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Market-Based Sourcing Goes Incognito

by Brian Strahle

The trend toward market-based sourcing of revenue from services has been increasing over the past several years. Some states have adopted market-based sourcing by enacting legislation, and others have imposed it by interpreting their statutes and regulations to allow it. Indiana has done the latter. Despite having statutes and regulations that clearly prescribe the income-producing activity test, Indiana has imposed market-based sourcing reasoning or methods in several letters of finding. That discretionary use of authority produces uncertainty for taxpayers domiciled outside Indiana, but may present an opportunity for taxpayers domiciled in the state.

What Is the Income-Producing Activity?

According to Indiana Code section 6-3-2-2(f), Indiana has adopted the income-producing activity test based on cost of performance. If the income-producing activity is performed both within and outside Indiana, the sale is sourced to Indiana if most of the activity is performed in Indiana. The term "cost 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.[1]

In a 2012 letter of finding, the Department of Revenue concluded that the taxpayer was being paid to sell compilations of data and not to conduct surveys.[2] The taxpayer, an out-of-state media and marketing services business, conducted surveys to measure the size and characteristics of the audience of radio and television programs and other media. The taxpayer then compiled the survey results and sold the information to interested parties. The taxpayer relied on an example in the regulations in which a taxpayer was paid to conduct surveys performed outside Indiana. The DOR differentiated the taxpayer's situation from that in the example by stating that the taxpayer was not paid to conduct surveys in Indiana or any other state. Rather, the taxpayer was paid to sell compilations of data based on the surveys. The DOR also stated that an example does not have the force of law.

The taxpayer unsuccessfully tried to explain that its core business was conducting public opinion surveys. The DOR argued that the surveys provided the raw data on which the taxpayer's salable information was compiled, but that the taxpayer did not earn the money from conducting surveys. "It earned money because it compiled and analyzed that data and sold the compilations of data to Indiana customers," the DOR said.

That's where the DOR's argument derailed. The DOR concluded that the taxpayer earned money because it sold compilations of data based on the surveys to Indiana customers (the sale). However, it also stated that the taxpayer earned money because it compiled and analyzed that data. Thus, Indiana customers are paying the taxpayer to compile and analyze data, not simply paying for the resulting data. Therefore, if the taxpayer performed the compilation and analytical services outside Indiana, the revenue should be sourced outside Indiana.

Provided vs. Performed

As mentioned, the DOR stated that the surveys provided the raw data on which the taxpayer's salable information was compiled, but it argued that conducting the surveys was not an income-producing activity. It reasoned that the money earned from selling compilations should be sourced to Indiana because the income-producing activity took place in Indiana where services were provided. That is where the DOR's position falls off the tracks again. Indiana statutes and regulations do not source service revenue based on where the service is provided, but on where it is performed.

Indiana regulations state:

> Gross receipts for the performance of personal services are attributable to this state to the extent such services are performed in this

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[1]Department of Revenue reg. 45 IAC 3.1-1-55, interpreting Ind. Code section 6-3-2-2(f).

[2]Indiana DOR letter of finding No. 02-20120316.

> 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.[3]

The regulations lead taxpayers to conclude that even negotiating or "selling" the contract should be excluded from the cost-of-performance computation. So how can a sale be sourced to the place of delivery or the customer's location unless the services were performed there as well?

Rendered?

Indiana regulations define income-producing activity as an act directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit.[4] The income-producing activity is deemed to be performed at the situs of real, tangible, or intangible personal property or the place where personal services are rendered.

In a recent letter of finding, the DOR determined that the income received by an out-of-state business that provides information services to customers in Indiana should be sourced to Indiana "because the information is 'rendered' to an Indiana customer."[5] The DOR stated:

> Upon audit, we believe that in Taxpayer's specialized business, the money Taxpayer receives is not received by virtue of the activities which Taxpayer conducts in other states. The money is received because the information is "rendered" to an Indiana customer.

The taxpayer conducted a comprehensive review of the direct costs associated with the income-producing activity giving rise to the service receipts to determine the proportion of the costs of performance within and outside Indiana. The primary direct costs were from (1) staffing, which included editorial, research, analysis, and systems and database managers, and (2) information technology, which included computers, servers, and software development and maintenance. The review concluded that most of the direct costs were incurred outside Indiana.

Despite the taxpayer's review, the DOR concluded that the actual income-producing activity was performed in Indiana because the activities in Indiana represented the acts directly engaged in by the taxpayer for the ultimate purpose of obtaining gains or profit. According to the DOR, the taxpayer did not earn money from conducting out-of-state financial research or because a specific Indiana customer hired the taxpayer to conduct that research. It earned money because it conducted financial research and then sold the information to Indiana customers.

The DOR's conclusion ignores the fact that most, if not all, activities engaged in by a company are for the ultimate purpose of obtaining gains or profit. In this case, the activities conducted by the taxpayer outside Indiana were services directly related to the sale made to Indiana customers. Those activities weren't back-office activities, but services the customer paid to receive. Like in its argument in the 2012 letter of finding, Indiana asserts that the results of a service performed in other states should be sourced to Indiana simply because they are delivered, provided, or rendered to an Indiana customer.

The DOR also argued that the information the "taxpayer acquires and manages would have no value unless that information was offered to and accepted by an Indiana customer." That of course is true, because a company's services and operations have no value until a customer buys them, but it doesn't mean the services or operations that are producing the results are not the income-producing activity. There would be no sale in Indiana if services weren't performed in other states.

The 'Audience Factor'

In another letter of finding, the DOR proposed an assessment of additional income tax against a taxpayer based on the use of the "audience factor" apportionment method in lieu of the cost-of-performance apportionment method.[6] The taxpayer argued unsuccessfully that Indiana hasn't adopted the audience factor by statute or regulation.

The taxpayer was a major media corporation engaged in television and motion picture production and distribution and television broadcasting. The taxpayer argued that its services originated primarily in two states outside Indiana and that the income-producing activities related to affiliate and advertising revenue were attributable to those states. However, the DOR said in its audit that both

[3]DOR reg. section 45 IAC 3.1-1-55, interpreting Ind. Code section 6-3-2-2(f).

[4]*Id.*

[5]Indiana DOR letter of finding No. 02-20130238.

[6]Indiana DOR letter of finding No. 02-20110473 (2013).

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of those other states source the revenue to where the programming is delivered. Hence, neither state taxes the portion of income that is derived from television viewers in other states.

The DOR concluded that the audience factor — based on the Nielsen audience factor ratio — more fairly reflected Indiana income because revenues earned by the taxpayer were based on the number of subscribers. The DOR also found that using that factor was consistent with its use in states such as those in which the taxpayer claimed its receipts should be attributed under Indiana law. The DOR argued that by using the audience factor, it followed the rules in Ind. Code section 6-3-2-2(l) and 45 IAC 3.1-1-39 and -62, which govern the interpretation of Indiana's sales factor when "uncontemplated apportionment issues are presented."

The DOR argued that it was applying the audience factor method to a limited situation and that it had the authority to apply Ind. Code section 6-3-2-2(l) to effectuate a result that more fairly represented the taxpayer's income derived from sources within the state. The law states that "if the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana . . . the department may require, in respect to all or any part of the taxpayer's business activity . . . the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income."[7]

The taxpayer argued that the DOR's application of the audience factor violated the state's Administrative Procedure Act. Indiana statutes define a rule as "the whole or any part of an agency statement of general applicability that: (1) has or is designed to have the effect of law; and (2) implements, interprets, or prescribes: (A) law or policy; or (B) the organization, procedure, or practice requirements of an agency."[8] The taxpayer claimed that the method the DOR applied on audit constituted a rule under that definition. The taxpayer also cited state supreme court cases from Maryland (*CBS Inc. v. Comptroller*, 575 A.2d 324 (Md. 1990)) and New Jersey (*Metromedia Inc. v. Director, Division of Taxation*, 478 A.2d 742 (N.J. 1984)) in which the courts upheld similar arguments.

In its letter of finding, the DOR stated that its application of the audience factor method did not violate the Administrative Procedure Act because the department had been consistent in applying the method to the taxpayer and to similarly situated taxpayers. The DOR also said that how other states interpret their laws is instructive but holds no precedential value in Indiana.[9]

The ultimate conclusion in the letter of finding is that the taxpayer did not meet its burden to show why the audience factor method of apportionment did not fairly reflect its corporate income from Indiana sources and why the cost-of-performance method would have more fairly reflected its income. That is another example of the taxpayer having the burden of proving that applying the state's regulations as written produces a fairer result. The DOR used its discretionary authority to alter the taxpayer's apportionment method, assess additional tax, and then place on the taxpayer the burden of proving that method incorrect.

Conclusion

The legislature may not have enacted market-based sourcing legislation, but the DOR has clearly adopted a market-based sourcing interpretation of the state's statutes and regulations. As a result, taxpayers are faced with a difficult decision when trying to comply with state law: Interpret and apply the regulations using an income-producing activity test based on where the services are performed, or interpret and apply the regulations using an income-producing activity test based on the DOR's interpretation as outlined in letters of finding.

Taxpayers domiciled outside Indiana will most likely face a negative result from following the DOR's interpretation, but taxpayers domiciled in Indiana might obtain a positive result — if most of a company's services are performed in Indiana, but the sale is delivered, rendered, or provided to customers outside Indiana, those sales may escape inclusion in the Indiana apportionment factor.

Taxpayers who are not active in Indiana should see the DOR's interpretation as a warning. Other states that have not enacted market-based sourcing might take positions similar to Indiana's, so taxpayers should not simply follow the "same as last year" approach when apportioning their income. ✰

The SALT Effect is written by Brian Strahle, a state and local tax researcher, writer, blogger, and consultant. He provides research, writing, and help-desk services to accounting firms, law firms, and news organizations, and is also the author of the state tax blog LEVERAGE SALT (www.leveragestateandlocaltax.com). He welcomes comments at Strahle@leveragesalt.com.

[7]Ind. Code section 6-3-2-2(l).

[8]Ind. Code section 4-22-2-3(b).

[9]Indiana courts haven't considered whether the use of the audience factor apportionment method constitutes a rulemaking action. Therefore, other taxpayers may want to consider such a challenge.

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