DEPARTMENT OF STATE REVENUE

02-20130402.LOF

Letter of Findings: 02-20130402
Corporate Income Tax
For the Years 2007 through 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register.

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); 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 the majority of the income producing activity performed in conjunction with its franchisees located in Indiana occurs in another state, and that its method of apportionment fairly reflects Taxpayer's income in Indiana.

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 a Delaware business, with principal headquarters in Minnesota. Taxpayer franchises its restaurant store business in various states, including Indiana. During the course of its business, Taxpayer does not own any of its local restaurant stores. Taxpayer alleges that Taxpayer supports its franchisees' retail business by managing and marketing the trademarks and other intellectual property rights Taxpayer owns, as well as providing centrally located administrative functions, including accounting, finance, marketing, data processing and numerous other functions. Taxpayer collects royalties from its Indiana franchisees, with such amounts providing the principal source of Taxpayer's gross income. The Indiana franchisees pay royalties for the right to use Taxpayer's trademarks and trade names in the franchisees' retail businesses. Taxpayer also collects lesser amounts representing sales income garnered from Taxpayer's distribution and purchasing processes, as well as services income from Taxpayer's training and consulting services.

During the audit for the 2007, 2008, 2009, 2010, and 2011 income tax years (the "Tax Years"), the Indiana Department of Revenue ("Department") verified that while Taxpayer is part of an affiliated group for Federal income tax purposes, Taxpayer did not file a consolidated or combined income tax return for Indiana income tax purposes. The Department's audit resulted in the assessment of additional income tax. Taxpayer objected and timely filed a protest. An administrative hearing was held, and this Letter of Findings results. Additional facts will be provided as needed.

I. Corporate Income Tax - Costs of Performance.

DISCUSSION

In order to prevail in its administrative protest, the taxpayer bears the responsibility to establish that the Department's tax assessment 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).

In apportioning a taxpayer's income between states during 2007, 2008, 2009, and 2010, Indiana retained a version of the three-factor payroll, property, sales apportionment method. In 2011, Indiana adopted a single sales factor formula to determine the apportionment amounts. IC § 6-3-2-2. The sales factor consists of the taxpayer's Indiana sales (the numerator) over the taxpayer's "everywhere" sales (the denominator). IC § 6-3-2-2(e).

To calculate a business's corporate income tax liability, the first step requires identifying 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 second step requires identifying the Indiana income. IC § 6-3-2-2(a) defines income derived from sources within Indiana:

> 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 income does not satisfy the aforementioned definition of "business income," then the special rules for allocating the income apply under IC § 6-3-2-2(h)-(k); if the income satisfies the "business income" definition, then the apportionment rules under IC § 6-3-2-2(b) are in effect.

The third step requires a determination whether the sales occur 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 where the real property is located. 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 the location 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.

The Department's audit determined that Taxpayer had correctly reported all adjusted gross income as apportionable business income. The audit further determined that Taxpayer had accurately calculated and reported its property and payroll factors on its returns for the Tax Years. However, the audit found that Taxpayer's calculation of its sales factor included a calculation to apportion royalty income received from Taxpayer's Indiana franchisees in determining receipts Taxpayer included in the sales factor numerator. Based upon this discovery, the audit concluded that Taxpayer improperly calculated its sales factor by apportioning receipts from Indiana sources twice.

In Taxpayer's protest, Taxpayer argues against a double apportionment of income by explaining that Taxpayer used an "alternative manner of sourcing sales to [Indiana]" rather than a cost of performance approach. However, Taxpayer also concedes to a mathematical error in the preparation of Taxpayer's income tax returns, which could cause a disagreement with the way that Taxpayer applied its property and payroll ratio. Taxpayer provided revised calculations in its protest materials.

IC § 6-3-2-2(f) addresses all other intangible personal property income, including income from providing services, 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.") If the IPA provides the principal source of the taxpayer's source of business income, the income is apportioned to Indiana to the extent that the IPA occurs in Indiana under IC § 6-3-2-2(f)(1). If the IPA does not provide the principal source for the taxpayer's business income and the taxpayer derives the income from providing services, the income is sourced to the location where the services were rendered under 45 IAC 3.1-1-55. If the taxpayer provides a greater proportion of the services in Indiana than it provides elsewhere, the taxpayer must identify the direct costs of performance to define that proportion of the IPA performed in Indiana as provided under 45 IAC 3.1-1-55. If a greater proportion of the IPA is performed in Indiana, the income is included in the Indiana sales numerator. If a greater proportion of the IPA is performed outside Indiana, the income is allocated elsewhere and is not included in the sales numerator.

Taxpayer does not have an office in Indiana. Taxpayer's Indiana employees, working from their homes, account for less than two percent of Taxpayer's total payroll for the Tax Years. Taxpayer argues that, with only seven employees in Indiana, and a preponderance of its business conducted in its headquarters located outside Indiana, Taxpayer's calculation of its sales factor fairly reflects its Indiana source income.

In exchange for an initial franchise fee and continuing payment of license fees, Taxpayer explains that franchisees have access to the following from Taxpayer, called its "System":

> [T]he sale of distinctive dairy products, beverages, food products and other products and services under the [intellectual property] utilizing certain distinctive types of facilities, equipment (including, without limitation the [Taxpayer's electronic point of sale system] and any required [c]omputer [s]ystems), supplies, ingredients, secret and confidential formulas, business techniques, methods, procedures, standards and specifications together with sales promotion programs, as the same may be modified and improved from time to time by [Taxpayer].

Taxpayer further asserts that the franchisees not only pay for use of intellectual property in the franchise stores, but also pay for certain services (the "System Services"), including: product design and development; purchasing and distribution; advertising; operating and pricing strategies; menu design; marketing plan; and new store services. Taxpayer argues that employees located in Minnesota provide these items and services.

Taxpayer asserts that it incurs expenses when it creates and then provides its System to its franchisees for a licensing fee. Several of Taxpayer's departments incur these costs, with both the departments and their respective costs supporting and building the value of Taxpayer's System. According to Taxpayer's protest, this support comes predominately from Taxpayer's headquarters in Minnesota. Therefore, Taxpayer bases its apportionment methodology on sourcing the income produced from provision of its System to Minnesota, based upon a cost of performance theory.

The apportionment formula's sales factor represents the market where a taxpayer sells products or services.

When the Department attempts to tax the adjusted gross income associated with the sale of goods, it can easily 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, IC § 6-3-2-2(f) governs the sourcing of the sale of services or other intangibles that do not fall under IC § 6-3-2-2.2:

> 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. IC § 6-3-2-2(f).

(Emphasis added).

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.

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 income-producing activity is performed within and without this state such receipts are attributed to this state if the greater proportion of the income producing activity is performed here, based on costs of performance.
>
> 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).

For all but one of the Tax Years, 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):

> 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.

(Emphasis added).

Effective with the 2011 tax year, Indiana adopted single factor apportionment, meaning the Indiana apportionment factor is calculated exclusively on the basis of the sales factor. The analysis relying on applications of the relevant statutes and regulations in determining the ratio of in-state gross receipts over total gross receipts remains the same.

In order for Indiana to impose tax on the income received from any intangible - such as Taxpayer's trademarks licensed to its franchisees - the intangible must have acquired a "business situs" within the state. Re-examining 45 IAC 3.1-1-55, "[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 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."

As explained herein, 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 franchisees that received Taxpayer's System and its System Services. Under Taxpayer's methodology, Taxpayer excludes nearly all of the Taxpayer's Indiana sales from its Indiana corporate income tax computation.

Applying the COP methodology to a taxpayer's sales must begin with defining the IPA and then determining the location in which 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, 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 conducted to provide the actual service. Typically, defining the IPA excludes administrative and executive activities, because defining the IPA relies upon 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 'income-producing activity' 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 with each state having the right to treat the IPA occurring within its borders as a separate, taxable transaction.

The analysis proceeds to identifying the gross receipts derived from those transactions. This step directly connects 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 results in a determination of 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). The "Federal Accounting Standards Advisory Board" ("FASAB") Handbook defines a "Direct Cost" 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 December 11, 2014)). Furthermore, that Handbook defines a "Cost Object" 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). To summarize, 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" in Indiana because Indiana is the location where the franchisees purchased Taxpayer's services. The sales of System and System Services to Indiana franchisees are the acts in which Taxpayer directly engaged for the purpose of obtaining gains or profit. But for the Indiana franchisees' use of Taxpayer's System and System Services, franchisees would not engage in Taxpayer's retail business. Further, Taxpayer engaged in these transactions in the regular course of its trade or business. In these individual transactions value was exchanged between the Indiana franchisees and Taxpayer. Taxpayer's records display the amount of income Taxpayer earned from selling its System and System Services to Indiana franchisees. Thus, Taxpayer's IPA consists of the individual transactions that it completed with Indiana franchisees when the franchisees purchased the System and System Services from Taxpayer. The receipts from these transactions are subject to the corporate income tax.

This analysis mimics the audit report's examination, which begins with the determination that "[t]he taxpayer collects intangible royalties from its franchisees located in the State of Indiana." The franchisees "deploy the taxpayer's intangible property at [Taxpayer's] stores located within the State of Indiana." The Indiana franchisees use the intangible property and value attaches to the intangible property through its deployment in Indiana. The intangible property which produces the royalty income for Taxpayer acquired a business situs through its operation and employment in Indiana. 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 product designers, purchasing agents, advertising professionals, or marketing strategists. Nor does Taxpayer earn money from developing store menus or new store procedures, or from incurring local overhead expenses. Taxpayer earns money by preparing its System and System Services and then licensing the System intangible property and selling those Services to Indiana franchisees within their home state. The money earned from those Indiana sales transactions constitutes Indiana source income because Taxpayer and its Indiana franchisees undertake those transactions in Indiana in the regular course of Taxpayer's business for the purpose of those franchisees producing the royalty income.

Taxpayer suggests that the income it earns from the fees paid by Indiana franchisees does not relate to Indiana. However, Taxpayer transforms the income from licensing its System and System Services to Indiana franchisees 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 methodology does not create income untaxed by any state, or 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.

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 . . . ." The Department must question whether Taxpayer sourcing all money it received from providing its System and System Services directly to Indiana franchisees to any state other than Indiana "fairly reflects" Taxpayer's Indiana income, under any reasonable standard. Given that the Taxpayer earned business income from its Indiana franchisees, the Department concludes that apportioning all–or nearly 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.

The Department finds the COP method relevant only if the Department attempts to apportion income-producing activity performed both within and without Indiana; 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 results 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), 20141126 Ind. Reg. 045140456NRA; 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 correctly found that the income Taxpayer earned from Indiana franchisees purchasing access to, and using, Taxpayer's System and System services to conduct the franchisees' business in Indiana constitutes a principal source of Taxpayer's income and should be apportioned between Indiana and the other states from which Taxpayer receives income. As referenced herein, the Department recognizes that Taxpayer has submitted revised calculations during its protest that, while not satisfying Taxpayer's burden of proving that the Department's position is wrong, could provide a basis for revising the assessment amounts.

FINDING

Taxpayer's protest is denied, but the Department will review the exhibit Taxpayer provided in its protest to determine if a revision of the assessment amounts is appropriate.

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 "in good faith" and any deficiency "was due to reasonable cause and not due to willful neglect."

The penalty is authorized under IC § 6-3-4-4.1(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.

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, Taxpayer has presented sufficient information to allow the Department to conclude that Taxpayer "exercised ordinary business care and prudence . . . ." and to allow the Department to abate the underpayment penalty.

FINDING

Taxpayer's protest is sustained.

SUMMARY

The Department agrees that it should abate the "underpayment penalty." In all other respects, Taxpayer's protest is denied, subject to a review of Taxpayer's revised calculations referenced in this Letter of Findings.

Posted: 02/25/2015 by Legislative Services Agency
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