DEPARTMENT OF STATE REVENUE

02-20100620.LOF

Letter of Findings: 02-20100620
Indiana Corporate Income Tax
For the Years 2004, 2005, 2006, and 2007

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ISSUES

I. Merchandise Shipped from Taxpayer's Out-of-State Location by Customer-Arranged Common Carrier – Corporate Income Tax.

Authority: IC § 6-3-2-1(b); IC § 6-3-2-2(b); IC § 6-3-2-1(e); IC § 6-3-2-1(e)(1); Miller Brewing Co. v. Ind. Dept. of State Revenue, 836 N.E.2d 498 (Ind. Tax Court 2005); Miller Brewing Co. v. Ind. Dept. of State Revenue, 831 N.E.2d 859 (Ind. Tax Ct. 2005); 45 IAC 3.1-1-53; 45 IAC 3.1-1-53(7); Letter of Findings 02-20010358 (June 12, 2006); Olympia Brewing Co. v. Comm'r of Revenue, 326 N.W.2d 642 (Minn. 1982); 2005 Multistate Corporate Tax Guide, "Corporate Income Tax" note 6, at I-632 to I-635; Jerome R. Hellerstein and Walter Hellerstein, State and Local Taxation: Cases and Materials 629 n.17 (7th ed. West Group 2001).

Taxpayer argues that the Department incorrectly denied Taxpayer a refund of income tax based on the Department's argument that all Indiana destination sales should be included in the numerator of the sales factor.

II. Expense Allocation – Corporate Income Tax.

Authority: IC § 6-3-2-2; IC § 6-3-2-2(l); IC § 6-3-1-3.5(b); IC § 6-8.1-5-1(c); 45 IAC 3.1-1-8.

Taxpayer maintains that the Department does not have the authority to reallocate expenses between members of its Corporate Group and that the decision requiring Taxpayer to do so was unjustified.

III. Indiana Nexus – Corporate Income Tax.

Authority: IC § 6-3-2-1; IC § 6-3-2-2(a); 15 U.S.C.S. § 381; 15 U.S.C.S. § 381(a), (c); 45 IAC 3.1-1-38; Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992).

Taxpayer maintains that the proposed assessment of corporate income tax violated Public Law 86-272 on the ground that Taxpayer does not have nexus with Indiana.

IV. Ten-Percent Negligence Penalty – Corporate Income Tax.

Authority: IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1(a)(3); IC § 6-8.1-10-2.1(a)(4); IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer states that the imposition of the ten-percent negligence penalty is unjustified because any purported income tax deficiency was "due to reasonable cause and not willful neglect."

STATEMENT OF FACTS

Taxpayer's parent company (Parent) is in the business of designing and marketing clothing and clothing accessories. The clothing and accessories are manufactured by third-party independent contractors most of which are located outside the United States.

Although Parent filed Indiana income taxes until 2003, Taxpayer has been the Indiana filer since Taxpayer became "active" in 2004. In effect, Taxpayer replaced Parent as an Indiana taxpayer.

Parent resells all of the clothing and accessories it acquires to Taxpayer. After Taxpayer pays for the clothing and accessories, Taxpayer ships the clothing and accessories to distribution centers located in Kentucky and Oregon. Taxpayer then markets and resells the clothing and accessories to third-party retailers including retailers in Indiana.

Taxpayer's retailers direct Taxpayer to ship the clothing and accessories to their retail locations. The clothing and accessories are shipped by means of common carrier. Title to the merchandise passes from Taxpayer to customers at the time the merchandise is loaded onto the customer-arranged common carrier.

Taxpayer filed amended Indiana income tax returns for the years ending 2004 through 2006 seeking a refund of income tax.

In apparent response to the refund claim, the Department of Revenue (Department) conducted an audit review of Taxpayer's income tax returns and business records. The audit denied Taxpayer's claim for a refund for income tax paid during 2004 through 2006. In addition, the Department assessed additional Indiana income tax for the years 2005 through 2007.

Taxpayer disagreed with the decision denying it a refund, disagreed with the decision assessing additional income tax, and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Merchandise Shipped from Taxpayer's Out-of-State Location by Customer-Arranged Common Carrier – Corporate Income Tax.

DISCUSSION

Taxpayer argues that the sales of its clothing and accessories to its third-party retail customers should not

have been included in the numerator of the sales factor when the third-party customers made arrangements to deliver and transport the merchandise to Indiana retail stores.

Taxpayer requests a refund of corporate income tax for the years 2004 through 2006 pursuant to the decision rendered in Miller Brewing Co. v. Ind. Dept. of State Revenue, 831 N.E.2d 859 (Ind. Tax Ct. 2005) (Miller I).

The issue raised by Taxpayer – just as it was in Miller I and Miller Brewing Co. v. Ind. Dept. of State Revenue, 836 N.E.2d 498 (Ind. Tax Ct. 2005) (Miller II) – was whether Indiana was entitled to tax the income taxpayer earns from "customer-arranged-transportation" sales to Indiana when the retail customers arrange for a common carrier to accept delivery of the clothing and accessories at Taxpayer's two out-of-state distribution centers.

During the years at issue, Indiana imposed a tax on each corporation's adjusted gross income attributable to "sources within Indiana." IC § 6-3-2-1(b). Where a corporation – such as Taxpayer – receives income from both Indiana and out-of-state sources, the amount of tax is determined by a three-factor apportionment formula set out in 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. IC § 6-3-2-2(b).

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). Sales of tangible personal property are "in this state" if "the property is delivered or shipped to a purchaser... within this state, regardless of the f.o.b. point or other conditions of the sale." IC § 6-3-2-2(e)(1) (amended January 1, 2007).

The issue – just as it was in Miller I and Miller II– is whether Indiana is entitled to tax the income taxpayer earns from "customer-arranged-transportation" sales to Indiana; were the sales to the Indiana retailers "in Indiana" as defined under IC § 6-3-2-2(e)(1)?

As noted previously, Taxpayer operates warehouse locations in Kentucky and Oregon. Taxpayer's retail customers arrange for third-party common carriers to transport clothing and accessories from Kentucky or Ohio to the retail customers' stores with title to the goods purportedly passing from Taxpayer to the retail customers at the time the goods are loaded on the common carriers' vehicles.

Taxpayer believes that Miller I and Miller II are dispositive of the issue and that income from the sales should have been attributed to the two states in which the common carrier accepted delivery of the merchandise destined for Indiana retail stores. However, the Department has consistently held that – contrary to the Miller decisions – IC § 6-3-2-2(e)(1) mandates the adoption of a "destination rule." ("[I]f the shipment terminates in this state there is a delivery or shipment within this state and the sale is deemed [within the state]." Olympia Brewing Co. v. Comm'r of Revenue, 326 N.W.2d 642, 647 (Minn. 1982)). The Department has consistently held that Indiana should source out-of-state "customer-arranged transportation" sales to Indiana's sales factor as long as the product comes directly to Indiana.

Nonetheless, in Miller I, the Tax Court agreed with petitioner's position that 45 IAC 3.1-1-53(7) should be broadly construed to exclude "customer-arranged-transportation" sales. Miller I, 831 N.E.2d at 862. The Department's regulation, on which the Tax Court relied, states in relevant part:

> Gross receipts from the sales of tangible personal property... 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. 45 IAC 3.1-1-53.

45 IAC 3.1-1-53 provides a series of examples to clarify the administrative rule including "Sales are not 'in this state' if the purchaser picks up the goods at an out-of-state location and brings them back into Indiana in his own conveyance." 45 IAC 3.1-1-53(7).

The Department believes that Taxpayer's position is at odds with IC § 6-3-2-2(e)(1), the interpretation placed upon that statutory language by states which – like Indiana – follow the Uniform Division of Income for Tax Purposes Act ("UDITPA"), and the fact that even states that have not adopted UDITPA – but impose a corporate income tax – use a destination rule. 2005 Multistate Corporate Tax Guide, "Corporate Income Tax" note 6, at I-632 to I-635; Jerome R. Hellerstein and Walter Hellerstein, State and Local Taxation: Cases and Materials 629 n.17 (7th ed. West Group 2001).

Taxpayer points out that, "While the Department has chosen to relitigate the Miller Brewing decision for subsequent tax years, no final decision has been reached in the matter. Until then Miller Brewing stands as the law in Indiana and the Auditor's refusal to adhere to Indiana law is without authority." Taxpayer is correct to the extent that the issues arising in Miller I remain in litigation and that the Department has a long-standing position disagreeing with the applicability of that case. See Letter of Findings 02-20010358 (June 12, 2006). However, whatever the state of the pending litigation, the Tax Court itself has pointed out that, "In this Court, each tax year stands alone." Barth, Inc. v. State Bd. of Tax Comm'rs, 699 N.E.2d 800, 805 n. 14 (Ind. Tax Ct. 1998), reh'g. denied; see also Kent Co. v. State Bd. of Tax Comm'rs, 685 N.E.2d 1156, 1159 (Ind. Tax Ct. 1997).

The Department's stance is that IC § 6-3-2-2(e)(1) requires that money earned from selling its clothing and clothing accessories to Indiana retailers was properly included in the numerator of the sales factor, that Taxpayer's reliance on Miller I is misplaced, and that the plain language of IC § 6-3-2-2(e)(1) runs contrary to

Taxpayer's argument.

FINDING

Taxpayer's protest is respectfully denied.

II. Expense Allocation – Corporate Income Tax.

DISCUSSION

Upon review of Taxpayer's business and business records, the Department's audit challenged Taxpayer's method of reporting of Indiana source income on the ground that Taxpayer – together with its parent – was "shifting... income within the Corporate Group." For purposes of simplicity and for this Letter of Findings, Taxpayer and Parent constitute the "Corporate Group."

The Department's objections stemmed from the financial relationship between Taxpayer and Parent.

As noted above, Parent purchased clothing and accessories from third-party manufacturers and then resold the goods to Taxpayer. During the years at issue, Parent and Taxpayer received approximately $2,217,000,000 in gross receipts. $2,193,000,000 of that amount was received by Taxpayer when it sold the merchandise to the third-party retailers. In other words Taxpayer's sales to third-party retailers accounted for about 99 percent of Corporate Group's receipts.

However, when it came to allocating net income to members within the Corporate Group, a relatively small amount of net income – approximately 7 to 17 percent of the net income – was allocated to Taxpayer. The audit report stated that this "shift in income is principally due to the markup of product which [Parent] buy[s] from foreign manufacturers then resells exclusively to [Taxpayer] at an inflated price."

The audit report sets out Taxpayer's rationale for this "shift" in net income as follows:

> The taxpayer has provided copies of transfer pricing agreements [] in place during the years under audit. These agreements set pricing between related parties and do not reflect on the overall company wide division of profits. This is not an open market situation. [Taxpayer] is captive and subject to the direction of the parent. The excess amounts paid by [Taxpayer] to the parent for merchandise distorts [Taxpayer's] true income derived from sources within Indiana.

On the ground that Taxpayer's Indiana source income was not "fairly reflected," the audit proposed alternatives including having Parent and Taxpayer file a "combined return." According to the audit report, "[T]axpayer was not agreeable to that resolution." Instead, the audit resorted to an "Allocation of Net Income" based on the following rationale.

> The average consolidated net profit ratio is approximately 15 to 17 percent of the Gross Receipts; therefore the audit proposes to correct the excess mark up of product sold by related entities to [Taxpayer] by allocating the same ratio of net profit to the [Taxpayer] as is applicable company wide. This methodology... should better align income and expenses and give a truer picture of the profits derived from Indiana.

Taxpayer objected to the reallocation of net income stating that "the Department may not make adjustments to [Taxpayer's] income unless there is evidence that its adjusted gross income from Indiana sources is not fairly represented." Taxpayer relies on its Transfer Pricing Studies to justify its allocation of net income stating that "the only way to determine whether or not the intercompany arrangement is 'fair' is by "comparing such prices to those arrived at in transactions between unrelated parties as was done by [Taxpayer] in its Transfer Pricing Studies." Taxpayer maintains that the "Transfer Pricing Studies establish that [Taxpayer's] taxable income for the Taxable Years was reasonable and arm's-length and therefore fairly reflected [Taxpayer's] Indiana source income for the Taxable Years."

IC § 6-3-1-3.5(b) provides the starting point for determining taxpayer's taxable income stating that the term "adjusted gross income" shall mean, "In the case of corporations the same as 'taxable income' (as defined in Section 63 of the Internal Revenue Code...."

The Department's Administrative Rules repeats the basic principle at 45 IAC 3.1-1-8 stating that "'Adjusted Gross Income' with respect to corporate taxpayers is 'taxable income' as defined in Internal Revenue Code - section 63)...." However, the taxpayer's federal "adjusted gross income" is merely the starting point; IC § 6-3-1-3.5(b) thereafter requires that the individual taxpayer make certain additions and subtractions to that starting point, the details of which are not relevant here.

The audit made its adjustment to the "Allocation of Net Income" under IC § 6-3-2-2(l). IC § 6-3-2-2 states in relevant part:

> (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 l, 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).

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

Taxpayer relies on the Transfer Pricing studies to justify its pricing and cost structure. However, the studies themselves would seem at odds with such reliance:

The tax advice set forth herein addresses specific U.S. federal income tax issues. [Taxpayer] has not requested us to consider, and we have not considered, any other U.S. federal income tax issues; any non-income tax issues; or any state, local or foreign income tax issues. Accordingly, we do not reach any conclusions regarding any other U.S. federal income tax; non-income tax; or state, local or foreign tax issues. (Emphasis added).

In lieu of requiring Taxpayer to file a combined return, the Department's audit took steps to address what it viewed as the allocation of a disproportionate amount of its expenses to the Taxpayer. Under Taxpayer's method of allocating expenses, Taxpayer received upwards of 99 percent of the gross receipts but was apportioned between 4 to 17 percent of the net profit while Parent – which was allotted approximately 1 percent of the gross receipts – was allocated 40 to 50 percent of the net profit.

The Department addressed what it deemed the "excess" mark up by allocating the same ratio of net profit to Taxpayer as was applicable company wide.

The Department is unable to agree that Taxpayer has met its burden of demonstrating that the proposed assessment is "wrong." A cursory review of the Corporate Group's records would – on its face – indicate that while Taxpayer was responsible for almost all the Corporate Group's income, only a relatively small proportion of the net profits were allocated to Taxpayer. The Transfer Pricing Studies fail to support Taxpayer's financial structure because the studies themselves explicitly indicate that they were intended only to address a specific set of federal income tax issues.

FINDING

Taxpayer's protest is respectfully denied.

III. Indiana Nexus – Corporate Income Tax.

DISCUSSION

Taxpayer argues that the assessment of additional income tax for 2005 through 2007 was unwarranted because Taxpayer does not have "nexus" with Indiana.

According to the audit report, Taxpayer's Indiana employees are called "Visual Merchandisers." As explained in the report:

Their primary task is to help and maintain fixed environments (display racks, seasonal graphics) which are owned by customers and are located in their stores. These activities are not protected and create Indiana nexus for [Taxpayer]. Each [Visual Merchandiser] is assigned a territory and lives within that territory, working from a home office when not conducting visits. The [Visual Merchandisers] travel to multiple states in order to visit a retailer's place of business. [Visual Merchandisers] do not carry product, sell product, replace product, or collect on accounts, etc.

Taxpayer disagrees with the audit report on the ground that the "'Visual Merchandiser' employees do not create nexus with Indiana under Public Law 86-272."

IC § 6-3-2-1 imposes a tax on the adjusted gross income derived from "sources within Indiana." IC 6-3-2-2(a) provides that adjusted gross income derived from sources within Indiana includes "income from doing business in this state."

45 IAC 3.1-1-38, in interpreting IC § 6-3-2-2(a), defines "doing business" within the state.

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.

15 U.S.C.S. § 381 (Public Law 86-272) prohibits states from imposing a net income tax on a foreign (out-of-state) 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. 15 U.S.C.S. § 381(a), (c).

According to the audit report and Taxpayer's explanation, Taxpayer hires "Visual Merchandisers" to work with the third-party retailers located in Indiana. Taxpayer's contention is that the Visual Merchandisers "do not create nexus with Indiana under Public Law 86-272...." The audit report states that the Visual Merchandisers' "primary task is to help and establish and maintain fixed environments (display racks, seasonal graphics) which are owned by customers and are located in their stores." The audit report states that the Visual Merchandisers' activities were "not protected" and that the Visual Merchandisers created Indiana nexus for the Taxpayer.

Information made publicly available by Taxpayer describes the "Essential Functions/Major Responsibilities" of the Visual Merchandisers. Those responsibilities are in part are as follows:

Install and maintain concept shops within assigned territory;

Manage category fixtures, brand signage and [point of purchase] programs within assigned territory;

Implement [Taxpayer's] visual merchandising standards at the retail level, creating a consistent and positive representation of the [Taxpayer's] brand;

Conduct visual merchandising clinics within assigned territory, training retail associates on [Taxpayer's] merchandising standards and Concept Shop guidelines;

Submit [Taxpayer] produce and marketing information / feedback to [Taxpayer] corporate, [Taxpayer's] sales reps and retailers;

Communicate current trends, competitive strategies and customer lifestyles to understand market needs;

Manage assigned territory's travel budget, expenses and schedule rotation;

Maintain positive open lines of communication with all [Taxpayer] management, staff and other departments in order to contribute to the smooth flow of information and efficient operation of the marketing department.

Taxpayer is correct to the extent that certain of the Visual Merchandiser's activities fall within the purview of P.L. 86-272 because those particular activities simply constitute the "mere solicitation" of sales or are activities ancillary to the solicitation of sales. However, the Visual Merchandisers evidently perform other activities which exceed that standard. When the Visual Merchandisers conduct sales clinics and train retail sales persons, those activities are at least one step beyond the "mere solicitation" standard set out in the law.

Taxpayer's rendering of services to its Indiana franchisees exceeds the "mere solicitation standard" established in 45 IAC 3.1-1-38(7) and as defined by the Supreme Court in Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992).

FINDING

Taxpayer's protest is respectfully denied.

IV. Ten-Percent Negligence Penalty – Corporate Income Tax.

DISCUSSION

Taxpayer believes that it is entitled to abatement of the ten-percent negligence penalty because it "properly calculated its federal and Indiana taxable income...." Taxpayer believes that its tax position "was reasonable given the lack of Indiana judicial precedent concerning the proper scope and application of [Indiana law]." Taxpayer concludes that its position was "based upon bona fide interpretations of Indiana taxing statutes, Indiana case law, and Department policy."

IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. IC § 6-8.1-10-2.1(a)(4) requires a ten-percent penalty if the taxpayer "fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment."

IC § 6-8.1-10-2.1(d) states that, "If a person subject to the penalty imposed under this section can show that the failure to... pay the full amount of tax shown on the person's return... or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall wave the penalty."

Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC § 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that 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 IC § 6-8.1-5-1(c), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." An assessment – including the negligence penalty – is

presumptively valid.

The Department believes that Taxpayer erred in determining its state income tax liability and that its arguments run contrary to the Department's well defined position on the issues. However, there is insufficient information to establish that Taxpayer's position was so egregious as to constitute "willful neglect." Based on a "case-by-case" analysis and after reviewing "the facts and circumstances of each taxpayer" the Department agrees that the ten-percent negligence penalty should be abated.

FINDING

Taxpayer's protest is sustained.

SUMMARY

Taxpayer's protest of the negligence penalty is sustained; in all other respects, Taxpayer's protest is denied.

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