DEPARTMENT OF STATE REVENUE

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Letter of Findings: 06-0494
Income Tax
For the Year 2002

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ISSUES

I. Adjusted Gross Income Tax – Combined Return.

Authority: IC § 6-3-2-2; IC § 6-5.5 et seq.; IC § 6-8.1-5-1; Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Meadwestvaco Corp. v. Illinois Dep't of Revenue, 128 S.Ct. 1498 (2008); Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768, 112 S.Ct. 2251 (1992); Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 103 S.Ct. 2933 (1983); ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 102 S.Ct. 3103 (1982).

Taxpayer protests the Department's decision to require filing a combined return with its federal consolidated group.

II. Adjusted Gross Income Tax – Net Operating Loss.

Authority: 45 IAC 15-9-2.

Taxpayer protests the disallowance of net operating loss.

STATEMENT OF FACTS

Taxpayer is a commercial printer with operations throughout the United States. Taxpayer and its subsidiaries provide integrated services to its customers that include content creation, digital content management, production, and distribution. Taxpayer, the parent, is the entity with the largest operations in Indiana. Taxpayer manages the company's resources. For the year at issue, Taxpayer had printing plants in Indiana. Taxpayer filed a consolidated return with one other company in Indiana for 2002.

The Indiana Department of Revenue ("Department") conducted an income tax audit of Taxpayer for the year in question. The Department made several adjustments to Taxpayer's income tax due as a result of the audit. Taxpayer agreed with some of the adjustments, but protested others. A hearing was held and this Letter of Findings ensues. Additional facts will be provided as required.

I. Adjusted Gross Income Tax – Combined Return.

DISCUSSION

In 2002 Taxpayer filed a consolidated Indiana income tax return that included Taxpayer and another company ("Company B"). The Department's audit proposed a combination of Taxpayer's entire federal consolidated group to more fairly reflect Taxpayer's Indiana income. The Department relied on IC § 6-3-2-2(l)(4) in doing so. Taxpayer protested this forced combination.

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(b), (c); Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

IC § 6-3-2-2(l)(4) states:

> (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;
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> (2) for a taxable year beginning before January 1, 2011, the exclusion of any one (1) or more of the factors, except the sales factor;
>
> (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.
>
> (Emphasis added).

The U.S. Supreme Court has considered the issue of a unitary relationship for adjusted gross income tax in several cases. The essential characteristic the Court requires for a unitary business is that the individual entities are functionally integrated in a common business. Meadwestvaco Corp. v. Illinois Dep't of Revenue, 128 S.Ct. 1498 (2008); Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768, 112 S.Ct. 2251 (1992); Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 103 S.Ct. 2933 (1983); ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 102 S.Ct. 3103 (1982). The Supreme Court found that unitary businesses that were functionally integrated shared many common characteristics. They had common ownership ("unity of ownership"). They had centralized management with a corporate strategy including the various entities ("unity of use"). Lastly,

the individual businesses were operated in such a manner as to further a common purpose ("unity of operation").

In the instant case, the Department found that the companies were functionally integrated and that it satisfied the three unities test. The Department found unity of ownership since all of Taxpayer's subsidiaries were either directly or indirectly one-hundred percent owned or controlled by Taxpayer. The Department found unity of use because Taxpayer provided administrative services to its subsidiaries. Taxpayer had centralized functions such as human resources, accounting, legal, tax reporting and compliance, treasury, information technology, risk management and other similar services which it provided to the subsidiaries. Services which were deemed to be corporate functions were paid for by Taxpayer and were not allocated to the subsidiaries. The Department found that unity of operation "is evidenced by the inter-company charges for interest (also known as factoring expense), royalties, logistics, satellite services, commercial photography, graphic design, [etc.]. The subsidiaries have different managers but have officers that are employees of the parent company."

Taxpayer argues that "the suggestion that the mere presence of inter-company charges requires the combined/unitary approach appears overreaching and fails to acknowledge transactions conducted on an arm's length basis with separate legal entities." In particular, Taxpayer presents additional background on three of its related entities ("Company C," "Company R," and "Company H") as examples of why Taxpayer should not be combined with its entire federal consolidated group.

Company C was incorporated in Delaware and was a wholly-owned subsidiary of Taxpayer. Per Taxpayer, Company C's sole function was to maintain and manage Taxpayer's investments. Company C contracted with third parties for asset management services, thus generally no employees were necessary. Company C borrowed funds from other subsidiaries and lent them to Taxpayer. Like a bank, Company C charged borrowers a higher rate than it paid its lenders based on market rates. Taxpayer argued that Company C is a legitimate enterprise because it paid and charged interest to its affiliate company debtors and creditors at market rates.

However, Taxpayer does not pay the accrued interest to Company C; instead such interest is added to the principal. Taxpayer's May 2004 master promissory note states that the principal of the note is the lesser of $6 billion dollars or the outstanding balance of the notes receivable amounting to $4,815,000,000 as of December 31, 2003. The note does not have a maturity date and provides that the loan can be repaid anytime without premium or penalty. Thus, the loans Company C extends to Taxpayer and the interest on those loans are generally not repaid to it – instead they are simply added to principal. This is not the sort of loan that would be available from an unrelated third party operating at arm's length. The fact that these loans are made at market rates, as Taxpayer argues, is only half the arm's length story. Company C reports minimal cash on its balance sheet for the year in question and its "notes receivables" exceed Taxpayer's total assets or even Taxpayer's sales as reported in its Indiana income tax return. Taxpayer only conducts business with its own related entities and no third parties. Lastly, the interest income on loans by Taxpayer is returned to Taxpayer through dividends which are not subject to tax in Indiana – Company C paid $100 million in dividends to Taxpayer in 2002.

Company R was incorporated in Nevada and was a wholly-owned subsidiary of Taxpayer. Company R purchased and managed receivables from Taxpayer and its affiliates. The receivables are purchased at a discount on a non-recourse basis. According to Taxpayer the discount reflected the credit risk, time value of money, and administrative costs associated with holding the receivables and was otherwise at arm's length. Taxpayer also stated that it had also factored receivables for unrelated third parties on the same terms (Taxpayer clarified at hearing that it had done so briefly in the past and no longer does so). Two of Company R's officers are also officers/employees of Taxpayer. Taxpayer's receivables are not securitized and sold to outside investors. Because of this, Company R has no interest expense in its federal income tax return for the year in question.

Taxpayer had $65 million of factoring expense in 2002 which could have been paid to Company R. Also Company R paid $150 million in dividends to Taxpayer in 2002.

By incorporating Taxpayer's credit and collection function into Company R income taxable in Indiana shifted to a state where there is no corporate income tax. Also, dividend income received by Taxpayer from Company R located outside Indiana is not subject to tax in Indiana. This circular flow of funds reduces Taxpayer's taxable income in Indiana to such an extent that it no longer fairly reflects Taxpayer's income generating activities in Indiana.

Company H was incorporated in South Carolina and was a holding company for Taxpayer's trademarks. At the time Company H was incorporated, Taxpayer made a $10,000 capital contribution to it with all rights, title and interest in the trademarks, trade names, etc. It appears that no value was assigned to the trademarks that were transferred to Company H because its balance sheet showed its intangible assets at zero. Most of its assets and retained earnings were in the form of notes receivables. Company H loaned all of its net earnings to Company C. Its only asset, therefore, besides a miniscule amount of cash, was its Trade Notes Receivables from Company C. The interest income reported by Company H represented interest on notes receivable from Company C. Company C paid Company H just enough of its loan so that Company H could turn around and pay Taxpayer a dividend of at least $50 million a year, as it did in 2002. All of Company H's officers are employees of Taxpayer. Company H's federal return shows no officer compensation and only $30,000 in salaries and wages. Taxpayer provided the Department a copy of the transfer pricing study that set the amount of the royalty fee charged to Taxpayer by Company H at 2.25 percent of net sales.

In summary, Taxpayer pays royalty fees on trademarks that are still in its books, which are managed and maintained by its own employees and where the royalty fees it pays Company H are loaned to Company C in exchange for interest payments that are then returned by Company H to Taxpayer in the form of dividends. Taxpayer deducted over $96 million in 2002. Company H paid $50 million in dividends to Taxpayer in 2002.

Taxpayer is the one entity among all its related entities that has the largest operation in Indiana. The Department correctly found that the companies were functionally integrated and satisfied the three unities test. The net income to Taxpayer from its sales in Indiana was clearly reduced by the flow of funds to and from its related entities thus not fairly reflecting Taxpayer's taxable income in Indiana.

Taxpayer raises two additional arguments against combination. First, Taxpayer protests in its April 14, 2008, email that the Department has not met the burden prescribed in IC § 6-3-2-2(p), which prescribes a prerequisite for requiring a combined filing. Taxpayer argues that:

> Indiana Code 6-3-2-2(p) specifically provides that the Department "may not require that income, deductions, and credits attributable to a taxpayer and another entity... be reported in a combined tax return for any taxable year, unless the department is unable to fairly reflect the taxpayer's adjusted gross income for the taxable year" under Indiana Code 6-3-2-2(l) or (m). In addition, the Taxpayer points out that under prior law, combination was mandatory. In repealing mandatory combination – and enacting Indiana Code 6-3-2-2(p) – the General Assembly demonstrated its preference against combination except as a last resort. As such, it is clear that Indiana Code 6-3-2-2(p) allows a forced combination only as a last resort, and further requires that the Department establish that any remedies available to the Department under Indiana Code 6-3-2-2(l) or (m) are not sufficient. Thus the Department clearly bears the burden of proof.

The Department found no such method to be more fairly reflective of Taxpayer's income earning activities in Indiana and therefore made its assessment of additional adjusted gross income tax by combining Taxpayer with its federal consolidated group. Furthermore, all that is demonstrated by the Indiana General Assembly's repeal of its old mandatory combination regime is that it would not force combination in all cases. The current regime's emphasis is on a fair and reasonable reflection of income earned from business activities within the state.

The second additional argument Taxpayer makes in an April 14, 2008, email is that:

> [Company R] and [Company C] are financial institutions subject to tax under IC 6-5.5 et seq. Both [Company R] and [Company C] receive over 80 [percent] of their respective gross income from extensions of credit or loans. As such they are each financial institutions under IC 6-5.5-1-17 and are exempt from adjusted gross income tax under IC 6-5.5-9-4. [Company C]'s gross receipts are from loans and [Company R]'s receipts are from factoring receivables. The Department has determined that factoring of receivables is the business of a financial institution.

Taxpayer is mistaken, Company R is not subjected to FIT because it does not function as a typical conduit for a bankruptcy remote entity whose function is to obtain loans with the receivables as collateral at rates that are lower than rates Taxpayer can secure by itself. Taxpayer has a substantial cash flow and a short collection cycle with payments generally 45 days after invoice date, therefore based on general securitization rationale it does not need to use its receivables as collateral for its financing needs. Company C, likewise, is not subjected to FIT because it does not function, at a minimum, at arm's length in its treatment of repayment of loans.

To recap, Taxpayer argues its reported Indiana taxable income is not a distortion of its Indiana income generating activities because there is no requisite uncompensated "flow of value." Taxpayer argues that in the instant case there is a compensated flow of value between Taxpayer and Company C, Company R, and Company H through arm's length transactions: interest between Company C and Taxpayer is set at prime; factoring payments made by Taxpayer to Company R were made to compensate for credit risk, time value of money, and administrative costs; and Taxpayer's royalty payments to Company H were made at a rate determined through a royalty study. The reality is, however, that the consolidated group's net federal taxable income is smaller than the net federal taxable income of Company H, Company C, and Company R, which Taxpayer uses to argue against forced combination. Therefore, if Taxpayer's method of filing were not changed to more fairly reflect its Indiana activity, Taxpayer will continue to report no Indiana adjusted gross income tax liability for years to come – not only because of large deductions for royalties, interest and factoring expense (which the above discussion demonstrates clearly) but also from the large net operating loss deduction built up since 1995 which are discussed in Issue II.

Taxpayer did not sustain its burden of proving that it and its federal consolidated group should not be included in an Indiana combined return to more fairly reflect its Indiana income generating activities.

FINDING

Taxpayer's protest against combination with its federal consolidated group is respectfully denied.

II. Adjusted Gross Income Tax – Net Operating Loss.

DISCUSSION

The Department disallowed Taxpayer's Net Operating Loss ("NOL") deduction because the adjusted gross income in prior years was computed incorrectly on the consolidated return basis. The Department found that if Taxpayer's adjusted gross income in prior years was recomputed on the unitary/combined method as used in the audit year currently at issue, Taxpayer would have no NOLs in 2002. Taxpayer protests this determination by the

Department that its NOLs should be adjusted to zero.

According to 45 IAC 15-9-2(c) "the department may still examine the closed years to determine whether the net operating loss is valid and properly calculated." Since the Department did not assess additional tax in the closed years and only disallowed the effect of that net operating loss in an open year, 2002, the Department acted properly within the statute of limitations.

Taxpayer reported millions in Indiana net operating losses despite generating an average of 69 percent of the consolidated group's sales for the audit period. Taxpayer has had consecutive net operating losses in Indiana for consecutive years starting in 1995 while the consolidated group was consistently profitable over those years. For example for 2002, Taxpayer shows a loss on Indiana adjusted gross income of over $19 million where the consolidated group's net federal taxable income was $93 million. Prior to 1995, Taxpayer reported taxable income in Indiana. Taxpayer's sales represent approximately 75 percent of the consolidated group's sales, yet it consistently has reported losses in Indiana in each of the years since 1995.

The Department, therefore, correctly disallowed Taxpayer's NOLs for 2002.

FINDING

Taxpayer's protest of the disallowance of NOLs in 2002 is respectfully denied.

CONCLUSION

Taxpayer is combined with its consolidated federal group for 2002, and its net operating loss deduction is disallowed.

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