DEPARTMENT OF STATE REVENUE

02-20140455.LOF

Letter of Findings: 02-20140455
Corporate Income Tax
For the Years 2009, 2010, and 2011

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.

ISSUES

I. Corporate Income Tax - Costs of Performance.

Authority: IC § 6-3-2-1(b); IC § 6-3-2-2(a); IC § 6-3-2-2(b); IC § 6-3-2-2(e); IC § 6-3-2-2(e)(2)(B); IC § 6-3-2-2(f); IC § 6-3-2-2(f)(1); IC § 6-3-2-2(f)(2); IC § 6-3-2-2(h)-(k); IC § 6-3-2-2.2; IC § 6-8.1-3-21; IC § 6-8.1-5-1(c); Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480 (Ind. Tax Ct. 2012); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138 (Ind. Tax Ct. 2010); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); City of North Vernon v. Jennings Northwest Regional Utilities, 829 N.E.2d 1 (Ind. 2005); 45 IAC 3.1-1-38; 45 IAC 3.1-1-55; Letter of Findings 02-20130359 (August 19, 2014); Letter of Findings 02-20130047 (November 27, 2013); Letter of Findings 02-20130238 (July 29, 2013); Letter of Findings 02-20120316 (September 7, 2012); Letter of Findings 02-20090496 (October 27, 2009); Letter of Findings 02-20040005 (June 19, 2006); Letter of Findings 02-20030154 (October, 21, 2004); Letter of Findings 02-20020060 (August 7, 2003); Federal Accounting Standards Advisory Board, FASAB Handbook (11th ed. 2012); P.L. 145-2007, § 17; MTC Reg. IV.17.(2); MTC Reg. IV.17.(4)(B)(c); Black's Law Dictionary (9th ed. 2009).

Taxpayer argues that, for purposes of calculating its Indiana adjusted gross income, it is entitled under Indiana law to source income received from Taxpayer's Indiana "online" students on a "Costs of Performance" basis to its out-of-state location and that the Department's position to the contrary is mistaken.

II. Corporate Income Tax - 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 maintains that the Department should exercise its discretion to abate a ten-percent "underpayment" penalty.

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the business of providing online educational services to students. Taxpayer provides its services to students within Indiana and outside the state. Taxpayer charges its students tuition fees based on a "credit hour" basis. Taxpayer provides direct, face-to-face instruction to students only at campuses located outside Indiana.

Taxpayer has no physical location (campuses) in Indiana and has attributed no tuition income to Indiana since 2009 which was the first year that Taxpayer filed Indiana income tax returns.

Taxpayer's online instructors work from their own homes. These online instructors teach students in Indiana and outside Indiana. As explained by Taxpayer:

> Instructors are selected based on need of course/subject. Students attending a particular course are located across the US and may or may not be located in [Indiana]. Any matching of [Indiana] online instructors to [Indiana] students is random coincidence. [Indiana] instructors are selected to teach course(s) in a particular program of study. Because the online platform does not impose geographic boundaries, instructors are not limited to specific geographies / states, nor does [Taxpayer's] instruction methodology result in geographically focused online instructors.

Taxpayer explains that it has little or no direct Indiana expenses:

> There are no [Indiana] expenses related to the delivery of online courses other than online instructor wages. No computers or other equipment/property are provided to instructors by [Taxpayer]. Instructors must have their own means of accessing the [I]nternet and [Taxpayer's] online platform.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business records and tax returns. The audit resulted in the assessment of additional corporate income tax on the ground that money received from providing educational services to Indiana students should be sourced to Indiana for purposes of determining Taxpayer's adjusted gross income tax liability.

The audit decision sourcing this income to Indiana resulted in the assessment of additional income tax. Taxpayer disagreed with the assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

I. Corporate Income Tax - Costs of Performance.

DISCUSSION

The issue is whether Taxpayer is required to pay income tax on money received from Indiana students who took online courses or whether these Indiana tuition fees should be "sourced" entirely to Taxpayer's home state based on a "Costs of Performance" basis.

The Department's audit concluded that Taxpayer was subject to Indiana income tax on money received from its Indiana, online students because this money was received for providing services to Indiana customers.

Taxpayer maintains that this money was not subject to Indiana income tax because substantially all the costs of providing Indiana, online students educational services were incurred at a location outside Indiana.

The audit cited to the Department's regulation, 45 IAC 3.1-1-55, as authority for its conclusion that money received from teaching Indiana, online students was subject to this state's adjusted gross income tax. As relied upon in the audit report, the regulation provides in part:

> 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 . . . .
>
> Income producing activity is deemed performed at the situs of real, tangible and intangible personal property or the place where personal services are rendered.

Id.

The audit stated that the issue was "the location of the [T]axpayer's 'income producing activity.'" The audit reasoned in pertinent part:

> Taxpayer is in the business of providing educational services; lectures through on-line reading assignments, discussions, and written assignments, for degrees to the students and is not in the business of selling property. [45 IAC 3.1-1-55] states that a service provider's income is sourced to the place where the personal services are rendered. The word "rendered" means to transmit or deliver.
>
> . . .
>
> Taxpayer develops the educational services including the lecture materials (intangible property) [outside Indiana]. The issue is not the cost of the development of the educational services; rather the question is the destination of sales through provision of services. Under [45 IAC 3.1-1-55], "income producing activity" occurs at the place where the taxpayer "renders" its services to Indiana customers. The educational services [T]axpayer develops would have no value unless they were offered to and accepted by the Indiana customers and provided by the services of the Indiana faculty members working in their homes in Indiana. The money (tuition) is received by the [T]axpayer because the educational services are "rendered" to the Indiana customers by the Indiana faculty members.

(Emphasis and internal citations omitted).

The audit stated that, based on IC § 6-3-2-2.2(e), the Indiana regulation, 45 IAC 3.1-1-55, was "straightforward" and concluded:

> Receipts from the performance of fiduciary and other services are attributable to the state in which the benefits of the services are consumed. Taxpayer receives money because it offers services to Indiana customers who obtain the benefit of those services within this state. (Internal emphasis omitted).

Taxpayer disagrees stating that the money received from its Indiana online students should be sourced outside Indiana on a "Costs of Performance" basis. Taxpayer explains:

> The primary direct costs involved providing [T]axpayer's educational service[s] are (1) faculty, (2) course development, (3) information technology. Course development and information technology costs are incurred entirely outside of Indiana . . . . Faculty costs are spread throughout the country with .1205[percent], .2092[percent], and .3206[percent] of faculty costs attributable to Indiana resident instructors for tax years 2009, 2010, and 2011, respectively.

A. Taxpayer's Burden of Proof.

At the outset, it should be noted that, in order to prevail in its administrative protest, it is the Taxpayer's responsibility to establish that the tax assessment at issue is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007). Thus, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Poorly developed and non-cogent arguments are subject to waiver. Scopelite v. Indiana Dep't of Local Gov't Fin., 939 N.E.2d 1138, 1145 (Ind. Tax Ct. 2010); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480, 486 n.9 (Ind. Tax Ct. 2012).

In addition, the Indiana Supreme Court has stated that, as the agency enforcing Indiana tax law, the Department's "reasonable interpretation of [a] statute" is entitled to deference "even over an equally reasonable interpretation of another party." Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579, 583 (Ind. 2014).

B. Introduction -Multi-State Corporation Doing Business in Indiana for Purposes of Indiana's Corporate Income Tax.

In calculating a business's corporate income tax liability, the first step is to identify the taxpayer. If the taxpayer is a corporation, income tax is imposed on income derived from sources in Indiana. IC § 6-3-2-1(b). The next step when reviewing a multi-state corporation's business, for purposes of Indiana's corporate income tax, is to determine whether the business generated business income from doing business in Indiana during the tax period in question. IC § 6-3-2-2(a) states in relevant 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 if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter. (Emphasis added).

45 IAC 3.1-1-38 defines "doing business in the state":

> Doing Business. For apportionment purposes, a taxpayer is "doing business" in a state if it operates a business enterprise or activity in such state including, but not limited to:
> (1) Maintenance of an office or other place of business in the state
> (2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods
> (3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated

vehicles where title to the goods passes at the time of sale or distribution
(4) Rendering services to customers in the state
(5) Ownership, rental or operation of a business or of property (real or personal) in the state
(6) Acceptance of orders in the state
(7) Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L. 86-272 to tax its net income.

As stated in Regulation 6-3-2-2(b)(010) [45 IAC 3.1-1-37], corporations doing business in Indiana as well as other states are subject to the allocation and apportionment provisions of IC 6-3-2-2(b)-(n). (Emphasis added).

If the multi-state corporation is generating "business income" from Indiana sources, then the IC § 6-3-2-2(b) apportionment rules are in effect. However, if the corporation did not generate "business income" from Indiana sources, then the special rules for allocating the non-business income apply under IC § 6-3-2-2(h)-(k), and there is no need to conduct an analysis of how to properly apportion the income.

C. Apportioning Business Income from a Multi-State Corporation Doing Business in Indiana for Purposes of Indiana's Corporate Income Tax.

Once it is determined that a multi-state corporation is generating income from doing business in Indiana, the next step is to determine how to apportion the corporation's business income to account for its activities in Indiana. IC § 6-3-2-2(b). As a practical matter, it is worth noting that in apportioning a taxpayer's income from doing business in Indiana among states during 2009 and 2010, Indiana retained a version of the three-factor payroll, property, sales apportionment method. IC § 6-3-2-2(b). Beginning in 2011, Indiana adopted a single sales factor formula to determine the apportionment amounts. Id. The sales factor consists of a taxpayer's Indiana sales (the numerator) over the taxpayer's "everywhere" sales (the denominator). IC § 6-3-2-2(e).

In order to apportion a corporation's business income to account for its activities in Indiana, it must be determined what type of sales occurred in Indiana. Was the subject of the sale real property, tangible personal property, or intangible personal property? The sale of real property is sourced to the location of the real property. If the real property is located in Indiana, then the income is included in the sales numerator under IC § 6-3-2-2(e). If the income is derived from the sale of tangible personal property, then the income is sourced to where the tangible personal property was delivered. Id. If the tangible personal property is delivered outside Indiana but the income is not subject to tax in the destination state, then the receipts are "thrown back" to Indiana under IC § 6-3-2-2(e)(2)(B). If the income is attributable to the discrete category of intangible personal property specifically identified in IC § 6-3-2-2.2, the income is apportioned under the special rule found in that statute.

All other intangible personal property income - including income from providing services - is addressed in IC § 6-3-2-2(f) and requires an identification of the "income producing activity" ("IPA") as defined under 45 IAC 3.1-1-55. ("[A]ct or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit.")

1. Apportioning Indiana Business Income from Intangibles.

The purpose of the apportionment formula's sales factor is to represent the market where a taxpayer's products or services are sold. When the Department attempts to tax the adjusted gross income associated with the sale of goods, it is relatively easy to identify the market where goods are ultimately sold. See IC § 6-3-2-2(e) (explaining that sales of tangible personal property are in this state if the property is delivered or shipped to a purchaser, other than the United States government, within this state, regardless of the f.o.b. point or other conditions of the sale). However, determining the market for the sale of services or other intangibles that do not fall under IC § 6-3-2-2.2 is more complex, and is governed by IC § 6-3-2-2(f) which 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.

Typically, the Department does not reach the Costs of Performance ("COP") issue contained in IC § 6-3-2-2(f)(2) because under IC § 6-3-2-2(f)(1) the Department only seeks to include in the numerator money earned from the income-producing activity performed in Indiana. Because taxpayers only pay adjusted gross income taxes on the

IPA conducted in the state, the COP associated with in-state IPA is not relevant. ("Income Producing Activity" as defined at 45 IAC 3.1-1-55).

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

> 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 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 ["IPA"] 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.
>
> . . .
>
> The term "costs of performance" means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer.
>
> If receipts from sales other than sales of tangible personal property do not constitute a principal source of business income and such receipts are included in the denominator of the receipts factor, such receipts are in this state if:
> (a) the income producing activity is performed wholly within this state; or
> (b) the income producing activity is performed both in and outside 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.
>
> . . .
>
> Except as provided by special apportionment formulas, receipts 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:
>
> (a) Gross receipts from the sale, lease, rental or other use of real property are in this state if the real property is located in this state.
> (b) Gross receipts from the rental, lease, licensing the use of or other use of tangible personal property shall be assigned to this state if the property is within this state during the entire period of rental, lease, license or other use. If the property is within and without this state during such period, gross receipts attributable to this state shall be based upon the ratio which the time the property was physically present or was used in this state bears to the total time or use of the property everywhere during such period.
> (c) Income from transportation between a point in Indiana and a point outside Indiana shall be attributed to this state on a mileage basis. See Regulation 6-3-2-2(l)(020) [45 IAC 3.1-1-63].
> (d) Gross receipts for the performance of personal services are attributable to this state to the extent such services are performed in this state. 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 services everywhere. 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. Personal service not directly connected with the performance of the contract or other obligation, as for example, time expended in negotiating the contract, is excluded from the computations.

(Emphasis added and examples omitted).

The COP method is only relevant if the Department is attempting to apportion income-producing activity performed both within and without Indiana under, or, if a corporation has income from services or other

intangibles and it is not possible to identify the market for services or other intangibles, but the locations of the costs associated with services can be identified.

D. Taxpayer's Interpretation/Application of Costs of Performance.

Taxpayer raises the issue of whether IC § 6-3-2-2(e) or IC § 6-3-2-2(f) govern the apportionment of the income Taxpayer receives from its Indiana, online students.

Taxpayer disagrees with the Department's interpretation and application of IC § 6-3-2-2(f). Taxpayer explains its business model:

> [Taxpayer] provides educational services to undergraduate and graduate students. The vast majority of [Taxpayer's] students receive their education through the online environment. The revenue at issue is derived from the services provided by the online faculty members [Taxpayer] employs.

Taxpayer explains that it sourced its service income pursuant to IC § 6-3-2-2(f) which is "clearly the applicable provision as these receipts were not from the sale of tangible personal property nor derived from the sale or licensing of intangible personal property."

Taxpayer indicates that direct costs attributable to its provision of educational services to Indiana students are "(1) faculty, (2) course development, (3) information technology," and that these costs are incurred almost entirely outside Indiana.

Taxpayer argues that the audit's interpretation and application of Indiana law is fundamentally flawed.

> [The Department] misstates, misinterprets and misapplies the relevant statutory provisions. The audit report does correctly note the sourcing scheme for receipts set out by IC 6-3-2-2 is "straightforward." Receipts resulting from the sale of tangible personal property are generally sourced to the destination of tangible personal property . . . . Receipts from intangibles that produce interest or dividend income are sourced pursuant to IC 6-3-2-2.2, which mirrors the sourcing provisions for such receipts under the Financial Institution Tax as imposed by IC 6-5.5. Finally, all other receipts are sourced to Indiana to the extent that the greater proportion of the income producing activity is performed in Indiana pursuant to IC 6-3-2-2(f).

Taxpayer maintains that, to the extent that the audit relied on IC § 6-3-2-2.2(e) ("performance of fiduciary and other services"), the assessment is erroneous on the ground that "Taxpayer's receipts are not derived from 'fiduciary and other services.'" According to Taxpayer, its receipts "clearly were not derived from [providing] fiduciary services, and [the tuition receipts] do not fit within the apparent meaning of 'other services.'" As Taxpayer explains:

> The term "other services" appears to include only those services typically performed along with fiduciary services. This more limited interpretation is appropriate because interpreting "other services" to include services unrelated to fiduciary services would result in all non-fiduciary services meeting the definition of "other services."

Taxpayer explains on what basis it interprets the "other services" provision. When sections of a statute are subject to more than one interpretation and if they can be harmonized, Indiana courts will read the sections together so that no part is rendered meaningless. See City of North Vernon v. Jennings Northwest Regional Utilities, 829 N.E.2d 1, 4-5 (Ind. 2005). Taxpayer also relies on the City of North Vernon case for the proposition that courts "will also examine those sections as a whole and will presume that the Legislature did not intend the language to be interpreted or applied to cause an illogical or absurd result." Id. at 2.

Taxpayer maintains that the rules of statutory interpretation support its own application of the Costs of Performance rule and summarizes its interpretation of that rule.

> Under [the] rules of statutory interpretation, IC 6-3-2-2.2(e) must be read in a manner that gives meaning both to IC 6-3-2-2.2(e) and IC 6-3-2-2(f). When both provisions are read as a whole, the only interpretation that makes sense is for section 2.2(e)'s "fiduciary and other services" to mean "fiduciary and related services." Under that interpretation, services related to fiduciary services would fall under IC 6-3-2-2.2(e), and all other services would fall under IC 6-3-2-2.2(f). This interpretation makes even more sense when one considers the other receipt items section 2.2 addresses. All of these receipts (except the redundant reference to dividends) are receipts typically received by financial institutions or, in the case of fiduciary services, trust

companies - secured and unsecured loan payments, credit card receipts, traveler's checks receipts, etc. (Emphasis added).

As noted above, IC 6-3-2-2(f) provides no exceptions to the Costs of Performance rule. If the receipt is subject to IC 6-3-2-2(f) then the Costs of Performance rule applies unless Taxpayer's circumstances are one of the "unique and nonrecurring" situations "when the standard apportionment provisions produce incongruous results." 45 IAC 3.1-1-62. Those circumstances do not exist here because Taxpayer's services are income producing activities and receipts that are commonplace in the educational services industry . . . . Thus the only possible exception to the Costs of Performance rule does not apply to Taxpayer. Taxpayer's receipts must therefore be attributed to Indiana based on the Costs of Performance rule.

E. Department's Interpretation/Application of Costs of Performance.

1. Findings of the Auditor.

In this particular instance, the audit concluded that tuition income received from Indiana students receiving online, Internet instruction constituted a principal source of Taxpayer's income and should be apportioned between Indiana and the other states from where Taxpayer received income.

As authority for its decision, the audit report pointed out that 45 IAC 3.1-1-55 is the rule for determining if "income-producing activity" is performed in Indiana and if the money earned from that activity is included in the numerator of the sales factor. Under that provision, the general rule is that "the income-producing activity" is "deemed performed" at and is attributed to "the situs of the real, tangible, and intangible property or to the place where personal services are rendered." Id. The regulation defines the term "income producing activity" ("IPA") as "the act or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit" and includes the "rendering of personal services by employees or the utilization of tangible and intangible property by the taxpayer in performing a service." Id.

As noted in the audit report, Taxpayer applied the "costs of performance standard" to source all Indiana tuition to a location outside the state:

Taxpayer excluded all 100[percent] of the on-line tuition income from Indiana customers in [the] Indiana receipts numerator factor while included in everywhere receipts received in denominator based on "Cost of Performance" Rule.

The audit concluded that Taxpayer's interpretation of IC § 6-3-2-2(f) was not correct. Based on the regulation, the IPA (sales of on-line course to Indiana residents) was performed in Indiana, and those sales were subject to Indiana corporate income tax.

2. Findings Based on the Administrative Protest.

As explained in the Department's summary of the statutory and regulatory law pertaining to COP, typically, the Department does not reach the COP issue. Nevertheless, Taxpayer asserted during the audit, and again during the administrative protest, that the COP apportionment methodology should be applied to the income generated from its Indiana customers that received online educational services, and which results in all of the Taxpayer's Indiana sales being excluded from Indiana's corporate income tax.

When an Indiana taxpayer is entitled to apply the COP methodology to its sales, the first step is defining the IPA and the second step is determining where the IPA in question occurred. As explained above, Indiana defines IPA as "the act or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit." 45 IAC 3.1-1-55. Based on the Indiana regulation definition cited, it is clear that Indiana has adopted a transactional-based approach when applying the COP apportionment methodology. 45 IAC 3.1-1-55 plainly states that "[g]ross 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." Such an approach to the income-producing activity requires consideration of each individual transaction from which the taxpayer receives payment from a customer.

Under the transactional approach, the analysis begins with identifying the transactions that constitute the IPAs or include the IPAs. Although defining the IPA may differ from one industry or business to another, there are several factors common to each. These factors include considering only the direct activity for which value is exchanged (i.e. the transfer of the goods or services). In some industries, simply providing access to the State's residents is

the IPA, rather than the activity that is conducted to provide the actual service. Typically, administrative and executive activities are excluded from defining the IPA, because defining the IPA is a question of identifying individual transactions giving rise to a taxpayer's income. Similar to Indiana's definition of IPA, the Multistate Tax Commission ("MTC") has explained that IPA generally means "the transactions and activity engaged in by the taxpayer in the regular course of its trade or business for the ultimate purpose of producing that item of income." MTC Reg. IV. 17.(2); See P.L. 145-2007, § 17; also IC § 6-8.1-3-21 (2009) (explaining that Indiana rejoined the MTC as an associate member effective July 1, 2007). The MTC regulations further provide that "[t]he term 'IPA' applies to each separate item of income." MTC Reg. IV. 17.(2). The MTC's regulation continues, providing specific guidance regarding the application of the COP methodology. "[W]here [personal] services are performed partly within and partly without this state, the services performed in each state will constitute a separate income producing activity . . . ." MTC Reg. IV.17.(4)(B)(c) (Emphasis added). Thus, the MTC has explained that if the IPA occurs in multiple states, the IPA must be divided amongst the states and each state having the right to treat the IPA occurring within its borders as a separate, taxable transaction.

The next step is to identify the gross receipts derived from those transactions. This step is directly connected to the first step of Indiana's transactional-based approach. Once the IPA is identified, a review of the taxpayer's documentation is necessary to identify the receipts directly linked to the IPA. In other words, the final step is to determine the direct costs (i.e. COP) associated with the IPA and the geographic location of the particular COP. According to Indiana's regulation, Costs of Performance means direct costs determined in a manner consistent with generally accepted accounting principles and in accordance with accepted conditions or practices in the trade or business of the taxpayer. 45 IAC 3.1-1-55 (Emphasis added). According to the "Federal Accounting Standards Advisory Board" ("FASAB") Handbook, a "Direct Cost" is defined as "[t]he cost of resources directly consumed by an activity. Direct Costs are assigned to activities by directly tracing of units of resources consumed by individual activities. A cost that is specifically identified with a single cost object." Federal Accounting Standards Advisory Board, FASAB Handbook, Version 11, Appendix E - Page 23 (11th ed. 2012) (available at www.fasab.gov/pdffiles/2012_fasab_handbook.pdf (last visited October 29, 2014)). Furthermore, a "Cost Object" is defined as "[a]n activity, output, or item whose cost is to be measured. In a broad sense, a cost object can be an organizational division, a function, task, product, service, or a customer." FASAB Handbook, Version 11, Appendix E - Page 19. Additionally, Black's Law Dictionary defines a direct cost as "[t]he amount of money for material, labor, and overhead to produce a product." Black's Law Dictionary 398 (9th ed. 2009). In summary, direct costs are those costs that are only incurred because the revenue producing transaction or activity in question occurred. Alternatively, indirect costs are those that would be incurred by a taxpayer even if the IPA transaction in question had not occurred.

Based on the analysis above, the Taxpayer's services were "rendered" here in Indiana because Indiana is the location where the students purchased Taxpayer's services. The sales of educational services to Indiana students are the acts directly engaged in by Taxpayer for the purpose of obtaining gains or profit. Further, these transactions were engaged in by Taxpayer in the regular course of its trade or business. It was these individual transactions for which value was exchanged between the Indiana residents and Taxpayer. The amount of income Taxpayer earned from selling its educational services to Indiana residents is readily available from Taxpayer's records and is not an issue for purposes of this analysis. Thus, Taxpayer's IPA consists of the individual transactions that it engaged in with Indiana residents when the residents purchased educational services from Taxpayer, and it is these receipts and only these receipts that are subject to the corporate income tax.

The Department agrees with the audit's observation that "[t]he issue is not the cost of the development of the educational services; rather the question is the destination of sales through provision of services." The Department concludes that Taxpayer's actual "income producing activity" is performed in Indiana because "the acts or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit" occurred in Indiana. 45 IAC 3.1-1-55. Taxpayer does not earn money from hiring or training its faculty members, from developing online courses or course materials, or from incurring local overhead expenses. Taxpayer does not earn money because its Indiana online students pay Taxpayer to incur out-of-state expenses or conduct out-of-state research or development activities on those students' behalf. Taxpayer earns money because it prepares online educational services and then sells those services to Indiana customers within their home state. The money earned from those Indiana sales transactions constitutes Indiana source income because those transactions were undertaken in Indiana in the regular course of its business for the purpose of producing the tuition income.

Taxpayer suggests that the income it earns from Indiana students does not relate to Indiana; however, Taxpayer transforms the income from its sale of educational services to Indiana students into income earned from an out-of-state activity under what the Department has previously and consistently determined is an erroneous and unsubstantiated application of a COP analysis. Formulary apportionment is designed to align the income tax

multistate taxpayers - such as Taxpayer - report to the states in which they conduct business with that taxpayer's business activity conducted in those states. Formulary apportionment is not designed to create income untaxed by any state or to exclude money earned from Indiana business activity from the Indiana sales numerator.

In summary, receipts 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 of a principal source of business income are attributed to Indiana when, under the Costs 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. In this case, the Department is taxing only receipts directly attributable to the IPA activities that occurred in Indiana. Therefore, applying the COP methodology is entirely inappropriate. However, even if the COP method were applied to Taxpayer's sales in question, the result would be the same–income from providing services to Indiana residents would still be subject to tax.

3. "Fairly Reflect" Standard.

IC § 6-2-2-2(l) provides the Department authority to resort to "the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income" if the standard "allocation and apportionment provisions of this article do not fairly reflect the taxpayer's income derived from sources within the state of Indiana . . . ." Although not directly raised during the audit, the Department must question whether sourcing all money received from providing services directly to Indiana students to any state other than Indiana does indeed - under any reasonable standard - "fairly reflect" Taxpayer's Indiana income.

IC § 6-2-2-2(l) provides the Department authority to resort to "the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income" if the standard "allocation and apportionment provisions of this article do not fairly reflect the taxpayer's income derived from sources within the state of Indiana . . . ." Although not directly raised during the audit, the Taxpayer's attempt to reapportion its Indiana business income–causing it to have zero income tax liability in Indiana–raises the question whether sourcing all money received from providing services directly to Indiana students to any state other than Indiana does indeed - under any reasonable standard - "fairly reflect" Taxpayer's Indiana income. Given that the Taxpayer has customers in Indiana from which it earned business income, the Department concludes that apportioning all of that income to another state, as suggested by the Taxpayer, would not "fairly reflect" the Taxpayer's income derived from sources within Indiana.

F. Conclusion.

The COP method is only relevant if the Department is attempting to apportion income-producing activity performed both within and without Indiana under, or, if a corporation has income from services or other intangibles and it is not possible to identify the market for services or other intangibles, but the locations of the costs associated with services can be identified. While Taxpayer has service income derived from intangible property, the income is from "income-producing activity" that was performed in Indiana under 45 IAC 3.1-1-55. See Letter of Findings 02-20130238 (July 29, 2013), 20130925 Ind. Reg. 045130426NRA ("Taxpayer does not earn money because a specific Indiana customer hires Taxpayer to conduct out-of-state financial research on that particular customer's behalf; Taxpayer earns money because it conducts financial research and then sells the results of that research to Indiana customers. The money earned from those Indiana sales transactions constitutes Indiana source income."). See also Letter of Findings 02-20130359 (August 19, 2014); Letter of Findings 02-20130047 (November 27, 2013), 20140129 Ind. Reg. 0455140003NRA; Letter of Findings 02-20120316 (September 7, 2012), 20121128 Ind. Reg. 045120595NRA; Letter of Findings 02-20090496 (October 27, 2009), 20091223 Ind. Reg. 045090944NRA; Letter of Findings 02-20040005 (June 19, 2006), 20060823 Ind. Reg. 045060298NRA; Letter of Findings 02-20030154 (October, 21, 2004), 28 Ind. Reg. 1399; Letter of Findings 02-20020060 (August 7, 2003), 27 Ind. Reg. 698.

The audit and Taxpayer differed on a factual issue; the issue was whether Indiana faculty members taught Indiana students or whether Indiana students were taught by faculty members located in both Indiana and by faculty members located outside Indiana. However, in the final analysis the question represents a distinction without a difference and is irrelevant in determining the sourcing question here at issue.

The audit correctly found that the income Taxpayer earned from Indiana students receiving online, Internet instruction constitutes a principal source of Taxpayer's income and should be apportioned between Indiana and the other states from where Taxpayer receives income.

FINDING

Taxpayer's protest is respectfully denied.

II. Corporate Income Tax - Underpayment Penalty.

DISCUSSION

Taxpayer objects to the imposition of the ten percent "underpayment penalty." Taxpayer explains that it filed its returns "following the prescribed statutory requirements . . . ." and that the Department should exercise its discretion to abate the 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 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. However, there is sufficient information to conclude that Taxpayer "exercised ordinary business care and prudence . . . ." and that the penalty should be abated.

FINDING

Taxpayer's protest is sustained.

SUMMARY

The Department agrees that the "underpayment penalty" should be abated; in all other respects, Taxpayer's protest is denied.

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