DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 02-20130326
Income Tax
For Fiscal Tax Years Ending July 31, 2010 – July 31, 2011

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ISSUES

I. Adjusted Gross Income Tax–Throwback Sales.

Authority: 15 U.S.C. § 381; IC § 6-3-2-2; IC § 6-8.1-5-1; 45 IAC 3.1-1-38; 45 IAC 3.1-1-53; 45 IAC 3.1-1-64; Indiana Dep't of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463 (Ind. 2012); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Wisconsin Dep't of Revenue v. William Wrigley, Jr., Co., 505 U.S. 214 (1992); Indiana Dep't of State Revenue v. Kimberly-Clark Corp., 416 N.E.2d 1264 (Ind. 1981).

Taxpayer protests the inclusion of throwback sales in the Department's Indiana adjusted gross income apportionment factor calculation.

STATEMENT OF FACTS

Taxpayer is a corporation headquartered in Indiana. Taxpayer manufactures computer numerical control ("CNC") routers. The Indiana Department of Revenue conducted an audit of the tax years 2010 and 2011. Pursuant to the audit, the Department found that Taxpayer had income derived from sales of items shipped to various foreign countries and Alaska during the audit years at issue. Taxpayer lacked sufficient nexus in those jurisdictions in order to subject Taxpayer to taxes on the income earned from those sales to those jurisdictions. As a result, the Department's audit determined that the Indiana "throwback" rule applied to Taxpayer. This adjustment to the sales factor increased the reported net operating loss ("NOL") for 2010, but increased the income reported for 2011. The net effect was additional income tax due for 2011, but no actual additional tax was due because Taxpayer had available Indiana Research Expense Credit amounts from prior years.

Taxpayer protests that its activities in the other jurisdictions exceeded "mere solicitation" of sales and that the income in question should be allocated to those other jurisdictions. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Adjusted Gross Income Tax–Throwback Sales.

DISCUSSION

Taxpayer protests the Department's decision to subject Taxpayer's income from sales to customers in Alaska and foreign countries to the "throwback" rule. The Department's audit concluded that Taxpayer's activities did not exceed the protection of P.L. 86-272 (codified as 15 U.S.C. § 381) and was not subject to tax in the foreign countries and Alaska. As a result, the Department's audit determined that the Indiana throwback rule applied to Taxpayer, denied Taxpayer's refund claim, and also imposed additional assessments for the Audit Years at issue.

Taxpayer asserted that it had nexus with Alaska and those foreign countries because its business activities in those jurisdictions went beyond the P.L. 86-272's protection. Thus, Taxpayer maintained that the Indiana throwback rule was not applicable.

As a threshold issue, all tax assessments are prima facie evidence that the Department's assessment of tax is presumed correct. "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." 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); Indiana Dep't. of State Revenue v. Rent-A-Center East, Inc., 963 N.E.2d 463, 466 (Ind. 2012).

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

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

(1) income from real or tangible personal property located in this state;
(2) income from doing business in this state;
(3) income from a trade or profession conducted in this state;
(4) compensation for labor or services rendered within this state; and
(5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property to the extent that the income is apportioned to Indiana under this section or if the income is allocated to Indiana or considered to be derived from sources within Indiana under this section.

Income from a pass through entity shall be characterized in a manner consistent with the income's characterization for federal income tax purposes and shall be considered Indiana source income as if the person, corporation, or pass through entity that received the income had directly engaged in the income

producing activity. Income that is derived from one (1) pass through entity and is considered to pass through to another pass through entity does not change these characteristics or attribution provisions. In the case of nonbusiness income described in subsection (g), only so much of such income as is allocated to this state under the provisions of subsections (h) through (k) shall be deemed to be derived from sources within Indiana. In the case of business income, only so much of such income as is apportioned to this state under the provision of subsection (b) shall be deemed to be derived from sources within the state of Indiana. In the case of compensation of a team member (as defined in section 2.7 of this chapter), only the portion of income determined to be Indiana income under section 2.7 of this chapter is considered derived from sources within Indiana. In the case of a corporation that is a life insurance company (as defined in Section 816(a) of the Internal Revenue Code) or an insurance company that is subject to tax under Section 831 of the Internal Revenue Code, only so much of the income as is apportioned to Indiana under subsection (r) is considered derived from sources within Indiana.

. . .

(e) The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year. Sales include receipts from intangible property and receipts from the sale or exchange of intangible property. However, with respect to a foreign corporation, the denominator does not include sales made in a place that is outside the United States. Receipts from intangible personal property are derived from sources within Indiana if the receipts from the intangible personal property are attributable to Indiana under section 2.2 of this chapter. Regardless of the f.o.b. point or other conditions of the sale, sales of tangible personal property are in this state if:

(1) the property is delivered or shipped to a purchaser that is within Indiana, other than the United States government; or

(2) the property is shipped from an office, a store, a warehouse, a factory, or other place of storage in this state and:

(A) the purchaser is the United States government; or

(B) the taxpayer is not taxable in the state of the purchaser.

Gross receipts derived from commercial printing as described in IC 6-2.5-1-10 shall be treated as sales of tangible personal property for purposes of this chapter.

. . .

(n) For purposes of allocation and apportionment of income under this article, a taxpayer is taxable in another state if:

(1) in that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or

(2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

. . ..

45 IAC 3.1-1-53 states:

Gross receipts from the sales of tangible personal property (except sales to the United States Government–See Regulation 6-3-2-2(e)(050) [45 IAC 3.1-1-54] are in this state: (a) if the property is delivered or shipped to a purchaser within this state regardless of the F.O.B. point or other conditions of sales; or (b) if the property is shipped from an office, store, factory, or other place of storage in this state, and the taxpayer is not taxable in the state of the purchaser. See Regulation 6-3-2-2(n)(010) [45 IAC 3.1-1-64]. Examples:

. . .

(5) **If the taxpayer is not taxable in the state of the purchaser, the sale is attributed to this state if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state. Such sale is termed a "Throwback" sale.** Example: The taxpayer has its head office and factory in State A. It maintains a branch office and inventory in Indiana. Taxpayer's only activity in State B is the solicitation of orders by a resident salesman. All orders by the State B salesman are sent to the branch office in Indiana for approval and are filled by shipment from the inventory in Indiana. Since the taxpayer is immune under P.L.86-272 from tax in State B, all sales of merchandise to purchasers in State B are attributed to Indiana, the state from which the merchandise was shipped.

. . ..

(**Emphasis added** .)

45 IAC 3.1-1-38 provides:

For apportionment purposes, a taxpayer is "doing business" in a state if it operates a business enterprise or activity in such state including, but not limited to:

(1) Maintenance of an office or other place of business in the state

(2) Maintenance of an inventory of merchandise or material for sale distribution, or manufacture, or consigned goods

(3) Sale or distribution of merchandise to customers in the state directly from company-owned or operated vehicles where title to the goods passes at the time of sale or distribution
(4) Rendering services to customers in the state
(5) Ownership, rental or operation of a business or of property (real or personal) in the state
(6) Acceptance of orders in the state
(7) **Any other act in such state which exceeds the mere solicitation of orders so as to give the state nexus under P.L.86-272 to tax its net income.**

As stated in Regulation 6-3-2-2(b)(010) [45 IAC 3.1-1-37], corporations doing business in Indiana as well as other states are subject to the allocation and apportionment provisions of IC 6-3-2-2(b)-(n). (**Emphasis added**).

45 IAC 3.1-1-64 states:

A corporation is "taxable in another state" under the Act when such state has jurisdiction to subject it to a net income tax. This test applies if the taxpayer's business activities are sufficient to give the state jurisdiction to impose a net income tax under the Constitution and statutes of the United States. **Jurisdiction to tax is not present where the state is prohibited from imposing the tax by reason of the provision of Public Law 86-272, 15 U.S.C.A. §381-385**. In the case of any "State," as defined in IC 6-3-1-25, other than a state of the United States or political subdivision of such state, the determination of whether such "state" has jurisdiction to subject the taxpayer to a net income tax shall be made by application of the jurisdictional standards applicable to that state of the United States. If jurisdiction to tax is otherwise present, such "state" is not considered as being without jurisdiction to tax by reason of the provisions of a treaty between that state and the United States.

Example:

Corporation X is actively engaged in manufacturing farm equipment in State A and foreign country B. Both State A and foreign country B impose a net income tax but foreign country B exempts corporations engaged in manufacturing farm equipment. Corporation X is subject to the jurisdiction of State A and foreign country B.

Taxpayers are not subject to throwback on sales into states in which they are taxable under this regulation [45 IAC 3.1-1-64]. See Regulation 6-3-2-2(e)(040) [45 IAC 3.1-1-53]. (**Emphasis added**).

15 U.S.C.A. § 381(a), which establishes minimum standards for a state to impose tax, provides:

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.A. § 381(c) further states:

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 of orders."

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.

Ruling in favor of Wisconsin, the Court thus held that the taxpayer in Wrigley was subject to Wisconsin's net income tax because its business activities in Wisconsin exceeded P.L. 86-272's protection.

Therefore, following the Wrigley decision, an Indiana company's income derived from its sales to other states (or foreign jurisdictions) is thrown back to Indiana for income tax purposes when the Indiana company's business activities in those states (or foreign jurisdictions) are protected and are not taxable pursuant to P.L. 86-272.

As explained in the audit report, Taxpayer did not provide sufficient documentation to establish that its activities in the foreign countries and Alaska rose above a de minimis level. In fact, the audit concluded that Taxpayer performed no activities in the foreign countries that would establish a taxable nexus and subject them to tax in those countries. As a result of the protest process, Taxpayer submitted additional documentation to support its protest, which included copies of Taxpayer's "Sales Representative Agreement," its foreign warranty certificate, its terms and conditions of sales, and a few examples of price quotes made to its clients. Taxpayer maintains that it has independent sales representatives (in other words, dealers of the CNCs) in foreign countries and Alaska who, according to Taxpayer, "not only solicit product sales but . . . provide training to customers of the machines

functions, supervise installation and initial set-up, [and]handle warranty and service repairs." Taxpayer points to the "Duties of Representative" section of the "Sales Representative Agreement" that was submitted with Taxpayer's protest. It provides that:

> For the duration of this agreement, [the independent sales] Representative shall:. . .e) attend to the installation and startup of Products at customers' facilities in the Territory, f) service warranty claims related to the Products installed in the Territory, g) facilitate generally the sale, installation, startup and servicing of Products in the Territory, h) maintain such facilities, staff and organization as may be required to facilitate the sale, and attend to the installation, startup and servicing of Products in the Territory . . . .

Taxpayer's argument is that the sales representatives are performing services on behalf of Taxpayer in the foreign countries and Alaska, and therefore these activities establish a taxable nexus and would subject Taxpayer to tax in the foreign countries and Alaska. Taxpayer thus asserts that its activities in those foreign jurisdictions exceeded P.L. 86-272's protection and the Indiana throwback rule was not applicable.

Taxpayer's documentation demonstrates that its independent sales representatives either were located in, or visited, several countries and Alaska, and that they were responsible for potentially performing activities that rose above the mere solicitation of sales. It follows that if the activities described in the Sales Representative Agreement were performed, the activities exceeded the P.L. 86-272's protection. However, the Department will need to see further documentation showing that those activities were performed. The Department will allow thirty days for Taxpayer to provide tax returns from the other jurisdictions, sample invoices relating to the performance of those activities that were performed, or any other source documentation that demonstrates that these activities occurred in these jurisdictions. If this information is received, the file will be returned to the audit division where they are requested to review the submitted documentation and make whatever adjustments it deems appropriate.

FINDING

Taxpayer's protest is sustained subject to Taxpayer providing the requested documentation and pending the results of an audit review of the submitted documentation.

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