DEPARTMENT OF STATE REVENUE

02-20070216.LOF

Letter of Findings: 07-0216
Corporate Income Tax
For the Years 2001, 2002, and 2003

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ISSUE

I. Net Operating Loss – Corporate Income Tax

Authority: IC § 6-8.1-5-1(b); *Sees v. Bank One, Indiana, N.A.*, 839 N.E.2d 154 (Ind. 2005); *Meridian Mut. Ins. Co. v. Richie*, 540 N.E.2d 27 (Ind. 1989). *Ruff v. Charter Behavioral Health System of Northwest Indiana, Inc.*, 699 N.E.2d 1171 (Ind. Ct. App. 1998)

Taxpayer argues that the Department of Revenue erred when it eliminated a net operating loss carry-forward as of January 29, 2000, and the consequent assessment of additional corporate income tax.

STATEMENT OF FACTS

Taxpayer is a member of a consolidated group which operates several chains of retail clothing stores in multiple states and affiliated companies which hold the rights to trademarks and trade brands associated with each particular retail chain.

The Department of Revenue (Department) conducted an audit review of taxpayer's tax returns and business records for the fiscal years ended January 31, 1998, January 30, 1999, and January 29, 2000. This first audit resulted in the assessment of additional adjusted gross income tax on the ground that royalty payments and interest payments paid and received by members of taxpayer's consolidated group should have been included in the consolidated return. In addition, the initial audit reduced to zero the amount of net operating losses available to carry forward into the tax periods subsequent to the audited years.

Taxpayer protested this decision on two occasions, but on each occasion the Department denied taxpayer's protest.

On August 2, 2005, taxpayer and the Department entered into an "Income Tax Settlement Agreement" which settled "all liabilities of [taxpayer] and the Subsidiaries for Indiana corporation income tax for the Periods in Issue [1998, 1999, and 2000]... all liabilities of [taxpayer] and the Subsidiaries relating to the [trademark protection companies] Issue for Indiana corporation income tax for taxable periods ending on or before the fiscal year ended January 29, 2005; and... the treatment of the [trademark protection companies] and their income for Indiana corporation income tax purposes for the fiscal year ended January 28, 2006."

In exchange for the payment of a sum of money, the Department agreed that the payment constituted a "full satisfaction of... the Proposed Assessments.... any and all Indiana corporation income tax liabilities of [taxpayer] and the Subsidiaries for the Periods in Issue [1998, 1999, and 2000].... and any and all Indiana corporation income tax liabilities of [taxpayer] and the Subsidiaries attributable to the [trademark protection company] Issue for all fiscal years through the fiscal year ended January 29, 2005...."

The Department agreed that upon payment of the agreed amount, "Periods at Issue" (1998, 1999, and 2000) were "closed for purposes of audit, assessment, claim for refund, and litigation of the Indiana corporation income tax liabilities of [taxpayer] and the Subsidiaries."

The taxpayer agreed that – for purposes of the un-audited, going-forward years – royalty income would be included in taxpayer's Indiana corporate tax returns. The Department agreed that "all fiscal years ended on or before January 29, 2005, [were] closed for purposes of audit, assessment, claim for refund, and litigation of the Indiana corporation income tax liabilities of [taxpayer] and the Subsidiaries attributable to the [trademark protection company] Issue."

The agreement effectively closed further consideration of the trademark protection company issue for both the original audited years (1998, 1999, and 2000) and the "going forward" years through the end of 2005. However, both parties agreed that for the "going forward years" the agreement "does not close any years subsequent to the Periods at Issue [1998, 1999, and 2000] for purposes of audit, assessment, claim for refund, and litigation of the Indiana corporation income tax liabilities of [taxpayer] and the Subsidiaries except as relating to the [trademark protection company] Issue."

After the Agreement was signed, the Internal Revenue Service audited taxpayer for 2001, 2002, and 2003. As a result of this federal audit, the IRS issued a "Revenue Agent's Report" (RAR) which adjusted taxpayer's federal taxable income. Thereafter, taxpayer filed amended Indiana returns reflecting the federal adjustment. During 2006, the Department reviewed the Indiana returns and determined that taxpayer owed additional state income tax. Taxpayer disagreed with a portion of the adjustment stemming from the Department's decision disallowing the carry-forward of net operating losses attributable to the trademark protection companies' activities during 1998, 1999, and 2000.

Taxpayer protested the results of the 2006 audit review and submitted a protest to that effect. A hearing was conducted during which taxpayer's representative explained the basis of its protest, and this Letter of Findings results.

I. Net Operating Loss – Corporate Income Tax

DISCUSSION

The issue is whether the net operating losses were available for taxpayer to carry-forward after the 2005 settlement was signed.

Taxpayer has the responsibility of demonstrating that the 2006 assessment was incorrect. IC § 6-8.1-5-1(b) states that, "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."

During the original audit of the taxpayer's 1998, 1999, and 2000 returns, the net operating losses which taxpayer cites were unequivocally disallowed. According to the original audit report, taxpayer had no operating losses to carry forward to subsequent years. As explained in the "Explanation of Adjustments" section of the audit report;

> On its IT-20 return the taxpayer had computed a net operating loss for FYE 1/31/98. It then carried this loss forward to FYE 1/30/99. The audit adjustments... have eliminated the FYE 1/31/98 net operating loss. Therefore, the carryforward to FYE 1/31/99 has also been eliminated.

In a second audit report, the carry-forward issue was addressed as follows;

> On its IT-20 return the taxpayer carried forward a net operating loss from FYE 1/30/99. As explained on page 4 of this narrative, the FYE 1/30/99 consolidated IT-20 was filed under a different "lead" corporation. In the separate report completed for that year, the auditors eliminated the Indiana net operating loss. Therefore, there is no loss available to carryforward to the FYE 1/29/00 return.

Both the audit and the Department agree that the net operating losses here at issue stemmed from payments made to taxpayer's trademark protection companies during 1998, 1999, and 2000. There is no dispute that the taxpayer protested on two occasions the result of the original audit and that the Department denied those protests.

However, taxpayer argues that the 2005 settlement agreement permitted taxpayer to carry forward the net operating losses; in effect, taxpayer states that the settlement agreement – without specifically addressing the issue – revived the previously disallowed losses in exchange for payment of the settlement amount.

Taxpayer argues that the current, outstanding assessment of additional corporate income tax "is not only contrary to the terms of the Agreement, it flatly conflicts with the parties' good-faith bargaining and understanding in arriving at the Agreement." Taxpayer maintains that the 2005 settlement agreement "expressly resolved any and all income tax liabilities of Taxpayer relating to the 'TPC Issue' for fiscal years ending on or before the fiscal year ended in 2005."

Taxpayer admits that the 2005 settlement agreement does not specifically address the net operating loss issue raised in the initial audit report. There is no indication that either of the Letters of Findings explicitly addressed the net operating loss issue. As set out in one of the two relevant Letters of Findings, "[T]he Department issued proposed assessments for adjusted gross income tax on the newly included income. Taxpayer protests that the income should not be included and that proposed assessments are incorrect."

Taxpayer maintains that the current disputed assessment – resulting from the review of taxpayer's 2001, 2002, and 2003 amended Indiana returns – constitutes a "recomputation" of taxpayer's adjusted gross income tax liabilities for 2001, 2002, and 2003 based on the disallowance of the net operating losses.

The 2005 agreement between taxpayer and the Department constitutes a written contract. In interpreting that contract, taxpayer invites consideration of the correspondence shared between taxpayer's representative and the Department's representative during the negotiation period leading up to the execution of the settlement contract. Taxpayer also invites consideration of the Department's past practice in addressing specifically net operating losses in previous settlement agreements. However, the Department must conclude that the 2005 agreement speaks plainly and that resorting to evidence outside of the four-corners of the agreement is unwarranted. "Only when ambiguities cannot be resolved within the four corners of the contract is a fact finder needed to determine those extrinsic facts upon which interpretation of the contract may rest." *Meridian Mut. Ins. Co. v. Richie*, 540 N.E.2d 27, 28 (Ind. 1989). "As a general proposition a party is excluded from presenting extrinsic evidence of prior or contemporaneous oral agreements offered to vary or contradict the terms of a written contract. Rather, a written contract is presumed to embody the parties' entire agreement." *Sees v. Bank One, Indiana., N.A.*, 839 N.E.2d 154, 161 (Ind. 2005). "Any ambiguities in a contract are to be strictly construed against the party who employed the language and who prepared the contract." *Ruff v. Charter Behavioral Health System of Northwest Indiana, Inc.*, 699 N.E.2d 1171, 1176 (Ind. Ct. App. 1998).

There is nothing in the 2005 settlement agreement which addressed the net operating loss. Taxpayer and the Department agreed that they would resolve their differences as to the amount of assessment without further protest or litigation, that taxpayer would pay a set amount to resolve the parties' differences, and that the Department would consider the matter closed. As stated in the agreement itself, "The parties agree that such payment represents the payment by [taxpayer] of a portion of the contested Indiana corporation income tax liabilities of [taxpayer] and the Subsidiaries and the Department's abatement of all proposed or potential liabilities."

In short, the current assessment is not an additional assessment of tax attributable to what the Department apparently viewed as a questionable payment of royalties to related entities. The current assessment is simply a recognition of the fact that the original audit review of taxpayer's 1998, 1999, and 2000 returns specifically disallowed the net operating losses. For all practical purposes, the original audit concluded that taxpayer had no net operating losses which could be carried forward into future years. That conclusion was unaltered by the 2005 settlement agreement. The net operating losses upon which taxpayer now relies were not available at the conclusion of the initial audit and were not available at the time the Department reviewed the 2001, 2002, and 2003 amended returns. Taxpayer's argument – that the Department has proposed an additional assessment of Indiana corporate income tax in contravention of the explicit terms of the 2005 agreement – is itself erroneous. The present assessment simply recognizes the reality of the conclusion reached in the first, contested audit review. Taxpayer was fully entitled to explicitly address the pending net operating loss issue in the 2005 settlement agreement but failed to do so. Taxpayer may not claim an additional benefit, denied it in the original audit report, denied during the administrative process, unaddressed in the 2005 settlement agreement, and neither bargained for nor apparently contemplated by the parties.

FINDING

Taxpayer's protest is respectfully denied.

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