DEPARTMENT OF STATE REVENUE

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Letter of Findings: 08-0637
Corporate Income Tax
For the Years 2004 and 2005

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ISSUES

I. Corporate Adjusted Gross Income Tax – Imposition – Throw-back Sales.

Authority: 15 U.S.C. § 381; IC § 6-3-2-1; IC § 6-3-2-2; IC § 6-8.1-5-1; Indiana Dep't. of State Revenue v. Continental Steel Corp., 399 N.E.2d 754 (Ind. Ct. App. 1980); Indiana Dep't of State Revenue v. Kimberly-Clark Corp., 416 N.E.2d 1264 (Ind. 1981); Wisconsin Dep't. of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); 45 IAC 3.1-1-64.

Taxpayer protests the application of throw-back sales, resulting in an increase of Taxpayer's corporate adjusted gross 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 the ten percent negligence penalty.

STATEMENT OF FACTS

Taxpayer is an Indiana corporation that designs and manufactures image transfer rollers to be incorporated into its customers' products such as, but not limited to, printers, copiers, cash dispensers, and mail handling equipment. Taxpayer's affiliate initially operated a facility in Mexico, but this facility ceased operation in May 2004. During 2004 and 2005, Taxpayer also contracted with manufacturers in Mexico and China to manufacture its products. To ensure its products' quality, Taxpayer regularly sends its employees to Mexico and China to coordinate with its vendor-manufacturers and to facilitate production.

In 2008, pursuant to an audit, the Department of Revenue ("Department") determined that Taxpayer had no nexus within Mexico for 2005 nor with China for 2004 and 2005. As a result, Taxpayer's sales made to Mexico and China were thrown back to Indiana, resulting in a change of the sales factor and an increase of Taxpayer's corporate adjusted gross income tax. Additionally, Taxpayer also manufactured some of its products in Indiana. The Department also concluded that Taxpayer's finished products, shipped from Indiana and delivered to Mexico, constituted sales in Indiana. Taxpayer protested the assessment of income tax on the throw-back sales. A hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Corporate Adjusted Gross Income Tax – Imposition – Throw-back Sales.

DISCUSSION

After an audit, the Department made several adjustments to Taxpayer's sales factor by applying the throw-back rule. The Department also determined that Taxpayer's finished products, shipped from Indiana and delivered to Mexico, constituted sales in Indiana. This resulted in an increase in Taxpayer's corporate adjusted gross income tax. Taxpayer, on the other hand, argued that the throw-back rule was not applicable. Taxpayer also claimed that its customer arranged a common carrier to pick up and deliver the finished products from Indiana to Mexico, and, therefore, those sales were not in Indiana under the "destination rule."

Indiana imposes a tax on each corporation's adjusted gross income attributable to "sources within Indiana." IC § 6-3-2-1(b). Where a corporation receives income from both Indiana and out-of-state sources, the amount of tax is determined by a three-factor apportionment established by IC § 6-3-2-2(b). That formula operates by multiplying taxpayer's total business income by a fraction composed of a property factor, a payroll factor, and a sales factor.

The "sales factor" consists of a fraction, "the numerator of which is the total sales of the taxpayer in [Indiana] during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year." IC § 6-3-2-2(e).

All tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

A. Nexus in China for Tax Year 2004 and 2005 and Nexus in Mexico for Tax Year 2005

The Department determined that Taxpayer did not have nexus in China for 2004 and 2005 nor in Mexico for 2005. The Department agreed that Taxpayer had nexus in Mexico in 2004 to the extent that Taxpayer's affiliate operated a manufacturing facility in Mexico. Nexus ended when the affiliate's facility ceased its operation. The Department concluded that since Taxpayer did not have nexus with those foreign jurisdictions, Taxpayer was not subject to taxes in the jurisdictions and, therefore, pursuant to Public Law 86-272 (codified at 15 U.S.C. § 381), Indiana statutes, and case law, all Taxpayer's sales made to its customers within those countries were thrown back to Indiana regarding numerator of sales factor in calculation of Taxpayer's corporate income tax.

Taxpayer argued that it had nexus in both countries for both tax year 2004 and 2005. In addition to operating a manufacturing facility in Mexico, Taxpayer claimed that its employees regularly traveled to those countries to coordinate with its customers and its vendor-manufacturers on development of products and to facilitate production. Taxpayer argued that those activities were nonsolicitous and not de minimis, rendering Taxpayer taxable in those foreign jurisdictions according to 15 U.S.C. § 381, Indiana statutes, and case law. Taxpayer further claimed that, while subject to taxation in those jurisdictions, it was also qualified for exemptions pursuant to international trade agreements and, therefore, need not pay tax in those countries.

IC § 6-3-2-2 (n), in part, states "[f]or purposes of allocation and apportionment of income under this article, a taxpayer is taxable in another state if:... (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 3.1-1-64 explains:

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) [45 IAC 3.1-1-53].

15 U.S.C. § 381 (a) establishes minimum standards for a state to impose tax and states:

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

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

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

15 U.S.C. § 381 (c) further provides:

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

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

In Indiana Dep't. of State Revenue v. Continental Steel Corp., 399 N.E.2d 754 (Ind. Ct. App. 1980), the court reviewed whether a taxpayer's activities exceed "solicitation." The taxpayer in Continental Steel was an Indiana corporation manufacturing wire, fencing, nails, and other steel products which were sold in the United States, Canada, and Virgin Islands. The Continental Steel court illustrated that, "solicitation should be limited to those generally accepted or customary acts in the industry which lead to the placing of orders, not those which follow as a natural result of the transaction, such as collections, servicing complaints, technical assistance[,] and training." Id. at 759. Examples of activity which exceeded "solicitation" include "giving spot credit, accepting orders, collecting delinquent accounts and picking up returned goods within the taxing state, collecting deposits and advances on orders within the taxing state, pooling and exchanging technical personnel in a complex mutual endeavor, maintaining personal property [,] and associated local business for purposes not related to soliciting orders within the taxing state." Id. The Continental Steel court held that the taxpayer's activities, including salesmen making adjustments on complaints and giving customers technical assistance, within the foreign state exceeded solicitation because taxpayer's activities did "not lead to the placing of orders but follow[ed] as a natural result of the transaction." Id.

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

The U.S. Supreme Court refined the "mere solicitation" standard in Wisconsin Dep't. of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992). The Court stated:

> We proceed, therefore, to describe what we think the proper standard to be. Once it is acknowledged, as we have concluded it must be, that "solicitation of orders" covers more than what is strictly essential to making requests for purchases, the next (and perhaps the only other) clear line is the one between those activities that are entirely ancillary to requests for purchases–those that serve no independent business function apart from their connection to the soliciting of orders–and those activities that the company would have reason to engage in anyway but chooses to allocate to its in-state sales force.... Providing a car and a stock of free samples to salesmen is part of the "solicitation of orders," because the only reason to do it is to facilitate requests for purchases. Contrariwise, employing salesmen to repair or service the company's products is not part of the "solicitation of orders," since there is good reason to get that done whether or not the company has a sales force. Repair and servicing may help to increase purchases; but it is not ancillary to requesting purchases, and cannot be converted into "solicitation" by merely being assigned to salesmen.

Id. at 228-29. The Court held that whether a taxpayer's in-state activity was sufficiently de minimis to avoid the loss of taxpayer immunity, conferred by 15 U.S.C. § 381, depended on whether the activity establishes a "non-trivial additional connection with the taxing State." Id. The Court determined that the taxpayer's sales representatives' activity, consisting of replacing stale gum at retail locations, was activity outside 15 U.S.C. § 381 immunity. Id. The Court held although the representatives' activity could be said to facilitate the sales, it did not facilitate the requesting of sales and was not ancillary to the solicitation of sales. Because taxpayer's practice of having its salesmen rotate stocks of stale gum was an activity outside the solicitation of sales, taxpayer brought itself outside the scope of 15 U.S.C. § 381.

In the present case, Taxpayer claimed that its employees, including but not limited to, managing director, quality manager, operations manager, customer service representative, process engineer, shift supervisor, and accountant, regularly traveled to Mexico and China in 2004 and 2005. Taxpayer demonstrated that its employees made several trips to both countries and spent several days during each trip in those countries. While there, Taxpayer's upper echelon employees administered logistics regarding company affairs in those countries. Additionally, Taxpayer's employees performed training at its vendor-manufacturer's facilities to ensure product quality during the manufacturing process. Taxpayer's employees also worked with its customers to resolve the complaints. Those activities were not ancillary to requesting purchases, and, therefore, were nonsolicitous. Moreover, the frequency and content of its employees' travel showed that Taxpayer's activities in China and Mexico were regular and systemic, and, therefore, were not de minimis. Thus, for both 2004 and 2005 tax year, Taxpayer established nexus in both China and Mexico, and was subject to taxes in both countries.

B. Goods Shipped From Taxpayer's Indiana Location to Mexico by Customer-Arranged Common Carrier.

According to Taxpayer, there were two different types of shipments from Indiana to Mexico, raw materials and finished products. Taxpayer stated that, prior to its affiliate ceasing its operation, Taxpayer sent raw materials to its affiliate's manufacturing facility in Mexico. Taxpayer's affiliate then manufactured products to meet its customer's specifications and delivered the products to its customer in Mexico. The Department agreed that sales fell into this category were sales in Mexico. Meanwhile, Taxpayer also manufactured in Indiana. Those products manufactured in Indiana were then shipped or delivered to the customer's facility in Mexico via common carrier. The Department determined that those sales originated in Indiana.

Taxpayer argued that its customer arranged shipment, F.O.B. origin, via common carrier, from Indiana to Mexico. Taxpayer's customer paid for and was responsible for the shipment. Although the goods were required to be unloaded from one set of trucks and reloaded on another truck in El Paso, Texas before they could be shipped to the customer's facility in Mexico, those sales were not sales in Indiana.

Indiana adopts the "destination rule." IC § 6-3-2-2 (e), in pertinent part, provides, "[r]egardless 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... (B) the taxpayer is not taxable in the state of the purchaser."

Here, Taxpayer claimed that its finished products were shipped and delivered by customer-arranged common carrier. Taxpayer's documentation showed that it was its customer who arranged with a common carrier to pick up the goods from Indiana. Taxpayer's documentation also showed that the term of the shipment was "third party billing" and its customer was billed by the common carrier. Further, Taxpayer's documentation showed that without international trade agreement, those goods would have been shipped directly from Indiana to Mexico. Since Taxpayer's customer's factory was in Mexico, the sales of finished products were taxable in Mexico and, therefore, cannot be thrown back to Indiana.

FINDING

Taxpayer's protest in Subpart A and B are sustained.

II. Tax Administration – Negligence Penalty.

DISCUSSION

Taxpayer also protests the assessment of the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1, the Department may assess a ten (10) percent negligence penalty if the taxpayer:

(1) fails to file a tax return;

(2) fails to pay the full amount of tax shown on the tax return;

(3) fails to remit in a timely manner the tax held in trust for Indiana (e.g., a sales tax); or

(4) fails to pay a tax deficiency determined by the Department to be owed by a taxpayer.

45 IAC 15-11-2(b) further 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.

The Department may waive a negligence penalty as provided in 45 IAC 15-11-2(c), in part, as follows:

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. Factors which may be considered in determining reasonable cause include, but are not limited to:

(1) the nature of the tax involved;

(2) judicial precedents set by Indiana courts;

(3) judicial precedents established in jurisdictions outside Indiana;

(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;

(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Here, Taxpayer provided sufficient documentation to establish that its failure to 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.

FINDING

Taxpayer's protest on the imposition of negligence penalty is sustained.

SUMMARY

For the reasons discussed above, Taxpayer's protest on adjustments of sales factor is sustained. Taxpayer's protest on imposition of negligence penalty is sustained.

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