DEPARTMENT OF STATE REVENUE

02-20130047.LOF

Letter of Findings: 02-20130047
Corporate Income Tax
For the Years 2007 through and including 2011

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Corporate Income Tax – Imposition.

Authority: IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-3-2-2.2; IC § 6-8.1-5-1; Sherwin-Williams Co. v. Indiana Dep't of State Revenue, 673 N.E.2d 849 (Ind. Tax Ct. 1996); Chief Industries Inc. v. Indiana Dep't of Revenue, 792 N.E.2d 972 (Ind. Tax Ct. 2000); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); 45 IAC 3.1-1-52; 45 IAC 3.1-1-55; Letter of Findings 02-20130238 (September 25, 2013).

Taxpayer protests the Department's proposed assessments.

II. Tax Administration – Underpayment Penalty and Negligence Penalty.

Authority: IC § 6-3-4-4.1; IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of the underpayment penalty and the negligence penalty.

III. Tax Administration – Interest.

Authority: IC § 6-8.1-10-1.

Taxpayer protests the imposition of statutory interest.

STATEMENT OF FACTS

Taxpayer is a multi-state company doing business in Indiana. Taxpayer owns and licenses its trade names, trademarks, service marks, logos, slogans, and brand identities ("Intellectual Property") to various individuals who operate and provide lodging accommodation ("Franchisees") in Indiana and outside of Indiana pursuant to franchise agreements. Taxpayer manages, maintains, administers, and protects its Intellectual Property and also hires employees to perform the reservation call center services under the franchise agreements.

Taxpayer owns a subsidiary ("Subsidiary"), which, in turn, owns real property and leases real estate to Taxpayer to be used as a reservation call center. Subsidiary also provides various services to Franchisees in addition to servicing Taxpayer. The services which Subsidiary provides include, but are not limited to, (1) the day-to-day corporate management functions, including managing all employees, except employees who are hired to perform reservation call center services; (2) marketing and promoting franchise sales; (3) training Franchisees how to operate or manage the lodging accommodation business, including use of the on-line "Profit Management System" and periodical on-site visits (consultation) of Franchisees' business locations; (4) updating and maintaining the "Profit Management System."

Upon entering into the franchise agreements, the Indiana Franchisees are charged various fees, including a one-time "Initial Franchise Fee" (or an "Affiliation Fee") and various monthly fees. Those monthly fees are based on a percentage of the preceding month's gross room revenues.

The Indiana Department of Revenue ("Department") conducted a corporate income tax audit of Taxpayer's business records for tax years 2007, 2008, 2009, and 2010. Pursuant to the audit, the Department determined that Taxpayer erred in reporting their income derived and attributable to Indiana. As a result, the Department assessed Taxpayer additional corporate income tax and interest. The Department's audit determined that there is reasonable cause to waive the negligence penalty for the tax years 2007–2010. For the 2009 tax year, however, Taxpayer was assessed a penalty for failure to remit adequate estimated income tax as statutorily required (also known as an underpayment penalty or a 2220 penalty).

Additionally, for the 2011 tax year, Taxpayer failed to remit sufficient estimated corporate income tax before the statutory due date. Taxpayer requested an extension to file its corporate income tax return, but it did not pay the full amount of tax owed and interest. As a result, Taxpayer was assessed interest and a late penalty, in addition to an underpayment penalty.

Taxpayer timely protests the assessments and penalties. A hearing was held for which Taxpayer's representative explained the basis of the protest. This Letter of Findings ensues. Letter of Findings 02-20130048 addresses Subsidiary's protest of the Department's assessment. Additional facts will be provided as necessary.

I. Corporate Income Tax – Imposition.

DISCUSSION

The Department's audit assessed Taxpayer additional corporate income tax on the ground that its income from the franchise agreements for licenses of intangible property and sales of services to Indiana Franchisees was attributable to Indiana.

Taxpayer, to the contrary, claims that it has no real property or employees in Indiana; that all of its costs in

performing services or licenses of intangible property pursuant to its franchise agreements were outside Indiana; and that it is not responsible for the Indiana corporate income tax under the "cost of performance" rules because the rules mandate Taxpayer to source its income at issue to states other than Indiana.

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012).

"Indiana imposes a tax on every corporation's adjusted gross income derived from sources within Indiana. [IC § 6-3-2-1(b).] In cases where a corporation derives business income from sources both within and without Indiana, the 'adjusted gross income derived from sources within the state of Indiana' is determined by an apportionment formula." Sherwin-Williams Co. v. Indiana Dep't of State Revenue, 673 N.E.2d 849, 851 (Ind. Tax Ct. 1996).

IC § 6-3-2-2 (as in effect for tax years 2007 – 2010), in relevant part, 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**;

(3) income from a trade or profession conducted in this state;

(4) compensation for labor or services rendered within this state; and

(5) **income from** stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, **franchises**, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.

. . .

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, [] 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 . . . . (**Emphasis added**).

"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. Sales include receipts from intangible property and receipts from the sale or exchange of intangible property." IC § 6-3-2-2(e). "The numerator of the sales factor generally includes gross receipts from sales attributable to this state, and includes all interest income, service charges, carrying charges, or time-price differential charges incidental to such sales. . . ." 45 IAC 3.1-1-52.

IC § 6-3-2-2(f) states:

Sales, other than receipts from intangible property covered by subsection (e) and sales of tangible personal property, are in this state if:

(1) the **income-producing activity is performed in this state**; or

(2) 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. (**Emphasis added**).

45 IAC 3.1-1-55, in relevant part, further explains:

The term "**income producing activity**" means the act or acts **directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit**. Such activity does not include activities performed on behalf of the taxpayer, such as those conducted on its behalf by an independent contractor. Accordingly, "income producing activity" includes but is not limited to the following: (1) The rendering of personal services by employees or the utilization of tangible and intangible property by the taxpayer in performing a service. (2) The sale, rental, leasing, or licensing the use of or other use of tangible personal property. (3) The sale, licensing the use of or other use of intangible personal property.

Income producing activity is deemed performed at the situs of real, tangible and intangible personal property or the place where personal services are rendered. The situs of real and tangible personal property is at its physical location. 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. "Business situs" is the place at which intangible personal property is employed as capital; or the place where the property is located if possession and control of the property is localized in connection with a trade or business so that substantial use or value attaches to the property. Example: Taxpayer, a corporation whose principal business activity is the manufacture and sale of hot water heaters, obtains notes for the sale of such water heaters in connection with its Indiana business activity. The property has a business situs in this state, therefore, interest income derived from such notes is attributable to this state. (**Emphasis added**).

In this instance, Taxpayer states that the Department's audit erred by not applying the "cost of performance" sourcing. Taxpayer objects that the audit relied on IC § 6-3-2-2(a)(5) and IC § 6-3-2-2.2(e) to impose additional Indiana income tax. Taxpayer explains that IC § 6-3-2-2.2(e) "is to direct the sourcing of only certain types of receipts from intangible property – intangible receipts from loans, credits, financing, or other the listed fiduciary activities in 2.2." Taxpayer maintains that, in this case, pursuant to the franchise agreements, it licenses the Intellectual Property, which is intangible property, and provides non-lending or non-fiduciary services to Indiana Franchisees. Thus, Taxpayer claims that the "cost of performance" rules under IC § 6-2-2-2(f)(2) should apply. Taxpayer further asserts that all of its employees work outside Indiana and "[a]lmost all costs of performance and income producing activities performed by" Taxpayer under the franchise agreements are outside Indiana. Thus, Taxpayer, referencing Chief Industries Inc. v. Indiana Dep't of Revenue, 792 N.E.2d 972 (Ind. Tax Ct. 2000), contend that it is not responsible for the additional income tax and that the Department's assessments are not correct on the ground that the Department's audit applied an incorrect method. Taxpayer submits a summary explaining its interpretation of the statutes, regulations and case law to support its protest.

Upon review, however, the Department is not able to agree with Taxpayer's conclusion that the "cost of performance" rules apply as a result. First, Chief Industries interpreted a previous statutory language concerning IC § 6-3-2-2(a)(5), which was applied in a dispute over an income tax assessment for tax year 1986. That previous provision stated that "income from . . . franchises and other intangible personal property having a situs" in Indiana. Since then, the Indiana General Assembly revised IC § 6-3-2-2(a)(5), deleting "having a situs" and adding "**if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter**" (**Emphasis in original 1989 amendment**) after "other intangible personal property." The Indiana General Assembly in the revised IC § 6-3-2-2(a)(5) kept the specific "income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises" intact and clarified the meaning of "other intangible personal property" by including an internal reference to IC § 6-3-2-2.2. IC § 6-3-2-2.2 is limited in its effect acting only to describe the manner in which interest and dividend income are attributed to the state. Specifically, IC § 6-3-2-2(a)(5) (as in effect for tax years 2007 – 2010) states that "[w]ith regard to corporations . . . 'adjusted gross income derived from sources within Indiana', for the purposes of this article, shall mean and include . . . income from . . . trademarks, trade brands, franchises, and other intangible personal property . . . ." The Indiana General Assembly clearly intended to tax income earned from trademarks, trade brands, and franchises that is attributable to Indiana. Thus, Taxpayer's reliance on Chief Industries is misplaced.

In this instance, Taxpayer entered into various franchise agreements with Indiana Franchisees. The Indiana Franchisees pay Taxpayer various fees, which include among other things the right to use Taxpayer's Intellectual Property and receive services in Indiana pursuant to the franchise agreements. The value attached to Taxpayer's Intellectual Property does not derive from – however necessary – activities surrounding the administration of the Intellectual Property outside this state but results from Taxpayer's ability to exploit the value of the property within the stream of Indiana commerce and to derive income from its ability to do so. The Intellectual Property, standing alone, does not have any value unless Taxpayer takes steps to associate that property with the conduct of a specific business operation, namely Franchisees' business operations. Taxpayer is not paid fees because it successfully administers and maintains the Intellectual Property or renders services at an out-of-state location; Taxpayer receives income because it licenses Intellectual Property to Indiana Franchisees and routinely conducts business activities to ensure the fulfillment of the franchise agreements in Indiana. Thus, Taxpayer's income at issue is business income and is attributable to Indiana under IC § 6-3-2-2(a)(2) or (a)(5).

Even if, assuming IC § 6-3-2-2(a)(2) and (a)(5), as well as IC § 6-3-2-2.2(e) do not apply, Taxpayer's income at issue, that Taxpayer classifies as fees paid for intangible property and services, is still attributable to Indiana and subject to Indiana income tax because the income producing activity is performed in Indiana.

First, IC § 6-3-2-2(f)(1) specifically states that "[s]ales, other than receipts from intangible property covered by subsection (e) and sales of tangible personal property, are in this state if the income-producing activity is performed in this state." 45 IAC 3.1-1-55 illustrates that "[t]he term 'income producing activity' means the act or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit. . . . Accordingly, 'income producing activity' includes but is not limited to the following: (1) The rendering of personal services by employees or the utilization of tangible and intangible property by the taxpayer in performing a service. (2) The sale, rental, leasing, or licensing the use of or other use of tangible personal property. (3) The sale, licensing the use of or other use of intangible personal property." 45 IAC 3.1-1-55 further states that "Income producing activity is deemed performed at the situs of real, tangible and intangible personal property or the place where personal services are rendered." In this instance, the Department's audit found that, pursuant to the franchise agreements, Taxpayer's franchise agreements have a business situs within Indiana. Indiana Franchisees pay Taxpayer various fees in exchange for employing Taxpayer's intangible property and services in Indiana. Taxpayer's "income producing activity" from those franchise agreements is "deemed performed" within Indiana. Thus, Taxpayer's income at issue is attributable to Indiana and subject to Indiana income tax pursuant to IC § 6-3-2-2(f)(1) and 45 IAC 3.1-1-55.

The Department, in Letter of Findings 02-20130238 (September 25, 2013), 20130925 Ind. Reg.

045130426NRA, further explains, in relevant part, that:

> [R]eceipts from any "income producing activity" performed in Indiana are always attributed to Indiana under IC § 6-3-2-2(f)(1); all of the receipts or a principal source of business income are attributed to Indiana when, under the cost of performance rules, the greater proportion of the income producing activity is performed in Indiana under IC § 6-3-2-2(f)(2) and 45 IAC 3.1-1-55.
>
> The "cost of performance" rules apply in two situations: (1) when attributing all of the receipts for a principal source of business income to Indiana because the greater proportion is performed in Indiana; (2) when income is not a "principal source of business income" and the greater proportion of the income producing activity is performed outside of Indiana.

Accordingly, Taxpayer has business income derived from licenses of intangible property or sales of services; the income at issue is a "principal source of business income" for Taxpayer and is from "income-producing activity" that was performed in Indiana under 45 IAC 3.1-1-55. Given the totality of circumstances, in the absence of other supporting documentation, the Department is not able to agree that Taxpayer met its burden demonstrating that the Department's assessments are not correct and that the "cost of performance" rules mandate Taxpayer to source its income at issue to states other than Indiana.

FINDING

Taxpayer's protest is respectfully denied.

II. Tax Administration – Underpayment Penalty and Negligence Penalty.

DISCUSSION

The Department assessed Taxpayer an underpayment penalty for 2009 tax year after the audit was concluded even though the audit did not impose negligence penalty. For tax year 2011, the Department did not audit Taxpayer. Nonetheless, Taxpayer was assessed an underpayment penalty and a negligence penalty.

Taxpayer protests the imposition of the underpayment and negligence penalties.

A. Underpayment Penalty.

The Department assessed Taxpayer two (2) underpayment penalties because it failed to timely remit its estimated payments of adjusted gross income tax for the 2009 and 2011 tax years pursuant to IC § 6-3-4-4.1(d). Taxpayer asks that the Department abate both underpayment penalties.

IC 6-3-4-4.1(d) states:

> The penalty prescribed by IC 6-8.1-10-2.1(b) shall be assessed by the department on corporations failing to make payments as required in subsection (c) or (f). However, no penalty shall be assessed as to any estimated payments of adjusted gross income tax which equal or exceed:
>
> (1) the annualized income installment calculated under subsection (c); or
>
> (2) twenty-five percent (25 [percent]) of the final tax liability for the taxpayer's previous taxable year.
>
> In addition, the penalty as to any underpayment of tax on an estimated return shall only be assessed on the difference between the actual amount paid by the corporation on such estimated return and twenty-five percent (25 [percent]) of the corporation's final adjusted gross income tax liability for such taxable year.

In this instance, the Department audited Taxpayer for tax years 2007 through 2010 and adjusted its income tax liability for those years. The Department assessed Taxpayer an underpayment penalty for 2009 tax year as a result of the audit's adjustments. Taxpayer has provided sufficient documentation demonstrating that the imposition of the underpayment for 2009 tax year is not appropriate.

As to the underpayment penalty for the 2011 tax year, Taxpayer explains that although the Department did not audit Taxpayer's 2011 return, it prepared its 2011 return following the audit methodology. Thus, Taxpayer contends that the underpayment penalty for 2011 tax year is not appropriate.

Upon reviewing the Department's records, however, the Department is not able to agree. First, the underpayment penalty at issue is not related to the Department's audit adjustments. Thus, whether Taxpayer prepared its 2011 return following the audit's methodology is not relevant. Taxpayer is required to timely remit estimated income tax before the statutory due date. Second, the Department's records show that, previously, Taxpayer has timely made its quarterly estimated payments in April, June, and September 2010 for the 2010 year; however, it made only a $1,000 estimated payment, in April 2011, for the tax year 2011. Taxpayer in this instance did not provide any documentation to demonstrate a reasonable cause for penalty waiver.

In short, Taxpayer's protest of the 2009 underpayment penalty is sustained, but its protest of the 2011 underpayment penalty is denied.

B. Negligence Penalty.

The Department assessed Taxpayer a ten percent negligence penalty for tax year 2011 because it did not file its 2011 return and pay the full amount of income tax before the statutory due date. Taxpayer also protests the imposition of the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1(a), the Department may assess a ten (10) percent negligence penalty if the taxpayer:

> (1) fails to file a return for any of the listed taxes;
>
> (2) fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment;

(3) incurs, upon examination by the department, a deficiency that is due to negligence;
(4) fails to timely remit any tax held in trust for the state; or
(5) is required to make a payment by electronic funds transfer (as defined in IC 4-8.1-2-7), overnight courier, or personal delivery and the payment is not received by the department by the due date in funds acceptable to the department.

45 IAC 15-11-2(b) further states:

"Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The Department may waive a negligence penalty as provided in 45 IAC 15-11-2(c), in part, as follows:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

(1) the nature of the tax involved;
(2) judicial precedents set by Indiana courts;
(3) judicial precedents established in jurisdictions outside Indiana;
(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

In this instance, Taxpayer did not provide sufficient documentation to demonstrate that the failure to timely remit tax was not due to negligence.

FINDING

Taxpayer's protest of the 2009 underpayment penalty is sustained, but its protest of imposition of the 2011 underpayment and negligence penalties is respectfully denied.

III. Tax Administration – Interest.

DISCUSSION

The Department assessed interest on the tax liabilities. Taxpayer protests the imposition of interest.

IC § 6-8.1-10-1(a) provides, as follows:

If a person fails to file a return for any of the listed taxes, fails to pay the full amount of tax shown on the person's return by the due date for the return or the payment, or incurs a deficiency upon a determination by the department, the person is subject to interest on the nonpayment.

Pursuant to IC § 6-8.1-10-1(e), the Department does not have the authority to waive the interest.

FINDING

Taxpayer's protest regarding the imposition of interest is respectfully denied.

SUMMARY

Taxpayer's protest of the 2009 underpayment penalty is sustained. However, the remainder of Taxpayer's protest is respectfully denied.

Posted: 01/29/2014 by Legislative Services Agency
An html version of this document.