**DEPARTMENT OF STATE REVENUE**

02-20060441.LOF

**Letter of Findings Number: 06-0441**
**Income Tax**
**For Tax Years 1996-7**

**NOTICE:** Under IC § 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

**ISSUES**

**I. Income Tax–Consolidated Net Operating Loss.**

**Authority**: Treasury Reg. § 1.1502-75 (as amended in 2006); Treasury Reg. § 1.1502-21 (as amended in 2007); IC § 6-3-1-11; IC § 6-8.1-5-1.

Taxpayer protests the assessment of individual income tax.

**II. Tax Administration–Negligence Penalty.**

**Authority:** IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of a ten percent negligence penalty.

**STATEMENT OF FACTS**

Taxpayer is primarily a wholesaler in the recreational vehicle, manufactured housing, and marine industries. As the result of an audit, the Indiana Department of Revenue ("Department") determined that a related company was the common parent of a group of four related companies which filed a federal consolidated return and an Indiana adjusted gross income tax consolidated return. Taxpayer was incorporated in 1980 in Indiana. On September 24, 1999, Taxpayer created a new holding company (hereinafter referred to as "HC"). Also on September 30, 1999, Taxpayer executed a reverse acquisition of HC. On October 1, 1999, HC acquired a company ("Related 1") in an asset acquisition under Internal Revenue Code § 338(h)(10). On December 1, 2002, HC formed another company ("Related 2") and purchased its assets. At the time of filing the 2001 consolidated Indiana return, Taxpayer also filed amended returns carrying back Consolidated Net Operating Loss ("CNOL") from the consolidated group to HC's 1999 and 2000 tax years. Subsequently, the federal government extended the time limit for applying CNOL to five years. Taxpayer re-amended its returns to remove the CNOL it had applied to HC's 1999 and 2000 returns, and applied the CNOL to its own 1996 and 1997 separate returns.

The Department conducted an audit of the amended 1996 and 1997 returns and determined that Taxpayer had incorrectly filed the returns under HC's name and using HC's federal identification number when it should have used its own number. The Department determined that Taxpayer was not the common parent of the consolidated group, and that the federal rules allowed CNOL carrybacks to separate return years only for common parents. The Department also disallowed the claim on the basis of Taxpayer's separate net operating losses (NOL) carryback to 1996, after determining that the claim was out of statute. The Department did allow NOL attributable to Taxpayer for the amended return for 1997. After these determinations, the Department assessed additional tax, penalty and interest against Taxpayer for 1996, which the Department subsequently satisfied by applying an overpayment from 2004 which Taxpayer had applied against Taxpayer's 2005 adjusted gross income tax liability. This resulted in an underpayment for Taxpayer's 2005 adjusted gross income tax liability.

Taxpayer protests that HC is only the common parent for legal purposes, and that Taxpayer is the common parent for tax purposes. Taxpayer protests that the Department should reinstate its 1996 and 1997 CNOL carrybacks, resulting in refunds for those two years and eliminating the Department's assessments for those years. Taxpayer also protests that the Department should readjust Taxpayer's 2004 and 2005 accounts to reinstate the originally-reported 2004 overpayment and apply that towards the 2005 liability. Further facts will be supplied as required.

**I. Income Tax–Consolidated Net Operating Loss.**

**DISCUSSION**

Taxpayer protests that the Department misapplied the federal offspring CNOL rule regarding its amended returns for 1996 and 1997, and that the resulting assessment for 1996 should actually be a refund. The Department notes that the burden of proving a proposed assessment wrong rests with Taxpayer, as provided by IC § 6-8.1-5-1(c).

The Department adopts the provisions of the Internal Revenue Code (I.R.C.) under IC § 6-3-1-11, which states:

> (a) The term "Internal Revenue Code" means the Internal Revenue Code of 1986 of the United States as amended and in effect on January 1, 2007.
> (b) Whenever the Internal Revenue Code is mentioned in this article, the particular provisions that are referred to, together with all the other provisions of the Internal Revenue Code in effect on January 1, 2007, that pertain to the provisions specifically mentioned, shall be regarded as incorporated in this article by

reference and have the same force and effect as though fully set forth in this article. To the extent the provisions apply to this article, regulations adopted under Section 7805(a) of the Internal Revenue Code and in effect on January 1, 2007, shall be regarded as rules adopted by the department under this article, unless the department adopts specific rules that supersede the regulation.

(c) An amendment to the Internal Revenue Code made by an act passed by Congress before January 1, 2007, that is effective for any taxable year that began before January 1, 2007, and that affects:

(1) individual adjusted gross income (as defined in Section 62 of the Internal Revenue Code);
(2) corporate taxable income (as defined in Section 63 of the Internal Revenue Code);
(3) trust and estate taxable income (as defined in Section 641(b) of the Internal Revenue Code);
(4) life insurance company taxable income (as defined in Section 801(b) of the Internal Revenue Code);
(5) mutual insurance company taxable income (as defined in Section 821(b) of the Internal Revenue Code); or
(6) taxable income (as defined in Section 832 of the Internal Revenue Code);

is also effective for that same taxable year for purposes of determining adjusted gross income under section 3.5 of this chapter.

The Department determined that the CNOL could not be applied to Taxpayer's separate year returns, after determining that CNOL could only be applied to a common parent's separate return and that Taxpayer was not the common parent. The Department also determined that NOL attributable to Taxpayer itself could be applied to Taxpayer's separate return for 1997. Treasury Reg. § 1.1502-21(b)(2)(ii)(B) states:

Offspring rule. In the case of a member that has been a member continuously since its organization (determined without regard to whether the member is a successor to any other corporation), the CNOL attributable to the member is included in the carrybacks to consolidated return years before the member's existence. If the group did not file a consolidated return for a carryback year, the loss may be carried back to a separate return year of the common parent under paragraph (b)(2)(i) of this section, but only if the common parent was not a member of a different consolidated group or of an affiliated group filing separate returns for the year to which the loss is carried or any subsequent year in the carryback period. Following an acquisition described in § 1.1502-75(d)(2) or (3), references to the common parent are to the corporation that was the common parent immediately before the acquisition.

In order to determine which entity is the common parent, it is necessary to review Treasury Reg. § 1.1502-75(d)(3), which states in relevant part:

Reverse acquisitions -- (i) In general. If a corporation (hereinafter referred to as the "first corporation") or any member of a group of which the first corporation is the common parent acquires after October 1, 1965:

(a) Stock of another corporation (hereinafter referred to as the second corporation), and as a result the second corporation becomes (or would become but for the application of this subparagraph) a member of a group of which the first corporation is the common parent, or

(b) Substantially all the assets of the second corporation, in exchange (in whole or in part) for stock of the first corporation, and the stockholders (immediately before the acquisition) of the second corporation, as a result of owning stock of the second corporation, own (immediately after the acquisition) more than 50 percent of the fair market value of the outstanding stock of the first corporation, *then any group of which the first corporation was the common parent immediately before the acquisition shall cease to exist as of the date of acquisition, and any group of which the second corporation was the common parent immediately before the acquisition shall be treated as remaining in existence (with the first corporation becoming the common parent of the group)*. Thus, assume that corporations P and S comprised group PS (P being the common parent), that P was merged into corporation T (the common parent of a group composed of T and corporation U), and that the shareholders of P immediately before the merger, as a result of owning stock in P, own 90 percent of the fair market value of T's stock immediately after the merger. The group of which P was the common parent is treated as continuing in existence with T and U being added as members of the group, and T taking the place of P as the common parent.

(*Emphasis added.*)

. . ..

In the instant case, Taxpayer acquired HC in a reverse acquisition. As explained by Treasury Reg. § 1.1502-75(d)(3), any group in which Taxpayer was the common parent immediately before the acquisition ceased to exist as of the date of acquisition, and any group of which HC was the common parent immediately before the acquisition is treated as remaining in existence with Taxpayer becoming the common parent of the group.

A review of the information in the file gives no indication that either Taxpayer or HC were members of consolidated groups prior to the formation and reverse acquisition of HC in 1999. Treasury Reg. § 1.1502-75(d)(3) allows common parents to transfer from one group to another in the case of reverse acquisitions, however that did not happen here. Taxpayer was not a common parent of a consolidated group. Taxpayer was a single entity. Taxpayer did acquire HC in a reverse acquisition, but Taxpayer was not a common parent of a consolidated group prior to that acquisition. Therefore, there was no common parent status for Taxpayer to transfer. Also, there was no prior consolidated group of which Taxpayer could become the common parent. There was only one consolidated group, and HC was always the common parent of that group.

Since Taxpayer cannot be considered the common parent of the consolidated group under Treasury Reg. § 1.1502-75(d)(3), the provision for carryback to a common parent's separate return years found at Treasury Reg. § 1.1502-21(b)(2)(ii)(B) does not apply to Taxpayer. The last sentence of Treasury Reg. § 1.1502-21(b)(2)(ii)(B) does state that following an acquisition described in Treasury Reg. § 1.1502-75(d)(2) or (3), references to the common parent are to the corporation that was the common parent immediately before the acquisition. If Taxpayer had been a common parent of a consolidated group prior to the acquisition, then it would qualify for the provisions of Treasury Reg. § 1.1502-21(b)(2)(ii)(B). However, as previously explained, there is no evidence in the file to indicate that Taxpayer has ever been the common parent of any consolidated group.

Taxpayer states that, if the Department decides against allowing the loss carryback, that the loss should still be available for carryforward. In the audit years at issue, the Department has only determined that the CNOL is not to be carried back to Taxpayer's separate return years. In this protest, there is no reason why the loss in question could not be applied as a carryforward according to relevant carryforward rules.

In conclusion, Taxpayer is not the common parent as described in Treasury Reg. § 1.1502-75(d)(3), and so is not allowed to carryback CNOL to its separate return years under Treasury Reg. § 1.1502-21(b)(2)(ii)(B). The Department properly allowed Taxpayer to carryback the NOL attributable to itself for 1997. Taxpayer's original filing of amended returns for HC, which included CNOL for 1999 and 2000, were the correct method to claim CNOL since HC was the common parent. The Department's offset of Taxpayer's 2004 overpayment which Taxpayer had applied toward 2005 was therefore correct, and the resulting underpayment for 2005 was correct. The loss in question is available as a carryforward.

**FINDING**

Taxpayer's protest is denied.

**II. Tax Administration–Negligence Penalty.**

**DISCUSSION**

The Department issued proposed assessments and the ten percent negligence penalty for the tax year in question. Taxpayer protests the imposition of penalty. The Department refers to IC § 6-8.1-10-2.1(a), which states in relevant part:

If a person:

. . .

(3) incurs, upon examination by the department, a deficiency that is due to negligence;

. . .

the person is subject to a penalty.

The Department refers to 45 IAC 15-11-2(b), which states:

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.

45 IAC 15-11-2(c) provides in pertinent part:

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.

In this case, taxpayer incurred a deficiency which the Department determined was due to negligence under 45 IAC 15-11-2(b), and so was subject to a penalty under IC § 6-8.1-10-2.1(a). In the course of this protest, Taxpayer has affirmatively established that it had reasonable cause and was not negligent, as required by 45 IAC 15-11-2(c). As explained in Issue I, the Department offset Taxpayer's 1996 assessment by applying an overpayment from 2004, which had been applied towards Taxpayer's 2005 liabilities, towards the 1996 assessment. Since it has been determined that there is no penalty due for the 1996 assessment, the amount of penalty on the 1996 assessment should be reinstated as originally applied by Taxpayer as overpayment from 2004 towards its 2005 liabilities.

**FINDING**

Taxpayer's protest is sustained.

*Posted: 12/05/2007 by Legislative Services Agency*
An html version of this document.