

09-0578
AUDIT
TAX YEARS: 2003- 2006
SIGNED: 08-11-2011
COMMISSIONERS: R. JOHNSON, M. JOHNSON, M. CRAGUN
RECUSED: D. DIXON

BEFORE THE UTAH STATE TAX COMMISSION

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| PETITIONER, Petitioner, v. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent. | INITIAL HEARING ORDER Appeal No. 09-0578 Account No. ##### Tax Type: Corporate Franchise Tax Years: 01/01/03 – 12/31/06 Judge: Chapman |
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Presiding:

Marc B. Johnson, Commissioner
Kerry R. Chapman, Administrative Law Judge

Appearances:

For Petitioner: PETITIONER REP. 1, Representative
 PETITIONER REP. 2, Representative
 PETITIONER REP. 3, from PETITIONER
For Respondent: RESPONDENT REP. 1, Assistant Attorney General
 RESPONDENT REP. 2, from Auditing Division

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for an Initial Hearing pursuant to Utah Code Ann. §59-1-502.5 on April 4, 2011.

On December 31, 2008, Auditing Division (“Division”) issued a Statutory Notice – Corporation Franchise Tax (“Statutory Notice”) to PETITIONER (“PETITIONER” or “taxpayer”) for the period January 1, 2003 through December 31, 2006 (“Audit Period”). In the Statutory Notice, the Division imposed additional corporate franchise tax of \$\$\$\$ and interest of \$\$\$\$¹, for a total assessment of \$\$\$\$\$. No penalties were

1 Interest continues to accrue.

imposed.

The only issue is whether tuition payments received by PETITIONER from students attending classes and receiving educational services at PETITIONER's Utah campus are includable in the numerator of the sales factor, which is one of the three factors used to calculate PETITIONER's Utah tax liability under the Uniform Division of Income for Tax Purposes Act ("UDITPA"). PETITIONER filed returns for the Audit Period in which it excluded the tuition revenue it received at its Utah campus from the numerator of its Utah sales factor. The Division determined that the tuition payments paid by students at PETITIONER's Utah campus were Utah sales that should be included in the numerator of the Utah sales factor, and it assessed PETITIONER accordingly.

APPLICABLE LAW

1. Utah's UDITPA provisions are set forth in Title 59, Chapter 7, Part 3 of the Utah Code. For purposes of the UDITPA provisions, Utah Code Ann. §59-7-303(1)² provides that "[a]ny taxpayer having income from business activity which is taxable both within and without this state shall allocate and apportion its adjusted income as provided in this part."

2. UCA §59-7-311 provides that "[a]ll business income shall be apportioned to this state by multiplying the income by a fraction[.]" The fraction is calculated on the basis of a property factor, a payroll factor, and a sales factor.

3. UCA §59-7-317 concerns the sales factor and provides that "[t]he sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the tax period, and the denominator of which is the total sales of the taxpayer everywhere during the tax period."

2 The 2006 version of Utah law is cited, unless otherwise indicated.

4. UCA §59-7-319³ also concerns the sales factor and, during the Audit Period, provided for the treatment of sales other than sales of tangible personal property, as follows in pertinent part:

- (1) 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 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.

5. Utah Admin. Rule R865-6F-8 (“Rule 8”)⁴ provides guidance concerning the calculation of the three UDITPA factors, including the sales factor, as follows in relevant part:

....

I. Sales Factor. In General.

....

6. Sales Other than Sales of Tangible Personal Property in this State.

- a) In general, Section 59-7-319(1) provides for the inclusion in the numerator of the sales factor of gross receipts from transactions other than sales of tangible personal property (including transactions with the United States government). 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.
- b) 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. Income producing activity does not include transactions and activities performed on behalf of a taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, the income producing activity includes the following:
 - (1) the rendering of personal services by employees or the utilization of tangible and intangible property by the taxpayer in performing a service;
 - (2) the sale, rental, leasing, or licensing or other use of real property;
 - (3) the rental, leasing, licensing or other use of intangible personal property; or
 - (4) the sale, licensing or other use of intangible personal property. The mere

3 Section 59-7-319 was substantively revised subsequent to the Audit Period.

4 The cited portions of Rule 8 were renumbered effective November 17, 2006, approximately six weeks before the end of the Audit Period at issue.

holding of intangible personal property is not, of itself, an income producing activity.

c) 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.

d) Receipts (other than from sales of tangible personal property) in respect to a particular income producing activity are in this state if:

- (1) the income producing activity is performed wholly within this state; or
- (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.

e) The following are special rules for determining when receipts from the income producing activities described below are in this state:

...

(3) Gross receipts for the performance of personal services are attributable to this state to the extent services are performed in this state. If services relating to a single item of income are performed partly within and partly without this state, the gross receipts for the performance of services shall be attributable to this state only if a greater portion of the services were performed in this state, based on costs of performance. Usually where services are performed partly within and partly without this state, the services performed in each state will constitute a separate income producing activity. In that case, the gross receipts for the performance of services attributable to this state shall be measured by the ratio that the time spent in performing services in this state bears to the total time spent in performing services everywhere. Time spent in performing services includes the amount of time expended in the performance of a contract or other obligation that gives rise to gross receipts. Personal service not directly connected with the performance of the contract or other obligations, as for example, time expended in negotiating the contract, is excluded from the computations.

....

6. UCA §59-1-1417 (2010) provides that the burden of proof is upon the petitioner in proceedings before the Commission, with limited exceptions as follows:

In a proceeding before the commission, the burden of proof is on the petitioner except for determining the following, in which the burden of proof is on the commission:

- (1) whether the petitioner committed fraud with intent to evade a tax, fee, or charge;
- (2) whether the petitioner is obligated as the transferee of property of the person that originally owes a liability or a preceding transferee, but not to show that the person that originally owes a liability is obligated for the liability; and
- (3) whether the petitioner is liable for an increase in a deficiency if the increase is asserted initially after a notice of deficiency is mailed in accordance with Section 59-1-1405 and a

petition under Part 5, Petitions for Redetermination of Deficiencies, is filed, unless the increase in the deficiency is the result of a change or correction of federal taxable income; (a) required to be reported; and (b) of which the commission has no notice at the time the commission mails the notice of deficiency.

APPLICABLE FACTS

1. PETITIONER is a for-profit, secondary educational institutional commonly referred to as a “WORDS REMOVED.” It provides educational services primarily in the (WORDS REMOVED) fields. PETITIONER is headquartered in STATE 1.

2. During the four-year Audit Period, PETITIONER operated (#) campus in Utah and between (#) and (#) campuses outside of Utah. PETITIONER has campuses in more than (#) states.

3. During the Audit Period, PETITIONER had between (#) and (#) students in Utah and between (#) and (#) students outside of Utah.

4. For the 2003 tax year, PETITIONER received \$\$\$\$ in tuition revenue from students attending classes at its Utah campus. In addition, PETITIONER received \$\$\$\$ of revenue at its Utah campus for (WORDS REMOVED). These amounts total \$\$\$\$.

5. On its original 2003 Utah return, PETITIONER calculated its Utah sales factor by including in the numerator (i.e., claiming as Utah sales) all revenue received at its Utah campus, specifically the \$\$\$\$ described in the preceding paragraph.

6. PETITIONER subsequently filed an amended 2003 Utah return, on which it revised its Utah sales factor to exclude from the numerator all tuition revenue paid by Utah students. On the amended 2003 return, PETITIONER only claimed as Utah sales the \$\$\$\$ of income it received at its Utah campus for (WORDS REMOVED).

7. PETITIONER claims that the revenue it received as tuition payments from students at its Utah

campus should not be considered Utah sales because most of the costs associated with providing the classes were not incurred in Utah, where the classes were taught, but were instead incurred in STATE 1, where PETITIONER is headquartered.

8. For example, for the 2003 tax year, PETITIONER had Utah costs (WORDS REMOVED) that totaled \$\$\$\$\$.

9. For the 2003 tax year, PETITIONER also had total company costs incurred outside of Utah of \$\$\$\$\$. These were the total costs incurred by PETITIONER for a number of activities occurring primarily in STATE 1 and included (WORDS REMOVED). The total company costs also included the costs paid by PETITIONER to COMPANY 1 (“COMPANY 1”), a subsidiary of PETITIONER, to obtain the curricula owned by COMPANY 1. (SENTENCE REMOVED).

10. For the 2003 tax year, PETITIONER’s total sales (i.e., the denominator of its sales factor) amounted to \$\$\$\$\$.

11. On PETITIONER’s 2004, 2005, and 2006 Utah returns, it also calculated its Utah sales factor by excluding from Utah sales the tuition payments that it received from students attending classes at its Utah campus.

DISCUSSION

The educational services that PETITIONER provides at its Utah campus and for which it receives tuition revenue is not the sale of tangible personal property. It is the sale of services. For purposes of calculating the Utah sales factor, Section 59-7-319 provides that sales other than sales of tangible personal property are Utah sales if either: 1) the income-producing activity is performed in Utah; or 2) the income-producing activity is performed both in and outside Utah and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance.

The parties have different opinions of how PETITIONER's "income-producing activity" should be characterized when determining where they are performed and the amounts of the costs of performance. When calculating the sales factor, PETITIONER claims that its income-producing activity should be characterized as its total operations, not just the educational services it provides to individual students at its Utah campus. PETITIONER claims that its income-producing activity is performed not only in Utah, where it provides educational services, but also outside of Utah (primarily in STATE 1), (WORDS REMOVED). PETITIONER contends that its costs of performance incurred outside of Utah are substantially greater than its costs of performance incurred in Utah for each year at issue. For the 2003 tax year, for example, PETITIONER claims that its costs of performance outside of Utah are approximately \$\$\$\$\$, while its costs of performance in Utah are approximately \$\$\$\$\$. For these reasons, PETITIONER claims that Section 59-7-319 provides that the tuition payments it receives from students at its Utah campus are not Utah sales.

The Division, however, contends that PETITIONER's income-producing activity should be characterized as PETITIONER's sale of educational services to individual students. Under the Division's approach, PETITIONER's total costs to (WORDS REMOVED) are not considered direct costs associated with providing educational services to individual customers in Utah. The Division asserts that its approach is fair, as it results in the tuition payments generated at PETITIONER's Utah campus being included as Utah sales when determining how much of PETITIONER's income is subject to tax in Utah. The Division also notes that Rule 8(I)(6)(c) provides that "[t]he 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" (emphasis added). The Division asserts that because the costs PETITIONER incurred in STATE 1 are not direct costs, they should not be considered costs of performance when determining where the income-producing activity at issue is performed.

PETITIONER counters that (WORDS REMOVED) are direct costs associated with providing educational services in Utah because it would not be able to offer courses, including those at its Utah campus, without these costs being incurred. PETITIONER argues that costs incurred by its unitary group should not be ignored when determining where its income-producing activities occur. For these reasons, PETITIONER contends that the Commission should use an “operational” approach and not a “transactional” approach when determining the costs of an activity. PETITIONER cites that this position was accepted by the Massachusetts Appellate Tax Board (“Tax Board”) in *The Interface Group v. Commissioner of Revenue*, 2008 WL 4642961 (Mass. App. Tax Bd.).

In *Interface*, the Tax Board considered a public charter tour operator that was in the business of assembling various components of travel packages and marketing those packages to travel agents who sold them to the ultimate customers. The public charter tour operator was headquartered in Massachusetts and most of its costs were incurred in Massachusetts, even though some of its costs were incurred in other states. The Tax Board found that the tour operator’s income-producing activity was more appropriately characterized as the bulk purchase of rooms and transportation and the package and sale of the tours through travel agents instead of being characterized as the sale of individual tours to individual customers. The Tax Board found that the tour operator was not “directly engaged” in the sale of individual vacation tour to individual customers as it sold the tours indirectly through travel agents.⁵ For these reasons, the Tax Board characterized the tour operator’s “income-producing activity” as its overall operation of a business that assembled, marketed and sold tours in bulk. With this characterization, the Tax Board found that the tour operator’s sales of tours in bulk were Massachusetts sales because most of the costs of performance associated with the bulk sales were incurred in Massachusetts.

⁵ Both Utah law pertinent to the instant case (Rule 8(I)(6)(b)) and Massachusetts law pertinent to *Interface* define “income-producing activity” to be an “activity **directly** engaged in by the taxpayer. . .”

The circumstances in PETITIONER's case at hand, however, are different from those in *Interface*. PETITIONER directly offers educational services to and collects tuition payments from individual customers (i.e., students), unlike the tour operator in *Interface*, which sold its packages indirectly through travel agents and did not sell directly to individual customers. For this reason, PETITIONER's income-producing activity is most appropriately characterized as the individual educational services that it provides directly to students from whom it collects tuition payments. PETITIONER provides educational services to Utah students at its Utah campus in exchange for tuition fees. The services are consumed by Utah customers at a location in Utah. The individual educational services provided to students at PETITIONER's Utah campus appear to be performed entirely in Utah. Accordingly, they are Utah sales under Section 59-7-319(1)(a), and the costs of performance analysis required in Subsection 319(1)(b) for services performed in more than one state is unnecessary.⁶

Furthermore, even had the services at issue in this appeal been performed in more than one state, the costs of performance associated with PETITIONER providing educational services to individual students at its Utah campus would not include PETITIONER's total costs. Rule 8(I)(6)(c) provides that "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." The "direct costs" of providing classes to students in Utah do not include all administrative and development costs that PETITIONER incurs to operate its unitary business and to develop and obtain curricula that is provided not only to Utah students, but to students throughout the United States.

(emphasis added).

⁶ Had some of the tuition revenue at issue been received in exchange for PETITIONER providing on-line courses where the instructors were in STATE 1 and the students where in Utah, the educational services would have been performed in more than one state, and the costs of performance analysis of Subsection 59-7-319(1)(b) would have been appropriate. However, there is no evidence to suggest that any of the tuition revenue at issue in this appeal included revenue associated with on-line courses.

The evidence proffered at the Initial Hearing shows that a majority, if not all, of the costs of performance incurred by PETITIONER to provide educational services to individual students at its Utah campus are incurred in Utah. For the 2003 year, for example, the direct costs that PETITIONER incurred in Utah to provide educational services to individual Utah students in exchange for tuition payments amounted to approximately \$\$\$\$\$. PETITIONER has not shown that it incurred any “direct costs” outside of Utah to provide educational services to individual students in Utah. PETITIONER has not produced any precedent or generally accepted accounting principles to show that the “direct costs” of performing this activity include any portion of the approximately \$\$\$\$\$ in management costs and curricula costs that it incurred in STATE 1 in 2003. Furthermore, even if PETITIONER had provided precedent or other evidence to show that such costs should be included as direct costs of providing educational services to individual Utah students, it is likely that such costs would need to be apportioned among the various states in which PETITIONER provides educational services in order to determine the amount of costs properly attributable to each state, including Utah. It is noted that allocating PETITIONER’s total costs of approximately \$\$\$\$\$ on either a student basis (number of students in Utah versus number nationwide) or on a campus basis (number of campuses in Utah versus number nationwide) would result in costs incurred outside of Utah that are significantly less than the direct costs incurred in Utah.

Based on the information proffered at the Initial Hearing, the direct costs associated with PETITIONER’s income-producing activity of providing educational services to individual students at its Utah campus are primarily, if not exclusively, incurred in Utah. As a result, the tuition revenue that PETITIONER received in exchange for providing educational services to its Utah students should be sourced to Utah for purposes of calculating PETITIONER’s sales factor for each year at issue.⁷

⁷ It is noted that the STATE 4 State Tax Commission has reached a similar decision in a case involving PETITIONER on the same issue. See *In the Matter of PETITIONER*, Docket No. 21750 (STATE 4 State Tax

It is also noted that a prior Commission decision supports the above conclusion that a company's total overall costs may not be relevant to a costs of performance analysis under Subsection 319(1)(b). In *USTC Appeal No. 96-2266* (Formal Hearing Decision Jan. 27, 1997), the Commission considered a matter in which a company argued that based on costs of performance, sales made to customers in Utah were not Utah sales for purposes of calculating its Utah sales factor. That case involved a telecommunications company that sold or resold long distance telephone access through a nationwide network. Because the company's network primarily operated from network centers in STATE 2 and STATE 3, the company argued that most of its costs of performance associated with its sales to Utah customers were incurred outside of Utah. The Commission, however, found that the net costs of operating the network "are irrelevant to the costs of performance ratio, which is used to determine whether receipts from an income producing activity in Utah should be included in the numerator of the Utah sales factor." The Commission found that the company's receipts from sales in Utah must be considered Utah sales and included in the numerator of the Utah sales factor, explaining that:

Petitioner has not identified the actual direct costs associated with [its] transactions in Utah. Instead, it attempts to impute to Utah the common costs that [it] incurred in providing services to all of its customers across the country and throughout the world. Following Petitioner's argument to its logical conclusion, [its] receipts cannot be attributed to *any* state's sales factor because its costs of performance in each state are outweighed by the collective costs incurred in all of the other states[.]

Although [Petitioner] has costs associated with maintaining a worldwide telephone network, these indirect costs are properly accounted for and weighted in the UDITPA property and payroll factors. Petitioner has not, and probably cannot, identify direct costs associated with providing service to its Utah customers.

Comm'n Decision Jan. 28, 2010). Although Utah is not bound by the STATE 4 decision, it is noted that STATE 4's applicable laws and regulations pertaining to the matter at issue are nearly identical to Utah's. The STATE 4 agency found that PETITIONER's costs associated with licensing fees for instructional materials and management costs were indirect costs, not direct costs, because such costs are not considered direct costs according to generally accepted accounting principles. In addition, the STATE 4 agency found that to include such indirect costs in a cost of performance analysis would defeat the purpose of the UDITPA statutes concerning the sales factor, explaining that the general philosophy of UDITPA is to source sales to the state in which the property or services are consumed (i.e., the place where the sales activity occurs).

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In conclusion, the tuition payments that PETITIONER receives from providing educational services to individual students at its Utah campus should be treated as Utah sales for purposes of calculating PETITIONER's sales factor for each year at issue.

Kerry R. Chapman
Administrative Law Judge

DECISION AND ORDER

Based upon the foregoing, the Commission denies the taxpayer's appeal and sustains the Division's assessment in its entirety. 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 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.

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DATED this _____ day of _____, 2011.

R. Bruce Johnson
Commission Chair

Marc B. Johnson
Commissioner

D'Arcy Dixon Pignanelli
Commissioner

Michael J. Cragun
Commissioner

Notice: If a Formal Hearing is not requested as discussed above, 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.

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