DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 99-0352
Indiana Adjusted Gross Income Tax
For Tax Years 1995, 1996, and 1997

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ISSUE

I. Apportionment of Out-of-State Taxpayer's Indiana Source Franchise Fee Income.

Authority: IC 6-3-1-1 et seq.; IC 6-3-2-2(a)(5); IC 6-3-2-2(f)(2); IC 6-3-2-2.2; Mobil Oil Corp. v. Comm'r of Taxes of Vermont, 445 U.S. 425 (1980); Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co., 112 S.Ct. 2447 (1992); Indiana Dept. of State Revenue v. Bethlehem Steel Corp., 639 N.E.2d 264 (Ind. 1994); 45 IAC 3.1-1-38; 45 IAC 3.1-1-38(7); 45 IAC 3.1-1-55.

Out-of-state taxpayer protests the determination that franchise fee income, derived from Indiana based franchisees, should be included in the numerator of the sales factor for the purpose of determining taxpayer's Indiana adjusted gross income tax liability.

STATEMENT OF FACTS

Taxpayer is restaurant franchisor incorporated in Delaware with its headquarters in another state. Taxpayer owns the right to market and license local franchises, a trade name registered with the United States Patent Office, and various associated product trademarks. Within its assigned territory, the use of the trade name and related trademarks is under taxpayer's exclusive control and supervision. Taxpayer enters into agreements with Indiana licensees to use taxpayer's operating system, the associated trade name, and trademarks. In turn, the Indiana franchisees pay taxpayer a percentage of their gross income for their license privileges. What the individual Indiana franchisees receive in return for the payment of the franchise fees is the right to locally exploit taxpayer's trade name, trademarks, and national reputation. The Indiana franchisees also receive the benefit of certain services which are performed at taxpayer's headquarters. These headquarters-based services include new product research and development and

the creation of company-wide advertising materials. The audit characterized these headquarters-based services as "minute." Audit Summary, p. 5.

Taxpayer also collects other charges from the Indiana franchisees which are unrelated to the franchise fees at issue. These separately billed charges include construction fees, new building plan fees, engineering fees, franchise transfer fees, training fees, national advertising fees, and fees for the costs associated with taxpayer provided training materials, local advertising, and local promotional materials.

To oversee the operation of its Indiana franchisees, taxpayer maintains a regional office located in Indiana. The Indiana regional office serves as a headquarters for its field consultants who visit each Indiana franchisee for a semi-annual inspection. The field consultants are responsible for insuring that each of the Indiana franchisees maintains the standards established by taxpayer and to answer local franchisees' requests for advisory services. The Indiana franchisees are independently responsible for their own building, equipment, maintenance, personnel recruitment, inventory, and all other normal operations associated with an independent business.

The audit determined that these franchisee fees should be included in the numerator of the sales factor for the purpose of determining taxpayer's adjusted gross income tax.

DISCUSSION

I. Apportionment of Out-of-State Taxpayer's Indiana Source Franchise Fee Income.

The audit determined that taxpayer's franchisee fee income was earned from the use of taxpayer's intangible trademark. According to audit, the trademark was a valuable commodity providing taxpayer with its principal source of income. The audit decided that taxpayer's franchisee fees could not be characterized as "service income" because the franchise fees were not received for services performed by the taxpayer. Audit distinguished franchise income received as a result of the parties' franchise agreement and that income unrelated to the agreement itself. In making that distinction, audit determined that services provided to Indiana franchisees derivative of the franchise agreement, were unrelated to those services – advertising, promotional materials, training materials – received when the local franchisee paid one of the separate service charges. Having made the distinction, audit determined that the cost of providing those services derivative of the franchise agreement itself, was less than five percent of the taxpayer's franchise fee income.

Because audit decided that the franchise fee income was actually income earned for the use of an intangible – the taxpayer's trade name, trademarks, and associated good will and reputation – the audit concluded that, under the provisions 45 IAC 3.1-1-55, the taxpayer's trademark had acquired a "business situs" in the state of Indiana and the

income derived from the exploitation of that trademark was subject to apportionment under the state's adjusted gross income tax scheme.

Taxpayer argues that the franchise fees should not be apportioned to Indiana. The taxpayer maintains that the sale of its intangible – the licensing of its trademark to its Indiana franchisees – may not be taxed under IC 6-3-2-2(f)(2) because the greater proportion of the cost of the activities which produce the franchise fee income were not incurred in Indiana.

Additionally, taxpayer challenges the determination that the franchise intangible had acquired a business situs in Indiana under 45 IAC 3.1-1-55. Taxpayer argues that the concept of "business situs," as described within 45 IAC 3.1-1-55, does not reflect current Indiana law. That administrative provision, as far as relevant, states that;

> 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 the intangible personal property is employed as capital; or the place where the property is located if possession and control of the property is localized in connection with a trade or business so that substantial use or value attaches to the property.

Taxpayer maintains that it would be impossible for its franchise intangible to acquire an Indiana business situs because the franchise intangible is not a divisible asset. Therefore, the "situs" of the franchise intangible can only be found at taxpayer's headquarters.

In summary, taxpayer's position is that the income from its franchise intangible cannot be attributed to Indiana because the intangible is not employed as capital in Indiana and has not acquired an Indiana business situs. Further, according to taxpayer, whether or not the franchise intangible has a situs in Indiana is finally irrelevant because taxpayer does not perform a greater proportion of its income producing activity in Indiana such that the receipts of that intangible may not be attributed to Indiana.

Indiana imposes an adjusted gross income tax on income derived from sources within this state. The adjusted gross income tax, IC 6-3-1-1 et seq., is an apportioned tax specifically designed to reach income derived from interstate transactions. Indiana Dept. of State Revenue v. Bethlehem Steel Corp., 639 N.E.2d 264, 266 n. 4 (Ind. 1994). The legislature has defined "adjusted gross income" as "(1) income from real and tangible or tangible personal property located in this state; (2) income from doing business in this state; (3) income from a trade or profession within this state; (4) compensation for labor or services 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 property if the receipt from the intangible is attributable

to Indiana under section 2.2 of this chapter . . . .” IC 6-3-2-2(a). IC 6-3-2-2(a)(5) includes an internal reference to IC 6-3-2-2.2. IC 6-3-2-2.2 is limited in its effect acting only to describe the manner in which interest and dividend income are attributed to the state.

The transactions here at issue – the receipt of franchisee fees from taxpayer’s Indiana franchisees – are inextricably related to taxpayer’s activities within the state. The receipt of the franchisee fees is an amount determined by and directly related to the sales generated by Indiana franchisees. Those sales are attributable to taxpayer’s purposeful Indiana activities. It cannot be said that the transactions occur entirely within the headquarter’s State because, absent the Indiana “connection” and the taxpayer’s Indiana activity, the franchise agreements become abstract paper agreements of no value to the taxpayer and of no interest to the Indiana taxing authorities. In addition, the substantial portion of the activities performed in exchange for the franchise fees take place in Indiana. Those headquarter-based activities, performed in exchange for the franchise fee, are limited to new product development and the production of certain advertising materials.

Taxpayer has established a physical Indiana presence by virtue of its decision to maintain an Indiana regional office, direct its field consultants to make periodic inspections of the Indiana franchisees, and to make its field consultants available when Indiana franchisee request advisory services. The taxpayer’s physical presence within the state – evidenced by its regional office and activities of its Indiana based representatives – helps to demonstrate that the income derived from taxpayer’s Indiana franchise agreements originates in and is attributable to Indiana income producing activities. Taxpayer’s Indiana activities exceed the minimum standard, set out in 45 IAC 3.1-1-38 (adopting P.L. 86-272) by which an out-of-state taxpayer is found to have established a nexus within the foreign state. 45 IAC 3.1-1-38 states that “[f]or 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 . . . (4) Rendering services to customers in the state . . . (7) Any other act in such state which exceeds there mere solicitation of orders so as to give the state nexus under P.L. 86-272 to tax its net income.” Taxpayer’s rendering of services to its Indiana franchisees exceeds the “mere solicitation standard” established in 45 IAC 3.1-1-38(7) and as defined by the Supreme Court in Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co., 112 S.Ct. 2447 (1992).

Taxpayer places undue reliance on a mechanistic interpretation of the “business situs” restriction. The Supreme Court in Mobil Oil Corp. v. Comm’r of Taxes of Vermont, 445 U.S. 425 (1980) stated that “[a]lthough a fictionalized situs of intangible property sometimes has been invoked to avoid multiple taxation for ownership, there is nothing talismanic about the concepts of ‘business situs’ or ‘commercial domicile’ that automatically renders those concepts applicable when taxation of income from intangibles is at issue.” Id. at 444. The Court has also stated that “the reason for a single place of taxation no longer obtains when the taxpayer’s activities with respect to the intangible property involve relations with more than one jurisdiction.”

Taxpayer argues that 45 IAC 3.1-1-55 – under which the audit determined that taxpayer's intangible franchise agreements had acquired an Indiana business situs – is inapplicable because the regulation interprets a prior and different version of the relevant apportionment statute (IC 6-3-2-2(a)(5)). When 45 IAC 3.1-1-55 was promulgated, the regulation interpreted an earlier version of IC 6-3-2-2(a)(5) which stated that adjusted gross income included "income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property having a situs in this state." Taxpayer correctly notes that the statute has been amended. Currently IC 6-3-2-2(a)(5) states that "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). Taxpayer contends that the elimination of the "situs" language is significant and that the referenced statute, IC 6-3-2-2.2, currently makes no reference to "situs." Taxpayer misapprehends the significance of the amended language. The referenced statute, IC 6-3-2-2.2, only affects the attribution of interest and dividend income and does not touch upon or affect the other income sources – including trademarks and franchises – previously and currently listed within IC 6-3-2-2(a)(5). Because the legislature made no change in the language regarding the tax treatment of franchise and trademark income when it amended IC 6-3-2-2(a)(5), there is no reason to presume that Departmental regulation 45 IAC 3.1-1-55 was in any way affected. There is no reason to presume that 45 IAC 3.1-1-55, and its reference to the business situs of intangible property, does not continue to apply with full force to Indiana taxpayers.

Taxpayer argues that its intangible asset – its brand name, associated reputation, and good name – is an indivisible asset incapable of acquiring an Indiana business situs under 45 IAC 3.1-1-55. Taxpayer's argument is counterintuitive. The very nature of taxpayer's intangible asset is its ability to be parceled out to various locations and exploited at those various locations. If, as taxpayer maintains, the intangible asset had only a headquarter's state location, the value of the intangible to both taxpayer and the Indiana franchisees would be negligible. What taxpayer sells, and what the Indiana franchisees purchase, is the right to vigorously exploit the intangible asset within the state of Indiana. Taxpayer's Indiana source income results from the utilization of the intangible within the state of Indiana made possible by the taxpayer's decision to establish a physical presence within the state of Indiana. Taxpayer's income is not derived from entering into theoretical paper franchise agreements created, performed, and executed entirely within headquarter's state. Taxpayer's income derives from and is directly linked its decision to purposefully avail itself of an Indiana business opportunity, a decision to recruit and license Indiana franchisees, and the decision by Indiana citizens to patronize those Indiana franchisees. Taxpayer's ability to derive income from its Indiana activities is made possible by the protections, benefts, and opportunities provided by the state of Indiana. Indiana has made it possible for taxpayer to enter into this state and to obtain income from its franchise agreements. Indiana, in turn, is entitled to tax that portion of taxpayer's income attributable to this state.

FINDING

Taxpayer's protest is respectfully denied.

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