10-0192
TAX TYPE: INCOME TAX
TAX YEARS: 2006 & 2007
DATE SIGNED: 1-6-2011
COMMISSIONERS: B. JOHNSON, M. JOHNSON, M. CRAGUN
EXCUSED: D. DIXON
SIGNED 01-06-2011

BEFORE THE UTAH STATE TAX COMMISSION

PETITIONER 1 & PETITIONER 2 Petitioners, v. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	**INITIAL HEARING ORDER** Appeal No. 10-0192 Account No. ##### Tax Type: Income Audit Period: 2006 & 2007 Judge: Phan

Presiding:
Jane Phan, Administrative Law Judge

Appearances:
For Petitioner: PETITIONER REP., CPA
For Respondent: RESPONDENT REP. 1, Assistant Attorney General
RESPONDENT REP. 2, Manager, Income Tax Auditing

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for an Initial Hearing pursuant to Utah Code Sec. 59-1-502.5 on September 9, 2009. Petitioners (the Taxpayers) are appealing an audit deficiency issued by Respondent (the Division) for the tax years 2006 and 2007. For each tax years at issue the Division denied enterprise zone credits claimed by the Taxpayers on their Utah Individual Income Tax Returns. The Statutory Notices of Audit Change were issued on December 29, 2009, for both tax years at issue. The Taxpayer timely appealed the audit. The amount of additional tax due for each tax year is as follows:

Tax Period	Tax	Interest	Penalty	Total[1]
2006	$$$$$	$$$$$	$$$$$	$$$$$
2007	$$$$$	$$$$$	$$$$$	$$$$$

1 Total listed as of date of Statutory Notice. Interest continues to accrue on the unpaid balance.

APPLICABLE LAW

Enterprise Zone Credits are provided at Utah Code 63-38f-413(1) (2006) as follows:

> Subject to the limitations of Subsections (2) through (4), the following nonrefundable tax credits against a tax under Title 59, Chapter 7, Corporate Franchise and Income Taxes, or Title 59, Chapter 10 Individual Income Tax Act, are applicable in an enterprise zone: . . . (g) an annual investment tax credit of 10% of the first $250,000 in investment, and 5% of the next $1,000,000 qualify investment in plant, equipment, or other depreciable property.

That section also provides that businesses engaged in retail trade and public utilities may not claim the credit. Utah Code Sec. 63-38f-413(5) provides:

> The tax credits under Subsections (1)(a) through (g) may not be claimed by a business entity engaged in retail trade or by a public utilities business.

A further qualification for the credit is located at Utah Code Ann. §63-38f-412 (2006) which provides that to qualify for an enterprise zone credit, a business must meet residency requirements as follows:

> The tax incentives described in this part are available only to a business entity for which at least 51% of the employees employed at facilities of the business entity located in the enterprise zone are individuals who, at the time of employment, reside in the county in which the enterprise zone is located.

"Business entity" is defined at Utah Code Sec. 63-38f-402 (2006) as follows:

> "Business entity" means an entity: (a) including a claimant, estate, or trust; and (b) under which business is conducted or transacted.

Utah Admin. Rule R865-9I-37 (2006) clarifies the retail sales criteria would not eliminate qualification for the credit if the sales were de minimis as follows:

> E. A business firm that conducts non-retail operations and is engaged in retail trade qualifies for the credits under Section 9-2-413 if the retail trade operations constitute a de minimis portion of the business firm's total operations.

The burden of proof in on the Petitioner in these proceedings pursuant to Utah Code Sec. 59-1-1417 (2009) which provides:

> In a proceeding before the commission, the burden of proof is on the petitioner . . .

Generally, tax exemption or tax credit statutes are strictly construed against the taxpayer. *See Parson Asphalt Prods., Inc. v. State Tax Comm'n,* 617 P.2d 397, 398 (Utah 1980)("[s]tatutes which provide for exemptions should be strictly construed, and one who so claims has the burden of showing his entitlement to

the exemption"). Tax credit statutes, like tax exemptions, "are to be strictly construed against the taxpayer." *MacFarlane v. State Tax Comm'n*, 2006 UT 18, ¶11. "While we recognize the general rule that statutes granting credits must be strictly construed against the taxpayer, the construction must not defeat the purposes of the statute. The best evidence of that intent is the plain language of the statute." (Citations omitted.) *See id. at* ¶19.

DISCUSSION

When the Taxpayers filed their Utah resident Individual Income Tax Returns for 2006 and 2007 they claimed enterprise credits in the amount of $$$$$ for the 2006 return and $$$$$ for the 2007 return. After auditing the returns, the Division disallowed the enterprise zone credits for each year. Whether or not the Taxpayers should receive these credits is the issue in this appeal.

During 2006 and 2007, PETITIONER 1 was the sole proprietor of the business COMPANY 1. For this business he leased (X) that were used in (X) operations. During 2006 and 2007 he had purchased equipment which he used in this operation. For the 2006 tax year, the Taxpayers' representative proffered that all equipment leases were to one entity COMPANY 2, and COMPANY 2 subleased the equipment to numerous other business that used the (X) in their operations. The Taxpayer's representative stated that COMPANY 2 collected sales tax on these subleases. For the 2007 tax year most leases were to COMPANY 2 which again subleased the equipment to individual users and collected sales tax. However, COMPANY 1 also made some leases to individual end users. The Taxpayers' representative maintains that the leases to the individual end users were less than 5% of COMPANY 1's gross receipts. COMPANY 1 collected sales tax for these leases to the end users and listed these leases as sales on its Sales and Use Tax Returns. For the third quarter 2007, $$$$$ was reflected on the sales tax return for the leases to individual end users and for the fourth quarter of 2007, $$$$$ in sales were claimed on the return for the leases to the end users.

The representative maintained that the because the leases from COMPANY 1 to COMPANY 2 were for the purpose of COMPANY 2 subleasing them to the end user, they were not subject to sales tax. The representative for the Taxpayer acknowledged that business engaged in retail sales do not qualify for the enterprise zone credits. However, he points out that for purposes of determining whether qualifications for the credits have been met, Utah Admin. Rule R865-9I-37 specifies that businesses engaged in retail trade are businesses that make a retail sale as defined in Utah Code Sec. 59-12-102. Sec. 102 clarifies that a lease made for the purpose of subleasing or subrenting does not qualify as a retail sale. For the limited rentals to end users

for which COMPANY 1 charged sales tax and reported on its Sales and Use Tax Returns, it was the representative's proffer that these rentals were less than 5% of the total proceeds and, therefore, were de minimis. Based on this he argued that COMPANY 1 could still qualify for the credit under Utah Admin. Rule R865-9I-37.

The Taxpayers did not have sales tax Exemption Certificates from COMPANY 2 going back to 2006 and 2007, but provided a current exemption certificate and a statement from COMPANY 2 that it had been collecting and remitting sales tax on the generator rentals during 2006 and 2007.

The Division stated it was unclear whether there had, in fact, been no retail sales in 2006. The Division indicates that the COMPANY 1 had filled out is Sales and Use Tax Returns incorrectly for all periods at issue. The returns should have reflected the total number of sales or leases and then list and subtract out the exempt sales. Instead the returns listed on Line 1 only its taxable sales. Further the Division pointed out that there had been $$$$$ in Nonemployee compensation listed on a 1099-MISC issued to COMPANY 1 by COMPANY 2 which was in addition to the rental payments and for which the Taxpayer's representative had no explanation. On PETITIONER 1's Schedule C for his 2006 federal return, $$$$$ is listed as gross receipts or sales for COMPANY 1. The Taxpayers provided a 1099-Misc which listed $$$$$ in rents and $$$$$ in Nonemployee Compensation for the 2006 tax year. So the Division had a concern regarding the reason for the non employee compensation. The Taxpayers' representative did not have an explanation for this at the hearing. For the 2007 tax year, COMPANY 2 did not issue a 1099-MISC to COMPANY 1 and very little support was provided by the Taxpayer for the gross receipts of COMPANY 1. Therefore there was a concern on the part of the Division whether the leases to individual end users had, in fact, been less than 5% of the gross receipts.

At the hearing the representative for the Taxpayers had focused on the issue of whether the rentals that were considered to be subject to sales tax were de minimis under Utah Admin. Rule R865-9I-37. However, there are a number of other criteria for the credit. Utah Code Sec. 63-38f-412 provides that at least 51% of the employees employed at the facilities of the business entity located in the enterprise zone reside in the County in which the enterprise zone is located. The Commission has interpreted this section to require several factors: 1) there must be a business entity; 2) the businesses must have a facility located within the enterprise zone; 3) employees of the business entity must employed at this facility; and 4) at least 51% of these employees so employed must reside in the County in which the enterprise zone was located.

The representative proffered this additional information at the hearing regarding these other factors, some of which was not refuted by the Division. There was no dispute that COMPANY 1 was a business entity. COMPANY 1 was a sole proprietorship and PETITIONER 1 was the owner. As far as the representative was aware, the business entity had no office. The representative was not sure if PETITIONER 1's office was in his residence or if he had an office somewhere that was not part of this business entity. The proffer was that COMPANY 1 owned and maintained a storage yard and the representative was not sure if there was even a building on the storage yard. The storage yard was located outside of CITY in COUNTY and it was used by COMPANY 1 in its business operations to store equipment that was not leased out. This storage yard was the only facility of the business entity COMPANY 1. There was only one employee, PETITIONER 2. She worked part-time as the book keeper and the representative proffered that she did receive wage income and a W-2. However, PETITIONER 2 did not work out of the facility of COMPANY 1; she worked out of her residence. This residence was also located just outside CITY in COUNTY.

The Division did not contest that the location of the storage yard or the PETITIONER 1 & PETITIONER 2 residence were within the enterprise zone boundaries. The Division did have concerns as to whether PETITIONER 2 was an employee employed at facilities of the business entity, since she actually worked out of her residence. The Division did not argue that the business would need to have more than one employee.

The legislature provided the credits to business entities that conducted or transacted business, had employees working in a facility of the business located in the enterprise zone and the employees were residents of the zone. See Utah Code Sec. 63-38f-402 and 63-38f-412. A plain reading of Utah Code Sec. 63-38f-412 supports the position that there must be employees employed at facilities of the business entity. The Courts have noted that tax credit statutes, like tax exemptions, "are to be strictly construed against the taxpayer." *MacFarlane v. State Tax Comm'n*, 2006 UT 18, ¶11. And "The best evidence of that intent is the plain language of the statute." (Citations omitted.) *See id. at* ¶19. Because the legislature expressly provided the requirement that the employees are employed at the facilities this is a factor that must be considered. The information presented at the hearing was that the only facility of the business entity was the storage yard and the only employee did not work at that facility. Therefore, the business entity does not qualify for enterprise zone credits as it fails to meet this express statutory provision.

In addition, the legislature specified that the credits "may not be claimed by a business entity engaged in retail trade." Utah Code Sec. 63-38f-413(5). "Retail Trade" was not defined in the Enterprise Zone Act. As noted by the Taxpayer's representative, the Tax Commission adopted a rule that clarifies what is "retail trade." Utah Admin. Rule R865-9I-37(E) (2006) also provides that a business firm that conducts non-retail operations and is engaged in retail trade could qualify for the credits "if the retail trade operations constitute a de minimis portion of the business firm's total operations." It is clear from the rule that the portion of the retail sales to the firm's total operations is relevant in determining when a business qualifies for the credits. However, the Commission has previously concluded that the percentage is not the only factor that needs to be considered in determining whether the sales were de minimis. In Tax Commission Appeal No. 09-3565, the Commission indicated that there was not a bright line based on the percentage of retail sales versus the gross receipts but concluded in that case that the that retail sales of less than 5% along with a number of other factors supported the position that the retail portion was de minimis.

Regardless of whether or not these sales would be considered de minimis, COMPANY 1 did not have employees employed at its facility and, therefore, the credits were properly disallowed by the Division. The audit should be sustained.

Jane Phan
Administrative Law Judge

ORDER

On the basis of the foregoing, the Commission sustains the Statutory Notices issued against the Taxpayers for the tax years 2006 and 2007. 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.

DATED this _____ day of _____, 2010.

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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