DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 09-0577
Corporate Income Tax
For the Tax Years 2004-2006

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ISSUES

I. Adjusted Gross Income Tax–Nexus.

Authority: IC § 6-3-2-2; IC § 6-8.1-5-1; 45 IAC 3.1-1-38; 15 U.S.C. § 381; Wisconsin Dep't. of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992); Indiana Dep't of Revenue v. Kimberly-Clark Corp., 416 N.E.2d 1264 (Ind. 1981).

Taxpayer maintains that its parent corporation lacked taxable nexus in Indiana.

II. Adjusted Gross Income Tax–Unitary Filing.

Authority: IC § 6-3-2-2; IC § 6-8.1-5-1; 45 IAC 3.1-1-62; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Allied-Signal Corp. v. Director, Division of Taxation, 504 U.S. 768 (1992).

Taxpayer maintains that the Department of Revenue erred when it recomputed Taxpayer's adjusted gross income to include its subsidiaries on a unitary combined-filing basis.

STATEMENT OF FACTS

Taxpayer is the parent corporation of a group of subsidiary corporations. Taxpayer is a corporation doing business in Indiana and several other states. Taxpayer filed Indiana corporate income tax returns for 2004 to 2006 tax years. As a result of the audit, the Indiana Department of Revenue ("Department") issued proposed assessments for additional adjusted gross income tax, interest, and negligence penalties for the 2004, 2005, and 2006 tax years. The Department determined that Taxpayer's adjusted gross income should be calculated using a unitary combined-filing basis. Taxpayer protested the assessments. An administrative hearing was held, and this Letter of Findings results. Further facts will be supplied as necessary.

I. Adjusted Gross Income Tax–Nexus.

Taxpayer protests the imposition of adjusted gross income tax for the 2004, 2005, and 2006 tax years. Taxpayer asserts that it did not have nexus with Indiana for these years. Taxpayer maintains that it should not have filed Indiana adjusted gross income tax returns for these years because its business activities were protected by 15 U.S.C. § 381 ("Public Law 86-272"). Taxpayer argues that since it does not have nexus with Indiana, the Department's assessment of additional tax on Taxpayer is not valid. 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 provides 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.

. . ..

Further, 45 IAC 3.1-1-38 states:

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.)

Public Law 86-272 (15 U.S.C.A. § 381) 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.

The Indiana Supreme Court explained in Indiana Dep't. 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.

The United States Supreme Court explained its standard for determining "solicitation of sales" in Wisconsin Dep't. of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992). In Wrigley, the 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.

Id. at 234-5.

Therefore, the Department will consider a taxpayer's Indiana activities as a whole to determine if the activities as a whole exceed the protection of Public Law 86-272.

Taxpayer maintains that it did not have taxable nexus in Indiana until 2008 when it opened retail stores in Indiana. During the years at issue, Taxpayer asserts that it had two employees in Indiana that were employed as sales representatives. The sales representatives were Indiana residents and worked from their homes to solicit orders in Indiana. Taxpayer claims that all sales solicited by the sales representatives were approved in the California sales office. Taxpayer also claims that the sales representatives were neither provided with company vehicles nor were they reimbursed for vehicle expenses. Taxpayer further claims that the sales representatives were not authorized to restock customer inventories, to handle merchandise returns, to issue store credits, or to send merchandise to alternative customer locations.

During the course of the hearing, Taxpayer was asked to provide sales contracts, training manuals, employee vacancy announcements, and/or any other documents that would help to demonstrate these facts. Pursuant to this request, Taxpayer submitted an affidavit from a senior manager of its sales division to demonstrate these facts. However, Taxpayer failed to provide any documentation to support its original assertions or the assertions made in the affidavit. While an affidavit can be a helpful tool to explain other documentation, an affidavit alone is rather self-serving and is insufficient to rebut the presumption of the Department's assessment.

Nonetheless, even taking Taxpayer's assertions at face value, Taxpayer has failed to discuss all of its Indiana activities. For example, Taxpayer has not discussed the role of its "visual merchandising representatives" that come into Indiana. Taxpayer's SEC 10-K annual report filing for the period ending December 31, 2004, on page 9, states as follows:

> Our [visual merchandising] coordinators communicate with and visit our wholesale customers on a regular basis to aid in proper visual display of our merchandise. They distribute point-of-purchase items such as signage, graphic, displays, counter cards, banners and other merchandising items.... The VMC's [visual merchandising coordinators] also run in store promotions to enhance the sale of [Taxpayer's product]....
>
> Our merchandise personnel also work closely with our wholesale customers to ensure the optimal exposure of our products. We have concept stores... which are exclusive selling areas with stores that offer our products and incorporate [Taxpayer's] signage and customize fixture designs.

Taxpayer's SEC 10-K annual report filing for the period ending December 31, 2005, on pages 8 and 9, also states as follows:

> Our visual merchandising coordinators ("VMC's") work with our sales force and directly with our customers to ensure better sell-through at the retail level by generating greater consumer awareness through [Taxpayer's] brand displays. Our VMC's communicate with and visit our wholesale customers on a regular basis to aid in proper display of our merchandise. They also run in-store promotions to enhance the sale of [Taxpayer's products] and create excitement surrounding [Taxpayer's] brand....
>
> ...
>
> Our visual merchandise coordinators work with our wholesale accounts to ensure that our merchandise and point-of-purchase marketing materials are properly presented. Sales executive and merchandise personnel work closely with accounts to ensure that appropriate inventory levels are carried at each store.

Taxpayer's SEC 10-K annual report filing for the period ending December 31, 2006, on pages 12-13 also states as follows:

> Our visual merchandising coordinators ("VMC's") work with our sales force and directly with our customers to ensure better sell-through at the retail level.... Our VMC's communicate with and visit our wholesale customers on a regular basis to aid in proper display of our merchandise. They also run in-store promotions to enhance the sale of [Taxpayer's products]....

Taxpayer further explains in its SEC 10-K annual report filing for the period ending December 31, 2006, on page 14 as follows:

> Our visual merchandise coordinators work with our wholesale accounts to ensure that our merchandise and point-of-purchase marketing materials are properly presented. Sales executives and merchandise personnel work closely with accounts to ensure that appropriate styles are purchased for specific accounts and for specific stores within those accounts as well as to ensure that appropriate inventory levels are carried at each store. Such information is then utilized to help develop sales projections and determine the product needs of our wholesale accounts.

In the instant case, even if Taxpayer's affidavit is taken face value, when Taxpayer's activities are reviewed as a whole its activities exceed the mere solicitation of sales. Taxpayer sends visual merchandising coordinators into Indiana that set up the stores' signage and point-of-purchase displays, coordinate the store's inventory levels, and run in-store promotions. In addition, Taxpayer's 10-K reports state that the sales representatives work with the visual merchandising coordinators to ensure that appropriate inventory levels are maintained at each of the store. Taxpayer's activities in Indiana exceed the protection of Public Law 86-272, as provided by the Supreme Court in Wrigley. Therefore, Taxpayer has taxable nexus with Indiana and is subject to adjusted gross income tax in Indiana.

FINDING

Taxpayer's protest is respectfully denied.

II. Adjusted Gross Income Tax–Unitary Filing.

DISCUSSION

Pursuant to IC § 6-8.1-5-1(c), all tax assessments are presumed accurate, and the taxpayer bears the burden of proving that an assessment is incorrect. Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Taxpayer asserts that the Department has wrongfully calculated Taxpayer's adjusted gross income under the unitary combined-filing method. Taxpayer maintains that it does not function as a unitary business with its subsidiaries. Taxpayer further maintains that the Department's audit report did not make the required finding that Taxpayer and its subsidiaries operate in a unitary business.

IC § 6-3-2-2, provides, in relevant parts:

> ...
> (l) 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:
> (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.
> (m) In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.
> ...
> (p) Notwithstanding subsections (l) and (m), the department may not require that income, deductions, and credits attributable to a taxpayer and another entity not described in subsection (o)(1) or (o)(2) be reported in a combined income tax return for any taxable year, unless the department is unable to fairly reflect the taxpayer's adjusted gross income for the taxable year through use of other powers granted to the department by subsections (l) and (m).
> ....

In addition, 45 IAC 3.1-1-62, states:

> All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) [45 IAC 3.1-1-37–45 IAC 3.1-1-61] unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income. However, the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states. It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results.

Accordingly, when a taxpayer's method of filing individual Indiana adjusted gross income tax returns for related corporations distorts the taxpayer's Indiana source income, the Department may require that the related entities file a combined return. The purpose of the combined return would be to fairly reflect the taxpayer's and related entities' actual Indiana income and expenses. In order to do so, the Department must find the entities form a unitary group. The second step is that the Department must make a finding that the taxpayer's own method of filing the adjusted gross income tax distorts the taxpayer's Indiana income and/or expenses. Lastly, the Department must be unable to fairly reflect Indiana income using other methods before requiring the combined-filing method.

Taxpayer maintains that it does not function as a unitary business with its subsidiaries. Taxpayer further maintains that the Department's audit report did not make the required finding that Taxpayer and its subsidiaries operate in a unitary business. See Allied-Signal Corp. v. Director, Division of Taxation, 504 U.S. 768, 781 (1992) (citing F.W. Woolworth Co. v. Taxation and Revenue Dep't. of New Mexico, 458 U.S. 354, 364 (1982) (explaining that one must look at the (1) functional integration; (2) centralization of management; and (3) economies of scale of the entities to determine whether the taxpayer and subsidiary comprise a unitary business).

Taxpayer argues that since the Department's audit report failed to make the conclusive statement that Taxpayer was in a unitary relationship with its subsidiaries precludes the Department from calculating Taxpayer's adjusted gross income under the unitary combined-filing method. However, the Department could demonstrate a unitary relationship by illustrating the factual basis that establishes the unitary relationship. Nevertheless, upon review of the Department's audit report and the information provided, the Department did not established a factual basis that illustrated a unitary relationship between Taxpayer and its subsidiaries. Therefore, in this instance, Taxpayer has provided sufficient information to meet its burden of proof under IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is sustained.

CONCLUSION

Taxpayer's protest is denied as to the imposition of tax on the parent corporation, as discussed in Issue I. Taxpayer's protest is sustained as to the imposition of tax based upon the combined return filing method, as discussed in Issue II.

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