DEPARTMENT OF STATE REVENUE

Revenue Ruling # 2014-01IT
March 18, 2015

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ISSUES

Adjusted Gross Income Tax - Apportionment & Nexus

Authority: IC 6-3-2-2; IC 6-3-2-2.2; IC 6-3-2-2.8; 45 IAC 3.1-1-38; 45 IAC 3.1-1-55; 45 IAC 3.1-1-62; Income Tax Information Bulletin #12.

A company ("Taxpayer") is seeking a ruling request related to its combined adjusted gross income tax filings. Specifically, Taxpayer seeks a ruling regarding the following:

1. Permission to utilize prospectively market-based sourcing as an alternative method of apportionment to source service revenues generated by Taxpayer.

2. Whether taxpayer's "nowhere" service sales will be subject to Indiana's throwback rules.

3. Whether Health Maintenance Organizations ("HMOs") should be included or excluded from an Indiana Corporate Adjusted Gross Income Tax Return.

STATEMENT OF FACTS

Taxpayer provides the following relevant, factual context regarding Taxpayer's business operations:

> [Taxpayers] are primarily in the business of providing complementary specialty managed health care solutions. [Taxpayers] health care solutions include arranging for chiropractic, acupuncture, massage therapy, naturopathy, and fitness and exercise services for a predetermined, periodic fee to enrolled subscribers through contractual arrangements with health plans and employer groups. [Taxpayers] arranges for the delivery of these services by contracting directly with individual third party health care providers on a nationwide basis. [Taxpayer's] other products include third-party administration services to employers and health plans, "affinity" discount access to the Company's provider networks, as well as the sale and distribution of dietary and nutritional supplements and wellness and prevention telephonic coaching programs. In short, the vast majority of the Company's total sales are generated from the sales of services.

Additionally, Taxpayer will move or has moved its headquarters to Indiana from California. Taxpayer also has operations in Texas.

DISCUSSION

In general, IC 6-3-2-2(a) defines adjusted gross income from sources within Indiana for corporations and nonresident persons to 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.

When a corporation derives business income from sources both within and without Indiana, the business income derived from sources within Indiana is determined by an apportionment formula. IC 6-3-2-2(b). Pursuant to 45 IAC

3.1-1-62, all corporations doing business in more than one state shall use the allocation and apportionment provisions provided in IC 6-3-2-2 unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. Pursuant to IC 6-3-2-2(l):

> If the allocation and apportionment provisions of [IC 6-3] do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
> (1) separate accounting;
> (2) for a taxable year beginning before January 1, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;
> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

Taxpayer requests permission from the Department to utilize the "market-based" sourcing method found at IC 6-3-2-2.2(e) to source its service receipts. Taxpayer's correspondence notes that:

> Under Indiana's Cost of Performance ("COP") rules for the sourcing of service sales, which we understand applies a predominance standard, we expect the following results to occur. For the first several years while the Company is in the process of building out its Indiana facilities, none of the Company's service sales will be sourced to Indiana, since California, without doubt, will be the predominate COP state. Even after the Indiana facilities are fully developed to equal the size of the California operations, it is likely that still no sales will be sourced to Indiana since the cost of doing business (i.e., facility rental expenses, employee wages, etc.) are substantially higher in California than it is in Indiana. It is also quite possible that the COP attributable to Texas will be higher than Indiana.
>
> On the other hand, under a Market-based approach for the sourcing of service sales, the Company will have Indiana sourced sales since the Company does have sales where the benefit of the services provided by the Company is consumed in Indiana.
>
> . . .
>
> The reason [Taxpayer] requests Market-based sourcing when we expect the result to produce a higher Indiana tax is to minimize [Taxpayer's] compliance and audit costs and burdens.

IC 6-3-2-2(f) provides:

> 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 6-3-2-2.2(e) is inapplicable to Taxpayers, as it provides:

> Receipts from the performance of fiduciary and other services are attributable to the state in which the benefits of the services are consumed. If the benefits are consumed in more than one (1) state, the receipts from those benefits are attributable to this state on a pro rata basis according to the portion of the benefits consumed in Indiana.

The Department's regulation, found at 45 IAC 3.1-1-55, provides further clarification:

> 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:
> . . .
> (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.

Taxpayer does have clients in Indiana that are currently being provided services, and does have taxable income attributable to Indiana. The Department agrees that Taxpayer may use the market-based sourcing approach in determining Indiana taxable income. Sourcing of the services shall be based on the location of actual receipt or use, or if unknown, to the location to which the services are billed.

Taxpayer next seeks clarification that a "throwback" concept will not be applied to its service sales and that the Department "specify that [Taxpayer] will not be required to source 'nowhere sales,' related to its service sales, to Indiana." Taxpayer requests this clarification on only its service sales, and not on the sales of tangible personal property, as Taxpayer intends to follow Indiana's standard rules for sourcing sales of tangible personal property (including the throwback rules).

As mentioned above, the adjusted gross income from sources within Indiana for corporations and nonresident persons is defined under IC 6-3-2-2, which states in relevant parts:

(a) 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**).
. . .
(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.

45 IAC 3.1-1-38 provides:

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**).

As mentioned above, 45 IAC 3.1-1-55 provides:

> 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.

Because rendering service in another state is not considered doing business in this state, and compensation for labor or services rendered in another state is not considered adjusted gross income derived from sources within Indiana, if the state in which the service is rendered or in which the service sales are sourced is not subject to that state's income tax, the sales income service would be considered "nowhere sales." Based on the information furnished by the Taxpayer in its ruling request, Taxpayer's service sales will not be subject to "throwback sales" for Indiana's adjusted gross income tax purposes.

Finally, Taxpayer seeks clarification on whether health maintenance organizations ("HMOs") should be included in its combined AGI tax return, and whether two members specifically should be included or excluded from a combined return.

Taxpayer states that each of these entities would be considered foreign HMOs. Taxpayer notes that HMOs are often subject to other state's premium tax, but if not, then they are usually subject to that state's corporate income tax. Indiana is no exception. IC 6-3-2-2.8 provides in relevant part:

> Notwithstanding any provision of IC 6-3-1 through IC 6-3-7, there shall be no tax on the adjusted gross income of the following:
> . . .
> (4) Insurance companies subject to tax under any of the following:
> (A) IC 27-1-18-2, including a domestic insurance company that elects to be taxed under IC 27-1-18-2.
> (B) IC 27-1-2-2.3.

According to Income Tax Information Bulletin #12:

> A foreign insurance company (one organized under the laws of a state other than Indiana) is required by IC 27-1-18-2 to pay the insurance premium tax to the Indiana Department of Insurance. Paying the premium tax exempts a foreign corporation from the adjusted gross income tax. A domestic insurance company is exempt from the adjusted gross income tax if it elects to pay the premium tax. A captive insurer subject to tax under IC 27-1-2-2.3 is exempt from the adjusted gross income tax.

The first issue is whether an HMO is considered an "insurance company" subject to the premiums tax. That is a determination to be made by the Indiana Department of Insurance ("DOI"). According to material from the Indiana DOI, an HMO is not subject to the premiums tax. If that is indeed the case, then an HMO, either foreign or domestic, is subject to the adjusted gross income tax.

The next issue is whether the two companies (for the purposes of this Ruling, "Company A" and "Company B"), should be included or excluded from Taxpayer's combined return. With regards to Company A, it is a wholly-owned subsidiary of Taxpayer and an Illinois corporation. It is a traditional life and health/accident insurer which conducts both lines of business in all states where it is admitted as an insurer, is regulated by each applicable state's Department of Insurance, and pays the states' premium taxes, as applicable. It is registered with the Indiana DOI and files a premium tax return, although because of sourcing rules, it files a zero return.

Company B is also a wholly-owned subsidiary of Taxpayer, and a New Jersey incorporated managed health care organization. It has been granted an Organized Delivery System license by the New Jersey Department of Banking and Insurance, which enables it to accept downstream risk from health plans and insurers. Taxpayer

maintains that this company is not an insurance company, but is an HMO. Taxpayer points out that the California Franchise Tax Board in a recent examination determined that Company B was not an insurance company and was therefore subject to California's corporate income tax.

Taxpayer concludes that Company A, the traditional insurer, is subject to the premium tax and should be excluded from the combined corporate adjusted gross income tax return, and Company B as an HMO should be included. The Department concurs.

RULINGS

Based on the authority granted the Department in IC 6-3-2-2(l)(4), the Department authorizes Taxpayer to use the market-based sourcing approach in determining Indiana taxable income. Sourcing of the services shall be based on the location of actual receipt or use, or if unknown, to the location to which the services are billed.

Taxpayer's service sales will not be subject to "throwback sales" for adjusted gross income tax purposes.

Taxpayer's HMOs, if they are not subject to the Indiana premium tax, should be included in the combined corporate adjusted gross income tax return; Company A, as a traditional insurer subject to the Indiana premium tax, should be excluded from the combined corporate adjusted gross income tax return.

CAVEAT

This ruling is issued to the taxpayer requesting it on the assumption that the taxpayer's facts and circumstances as stated herein are correct. If the facts and circumstances given are not correct, or if they change, then the taxpayer requesting this ruling may not rely on it. However, other taxpayers with substantially identical factual situations may rely on this ruling for informational purposes in preparing returns and making tax decisions. If a taxpayer relies on this ruling and the Department discovers, upon examination, that the fact situation of the taxpayer is different in any material respect from the facts and circumstances given in this ruling, then the ruling will not afford the taxpayer any protection. It should be noted that subsequent to the publication of this ruling a change in statute, regulation, or case law could void the ruling. If this occurs, the ruling will not afford the taxpayer any protection.

Posted: 04/29/2015 by Legislative Services Agency
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