percentage would be 3.6500%.¹¹ The Commission does not find the apportionment percentage indicated on the amended return to unfairly represent the extent of Petitioner's business activities in this state.

APPLICABLE LAW

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. (Utah Code Sec. 59-7-311.)

The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this

7 Testimony of (X).

8 Petitioner's Exhibits 1-4.

9 Petitioner's Post Hearing Brief, pg. 19.

10 Respondent's Exhibit 1.

state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period. (Utah Code Sec. 59-7-317)

Sales, other than sales of tangible personal property, are in this state if (a) the income-producing activity is performed in this state; or (b) the income producing 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. (Utah Code Sec. 59-7-319(1).)

Under Section 59-7-319(1), gross receipts are attributed to this state if the income producing activity that gave rise to the receipts is performed wholly within this state. Also, gross receipts are attributed to this state if, with respect to a particular item of income, the income producing activity is performed within and without this state but the greater proportion of the income producing activity is performed in this state, based on costs of performance. (Utah Admin. Rule R865-6F-8(I)(6)(a).)

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. (Utah Admin. Rule R865-6F-8(I)(6)(b).)

The term “costs of performance” means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer. (Utah Admin. Rule R865-6F-8(I)(6)(c).)

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 to all or any part of the taxpayer’s business activity, if reasonable: (1) separate accounting; (2) the exclusion of any one or more of the factors; (3) the inclusion of one or more additional factors which will fairly represent the taxpayer’s business activities in this state; (4) the employment of any other method to effectuate

11 Complied by Petitioner based on evinced presented at the hearing. Petitioner’s Post Hearing Brief, pg. 22.

an equitable allocation and apportionment of the taxpayer's income. (Utah Code. Sec. 59-7-320.)

DISCUSSION

The first issue before the Tax Commission in this matter is whether there were sales attributable to Utah during the tax year 1998 for the purposes of determining the sales factor as set out in Utah Code Ann. 59-7-317 & 59-7-319. The second issue is whether the statutory allocation and apportionment provisions do not fairly represent the extent of the taxpayer's business activity in this state, such that a different method may be applied pursuant to Utah Code Sec. 59-7-320.

Considering the first issue in this matter, Utah Code Sec. 59-7-311 provides that business income is apportioned to Utah by multiplying the income by a fraction, the numerator of which is the property factor, plus the payroll factor, plus the sales factor. It is only the sales factor that is at issue in this matter. Utah Code Section 59-7-317 provides that the sales factor is a fraction based on the sale in this state and the total sales of the taxpayer everywhere. Utah Code Sec. 59-7-319(1) indicates that for sales other than of tangible personal property to be considered to have occurred "in this state": a) the income producing activity is performed in this state; or b) if the income producing activity is performed both in and outside this state and a greater portion of the income producing activity is performed in this state based on cost of performance.

Petitioner argues that all its income producing activity occurs in STATE 1, because it bills its customers only for services that are performed in STATE 1. The invoices indicate various line items relating to services performed, all of which refer to services performed in STATE 1. The customer services support functions performed in Utah, although an important and integral part of Petitioner's business, are not separately billed on an invoice. In fact, the evidence indicated that whether the customer called the Utah customer service support center one time or twenty times during the month would not be considered in the amount billed to the customer by Petitioner.

Petitioner points out, however, that if the Utah support function was included as part of the

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income producing activity, then the cost of performance would indicate that the income producing activity occurred in STATE 1. Petitioner went through a number of cost calculations under which, in every instance the result was less than 10% of the costs attributable to the Utah center. So even if the Utah customer service activity was considered to be part of the income producing activity, Petitioner argues that there would be no sales “in this state” pursuant to the applicable statutes in this matter.

Respondent points out that some of Petitioner’s customers, the banks and financial institutions, are primarily Utah businesses. In fact, of Petitioner’s 5,000 or so customers during this period, less than 100 were primarily Utah businesses. The argument was then that because the customer was located in Utah, the customer receives the services in Utah and that is where the receipts should be sourced. Respondent based this position on a decision in Tax Commission Appeal No. 96-2266, which, according to Respondent supports a marketplace approach. In addition, Respondent argues that Petitioner had not provided a sufficient breakout of the costs for the Commission to consider that the income producing activity occurred both within and without the state.

The Commission does not find Respondent’s arguments to be persuasive. The express language of the statute and applicable rules supports Petitioner’s contention that the sales factor is based on the activity of the taxpayer that produces income, not the location of the customer. Utah Admin. Rule R865-6F-8(I)(6)(b) defines income producing activity specifically to be the transactions and activity directly engaged in by the “taxpayer” in the regular course of its trade or business. The Commission concurs with Respondent that the customer service provided in Utah is part of the service package for which Petitioner received income. However, under Utah Code Sec. 59-7-319(1) the greater proportion of the income producing activity took place in STATE 1. Petitioner has clearly established this fact and the Commission disagrees with Respondent that sufficient evidence has not been received to support this contention. This is not an instance where the costs were fairly evenly distributed between Utah and the other state. In addition the Commission finds that

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Respondent has misconstrued the decision in Tax Commission Appeal No. 96-2266 (1997).

Turning to the issue raised by Respondent under Utah Code Sec. 59-7-320, whether the allocation formula should be altered on the basis that it does not fairly represent the extent of the taxpayer's business activity in this state, Petitioner points out that the Utah apportionment percentage, after it amended its return was 3.338%. If the sales factor was adjusted to reflect receipts from the customers located in Utah the resulting Utah apportionment percentage would be increased to 3.65%, a difference of less than one third of one percentage point. The Commission remains unpersuaded that the fact that 100 out of Petitioner's 5000 customers were primarily based in Utah combined with the fact that the statutory formula for determining the sales factor would attribute no sales to Utah is sufficient to find that the statutory formula does not fairly represent the extent of the taxpayer's business activity in the state. Petitioner's Utah payroll and property are still considered as part of the other factors in the apportionment formula. Respondent does allege that allowing Petitioner to remove the sales from Utah will result in the sales not being taxed in any other state. The fact that the laws or filings in other states differ is not of itself sufficient to apply Utah Code Sec. 59-7-320.

Turning to the question of the embossing receipts and the sale of tangible personal property. Respondent argues that the sale of the actual piece of plastic is a sale of tangible personal property and therefore should be viewed separately from the other service transactions. Petitioner offers that of the total \$\$\$\$ in embossing receipts from its Utah customers during 1998, only \$\$\$\$ relates to the actual piece of plastic. The rest of the costs are for services, none of which were performed in Utah. It appears there is a separate charge for tangible personal property relating to the charge for the piece of plastic. However, that amount is so small in relation to the total sales that if properly accounted for there would be no discernable affect in the tax liability. Respondent also argues that there were pieces of equipment that were sold or leased to the Utah customers, but fails to allege if the sales are sufficiently significant to impact the audit. From the invoices presented this appears unlikely.

CONCLUSIONS OF LAW

1. In determining the fraction for apportioning business income to this state pursuant to Utah Code Sec. 59-7-311 one of the factors considered is the sales factor. Utah Code Sec. 59-7-317 provides that the sales factor is a fraction with the numerator being the total sales of the taxpayer in this state and the denominator the total sales.

2. To determine whether sales occurred “in this state” the statute specifies the consideration is where the income producing activity is performed. For purposes of determining whether income-producing activity occurred within this state the relevant consideration is where the transactions or activity directly engaged in by the taxpayer for the purposes of producing the income occurred, not the location of the customer. See Utah Admin. Rule R865-6F-8(I)(6)(a). The factual evidence presented in this matter indicated that the greater portion of this income producing activity on the part of the taxpayer occurred in STATE 1. Therefore, based on the cost of performance as set forth at Utah Code Sec. 59-7-319(1) the income producing activity did not occur in Utah and Petitioner appropriately determined that its sales factor should be \$\$\$\$ for purposes of the apportionment percentage.

3. There has been no showing in this matter that the statutory apportionment provisions do not fairly represent the extent of the taxpayer’s business activities in this state to the extent that the Commission should allow a deviation from the statutory formula under Utah Code Sec. 59-7-320.

DECISION AND ORDER

Based upon the foregoing, the Tax Commission grants Petitioner's appeal in this matter and orders Respondent to issue a refund to Petitioner based on Petitioner's Amended 1998 return. It is so ordered.

DATED this ____ day of _____, 2005.

Jane Phan
Administrative Law Judge

BY ORDER OF THE UTAH STATE TAX COMMISSION:

The Commission has reviewed this case and the undersigned concur in this decision.

DATED this ____ day of _____, 2005.

Pam Hendrickson
Commission Chair

R. Bruce Johnson
Commissioner

Palmer DePaulis
Commissioner

Marc B. Johnson
Commissioner

Notice of Appeal Rights and Payment Requirement: You have twenty (20) days after the date of this order to file a Request for Reconsideration with the Tax Commission Appeals Unit pursuant to Utah Code Ann. 63-46b-13. A Request for Reconsideration must allege newly discovered evidence or a mistake of law or fact. If you do not file a Request for Reconsideration with the Commission, this order constitutes final agency action. You have thirty (30) days after the date of this order to pursue judicial review of this order in accordance with Utah Code Ann. 63-46b-13 et. seq. Failure to pay the balance resulting from this order within thirty (30) days from the date of this order may result in a late payment penalty.