DEPARTMENT OF STATE REVENUE

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Letters of Findings Numbers: 08-0261, 08-0262
Income Tax
For Tax Years 2002-04

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ISSUES

I. Gross Income Tax–Imposition.

Authority: Enterprise Leasing Co. of Chicago v. Indiana Dep't of State Revenue, 779 N.E.2d 1284 (Ind. Tax Ct. 2002); Bethlehem Steel Corp. v. Indiana Dep't of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992); IC § 6-2.1-2-2; IC § 6-8.1-5-1.

Taxpayer protests the assessment of gross income tax.

II. Adjusted Gross Income Tax–Combined Return.

Authority: IC § 6-3-2-2; 45 IAC 3.1-1-62.

Taxpayer protests the determination that it should file a combined return.

III. 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 doing business in Indiana and nationwide. Taxpayer merged with another company in one of the audit years, resulting in two taxpayer identification numbers (TIDs) for Taxpayer during the audit period. Therefore, for the three-year audit period, there were two TIDs and two audit reports for one Taxpayer. The two audit reports and proposed assessments resulted in two protests. For convenience, both protests will be addressed in one Letter of Findings (LOF). As the result of the audits, the Department determined that Taxpayer owed additional gross income tax and supplemental net income tax for 2002, additional adjusted gross income tax for 2003 and 2004, and ten percent negligence penalties and interest for 2002, 2003, and 2004. Taxpayer protests the imposition of gross income tax, adjusted gross income tax, and penalties. An administrative hearing was held, and this Letter of Findings results. Further facts will be supplied as required.

I. Gross Income Tax–Imposition.

DISCUSSION

Taxpayer protests the imposition of gross income tax for 2002. The gross income tax has since been repealed, and all statutes and regulations referred to in this Letter of Findings are as they were in effect during the tax years at issue. Taxpayer had employees in Indiana in 2002. As described in the audit report, those employees were primarily sales representatives. The remaining employees were sales managers. The Department determined that this gave Taxpayer a business situs in Indiana. The Department also determined that Taxpayer's sales in Indiana were sufficiently associated with the Indiana business situs to give Taxpayer a tax situs in Indiana and therefore subject the income from those sales to gross income tax. Taxpayer protests that it lacked the required tax situs to subject the sales in question to gross income tax. 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).

The gross income tax was imposed under IC § 6-2.1-2-2, which stated in relevant part:

(a) An income tax, known as the gross income tax, is imposed upon the receipt of:

(1) the entire taxable gross income of a taxpayer who is a resident or a domiciliary of Indiana; and

(2) the taxable gross income derived from activities or businesses or any other source within Indiana by a taxpayer who is not a resident or a domiciliary of Indiana.

...

Of relevance is the Indiana Tax Court's decision in Bethlehem Steel Corp. v. Indiana Dep't of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992), where the court stated:

Insofar as here pertinent, the Gross Income Tax statute requires that in order to be taxable, gross income of a non-resident must be derived from activities within the state. If the activities giving rise to the income sought to be taxed do not occur within Indiana, then the tax may not be levied -- not because to do so is forbidden by the United States Constitution (although it may well be) -- but rather because under those facts the levy is forbidden by the statute.

Id. at 1330.

The Indiana Tax Court has since refined its explanation concerning the applicability of gross income tax to nonresidents, and determined that there are three steps to reach such a decision. In Enterprise Leasing Co. of

Chicago v. Indiana Dep't of State Revenue, 779 N.E.2d 1284 (Ind. Tax Ct. 2002), the court explained:

> To determine whether gross income is derived from an Indiana "source," the Court must (1) isolate the transaction giving rise to the income ("the critical transaction"), (2) determine whether the Petitioners have a physical presence in, or significant business activities within the taxing state ("business situs"), and (3) determine whether the Indiana activities are related to the critical transaction and are more than minimal, not remote or incidental to the total transaction ("tax situs").

Id. at 1290 (citations omitted).

In this case, the critical transaction is Taxpayer's sale of its product. Taxpayer has significant business activities in Indiana and therefore does have a business situs in Indiana. The remaining question is whether or not Taxpayer's Indiana activities were related to the critical transaction and were more than minimal, not remote or incidental to the total transaction.

The Department determined in the audit that Taxpayer's Indiana activities were related to the critical transaction and not more than minimal, not remote, and not incidental to the total transaction. In support of this, the Department listed many of the activities of Taxpayer's sales representatives in Indiana. Those activities were primarily focused on retail placement, promotion, and sales of the products. The Department considered these activities to be directly related to the sales of Taxpayer's product in Indiana.

Taxpayer protests that the sales into Indiana were to wholesalers. The wholesalers ordered the products via telephone, facsimile, or e-mail. The products were shipped from third-party warehouses and the wholesalers owned the product at the time it left the warehouses, prior to entry into Indiana. Since the sales were to the wholesalers, and since Taxpayer's sales activities in Indiana dealt with retailers, the two activities are not sufficiently connected to establish a tax situs for the sales of product to Indiana customers, as provided by Enterprise Leasing. Taxpayer has met its burden of demonstrating that its Indiana activities are not sufficiently related to the critical transaction necessary to establish a tax situs for the sales of product to Indiana customers as provided by Enterprise Leasing.

FINDING

Taxpayer's protest is sustained.

II. Adjusted Gross Income Tax–Combined Return.

DISCUSSION

Taxpayer protests the Department's determination that Taxpayer should file a combined Indiana return including all companies listed in its federal consolidated group. The Department determined that the companies in question were so intertwined that it was impossible to accurately separate the activities in order to fairly reflect Indiana adjusted gross income. Primarily, the uncertainty arises from two companies in the consolidated group. One company ("Related 1") received royalty payments from Taxpayer for the use of intangible personal property in the form of trademarks. The audit report found little evidence of any activity by Related 1 which would warrant millions of dollars of royalty payments by Taxpayer. Another company ("Related 2"), which is the direct parent of Related 1, invested Related 1's income in the form of loans to Taxpayer and other companies in the consolidated group. Almost ninety-nine percent of Related 2's income resulted from interest on inter-company loans to Taxpayer. The Department concluded that the result of these operations was to move income earned in Indiana elsewhere without valid business reasons. This resulted in an unfair representation of Taxpayer's Indiana income. Taxpayer protests that it had valid reasons for its arrangements and that the Department did not properly consider alternative methods other than requiring combined filing. 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-(c).

Taxpayer's first point of protest is that it did have valid business reasons for its arrangements. Taxpayer notes that it formed Related 1 several years prior to the audit period for the express purpose of marketing and licensing the trademarks to third parties. Two years after its formation, due to a change in circumstances, Related 1 was no longer allowed to market and license the trademarks to third parties. Related 1 was still allowed to license the trademarks to Taxpayer. Taxpayer states that the royalty rate paid to Related 1 was arm's length and provided a third-party pricing study in support of this position. Taxpayer also states that Related 1 filed state income tax returns in another state, where it is incorporated and has its office.

Taxpayer believes that the Department did not properly follow IC § 6-3-2-2, which states in relevant parts:

> ...
>
> (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) 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.

(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.

...

(p) Notwithstanding subsections (l) and (m), the department may not require that income, deductions, and credits attributable to a taxpayer and another entity not described in subsection (o)(1) or (o)(2) be reported in a combined income tax return for any taxable year, unless the department is unable to fairly reflect the taxpayer's adjusted gross income for the taxable year through use of other powers granted to the department by subsections (l) and (m).

....

(Emphasis added).

Taxpayer also refers to 45 IAC 3.1-1-62, which states:

All corporations doing business in more than one state shall use the allocation and apportionment provisions described in Regulations 6-3-2-2(b)-(k) [45 IAC 3.1-1-37–45 IAC 3.1-1-61] unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income. However, the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states. It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results.

(Emphasis added).

Taxpayer states that the Department did not properly consider IC § 6-3-2-2(p) and did not demonstrate that the methods provided by IC § 6-3-2-2(l) and (m) did not properly reflect Indiana income. Taxpayer believes that 45 IAC 3.1-1-62 requires that a combined return be used only as a last resort.

The Department notes that IC § 6-3-2-2(p) does not require the Department to provide explanations of why other methods do not fairly reflect Indiana income. The requirement is that the Department be unable to fairly reflect Indiana income using other methods before requiring a combined return. The Department provided extensive explanation in the audit report concerning the interwoven nature of the companies in this case. The Department explained that it was unable to otherwise fairly reflect Taxpayer's Indiana income and so required combined filing, as allowed under IC § 6-3-2-2(l). The Department considered combined filing as a last resort to fairly reflect Indiana income, as required by 45 IAC 3.1-1-62.

Taxpayer has only offered the option of individual filing as an alternative to combined filing. As noted above, under IC § 6-8.1-5-1(c), the burden of proving a proposed assessment wrong rests with Taxpayer. While it is certain that Taxpayer disagrees with the combined filing approach, merely stating that the Department has not written out all possible alternatives and why they do not work is insufficient to prove that the Department is wrong.

Also, while Taxpayer has established that Related 1 was originally established for valid business reasons, it has not established what Related 1 did during the audit years to require it to continue collecting millions of dollars of royalties. After the change in circumstances, Related 1 was no longer allowed to pursue its original business purpose. There is no evidence that during the audit period Related 1 took any actions concerning the trademarks other than collecting royalties from Taxpayer.

Taxpayer has established that the interest rates charged by Related 2 were arm's-length rates. Taxpayer has not established the reasons why Taxpayer required these loans in the first place. As provided in the audit report, it is reasonable for the Department to conclude that the loans to Taxpayer served no other purpose than to pay royalties to Related 1 which were then given to Related 2 to loan to Taxpayer. This results in Indiana income being moved out of Indiana in a circular flow for no other apparent reason than to avoid Indiana adjusted gross income tax. Even with arm's-length royalty and interest rates, Taxpayer has not established that there were valid underlying business reasons for these arrangements.

Taxpayer also makes the general statement that combined filing violates the Due Process and Commerce Clauses of the United States Constitution. Taxpayer lists several United States Supreme Court cases along with this statement. Taxpayer does not offer a detailed analysis of why these cases apply in this instance. Considering that the Department combined Taxpayer with its federal consolidated group and then apportioned the income using the apportionment formula provided in IC § 6-3-2-2, the Department is not convinced that the proposed assessments violate either the Due Process or Commerce Clause.

In conclusion, the Department is not required to provide explanations of why other methods do not fairly reflect Taxpayer's Indiana income. IC § 6-3-2-2(p) only requires that the Department be unable to fairly reflect Indiana income through other means. Taxpayer has not provided any alternative other than single filing, let alone a demonstrably superior method. Given the volume of royalties, loans, and interest and given the lack of activity

by Related 1 and lack of valid business reasons for the loans from Related 2 to Taxpayer, the Department was correct to require combined filing. Combined filing does not violate the Due Process or Commerce Clause. Taxpayer has not met the burden imposed by IC § 6-8.l-5-1(c) of proving the proposed assessments for adjusted gross income tax wrong.

FINDING

Taxpayer's protest is denied.

III. 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). While Taxpayer sustained in Issue I above, Taxpayer has not affirmatively established that its failure to pay the deficiency discussed in Issue II was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c). The ten percent penalty will be imposed on the remaining amount after gross income tax is removed from the assessments.

FINDING

Taxpayer's protest is denied.

CONCLUSION

Taxpayer is sustained on Issue I regarding imposition of gross income tax. Taxpayer is denied on Issue II regarding the requirement to file a combined return for adjusted gross income tax. Taxpayer is denied on Issue III regarding imposition of ten percent negligence penalty.

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