

Letter of Findings Number: 05-0318, 05-0319
Adjusted Gross Income Tax
For the Years 2001-2003

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ISSUES

I. Adjusted Gross Income Tax—Unitary filing

Authority: Ind. Code § 6-3-2-2

Taxpayer protests the imposition of adjusted gross income tax based on the forced combination of Taxpayer and other affiliated corporations

II. Penalty—Request for waiver

Authority: Ind. Code § 6-8.1-10-2.1; [45 IAC 15-11-2](#).

Taxpayer protests the Department's imposition of the ten percent negligence penalty, requesting a waiver for reasonable cause.

STATEMENT OF FACTS

Taxpayer is a corporation engaged in the sale of various products. Sub H is a company engaged in the sale of various supplies and services related to Taxpayer's business. Sub I is a third company that files in Indiana. Taxpayer also had other affiliated corporations engaged in the same or related businesses. In addition, two subsidiaries, Sub M and Sub N, operated on behalf of Taxpayer's affiliated businesses. Sub M is a procurement agent for certain products for Taxpayer and entities related to Taxpayer, in exchange for a fee based on a percentage of the purchase price for the items Sub M purchases. Sub M also provides certain marketing and other services on behalf of Taxpayer and Taxpayer's affiliated companies. Sub N is a procurement agent for products, services, and technology on behalf of Taxpayer's corporate offices and stores, and also receives a fee based on a percentage of the purchase price of items that Sub N purchases.

During the years in question, Taxpayer, Sub H, and Sub I filed Indiana returns. Each corporation filed their respective returns on a separate company basis. However, the Department audited Taxpayer, and concluded that Taxpayer, Sub H, Sub I, Sub M, Sub N, and a number of other subsidiaries, should have filed combined (unitary) tax returns for the years in question. The Department assessed additional tax, penalty, and interest, which Taxpayer, Sub H and Sub I protested. Additional facts will be supplied as necessary.

I. Adjusted Gross Income Tax—Unitary filing

DISCUSSION

For purposes of this letter of findings, it is assumed that Taxpayer and other affiliated companies combined by the Department are unitary. However, Taxpayer disputes this assumption.

Taxpayer argues that its arrangement with Sub M and Sub N was legitimate. In particular, Taxpayer argues that the costs paid by Taxpayer and its affiliates to Sub M and Sub N represented the costs that Taxpayer would pay on an arms length basis to an unrelated third party. Further, Taxpayer argues that its arrangement performs a variety of valid business purposes, and both Sub M and Sub N had significant payroll independent of Taxpayer.

To illustrate Taxpayer's overall financial picture, the transactions between Taxpayer and Sub M for one of the years in dispute will be analyzed (a more detailed table was initially included, but the table was redacted after the initial letter of findings was issued). For analytical purposes, it will be assumed that Taxpayer's income for the year in question was \$1,000,000, prior to any transactions with Sub M. The \$1,000,000 assumes that Taxpayer would have incurred the expenses that Sub M actually incurred.

When Taxpayer paid Sub M for procurement fees, Taxpayer's income was reduced to roughly \$660,000, even though Sub M's operating expenses totaled \$14,000. Sub M had an income of \$340,000.

Next, Sub M loaned money back to Taxpayer. Taxpayer paid interest on the loans to Sub M. The interest payments reduced Taxpayer's income to \$640,000. Sub M's income increased to \$360,000.

Finally, Sub M paid \$270,000 dividends back to Taxpayer. However, Taxpayer claimed a deduction for the dividends received based on Taxpayer's ownership of Sub M under I.R.C. § 243. Thus, Taxpayer had an income of \$910,000, but reported only \$640,000 to Indiana—reducing its income apportionable to Indiana by \$270,000 by creating an entity, Sub M, which incurred only *\$14,000 of actual expenses which Taxpayer would have otherwise incurred*, then receiving the funds that it paid to Sub M back from Sub M, and then reporting the returned funds as tax-exempt dividends.

In a unitary state, such as the state where Sub M was located, Taxpayer and Sub M reported a combined \$1,000,000, and apportioned the income effectively based on Taxpayer's much larger apportionment numbers. Assuming that Taxpayer had an apportionment factor of 50 percent in states where Taxpayer filed separate

returns and 50 percent in states where Taxpayer and Sub M filed combined returns, Taxpayer's selective use of filing status reduced Taxpayer's income for tax purposes to \$820,000 overall, rather than its actual \$1,000,000 income. The arrangement between Taxpayer and Sub M had the effect of diluting the income reported by the overall entity of Taxpayer and Sub M to *both* groups of states.

Finally, Sub H and Sub I also made payments to Sub M and Sub N, though without the flow of dividends back to Sub H and Sub I, which had a smaller effect of Sub H's and Sub I's respective net profits. Sub N had some independent activities separate from its procurement role; however, Sub N also had a circular flow of payments from Taxpayer followed by dividends back to Taxpayer.

In summary, Taxpayer, Sub H and Sub I earned incomes that were reduced, though significantly different than its number reported for tax purposes, both before and after Taxpayer and Taxpayer's affiliates entered into the arrangement, and had no change in its pattern of dividend distribution to Taxpayer's shareholders. The only difference that Taxpayer demonstrated was shielding a considerable portion of its income via a related entity and apparently selectively filing its returns to minimize its overall income. Taxpayer's, Sub H's, and Sub I's incomes were artificially lowered by deductions to Sub M and Sub N, and resulting effective exclusion (i.e., inclusion in income, followed by an immediate deduction of the same amount) of the dividends paid back to Taxpayer from Sub M and Sub N. Regardless of whether Taxpayer, Sub H, and Sub I are viewed as a separate entities or if all of Taxpayer's entities are viewed as a combined entity, Taxpayer's return as filed for the years in question did not fairly reflect Taxpayer's Indiana income. Taxpayer, Sub H, and Sub I have failed to fairly reflect their Indiana incomes.

Because Taxpayer's, Sub H's, and Sub I's Indiana incomes as reported do not fairly reflect their overall Indiana income, the issue of appropriate remedial provisions must be addressed. Taxpayer asserts that forced combined filing—the method used by the auditor—can only be used by the Department when all other methods of fairly reflecting Taxpayer's income fail to fairly reflect. Taxpayer cites to Ind. Code § 6-3-2-2(p) for this proposition.

Under Ind. Code § 6-3-2-2(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) the exclusion of any one (1) or more of the factors;
- (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.

Under Ind. Code § 6-3-2-2(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.

Under these provisions, the Department is given authority to depart from the general apportionment and allocation provisions provided under Ind. Code § 6-3-2-2 in circumstances where those general provisions fail to fairly reflect a taxpayer's income.

Because Taxpayer's, Sub H's, and Sub I's Indiana incomes were not fairly reflected by their returns as filed, the Department's choice of forced unitary filing of Taxpayer and various other entities was proper. The incomes of Taxpayer, Sub H, and Sub I were not that of single entities acting in isolation, but rather that of a larger, interdependent enterprise. Taxpayer, Sub H, and Sub I were seeking to benefit from deducting payments to Sub M and Sub N, while effectively excluding the flow of funds back to Taxpayer of a significant portion of same payments. Taxpayer's protest in light of Taxpayer, Sub H and Sub I seeking to use its separate filing in Indiana to shield their incomes—followed by combined (either consolidated or unitary) filing in other states to dilute Sub M and Sub N's respective incomes—does not pass muster.

The Department has considered other possible methods of fairly reflecting Taxpayer's, Sub H's, and Sub I's income. Most notably, the Department has considered the possible disallowance of Taxpayer's deductions for interest paid to Sub M and Sub N, and dividends Taxpayer received from Sub M and Sub N and the disallowance of the deduction for the portion of Taxpayer's dividends received from Sub M and Sub N that Taxpayer, Sub H, and Sub I had previously claimed as deductions for procurement expenses; however, the Department has appropriately concluded that unitary filing best reflects Taxpayer's, Sub H's, and Sub I's income out of all possible remedial measures available to the Department.

FINDING

Taxpayer's protest is denied.

II. Tax Administration--Penalty

DISCUSSION

Taxpayer argues that it is not subject to negligence penalties with respect to the additional taxes assessed

against it. In particular, Taxpayer argues that the additional tax was due to its different, but reasonable, interpretation of the statute. Accordingly, it argues that it was not negligent in its tax returns for the years in question.

Penalty waiver is permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. Ind. Code § 6-8.1-10-2.1. The Indiana Administrative Code further provides:

(b) "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

(c) The department shall waive the negligence penalty imposed under [IC 6-8.1-10-1](#) if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

- (1) the nature of the tax involved;
- (2) judicial precedents set by Indiana courts;
- (3) judicial precedents established in jurisdictions outside Indiana;
- (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
- (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

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

[45 IAC 15-11-2](#).

Though the Department does not agree with Taxpayer's position regarding its separately filed returns, Taxpayer acted with reasonable business care in preparing its returns. Accordingly, Taxpayer's protest of the penalty is sustained.

FINDING

Taxpayer's protest is sustained.

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