DEPARTMENT OF STATE REVENUE

02-20030487.SLOF

Supplemental Letter of Findings Number: 03-0487
Gross Income Tax and Adjusted Gross Income Tax
For the Years 1998-2000

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ISSUE

I. Gross Income Tax–Applicability

Authority: IC § 6-2.1-2-2; IC § 6-2.1-4-6; IC 6-2.1-5-5; *Indiana Dep't of State Revenue v. Bethlehem Steel Corp.*, 639 N.E.2d 264 (Ind. 1994); *Indiana-Kentucky Electric Corp. v. Ind. Dep't of State Revenue*, 598 N.E.2d 647 (Ind. Tax Ct. 1992); *First Nat'l Leasing & Financial Corp. v. Indiana Dep't of State Revenue*, 598 N.E.2d 640 (Ind. Tax Ct. 1992).

Taxpayer protests the assessment of gross income tax with respect to sales from an affiliated corporation's Indiana manufacturing plant to Indiana customers, where the taxpayer momentarily held the title.

II. Adjusted Gross Income Tax–Applicability

Authority: IC § 6-3-2-2; 15 U.S.C. §§ 381-385

Taxpayer protests the inclusion of sales to Indiana in its sales numerator as well as the inclusion of sales made from Indiana to customers in several other states.

III. Tax Administration--Negligence Penalty

Authority: IC § 6-3-4-4.1; IC § 6-8.1-10-2.1

Taxpayer protests penalties based on Taxpayer's failure to make estimated tax payments.

STATEMENT OF FACTS

Parent is a corporation headquartered in Ohio. Parent had an affiliated corporation ("Affiliate") that manufactured and sold recreational vehicle doors and windows. Affiliate's state of domicile was Texas. In 1996, Affiliate divided into two companies, Sales Office and Manufacturing Division. Manufacturing Division operates manufacturing facilities in Indiana. Sales Office as a separate entity does not have property or payroll in Indiana.

Whenever a customer places an order for products, the customer can call either Sales Office or Manufacturing Division, per the Sales Office/Manufacturing Division's website. Regardless of which company the customer contacts, Manufacturing Division manufactures the products for the customer and delivers the products to the customer's location. At the instant that the customer receives the property, Manufacturing Division transfers the title in the property to Sales Office, and Sales Office transfers the same title to the customer.

During the years in question, Manufacturing Division was included in a consolidated gross income tax and adjusted gross income tax return with other corporations owned by Parent. However, Sales Office was not included in the consolidated return and did not file a separate return. The Department determined that Sales Office engaged in the business of selling products in Indiana, and assessed both gross income tax and adjusted gross income tax with respect to Sales Office's sales to Indiana customers. The Department further assessed Sales Office adjusted gross income tax with respect to its sales shipped from Manufacturing Division's Indiana locations to customers in several other states where neither Sales Office nor Manufacturing Division had nexus. The Department also assessed a negligence penalty and a penalty for failure to make sufficient estimated payments of income tax. Sales Office protested these issues.

The Department held a hearing, and the Department issued a letter of findings which denied Sales Office's protest. Sales Office requested a rehearing, which the Department granted.

I. Gross Income Tax–Applicability

DISCUSSION

A. Inclusion of Indiana Sales

Sales Office argues that its receipts are not subject to gross income tax. In particular, Sales Office argues that its only contacts with Indiana occur when Manufacturing Division momentarily transfers title to Sales Office. Thus, Sales Office argues that it had neither an Indiana business nor a tax situs that would subject it to gross income tax. At issue is whether a sale of merchandise is subject to Indiana gross income tax when the merchandise is manufactured in Indiana and sold to customers at an Indiana destination, when an out-of-state company–Sales Office–holds instantaneous title momentarily before transfer to customers.

Under IC § 6-2.1-2-2(b) (repealed effective January 1, 2003), the gross income tax is imposed upon "the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or domiciliary of Indiana." In this case, the transactions that the Department sought to tax were entirely intrastate transactions. The sales by Sales Office that the Department taxed were of goods manufactured in Indiana and sold to Indiana customers; the sales of merchandise to locations outside Indiana were not taxed by the Department. Sales Office cites to various Indiana cases that consider the taxation of corporations with commercial domiciles outside Indiana for gross income tax purposes. *See Indiana Dep't of State Revenue v. Bethlehem Steel Corp.*, 639 N.E.2d 264 (Ind. 1994); *Indiana-Kentucky Electric Corp. v. Ind. Dep't of State Revenue*, 598 N.E.2d 647 (Ind. Tax Ct. 1992); *First Nat'l Leasing & Financial Corp. v. Indiana Dep't of State Revenue*, 598 N.E.2d 640 (Ind. Tax Ct. 1992). However, these cases discuss the gross income tax consequences of transactions that originated or terminated outside Indiana; Sales Office's transactions occurred entirely within Indiana.

B. Intercompany Transfers

Sales Office argues that if its sales were taxable, a portion of these sales should be exempt as intercompany transfers. Sales Office argues that Manufacturing Division derives its Indiana receipts from sales to Sales Office. Sales Office in turn receives its gross receipts from the sale of items to the customers. To illustrate Sales Office's argument, an Indiana customer purchased an item for $12,000. Manufacturing Division charged Sales Office $11,000, and Manufacturing Division reported the $11,000 as subject to gross income tax. Sales Office argues that it was assessed gross income tax on the full $12,000. Sales Office proposes that $11,000–the amount paid from Sales Office to Manufacturing Division–should have been eliminated as an intercompany transfer.

The issue is whether the intercompany transfers (i.e., the charges to Manufacturing Division to Sales Office) should be deducted from the gross income of either Sales Office or Manufacturing Division. The statute providing for the deduction of intercompany transfers, IC § 6-2.1-4-6(a), states:

> Except as provided in subsections (b) and (c), each taxable year an affiliated group of corporations filing a consolidated return pursuant to IC 6-2.1-5-5 is entitled to a deduction from the gross income reported on such a return. The amount of the deduction equals the total amount of gross income received during the taxable year from transactions between members of the group that are incorporated or authorized to do business in Indiana.

Thus, IC § 6-2.1-4-6 requires that a corporation must file a consolidated gross income tax return in order to be permitted an elimination for intercompany transfers. The test for determining whether Sales Office can be included in a consolidated gross income return is set forth in IC § 6-2.1-5-5(b), which states:

> Corporate 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.

Assuming (without conceding) that "intercompany transfers" occurred, Sales Office filed an "Application for Certificate of Withdrawal of a Foreign Corporation" with the Indiana Secretary of State prior to the audit period. Sales Office's filing of the form constituted a revocation of Sales Office's authority to conduct business in Indiana. Sales Office was not authorized to conduct business in Indiana and as a result Manufacturing Division and Sales Office could not be included in a consolidated gross income tax return. Because Manufacturing Division and Sales Office could not file a consolidated gross income tax return, intercompany transfers between Sales Office and Manufacturing Division could not be eliminated from either Sales Office's or Manufacturing Division's respective gross incomes.

FINDING

Sales Office's protest is denied.

II. Adjusted Gross Income Tax–Applicability

A. Indiana to Indiana Sales

Sales Office argues that its sales–both to Indiana destinations and to destinations outside Indiana–are not subject to Indiana adjusted gross income tax because Sales Office asserts that it lacks sufficient contacts with Indiana. The first issue is whether sales shipped from Indiana locations to customers in Indiana are subject to Indiana adjusted gross income tax.

IC § 6-3-2-2(e) provides that the sales numerator for a corporation consists of its sales of the corporation within Indiana divided by its sales everywhere. To determine the attribution of sales of tangible personal property to Indiana or to a jurisdiction other than Indiana, IC § 6-3-2-2(e) states:

> 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.

However, P.L. 86-272 (15 U.S.C.S. §§ 381-385) provides for limitations on corporate income taxation by states. In particular, 15 U.S.C.S. § 381 provides (**emphasis** added):

> (a) Minimum standards. No State, or political subdivision thereof, shall have power to impose, for any taxable year ending after the date of the enactment of this Act [enacted Sept. 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).

Generally, sales receipts are attributed to the state in which the goods are delivered ("destination test"). However, constitutional or statutory constraints such as P.L. 86-272 may restrict the rights of the destination state to tax the seller. If the purchaser's state cannot impose a net income tax against the seller due to these constraints, the sales are attributed to the state from which the sales were shipped ("throwback sales").

Sales Office's argument is that its activities in Indiana are not sufficient to subject it to Indiana adjusted gross income tax. Sales Office asserts that its only contact with Indiana is the fact that it held title in the goods for a moment. As such, Sales Office argues that its contacts with Indiana do not exceed the "mere solicitation" standard set forth under P.L. 86-272.

If Sales Office's argument is to be accepted, its sales to Indiana destinations, as well as those in several other states, are exempt because it did not have the requisite level of activities within Indiana to be subject to Indiana adjusted gross income tax. However, in instances in which sales are not sourced to a destination state because of P.L. 86-272, Sales Office's sales are attributed to the state from which the sales originated.

The logical consequence is Sales Office's sales would be sourced to the state from which the goods originated–Indiana, where Sales Office has asserted a lack of activities that would subject it to Indiana adjusted gross income tax. Sales Office argues that its sales should have been sourced nowhere yet still included in Sales Office's sales denominator for apportionment purposes. Thus, Sales Office argues that the mere holding of title for a moment results in the anomalous scenario in which a *minimum* of $160,000,000 of sales (out of $430,000,000 overall sales) for the years in question was subject to tax in no jurisdiction despite Manufacturing Division and Sales Office conducting a single business yielding those sales.

The Department's original determination–that Sales Office had Indiana inventory for the moment that Sales Office held title to the goods–was correct. In addition, Sales Office's own website discusses placing orders with either Sales Office or Manufacturing Division, and includes the address and telephone number of several Indiana locations. The listing of Manufacturing Division's address and telephone number for orders meant that Manufacturing Division acted on behalf of Sales Office in many cases in receiving and filling customers' orders. Manufacturing Division's Indiana activities on behalf of Sales Office, including manufacturing goods on behalf of Sales Office and taking orders for Sales Office, exceed the solicitation standard that otherwise may have protected Sales Office's Indiana activities.

In reality Manufacturing Division manufactured goods in Indiana, and shipped a majority of those goods to Indiana customers. The *intrastate* transactions–manufacturing orders at an Indiana location and shipping to customers at Indiana locations–take Sales Office out of the protections of P.L. 86-272. P.L. 86-272 limitations against state taxations are limited to sales shipped from outside a given state to the given state–*interstate* transactions.

B. Throwback Sales

Sales Office also sold goods that were transported from Indiana to other jurisdictions in which the Department asserted that Sales Office did not have nexus. The Department included the sales delivered to customers in these other jurisdictions in Sales Office's Indiana sales numerator per IC § 6-3-2-2(e)(2). Sales Office contends that if Indiana asserted nexus based on Sales Office having Indiana inventory because of its momentary title, then Sales Office had nexus with the states other than Indiana in which Sales Office's sales occurred because Sales Office had inventory in those states at the moment it held and transferred title to customers in these states.

Sales Office argues that the Department should exclude its sales from Indiana to states in which Sales Office has not filed income tax returns or paid taxes for the years at issue from Sales Office's Indiana sales numerator.

However, Sales Office's failure to file returns or to pay taxes to these other states would seem to indicate that Sales Office itself does not believe that it had nexus in those states. In addition, unlike the states in which Indiana has sought to "throw back" sales based on Sales Office's lack of contacts with those states, Sales Office has items produced on its behalf at Manufacturing Division's Indiana location and has sales accepted on its behalf by Manufacturing Division's Indiana employees. Based on the lack of filing and payment of taxes in the states in which Sales Office *now* asserts nexus, along with the contacts in Indiana that do not otherwise exist in the states to which Sales Office sells Indiana-produced goods, Sales Office's protest is denied with respect to the throwback sales.

FINDING

Sales Office's protest is denied.

III. Tax Administration--Negligence Penalty

DISCUSSION

Sales Office protests the imposition of penalties for failure to make sufficient estimated income tax payments as required by IC § 6-3-4-4.1. Sales Office argues that the failure to make estimated payments of tax due based on the amount of tax determined due by the Department was not the result of negligence. In the alternative, Sales

Office argues that the penalty for making estimated tax payments cannot be imposed in addition to general negligence penalty under IC § 6-8.1-10-2.1(a)(3).

Each penalty stands alone and is imposed on a separate basis; the general penalty is imposed for failing to make a payment on time, and the estimated tax penalty is imposed separately for the failure to make those payments during the course of the year. As such, the penalties can be imposed in conjunction with each other. Accordingly, Sales Office's protest is denied.

FINDING

Sales Office's protest is denied.

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