DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 08-0402
Income Tax
For Tax Years 2002-04

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ISSUES

I. Income Tax–Corporate.

Authority: Aztar Indiana Gaming Corp. v. Indiana Dep't of State Revenue, 806 N.E.2d 381 (Ind. Tax Ct. 2004); First Chicago NBD Corp. v. Indiana Dep't of State Revenue, 708 N.E.2d 631 (Ind. Tax Ct. 1999); Consolidation Coal Co. v. Indiana Dep't of State Revenue, 583 N.E.2d 1199 (Ind. 1991); IC § 6-3-1-3.5IC § 6-3-2-2.6; IC § 6-8.1-5-1; IC § 27-1-18-2.

Taxpayer protests the assessment of corporate 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 a corporation in the insurance industry doing business in Indiana. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer owed additional corporate income tax, interest, and a ten percent negligence penalty. Taxpayer protests the imposition of income tax and penalty. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Income Tax–Corporate.

DISCUSSION

Taxpayer protests the imposition of income tax for the tax years 2002 through 2004. The Department determined that Taxpayer had incorrectly claimed Net Operating Losses (NOL) from years for which it was not eligible to claim NOLs. The Department also determined that Taxpayer should have added back premium taxes paid elsewhere to its Indiana adjusted gross income tax (AGIT) returns for those years. Taxpayer protests that it was allowed to claim the NOLs for the years in question. Taxpayer also protests that the premium taxes in question do not qualify for addback. The Department notes that the burden of proving a proposed assessment wrong rests with the person against whom the proposed assessment is made, as provided by IC § 6-8.1-5-1(c).

Taxpayer protests that it is allowed to claim NOLs for the years in question. The Department determined that, since Taxpayer was not subject to AGIT prior to 2003, Taxpayer was ineligible to claim NOLs as carry forwards. Taxpayer refers to IC § 6-3-2-2.6(h), which states:

> An Indiana net operating loss deduction determined under this section shall be allowed notwithstanding the fact that in the year the taxpayer incurred the net operating loss the taxpayer was not subject to the tax imposed under section 1 of this chapter because the taxpayer was:
>
> (1) a life insurance company (as defined in Section 816(a) of the Internal Revenue Code); or
>
> (2) an insurance company subject to tax under Section 831 of the Internal Revenue Code.
>
> (Emphasis added).

Taxpayer is an insurance company subject to tax under Section 831 of the Internal Revenue Code. Therefore, under IC § 6-3-2-2.6(h), Taxpayer is allowed to use NOL carry forwards despite the fact that Taxpayer was not subject to AGIT in the years the NOL was incurred.

Taxpayer also protests the Department's determination to addback premium taxes paid in Indiana and elsewhere to Taxpayer's Indiana AGIT calculations. In support of this determination, the Department referred to IC § 6-3-1-3.5(d), which states in relevant part:

> In the case of insurance companies subject to tax under Section 831 of the Internal Revenue Code and organized under Indiana law, the same as "taxable income" (as defined in Section 832 of the Internal Revenue Code), adjusted as follows:
>
> (1) Subtract income that is exempt from taxation under this article by the Constitution and statutes of the United States.
>
> (2) Add an amount equal to any deduction allowed or allowable under Section 170 of the Internal Revenue Code.
>
> (3) Add an amount equal to a deduction allowed or allowable under Section 805 or Section 831(c) of the Internal Revenue Code for taxes based on or measured by income and levied at the state level by any state.....
>
> (Emphasis added).

The Indiana insurance premium tax is imposed under IC § 27-1-18-2, which states in relevant part:

(a) Every insurance company not organized under the laws of this state, and each domestic company electing to be taxed under this section, and doing business within this state shall, on or before March 1 of each year, report to the department, under the oath of the president and secretary, the gross amount of all premiums received by it on policies of insurance covering risks within this state, or in the case of marine or transportation risks, on policies made, written, or renewed within this state during the twelve (12) month period ending on December 31 of the preceding calendar year. From the amount of gross premiums described in this subsection shall be deducted:

(1) considerations received for reinsurance of risks within this state from companies authorized to transact an insurance business in this state;

(2) the amount of dividends paid or credited to resident insureds, or used to reduce current premiums of resident insureds;

(3) the amount of premiums actually returned to residents on account of applications not accepted or on account of policies not delivered; and

(4) the amount of unearned premiums returned on account of the cancellation of policies covering risks within the state.

(b) A domestic company shall be taxed under this section only in each calendar year with respect to which it files a notice of election. The notice of election shall be filed with the insurance commissioner and the commissioner of the department of state revenue on or before November 30 in each year and shall state that the domestic company elects to submit to the tax imposed by this section with respect to the calendar year commencing January 1 next following the filing of the notice. The exemption from license fees, privilege, or other taxes accorded by this section to insurance companies not organized under the laws of this state and doing business within this state which are taxed under this chapter shall be applicable to each domestic company in each calendar year with respect to which it is taxed under this section. In each calendar year with respect to which a domestic company has not elected to be taxed under this section it shall be taxed without regard to this section.

(c) For the privilege of doing business in this state, every insurance company required to file the report provided in this section shall pay into the treasury of this state an amount equal to the excess, if any, of the gross premiums over the allowable deductions multiplied by the following rate for the year that the report covers:

(1) For 2000, two percent (2[percent]).

(2) For 2001, one and nine-tenths percent (1.9[percent]).

(3) For 2002, one and eight-tenths percent (1.8[percent]).

(4) For 2003, one and seven-tenths percent (1.7[percent]).

(5) For 2004, one and five-tenths percent (1.5[percent]).

(6) For 2005 and thereafter, one and three-tenths percent (1.3[percent]).

....

(Emphasis added).

The Department determined that the premium taxes paid in Indiana and elsewhere constituted taxes based on or measured by income and levied at the state level by any state, and should therefore be added back as provided by IC § 6-3-1-3.5(d)(3).

Taxpayer protests that premium taxes are not taxes based on or measured by income. Taxpayer refers to First Chicago NBD Corp. v. Indiana Dep't of State Revenue, 708 N.E.2d 631 (Ind. Tax Ct. 1999), in which the Indiana Tax Court discussed the Michigan Single Business Tax ("MSBT") and stated:

Admittedly, income is one way to measure the market's valuation of the production process. However, based on this reasoning, almost every tax could be construed as measured by income. Income is naturally linked to all aspects of the production process. As the Supreme Court noted, "compensation, depreciation and profit are not independent variables to be adjusted without reference to each other." Trinova, 498 U.S. at 376, 111 S.Ct. 818. However, this does not mean that every tax is based on income. Other aspects of the production process may be valued and taxed just as readily as income, and this is what has been done in Michigan with the MSBT.

Id. at 635.

The court also provided:

In the MSBT formula, corporate outlays such as wages are added to income to calculate the tax base. This formula is therefore not designed to measure income but rather the value added through the production process. In contrast, a tax based on or measured by income would be calculated by subtracting such outlays in order to arrive at the income or profit made after the product is sold, and a tax measured by gross income or gross receipts would not add such outlays-it would merely look to what the taxpayer received during that tax period.

Id. at 634. (Emphasis in original).

Next Taxpayer refers to Aztar Indiana Gaming Corp. v. Indiana Dep't of State Revenue, 806 N.E.2d 381 (Ind. Tax Ct. 2004), a case discussing Riverboat Wagering Tax ("RWT"), in which the Indiana Tax Court stated:

> In this case, it is clear that the RWT is an excise tax: it is not payable unless the privilege of conducting riverboat gambling is exercised and the exercising of those privileges is the occasion for the imposition of the tax. See Fort Wayne Nat'l Corp., 649 N.E.2d at 111 (citing Lutz, 193 N.E. at 844). Nevertheless, it is an excise tax that is measured by income. Indeed, Aztar's RWT liability calculation is measured by the adjusted gross receipts it receives from its gaming operations: all cash and property received by Aztar from its gaming operations (minus certain adjustments) certainly constitute income to Aztar. See A.I.C. § 4-33-2-2. See also BLACK'S LAW DICTIONARY 766 (7th ed.) (defining income as "[t]he money or other form of payment that one receives... from employment, business, investments, royalties, gifts, and the like"). Accordingly, Aztar's RWT liability is subject to the add-back provision of Indiana Code § 6-3-1-3.5(b)(3).
> Id. at 386.

Taxpayer also refers to Consolidation Coal Co. v. Indiana Dep't of State Revenue, 583 N.E.2d 1199 (Ind. 1991), in which the Indiana Supreme Court determined that the West Virginia B & O tax was based on income and therefore should be added back to Indiana AGIT under IC § 6-3-1-3.5(d)(3). The Court explained:

> If "income" were the only word that required defining to resolve this case, the matter might be settled. The legislature has given us more, however, by using the phrase "based on or measured by income." This suggests a broader inquiry than would be appropriate if the legislature had provided for adding back, say, "taxes on income." We think this broader analysis is much like the one we used in Miles v. Department of Treasury (1935), 209 Ind. 172, 199 N.E. 372. The Miles Court held that Indiana's Gross Income Tax was a "tax on income," focusing on whether Indiana's Gross Income Tax constituted a property or non-property tax, a critical distinction under Article X of the Indiana Constitution as it read in 1935. We think that the whole phrase, "based on or measured by income" seems likely to be used in the same, simple sense which defined the inquiry in Miles. Is the tax which the payor wishes to add back measured by income? Or measured by value of property held? We conclude that the add-back provisions at issue in this case are designed to describe the kind of tax to be added back-permitting the add-back of taxes based on income but not those such as property or excise taxes.
> Id. at 1201-2.
> The Court further provided:
> West Virginia's Business and Occupation Tax law places a tax on the privilege of doing business in that state. "[T]here is hereby levied and shall be collected annual privilege taxes against the persons, on account of the business and other activities, and in the amounts to be determined by the application of rates against values or gross income...." W.Va.Code § 11-13-2(a) (Michie 1987). During the years pertinent to this case, businesses extracting coal from West Virginia soil paid a tax of 3.5[percent] on the "gross proceeds derived from the sale" of the coal, and an "additional tax" of.35% on the "gross proceeds," pursuant to W.Va.Code § 11-13-2a, and -21 (Michie 1987). Both of these provisions were repealed in 1987. Under the B & O Tax law, the term "gross proceeds of sales" is defined as "the value... actually proceeding from the sale of tangible property without any deduction on account of the cost of property sold or expenses of any kind." W.Va.Code § 11-13-1 (Michie 1987). We take this to be a tax "measured by income" in the sense we examined the issues in Miles.
> Id. at 1202. (Emphasis added).

Taxpayer states that these cases support its position that the premium taxes at issue here do not constitute taxes based on or measured by income. Taxpayer states that the court in Aztar found the RWT to be a tax based on income because it first found that the RWT was measured by all cash and property received less adjustments, including payouts. Taxpayer believes that the premium taxes imposed by Indiana and other states are not measured on income, but rather are excise taxes for the privilege of doing business in those states.

While none of these cases directly discuss the premium tax at issue here, they do provide guidance in determining what constitutes a tax based on or measured by income. As explained in First Chicago NBD, a tax based on income or measured by income would be calculated by subtracting such outlays in order to arrive at the income or profit made after the product is sold. Aztar provided that a tax based on cash and property received minus certain adjustments certainly constituted income to the taxpayer. Consolidation Coal determined that the West Virginia tax was imposed on gross proceeds and was therefore a tax based on or measured by income.

Under IC § 27-1-18-2(a), the premium tax is based on the gross amounts of premiums with subtractions, which is a tax based on or measured by income as provided by First Chicago NBD and Aztar. Under IC § 27-1-18-2(c), a taxpayer pays an amount equal to the excess, if any, of the gross premiums over the allowable deductions, which is a tax based on or measured by income as provided by Consolidation Coal. In the instant case, IC § 6-3-1-3.5(d)(3) requires the addback of state taxes based on or measured by income. Taxpayer has not established that the other state insurance premium taxes are different from Indiana's insurance premium tax. Therefore, the insurance premium taxes should be added back under IC § 6-3-1-3.5(d)(3).

In conclusion, Taxpayer is allowed to carry forward NOLs under IC § 6-3-2-2.6(h). Insurance premium taxes should be added back under IC § 6-3-1-3.5(d)(3). Taxpayer also protested that there were typographical and calculational errors in the audit report's workpapers. A supplemental audit will be required to make the adjustments for NOLs. The supplemental audit will review and verify or correct the workpapers for the protested

typographical and calculational errors.

FINDING

Taxpayer's protest is sustained in part and denied in part.

II. Tax Administration–Negligence Penalty.

DISCUSSION

The Department issued proposed assessments and the ten percent negligence penalty for the tax years in question and a twenty percent underpayment of estimated tax for 2004. 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). Taxpayer has affirmatively established that the failure to pay the deficiency and the underpayment for 2004 was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest is sustained.

CONCLUSION

Taxpayer is sustained in Issue I with regard to Net Operating Loss carry forwards. Taxpayer is denied in Issue I with regard to add backs of insurance premium taxes. Taxpayer is sustained in Issue II with regard to negligence penalty and underpayment penalty.

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