**DEPARTMENT OF STATE REVENUE**

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**Letter of Findings Number: 07-0537**
**Income Tax**
**For Tax Year 2005**

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## ISSUES

**I. Income Tax–Throwback Sales.**

**Authority:** *Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214 (1992); *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue*, 483 U.S. 232 (1987); 15 U.S.C. § 381; 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.

Taxpayer protests the assessment of individual income tax.

**II. Tax Administration–Negligence Penalty.**

**Authority:** IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of a ten percent negligence penalty.

## STATEMENT OF FACTS

Taxpayer is a shareholder in a Subchapter S corporation which is in the recreational vehicle repair parts business in Indiana and several other states. As the result of an audit, the Indiana Department of Revenue ("Department") determined that, due to additional income attributable to the S corporation, Taxpayer owed additional Indiana adjusted gross income tax for the tax year 2005. The Department issued proposed assessments for adjusted gross income tax, interest, and ten percent negligence penalty. Taxpayer protests these proposed assessments. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

**I. Income Tax–Throwback Sales.**

## DISCUSSION

Taxpayer protests the imposition of Indiana adjusted gross income tax for the years at issue. Income attributable to the Subchapter S corporation flows through to the shareholders. The Subchapter S corporation of which Taxpayer is a shareholder is headquartered in Indiana with repair centers in Florida and Arizona. Drivers of recreational vehicles and commercial trucks often need replacement parts which the corporation provides. In 2005, the drivers contacted their insurance provider, which in turn contacted the corporation. If the drivers were not near the corporation's repair centers, or if the drivers preferred another entity to perform the installation, the corporation sent the parts to repair shops near the drivers' locations. The repair shops installed the parts and collected the drivers' insurance deductibles. The shops retained their repair fees, covering installation only and excluding the cost of the part, from these deductibles. If the deductible was greater than the shop's installation charges, the shop remitted the remaining amount to the corporation, at which point the corporation charged the insurance provider for the difference between the amount remitted by the shop and the cost of the part. If the deductible was less than the shop's installation charges, the corporation remitted the remaining amount of installation charges to the shop, at which point the corporation charged the insurance provider for the cost of the part and the amount it remitted to the shop.

The Department determined that the corporation should have been apportioning the income from the sales of the replacement only to Indiana, Florida, or Arizona, rather than to those three states and all other states to which the parts were shipped. The Department's reason was that it found that the corporation lacked agency relationships with the repair shops and lacked nexus with any states other than Indiana, Florida, and Arizona, and so would be exempt from taxation in those states under the protection of P.L. 86-272. Taxpayer states that the corporation had sufficient nexus in the other states to subject the income in question to taxation in those states. Taxpayer provided letters from the various states in question, in which those states' Departments of Revenue found that the corporation did have nexus and that Taxpayer should pay income tax on sales in those states. Also, Taxpayer explained that he did in fact pay income taxes to those states. Taxpayer argues that the income attributable to sales in those states should therefore be apportioned to those states, not to Indiana. The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

The adjusted gross income tax is imposed under IC § 6-3-2-2, which states in relevant parts:

(a) With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:

(1) income from real or tangible personal property located in this state;

(2) income from doing business in this state;

(3) income from a trade or profession conducted in this state;

(4) compensation for labor or services rendered within this state; and

(5) 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.

In the case of nonbusiness income described in subsection (g), only so much of such income as is allocated to this state under the provisions of subsections (h) through (k) shall be deemed to be derived from sources within Indiana. In the case of business income, only so much of such income as is apportioned to this state under the provision of subsection (b) shall be deemed to be derived from sources within the state of Indiana. In the case of compensation of a team member (as defined in section 2.7 of this chapter) only the portion of income determined to be Indiana income under section 2.7 of this chapter is considered derived from sources within Indiana. In the case of a corporation that is a life insurance company (as defined in Section 816(a) of the Internal Revenue Code) or an insurance company that is subject to tax under Section 831 of the Internal Revenue Code, only so much of the income as is apportioned to Indiana under subsection (r) is considered derived from sources within Indiana.

. . .

(e) 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.

. . .

(n) 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 states:

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 states:

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.*)

The Department determined that the corporation did not meet any of the categories listed in 45 IAC 3.1-1-38, including the determination that the corporation did not exceed the mere solicitation of orders in the states other than Indiana, Florida, and Arizona, and so did not have nexus in those states under P.L.86-272. Therefore, the Department determined that the corporation was not doing business in those states as explained by 45 IAC 3.1-1-38 and did not qualify as taxable in those states as provided by 45 IAC 3.1-1-64. Since the Department made the determination that the corporation was not doing business in those states, the Department then determined that the corporation's sales in those states were "throwback sales" and Taxpayer's income was therefore subject to Indiana adjusted gross income tax, as provided by 45 IAC 3.1-1-53(5).

Of relevance here is 15 U.S.C. § 381 (Public Law 86-272), which prohibits states from imposing a net income tax on a foreign taxpayer if the foreign taxpayer's only business activity within that state is the solicitation of sales. A state may not impose an income tax on income derived from business activities within that state unless those activities exceed the mere solicitation of sales. Taxpayer states that the corporation's activities in the other states did exceed the protection of P.L. 86-272, by virtue of the activities by the repair shops on its behalf.

The Department addressed this in the audit report, quoting a regulation which provided a definition for "agent." The Department determined that the definition precluded the actions of the repair centers from qualifying as the actions of an agent and so reduced the corporation's activities in the states at issue to the point at which they were shielded from income tax by P.L. 86-272. Upon review, the regulation quoted by the Department is actually a gross income tax regulation. The tax at issue is adjusted gross income tax. Therefore the Department's reliance on the gross income tax regulation is misplaced. There is no Indiana adjusted gross income tax regulation defining "agent."

Still, there is guidance available. In determining how the actions of an independent contractor affected nexus for an out-of-state business in Washington, in *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue*, 483 U.S. 232 (1987), the United States Supreme Court explained:

Tyler seeks a refund of wholesale taxes it paid on sales to customers in Washington for the period from January 1, 1976, through September 30, 1980. These products were manufactured outside of Washington. Tyler argues that its business does not have a sufficient nexus with the State of Washington to justify the collection of a gross receipts tax on its sales. Tyler sells a large volume of cast iron, pressure and plastic pipe and fittings, and drainage products in Washington, but all of those products are manufactured in other States. Tyler maintains no office, owns no property, and has no employees residing in the State of Washington. Its solicitation of business in Washington is directed by executives who maintain their offices out-of-state and by

an independent contractor located in Seattle.

*Id.* at 249.

The Court then explained:

As a matter of law, the Washington Supreme Court concluded that this showing of a sufficient nexus could not be defeated by the argument that the taxpayer's representative was properly characterized as an independent contractor instead of as an agent. We agree with this analysis. In *Scripto, Inc*. v. *Carson, 362 U.S. 207 (1960)*, Scripto, a Georgia corporation, had no office or regular employees in Florida, but it employed wholesalers or jobbers to solicit sales of its products in Florida. We held that Florida may require these solicitors to collect a use tax from Florida customers. Although the "salesmen" were not employees of Scripto, we determined that "such a fine distinction is without constitutional significance." *Id., at 211*. This conclusion is consistent with our more recent cases.

*Id*. at 250.

Finally, the Court explained:

As the Washington Supreme Court determined, "the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales." *105 Wash. 2d, at 323, 715 P. 2d, at 126*.The court found this standard was satisfied because Tyler's "sales representatives perform any local activities necessary for maintenance of Tyler Pipe's market and protection of its interests...." *Id., at 321, 715 P. 2d, at 125*. We agree that the activities of Tyler's sales representatives adequately support the State's jurisdiction to impose its wholesale tax on Tyler.

*Id.* at 250-1.

In *Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co.*, 505 U.S. 214 (1992), the taxpayer was arguing that it did not have sufficient contact with Wisconsin to constitute nexus. The United States Supreme Court explained:

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.

Therefore, read together, *Tyler Pipe* and *Wrigley* provide that an independent contractor's actions may be considered when determining nexus for a taxpayer which has no employees of its own in a state and that the contractor's actions are to be considered with all other activities by the taxpayer in determining whether or not those actions and activities are de minimis.

In the instant case, the corporation is dependent on the repair shops' activities to maintain sales in those states where it does not have repair shops. Under *Tyler Pipe*, this is a factor in favor of establishing nexus. The corporation had inventory in those states when it shipped the parts to the repair shops and the repair shops did not install the parts immediately, since the repair shops never took title to the parts. Taxpayer provided copies of letters from the Departments of Revenue for the various states at issue which explained that the respective Departments determined that the corporation had nexus with those states for income tax purposes. Taxpayer filed non-resident income tax returns with all of the states in question. Under *Wrigley*, all of these activities are to be considered in determining if a taxpayer has nexus in a state.

When reviewed and weighed together, the corporation did have nexus with the states at issue. The contacts were more than de minimis and therefore exceeded the protection of P.L.86-272. While the Department was correct in its position that merely filing income tax returns with a particular state does not in and of itself establish nexus, Taxpayer has provided sufficient documentation to show additional corporate contacts which collectively establish nexus with the states in question. Taxpayer has met the burden imposed by IC § 6-8.1-5-1(c).

**FINDING**

Taxpayer's protest is sustained.

**II. Tax Administration–Negligence Penalty.**

**DISCUSSION**

The Department issued proposed assessments and the ten percent negligence penalty for the tax year in question. Taxpayer protests the imposition of penalty. The Department refers to IC § 6-8.1-10-2.1(a), which states in relevant part:

If a person:

. . .

(3) incurs, upon examination by the department, a deficiency that is due to negligence;

. . .

the person is subject to a penalty.

The Department refers to 45 IAC 15-11-2(b), which states:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

45 IAC 15-11-2(c) provides in pertinent part:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

In this case, taxpayer incurred a deficiency which the Department determined was due to negligence under 45 IAC 15-11-2(b), and so was subject to a penalty under IC § 6-8.1-10-2.1(a). Taxpayer was sustained in Issue I above, and therefore has affirmatively established that it exercised ordinary business care, as required by 45 IAC 15-11-2(c).

**FINDING**

Taxpayer's protest is sustained.

**CONCLUSION**

Taxpayer is sustained on Issue I and the apportionment formula will be readjusted to include all of the states where the corporation had nexus. Taxpayer is sustained on Issue II and will not owe the negligence penalty.

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