14-2208
TAX TYPE: INCOME TAX
TAX YEAR: 2011 & 2012
DATE SIGNED: 4-1- 2016
COMMISSIONERS: J. VALENTINE, R. PERO, R. ROCKWELL
EXCUSED: M. CRAGUN
GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

TAXPAYER, Petitioner, v. AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION, Respondent.	**INITIAL HEARING ORDER** Appeal No. 14-2208 Account No. ##### Tax Type: Income Tax Year: 2011 & 2012 Judge: Chapman

Presiding:
Kerry R. Chapman, Administrative Law Judge

Appearances:
For Petitioner: REPRESENTATIVE FOR TAXPAYER, CPA
For Respondent: REPRESENTATIVE FOR RESPONDENT, Assistant Attorney General
RESPONDENT, from Auditing Division

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for an Initial Hearing pursuant to the provisions of Utah Code Ann. §59-1-502.5, on August 26, 2015.

TAXPAYER ("Petitioner" or "taxpayer")[1] is appealing Auditing Division's (the "Division") assessment of additional individual income tax for the 2011 and 2012 tax years. On November 5, 2014, the Division issued Notices of Deficiency and Audit Change ("Statutory Notices") to the taxpayer, in which it imposed additional tax and interest (calculated as of December 5, 2014),[2] as follows:

1 The Division issued its 2011 and 2012 assessments not only to TAXPAYER, but also to his late wife, NAME-1. NAME-1 passed away in October 2012. In the decision, only TAXPAYER will be referred to as the "Petitioner" or "taxpayer."
2 Interest continues to accrue until any tax liability is paid.

Year	Tax	Penalties	Interest	Total
2011	$$$$$	$$$$$	$$$$$	$$$$$
2012	$$$$$	$$$$$	$$$$$	$$$$$

TAXPAYER had lived and worked in Utah for many years until he moved and became a resident of STATE-1 in 2009. In 1973, TAXPAYER was one of the original incorporators of the CREDIT BUREAU, Inc. ("CREDIT BUREAU"), a Utah corporation. In 1988, the name of CREDIT BUREAU was changed to the CREDIT SERVICE. ("CREDIT SERVICE"). In 2006, CREDIT SERVICE decided to sell its assets to TAXPAYER children. On July 26, 2006, CREDIT SERVICE changed its name to CREDIT SERVICE-1("CREDIT SERVICE-1"), which is a Utah S corporation that still existed in 2011 and 2012. On October 1, 2006, CREDIT SERVICE-1 sold most of its assets to TAXPAYER children under two installment sales, one for CREDIT SERVICE-1's real property and the other for CREDIT SERVICE-1's intangible goodwill.[3] Thereafter, the only income that CREDIT SERVICE-1 generated was the capital gains and interest income arising from the two 2006 installment sales. Because the sales at issue were installment sales, CREDIT SERVICE-1 did not have to recognize all of the capital gains arising from these two sales in 2006.

TAXPAYER is the sole shareholder of CREDIT SERVICE-1. REPRESENTATIVE FOR TAXPAYER, the taxpayer's CPA, explained that once TAXPAYER moved to STATE-1, REPRESENTATIVE FOR TAXPAYER had to decide whether CREDIT SERVICE-1's capital gains and interest income should be sourced to STATE-1, where TAXPAYER resided, or to Utah. REPRESENTATIVE FOR TAXPAYER decided to report the capital gains arising from the installment sale of CREDIT SERVICE-

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3 Each of these installment sales was for 10 years and paid interest at a rate of 6% per annum. CREDIT SERVICE-1 also sold its *tangible* personal property to TAXPAYER children. The sale of the tangible personal property, however, was not an installment sale. Thus, any income arising from the sale of CREDIT SERVICE-1 to tangible personal property was recognized in 2006 and is not at issue in this appeal. TAXPAYER children transferred all assets they acquired from CREDIT SERVICE-1 to a new S corporation that is also not at issue in this appeal.

1's real property to Utah because the real property was located in Utah. However, he sourced the interest income arising from the sale of the real property to STATE-1. In addition, REPRESENTATIVE FOR TAXPAYER sourced both the capital gains income and the interest income arising from the sale of the goodwill to STATE-1. TAXPAYER filed Utah nonresident returns for 2011 and 2012, in which he allocated the capital gains and interest income arising from CREDIT SERVICE-1's two installment sales between STATE-1 and Utah in this manner.

The Division has determined that all of the capital gains and interest income arising from both 2006 installment sales should be sourced to Utah, and it has changed TAXPAYER 2011 and 2012 Utah nonresident returns to reflect this determination. The Division contends that all of the income generated at the CREDIT SERVICE-1 level is Utah source income regardless of whether it is business income or nonbusiness income because CREDIT SERVICE-1 filed 2011 and 2012 Utah S Corporation returns on which it reported that its Utah apportionment fraction is 100% and that its place of commercial domicile is Utah.[4] As a result, the Division contends that the taxpayer should have reported all income that flowed from CREDIT SERVICE-1 to him as Utah source income, including all capital gains and interest income arising from the two installment sales at issue.[5] For these reasons, the Division asks the Commission to sustain its assessments.

REPRESENTATIVE FOR TAXPAYER contends that the Division's position is "aggressive" and should be reversed. REPRESENTATIVE FOR TAXPAYER proffers different arguments in regards to the capital gains income that arose from the sale of CREDIT SERVICE-1's goodwill and the interest income that arose from both of the installment sales. REPRESENTATIVE FOR TAXPAYER stated that he can see why the Division has taken the position that capital gains income arising from CREDIT SERVICE-1's sale of goodwill is "business income" that the taxpayer should apportion to Utah. However, he asks the Commission

4 On these returns, CREDIT SERVICE-1 also used a Utah address and indicated that its corporate books and records are maintained at P.O. Box #####, CITY-1, UT #####.

5 In its assessment, the Division determined that the taxpayer failed to source to Utah $$$$$ of income

to find that the capital gains income arising from the sale of goodwill is "nonbusiness income" pursuant to Utah Admin. Rule R865-6F-8(2)(c)(ii), which provides that property that had once been a "business asset" can convert to a "nonbusiness asset" if a sufficiently lengthy period of time, generally five years, has passed. Because five or so years had passed between the October 1, 2006 date of the sale involving goodwill and the 2011 and 2012 tax years, REPRESENTATIVE FOR TAXPAYER contends that sufficient time had passed to consider the capital gains income arising from this sale to be nonbusiness income for the years at issue. If this income is nonbusiness income, REPRESENTATIVE FOR TAXPAYER contends that it should be sourced to the state in which the taxpayer resided in 2011 and 2012, which is STATE-1.

In addition, REPRESENTATIVE FOR TAXPAYER asks the Commission to consider that the Tax Commission's instruction booklets for 2011 and 2012 do not provide adequate information to show whether capital gains income from the sale of goodwill should be classified as business income or nonbusiness income. For these reasons, the taxpayer asks the Commission to find that the taxpayer properly sourced the capital gains arising from CREDIT SERVICE-1's sales of its goodwill to STATE-1 and not to Utah.

As to the interest income arising from both installment sales, REPRESENTATIVE FOR TAXPAYER asserts that none of it should be sourced to Utah after the taxpayer moved to STATE-1. REPRESENTATIVE FOR TAXPAYER asserts that federal law provides that interest income not arising from ordinary business operations is investment or portfolio income. Because CREDIT SERVICE-1 had no ordinary business operations after 2006, REPRESENTATIVE FOR TAXPAYER contends that the interest income recognized in 2011 and 2012 must be considered investment or portfolio income that is sourced to the taxpayer's state of residence in these years, regardless of whether the interest income arose from installment sales of assets of a Utah operating company. Because the taxpayer resided in STATE-1 in 2011 and 2012, REPRESENTATIVE FOR TAXPAYER asks the Commission to find that the interest income at issue should be sourced to STATE-

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from the two installment sales for 2011 and $$$$$ of income for 2012.

1 and not to Utah. For these reasons, the taxpayer asks the Commission to accept his 2011 and 2012 Utah nonresident returns, as filed, and to reverse the Division's assessments.

APPLICABLE LAW

Utah Code Ann. §59-10-103(1)(w) (2012)[6] defines "'taxable income' or 'state taxable income'" for a nonresident individual to be, as follows in pertinent part:

> (w) "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 . . . 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;
> . . . .

UCA §59-10-117 provides guidance as to which items of a Utah nonresident's adjusted gross income are considered to be derived from Utah sources and includable in Utah state taxable income, as follows in pertinent part:

> (1) . . . state taxable income derived from Utah sources includes those items includable in state taxable income attributable to or resulting from:
> . . . .
> (b) the carrying on of a business, trade, profession, or occupation in this state;
> . . . .
> (2) For the purposes of Subsection (1):
> (a) income from intangible personal property, including annuities, dividends, interest, and gains from the disposition of intangible personal property shall constitute income derived from Utah sources only to the extent that the income is from property employed in a trade, business, profession, or occupation carried on in this state;
> . . . .
> (d) a nonresident shareholder's distributive share of ordinary income, gain, loss, and deduction derived from or connected with Utah sources shall be determined under Section 59-10-118;
> . . . .

For purposes of Subsection 59-10-117(2)(d), UCA §59-10-118 provides for income to be apportioned or allocated, as follows in pertinent part:

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6 The 2012 version of Utah law is cited, unless otherwise indicated. The applicable law that is cited

(1) As used in this section:
(a) "Business income" means income arising from transactions and activity in the regular course of a 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.
(b) "Commercial domicile" means the principal place from which the trade or business of a taxpayer is directed or managed.
(c) "Nonbusiness income" means all income other than business income.
. . . .
(2) A taxpayer having business income that is taxable both within and without this state, shall allocate and apportion the taxpayer's net income as provided in this section.
(3) Rents and royalties from real or tangible personal property, capital gains, interest, dividends, or patent or copyright royalties, to the extent that they constitute nonbusiness income, shall be allocated as provided in Subsections (4) through (7).
. . . .
(5) (a) Capital gains and losses from sales of real property located in this state are allocable to this state.
. . . .
(c) Capital gains and losses from sales of intangible personal property are allocable to this state if the taxpayer's commercial domicile is in this state.
(6) Interest and dividends are allocable to this state if the taxpayer's commercial domicile is in this state.
. . . .
(8) All business income shall be apportioned to this state using the same methods, procedures, and requirements of Sections 59-7-311 through 59-7-320
. . . .

UCA §59-7-311 provides that ". . . all business income shall be apportioned to this state by multiplying the business income by a fraction calculated as provided in this section."

The Commission has enacted Utah Admin. Rule R865-6F-8 ("Rule 8")[7] to provide guidance concerning the determination of "business income" and "nonbusiness income" and the allocation or apportionment of that income to Utah, as follows in pertinent part:

(1) Definitions.
(a) "Allocation" means the assignment of nonbusiness income to a particular state.
(b) "Apportionment" means the division of business income between states by the use of a formula containing apportionment factors.
. . . .

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remained the same throughout 2011 and 2012.

7 Rule 8 was amended on December 12, 2011. Those portions of the rule included here as Applicable Law, however, remained the same throughout the 2011 and 2012 tax years at issue in this appeal.

(e) "Business income" means income of any type or class, and from any activity, that meets the relationship described in Subsection (2)(b), the transactional test, or Subsection (2)(c), the functional test. The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, and nonoperating income is of no aid in determining whether income is business or nonbusiness income.

. . . .

(i) "Nonbusiness income" means all income other than business income.

. . . .

(2) Business and Nonbusiness Income.

(a) Apportionment and Allocation. Section 59-7-303 requires that every item of income be classified as either business income or nonbusiness income. Income for purposes of classification as business or nonbusiness includes gains and losses. Business income is apportioned among jurisdictions by use of a formula. Nonbusiness income is specifically assigned or allocated to one or more specific jurisdictions pursuant to express rules. An item of income is classified as business income if it falls within the definition of business income. An item of income is nonbusiness income only if it does not meet the definitional requirements for being classified as business income.

(b) Transactional Test. Business income includes income arising from transactions and activity in the regular course of the taxpayer's trade or business.

. . . .

(c) Functional Test. Business income also includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

. . . .

(ii) Under the functional test, business income need not be derived from transactions or activities that are in the regular course of the taxpayer's own particular trade or business. It is sufficient, if the property from which the income is derived is or was an integral, functional, or operative component used in the taxpayer's trade or business operations, or otherwise materially contributed to the production of business income of the trade or business, part of which trade or business is or was conducted within the state. Property that has been converted to nonbusiness use through the passage of a sufficiently lengthy period of time, generally five years, or that has been removed as an operational asset and is instead held by the taxpayer's trade or business exclusively for investment purposes, has lost its character as a business asset and is not subject to this subsection. Property that was an integral part of the trade or business is not considered converted to investment purposes merely because it is placed for sale.

(iii) Income that is derived from isolated sales, leases, assignments, licenses, and other infrequently occurring dispositions, transfers, or transactions involving property, including transactions made in liquidation or the winding-up of business, is business income if the property is or was used in the taxpayer's trade or business operations. . . .

(iv) Under the functional test, income from intangible property is business income when the intangible property serves an operational function as opposed to solely an investment function. The relevant inquiry focuses on whether the property is or was

held in furtherance of the taxpayer's trade or business, that is, on the objective characteristics of the intangible property's use or acquisition and its relation to the taxpayer and the taxpayer's activities. The functional test is not satisfied where the holding of the property is limited to solely an investment function as is the case where the holding of the property is limited to mere financial betterment of the taxpayer in general.

. . . .

(vii) Application of the functional test is generally unaffected by the form of the property, whether tangible or intangible, real or personal. Income arising from an intangible interest, for example, corporate stock or other intangible interest in a business or a group of assets, is business income when the intangible itself or the property underlying or associated with the intangible is or was an integral, functional, or operative component of the taxpayer's trade or business operations.

. . . .

(C) It is sufficient to support the finding of apportionable income if the holding of the intangible interest served an operational rather than an investment function of mere financial betterment.

. . . .

(e) Business and Nonbusiness Income Application of Definitions.

. . . .

(ii) Gains or Losses From Sales of Assets. Gain or loss from the sale, exchange, or other disposition of real property or of tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used in, or was otherwise included in the property factor of the taxpayer's trade or business. However, if the property was utilized for the production of nonbusiness income or it was previously included in the property factor and later removed from the property factor before its sale, exchange, or other disposition, the gain or loss constitutes nonbusiness income. See Subsection (8)(a)(ii).

(iii) Interest. Interest income is business income where the intangible with respect to which the interest was received arises out of or was created in the regular course of the taxpayer's trade or business operations, or where the purpose for acquiring and holding the intangible is an integral, functional, or operative component of the taxpayer's trade or business operations, or otherwise materially contributes to the production of business income of the trade or business operations.

. . . .

(4) Apportionment and Allocation.

(a) (i) If the business activity with respect to the trade or business of a taxpayer occurs both within and without this state, and if by reason of that business activity the taxpayer is taxable in another state, the portion of the net income (or net loss) arising from the trade or business derived from sources within this state shall be determined by apportionment in accordance with Sections 59-7-311 to 59-7-319.

. . . .

(b) Allocation. Any taxpayer subject to the taxing jurisdiction of this state shall allocate all of its nonbusiness income or loss within or without this state in accordance with Sections 59-7-306 to 59-7-310.

. . . .

> (7) Apportionment Formula. All business income of the taxpayer shall be apportioned to this state by use of the apportionment formula set forth in Section 59-7-311. The elements of the apportionment formula are the property factor, see Subsection (8), the payroll factor, see Subsection (9), and the sales factor, see Subsection (10) of the trade or business of the taxpayer. For exceptions see Subsection (11).
> . . . .

UCA §59-1-1417(1) (2015) provides that the burden of proof is upon the petitioner in proceedings before the Commission, with limited exceptions as follows:

> (1) 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:
> (a) whether the petitioner committed fraud with intent to evade a tax, fee, or charge;
> (b) 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
> (c) 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:
> (i) required to be reported; and
> (ii) of which the commission has no notice at the time the commission mails the notice of deficiency.

DISCUSSION

In accordance with Subsection 59-1-1417(1), the taxpayer has the burden of proof in this matter. At issue is whether or not certain income generated by CREDIT SERVICE-1, an S corporation, is sourced to Utah when it flows through to the taxpayer, CREDIT SERVICE-1's sole shareholder, for taxation purposes. The income at issue originated at the CREDIT SERVICE-1 level pursuant to two installment sales that CREDIT SERVICE-1 entered into in 2006 to sell its real property and goodwill.

The taxpayer claims to be a Utah nonresident for the 2011 and 2012 tax years, which the Division did not refute. Pursuant to 59-10-103(1)(w), the income that flowed through to the taxpayer from CREDIT SERVICE-1 is sourced in accordance with Section 59-10-117. Subsection 59-10-117(1)(b) provides that Utah source income includes income attributable to or resulting from "the carrying on of a business, trade, profession, or occupation in this state[.]" The Division contends that the income at issue is sourced to Utah

under this provision because Subsection 59-10-117(2)(a) provides that gains from the disposition of intangible personal property and interest is sourced to Utah if the income is from property employed in a trade, business, profession, or occupation carried on in Utah. Because the income at issue is from the sale of property that was owned by CREDIT SERVICE-1, a Utah corporation, and employed in CREDIT SERVICE-1's business that was carried on in Utah, the Division contends that it is sourced to Utah when it flows through to the taxpayer regardless of whether it is considered business income or nonbusiness income.

The Division also stated that Subsection 59-10-117(2)(d) is applicable, which provides that "a nonresident shareholder's distributive share of ordinary income, gain, loss, and deduction derived from or connected with Utah sources shall be determined under Section 59-10-118[.]"[8] Subsection 59-10-118(8) provides that "business income" is apportioned to Utah using the same apportionment methods, procedures, and requirements found in certain provisions of the Utah Corporate Franchise and Income Taxes Act, whereas Subsections 59-10-118(3), (6), and (7) provide that "nonbusiness income" constituting interest income or capital gains from the sale of intangible personal property is allocable to a taxpayer's "commercial domicile."

The taxpayer contends that the capital gains arising from the installment sale of goodwill (i.e., intangible personal property) and that the interest income arising from both installment sales are sourced to STATE-1 in 2011 and 2012 because that is where the taxpayer resided in those years. That argument, however, improperly considers the character of the income at the taxpayer's level instead of considering it at CREDIT SERVICE-1's level, where the income was generated.[9] The income generated by CREDIT

8 Because the income at issue may not be considered "ordinary income," as referred to in Subsection 59-10-117(2)(d), it may be sourced not under Section 59-10-118, but under the Utah Pass-Through Entities and Pass-Through Entity Taxpayers Act (i.e., UCA §§59-10-1401 though 59-10-1405) (the "Act"). Sourcing the interest income at issue in this appeal through the provisions of the Act instead of Section 59-10-118, however, would not change this decision because under the Act as well as under Section 59-10-118, the income is apportioned using the same apportionment methods, procedures, and requirements found in certain provisions of the Utah Corporate Franchise and Income Taxes Act.

9 At the hearing, REPRESENTATIVE FOR TAXPAYER suggested that the Commission should ignore CREDIT SERVICE-1 because the taxpayer operated the S corporation and built up its business. The fact that

SERVICE-1's sale of property that it used in a Utah business is attributable to the taxpayer as if the taxpayer had sold property that was used in a Utah business himself, pursuant to either UCA §59-10-1404 or Internal Revenue Code §1366(b).[10]

The taxpayer argues that the capital gains arising from the sale of the goodwill is nonbusiness income. Regardless of whether this income is business income or nonbusiness income, it is sourced to Utah under Section 59-10-118. First, if it is business income, Subsection 59-10-118(8) provides for it to be apportioned to Utah using the Utah apportionment factor derived under the Utah Corporate Franchise and Income Taxes Act. CREDIT SERVICE-1 has reported its Utah apportionment factor to be 100%. The taxpayer has submitted no evidence to suggest that the Utah apportionment factor it reported is incorrect, nor does the taxpayer *argue* that this factor is incorrect. Furthermore, CREDIT SERVICE-1 has reported that its address is in Utah, that the principal place from which it is directed or managed[11] is Utah, and that the place where its books and records are maintained is Utah. In addition, the state in which CREDIT SERVICE-1 was registered to conduct business in 2011 and 2012 is Utah. Accordingly, if the capital gains income arising from CREDIT SERVICE-1's sale of goodwill is business income, it is sourced 100% to Utah.

Second, if the income generated from CREDIT SERVICE-1's sale of goodwill is nonbusiness income, it is still sourced to Utah. Subsection 59-10-118(5)(c) provides that if capital gains income from a sale of intangible personal property is nonbusiness income, the income is sourced to the state of commercial domicile,

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the income at issue is generated at the CREDIT SERVICE-1 level, however, cannot be ignored. In *Ivory Homes, Ltd. v. Utah State Tax Comm'n*, 2011 UT 54, ¶16, 266 P.3d 751 (Utah 2011), the Utah Supreme Court noted that "[i]n recognizing the importance of form under our tax law, we held that, '[w]hen a taxpayer has chosen to conduct business under a particular arrangement, it cannot disregard the consequence of that arrangement when it would otherwise be to the taxpayer's disadvantage'" (*citing Institutional Laundry, Inc. v. Utah State Tax Comm'n*, 706 P.2d 1066 (Utah 1985)).

10 It is unclear which of these provisions is applicable to this case because of ambiguity concerning the applicability of UCA §59-7-701(1) to an S corporation for the years at issue.

11 On its 2011 and 2012 Utah S Corporation returns, CREDIT SERVICE-1 reported that its place of "commercial domicile" is in Utah. "Commercial domicile" is defined in Subsection 59-10-118(1)(b) as "the principal place from which the trade or business of a taxpayer is directed or managed."

which for CREDIT SERVICE-1 is Utah. For these reasons, the capital gains income arising at the CREDIT SERVICE-1 level from its sale of goodwill that it used as an integral part of its trade or business in Utah is sourced to Utah when it flows through to the taxpayer for taxation purposes.[12]

Such a determination is supported by *Mandell v. Auditing Div. of the Utah State Tax Comm'n*, 2008 UT 34, 186 P.3d 335 (Utah 2008), in which the Utah Supreme Court considered income arising from the sale of assets of another S corporation that had been doing business in Utah. Mandell was a shareholder of this S corporation. The assets of the S corporation were sold in 1998, and the Mandell moved to STATE-2 in 1999. In 2000, the Mandell filed suit in STATE-2 because they had not received their full share of the sales proceeds. In 2001, the Mandell were awarded a settlement, and they reported the settlement proceeds as a capital gain from the sale for purposes of taxation. Because the lawsuit was litigated in STATE-2 when the

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12 The Commission has found that the taxpayer is required to source the income generated by CREDIT SERVICE-1 to sale of goodwill to Utah regardless of whether it is business income or nonbusiness income. As a result, it is unnecessary to address the taxpayer's argument that sufficient time has elapsed since the 2006 sale to convert income arising from that sale to investment income that is nonbusiness income. Nevertheless, it may prove useful to know why the Commission does not find such an argument to be persuasive. Rule 8(2)(c)(ii) provides that:

> . . . Property that has been converted to nonbusiness use through the passage of a sufficiently lengthy period of time, generally five years, or that has been removed as an operational asset and is instead held by the taxpayer's trade or business exclusively for investment purposes, has lost its character as a business asset and is not subject to this subsection. Property that was an integral part of the trade or business is not considered converted to investment purposes merely because it is placed for sale.

This rule provides guidance concerning the classification of "property" that has been converted to nonbusiness use or removed as an operational asset. This rule is not particularly helpful for the 2011 and 2012 years at issue because CREDIT SERVICE-1 sold all of its property, including its goodwill, in 2006. Furthermore, Rule 8(2)(c)(ii) does not provide specific guidance in regards to an installment sales contract, to the extent that such a contract is considered property. The rule does, however, specifically provide that property that was an integral part of a trade or business is not considered converted to investment purposes merely because it is placed for sale. Accordingly, the goodwill that was an integral part of CREDIT SERVICE-1 to trade or business in Utah was not converted to investment purposes because CREDIT SERVICE-1 sold it.

Furthermore, Rule 8(2)(e)(ii) provides that a gain from property, including intangible personal property, constitutes business income if the property while owned by a taxpayer was used in its trade or business. CREDIT SERVICE-1 used the goodwill that it sold as an integral part of its trade or business in Utah. As a result, it is arguable that the capital gains income generated from CREDIT SERVICE-1 to sale of its goodwill is business income.

Mandell were STATE-2 residents, they argued that Utah could not tax the settlement proceeds. The Court disagreed and found that the proceeds constituted Utah source income under Subsections 59-10-118(1)(a) and 59-10-117(2)(d), specifically stating that:

> the settlement proceeds are taxable by Utah because they relate to the sale of Utah assets. Gains received from such a sale are clearly taxable under the Utah Code. It is of no import that the Mandell did not receive the sale proceeds until after they moved to STATE-2 because Utah may tax the income of nonresidents if that income is derived from this state.

Id., at ¶ 40. Admittedly, the circumstances in *Mandell* are somewhat different from those in the instant case. Nevertheless, the circumstances are similar enough to support a finding that the income arising from CREDIT SERVICE-1's sale of goodwill that was an integral part of its trade or business in Utah is subject to Utah taxation, even if the income is received after CREDIT SERVICE-1's shareholder (i.e., the taxpayer) moved outside of Utah.

Mandell also supports a finding that the interest income generated from both of CREDIT SERVICE-1's installment sales is subject to Utah taxation because that income is also derived from sales of property that was an integral part of a Utah corporation's trade or business in Utah. Furthermore, the Commission has previously found that interest income generated by a pass-through entity may be sourced to Utah even though it flows through to a Utah nonresident for taxation purposes. In *USTC Appeal No. 13-1337* (Initial Hearing Order Jun. 10, 2014),[13] the Commission considered the interest income generated by a Utah limited liability company ("Utah LLC") that had been set up for purposes of providing a loan. Part of the interest income generated by the Utah LLC flowed up to the petitioner, who was a member of the Utah LLC, but was not a resident of Utah. The petitioner argued that the interest income was taxable only to his state of domicile and, thus, not to Utah. The Commission found that the interest income should be sourced to Utah because the Utah

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13 Redacted copies of this and other selected decisions can be viewed on the Commission's website at http://www.tax.utah.gov/commission-office/decisions.

LLC reported that its income was 100% apportionable to Utah and because the interest income resulted from the Utah LLC's carrying on a business in Utah under Section 59-10-117.[14]

For similar reasons, the interest income generated at the CREDIT SERVICE-1 level is subject to Utah taxation. Regardless of whether the interest income is business income or nonbusiness income, it is sourced to Utah if it is business income (because CREDIT SERVICE-1's Utah apportionment factor is 100%) or if it is nonbusiness income (because CREDIT SERVICE-1's state of commercial domicile is Utah).[15]

The taxpayer has not provided any case law or other precedent to show any of the income that CREDIT SERVICE-1 generated should be sourced to a state other than Utah when it flows through to the taxpayer for taxation purposes. The taxpayer contends that the instruction booklets that the Tax Commission provides do not provide enough detail to show how the income at issue should be sourced. Instruction booklets and publications that the Tax Commission provides, however, cannot possibly provide examples of every tax circumstance that can exist. As a result, the Division's assessment should not be abated because the taxpayer's specific circumstances may not be found in one of the Tax Commission's instruction booklet or publications. For reasons already explained, the Division's assessments are valid under Utah law. Because the taxpayer has not met his burden to show otherwise, the Commission should sustain the Division's assessments.

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14 The Commission reached a similar result in an older case with circumstances even more similar to those of the instant matter. In *USTC Appeal No. 96-0856* (Order Oct. 28, 1997), the Commission considered an installment sale of assets by a Utah S corporation that only conducted business in Utah. The petitioner in that case argued that a portion of the interest income generated under the installment sale should not be sourced to Utah because two of its six shareholders were Utah nonresidents. The Commission found that all of the interest generated under the installment sale should be sourced to Utah, regardless of whether it flowed through to Utah residents or Utah nonresidents.

The Commission also notes that the Utah Supreme Court supported its ruling in *Mandell* by pointing out that the Iowa Supreme Court had held that Iowa could tax an S corporation's dividends that were received by Iowa nonresidents.

15 Rule 8(2)(e)(iii) provides that interest income may be considered business income or nonbusiness income, depending on the circumstances. The Commission need not make a determination of whether the interest income generated at the CREDIT SERVICE-1 level is business income or nonbusiness income because

Kerry R. Chapman
Administrative Law Judge

DECISION AND ORDER

Based on the foregoing, the Commission sustains the Division's assessments for the 2011 and 2012 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 request shall be mailed, or emailed, 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

or emailed to:

taxappeals@utah.gov

it is sourced to Utah in either circumstance.

Appeal No.

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

DATED this _____ day of _____, 2016.

John L. Valentine
Commission Chair

Michael J. Cragun
Commissioner

Robert P. Pero
Commissioner

Rebecca L. Rockwell
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.