

**Supplemental Letter of Findings: 02-20170969
Corporate Income Tax
For the Tax Years 2013-14**

NOTICE: IC § 6-8.1-3-3.5 and IC § 4-22-7-7 requires 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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Supplemental Letter of Findings.

HOLDING

Company provided sufficient documentation to support its protest that income-producing activities were predominantly performed outside Indiana. Therefore, Indiana income tax was not applicable to Company's income.

ISSUE

I. Income Tax–Cost of Performance.

Authority: IC § 6-3-2-2; IC § 6-8.1-5-1; *Dept. of State Revenue v. Caterpillar, Inc.*, 15 N.E.3d 579 (Ind. 2014); *Scopelite v. Indiana Dept. of Local Gov't Fin.*, 939 N.E.2d 1138 (Ind. Tax 2010); *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463 (Ind. 2012); *Lafayette Square Amoco, Inc. v. Indiana Dept. of State Revenue*, 867 N.E.2d 289 (Ind. Tax 2007); *University of Phoenix, Inc. v. Indiana Dept. of State Revenue*, 88 N.E.3d 805 (Ind. Tax 2017); [45 IAC 3.1-1-55](#).

Taxpayer protests the assessment of adjusted gross income tax.

STATEMENT OF FACTS

Taxpayer is a partner in a partnership with operations in Indiana and other states. As the result of an audit, the Indiana Department of Revenue ("Department") determined that the partnership had additional Indiana adjusted gross income tax ("AGIT") due for the tax years 2013 and 2014 which flowed through to Taxpayer. Therefore, the Department issued proposed assessments for AGIT, penalty, and interest for those years. Taxpayer disagreed with the proposed assessments and filed a written protest. An administrative hearing was scheduled, but Taxpayer did not attend the scheduled hearing. Neither did anyone representing Taxpayer contact the Department. Taxpayer's protest was therefore deemed withdrawn. Taxpayer then contacted the Department to request a rehearing, which the Department granted. A supplemental hearing was conducted and this Supplemental Letter of Findings results. Further facts will be supplied as required.

I. Income Tax–Cost of Performance.

DISCUSSION

Taxpayer protests the Department's determination that it was subject to Indiana AGIT for the tax years 2013 and 2014. The Department based its determination on the grounds that Taxpayer's partnership owned a business ("Operating Business") whose customers were Indiana residents and that those Indiana residents consumed Operating Business' services in Indiana. Those services were in the form of laboratory testing in the medical industry. Operating Business had some collection facilities in Indiana, but its testing facilities were in other states. Since Operating Business' customers were located in Indiana, the Department viewed Operating Business' income as Indiana-sourced and subject to Indiana AGIT. The income which flowed through to Taxpayer via the partnership which owned Operating Business was therefore also Indiana-sourced and subject to Indiana AGIT, in the Department's view. Taxpayer protests that the greater portion of Operating Business' costs in performing those services were incurred outside Indiana and therefore the income is not subject to Indiana AGIT for either entity. Taxpayer provided substantial documentation, including a cost study, in support of its protest.

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); *Lafayette*

Square Amoco, Inc. v. Indiana Dept. of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax. 2007); *Indiana Dept. of State Revenue v. Rent-A-Center East, Inc.*, 963 N.E.2d 463, 466 (Ind. 2012). Thus, the taxpayer is required to provide documentation explaining and supporting its challenge that the Department's assessment is wrong. Poorly developed and non-cogent arguments are subject to waiver. *Scopelite v. Indiana Dept. of Local Gov't Fin.*, 939 N.E.2d 1138, 1145 (Ind. Tax 2010); see also *Wendt LLP v. Indiana Dept. of State Revenue*, 977 N.E.2d 480, 486 n.9 (Ind. Tax 2012). Also, "all statutes are presumptively constitutional." *Indiana Dept. of State Rev. v. Caterpillar, Inc.*, 15 N.E.3d 579, 587 (Ind. 2014) (citing *UACC Midwest, Inc. v. Indiana Dept. of State Rev.* 629 N.E.2d 1295, 1299 (Ind. Tax Ct. 1994)). When an agency is charged with enforcing a statute, the jurisprudence defers the agency's reasonable interpretation of that statute "over an equally reasonable interpretation by another party." *Caterpillar, Inc.*, 15 N.E.3d at 583.

Indiana income tax is established under IC § 6-3-2-2(a), which states:

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.

Income from a pass through entity shall be characterized in a manner consistent with the income's characterization for federal income tax purposes and shall be considered Indiana source income as if the person, corporation, or pass through entity that received the income had directly engaged in the income producing activity. Income that is derived from one (1) pass through entity and is considered to pass through to another pass through entity does not change these characteristics or attribution provisions. In the case of nonbusiness income described in subsection (g), only so much of such income as is allocated to this state under the provisions of subsections (h) through (k) shall be deemed to be derived from sources within Indiana. In the case of business income, only so much of such income as is apportioned to this state under the provision of subsection (b) shall be deemed to be derived from sources within the state of Indiana. In the case of compensation of a team member (as defined in section 2.7 of this chapter), only the portion of income determined to be Indiana income under section 2.7 of this chapter is considered derived from sources within Indiana. In the case of a corporation that is a life insurance company (as defined in Section 816(a) of the Internal Revenue Code) or an insurance company that is subject to tax under Section 831 of the Internal Revenue Code, only so much of the income as is apportioned to Indiana under subsection (r) is considered derived from sources within Indiana.

(Emphasis added).

Next, 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.*
- (Emphasis added).*

Also [45 IAC 3.1-1-55](#), provides in relevant 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. 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.

Example: Taxpayer, a corporation whose principal business activity is the manufacture and sale of hot water heaters, obtains notes for the sale of such water heaters in connection with its Indiana business activity. The property has a business situs in this state, therefore, interest income derived from such notes is attributable to this state.

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.

. . . .

Finally, the Indiana Tax Court's decision in *University of Phoenix, Inc. v. Indiana Dept. of State Revenue*, 88 N.E.3d 805 (Ind. Tax 2017) provided:

Indiana Code § 6-3-2-2(f)(2) provides an "all-or-nothing" method for sourcing service income: if the greater proportion of the costs of performing the income-producing activities are performed within Indiana, all the service income is attributed here. See I.C. § 6-3-2-2(f)(2). Moreover, if the greater proportion of the costs are incurred outside the state, none of the income is attributed to Indiana. *Id* at 812, (Emphasis in original).

The court further provided:

Indiana's regulation, however, does not refer to looking at each separate item of income; instead, it defines an income-producing activity more broadly as "the act or acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit." See 45 I.A.C. 3.1-1-55. To find that a transaction-by-transaction approach is required merely because the word "transactions" appears in the regulation, would be tantamount to forcing a square peg into a round hole. Rather, the use of the word "transactions" in [45 IAC 3.1-1-55](#) describes what type of transactions are subject to the regulation's direction, i.e., transactions from sales of other than tangible personal property. See 45 I.A.C. 3.1-1-55. Accordingly, the word "transactions" is used to identify what the regulation applies to, not how it is to be applied. *Id* at 813. (Emphasis in original).

Finally, the court wrote in pertinent part:

Under Indiana's regulation, therefore, the University was not required to use a transaction-by-transaction approach as the basis of its cost study. Accordingly, the University's cost study is probative evidence that the Court finds persuasively demonstrates that the greater proportion of the University's income-producing activities were performed outside of Indiana.

CONCLUSION

After weighing the evidence and for all the reasons stated above, the Court holds that the Department erroneously calculated the Proposed Assessments for 2009, 2010, and 2011 by sourcing the University's revenue according to the location of its market, rather than the location of the costs of its income-producing activities as required by Indiana Code § 6-3-2-2(f)(2). *Id* at 814.

In the instant case, after review of the audit report and cost study provided by Taxpayer in the course of the protest process, it is clear that the majority of Operating Business' income-producing service activities were

performed outside Indiana. Therefore, as provided by the court in *University of Phoenix* and its analysis of IC § 6-3-2-2(f)(2) Operating Business' service income was not subject to Indiana AGIT. Since IC § 6-3-2-2(a) provides that income from a pass through entity shall be characterized in a manner consistent with the income's characterization for federal income tax purposes and shall be considered Indiana source income as if the person, corporation, or pass through entity that received the income had directly engaged in the income producing activity, and since Taxpayer has established that the greater proportion of the costs of providing the services through which Operating Business earned its income were incurred outside Indiana and that under IC § 6-3-2-2(f)(2) none of the income is attributed to Indiana, Taxpayer has met the burden imposed under IC § 6-8.1-5-1(c) of proving the proposed assessments wrong.

FINDING

Taxpayer's protest is sustained.

September 6, 2018

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