Indiana - Royalty income from foreign subsidiaries constituting business income is included in the calculation of Indiana income tax

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In brief

Taxpayer developed intellectual property in the ordinary course of its business. The royalty income Taxpayer received from allowing its affiliates to exploit that intellectual property constituted business income and therefore was included in the calculation of Taxpayer's Indiana income tax. [Indiana Letter of Findings, Indiana Department of Revenue, No. 02-20120249, (11/28/12)]

In detail

Taxpayer excluded royalty income from Indiana taxable income

During the 2007 to 2009 tax years, Taxpayer was a producer of consumer products and sold such products to customers inside and outside of Indiana. Taxpayer owned intangible personal property such as patents, trademarks, tradenames, and "know how" and managed such intangibles in New Jersey and New York. Taxpayer charged its affiliates a royalty fee providing them with a non-exclusive right to use the intangibles. Taxpayer excluded from its Indiana income tax returns the royalty income earned from foreign subsidiaries because the royalties had no Indiana situs and were not "derived from sources within the state."

Indiana law

Indiana imposes its income tax on a corporation's adjusted gross income "derived from sources within Indiana." Indiana Code (IC) sec. 6-3-2-1(b).

Prior to 1990, income "derived from sources within Indiana" 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.*
> IC sec. 6-3-2-2(a)(5) (1989) (emphasis added).

Effective January 1, 1990, this definition changed to:

> 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.*
> IC sec. 6-3-2-2(a)(5) (1990) (emphasis added)

Also effective January 1, 1990, IC section 6-3-2-2.2 ("Section 2.2") was enacted. It provided whether certain income is attributable to Indiana, including interest income, dividend receipts, unsecured consumer loan receipts, financial institution service charges, and fiduciary service receipts. Royalty income is not included within Section 2.2.

Department rejects Taxpayer's positions

In the Letter of Findings, Taxpayer asserted that, pursuant to IC sec. 6-3-2-2(a)(5) ("Section 2") and Section 2.2, that income from intangible property must first be classified as income "attributable to Indiana." According to Taxpayer, royalty income is always sourced to the state of a taxpayer's domicile. Taxpayer advanced three primary arguments to support its position to exclude royalty income from its taxable income: (1) Section 2.2 limited the specific types of intangible personal property attributable to Indiana; (2) the Tax Court's prior decision in *Chief Industries v. Indiana Dep't of Revenue* supports that royalty income is sourced to a taxpayer's domicile; and (3) the Tax Court's prior decision in *Riverboat Development, Inc. v. Indiana Dep't of Revenue* supports that intangible income is sourced to a taxpayer's domicile.

Interplay between Section 2 and Section 2.2

Taxpayer relied on the interplay of Section 2 and Section 2.2. For the relevant tax years, Section 2 provided that Indiana 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, *if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter*" (emphasis added).

Section 2.2 provided rules for determining whether certain types of intangible personal property were attributable to Indiana. Because Section 2.2 did not specifically provide rules for attributing royalty income to Indiana, Taxpayer argued that its royalty income was not attributable to Indiana and therefore was not included in Indiana taxable income.

The Department rejected Taxpayer's interpretation. The Department recognized that Section 2.2 *complements* Section 2 and doesn't serve to limit intangible property attributable to Indiana. To follow Taxpayer's interpretation would effectively nullify the eleven categories of intangible property specifically included within taxable income under Section 2. The Department held that "the taxpayer's belief that IC sec. 6-3-2-2.2 must be satisfied for the eleven non-related categories [in Section 2] is incorrect."

Chief Industries

Taxpayer relied on *Chief Industries* for proposition that an out-of-state entity's income from intangible property is sourced to the state of a taxpayer's domicile. In *Chief Industries*, the Tax Court interpreted pre-1990 language of Section 2, providing that intangible property is attributable to Indiana if it has a "situs" in Indiana and that "***this classification must have been made prior to deciding whether the income was business or nonbusiness income"*** (emphasis added). The court held that the sale of a corporation's stock by a related out-of-state corporation lacked an Indiana tax situs and therefore could not be subject to Indiana income tax. Similarly, Taxpayer argues that its royalty income does not have an Indiana situs and therefore cannot be subject to Indiana income tax.

The Department rejected Taxpayer's reliance on *Chief Industries* because the decision relied on superseded statutory language ("having a situs in this state" was replaced by a determination of whether such income is "attributable to the state of Indiana"). Furthermore, the court found that Taxpayer's reliance on *Chief Industries* "flies in the face of the Tax Court's decision in *Hunt*" (summarized below), which holds that inclusion of an item of income in Indiana taxable income depends first on whether the income is classified as either business or non-business income.

Riverboat Development, Inc.

In *Riverboat*, the Tax Court held that a nonresident S-corporation that owned a minority interest in a limited liability company doing business in Indiana did not have a withholding tax responsibility because the S-corporation's interest was deemed to be a "dividend" that was sourced to the S-corporation's domicile and not to Indiana. The Department did not determine whether it agreed with Taxpayer's interpretation. Rather, the Department determined that Taxpayer's facts were distinguishable from *Riverboat* for reasons including: (1) Taxpayer had a controlling interest in its foreign subsidiaries; and (2) the source and nature of Taxpayer's royalty income was substantially different than *Riverboat's* "dividend" income.

Taxpayer's royalty income is business income and must be included in Indiana apportionable income

The Department recognized that the Indiana Tax Court in *Hunt Corp. v. Indiana Dep't of State Revenue* held that the first step in determining what income is subject to Indiana income

tax is whether the income at issue consists of business or non-business income. Indiana adopts a transactional test and a functional test to determine whether a taxpayer's income is considered business income.

The Department found that Taxpayer created its intellectual property in the course of developing and selling its products. As a result, the associated royalty income arose from "transactions and activity in the regular course" of its business and therefore satisfied both the transactional and functional test for business income.

The Department rejected the Taxpayer's position that relied on the *Riverboat* and *Chief Industries* Tax Court decisions and ruled consistent with the *Hunt* Tax Court that the inclusion of an item of income in Indiana taxable income depends on whether the income is classified as either business or non-business income. Accordingly, because Taxpayer's royalty income was classified as business income, the income should be included in the calculation of Taxpayer's Indiana income tax. The court did not make a determination regarding how the royalty income should be apportioned, only that the income should be included in Taxpayer's apportionable income tax base.

The takeaway

A strict reading of Section 2's requirement that an item of intangible income must satisfy the Indiana attribution rules of Section 2.2 could lead a taxpayer to interpret Section 2.2 as providing the exclusive list of taxable intangible items subject to Indiana taxation. Indiana modified Section 2 effective January 1, 2011 by removing the reference to Section 2.2 and defining income "derived from sources within Indiana" as including:

> 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.*

Presumably, the above clarified that Section 2.2 does not limit intangible income subject to Indiana tax for 2011 and future years. However, years prior to 2011 remained subject to confusion as the interplay between Section 2.2 and Section 2 was not fully understood.

In this Letter of Findings, the Department concludes that Section 2.2 does not limit the category of intangible income subject to Indiana tax and reaffirms the holding in *Hunt*, which provides that inclusion of an item of income in Indiana taxable income depends first on whether the income is classified as either business or non-business income.

The Department's interpretation of the *Chief Industries* and *Riverboat* cases is presently being litigated in several cases before the Tax Court. The Department's position is generally in conflict with the holdings in these cases. However, due to subsequent legislative changes to IC sec. 6-3-2-2(a), arguably the issues in those cases have been clarified for periods beginning on or after January 1, 2009 regarding flow through income and for periods beginning on or after January 1, 2011 for all other types of intangible income.

Let's talk

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