

Letter of Findings Number: 05-0462
Corporate Income Tax
Tax Period 2000-2002

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ISSUE

I. Corporate Income Tax- Gross Income Tax Adjustments

Authority: [IC 6-8.1-5-1\(b\)](#); [IC 6-2.1-5-5](#); [45 IAC 1.1-4-5](#); [45 IAC 3.1-1-111](#).

Taxpayer protests the assessment of additional gross income tax.

II. Corporate Income Tax- Adjusted Gross Income Tax Adjustments

Authority: [IC 6-8.1-5-1\(b\)](#); [45 IAC 3.1-1-8\(2\)](#); [45 IAC 3.1-1-49](#); I.R.C. §170; [IC 6-3-2-2](#); [45 IAC 3.1-1-64](#); [IC 6-3-1-24](#); [45 IAC 3.1-1-34](#); 15 U.S.C.S. §381; [Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co.](#), 505 U.S. 214 (1992); [Marquis v. Commissioner](#), 49 TC 695 (1968); [Singer Co. v. United States](#), 196 Ct. Cl. 90, 449 F.2d 413 (1971).

Taxpayer protests the assessment of additional adjusted gross income tax.

III. Tax Administration- Penalties

Authority: [IC 6-8.1-10-2.1](#); [45 IAC 15-11-2](#).

Taxpayer protests the assessment of penalties.

IV. Tax Administration- Interest

Authority: [IC 6-8.1-10-1](#); [IC 6-8.1-5-2\(e\)\(2\)](#).

Taxpayer protests the assessment of interest.

STATEMENT OF FACTS

Taxpayer, an Indiana based company, sells parts to automobile manufacturers. Prior to 2001, taxpayer manufactured a majority of its parts. After 2001, the taxpayer purchased its parts from its wholly-owned subsidiary (hereinafter referred to as "Company A"). In addition to Company A, the taxpayer owned eighty percent of a company (hereinafter referred to as "Company B") and one-hundred percent of another company (hereinafter referred to as "Company C"). Both Company A and Company B are located in Indiana. Company C is located outside of Indiana. All of the companies are involved in the production or sale of automobile component parts.

The Indiana Department of Revenue ("Department") audited the taxpayer's returns. The Department made adjustments to the returns and assessed additional tax for gross income, adjusted gross income, penalties, and interest. The taxpayer submitted a protest challenging the assessment. The Department held a hearing and now presents this Letter of Findings.

I. Corporate Income Tax- Gross Income Tax Adjustments

DISCUSSION

Taxpayer, Company A, Company B, and Company C filed an Indiana consolidated return for gross income tax purposes. But, for adjusted gross income tax and supplemental net income tax purposes, only Taxpayer, Company A, and Company B filed an Indiana consolidated return. Pursuant to [45 IAC 3.1-1-111](#), the audit review disallowed the taxpayer's inclusion of Company C on its consolidated gross income tax return. The audit review determined since Company C did not have nexus with Indiana for adjusted gross income tax purposes, the taxpayer was not permitted to include Company C on its consolidated gross income tax return. Additionally, the audit review further adjusted the return to reflect the taxpayer's failure to report receipts derived from performing management and support services on behalf of Company C in Indiana.

The taxpayer argues the audit review erred by excluding Company C from the consolidated gross income tax return. The taxpayer believes either the audit review relied upon the wrong regulations or it imposed an additional requirement not found in the statute or regulations to reach its conclusion. The taxpayer explains that there is no statutory or regulatory prerequisite requiring that Company C have nexus with Indiana for inclusion on the taxpayer's consolidated gross income tax return. The taxpayer contends since both the taxpayer and Company C satisfy the requirements of [IC 6-2.1-5-5\(b\)](#), the audit review erred by excluding Company C from the consolidated gross income tax return.

Indiana Department of Revenue assessments are prima facie evidence the department's claim for unpaid taxes is valid. [IC 6-8.1-5-1\(b\)](#). The taxpayer has the burden of proving whether the department incorrectly imposed the assessment. *Id.* Upon clarification with the Department's audit review, the audit review actually intended to cite [IC 6-2.1-5-5](#). Thus, the taxpayer was correct to state that the audit review relied upon an inappropriate authority. However, this harmless error does not necessitate the Department's agreement with the taxpayer on whether the audit review improperly excluded Company C from the consolidated gross income tax return or that the audit review incorrectly imposed the assessment.

For inclusion on a consolidated return, a taxpayer must satisfy [IC 6-2.1-5-5\(b\)](#). [IC 6-2.1-5-5\(b\)](#) provides "[c]orporate members of an affiliated group that are incorporated in the state of Indiana or are authorized to do business in the state of Indiana may file a consolidated gross income tax return." Utilizing the standards described in the statute, the taxpayer must first establish whether Company C was a part of the taxpayer's affiliated group. [IC 6-2.1-5-5\(a\)](#) provides:

Corporations are affiliated if at least eighty percent (80%) of the voting stock of one (1) corporation (exclusive of directors' qualifying shares) is owned by the other corporation. Every corporation affiliated with another corporation is affiliated with every corporation that is affiliated with such other corporation. All corporations so affiliated constitute an affiliated group.

After this is established, the taxpayer must then prove whether Company C was incorporated in Indiana or that Company C was authorized to do business in Indiana.

Since the taxpayer owns one hundred percent of Company C, Company C qualifies as a corporate member of the taxpayer's affiliate group. However, the taxpayer fails to provide the Department with sufficient evidence to establish whether Company C was authorized to conduct business in Indiana. Until the taxpayer furnishes the Department with this evidence, the taxpayer fails to rebut the audits exclusion of Company C from the consolidated gross income tax return.

The taxpayer further argues the receipts it received from Company C, as income from management fees, is not taxable under the provisions of [IC 6-2.1-5-5](#) and [45 IAC 1.1-4-5](#). However, the taxpayer fails to articulate what specific provisions of [45 IAC 1.1-4-5](#) or [IC 6-2.1-5-5](#) renders the income it received from Company C non-taxable. Neither the statute nor the regulations suggest or expound provisions which would make income non-taxable. Therefore, the taxpayer's argument lacks sufficient foundation for the Department to address the issue.

FINDING

For the above reasons, the Department denies the taxpayer's protest.

II. Corporate Income Tax- Adjusted Gross Income Tax Adjustments

DISCUSSION

On audit review, the Department made the following adjustments to the taxpayer's return for adjusted gross income tax purposes: (1) adjustment for charitable contributions; (2) adjustments to the numerator of the Indiana payroll factor; and (3) adjustments to the Indiana sales factor. After making these adjustments, the audit review determined the taxpayer owed additional adjusted gross income tax.

Indiana Department of Revenue assessments are prima facie evidence the department's claim for unpaid taxes is valid. [IC 6-8.1-5-1\(b\)](#). The taxpayer has the burden of proving whether the department incorrectly imposed the assessment. *Id.* The taxpayer separately addressed these adjustments.

A. Charitable Contributions

After conducting an audit of the taxpayer's return, the Department adjusted the taxpayer's return and added back charitable contributions. The audit discovered the taxpayer had deducted charitable contributions of \$103,226.73 on its federal income tax return for tax year 2002, but only added back \$24,275 of the contribution on its Indiana income tax return. This resulted in underreporting \$78,951.73 of charitable contributions add backs on the taxpayer's 2002 state income tax return. In previous years, the taxpayer's add back of charitable contributions matched the amounts the taxpayer claimed on its federal return.

The taxpayer argues the amounts in question do not constitute charitable contributions. The taxpayer claims the items it listed as contributions were in fact a sponsorship of community events and amounts paid to business organizations (i.e. Chamber of Commerce). The taxpayer contends these items are clearly fall within the purview of business expenses rather than contributions under I.R.C. §170. The taxpayer supports its contention by stating in its protest letter that:

Federal case law and Internal Revenue Service guidance indicates that amounts paid to charitable organizations are not always a "charitable contribution" under §170. Under Rev. Rul. 72-314, whether payments are "contributions or gifts" within the meaning of §170 or business expenses under §162 depends on whether they bear a direct relationship to the taxpayer's business and are made with a reasonable expectation of a financial return. See also *Marquis v. Commissioner*, 49 TC 695 (1968) and *Singer Co. v. United States*, 196 Ct. Cl. 90, 449 F.2d 413 (1971).

Therefore, the taxpayer insists since the contributions were given with the expectation of some economic benefit and because they were not motivated by generosity, the Department should not add back the amounts for Indiana adjusted gross income.

To arrive at Indiana adjusted gross income, [45 IAC 3.1-1-8\(2\)](#) provides:

"Adjusted Gross Income" with respect to corporate taxpayers is "taxable income" as defined in Internal Revenue Code Section 63 with [modifications]:

(2) Add[ing] back deductions taken pursuant to Internal [sic.] Revenue Code section 170 (Charitable contributions). . .

The taxpayer provides the Department with no evidence to corroborate that it reported the charitable contributions erroneously on its federal return. Moreover, the taxpayer provides no evidence showing whether it amended its return to reflect a reduction in the charitable contribution amounts for the years in question.

Therefore, because the basis for adding back charitable deductions is derived from the specific amounts taxpayer reported on its Federal tax return, the audit review properly added back the charitable contribution amounts.

B. Payroll Factor

The audit review adjusted the taxpayer's payroll factor. The audit review included the amounts the taxpayer paid to its Ohio based employees in the payroll factor numerator. The audit review concluded since the taxpayer placed these employees on its Indiana payroll and reported the wages to the Indiana Unemployment Security Division for unemployment compensation until June of 2003, the amounts represent compensation paid in Indiana.

The taxpayer argues the wages do not constitute Indiana wages under [IC 6-3-2-2\(d\)](#). [IC 6-3-2-2\(d\)](#) provides: The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the taxable year by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the taxable year. . . Compensation is paid in this state if:

- (1) the individual's service is performed entirely within the state;
- (2) the individual's service is performed both within and without this state, but the service performed without this state is incidental to the individual's service within this state; or
- (3) some of the service is performed in this state and:
 - (A) the base of operations or, if there is no base of operations, the place from which the service is directed or controlled is in this state; or
 - (B) the base of operations or the place from which the service is directed or controlled is not in any state in which some part of the service is performed, but the individual is a resident of this state.

The taxpayer maintains the compensation was not paid within this state because the employees actually live and work in Ohio. Thus, the Department should properly attribute the wages to Ohio rather than Indiana.

[45 IAC 3.1-1-49](#) establishes guidance as to whether a taxpayer has paid compensation in Indiana. [45 IAC 3.1-1-49](#) provides

The numerator of payroll factor is the total amount paid in this state during the tax period by the taxpayer for compensation. The test in this Regulation [[45 IAC 3.1-1-62](#)] to be applied in determining whether compensation is paid in this state are derived from the Model Unemployment Compensation Act. Accordingly, if compensation paid to employees is included in the payroll factor by use of the cash method of accounting or if the taxpayer is required to report such compensation under such method for unemployment compensation purposes, it shall be presumed that the total wages reported by the taxpayer to this state for unemployment compensation constitutes compensation paid in this state. . . The presumption may be overcome by satisfactory evidence that an employee's compensation is not properly reportable to this state for unemployment compensation purposes. . . .

The taxpayer placed the employee's on its Indiana payroll and reported the compensation to Indiana for unemployment purposes. The taxpayer provides no evidence supporting a proposition that it mistakenly placed the employee's on its Indiana payroll or that it informed the Indiana Unemployment Security Division that it improperly paid unemployment compensation to the Division for the employees. Since the taxpayer provides no evidence of the occurrence of those events, then consistent with [45 IAC 3.1-1-49](#) "it shall be presumed that the total wages reported by the taxpayer to this state for unemployment compensation constitutes compensation paid in this state. . . The presumption may be overcome by satisfactory evidence that an employee's compensation is not properly reportable to this state for unemployment compensation purposes." The taxpayer provides insufficient evidence to overcome this presumption, so the audit review was correct to include the employee's wages in the Indiana payroll factor numerator.

The taxpayer further argues the audit review should have included compensation paid to an employee working in Canada for Company B in the payroll factor. However, the taxpayer fails to address or analyze why the Department should include the employee in the Indiana payroll factor. Thus, the taxpayer's argument lacks sufficient foundation for the Department to address the issue.

C. Sales Factor

Pursuant to [45 IAC 3.1-1-64](#), the audit review made adjustments to the taxpayer's sale factor. [45 IAC 3.1-1-64](#) provides:

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. . . .

Taxpayers are not subject to throwback on sales into states in which they are taxable under this regulation

[45 IAC 3.1-64](#)]. . .

Applying this regulation, the audit review treated as Indiana sales the sales of goods shipped to destinations where the taxpayer did not establish nexus. The audit review concluded since the taxpayer did not establish nexus in any other states besides Indiana and Ohio, all sales made to states other than Ohio were thrown back to the Indiana numerator for sales apportionment.

In every sales transaction, at least one state has the power to tax income derived from the sale of tangible personal property. [IC 6-3-2-2\(e\)](#) provides that "[s]ales of tangible personal property are in this state if. . . (2) the property is shipped from an office, a store, a warehouse, a factory, or other place of storage in this state and . . . (B) the taxpayer is not taxable in the state of the purchaser." [IC 6-3-2-2\(n\)](#) provides that "[f]or purposes of allocation and apportionment of income. . . a taxpayer is taxable in another state if: (1) in that state the taxpayer is subject to a net income tax, 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." The term "state" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof. [IC 6-3-1-25](#). Thus, in order to properly attribute income to a foreign state, the taxpayer must establish whether the state imposed one of the [IC 6-3-2-2\(n\)\(1\)](#) listed taxes upon the taxpayer or that the state had jurisdiction to impose a net income tax.

15 U.S.C.S. § 381 regulates when a state may impose a tax on an out-of-state taxpayer. 15 U.S.C.S. § 381 establishes minimum standards for imposing a state income tax on a taxpayer based on the solicitation of interstate sales. *Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214, 221 (1992). 15 U.S.C.S. § 381 will prohibit a state from imposing a net income tax on a foreign taxpayer if the foreign taxpayer's business activities within that state does not exceed the mere solicitation of sales. *Id.* When this occurs, the effect is to "throw back" the sales receipts to the originating state, since the right to tax those out-of-state activities is derivative upon the foreign state's own taxing authority. [45 IAC 3.1-1-64](#).

The taxpayer argues the activities relating to the sales made in Canada, Japan, and North Carolina clearly exceed "mere solicitation" as defined in § 381. As a result, the taxpayer would have subjected itself to taxation in those jurisdictions, which in effect would disqualify the sales from the Indiana "throw back" rules. Using the same analysis, the taxpayer further argues the sales Company B made to Canada and Michigan would not qualify as Indiana throwback sales. Therefore, because the taxpayer arguments involve multiple jurisdictions, the Department will separately address whether the sales would qualify as Indiana "throw back" sales.

Taxpayer's Sales to Canada

The taxpayer explains that it sends employees and representatives to Canada on a regular basis to perform the following: investigate or assist in resolving customer complaints; handle problems relating to quality issues; and other unspecified matters. The taxpayer corroborated these activities with travel expense reports. The taxpayer maintains since these activities clearly extend beyond mere solicitation, Canada had jurisdiction to impose an income tax on the taxpayer. But, because of a treaty between the United States and Canada, Canada did not impose the tax. Accordingly, the audit review should have attributed the sales to Canada, rather than Indiana.

From the information provided by the taxpayer, the taxpayer's activities performed in Canada exceed mere solicitation. The extent of the taxpayer's Canadian non-solicitation activities were to occasionally send employees to attend meetings, make quality assurance visits, and conduct presentations in the country. These activities usually lasted for two days, with the taxpayer reimbursing the employee for gas and occasionally lodging. These activities establish "a nontrivial additional connection to the taxing State." *Wrigley*, 505 U.S. at 230. The activities served an "independent business function apart from their connection to the soliciting of orders." *Id.* at 229. Therefore, because the taxpayer's activities exceeded 15 U.S.C.S. § 381 "mere solicitation" standard and the taxpayer was subject to taxation within the jurisdiction, the audit review erred in attributing the sales to Indiana.

Taxpayer's Sales to Japan

The taxpayer explains that it sends employees and representative to Japan at least annually to learn about new model issues, receive training, and conduct business matters unrelated to sales. To corroborate its explanation, the taxpayer provided the Department with travel expense reports, which verified the taxpayer sending an employee to Japan only one time out of the year. The taxpayer contends these activities exceed mere solicitation and gives Japan the authority to impose an income tax on the taxpayer. However, because of a treaty between Japan and the United States, Japan did not impose the tax. Hence, the audit review should have attributed the sales to Japan, rather than Indiana.

The Department is unable to concur with the taxpayer's assertion that the activities in Japan exceeded mere solicitation. The taxpayer's activities in Japan "[are] sufficiently de minimis to avoid loss of the tax immunity conferred by § 381." *Wrigley*, 505 U.S. at 233. As explained in *Wrigley*, "[a] company does not necessarily forfeit its tax immunity under §381 by performing some in state-business activities." *Wrigley*, 505 U.S. at 230. The taxpayer activities in Japan only occurred one time a year, which is not enough to establish "a nontrivial additional connection to the taxing State." *Id.* at 234. Moreover, the level of activity does not exceed the scope of 15 U.S.C.S. § 381 "de minimis" standard. Thus, the audit review correctly attributed the sales the taxpayer made to

Japan to Indiana.

Taxpayer's Sales to North Carolina

The taxpayer explains the transactions which occurred in North Carolina were not really "sales". The taxpayer states that both it and Company C separately ordered items from Japan. The items were shipped as bundled orders to the taxpayer, with the taxpayer receiving and paying for the entire bill amount. The taxpayer later broke down the order, shipped Company C its order, and billed Company C for the ordered items. This occurred only in the first year of Company C's existence since Company C was not fully functional from an accounting perspective during its start-up period. The taxpayer maintains that it was merely acting as an intermediary in the transaction. Accordingly, the audit review should not have treated the amounts in question as sales for purposes of [IC 6-3-2-2\(e\)](#). Moreover, the taxpayer explains that even if the Department determines the sales made to North Carolina were "sales", the sales are not attributable to Indiana.

[IC 6-3-1-24](#) defines sales as "all gross receipts of the taxpayer. . . , other than compensation." [45 IAC 3.1-1-34](#) further explains the definition of sales as "[t]he term "sales" as used in the Act includes all gross receipts. . . which are not the compensation of an employee for personal services. . . Thus any business income of a corporate taxpayer is considered to be from "sales" under this definition, regardless of its actual source."

Applying the definition for sales under the statute and regulations, the transaction between the taxpayer and Company C represents a sale. When the taxpayer broke down the order and billed Company C for the order, the parties entered into an intercompany transfer. This transfer allowed the taxpayer to receive receipts from Company C. Accordingly, because both the statute and regulations broadly include all receipts, regardless of the actual source in the definition of sales, the transaction qualifies as a sale.

To determine whether the sales were attributable to Indiana, the taxpayer must establish whether it was subject to tax in the purchaser state. The taxpayer files tax returns in North Carolina and pays both an income tax and a franchise tax in the state. Therefore, because the taxpayer was subject to taxation in the jurisdiction, the audit review improperly attributed the sales made in North Carolina to the Indiana for the "throw back" rules.

Company B's Sales to Canada

The taxpayer explains that Company B had a full-time employee based in Canada who performed the following tasks: investigate or assist in resolving customer complaints; perform duties related to possible quality issues; and other unspecified matters. The taxpayer corroborated these activities with travel expense reports. The taxpayer argues since these activities are beyond mere solicitation, Canada had authority to impose a tax on Company B. But, because of a treaty between Canada and the United States, Canada did not impose the tax. Hence, the audit review should have attributed Company B's sales to Canada, rather than Indiana.

Based upon the information the taxpayer chose to provide the Department, the documentation does not specifically describe Company B's activity within Canada. Moreover, the Department is unable to discern whether the travel expense reports provided by the taxpayer are for an employee of Company B or an employee of the taxpayer. Consequently, the Department is unable to conclude whether the activities conducted by Company B in Canada exceed mere solicitation. Thus, the taxpayer fails to sustain its burden of proof that the audit review improperly attributed to Indiana the sales Company B made to Canada.

Company B's Sales to Michigan

The taxpayer explains that at the request of its customer, Company B ships certain items to Michigan in order for the customer to make consolidated shipments into Canada. The items shipped by Company B were not manufactured, processed, or packaged in Michigan. The items stayed in Michigan for only as long as necessary to consolidate the shipments. Therefore, the taxpayer contends the purchase occurred in Canada rather than Michigan. The taxpayer further contends that since Company B had nexus with Canada, the audit review should have attributed the sales to Canada, rather than Indiana.

The taxpayer fails to provide any sufficient evidence to corroborate its argument. Hence, the Department is unable to ascertain or reach a conclusion whether the jurisdiction of the purchaser was either Canada or Michigan. Thus, the taxpayer fails to sustain its burden of proof that the audit review improperly attributed to Indiana the sales Company B made to Michigan.

FINDING

The Department sustains in part and denies in part the taxpayer's protest.

III. Tax Administration- Penalties

DISCUSSION

The taxpayer requests the Department waive the assessment of penalties on the tax liability.

[IC 6-8.1-10-2.1\(a\)\(3\)](#) provides in part that "if a person. . . incurs, upon examination by the department, a deficiency that is due to negligence. . . , the person is subject to a penalty." Negligence is defined "as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. . . ." [45 IAC 15-11-2\(b\)](#). Negligence is "determined on a case-by-case basis according to the facts and circumstances of each taxpayer." *Id.*

The Department may waive the penalty upon a showing that the failure to pay the deficiency was due to reasonable cause and not due to willful neglect. [IC 6-8.1-10-2.1\(d\)](#). However, in order to establish reasonable cause, the taxpayer must demonstrate that the taxpayer "exercised ordinary business care and prudence in

carrying out or failing to carry out a duty giving rise to the penalty imposed. . . ." [45 IAC 15-11-2\(c\)](#).

Taxpayer provides no substantive basis to justify the Department finding the taxpayer's failure to pay the tax deficiency was due to reasonable cause. The Department is unable to waive the negligence penalty.

FINDING

The Department denies the taxpayer's protest.

IV. Tax Administration- Interest

DISCUSSION

[IC 6-8.1-10-1\(a\)](#) provides:

If a person fails to file a return for any of the listed taxes, fails to pay the full amount of tax shown on his return by the due date for the return or the payment, or incurs a deficiency upon a determination by the department, the person is subject to interest on the nonpayment.

The taxpayer requests the Department waive the assessment of interest on the tax liability. However, [IC 6-8.1-10-1\(e\)](#) provides "[e]xcept as provided by [IC 6-8.1-5-2\(e\)\(2\)](#), the department may not waive the interest imposed under this section." As such, the Department finds the assessment of interest proper and denies the taxpayer's protest of interest.

FINDING

The Department denies the taxpayer's protest.

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