

Letter of Findings Number: 04-0005
Corporate Income Tax
Tax Period 1999-2000

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ISSUES

I. Gross Income Tax- Sourcing Receipts to Indiana

Authority: [IC 6-8.1-5-1\(b\)](#); [IC 6-2.1-2-2\(a\)\(2\)](#); [IC 6-2.1-2-4\(2\)](#); [45 IAC 1.1-2-3](#); [45 IAC 1.1-2-5](#); Uniden America Corporation v. Indiana Dep't of State Revenue, 718 N.E.2d 821 (Ind. Tax Ct. 1999); 27 Ind. Reg. 698 (Ind. Dept. of Revenue 2003).

Taxpayer protests the method the Department used to source receipts to Indiana for gross income tax purposes.

II. Adjusted Gross Income Tax- Sourcing Receipts to Indiana for Sales Factor Numerator

Authority: [IC 6-3-2-1](#); [IC 6-3-2-2](#); [45 IAC 3.1-1-52](#); [45 IAC 3.1-1-55](#); May Department Store Co. v. Indiana Dept. of State Revenue, 749 N.E.2d 651, 656 (Ind. Tax Ct. 2001).

Taxpayer protests the method the Department applied in sourcing certain receipts to Indiana for the Sales Factor Numerator.

III. Tax Administration – Penalty

Authority: [IC 6-8.1-10-2.1](#); [45 IAC 15-11-2](#).

The taxpayer protests the imposition of penalties.

STATEMENT OF FACTS

Taxpayer is headquartered and commercially domiciled outside of Indiana. The taxpayer conducts a small amount of its technical operations in Indiana. Taxpayer maintains one of its two call centers in Indiana. The taxpayer derives income from the following revenue streams: license fees for the right to access taxpayer's proprietary database; advertising services; and ancillary interactive tools. The Indiana Department of Revenue ("Department") investigated the taxpayer's returns for tax years 1999 and 2000. During both tax years, the taxpayer sourced its gross receipts to Indiana at a low rate of tax. The Department adjusted the returns and moved the receipts attributable to Indiana to the high rate of tax. The Department issued a proposed assessment to reflect the adjustments. The taxpayer challenged the Department's assessment. The Department held a hearing and now presents this Letter of Findings.

I. Gross Income Tax- Sourcing Receipts to Indiana

DISCUSSION

The audit review took the position the taxpayer derives income from services. [IC 6-2.1-2-2\(a\)\(2\)](#) imposes an "income tax, know as the gross income tax. . .upon the receipt of the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or domiciliary of Indiana." [45 IAC 1.1-2-5](#) specifically provides:

(a) Gross income derived from the provisions of a service of any character within Indiana is subject to the gross income tax. . .

(b) Except as otherwise provided in this rule and [IC 6-2.1-2-4](#), gross income derived from the provision of service of any character within Indiana is taxable at the high rate of tax.

Indiana Department of Revenue assessments are prima facie evidence the Department's claim for unpaid taxes is valid. [IC 6-8.1-5-1\(b\)](#). The taxpayer has the burden of proving whether the Department incorrectly imposed the assessment. Id.

The taxpayer asserts the Department erred when it adjusted the taxpayer's gross receipts to a high rate of tax. The taxpayer supports its assertion by making the following two substantive arguments: (1) "Indiana activities" are determined under [45 IAC 1.1-2-5\(e\)](#) using the cost of performance method or the location of the customer; and (2) the receipts the taxpayer derived from advertising services was subject to the low rate of tax under [IC 6-2.1-2-4\(2\)](#). The Department will separately address these arguments below.

A. Determining How to Source Receipts from Service Contracts:

Generally, receipts are sourced by stream of income for gross income tax purposes. Uniden America Corporation v. Indiana Dep't of State Revenue, 718 N.E.2d 821 (Ind. Tax Ct. 1999). The taxpayer explains the only Indiana activity it derives receipts originate from service contracts. The taxpayer claims these receipts are governed by [45 IAC 1.1-2-5\(e\)](#). [45 IAC 1.1-2-5\(e\)](#) provides:

When a contract provides for the provision of services in a state besides Indiana, gross income derived from the provision of services within Indiana will be determined by multiplying the gross income derived from the contract by the ratio of Indiana activities to total activities provided under the contract. The activities used will

be only those related to the services performed and reasonably calculated to effectuate an equitable allocation and apportionment of the taxpayer's gross income under the contract. However, if the percentage of Indiana activities to total activities under the contract is less than five percent (5%), then the entire proceeds of the contract received in that year are exempt from the gross income tax.

The taxpayer claims the regulations provide no guidance about how to measure "Indiana activities" versus total activities when sourcing receipts to Indiana. The taxpayer explains in order to respect the Constitutional requirement that a state tax only income effectively connected with the state, the gross income tax must protect against taxing receipts generated from activities outside Indiana. Thus, the taxpayer suggests the Department should measure "Indiana activities" using either: (1) the cost of performance method; or (2) the method based on where the customer is located as described in 27 Ind. Reg. 698 (Ind. Dept. of Revenue 2003). The taxpayer states if the Department decides to utilize the cost of performance method, all of the taxpayer's sales would be sourced outside of Indiana. In contrast, if the Department utilizes the latter method, this method would only subject three-percent of the taxpayer's sales to Indiana's gross income tax.

The Department will accept neither of the taxpayer's suggestions. The suggested methods the taxpayer references are specific to Indiana *adjusted gross income tax*. The taxpayer provides no foundation in case law or statute to establish their suggested methods are applicable to Indiana gross income tax. Moreover, the taxpayer fails to note the existence of relevant Indiana case law, which provides guidance as to the proper approach to measure "Indiana activities" versus total activities in sourcing receipts to Indiana. If the taxpayer would have utilized the analysis provided under the case law, the taxpayer could have distinguished its facts and arrived at an appropriate measure of "Indiana activities". Thus, the Department will not question the taxpayer using the total number of Indiana telemarketers divided by the total number of telemarketers as an equitable measure of the taxpayer's gross income derived from services within Indiana.

B. Receipts Derived from Advertising Services:

The taxpayer explains its receipts derived from providing advertising services (i.e. banner advertisements; and employer want ads) are best characterized as received from display advertising, as the term is used in [IC 6-2.1-2-4\(2\)](#). [IC 6-2.1-2-4\(2\)](#) states in part that "the receipts of gross income from. . .display advertising, including outdoor painted and poster display advertising and radio and television media advertising, but not including any sale or rental of tangible property or any personal professional service rendered in connection with such advertising" is subject to a low rate of tax. [45 IAC 1.1-2-3](#) further defines "display advertising":

(a) As used in section 2 of this rule, to . . . include[]:

- (1) outdoor billboards;
- (2) outdoor posters;
- (3) outdoor painted displays;
- (4) print media advertising; and
- (5) the sale of time by a radio station, a television station, and a cable television operator.

(b) The term does not include the following:

- (1) The rendering of professional services in connection with such advertising.
- (2) The sale or rental of tangible property that will be used in display advertising. . .

The taxpayer notes the regulations under [45 IAC 1.1-2-3](#) specifically identifies activities as display advertising for more traditional forms of media. Yet, the taxpayer argues the Department has no reasonable basis why it would characterize its advertising services any differently, just because the taxpayer utilized the internet as a media form, rather than the traditional media forms. The taxpayer further argues if the Department had correctly classified the advertising services as display advertising, the receipts derived from the advertising services would qualify for a lower tax treatment under [IC 6-2.1-2-3\(a\)](#).

Both the statute and regulations specifically describe display advertising. The type of advertising services provided by the taxpayer does not fit into any of the statutory or regulatory descriptions of "display advertising". The advertising services provided by the taxpayer are more analogous to the rendering of services in connection with advertising. Neither the statute nor regulations identify this type of advertising as display advertising. Thus, the audit review was correct to not treat the advertising services as "display advertising" subject to the low rate of tax.

C. Conclusion

In summary, the Department agrees with the audit reviews adjustment of the taxpayer's services to the high rate of tax.

FINDING

The Department respectfully denies the taxpayer's protest.

II. Adjusted Gross Income Tax- Sourcing Receipts to Indiana for Sales Factor Numerator DISCUSSION

The taxpayer states it generally derives receipts from various services and the sale of intangible rights to access its proprietary database. The taxpayer claims it used an erroneous method to calculate sales attributable to Indiana, as pointed out by a Massachusetts audit. The taxpayer contends because of this mistake the sales factor numerator did not accurately reflect sales attributable to Indiana. The taxpayer argues the proper method of

determining whether receipts are attributable to Indiana is the cost of performance method. According to the taxpayer, the cost of performance method is an all or nothing method, in which receipts are sourced to wherever the taxpayer performs a majority of the activities related to the receipts. Thus, the taxpayer contends since the greatest portion of activities with respect to its receipts is performed at its Massachusetts headquarters, the taxpayer should have sourced the receipts to Massachusetts. Accordingly, a Massachusetts audit applied the cost of performance method and attributed one hundred percent of the receipts from services and intangible rights to Massachusetts. Therefore, the taxpayer concludes the Department should properly source those receipts outside Indiana for the Indiana sales factor.

[IC 6-3-2-1](#) imposes a tax "on that part of the adjusted gross income derived from sources within Indiana of every corporation." [IC 6-3-2-2](#) provides:

(a) With regard to corporations. . . "adjusted gross income derived from sources within Indiana" for the purposes of this article, shall mean and include:

- (1) income from real or tangible personal property located in this state;
- (2) income from doing business in this state. . .

In the case of business income, only so much of such income as is apportioned to this state under the provision of subsection (b) shall be deemed to be derived from sources within the state of Indiana. . .

(b) Except as provided in subsection (l), if business income of a corporation. . . is derived from sources within the state of Indiana and from sources without the state of Indiana, then the business income derived from sources within this state shall be determined by multiplying the business income derived from sources both within and without the state of Indiana by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three (3). . .

The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year. [IC 6-3-2-2](#)(e). The numerator of the sales factor generally includes gross receipts from sales attributable to this state. [45 IAC 3.1-1-52](#). Accordingly, to determine if the taxpayer's receipts are attributable to Indiana for the sales factor numerator, the Department will address each of these items separately.

A. Receipts from Services:

The taxpayer explains it performs services within and without Indiana. The taxpayer contends to determine if services are in Indiana, the Department must apply [IC 6-3-2-2](#)(f)(2). [IC 6-3-2-2](#)(f)(2) provides "[s]ales, other than receipts from intangible property. . . are in this state if: the income-producing activity is performed both within and without this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance." "Income producing activity is deemed performed at the. . . place where personal services are rendered." [45 IAC 3.1-1-55](#).

The taxpayer argues that it renders its services at its Massachusetts headquarters. The taxpayer further argues a majority of the activities related to the service occurs in Massachusetts, rather than Indiana. Thus, taking these facts together, the Department should not attribute any of the receipts from services to Indiana, nor include those amounts in the sales factor numerator.

The taxpayer fails to consider that the receipts from services constitute a principal source of business income. [IC 6-3-1-20](#) defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business. . . ." For purposes of adjusted gross income tax, business income is apportioned between Indiana and other states using a three factor formula. [IC 6-3-2-2](#)(b). In contrast, non-business income is allocated to Indiana or it is allocated to another state. [IC 6-3-2-2](#)(g) to (k). Thus, "whether income is deemed business income or non-business income determines whether it is allocated to a specific state or whether it is apportioned between Indiana and other states [in which] the taxpayer is conducting its trade or business." *May Department Store Co. v. Indiana Dept. of State Revenue*, 749 N.E.2d 651, 656 (Ind. Tax Ct. 2001). Once this is considered, [45 IAC 3.1-1-55](#) provides:

[R]eceipts from sales other than sales of tangible personal property which constitute a principal source of business income shall be attributed to this state in accordance with the following. . .

- (d) If the services are performed partly within and without this state, such receipts shall be attributed to this state based upon the ratio which the time spent in performing such services in this state bears to the total time spent in performing such service elsewhere. Time spent in performing services includes the amount of time expended in the performance of a contract or other obligation which gives rise to such gross receipts.

Therefore, because the receipt's from services represents business income of the taxpayer, the taxpayer cannot use the cost of performance method to determine if the receipts are attributable to Indiana. The proper method to attribute the Indiana receipts from services is described in [45 IAC 3.1-1-55](#)(d). Once this method is used, then the taxpayer can determine if the sale of the services are attributable to this state for the sales factor numerator.

B. Receipts from Sales of Intangible Rights to Access the Taxpayer's Proprietary Database:

The taxpayer asserts its receipts from the sale of intangible rights are not within this state. The taxpayer explains "[s]ales, other than receipts from intangible property. . . are in this state if: the income-producing activity

is performed both within and without this state and a greater proportion of the income-producing activity is performed in this state than in any other state, based on costs of performance." [IC 6-3-2-2\(f\)\(2\)](#). [45 IAC 3.1-1-55](#) clarifies [IC 6-3-2-2\(f\)\(2\)](#) and provides:

Gross receipts from transactions other than sales of tangible personal property shall be included in the numerator of the sales factor if the income-producing activity. . . is performed within and without this state such receipts are attributed to this state if the greater proportion of the income producing activity is performed here, based on costs of performance. . . Income producing activity is deemed performed at the situs of. . . intangible personal property. . . The situs of intangible personal property is the commercial domicile of the taxpayer (i.e., the principal place from which trade or business of the taxpayer is directed or managed), unless the property has acquired a "business situs" elsewhere. . . .

The taxpayer states that using the guidelines provide under the regulations, the greatest portion of its activities related to the receipts from the sale of intangible rights occurs at its commercial domicile in Massachusetts. The taxpayer explains it reviews all the sales orders for the intangible rights, enters those orders into its ordering system, and gives all final approval of those orders at its Massachusetts headquarters. Thus, the taxpayer argues since a substantial portion of the activity occurs outside of Indiana, the Department should not attribute any of these receipts to Indiana.

Again, the taxpayer fails to consider the receipts from sales of intangible rights represent a principal source of business income for the taxpayer. [IC 6-3-1-20](#) defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the. . . property constitutes integral parts of the taxpayer's regular trade or business." As previously stated, for adjusted gross income tax purposes, business income is apportioned between Indiana and other states using a three factor formula. [IC 6-3-2-2\(b\)](#). In contrast, non-business income is allocated to Indiana or it is allocated to another state. [IC 6-3-2-2\(g\)](#) to (k). Thus, "whether income is deemed business income or non-business income determines whether it is allocated to a specific state or whether it is apportioned between Indiana and other states [in which] the taxpayer is conducting its trade or business." May Department Store Co. v. Indiana Dept. of State Revenue, 749 N.E.2d 651, 656 (Ind. Tax Ct. 2001). Once the Department identifies the receipt from the sales of intangible rights as business income, [45 IAC 3.1-1-55](#) provides:

[R]eceipts from sales other than sales of tangible personal property which constitute a principal source of business income shall be attributed to this state in accordance with the following. . . .

(e) Gross receipts from intangible personal property shall, if classified as business income, be attributed to this state based upon the ratio which the total property and payroll factors in this state bears to the total of the property and payroll factors everywhere for the tax period as determined in Regulations 6-3-2-2(d)(010) [[45 IAC 3.1-1-40](#)] et seq. and 6-3-2-2(d)(010) [[45 IAC 3.1-1-47](#)] et seq.

Therefore, because the receipt from the sale of intangible rights represent a principal source of business income, the taxpayer should not use the cost of performance method to determine whether the receipts are attributable to Indiana. The proper approach to attribute the receipts from the sale of intangible rights to Indiana is explained in [45 IAC 3.1-1-55\(e\)](#). Once this method is used, then the taxpayer can determine whether the receipts are attributable to this state for the sales factor numerator.

FINDING

The Department respectfully denies the taxpayer's protest.

III. Tax Administration- Penalty

DISCUSSION

The taxpayer requests the Department waive the assessment of penalties on the tax liability. The taxpayer states because Indiana has provided little guidance as to the issues involved in the protest, this created a reasonable disagreement between the taxpayer and the Department. Therefore, the taxpayer maintains its underpayment of tax was due to reasonable cause and not willful neglect.

[IC 6-8.1-10-2.1\(a\)\(3\)](#) provides in part that "if a person. . . incurs, upon examination by the department, a deficiency that is due to negligence. . . the person is subject to a penalty." Negligence is defined "as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. . . ." [45 IAC 15-11-2\(b\)](#). Negligence is "determined on a case-by-case basis according to the facts and circumstances of each taxpayer." *Id.*

The Department may waive the penalty upon a showing that the failure to pay the deficiency was due to reasonable cause and not due to willful neglect. [IC 6-8.1-10-2.1\(d\)](#). However, in order to establish reasonable cause, the taxpayer must demonstrate that the taxpayer "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed. . . ." [45 IAC 15-11-2\(c\)](#).

Taxpayer provides no substantive basis to justify the Department finding the taxpayer's failure to pay the tax deficiency was due to reasonable cause. The taxpayer's assertions do not rise to a level of "reasonable cause" sufficient to permit the Department to waive the negligence penalty assessed against an otherwise sophisticated taxpayer.

FINDING

For the reasons stated above, the Department respectfully denies the taxpayer's protest.

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