DEPARTMENT OF STATE REVENUE

02-20160336R.MOD

Memorandum of Decision: 02-20160336R
Corporate Income Tax
For Tax Year 2011

NOTICE: IC § 4-22-7-7 permits the publication of this document in the Indiana Register. The publication of this document provides the general public with information about the Indiana Department of Revenue's official position concerning a specific set of facts and issues. The "Holding" section of this document is provided for the convenience of the reader and is not part of the analysis contained in this Memorandum of Decision.

HOLDING

Out-of-State Corporation demonstrated that it was entitled to a reduction of its Indiana sales factor because sales in foreign jurisdictions should not have been sourced to Indiana under the throwback rule.

ISSUE

I. Adjusted Gross Income Tax - Throwback Sales.

Authority: 15 U.S.C. § 381; IC § 6-3-2-2; Sherwin-Williams Co. v. Indiana Dep't. of State Revenue, 673 N.E.2d 849 (Ind. Tax Ct. 1996); 45 IAC 3.1-1-38; 45 IAC 3.1-1-53; 45 IAC 3.1-1-64; Tax Policy Directive 6 (June 1992); Letter of Findings 02-20140358 (January 2015).

Taxpayer maintains that sales to customers located in various foreign jurisdictions should not be thrown back to Indiana because Taxpayer has nexus in those jurisdictions.

STATEMENT OF FACTS

Taxpayer is an out-of-state corporation doing business in Indiana and worldwide. As part of its operations, Taxpayer licenses intellectual property to foreign affiliates in various countries around the world. Taxpayer has two locations in Indiana; thus it elects to file a separate Indiana income tax return based on its nexus with Indiana.

The Indiana Department of Revenue ("Department") conducted an audit on Taxpayer's business for the 2009 through 2011 tax years. The audit report contained various adjustments to Taxpayer's 2011 return, including increasing its income apportionable to Indiana and an adjustment decreasing its Indiana apportionment factor. The Department previously determined that income received by Taxpayer's subsidiaries for licensing intellectual property must be included in Taxpayer's adjusted gross income in order to fairly reflect Taxpayer's reported total adjusted income to cure distortion in the reporting of Taxpayer's income. See Letter of Findings 02-20140358 (January 2015), 20150128 Ind. Reg. 045150015NRA.

Subsequent to the audit, Taxpayer amended its 2011 Indiana corporate income tax return by filing an IT-20X form, using the adjustments made during the audit as a starting point. Taxpayer's amended return purports to exclude income from foreign jurisdictions in which Taxpayer claims it had nexus, and therefore should not have been included in the Indiana sales factor numerator. The amended return requested a refund and an increased Indiana Research Expense Tax Credit carryover.

The Department did not accept Taxpayer's amended return as filed, thus denying Taxpayer's claim for refund. The refund denial letter stated, "The refund has been denied due to the amended changes did not reflect the previous Indiana Audit changes under Audit Control # [XXXXXX]." The Department did not make a substantive determination on the sales apportionment issue.

Taxpayer subsequently filed the instant protest. An administrative hearing was held during which Taxpayer's representative explained the basis of its protest, and this Memorandum of Decision results. Further facts will be provided as necessary.

I. Adjusted Gross Income Tax - Throwback Sales.

DISCUSSION

The issue is whether Taxpayer was entitled to a refund of tax on its apportionable income previously adjusted by

the Department's audit because the throwback rule does not apply to its sales of tangible personal property in various foreign jurisdictions. Specifically, Taxpayer stated that it had mistakenly included income from receipts in foreign jurisdictions in its Indiana sales based on the "throwback rule," and therefore requested a refund based on the revised apportionment formula. During the protest, Taxpayer provided documentation for several foreign jurisdictions to support its assertion that it had nexus with the country, and that it would be subject to jurisdiction for the imposition of a net income tax. The Department rejected the amendments to Taxpayer's 2011 return without addressing Taxpayer's argument regarding throwback sales.

"Indiana imposes a tax on every corporation's adjusted gross income derived from sources within Indiana. [IC § 6-3-2-1(b).] In cases where a corporation derives business income from sources both within and without Indiana, the 'adjusted gross income derived from sources within the state of Indiana' is determined by an apportionment formula." Sherwin-Williams Co. v. Indiana Dep't. of State Revenue, 673 N.E.2d 849, 851 (Ind. Tax Ct. 1996). For all tax years after December 31, 2010, the formula operates by multiplying taxpayer's total business income by a fraction composed of a sales factor. IC § 6-3-2-2(b)(5). 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).

IC § 6-3-2-2(a) (2011), in pertinent part, states that Indiana taxpayers are subject to this state's income tax on money earned from doing business within this state:

> 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:
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> (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.

However, IC § 6-3-2-2(n) (2011) provides that a taxpayer's income is not subject to this state's income tax if that income is attributable to conducting business in another state in which it is subject to that foreign state's own tax regime:

> For purposes of allocation and apportionment of income under this article, a taxpayer is taxable in another state if:
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> (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 3.1-1-38 illustrates the "doing business" in a foreign state principle:

> Doing Business. 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:
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> (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.** (**Emphasis added**).

45 IAC 3.1-1-64, in relevant part, further explains under what conditions a taxpayer is conducting business and

taxable in another state:

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

45 IAC 3.1-1-53 further illustrates the "throw back" principle:

> When Sales of Tangible Personal Property Are in This State. 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].
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> (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**).

The issue then becomes whether Taxpayer's activities brought itself within the purview of the foreign countries' income tax regimes. 15 U.S.C. § 381(a) (Public Law 86-272) establishes the minimum standards under which Indiana or any foreign state may permissibly impose tax. In relevant part, the law provides as follows:

> 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:
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> > (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) explains under what conditions a company is not conducting business in another state:

> 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.

In summary, Public Law 86-272 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.

In this instance, Taxpayer has foreign subsidiaries or affiliates in various foreign jurisdictions outside of the United States. In the prior audit, the Department determined that royalty income from Taxpayer's foreign subsidiary that licenses Taxpayer's intellectual property ("IP Subsidiary") must be allocated to Taxpayer under IC § 6-3-2-2(l) and (m) in order to fairly reflect Taxpayer's total adjusted gross income. Royalty income from the IP Subsidiary was also included in the denominator of Taxpayer's apportionment factor. Taxpayer now asserts that the activities of its subsidiaries in 42 foreign jurisdictions exceed the protections of P.L.86-272, thus giving Taxpayer nexus with those countries. Taxpayer asserts that either royalty income received by Taxpayer's subsidiaries from the use of intellectual property in foreign jurisdictions, or the presence of employees providing more than mere solicitation, provides sufficient nexus with these countries such that the throwback rule is inapplicable to sales in these countries.

As a general rule, the nexus of a subsidiary or affiliate is not attributed to the parent company unless the entities file a unitary/combined return. This is known as the Finnigan concept. Tax Policy Directive 6 (June 1992) states, "Under Finnigan, sales made by a member of the unitary group to a destination in another state in which that member was not taxable should not be "thrown back" to Indiana unless no member of the unitary group was taxable in the other state . . . . The adoption of Finnigan only applies to corporations who file unitary/combined returns in Indiana . . . . Corporations not filing combined/unitary returns in Indiana will continue to apply the throwback sales rule in the normal fashion." (Emphasis in original).

Although under these circumstances Taxpayer did not file a combined return with IP Subsidiary under IC § 6-3-2-2(p), the Department's prior audit required Taxpayer to include the royalty income from IP Subsidiary in its total income in order to correct distortion under IC § 6-3-2-2(l) and (m). By allocating the royalty income to Taxpayer, the Department's prior audit implicitly considered that Taxpayer's subsidiaries' nexus could be attributable to Taxpayer concerning the income at issue. Therefore, for purposes of Taxpayer's apportionment computation for 2011, the Department will apply the Finnigan concept and consider the IP Subsidiary's nexus in determining where Taxpayer's income from foreign jurisdictions should be sourced. Application of the Finnigan concept under these circumstances is as a matter of equity under these particular set of facts.

In its amended 2011 income tax return, Taxpayer sought to exclude income from 42 countries. To support its protest, Taxpayer provided documentation for eight countries showing that the countries had laws enacted that would subject Taxpayer 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" as stated in IC § 6-3-2-2(n), and that Taxpayer or Taxpayer's IP subsidiary either had employees working in those countries or that intellectual property was licensed for use in that country such that those countries would have jurisdiction to impose a net income tax. These countries include Germany, Canada, Great Britain, China, Indonesia, South Korea, Thailand, and Singapore. For each of these countries, Taxpayer provided copies of Trademark and Technology License and Technical Services Agreements evidencing that the IP Subsidiary both licensed intangible property and provided personnel for technical assistance with manufacturing and application of the intangible property. Taxpayer did not provide adequate documentation for the remaining 34 countries.

Upon reviewing Taxpayer's documentation, the Department agrees that Taxpayer's documentation demonstrated that its subsidiaries' activities in Germany, Canada, Great Britain, China, Indonesia, South Korea, Thailand, and Singapore exceeded the P.L.86-272's protection, and that it would be subject to a net income tax in those countries. Thus, the Indiana throwback rule should not apply to the income derived from Taxpayer's sales to Germany, Canada, Great Britain, China, Indonesia, South Korea, Thailand, and Singapore for tax year 2011. Taxpayer's protest with respect to income from Germany, Canada, Great Britain, China, Indonesia, South Korea, Thailand, and Singapore is sustained. Taxpayer's protest with respect to the income from the remaining countries is denied.

FINDING

Taxpayer's protest is sustained in part with respect to income from Germany, Canada, Great Britain, China, Indonesia, South Korea, Thailand, and Singapore, and denied in part with respect to income from the remaining countries under protest.

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