DEPARTMENT OF STATE REVENUE

02-20150523.LOF

Letter of Findings: 02-20150523
Corporate Income Tax
For the Years 2009 through 2013

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 This document is effective on its date of publication and remains in effect until the date it is superseded or deleted by the publication of another document in the Indiana Register. The "Holding section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Letter of Findings.

HOLDING

The Department accepted Advertising Service Provider's argument that it was entitled to apportion income received from delivering advertising to Indiana recipients on a "cost of performance basis;" the Department found that the Service Provider's "cost of performance" standard more fairly reflected its Indiana source income.

ISSUE

I. Corporate Income Tax - Cost of Performance.

Authority: IC § 6-3-2-2(f); IC § 6-3-2-2(l); IC § 6-8.1-5-1(c); Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579 (Ind. 2014); Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Wendt LLP v. Indiana Dep't of State Revenue, 977 N.E.2d 480 (Ind. Tax Ct. 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 3.1-1-53; 45 IAC 3.1-1-53(3); 45 IAC 3.1-1-55; 45 IAC 3.1-1-62.

Taxpayer argues that it is entitled to apportion its Indiana income on a cost of performance basis and that the Department's decision to the contrary was incorrect.

II. Administration - Underpayment Penalty.

Authority: IC § 6-3-4-4.1(b); IC § 6-3-4-4.1(c); IC § 6-3-4-4.1(d); IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1(a)(2); IC § 6-8.1-10-2.1(a)(3); IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer maintains its underpayment of Indiana tax was not attributable to its own negligence and that the Department should exercise its discretion to abate the penalty.

STATEMENT OF FACTS

Taxpayer is a multi-state company in the business of providing direct mail services. Taxpayer has an Indiana business location which serves as one of its three production facilities. The other two locations are outside Indiana and are both located in the same state.

Taxpayer previously filed Indiana corporate income taxes allocating their income based upon the state in which Taxpayer delivered mail on behalf of its customers.

Taxpayer filed amended Indiana income tax returns reallocating that Indiana income on a "cost of performance" basis. In those amended returns, Taxpayer indicated that most of its costs were incurred outside Indiana.

The Indiana Department of Revenue ("Department") conducted an audit review of Taxpayer's business records and the amended tax returns. The audit resulted in the assessment of additional tax. Taxpayer disagreed with the results and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Corporate Income Tax - Cost of Performance.

DISCUSSION

The issue is whether Taxpayer is entitled to source income received for delivering advertising materials to Indiana customers on a "cost of performance" basis.

A. Audit Results.

The audit report indicates that Taxpayer distributes "shared mail advertising" in over 30 states. Taxpayer's business consists of providing "mailing services, including providing customers with a proprietary household list, presorting and address qualification, delivery point bar-coding, addressing, inserting, bundling and consolidation of mail . . . ." These services are provided at one of its three locations depending on the location where the mail was ultimately delivered.

Taxpayer's customers may prepare and supply the printed advertisements themselves. In that case, the materials are sent by the customer - or the customer's printer - to one of Taxpayer's three locations. Alternatively, the customer may arrange for Taxpayer to print the materials, have those materials shipped for processing to one of Taxpayer's three locations, and eventually transport the materials to the appropriate postal center. Taxpayer earns money three different ways:

1. Income Received from the Sale of Advertising Materials.

Taxpayer earns money when it provides advertising materials which it later distributes on behalf of its customers to recipients both within and outside the state. As described in the audit report, Taxpayer "designs, proofs, has materials printed by third parties, has those products delivered to Indiana, addresses them, inserts, sorts and delivers to the post office . . . ." In these instances, Taxpayer's customer contracts for a completed and delivered item of advertising delivered to a specific address. These items are sent to a chosen list of addresses based on Taxpayer's insight, knowledge, and experience.

In the transactions described above, the audit report indicates that the customer is billed for the cost of the designed, printed, and distributed advertising material.

The audit cited to 45 IAC 3.1-1-53 as authority for its decision that money received from these transactions is sourced to Indiana. The regulation provides in part as follows:

> Gross receipts from the sales of tangible personal property (except sales to the United States Government-See Regulation 6-3-2-2(e)(050) [45 IAC 3.1-1-54] are in this state: (a) if the property is delivered or shipped to a purchaser within this state regardless of the F.O.B. point or other conditions of sales; or (b) if the property is shipped from an office, store, factory, or other place of storage in this state, and the taxpayer is not taxable in the state of the purchaser.
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> . . . .
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> The term "purchaser within this state" shall include the ultimate recipient of the property if the taxpayer in this state, at the designation of the purchaser, delivers to or has the property shipped to the ultimate recipient within this state. Example: A taxpayer in Indiana sold merchandise to a purchaser in State A. The taxpayer directed the manufacturer or supplier of the merchandise in State B to ship the merchandise to the purchaser's customer in Indiana pursuant to the purchaser's instructions. The sale by the taxpayer is "in this state." (Emphasis added).

45 IAC 3.1-1-53(3).

2. Income from Delivery of Client Supplied Advertising Materials.

Taxpayer earns money a second way; Taxpayer arranges for the delivery of pre-printed advertising materials supplied by the client. The client delivers the materials to one of Taxpayer's three processing center. Taxpayer prints the address labels, "merge[s] the mailing pieces," bundles the materials as required by the postal service, and delivers the advertisements to a postal service location.

The audit cites to 45 IAC 3.1-1-55 as authority for its position that income earned in this manner should have been sourced - at least in part - to Indiana. The Department's regulation provides:

> 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. (Emphasis added).

The audit concluded that Taxpayer (1) was not providing a personal service, (2) the "income producing activity" which gave rise to the receipts for fulfillment of Indiana contracts did not take place in more than one state, and (3) the income producing activity consists of "merging, bundling, printing of labels and delivery to the post office . . . ."

The audit report rejected Taxpayer's allocation of income attributable to Indiana contracts, on a "cost of performance" basis. The report explains:

"Cost of performance" is an allocation method to be utilized when direct activities that gave rise to a specific revenue stream were conducted in more than one state. And even then, it would only apply to that specific contract revenue, not ALL revenue. For example, a company is hired for a fixed sum to conduct surveys at various locations in several states. This specific revenue from this contract would qualify to be allocated based upon cost of performance but would still only consider the direct costs of performing those surveys under that contract that would be included.

For each contract, taxpayer completes the fulfillment EITHER in Indiana or [second state]. Taxpayer employs capital, pays workers, rents buildings, etc. in Indiana in order to complete a contract. There are no [second state] direct costs associated with the completion of a contract performed entirely in Indiana. While there may be indirect costs associated with producing revenue in general, such as sales activities, credit checks and billing, the customer is not paying for those services. The term "income producing activity" is defined in the Indiana regulation and does not include ancillary activities. There are no direct costs incurred at the [second state] production centers with regard to this income generated by the services performed in Indiana. Therefore, the income producing activity associated with the revenue generated by the fulfillment of contracts is NOT income producing activity performed within and without this state.

3. Sale of Advertising Printed on Detached Address Labels.

Taxpayer earns money a third way; Taxpayer sells advertising space on "Detached Address Labels." These address labels are similar to free-standing postcards containing the address of the recipient. Once printed and prepared, the labels are bundled together with other advertising materials all of which are mailed to the recipient.

The audit found that money received from selling advertising on these labels is "allocable to where the [labels] were shipped." However, as explained the audit report, "[T]he service income from this shared advertising has been included in the Indiana numerator when the [label] is shipped to an Indiana resident."

The audit rejected Taxpayer's argument that money received from selling space on these labels should be sourced on a "cost of performance basis." As authority for making that decision, the audit report cites to 45 IAC 3.1-1-62. That regulation provides as follows:

All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) [45 IAC 3.1-1-37-45 IAC 3.1-1-61] unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income. However, the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states. It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and

nonrecurring) when the standard apportionment provisions produce incongruous results.

The audit found Taxpayer's method of allocating its income based on a "cost of performance" did not fairly reflect income received from selling advertising space on labels delivered to Indiana recipients. As explained in the audit report:

> In this case, not only does the "cost of performance" method not fairly reflect Indiana income, there is no reason that standard apportionment formula should not be used. With only three production locations and one being in Indiana (33[percent]), taxpayer's Indiana apportionment based on cost of performance was reported as follows:

For the calendar years 2009 through 2013, Taxpayer reported - on average and on a "cost of performance basis - approximately 1.5 percent of its income as attributable to Indiana.

Based on the analysis and review conducted by the Department's audit:

> It is agreed that because taxpayer has its corporate headquarters and two production facilities in [second state] that the majority of their costs are incurred in [second state]. However, to then conclude that all of its income, including that generated in Indiana must be allocated to [second state] is misplaced. While it may be argued that all of taxpayer's costs are incurred to produce revenue, the contemplation of apportionment is to identify the income producing activity at a given location. Cost of performance is a method to be utilized by a taxpayer where the costs to actually fulfill a specific contract occur in more than one place. [second state] locations have costs associated with the fulfillment of their contracts and the Indiana location has separate costs. It is unfair to presume that corporate costs incurred at the [second state] corporate headquarters does not support income earned in Indiana. For example, to assert that the billing activities in [second state] only relate to [second state] revenue or the officers costs only relate to [second state] revenue is to place more importance on where the costs are incurred rather than where or how the revenue is earned. Cost of performance is a method of allocating "income producing activity" not a method of allocating all costs.

The audit report concludes:

> [T]his audit has included in the sales numerator, Indiana sales of tangible personal property where the [T]axpayer has supplied materials and also the Indiana portion of the insert only revenue, where [T]axpayer addresses, and sorts the [materials] provided by their customers.

B. Taxpayer's Response.

Taxpayer disagrees with the audit's results stating that the "overwhelming" cost of preparing advertising materials for delivery into Indiana occur in another state. Taxpayer explains that "[t]he activities in Indiana are limited to simply assembling and addressing mailer packages for delivery to the [postal service]." Further costs incurred in assembling and addressing the materials "are much lower than the costs of creating, managing, and maintaining the marketing data that is the true object of customers engaging [Taxpayer] and those activities take place in [another state]."

Taxpayer cites to IC § 6-3-2-2(f) as authority for its position that there are no exceptions to the "cost of performance" rule.

> 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.

Taxpayer points to the provision contained in IC § 6-3-2-2(l) which permits either a taxpayer or the Department to resort to an alternate method of apportioning income "if the allocation and provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana . . . ." Id.

However, Taxpayer maintains that the Department may not resort to this alternative. As authority for that position, Taxpayer cites to 45 IAC 3.1-1-62.

> All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) [45 IAC 3.1-1-37-45 IAC 3.1-1-61] unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income. However, the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states. It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results.

Taxpayer concludes that the "limited and unusual circumstances" do not exist and that the "only possible exception to the cost of performance rule does not apply to Taxpayer."

The issue is whether the money Taxpayer receives from preparing and distributing advertising materials to Indiana customers, money received from delivering pre-printed advertising materials to Indiana customers, and money received by selling advertising space on labels used to deliver advertising materials should be sourced to a state other than Indiana based on Taxpayer's "cost of performance" analysis.

In considering Taxpayer's various arguments and as a threshold issue, it is the Taxpayer's responsibility to establish that the existing 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." See 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).

Consequently, a taxpayer is required to provide documentation explaining and supporting his or her challenge that the Department's position is wrong. Further, "[W]hen [courts] examine a statute that an agency is 'charged with enforcing . . . [courts] defer to the agency's reasonable interpretation of [the] statute even over an equally reasonable interpretation by another party.'" Dept. of State Revenue v. Caterpillar, Inc., 15 N.E.3d 579, 583 (Ind. 2014). Thus, interpretations of Indiana tax law contained within this decision, as well as the preceding audit, are entitled to deference.

Taxpayer asks the Department to accept its assertion that its costs are "overwhelmingly" incurred in a state other than Indiana. Taxpayer bases this assertion on what it believes is a "detailed study analyzing all the direct costs incurred by [Taxpayer] in performing its services." Taxpayer's premise is that the activities that produce the earnings obtained from providing its delivery services are attributable to a state other than Indiana. In this case, the Department is prepared to agree with its assertion that it has provided information sufficient to conclude that the majority of Taxpayer's direct costs are incurred in a state other than Indiana and that costs associated with its Indiana location - including assembling and addressing the mailings - are much lower than that its costs of creating, managing, and maintaining the marketing data which is the foundation of Taxpayer's mail services. Therefore, an apportionment of Taxpayer's Indiana income based on the cost of rendering its mailing services more fairly reflects that income.

FINDING

Taxpayer's protest is sustained.

II. Administration - Underpayment Penalty.

DISCUSSION

Taxpayer challenges imposition of a penalty for "failure to make sufficient estimated payments." Taxpayer explains that it "filed its returns following the prescribed statutory requirements" and that "any penalties should be abated."

IC § 6-3-4-4.1(b) imposes on each taxpayer the responsibility to make and pay a "declaration of estimated tax for the taxable years" if the amount of that estimated is more than $1,000. Id.

> c) Every corporation subject to the adjusted gross income tax liability imposed by this article shall be required to report and pay an estimated tax equal to the lesser of:
> (1) twenty-five percent (25[percent]) of such corporation's estimated adjusted gross income tax liability for the taxable year; or
> (2) the annualized income installment calculated in the manner provided by Section 6655(e) of the Internal Revenue Code as applied to the corporation's liability for adjusted gross income tax. IC § 6-3-4-4.1(c).

IC § 6-3-4-4.1(d) imposes a penalty if a taxpayer fails to pay the correct amount of estimated tax.

> 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. Id.

IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. IC § 6-8.1-10-2.1(a)(2) requires a ten-percent penalty if the taxpayer "fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment."

IC § 6-8.1-10-2.1(d) states that, "If a person subject to the penalty imposed under this section can show that the failure to . . . pay the full amount of tax shown on the person's return . . . 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(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

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 . . . ."

Under IC § 6-8.1-5-1(c), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." An assessment - including the negligence penalty - is presumptively valid.

As discussed in Part I above, the Department disagrees with Taxpayer's substantive argument concerning application of the "cost of performance" standard. 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.

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