DEPARTMENT OF STATE REVENUE

02-20140072.LOF

Letter of Findings: 02-20140072
Corporate Income Tax
For the Years 2005 through 2013

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 require the publication of this document in the Indiana Register. This document provides the general public with information about the Department's official position concerning a specific set of facts and issues. This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.

I. Corporate Income Tax – Nexus.

Authority: IC § 6-3-2-1; IC § 6-3-2-2(a); IC § 6-3-2-2(e); IC § 6-3-2-2(f); IC § 6-8.1-9-1(a); United Parcel Service, Inc. v. Indiana Dept. of State Revenue, 995 N.E.2d 20 (Ind. Tax Ct. 2013); 45 IAC 3.1-1-38; 45 IAC 3.1-1-38(4); 45 IAC 3.1-1-55.

Taxpayer argues that it does not have nexus with the state of Indiana, that it erred in filing Indiana tax returns and paying corporate income taxes from 2005 through 2013, and asks that the Department return the income tax it paid during 2010, 2011, and 2012.

II. Underpayment Penalty.

Authority: IC § 6-3-4-4.1(d); IC § 6-8.1-10-2.1(b); IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(c).

Taxpayer asks that the Department abate a penalty.

STATEMENT OF FACTS

Taxpayer is a Delaware business. Taxpayer earns royalties from two of its Indiana affiliates. The Indiana affiliates pay royalties for the right to use Taxpayer's trademarks and trade names in manufacturing certain products. The two Indiana affiliates manufacture and sell goods which incorporate Taxpayer's trademarks and other intellectual property and which are licensed for use in Indiana.

In February 2009, Taxpayer contacted the Department of Revenue ("Department") stating it "ha[d] been collecting royalty payments from various companies that are part of a consolidated group of companies." Taxpayer stated that "[i]t earns royalties from the sale of products sold to Indiana customers by related companies in the consolidated group." Taxpayer explained that it "manages the trade names and trademark from its corporate offices that are located outside the state of Indiana."

Taxpayer estimated that it owed Indiana tax for 2005, 2006, 2007, and 2008. As such, Taxpayer stated it "would like to participate in the Indiana Voluntary Compliance Program." In return, it asked the Department "consider a limited look back period and the waiver of all penalties."

The Department responded June 2009 agreeing to enter into a "Voluntary Compliance Agreement for Collection of Income Taxes." The Agreement provided that the Department would "limit[] the liability to the 'Company' for income tax from the 'Company's' business activities during certain tax periods." The Agreement required Taxpayer to file and pay income tax for 2005 through 2008 and required the company to "file the applicable Indiana Income Tax Return(s) through the tax year ending 12/31/2011." In turn, the Department agreed to waive all penalties.

The Department conducted an audit review of Taxpayer's books and financial records for the years 2008 through 2010. The audit was completed in 2012. The 2012 audit resulted in the assessment of additional income tax. When Taxpayer filed its 2008 through 2010 returns, Taxpayer calculated its apportionable destination sales based upon the royalties it received from its two Indiana affiliates. The two affiliates did not "add back" their royalty expenses during 2008, 2019, and 2010 because "they met the exception to the add back of the deduction" when Taxpayer became an Indiana filer.

According to the audit report, "The Indiana destination sales were then multiplied by the respective rate for each entity which drastically diluted the numerator of the sales factor." The 2012 audit found that the method by which the Taxpayer calculated the numerator of its sales factor "drastically diluted the numerator of the sales factor."

As the audit report explained:

> The numerator should have been determined by the royalty income received from the two Indiana entities. These amounts are what [Affiliate One] and [Affiliate Two] would have added back on their tax returns. Furthermore, these amounts represent the true economic business activity from sales attributable to Indiana.

Taxpayer objected and filed a protest to that effect. Taxpayer stated:

> Royalties are not earned until a product is sold. The sale of a licensed product is the event that triggers a liability to the selling company using the trade name. The selling company incurs a liability to the taxpayer. The liability is based on an established royalty rate between the company selling the licensed product and the company holding the right to license the product which in this case is the taxpayer.
>
> For purposes of apportioning income to Indiana, the taxpayer treated all of its royalty income associated with sales of licensed products to Indiana customers as Indiana-source sales and included this royalty income in the numerator of its receipts factor. We believe this method fairly reflects the taxpayer's Indiana-source sales. (Emphasis added).

As an alternative to the 2012 audit conclusion, Taxpayer proposed two alternative reporting methodologies. According to Taxpayer, its "first method is to use only the receipts factor to calculate the Taxpayer's apportionment [which ignores both the property and payroll factors in the apportionment calculation." Taxpayer also offered a second method "which many states use and Indiana has the authority to use [to] file a combined Indiana income tax return." Taxpayer offered "combined/unitary income tax returns for the years 2008, 2009, and 2010 that include [Taxpayer] and entities in [parent company] group." Taxpayer stated that it filed similar combined returns in nine different states. In its original protest letter, Taxpayer stated that "Either of these methods would provide a much more reasonable and fair result than the unpublished derivative that the auditor used to produce the proposed 2008 audit result" and would be "more representative of the Taxpayer's Indiana activity and thus more fairly reflect[] the Taxpayer's income earned in Indiana."

In a letter dated September 2013, the Department agreed to conduct a supplemental review of the two proposed alternatives.

The supplemental review was conducted and a second audit report generated in October 2013. According to the report, "Audit Division has reviewed the two proposed alternatives and has determined that the combined unitary alternative more fairly reflects the [T]axpayer's income in Indiana per Indiana Code 6-3-2-2(l) & (m)." The audit resulted in the base tax due for 2008 through 2010 "reduced by the supplemental adjustments . . . ."

After Taxpayer received the Supplemental Audit report, Taxpayer objected on entirely new grounds. Taxpayer reversed its previous stance concluding that it "does not, and never had nexus with Indiana because [Indiana] has never adopted the economic nexus doctrine." As a result, Taxpayer originally asked that all of the taxes it paid during 2005, 2006, 2007, 2008, 2009, 2010, 2011, 2012, and 2013 be refunded. That request was subsequently modified when it "recognize[d] that only tax years 2010 and subsequent years are open for refund."

I. Corporate Income Tax – Nexus.

DISCUSSION

Taxpayer argues that it should never have filed Indiana returns because it does not have nexus with Indiana. In support of its argument, Taxpayer cites to the United Parcel Service, Inc. v. Indiana Dept. of State Revenue, 995 N.E.2d 20 (Ind. Tax Ct. 2013). In that case, the Tax Court held that two foreign reinsurance companies had to be physically present in Indiana in order to satisfy the "doing business" standard for purposes of Indiana's premiums tax. Id. at 23. In particular, Taxpayer cites from the court's written decision which stated that:

> At the outset, and contrary to [petitioner's] claim, there is no tension between Indiana's premiums tax and its corporate income tax because each utilizes a physical presence standard. Thus, to the extent [petitioner] believe this Court's decision in MBNA held that Indiana's corporate income tax utilized an economic standard, it is incorrect. Id. at 23.

Taxpayer argues that because it does not have a physical, "brick, and mortar" presence in this state, it is not required to report or pay tax on its Indiana source income. In addition, Taxpayer asks for a refund of all the tax it

paid during the years 2005 through 2013.

Indiana law sets rules for determining what portion of a multistate business' income is subject to Indiana tax. IC § 6-3-2-2(a) provides in part:

> With regard to corporations and nonresident persons, "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 to the extent that the income is apportioned to Indiana under this section or if the income is allocated to Indiana or considered to be derived from sources within Indiana under this section. (Emphasis added).

During the relevant periods, Indiana's "apportionment formula" was based on three factors which were "weighted" differently during the audit period. For purposes of this protest, the "receipts factor" is relevant as set out in IC § 6-3-2-2(e), (f).

> (e) 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. However, with respect to a foreign corporation, the denominator does not include sales made in a place that is outside the United States. Receipts from intangible personal property are derived from sources within Indiana if the receipts from the intangible personal property are attributable to Indiana under section 2.2 of this chapter. Regardless of the f.o.b. point or other conditions of the sale, sales of tangible personal property are in this state if:
>
> > (1) the property is delivered or shipped to a purchaser that is within Indiana, other than the United States government; or
> > (2) the property is shipped from an office, a store, a warehouse, a factory, or other place of storage in this state and:
> >
> > > (A) the purchaser is the United States government; or
> > > (B) the taxpayer is not taxable in the state of the purchaser.
>
> Gross receipts derived from commercial printing as described in IC § 6-2.5-1-10 shall be treated as sales of tangible personal property for purposes of this chapter.

(Emphasis added).

Receipts from the sale other than tangible personal property or from certain intangibles are sourced according to IC § 6-3-2-2(f) which states:

> (f) 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).

The Department's regulation, 45 IAC 3.1-1-55, interprets IC § 6-3-2-2(f). The regulation states:

> When Sales Other Than Sales of Tangible Personal Property Are in This State. 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 which gave rise to the receipts is performed wholly within this state. Except as provided below if the 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. 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.

(Emphasis added).

In order for Indiana to tax the money received from any intangible – such as Taxpayer's patents and trademarks licensed to its affiliates – the intangible must have acquired a "business situs" within the state. 45 IAC 3.1-1-55 states that "[t]he situs of intangible personal property is the commercial domicile of the taxpayer . . . unless the property has acquired a 'business situs' elsewhere. 'Business situs' is the place at which the 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."

IC § 6-3-2-1 imposes a tax on the adjusted gross income derived from "sources within Indiana." IC § 6-3-2-2(a) states that adjusted gross income derived from sources within Indiana includes "income from doing business in this state." IC § 6-3-2-2(a). 45 IAC 3.1-1-38, in interpreting IC § 6-3-2-2(a), provides that for apportionment purposes a taxpayer is "doing business" in Indiana if it operates a business enterprise or activity in Indiana including "[r]endering services to customers in the state." 45 IAC 3.1-1-38(4).

Taxpayer's commercial domicile is in Delaware. However, by virtue of the royalty agreements between itself and its affiliates, the intellectual property – consisting of its trade names and trademarks – has acquired a "business situs" within Indiana. Taxpayer licensed its intellectual property to its Indiana affiliates and earned money from those licensing agreements. Although Taxpayer declined the opportunity to provide contemporaneous copies of the licensing agreements it had with its Indiana affiliates, the 2013 version of the licensing agreements allowed the affiliates the right "to use [Taxpayer's] Intellectual Property in connection with the marketing, sale, manufacture and distribution of the [affiliates'] Licensed Products and Services within the Territory." In return, Taxpayer received a five percent royalty fee.

The "substantial use or value" which attaches to this intellectual property derives from the Taxpayer's right to exploit that intellectual property within this state. Taxpayer is the entity which exploits the intellectual property because it is the licensee in the royalty agreement. As the licensee, Taxpayer exploits its intellectual property within Indiana each time a manufactured good is produced and sold within this state. The royalties are simply the economic benefits which derive from the ability of Taxpayer to exploit the intellectual property within this state; those economic benefits (the royalties) flow from Taxpayer's affiliates to Taxpayer. Under 45 IAC 3.1-1-55, the trademarks have acquired an Indiana business situs; under IC § 6-3-2-2(a), the royalty payments are subject to Indiana's adjusted gross income tax.

The Department concludes that Taxpayer's "income producing activity" is performed in Indiana because "the act or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit" occur in Indiana. 45 IAC 3.1-1-55. Taxpayer does not earn money from managing its intellectual property in Delaware; Taxpayer earns money because it develops intellectual property, licenses that intellectual property to its Indiana affiliates, and obtains money from activity which occurs within this state. Under any reasonable interpretation of IC § 6-3-2-2(a), Taxpayer has nexus with Indiana because it has "income from doing business in this state."

FINDING

Taxpayer's protest is denied.

II. Underpayment Penalty.

DISCUSSION

Taxpayer objects to the imposition of the ten percent "underpayment penalty." The penalty is authorized under IC § 6-3-4-4.1(d);

> (d) 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.

IC § 6-8.1-10-2.1(b) sets the amount of penalty as ten percent. However, IC § 6-8.1-10-2.1(d) provides:

> If a person subject to the penalty imposed under this section can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty.

Departmental regulation 45 IAC 15-11-2(c) requires that 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 . . . ."

As discussed in Part I above, the Department disagrees with Taxpayer's substantive argument. In addition, the Department does not agree that Taxpayer's actions establish that it has "exercised ordinary business care" but that it has taken conflicting positions regarding its tax liability.

FINDING

Taxpayer's protest is denied.

SUMMARY

Taxpayer's protest is denied in its entirety.

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