DEPARTMENT OF STATE REVENUE

02-20070330.LOF

Letter of Findings Number: 07-0330
Income Tax
For Tax Years 2001-03

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ISSUE

I. Income Tax–Adjusted Gross Income Tax.

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; *Indiana Dept. of Revenue v. Kimberly-Clark Corp.*, 416 N.E.2d 1264 (Ind. 1981); IC § 6-3-2-2; IC § 6-3-4-14; IC § 6-8.1-5-1; 45 IAC 3.1-1-38; 45 IAC 3.1-1-64; *Black's Law Dictionary* (6th ed. 1991).

Taxpayer protests various adjustments to its adjusted gross income tax.

STATEMENT OF FACTS

Taxpayer is a corporation in the medical supply industry headquartered in another state and domiciled in Indiana. Taxpayer files a consolidated adjusted gross income tax return which includes several related companies. As the result of an audit, the Indiana Department of Revenue ("Department") issued proposed assessments for additional adjusted gross income tax and interest. 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–Adjusted Gross Income Tax.

DISCUSSION

Taxpayer protests several adjustments made by the Department in its audit report. The first adjustment protested is the Department's decision to add two related companies to the consolidated group which filed consolidated Indiana adjusted gross income tax returns for the tax years 2001, 2002, and 2003. The second adjustment protested is the Department's decision to throwback sales to foreign corporations to the income subject to Indiana adjusted gross income tax. The third adjustment protested is the Department's decision to disallow royalty expenses paid by a member of the consolidated group to another related corporation. 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).

1. Consolidated Return.

Taxpayer's first point of protest is the addition of two corporations to the consolidated return. The Department reviewed the status of these two corporations and determined that both had sufficient contact with Indiana to subject them to Indiana adjusted gross income tax. Taxpayer states that neither company is subject to Indiana adjusted gross income tax due to the protection of P.L.86-272, and therefore should not be included in the consolidated return.

The relevant statute for consolidated returns is IC § 6-3-4-14, which states:

(a) An affiliated group of corporations shall have the privilege of making a consolidated return with respect to the taxes imposed by IC 6-3. The making of a consolidated return shall be upon the condition that all corporations which at any time during the taxable year have been members of the affiliated group consent to all of the provisions of this section including all provisions of the consolidated return regulations prescribed pursuant to Section 1502 of the Internal Revenue Code and incorporated herein by reference and all regulations promulgated by the department implementing this section prior to the last day prescribed by law for the filing of such return. The making of a consolidated return shall be considered as such consent. In the case of a corporation which is a member of the affiliated group for a fractional part of the year, the consolidated return shall include the income of such corporation for such part of the year as it is a member of the affiliated group.

(b) *For the purposes of this section the term "affiliated group" shall mean an "affiliated group" as defined in Section 1504 of the Internal Revenue Code with the exception that the affiliated group shall not include any corporation which does not have adjusted gross income derived from sources within the state of Indiana.*

(c) For purposes of IC 6-3-1-3.5(b), the determination of "taxable income," as defined in Section 63 of the Internal Revenue Code, of any affiliated group of corporations making a consolidated return and of each corporation in the group, both during and after the period of affiliation, shall be determined pursuant to the regulations prescribed under Section 1502 of the Internal Revenue Code.

(d) Any credit against the taxes imposed by IC 6-3 which is available to any corporation which is a member of an affiliated group of corporations making a consolidated return shall be applied against the tax liability of the affiliated group.

(*Emphasis added*.)

The Department determined that the two companies it added to the consolidated return had adjusted gross income attributable to Indiana for the years in question. Therefore, as explained by IC § 6-3-4-14(b), those two companies are eligible for inclusion in the affiliated group filing a consolidated return.

Taxpayer protests that the two companies should not be included in the consolidated return, and that they did not have adjusted gross income attributable to sources within the State of Indiana due to lack of nexus. The adjusted gross income tax is imposed under IC § 6-3-2-2, which states in relevant part:

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.

. . ..

(*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.*)

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.

The Indiana Supreme Court explained in *Indiana Dept. of Revenue v. Kimberly-Clark Corp.*, 416 N.E.2d 1264 (Ind. 1981):

Public Law 86-272 (*15 U.S.C.A. § 381*), in pertinent part is as follows:

(a) 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).

Id., at 1265.

The Court then explained:

> We also believe that Congress perceived "solicitation" as embodying "sundry activities so long as those activities [are] closely related to the eventual sale of a product." Finally, when a corporate representative performs an "act of courtesy" in order to accommodate a customer, he has not ventured beyond the realm of "solicitation."
> *Id.*, at 1268.

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 argued that it did not have sufficient non-solicitation contact with Wisconsin to constitute nexus. The United States Supreme Court explained:

> 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. *National Tires, Inc. v. Lindley, 68 Ohio App. 2d 71, 78-79 426 N.E.2d 793, 798 (1980)* (company's activities went beyond solicitation to "functions more commonly related to maintaining an on-going business"). 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. See, *e. g., Herff Jones Co. v. State Tax Comm'n, 247 Ore. 404, 412, 430 P.2d 998, 1001-1002 (1967)* (no § 381 immunity for sales representatives' collection activities).
> *Id.,* at 228-30.
> 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." App. 71, 72. 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.
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> *Id.*, at 234-5.

Therefore, read together, *Tyler Pipe* and *Wrigley* provide that a third party's actions may be considered when determining nexus for a taxpayer which has no employees of its own in a state and that the third party'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. *Kimberly-Clark* and *Wrigley* both explain that sales staff may engage in certain activities which may not be the strict solicitation of sales, but which aid in the solicitation of sales, and still enjoy the protection of P.L.86-272.

In the instant case, two companies were added to the consolidated return. The two companies will be referred to as "Related 1" and "Related 2." Related 1 had sales staff in Indiana for the years 2001, 2002, and 2003. The sales staff would occasionally pick up out-dated equipment or equipment which had malfunctioned, help with paperwork to return damaged goods, provide on-site technical assistance, conduct in-state training seminars, and supervise the installation or usage of products. Related 1 also owned property in Indiana in the form of molds and dies which it provided to unrelated manufacturers who in turn used the molds and dies to produce containers for Related 1's products.

Taxpayer has provided sufficient documentation to establish that Related 1's sales staff's activities were all performed as acts of courtesy and therefore still enjoy the protection of P.L.86-272, as provided in *Kimberly-Clark*. The molds and dies used by third-party contractors do not contribute to Related 1's ability to maintain a market in Indiana and therefore do not establish nexus, as provided in *Tyler Pipe*. Also, IC § 6-3-2-2(a)(1) establishes that income considered to be derived from Indiana sources includes income from real or tangible property located in Indiana. Here, the tangible property does not produce income. There is no evidence or assertion that Related 1 sold the items produced with the molds and dies. Rather, it shipped the property produced in Indiana to out-of-state locations where it then used the items as packaging to ship its products. When reviewed as a whole as provided by *Wrigley*, Related 1's activities do not establish nexus in Indiana.

Related 2 had sales staff in Indiana in 2001, 2002, and 2003, and also had inventory at several Indiana hospitals during the tax period. The hospitals purchased and removed the goods from the inventory on an as-needed basis. Taxpayer states that the hospitals maintained the inventory on a consignment basis and that Related 2 did not perform any activities in Indiana regarding the inventory. 45 IAC 3.1-1-38(2) explains that a taxpayer is doing business in a state if it maintains an inventory of consigned goods in that state. *Black's Law Dictionary*, page 953, (6th ed. 1991) defines "maintain" in relevant part as follows:

> The term is variously defined as acts of repairs and other acts to prevent a decline, lapse or cessation from existing state or condition; bear the expense of; carry on; commence; continue; furnish means for subsistence or existence of; hold; hold on or keep in an existing state or condition; keep from change; keep from falling, declining, or ceasing; keep in existence or continuance; keep in force; keep in good order; keep in proper condition; keep in repair; keep up; preserve; preserve from lapse, decline, failure, or cessation; provide for; rebuild; repair; replace; supply with means of support; supply with what is needed; support; sustain; uphold. Negatively stated, it is defined as not to lose or surrender; not to suffer or fail or decline.
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> *Id.* at 953.

While the hospitals may have "maintained" Taxpayer's inventory as described by a few of the sub-definitions listed, Taxpayer clearly did maintain an inventory in Indiana since it had property located in Indiana for later distribution, and did not lose or surrender the inventory. Also, as previously explained, *Tyler Pipe* provides that if the actions on behalf of a taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in a state for sales of its goods, those activities are adequate to establish nexus in that state. Therefore, even if Related 2's customers performed maintenance in the sense of keeping the goods in a safe and secure place until purchased and removed from inventory, those activities on Related 2's behalf contributed to Related 2's ability to establish and maintain a market in Indiana for the sale of its goods. Under *Tyler Pipe*, and read together with *Wrigley*, Related 2's activities as a whole establish nexus in Indiana.

2. Throwback Sales.

Taxpayer protests the Department's decision to subject sales to foreign countries to Indiana adjusted gross income under the throwback rule. The Department considered that Taxpayer did not have nexus in the foreign countries since the documentation provided by Taxpayer did not establish that Taxpayer stored the goods in the foreign country prior to its destination. The relevant regulation is 45 IAC 3.1-1-64, which 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.
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> Example:
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> 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].
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> (*Emphasis added*.)

The documentation supplied as part of this protest establishes that Taxpayer retains title to the goods until delivered to its customers in various foreign nations. Delivery occurred after entry into the country. Since Taxpayer has goods in those countries, Taxpayer has inventory in those countries. There is no requirement of a specific amount of time for inventory to be stored in a particular state or nation in order to establish nexus. Under 45 IAC 3.1-1-38(2) and 45 IAC 3.1-1-38(5), Taxpayer was doing business in and had nexus in those foreign nations. The income from these sales is not subject to throwback under 45 IAC 3.1-1-64.

3. Royalty Expenses.

Taxpayer protests the Department's decision to disallow royalty payments from one company on the consolidated return (Related 3) to another related company (Related 4). The royalty payments were from Related 3 for the use of a brand name/trademark which was held by Related 4. Related 4 in turn paid dividends to the Related 3. The Department noted that Related 4 did nothing to maintain the value of the trademarks, tradenames, patents, etc., and that Related 3 paid the costs of marketing and maintaining the intellectual property. As explained in the audit report, the Department considered this to be a circular flow of money without any real economic substance. The Department also noted that the effect of this was to shift income from unitary to non-unitary states, where Related 3's income is substantially under-reported. The Department based its decision to disallow the royalty payments on IC § 6-3-2-2(*l*), which states:

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
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> (1) separate accounting;
>
> (2) for a taxable year beginning before January 1, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;
>
> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
>
> (4) *the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income*.
>
> (*Emphasis added*.)

The Department determined that the royalty payment and dividend arrangement did not fairly represent income derived from sources within the state of Indiana under standard allocation and apportionment provisions and therefore employed another method to effectuate an equitable allocation and apportionment of income. That alternative method was to add the royalty payments from Related 3 back to the income subject to Indiana adjusted gross income tax.

Taxpayer states that there was legitimate business purpose to the transactions. Taxpayer explained that Related 4 does undertake actions related to the preservation and protection of the trademark. While both corporations are owned by the same ultimate parent, the direct senior management of Related 3 and Related 4 do not overlap. Taxpayer provided documentation supporting its position that all of the steps undertaken to reach the royalty and dividend arrangement were done with legitimate business purposes and at rates as determined by an unrelated third party. Taxpayer also provided documentation supporting its position that Related 4 paid federal income taxes and state income taxes in the state where it is located.

When reviewed as a whole, Related 3's royalty payments were in regards to legitimate business purposes. However, Related 4's only asset was the trademark for which it charged royalties. Since Related 4 returned significant sums to Related 3 in the form of dividends, it is clear that the royalty fees were higher than protection of the trademark required. The Department's original intention to fairly reflect Indiana-sourced income for Related 3 was correct, but the decision to add back all royalty payments was over-reaching. The correct application of IC § 6-3-2-2(*l*) is to subtract the dividends paid by Related 4 to Related 3 from the royalty payments paid by Related 3 to Related 4. The remaining amounts of royalties are fairly excluded from Related 3's Indiana-sourced income as legitimate business expenses.

In conclusion, Related 1 does not have nexus with Indiana and will not be included on the consolidated return. Related 2 does have nexus with Indiana and will be included on the consolidated return. The foreign nations in question do have jurisdiction to impose tax, and so those sales will not be thrown back to Indiana. Related 3's royalty payments will be allowed, but the dividends from Related 4 to Related 3 will be added back.

FINDING

Taxpayer's protest is sustained regarding one related corporation's inclusion on the consolidated return, throwback sales, and the royalty payments from the licensee to the licensor minus the amount of dividends paid by the licensor to the licensee. Taxpayer's protest is denied regarding the second corporation's inclusion on the consolidated return and the amount of dividend payments from the licensor to the licensee.

Posted: 10/01/2008 by Legislative Services Agency
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