DEPARTMENT OF STATE REVENUE

02-20130048.LOF

Letter of Findings: 02-20130048
Corporate Income Tax
For the Years 2008 through and including 2010

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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 assessment.

II. Tax Administration – Interest.

Authority: IC § 6-8.1-10-1.

Taxpayer protests the imposition of statutory interest.

STATEMENT OF FACTS

Taxpayer is an out-of-state company doing business in Indiana pursuant to various franchise agreements which its parent company ("Parent") manages. Parent owns and licenses certain intellectual property, which includes trade names, trademarks, 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, on the other hand, owns real property in states other than Indiana and leases real estate to Parent to be used as a reservation call center. In addition to servicing Parent, Taxpayer provides various services to Franchisees. Taxpayer's services 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 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 for the 2010 tax year. The Department's audit determined that there is reasonable cause to waive the negligence penalty.

Taxpayer timely protests the assessment. A hearing was held for which Taxpayer's representative explained the basis of the protest. This Letter of Findings ensues. Letter of Findings 02-20130047 addresses Parent's protest of the Department's assessments. 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 2008 – 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 2008 – 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" 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.
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> 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 – 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 additional income tax for tax year 2010 and imposition of statutory interest is respectfully denied.

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