DEPARTMENT OF STATE REVENUE

02-20120352.LOF

Letter of Findings: 02-20120352
Corporate Income Tax
For the Year 2007, 2008, 2009, and 2010

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ISSUE

I. Adjusted Gross Income Tax – Sales to foreign countries – Throwback Sales.

Authority: 15 U.S.C. § 381; IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-8.1-5-1; 45 IAC 3.1-1-38; 45 IAC 3.1-1-53; 45 IAC 3.1-1-64; Indiana Dep't. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Sherwin-Williams Co. v. Indiana Dep't. of State Revenue, 673 N.E.2d 849 (Ind. Tax Ct. 1996); Wisconsin Dep't. of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992); Indiana Dep't of State Revenue v. Kimberly-Clark Corp., 416 N.E.2d 1264 (Ind. 1981).

Taxpayer protests the imposition of additional adjusted gross income.

STATEMENT OF FACTS

Taxpayer is an Indiana company doing business in Indiana and outside of Indiana. Taxpayer designs, manufactures, and sells precision food cutting equipment. Claiming that it was entitled to refund, Taxpayer amended its Indiana consolidated corporate income tax returns, which excluded its income derived from its sales to certain foreign countries for tax periods ending 2/28/2007 and 2/29/2008. Subsequently, the Indiana Department of Revenue ("Department") conducted an income tax audit and reviewed Taxpayer's business records for tax periods ending 2/28/2007 through and including 2/28/2010 (collectively, the Audit Years at issue).

Pursuant to the audit, the Department denied Taxpayer's refund claim and also assessed Taxpayer additional income tax for the Audit Years at issue. Taxpayer protested the Department's refund denial and proposed assessment of additional income tax. A hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Adjusted Gross Income Tax – Sales to foreign countries – Throwback Sales.

DISCUSSION

Pursuant to the audit, the Department found that Taxpayer had income derived from sales of items shipped to various foreign countries during the Audit Years at issue, but Taxpayer did not pay taxes on the income earned from those sales to those countries. The Department's audit thus concluded that Taxpayer's activities did not exceed the protection of P.L.86-272 (codified as 15 U.S.C. § 381) and was not subject to tax in those countries. As a result, the Department's audit determined that the Indiana throwback rule applied to Taxpayer and denied Taxpayer's refund claim and also imposed additional assessments for the Audit Years at issue.

Taxpayer, to the contrary, asserted that it had nexus with those foreign countries because its business activities in those countries went beyond the P.L. 86-272's protection. Thus, Taxpayer maintained that the Indiana throwback rule was not applicable.

As a threshold issue, all tax assessments are prima facie evidence that the Department's assessment of tax is presumed correct. "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007); Indiana Dep't. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012).

"Indiana imposes a tax on every corporation's adjusted gross income derived from sources within Indiana. [IC § 6-3-2-1(b).] In cases where a corporation derives business income from sources both within and without Indiana, the 'adjusted gross income derived from sources within the state of Indiana' is determined by an apportionment formula." Sherwin-Williams Co. v. Indiana Dep't. of State Revenue, 673 N.E.2d 849, 851 (Ind. Tax Ct. 1996). That formula operates by multiplying taxpayer's total business income by a fraction composed of a property factor, a payroll factor, and a sales factor. The "sales factor" consists of a fraction, "the numerator of which is the total sales of the taxpayer in [Indiana] during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year." IC § 6-3-2-2(e).

For taxable years beginning prior to January 1, 2007, IC § 6-3-2-2(e) provided that:

> The "sales factor" is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year. Sales include receipts from intangible property and receipts from the sale or exchange of intangible property. However, with respect to a foreign corporation, the denominator does not include sales made in a place that is outside the United States. Receipts from intangible personal property are derived from sources within Indiana if the receipts from the intangible personal property are attributable to Indiana under section

2.2 of this chapter. Sales of tangible personal property are in this state if:

(1) the property is delivered or shipped to a purchaser, other than the United States government, within this state, regardless of the f.o.b. point or other conditions of the sale; or

(2) the property is shipped from an office, a store, a warehouse, a factory, or other place of storage in this state and:

(A) the purchaser is the United States government; or

(B) the taxpayer is not taxable in the state of the purchaser.

Gross receipts derived from commercial printing as described in IC 6-2.5-1-10 shall be treated as sales of tangible personal property for purposes of this chapter.

IC § 6-3-2-2(e), which applies to taxable years beginning after December 31, 2006, states as follows:

The "sales factor" is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year. Sales include receipts from intangible property and receipts from the sale or exchange of intangible property. However, with respect to a foreign corporation, the denominator does not include sales made in a place that is outside the United States. Receipts from intangible personal property are derived from sources within Indiana if the receipts from the intangible personal property are attributable to Indiana under section 2.2 of this chapter. Regardless of the f.o.b. point or other conditions of the sale, sales of tangible personal property are in this state if:

(1) the property is delivered or shipped to a purchaser that is within Indiana, other than the United States government; or

(2) the property is shipped from an office, a store, a warehouse, a factory, or other place of storage in this state and:

(A) the purchaser is the United States government; or

(B) the taxpayer is not taxable in the state of the purchaser.

Gross receipts derived from commercial printing as described in IC 6-2.5-1-10 shall be treated as sales of tangible personal property for purposes of this chapter.

IC § 6-3-2-2(n) further states:

For purposes of allocation and apportionment of income under this article, a taxpayer is taxable in another state if:

(1) in that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or

(2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

45 IAC 3.1-1-53 explains:

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. See Regulation 6-3-2-2(n)(010) [45 IAC 3.1-1-64]. Examples:

...

(5) **If the taxpayer is not taxable in the state of the purchaser, the sale is attributed to this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state. Such sale is termed a "Throwback" sale**. Example: The taxpayer has its head office and factory in State A. It maintains a branch office and inventory in Indiana. Taxpayer's only activity in State B is the solicitation of orders by a resident salesman. All orders by the State B salesman are sent to the branch office in Indiana for approval and are filled by shipment from the inventory in Indiana. Since the taxpayer is immune under P.L.86-272 from tax in State B, all sales of merchandise to purchasers in State B are attributed to Indiana, the state from which the merchandise was shipped. (**Emphasis added**).

45 IAC 3.1-1-38 provides:

For 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:

(1) Maintenance of an office or other place of business in the state

(2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods

(3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution

(4) Rendering services to customers in the state

(5) Ownership, rental or operation of a business or of property (real or personal) in the state

(6) Acceptance of orders in the state

(7) **Any other act in such state which exceeds the mere solicitation of orders so as to give the state**

nexus under P.L.86-272 to tax its net income.

As stated in Regulation 6-3-2-2(b)(010) [45 IAC 3.1-1-37], corporations doing business in Indiana as well as other states are subject to the allocation and apportionment provisions of IC 6-3-2-2(b)-(n). (**Emphasis added**).

45 IAC 3.1-1-64 further illustrates:

A corporation is "taxable in another state" under the Act when such state has jurisdiction to subject it to a net income tax. This test applies if the taxpayer's business activities are sufficient to give the state jurisdiction to impose a net income tax under the Constitution and statutes of the United States. **Jurisdiction to tax is not present where the state is prohibited from imposing the tax by reason of the provision of Public Law 86-272, 15 U.S.C.A. §381-385**. In the case of any "State," as defined in IC 6-3-1-25, other than a state of the United States or political subdivision of such state, the determination of whether such "state" has jurisdiction to subject the taxpayer to a net income tax shall be made by application of the jurisdictional standards applicable to that state of the United States. If jurisdiction to tax is otherwise present, such "state" is not considered as being without jurisdiction to tax by reason of the provisions of a treaty between that state and the United States.

Example:

Corporation X is actively engaged in manufacturing farm equipment in State A and foreign country B. Both State A and foreign country B impose a net income tax but foreign country B exempts corporations engaged in manufacturing farm equipment. Corporation X is subject to the jurisdiction of State A and foreign country B. **Taxpayers are not subject to throwback on sales into states in which they are taxable under this regulation** [45 IAC 3.1-1-64]. See Regulation 6-3-2-2(e)(040) [45 IAC 3.1-1-53]. (**Emphasis added**).

15 U.S.C.A. § 381(a), which establishes minimum standards for a state to impose tax, provides:

No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after September 14, 1959, a net income tax on the income derived within such State by any person from interstate commerce if the only business activities within such State by or on behalf of such person during such taxable year are either, or both, of the following:

(1) the solicitation of orders by such person, or his representative, in such State for sales of tangible personal property, which orders are sent outside the State for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the State; and

(2) the solicitation of orders by such person, or his representative, in such State in the name of or for the benefit of a prospective customer of such person, if orders by such customer to such person to enable such customer to fill orders resulting from such solicitation are orders described in paragraph (1).

15 U.S.C.A. § 381(c) further states:

For purposes of subsection (a) of this section, a person shall not be considered to have engaged in business activities within a State during any taxable year merely by reason of sales in such State, or the solicitation of orders for sales in such State, of tangible personal property on behalf of such person by one or more independent contractors, or by reason of the maintenance, of an office in such State by one or more independent contractors whose activities on behalf of such person in such State consist solely of making sales, or soliciting orders for sales, of tangible personal property.

Accordingly, in every transaction, at least one state has the authority to impose tax on income derived from the sale of tangible personal property. A state could impose tax on a taxpayer if its activity within the state exceeds "solicitation of orders."

The court in Indiana Dep't of State Revenue v. Kimberly-Clark Corp., 416 N.E.2d 1264 (Ind. 1981), found that the nonresident taxpayer did not exceed solicitation of orders for sales in Indiana because it only employed several salesmen who live in Indiana to perform activities such as, checking inventories, checking shelf facings, and explaining products. Id. at 1266. The Kimberly-Clark court stated that "each case must be judged upon its own merits, with particular emphasis placed upon the totality of a corporation's activities within a state." Id. at 1268. The Kimberly-Clark court held that solicitation of orders for sales includes "sundry activities so long as those activities (are) closely related to the eventual sale of a product." Id. The Kimberly-Clark court concluded that the taxpayer's activities in Indiana were "inextricably related to solicitation" or as "acts of courtesy," and, therefore, the taxpayer was not taxable in Indiana.

The U.S. Supreme Court refined the "mere solicitation" standard in Wisconsin Dep't. of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992). In Wrigley, the taxpayer, a manufacturer of chewing gum, claimed that P.L. 86-272 prohibits Wisconsin from taxing its income because (1) it did not have any office (or real estate) in Wisconsin and (2) its business activities in Wisconsin were within the scope of solicitation of orders and were de minimis. The Court disagreed and, in relevant part, stated:

We proceed, therefore, to describe what we think the proper standard to be. Once it is acknowledged, as we have concluded it must be, that "solicitation of orders" covers more than what is strictly essential to making requests for purchases, the next (and perhaps the only other) clear line is the one between those activities that are entirely ancillary to requests for purchases–those that serve no independent business function apart from their connection to the soliciting of orders–and those activities that the company would have reason to

> engage in anyway but chooses to allocate to its in-state sales force.... Providing a car and a stock of free samples to salesmen is part of the "solicitation of orders," because the only reason to do it is to facilitate requests for purchases. Contrariwise, employing salesmen to repair or service the company's products is not part of the "solicitation of orders," since there is good reason to get that done whether or not the company has a sales force. Repair and servicing may help to increase purchases; but it is not ancillary to requesting purchases, and cannot be converted into "solicitation" by merely being assigned to salesmen.
> Id. at 228-29. (Emphasis in original).
> The Court further explained:
> By contrast, Wrigley's in-state recruitment, training, and evaluation of sales representatives and its use of hotels and homes for sales-related meetings served no purpose apart from their role in facilitating solicitation. The same must be said of the instances in which Wrigley's regional sales manager contacted the Chicago office about "rather nasty" credit disputes involving important accounts in order to "get the account and [Wrigley's] credit department communicating." It hardly appears likely that this mediating function between the customer and the central office would have been performed by some other employee – some company ombudsman, so to speak – if the on-location sales staff did not exist. The purpose of the activity, in other words, was to ingratiate the salesman with the customer, thereby facilitating requests for purchases.
> Finally, Wrigley argues that the various nonimmune activities, considered singly or together, are de minimis. In particular, Wrigley emphasizes that the gum sales through "agency stock checks" accounted for only 0.00007 [percent] of Wrigley's annual Wisconsin sales, and in absolute terms amounted to only several hundred dollars a year. We need not decide whether any of the nonimmune activities was de minimis in isolation; taken together, they clearly are not. Wrigley's sales representatives exchanged stale gum, as a matter of regular company policy, on a continuing basis, and Wrigley maintained a stock of gum worth several thousand dollars in the State for this purpose, as well as for the less frequently pursued (but equally unprotected) purpose of selling gum through "agency stock checks." Although the relative magnitude of these activities was not large compared to Wrigley's other operations in Wisconsin, we have little difficulty concluding that they constituted a nontrivial additional connection with the State. Because Wrigley's business activities within Wisconsin were not limited to those specified in § 381, the prohibition on net-income taxation contained in that provision was inapplicable.
> Id. at 234-5.

Ruling in favor of Wisconsin, the Court thus held that the taxpayer in Wrigley was subject to Wisconsin's net income tax because its business activities in Wisconsin exceeded P.L.86-272's protection.

Thus, following the Wrigley decision, an Indiana company's income derived from its sales to other states (or foreign jurisdictions) is thrown back to Indiana for income tax purposes when the Indiana company's business activities in those states (or foreign jurisdictions) are protected and are not taxable pursuant to P.L.86-272.

In this instance, Taxpayer, an Indiana company, has foreign subsidiaries or affiliates in North America, South America, Europe, and Asia. However, Taxpayer's foreign subsidiaries/affiliates were not included in Taxpayer's Indiana consolidated return filings. Taxpayer stated that it "shipped approximately 40 percent of its U.S. production to foreign countries" where its customers are located. Taxpayer also stated that, "to maintain these foreign markets, it dedicated significant resources in the form of senior management involvement, technical support, sales representation, and integrated training programs." Taxpayer thus asserted that its activities in those foreign jurisdictions exceeded P.L. 86-272's protection and the Indiana throwback rule was not applicable. To support its protest, Taxpayer submitted additional documentation which included copies of e-mail correspondence among Taxpayer's employees, travel arrangements, sales invoices, and employee trip summary reports.

Upon reviewing Taxpayer's documentation, the Department agrees that Taxpayer's documentation demonstrated that its activities in Russia, Spain, and Mexico for the tax period ending 2/28/2010 exceeded the P.L. 86-272's protection. Thus, the Indiana throwback rule should not apply to the income derived from Taxpayer's sales to Russia, Spain, and Mexico for the tax year ending 2/28/2010.

As to the remaining countries and remaining Audit Years at issue, Taxpayer's documentation demonstrated that its employees planned, travelled, and visited several countries. However, Taxpayer's documentation showed that those employees' stays in each foreign country were primarily to attend fairs and sales conferences/meetings to promote its products or to test (or replace/repair) its prototypes (or demo equipment). The employee trip summary reports offered the employees' observations or reflections on their trips to those foreign countries; however, the information contained in those reports cannot be verified in the absence of other supporting documentation. Thus, those activities at best were solicitation of orders for sales and fell within the P.L. 86-272's protection.

Finally, Taxpayer claimed that its invoices demonstrated that it had property in those foreign countries. The Department is not able to agree. First, Taxpayer did not own any real property in those foreign countries. Taxpayer's invoices showed that it shipped its demo equipment and/or replacement parts to its foreign subsidiaries/affiliates either with no charges or only the shipping/insurance charges. Those foreign subsidiaries did not file the Indiana consolidated returns for the Tax Years at issue. While the invoices recorded that replacement parts were shipped by Taxpayer to its subsidiaries, those subsidiaries were not included in

Taxpayer's Indiana returns. Thus, the sales invoices alone were insufficient to support that Taxpayer owned property in those countries.

In conclusion, the Department agrees that Taxpayer has provided sufficient documentation establishing that its activities in Russia, Spain, and Mexico exceeded the P.L. 86-272's protection, and that it had nexus with Russia, Spain, and Mexico for tax period ending 2/28/2010. Therefore, the Indiana throwback rule does not apply to Taxpayer's income derived from its sales to Russia, Spain, and Mexico for the tax period ending 2/28/2010. However, Taxpayer's documentation failed to show that its activities in the remaining foreign countries for the remaining Audit Years at issue exceeded the P.L. 86-272's protection. Given the totality of the circumstances, in the absence of other supporting documentation, the Department is not able to agree that Taxpayer has met its burden of proof demonstrating that the Department assessments are wrong.

FINDING

Taxpayer's protest is sustained as to Russia, Spain, and Mexico for tax year ending 2/28/2010; the remainder of Taxpayer's protest is denied.

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