

16-155
TAX TYPE: CORPORATE FRANCHISE
TAX YEAR: 2009-2013
DATE SIGNED: 02/15/2018
COMMISSIONERS: J. VALENTINE, M. CRAGUN, R. PERO, R. ROCKWELL
GUIDING DECISION

BEFORE THE UTAH STATE TAX COMMISSION

<p>PETITIONER,</p> <p>Petitioner,</p> <p>v.</p> <p>AUDITING DIVISION OF THE UTAH STATE TAX COMMISSION,</p> <p>Respondent.</p>	<p>FINDINGS OF FACT, CONCLUSIONS OF LAW, AND FINAL DECISION</p> <p>Appeal No. 16-155</p> <p>Account No. #####</p> <p>Tax Type: Corporate Franchise</p> <p>Audit Periods: 01/01/09 - 12/31/09; 01/01/11 - 12/31/13</p> <p>Judge: Chapman</p>
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Presiding:

John L. Valentine, Commission Chair
Michael J. Cragun, Commissioner
Robert P. Pero, Commissioner
Rebecca L. Rockwell, Commissioner
Kerry R. Chapman, Administrative Law Judge

Appearances:

For Petitioner: REPRESENTATIVE FOR PETITIONER-1, Attorney
REPRESENTATIVE FOR PETITIONER-2, Attorney
REPRESENTATIVE FOR PETITIONER-3, from Petitioner.
REPRESENTATIVE FOR PETITIONER-4, from Petitioner.

For Respondent: REPRESENTATIVE FOR RESPONDENT-1, Assistant Attorney General
REPRESENTATIVE FOR RESPONDENT-2, Assistant Attorney General
RESPONDENT, from Auditing Division

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission for a Formal Hearing on May 31, 2017.¹

1 At the hearing, the parties notified the Commission that the Petitioner had recently filed amended returns to correct a recently-discovered error, which is a different issue from the issue the parties briefed and argued at the Formal Hearing. The parties, however, indicated that they thought that they might be able to resolve the newly-discovered issue on their own. The Commission asked the parties to report back within 30

Based upon the evidence and testimony, the Tax Commission hereby makes its:

FINDINGS OF FACT

1. The tax at issue is Utah corporate franchise and income tax (“corporate franchise tax”).
2. The periods at issue are the tax years ending December 31, 2011 (“2011 tax year”), December 31, 2012 (“2012 tax year”), and December 31, 2013 (“2013 tax year”).²
3. On January 8, 2016, the Auditing Division (“Respondent” or “Division”) issued a Statutory Notice – Corporate Franchise Tax (“Statutory Notice”) to Petitioner. (“Petitioner,” “PETITIONER” or “taxpayer”) for the 2009, 2011, 2012, and 2013 tax years.³ In this notice, the Division imposed additional Utah corporate franchise tax and interest (calculated through February 7, 2016),⁴ as follows:

<u>Tax Year</u>	<u>Tax</u>	<u>Penalties</u>	<u>Interest</u>	<u>Total</u>
2009	\$0	\$0	\$0	\$0
2011	\$\$\$\$\$	\$0	\$\$\$\$\$	\$\$\$\$\$
2012	\$\$\$\$\$	\$0	\$\$\$\$\$	\$\$\$\$\$
2013	<u>\$\$\$\$\$</u>	<u>\$0</u>	<u>\$\$\$\$\$</u>	<u>\$\$\$\$\$</u>
Total	\$\$\$\$\$	\$0	\$\$\$\$\$	\$\$\$\$\$

4. Both parties waived their right to an Initial Hearing in this matter.
5. At issue is whether PETITIONER qualifies as a “sales factor weighted taxpayer,” as defined in Utah Code Ann. §59-7-302(1)(k) (2013), for corporate franchise tax purposes for the 2011, 2012, and 2013 tax years. In the Statutory Notice, the Division explained that it “has determined that [the taxpayer] does not meet the definition of a sales factor weighted taxpayer pursuant to Utah [C]ode Ann. §59-7-302(1)(k), based upon

days whether the newly-discovered issue had been resolved or whether it required Commission attention. On June 21, 2017, the parties informed the Commission that the newly-discovered issue had been resolved and did not require Commission attention. Accordingly, for this decision, the Commission will only address the issue that the parties briefed and argued at the Formal Hearing.

2 As will be shown in the next paragraph, the Division issued an audit assessment that not only concerned the 2011, 2012, and 2013 tax years, but also concerned the tax year ending December 31, 2009 (“2009 tax year”). Because the taxpayer does not disagree with that portion of the audit assessment concerning the 2009 tax year, the 2009 tax year is not at issue.

3 Formal Hearing Exhibit 1. The audit assessment did not address the tax year ending December 31, 2010 (“2010 tax year”).

its conclusion that the predominance of the taxpayer's total sales everywhere are generated by manufacturing economic activities.”⁵ PETITIONER, on the other hand, contends that a predominance of its total sales everywhere are generated by its multi-level marketing economic activities, not its manufacturing economic activities. As a result, PETITIONER contends that it does meet the definition of a “sales factor weighted taxpayer” for the 2011, 2012, and 2013 tax years.

6. PETITIONER is a unitary group that, in Utah, files a water's edge combined report on its TC-20 that includes the following six entities: 1) PETITIONER; 2) PETITIONER ENTITY-1; 3) PETITIONER ENTITY-2; 4) ENTITY-3; 5) ENTITY-4; and 6) ENTITY-5. On its 2011, 2012, and 2013 federal returns, PETITIONER identified the “principal business activity” of these first five entities as “wholesale sales” and the principal business activity of the sixth entity as “insurance.”⁶

7. For many years prior to and including the 2011, 2012, and 2013 tax years at issue, PETITIONER has filed its federal income tax returns using the North American Industry Classification System (“NAICS”) code 424990 – Other Miscellaneous Nondurable Goods Merchant Wholesalers US, which is described in the 2007 NAICS manual, as follows:

This industry comprises establishments primarily engaged in the merchant wholesale distribution of nondurable goods (except printing and writing paper; stationery and office supplies; industrial and personal service paper; drugs and druggists' sundries; apparel, piece goods, and notions; grocery and related products; farm product raw materials; chemical and allied products; petroleum and petroleum products; beer, wine, and distilled alcoholic beverages; farm supplies; books, periodicals and newspapers; flower, nursery stock and florists' supplies; tobacco and tobacco products; and paint, varnishes, wallpaper, and supplies).

On its federal returns for the 2011, 2012, and 2013 tax years, PETITIONER identified its “product or service” to be “food supplements.”⁷

4 Interest continues to accrue while any tax liability remains unpaid. No penalties were imposed.
5 Formal Hearing Exhibit 1.
6 Formal Hearing Exhibit 3.
7 Formal Hearing Exhibit 3.

8. PETITIONER is a company engaged in the multi-level marketing of nutritional and personal care products.⁸ For a number of years until August 2012, PETITIONER's principal place of business was in CITY-1, Utah. In August 2012, PETITIONER moved its principal place of business to CITY-2, Utah (where it remains today), at which time it also moved some of its call center and IT activities from CITY-1 to a CITY-3, Utah facility.

9. From its corporate headquarters in CITY-2, PETITIONER directs and manages its worldwide business, which includes approximately 50 PETITIONER subsidiaries in dozens of countries around the world.⁹ PETITIONER sells its products through a worldwide sales force of independent distributors. These distributors either buy and use the products themselves or are compensated by PETITIONER for selling products to third parties.

10. At its facility in CITY-3, Utah, PETITIONER manufactures much of the product that it sells. At this facility, PETITIONER manufactured approximately 80% of the product that it sold during the 2011, 2012, and 2013 tax years. PETITIONER purchased the remaining 20% of product that it sold from third-party manufacturers. PETITIONER only manufactures products that it and its independent distributors sell (i.e., PETITIONER does not engage in the manufacturing of products for other entities).¹⁰

11. Of the six entities included in the water's edge combined reports that PETITIONER filed with Utah for the three years at issue, PETITIONER is the primary operating entity and reports the majority of income and sales.¹¹ In 2011, PETITIONER reported \$\$\$\$ in income on \$\$\$\$ in sales. It had 95% of its property and payroll in Utah. This information is not significantly different for the 2012 and 2013 tax years.

8 PETITIONER's Form 10-K for the 2012 tax year indicates that the taxpayer sells over 700 products, including "PRODUCTS." Formal Hearing Exhibit 8.

9 Formal Hearing Exhibit 3.

10 Testimony of REPRESENTATIVE FOR PETITIONER-3, PETITIONER's Executor Director of Corporate Tax.

11 Formal Hearing Exhibit 3. For the 2012 tax year, the six companies' combined sales everywhere were approximately \$\$\$\$\$. PETITIONER's sales were approximately \$\$\$\$\$, which accounts for approximately 78% of the combined group's sales for this year (p. 60).

12. PETITIONER ENTITY-1 sells product into COUNTRY-1. In 2011, it reported a \$\$\$\$ loss on \$\$\$\$ in sales. It had no employees, and all of its \$\$\$\$ in property is located outside Utah. This information is not significantly different for the 2012 and 2013 tax years.¹²

13. PETITIONER ENTITY-2. is an entity that makes minor sales separate and apart from PETITIONER. In 2011, it reported a \$\$\$\$ loss on \$\$\$\$ in sales. All of its employees and property are in CITY-2. This information is not significantly different for the 2012 and 2013 tax years.¹³

14. ENTITY-3. (“ENTITY-3”) is a subsidiary acquired by PETITIONER in or around 2001. ENTITY-3 is also a multi-level marketing company. Its headquarters are located in CITY-4, Utah. PETITIONER makes many intercompany sales of product to ENTITY-3, which ENTITY-3 then re-sells. In 2011, ENTITY-3 reported a \$\$\$\$ on \$\$\$\$ in sales. All of ENTITY-3’s employees are located in CITY-4, where approximately 99% of its property is located. This information is not significantly different for the 2012 and 2013 tax years.¹⁴

15. ENTITY-4 is a subsidiary of ENTITY-3 that sells product in COUNTRY-2. In 2011, it reported a \$\$\$\$ on \$\$\$\$ in sales. Its employees and property are all located outside Utah. This information is not significantly different for the 2012 and 2013 tax years.¹⁵

16. ENTITY-5 is a captive WORD REMOVED company operated by PETITIONER to provide WORDS REMOVED for PETITIONER products. It receives WORD REMOVED from other PETITIONER entities. In 2011, it reported \$\$\$\$ in income on \$\$\$\$ in sales, all of which were in Utah. It had no employees or property. This information is not significantly different for the 2012 and 2013 tax years.¹⁶

Parties’ Arguments

- 12 Formal Hearing Exhibit 3.
- 13 Formal Hearing Exhibit 3.
- 14 Formal Hearing Exhibit 3.
- 15 Formal Hearing Exhibit 3.
- 16 Formal Hearing Exhibit 3.

17. For a taxpayer that is a unitary group, Subsection 59-7-302(1)(k)(ii) provides, in pertinent part, that a “sales factor weighted taxpayer” is a “a taxpayer having greater than 50% of the taxpayer's total sales everywhere generated by economic activities: (A) performed by the unitary group; and (B) classified in [a 2002 or 2007] NAICS code . . . , except for . . . (II) a NAICS code within NAICS Sector 31-33, Manufacturing[.]” The Division contends that PETITIONER’s activity of manufacturing much of the product that it sells is an economic activity classified within NAICS Section 31-33, Manufacturing. For this reason and because PETITIONER manufactured approximately 80% of the product that it sold for each of the three years at issue, the Division contends that PETITIONER has greater than 50% of its total sales everywhere generated by economic activities that are classified in a manufacturing NAICS code for each of the years at issue. As a result, the Division contends that PETITIONER does not qualify as a “sales factor weighted taxpayer” for 2011, 2012, or 2013.

18. For the three years at issue, PETITIONER admits that it manufactured approximately 80% of the product that it sold and that its activity of manufacturing these products is an economic activity that is classified in a manufacturing NAICS code (i.e., in NAICS Sector 31-33, Manufacturing). However, PETITIONER disagrees with the Division’s conclusion that greater than 50% of its total sales everywhere were generated by economic activities that are classified in a manufacturing NAICS code. PETITIONER contends that the Division’s analysis of the economic activities with which its total sales everywhere are generated does not adequately consider and give weight to its other non-manufacturing economic activities. PETITIONER contends that greater than 50% of its total sales everywhere are generated by its multi-level marketing economic activities, which are separate from its manufacturing activities and which it contends are significant enough to qualify it as a “sales factor weighted taxpayer” for each year at issue.

19. To determine whether greater than 50% of its total sales everywhere were generated by “qualifying economic activities,”¹⁷ PETITIONER contends that the Commission must analyze the economic activities performed at each of its separate “establishments,” which, it argues, should be determined in accordance with the 2002 or 2007 NAICS manual.

20. PETITIONER contends that between January 1, 2011 and August 2012, its group of companies operated through the following NAICS manual establishments:¹⁸

a. PETITIONER had a physical location in CITY-1, Utah that was comprised of three establishments where employees: 1) operated a call center to assist in the multi-marketing activities of its independent distributors (as classified in NAICS code 424990); 2) operated PETITIONER’s wholesaling activities (as classified in NAICS code 424990); and 3) provided management, accounting, finance, legal, human resources, marketing, IT and similar services to the enterprise (as classified in NAICS code 551114).

b. PETITIONER had a physical location in CITY-3, Utah that was comprised of four establishments where employees: 1) manufactured approximately 80% of the product sold by PETITIONER (as classified in NAICS code 325411); 2) operated a warehouse where raw materials and finished product were stored (as classified in NAICS code 424990); 3) conducted research and development activities designed to create new products (as classified in NAICS code 541711); and 4) provided management, accounting, and similar services to the enterprise (as classified in NAICS code 551114).

c. PETITIONER had a physical location in CITY-4, Utah that was comprised of three establishments where employees: 1) operated a call center to assist in the multi-marketing activities of its

17 To qualify as a “sales factor weighted taxpayer,” Subsection 59-7-302(1)(k)(ii) requires that greater than 50% of the taxpayer’s total sales everywhere be generated by economic activities classified in a NAICS code identified in the 2002 or 2007 NAICS manual, subject to five exceptions. The parties agree that the only exception that applies to PETITIONER economic activities is the exception for manufacturing activities (as classified under Subsection 59-7-302(1)(k)(ii)(B)(II)). For ease of reference, PETITIONER manufacturing activities (as classified in Subsection 59-7-302(1)(k)(ii)(B)(II)) will be referred to “non-qualifying economic activities,” while its remaining economic activities will be referred to as “qualifying economic activities.”

18 Formal Hearing Exhibit 5.

independent distributors (as classified in NAICS code 424990); 2) operated ENTITY-3's wholesaling activities (as classified in NAICS code 424990); and 3) provided management, accounting, finance, legal, human resources, marketing, IT and similar services to ENTITY-3 (as classified in NAICS code 551114).

d. PETITIONER had physical locations in Georgia, Texas, and Ohio. They were each comprised of one establishment where employees operated a warehouse where finished product was stored (as classified in NAICS code 424990).

21. PETITIONER contends that between August 2012 and December 31, 2013, its group of companies operated in the same manner as from January 1, 2011 to August 2012, with the exception that: 1) the CITY-1 wholesaling and management establishments (as classified under NAICS code 424990) were moved to CITY-2; and 2) the CITY-3 wholesaling and management establishments expanded significantly with the addition of a call center (as classified in NAICS code 424990) and IT employees (as classified in NAICS code 551114) that were formerly in CITY-1.¹⁹

22. PETITIONER contends that the economic activities of all of these establishments, not just its manufacturing establishment, contributed to the generation of its total sales everywhere. PETITIONER argues that because the term "economic activity" is not defined in statute or rule, the Commission should rely on the guidance provided in the "Introduction" section of the NAICS manual to determine how the economic activities of its various establishments contributed to the generation of its total sales everywhere. For this purpose, PETITIONER explained that the Introduction section of the 2007 NAICS manual provides that an establishment, as a statistical unit, is defined "as the smallest operating entity for which records provide information on the cost of resources – materials, labor, and capital – employed to produce the units of output" (at p. 19), and that "[i]deally, the principal good or service should be determined by its relative share of current production costs and capital investment at the establishment. In practice, however, it is often necessary to use

19 Formal Hearing Exhibit 5.

other variables such as revenue, shipments, or employment as proxies for measuring significance” (at pp. 20-21). REPRESENTATIVE FOR PETITIONER-3 testified that PETITIONER is able to prepare separate reports for each of the establishments it identified (as described above in Findings of Fact #20 and #21).

23. To quantify how the economic activities of the individual establishments identified by PETITIONER contributed to the generation of its total sales everywhere, the taxpayer provided cost of resources information about each of these establishments for the 2011, 2012, and 2013 tax years. Specifically, PETITIONER provided for each of these establishments its number of employees, employee compensation, employee and independent distributor compensation, and property cost.²⁰ PETITIONER allocated these costs of resources between its qualifying and non-qualifying economic activities by: 1) considering 100% of the costs of resources of its one manufacturing establishment to be non-qualifying economic activities; and 2) considering 100% of the costs of resources of all of its other establishments to be qualifying economic activities.²¹

24. With this methodology, PETITIONER determined that: 1) its non-qualifying economic activities (i.e., its manufacturing activities) contributed no more than 31% to the generation of its total sales everywhere for any of three years at issue; and 2) that its qualifying economic activities (i.e., all economic activities exclusive of its manufacturing activities) contributed at least 69% to the generation of its total sales everywhere for each of the three years.²² On this basis, PETITIONER concluded that its qualifying economic activities contributed greater than 50% to the generation of its total sales everywhere for each of 2011, 2012, and 2013 tax years, which qualifies it as a “sales factor weighted taxpayer” for all three of these years.

20 Formal Hearing Exhibit 7 (which was prepared by REPRESENTATIVE FOR PETITIONER-3).

21 PETITIONER did not apportion the costs of resources of any single establishment between qualifying and non-qualifying economic activities. For example, PETITIONER considered 100% of the costs of resources of its management establishments to be qualifying economic activities, even though it is possible that its management establishments performed management services not only for its multi-level marketing activities, but also its manufacturing activities.

22 Formal Hearing Exhibit 7.

25. To support its position that the total sales everywhere of a multi-level marketing company that makes much of its own product, like itself, are not predominately generated by its manufacturing economic activities, PETITIONER asks the Commission to compare information from its Form 10-K with information from the Form 10-K of Micron Technology, Inc. (“Micron”), which it describes as a “prototypical” manufacturing company.²³ Micron’s Form 10-K shows that its “cost of goods sold” accounts for at least 67% of its “net sales,” while its operating expenses (which includes selling and administrative expenses) only account for approximately 19% of its “gross margin.” In comparison, PETITIONER’s “cost of sales”²⁴ accounts for only approximately 25% of its “net sales revenue,” while its operating expenses (which includes selling and administrative expenses) account for at least 65% of its “gross profit.” PETITIONER contends that this information shows that Micron’s revenue relates more to manufacturing its product than selling it, while PETITIONER revenue relates more to selling its product than to manufacturing it.

26. The Division contends that PETITIONER’s position improperly focuses on its “costs everywhere” instead of its “sales everywhere.” Furthermore, the Division contends that the Commission should rely on a single factor to determine whether a taxpayer’s economic activities generate greater than 50% of its total sales everywhere, specifically the percentage of product sold that a taxpayer manufactures itself. The Division argues that relying on this single factor is appropriate for an entity like the taxpayer who is in the business of selling product and who is not in the business of warehousing, research and development, or providing a call center.²⁵ For these reasons, the Division asks the Commission to find that the taxpayer’s methodology does not comply with Utah law and to find that the taxpayer does not qualify as a “sales factor weighted taxpayer” for any year at issue.

23 Formal Hearing Exhibit 9.

24 On PETITIONER Form 10-K, “cost of sales” is described as “our manufacturing costs, the price we pay to our raw material suppliers and manufacturers of our products, and duties and tariffs, as well as shipping and handling costs related to product shipments and distribution to our Managers, Distributors and customers.” Formal Hearing Exhibit 9.

25 The Division asks the Commission to consider PETITIONER Form 10-K for the 2012 tax year, on

27. In case the Commission finds that the Division's single-factor test does not give adequate consideration to all of PETITIONER's economic activities and that the taxpayer's methodology does, the Division has not challenged any specific component that the taxpayer used in its methodology. As a result, the Division has not contended that PETITIONER improperly classified its economic activities into the various and separate establishments that the taxpayer identified. In addition, the Division has not contended that any of the costs of resources that PETITIONER identified for these various establishments is incorrect, nor has the Division contended that PETITIONER has improperly allocated the costs of resources of these various establishments between its qualifying and non-qualifying economic activities. RESPONDENT, a Senior Auditor with the Division, testified that the Division received the taxpayer's establishment information before it issued its audit, but indicates that the Division did not audit the information because it thought it to be irrelevant. The Division suggests that the taxpayer's establishment information is irrelevant because Subsection 59-7-302(1)(k)(ii), the pertinent statutory provision, does not specifically refer to the term "establishment" and because one can determine the classification of an entity's activities under the NAICS manual without having to determine its establishment(s).

28. The Division also points out that in the United States Security and Exchange Commission's ("SEC") EDGAR system, PETITIONER is classified under Standard Industrial Classification ("SIC") code 2834 – Pharmaceutical Preparations.²⁶ RESPONDENT stated that SIC code 2834 is a manufacturing SIC code, but admitted that he is not aware of the standard that the SEC uses for its EDGAR classifications. RESPONDENT also stated that the Division did not rely on PETITIONER's EDGAR system classification when it determined that the taxpayer did not qualify as a "sales factor weighted taxpayer." REPRESENTATIVE FOR PETITIONER-4, who is PETITIONER's Senior Director, Legal Counsel, testified

which all of its revenues are reported as coming from the sales of products. Formal Hearing Exhibit 8, p. 179.
26 Formal Hearing Exhibit 10. The SEC's EDGAR system refers to its "Electronic Data Gathering, Analysis, and Retrieval" system.

that in regards to the taxpayer, the EDGAR system classification may have been a “default” classification because PETITIONER does not produce or sell pharmaceutical products.

APPLICABLE LAW

1. UCA §59-7-302(1)(k) (2013)²⁷ defines the term “sales factor weighted taxpayer,” as follows in pertinent part:

(1) As used in this part, unless the context otherwise requires:

....

(k) Subject to Subsection (2), "sales factor weighted taxpayer" means:

....

(ii) for a taxpayer that is a unitary group, a taxpayer having greater than 50% of the taxpayer's total sales everywhere generated by economic activities:

(A) performed by the unitary group; and

(B) classified in a NAICS code of the 2002 or 2007 North American Industry Classification System of the federal Executive Office of the President, Office of Management and Budget, except for:

(I) a NAICS code within NAICS Sector 21, Mining;

(II) a NAICS code within NAICS Sector 31-33, Manufacturing;

(III) a NAICS code within NAICS Sector 48-49, Transportation and Warehousing;

(IV) a NAICS code within NAICS Sector 51, Information, except for NAICS Subsector 519, Other Information Services; or

(V) a NAICS code within NAICS Sector 52, Finance and Insurance.

....

(2) The following apply to Subsection (1)(k):

(a) (i) Subject to the other provisions of this Subsection (2), a taxpayer shall for each taxable year determine whether the taxpayer is a sales factor weighted taxpayer.

(ii) A taxpayer shall make the determination required by Subsection (2)(a)(i) before the due date for filing the taxpayer's return under this chapter for the taxable year, including extensions.

(iii) For purposes of making the determination required by Subsection (2)(a)(i), total sales everywhere include only the total sales everywhere:

(A) as determined in accordance with this part; and

(B) made during the taxable year for which a taxpayer makes the determination required by Subsection (2)(a)(i).

(b) A taxpayer that files a return as a unitary group for a taxable year is considered to be a unitary group for that taxable year.

(c) In accordance with Title 63G, Chapter 3, Utah Administrative Rulemaking Act, the

²⁷ The 2013 version of Utah law is cited, unless otherwise indicated. The cited subsections of Section 59-7-302 were in effect for the 2011, 2012, and 2013 tax years at issue. For periods subsequent to the 2013 tax year, the cited subsections have been amended and/or renumbered. However, it is the version of these subsections that was in effect for the 2011, 2012, and 2013 tax years that is applicable to the instant appeal.

commission may define the term "economic activity" consistent with the use of the term "activity" in the 2007 North American Industry Classification System of the federal Executive Office of the President, Office of Management and Budget.

2. The Introduction section of the 2007 NAICS manual provides, as follows in pertinent part:

Purpose of NAICS

NAICS is an industry classification system that groups establishments into industries based on the similarity of their production processes. It is a comprehensive system covering all economic activities. . . .

At p. 14.

Definition of an Establishment

NAICS is a classification system for establishments. The establishment as a statistical unit is defined as the smallest operating entity for which records provide information on the cost of resources – materials, labor, and capital – employed to produce the units of output. The output may be sold to other establishments and receipts or sales recorded, or the output may be provided without explicit charge, that is, the good or service may be ‘sold’ within the company itself.

The establishment . . . is generally a single physical location, where business is conducted or where services or industrial operations are performed (for example, a factory, mill, store, hotel, movie theater, mine, farm, airline terminal, sales office, warehouse, or central administrative office). There are cases where records identify distinct and separate economic activities performed at a single physical location. . . . In such cases, each activity is treated as a separate establishment provided: (1) no one industry description in the classification includes such combined activities; (2) separate reports can be prepared on the number of employees, their wages and salaries, sales or receipts, and expenses; and (3) employment and output are significant for both activities.

At pp. 19-20.

Determining an Establishment’s Industry Classification

An establishment is classified to an industry when its primary activity meets the definition for that industry. Because establishments may perform more than one activity, it is necessary to determine procedures for identifying the primary activity of the establishment.

In most cases, if an establishment is engaged in more than one activity, the industry code is assigned based on the establishment’s principal product or group of products produced or distributed, or services rendered. Ideally, the principal good or service should be determined by its relative share of current production costs and capital investment at the establishment. In practice, however, it is often necessary to use other variables such as revenue, shipments, or employment as proxies for measuring significance.

At pp. 20-21.

3. UCA §59-1-1417(1) (2017) 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

At issue is whether PETITIONER qualifies as a “sales factor weighted taxpayer” for the 2011, 2012, and 2013 tax years. PETITIONER files as a unitary group. For a unitary group, a “sales factor weighted taxpayer” is defined in Subsection 59-7-302(1)(k), in pertinent part, as “a taxpayer having greater than 50% of the taxpayer's total sales everywhere generated by economic activities: (A) performed by the unitary group; and (B) classified in a NAICS code of the 2002 or 2007 North American Industry Classification System of the federal Executive Office of the President, Office of Management and Budget, except for . . . (II) a NAICS code within NAICS Sector 31-33, Manufacturing. . . .” In Subsection 59-7-302(2)(c), the Legislature has provided that the Commission “may define the term ‘economic activity’ consistent with the use of the term ‘activity’ in the 2007 [NAICS manual].”

For purposes of determining whether PETITIONER qualifies as a “sales factor weighted taxpayer” under Subsection 59-7-302(1)(k)(ii), the Division appears to agree that PETITIONER’s economic activities are performed by the unitary group. It did not argue otherwise. The Division, however, disagrees with PETITIONER’s position that greater than 50% of its total sales everywhere are generated by qualifying

economic activities (i.e., economic activities other than those that are classified in a NAICS code within NAICS Sector 31-33, Manufacturing). The Commission has not adopted a rule in which it has defined the term “economic activity.” However, were the Commission to define the term in rule, the Legislature has provided in Subsection 59-7-302(2)(c) that the definition must be consistent with the use of the term “activity” in the 2007 NAICS manual. Accordingly, in this decision, the Commission will interpret the term “economic activities” (as used in Subsection 59-7-302(1)(k)(ii)) consistent with the use of the term “activity” in the 2007 NAICS manual.

The parties have very different opinions on how economic activities are to be identified and classified in the 2007 NAICS manual. The taxpayer contends that the identification and analysis of an entity’s “establishments” should be considered when classifying an entity’s economic activities under the 2007 NAICS manual. The Division, on the other hand, claims that identifying and analyzing an entity’s establishments when classifying its economic activities under the NAICS manual would be contrary to Utah law, in part at least, because the Subsection 59-7-302(1)(k)(ii) definition of “sales factor weighted taxpayer” does not mention the word “establishment.”

The Division’s argument is unpersuasive. The Introduction section of the 2007 NAICS manual (“Introduction”) indicates that an entity’s activities and the establishments into which they are classified under the NAICS manual are intertwined concepts that are not independent from one another. The “Purpose of NAICS” portion of the Introduction indicates that “NAICS is an industry classification system that groups establishments into industries” and that “[i]t is a comprehensive system covering all economic activities.” Furthermore, in the “Definition of an Establishment” portion of the Introduction, the manual makes clear that “NAICS is a classification system for establishments” and provides guidance as to when “each activity is treated as a separate establishment[.]” Lastly, the “Determining an Establishment’s Industry Classification” portion of the Introduction provides that “[a]n establishment is classified to an industry when its primary

activity meets the definition of that industry” and that “[b]ecause establishments may perform more than one activity, it is necessary to determine procedures for identifying the primary activity of the establishment.”

Even though the Legislature did not specifically use the word “establishment” in the definition of “sales factor weighted taxpayer,” Subsection 59-7-302(1)(k)(ii)(B) does require a consideration of an entity’s economic activities as classified in the 2002 or 2007 NAICS manual. The 2007 NAICS manual’s introductory language explains that it groups establishments into industries on the basis of the establishments’ activities. Where the Legislature references a classification system (such as the 2002 or 2007 NAICS manual) in statute, the Commission finds it reasonable to use the introductory and explanatory language found in that classification system to give meaning to the Legislature’s statutory terms, especially where: 1) the Legislature provides that any definition that the Commission adopts for the statutory term “economic activity” must be consistent with the use of the term “activity” in the 2007 NAICS manual; and 2) the Legislature does not specifically indicate that the introductory and explanatory portions of the 2002 and 2007 NAICS manuals should not be considered.

As a result, the Commission finds that the guidelines concerning the relationship between activities and establishments, as found in the NAICS manual’s introductory and explanatory language, are relevant when determining the NAICS manual classifications of PETITIONER’s various economic activities. The “Definition of an Establishment” portion of the Introduction provides that each activity of an entity is treated as a separate establishment if: “(1) no one industry description in the classification includes such combined activities; (2) separate reports can be prepared on the number of employees, their wages and salaries, sales or receipts, and expenses; and (3) employment and output are significant for both activities.” As discussed earlier, the taxpayer has determined that its economic activities can be classified into a number of separate establishments because a number of its various activities meet these three criteria.

The Division did not argue that PETITIONER's segregation of its activities into the various establishments it identified is inconsistent with the guidelines provided in the 2002 and 2007 NAICS manuals, in part at least, because it believes that the taxpayer's methodology is contrary to Utah law. However, the taxpayer's methodology does give weight to each of its various activities, while the Division's single-factor test does not. It is noted that UCA §59-7-317 provides that "[t]he sales factor is a fraction . . . the denominator of which is the *total sales of the taxpayer everywhere* during the tax period" (emphasis added). In comparison, the Subsection 59-7-302(1)(k)(ii) definition of "sales factor weighted taxpayer" references *total sales everywhere generated by economic activities . . . classified in [the NAICS manual]*" (emphasis added). As a result, the additional language that is found in Subsection 59-7-302(1)(k)(ii) but not Section 59-7-317 (i.e., specifically the language "generated by economic activities . . . classified in [the NAICS manual]") must be given meaning when the Commission determines whether a taxpayer is a "sales factor weighted taxpayer."²⁸

The Division's single-factor test appears to focus primarily on the "total sales everywhere" language of Subsection 59-7-302(1)(k)(ii) without giving adequate consideration to the additional "generated by economic activities . . . classified in [the NAICS manual]" language of the definition. The taxpayer's methodology, on the other hand, focuses on all of its activities and, thus, better reflects all of language found in the definition. For these reasons, the taxpayer's attempt to classify its various activities into different NAICS codes by

28 In *Warne v. Warne*, 275 P.3d 238, 2012 UT 13 (Utah 2012), the Utah Supreme Court ruled that "[u]nder our rules of statutory construction, we must give effect to every provision of a statute and avoid an interpretation that will render portions of a statute inoperative" (citing *Hall v. Utah State Dep't of Corr.*, 2001 UT 34, ¶ 15, 24 P.3d 958). The Court further stated that in order "[t]o achieve this goal, we construe the provision at issue 'with every other part or section so as to produce a harmonious whole'" (citing *Sill v. Hart*, 2007 UT 45, ¶ 7, 162 P.3d 1099) (internal quotation marks omitted).

In *Hall v. Utah State Dept. of Corrections*, 24 P.3d 958, 2001 UT 34 (Utah 2001), the Court also stated that "our primary goal when construing statutes is to evince 'the true intent and purpose of the Legislature [as expressed through] the plain language of the Act.'" (citing *Jensen v. Intermountain Health Care, Inc.*, 679 P.2d 903, 906 (Utah 1984)). The Court further stated that "[i]n doing so, we seek 'to render all parts thereof relevant and meaningful' . . . and we accordingly avoid interpretations that will render portions of a statute superfluous or inoperative (citing *Millett v. Clark Clinic Corp.*, 609 P.2d 934, 936 (Utah 1980), *Platts v. Parents Helping Parents*, 947 P.2d 658, 662 (Utah 1997); *State v. Hunt*, 906 P.2d 311, 312 (Utah 1995)).

Appeal No. 16-155

following the guidelines found in the introductory and explanatory sections of the 2007 NAICS manual appears to be consistent with Utah law.

Once the taxpayer segregated its economic activities into the various establishments it identified, it used cost of resources information (such as number of employees, employee compensation, and property costs) to allocate the activities of these establishments between qualifying and non-qualifying economic activities. With this methodology, PETITIONER contends that it has shown that greater than 50% of its total sales everywhere are generated by qualifying economic activities. Because the Division has not audited and presented specific arguments challenging the individual components of the taxpayer's methodology, the Division has not shown that any of the cost of resources information the taxpayer used is incorrect. Furthermore, the Division has not challenged the manner in which the taxpayer allocated these costs of resources between qualifying and non-qualifying economic activities.

The Commission is not convinced that the cost of resources factors that PETITIONER used in its methodology and the manner in which it allocated these factors between qualifying and non-qualifying economic activities is necessarily the best methodology to determine how its economic activities generated its total sales everywhere. The Commission particularly has concerns that PETITIONER did not allocate the costs of resources of any single establishment (such as its management establishments, its research and development establishment, or its warehousing establishments) between qualifying and non-qualifying activities. However, where the Division has not shown that the taxpayer's segregation of its activities into the various establishments it identified is inconsistent with the 2002 and 2007 NAICS manuals and where the Division has not shown that any component or allocation used in the taxpayer's methodology is incorrect or improper, the taxpayer's methodology for determining whether it is a "sales factor weighted taxpayer" is the best methodology presented in this appeal.

PETITIONER's argument that it is primarily a multi-level marketer instead of a manufacturer is persuasive. The taxpayer's methodology shows that *significantly* greater than 50% of its total sales everywhere are generated by economic activities that are classified under the 2002 or 2007 NAICS manual as qualifying economic activities. Even if the costs of resources of some of PETITIONER establishments were allocated between qualifying and non-qualifying activities, there is no evidence to suggest that such adjustments would reduce the taxpayer's qualifying economic activities below the greater than 50% threshold. Accordingly, the Commission finds that the taxpayer has met its burden of proof and shown that it qualifies as a "sales factor weighted taxpayer" for the 2011, 2012, and 2013 tax years.

CONCLUSIONS OF LAW

1. Subsection 59-1-1417(1) provides a petitioner has the burden of proof in appeals before the Tax Commission, subject to limited exceptions that are not applicable in this appeal. Accordingly, PETITIONER has the burden of proof in this matter.

2. PETITIONER filed as a unitary group for the 2011, 2012, and 2013 tax years. For each of these years, PETITIONER has shown that greater than 50% of its total sales everywhere are generated by economic activities that are performed by its unitary group and that are classified in NAICS codes other than the excluded NAICS codes described in Subsections 59-7-302(1)(k)(ii)(B)(I) through (V). Accordingly, PETITIONER has shown that it qualifies as a "sales factor weighted taxpayer" for each of the 2011, 2012, and 2013 tax years.

Kerry R. Chapman
Administrative Law Judge

DECISION AND ORDER

Based on the foregoing, the Commission finds that the taxpayer qualifies as a “sales factor weighted taxpayer” for each of the 2011, 2012, and 2013 tax years. The Division is ordered to adjust its assessment accordingly.

DATED this _____ day of _____, 2018.

John L. Valentine
Commission Chair

Michael J. Cragun
Commissioner

Robert P. Pero
Commissioner

Rebecca L. Rockwell
Commissioner

Notice of Appeal Rights: 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. §63G-4-302. 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. §§59-1-601 et seq. and 63G-4-401 et seq.