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State & Local Tax Alert

Provided by the National Tax Office

Indiana adopts market-based sourcing and clarifies income tax nexus standard

Under Public Law 159, Indiana has adopted market-based sourcing for income tax and clarifies that physical presence isn’t required for income tax nexus.

With the enactment of Public Law 159 of 2019, Indiana adopted market-based sourcing for income tax apportionment purposes and clarifies that a physical presence isn’t required to have income tax nexus. These changes to the income tax law are effective retroactive to Jan. 1, 2019.

As part of these changes, service industries will be required to adopt market-based sourcing, with the exception of broadcasting and telecommunication services and specified revenue related to financial services. Broadcasting and telecommunication services will still apportion income using the cost-of-performance methods. Revenue related to financial services will also continue to be apportioned the same as before.

There are two general approaches to sourcing sales other than sales of tangible personal property: market-based sourcing and cost-of-performance sourcing. These methods are typically used for service-based entities. Market-based sourcing is the approach of sourcing income based on where the services are received or where the customer is located. Cost-of-performance sourcing is the approach of sourcing income where the greater or greatest cost associated with the income-producing activity is performed. In the modern market, services don’t always have to be performed at the customer location. Oftentimes, the service can be performed remotely, which has driven many states to adopt market-based sourcing as opposed to cost-of-performance-based sourcing.

When calculating Indiana source receipts, taxpayers must include the receipts from services to the extent the benefit of the service is received in Indiana. The rental, lease, and licensing of tangible and real property located in Indiana are sourced to the state. For intangible property, the rental, lease, or license receipts are sourced to Indiana to the extent the property is used in the state, provided that intangible property used in marketing a good or service to a consumer is used in the state if that good or service is purchased by a consumer who is in Indiana.

With the change to Indiana's income tax statute stating "income derived from Indiana shall be taxable to the fullest extent permitted by the Constitution, regardless of whether the taxpayer has a physical presence in Indiana," coupled with the market-based sourcing change, this could mean more taxpayers will now have income tax nexus in Indiana and a new filing requirement for 2019. Indiana states that physical presence isn't the only cause of income to be taxable in the state. Companies located outside of Indiana, and performing services outside of Indiana, in the past may not have had nexus. Now with the adoption of market-based sourcing, as long as the benefit of the service is in Indiana, a taxpayer will have income derived from Indiana.

Example

Company A is a provider of cloud-based services and is located in Illinois with no activities outside of the state. Company B, located in Indiana, is a customer of Company A. Prior to Jan. 1, 2019, when Indiana was a cost-of-performance-sourcing state, any sales from Company A to Company B would've been sourced to Illinois, based on Indiana law, since the actual service is performed in Illinois. Further, Company A wouldn't have had an Indiana filing obligation. Under market-based sourcing, these sales are now sourced to Indiana since Company B, the recipient of the service, is located in Indiana. In addition, Company A now has Indiana-derived income and arguably has a filing obligation in Indiana.

Taxpayers impacted by these changes, including those previously subject to Indiana income tax, should review whether making or adjusting estimated tax payments is warranted due to the retroactive effective date of Jan. 1, 2019. Taxpayers previously subject to Indiana income tax could find their tax liability increase or decrease under the new rules. Taxpayers that will experience an increase in tax may rely on the prior-year safe harbor rules previously in effect.

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