

*Expedia*: New York and Nationwide Implications  
**Arthur R. Rosen**

Summary by taxanalysts®

In the first article of his new column, Arthur R. Rosen, a partner in **McDermott Will & Emery**'s Miami and New York City offices, analyzes the New York state administrative law determination in *Expedia*, a dispute over how the company's receipts should be sourced for corporate income tax apportionment purposes.

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A recent New York state administrative law determination is worth analyzing at several levels: the specific case and the administrative law judge's conclusion; the likely implications for other service businesses that employ electronic means to render or deliver their services; and the effect on all taxpayers' decisions regarding protesting any state tax assessment (or refund denial). It also serves as a sterling example of what is wrong with so many state tax audit programs throughout the country.

### The Case

*Expedia Inc. and Expedia Inc. (Delaware Company)* were decided by ALJ Herbert Friedman on February 5.<sup>1</sup> The issue was how Expedia's and Expedia Delaware's receipts should be sourced for corporate income tax apportionment purposes.

It seems safe to assume that Expedia's services are widely known. Simply stated, Expedia (along with its affiliates) is a travel intermediary that enables consumers to (1) purchase hotel accommodations, usually accomplished by Expedia purchasing the accommodations and then reselling them to consumers, and (2) make reservations for airline flights, ship cruises, car rentals, and some resort stays, usually accomplished by Expedia acting as a mere agent for (and receiving a commission from) the actual suppliers of the services and accommodations. Expedia Delaware's subsidiary, TripAdvisor, earns revenue through providing advertising space on its website to various businesses.

For the years at issue, 2005 through 2007, a general business corporation subject to New York's corporation franchise tax computed its income tax base by apportioning its modified federal taxable income (called New York entire net income) under the traditional three-factor formula consisting of property, payroll, and receipts, where receipts from the furnishing of services were assigned to New York according to the proportion of the costs of generating those receipts that were incurred in New York (that is, a proportional cost-of-performance regime)<sup>2</sup> and "other receipts" were assigned to New York to the extent that they were "earned" there<sup>3</sup> (receipts from sales of tangible personal property were assigned to the place of delivery<sup>4</sup>). Some taxpayers and practitioners saw this as an attempt to increase revenue by bending the law so as to accelerate the Legislature's enactment of market-based sourcing. The audit group in New York's Department of Taxation and Finance (the tax division) developed the concept that those who sell services electronically were really earning their profit from the existence of their networks, and therefore the income was earned at the termination point of those networks, that is, where the customers were located. The state tax department had even issued formal guidance taking that position (albeit not consistently).<sup>5</sup>

In *Expedia*, the crux of the tax department's case was its claim that the term "services" as used in the apportionment statute meant only services provided by human beings at the moment of sale.

The ALJ was not persuaded, principally relying on the common meaning of service, which does not require any human delivery. Further, the ALJ noted that Expedia did, in fact, employ about 6,600 people. Finally, the ALJ cited the New York Court of Appeals' *Siemens* decision, in which the state's highest court had ruled that even for non-service "other

receipts," proper apportionment meant sourcing to where the taxpayer conducted its activities, not where the taxpayer's customers or clients were located.<sup>6</sup> Of course, New York's recent law change to impose market-based sourcing for service receipts<sup>7</sup> rather than cost-of-performance sourcing further demonstrated the legislative intent for the years at issue -- that is, that cost-of-performance sourcing was the appropriate apportionment approval for service receipts. Thus, Expedia prevailed regarding this apportionment issue.

### **Implications for Other Service Providers**

Many state revenue agencies have attempted to ignore cost-of-performance laws and, instead, impose market-based sourcing regimes ahead of the legislative decisions to do so, sometimes bending the law in a shameful manner. I have been involved in this type of situation in almost a dozen states so far; sometimes they have attempted to use statutory discretionary alternative apportionment powers. When faced with the former situation, service providers should resist strongly and present evidence not only that the service is, indeed, a service but also that a cost-of-performance study -- whether conducted on a transactional or an operational basis -- would clearly demonstrate that only a minimal portion of the costs of performance are incurred in the taxing state. When faced with the latter situation, taxpayers have experienced different results in different states.<sup>8</sup> In those situations, the taxpayer should argue, with support from appropriate experts on tax policy, that statutory alternative apportionment provisions are intended to give revenue agencies the freedom to find other measureable quantities when the statutory ones do not work well in implementing legislative policy, not to invent approaches that dramatically deviate from legislative policy. For example, if a legislature has enacted a cost-of-performance sourcing regime for a receipts apportionment formula, it has decided that the income should be taxed by the jurisdiction where the taxpayer employs its labor and capital; this is consistent with the conceptual basis of an income tax. That is, a business turning a profit pays tax to the jurisdiction that provided the resources to enable it to operate. Accordingly, attempts at using alternative apportionment to change a tax imposition from a cost-of-performance basis to a market basis are clearly wrong, and that should be emphasized to courts when appropriate.

### **Deciding When to Litigate**

The *Expedia Inc. and Expedia Inc. (Delaware Company)* determinations are important examples that show that a state's audit initiative, even if used widely and for a long period, can be -- and often should be -- successfully challenged. For New York's network argument, dozens of taxpayers faced that audit position, and in virtually every case, the taxpayer opted to settle rather than litigate. In a different area, New York's auditors -- for decades -- took the position that net operating loss carryovers were "used" and unavailable for future use even in years when the tax paid was not based on income; a taxpayer mounted a successful challenge to that position.<sup>9</sup> In yet a different tax area, sales tax, New York has repeatedly taken a legally incorrect position on the taxability of cloud computing, and, so far, in the only decision on the matter, the ALJ declined to follow the tax department's position.<sup>10</sup>

These cases bring to memory a sentence from a decision rendered by the court of appeals. Reflecting on property assessors' tendency to follow custom and not statute, the court stated, "In this case, the 'practical construction' is nothing more than a violation, which, no

matter how persistent, widespread and uncorrected, cannot alter the meaning of the statute."<sup>11</sup>

Of course, "many other states are doing this" was a justification the state unsuccessfully used in *Davis v. Michigan*, 489 U.S. 803 (1989). When a decision to settle is based on the cost to litigate, time that would have to be dedicated to manage the effort, and myriad other issues raised in an audit, settlement may be the most appropriate course for the business to take. However, a decision influenced by thoughts such as "the state is doing this across the board, so we will never win" or "the state has been doing this for years, so we will never win" may be wrong.

### Improper Audit Initiatives

Someone fortunate enough to be a tax practitioner has likely heard innumerable times that state auditors are instructed by their management simply to enforce the law as enacted. In reality, however, it appears that many state revenue agencies spend significant effort and brainpower determining how laws can be interpreted and applied creatively to increase tax revenue. We all know that this is wrong, but revenue agencies defend themselves by asserting that the world has changed and the application of the laws must be changed to meet those changes. It seems that many believe that that is the job of legislatures. Is there any hope this situation will change? Absolutely -- in my dreams.

### FOOTNOTES

<sup>1</sup> *Matter of Expedia Inc.*, DTA Nos. 825025 and 825026 (N.Y. Div. Tax App. Feb. 5, 2015) 

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<sup>2</sup> N.Y. Tax Law former section 210.3(a)(2)(B).

<sup>3</sup> N.Y. Tax Law former section 210.3(a)(2)(D).

<sup>4</sup> N.Y. Tax Law former section 210.3(a)(2)(A).

<sup>5</sup> *Alvarez & Marsal* (advisory opinion), TSB-A-11(8)C (July 12, 2011) ; TSB-A-11(1)C (Dec. 28, 2010); *Deloitte & Touche LLP* (advisory opinion), TSB-A-02(3)C (Apr. 18, 2002); *Insurance Services Office Inc.* (advisory opinion), TSB-A-00(15)C (Sept. 6, 2000); *New York Mercantile Exchange* (advisory opinion), TSB-A-99(16)C (Apr. 7, 1999).

<sup>6</sup> *In re Siemens Corp.*, 679 N.E.2d 1072 (N.Y. 1997) .

<sup>7</sup> N.Y. Tax Law section 210-A.

<sup>8</sup> *Cable One Inc. v. Idaho State Tax Comm'n*, 337 P.3d 595 (Idaho 2014) ; *Matter of The McGraw-Hill Companies Inc.*, TAT(H)10-19(GC) et al. (NYC Tax App. Trib. Feb. 24, 2014) ; *Equifax Inc. v. Mississippi Dep't of Revenue*, 125 So. 3d 36 (Miss. 2013) ; *Ameritech Publishing Inc. v. Wisconsin Dep't of Revenue*, 788 N.W.2d 383 (Wis. App.

2010) ; *BellSouth Adver'g & Publ'g Corp. v. Chumley*, 308 S.W.3d 350 (Tenn. Ct. App. 2009) .

<sup>9</sup> *Matter of TD Holdings II Inc.*, DTA No. 825329 (N.Y. Div. Tax App. Jan. 22, 2015) .

<sup>10</sup> *Matter of Sungard Securities Finance LLC*, DTA No. 824336 (N.Y. Div. Tax App. Feb. 6, 2014) .

<sup>11</sup> *Matter of Hellerstein v. Assessor of the Town of Islip*, 332 N.E.2d 279 (N.Y. 1975).