DEPARTMENT OF STATE REVENUE

02-20090007.LOF

Letter of Findings Number: 09-0007
Adjusted Gross Income Tax
For Tax Years Ending March 31, 2003-March 31, 2007

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 It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register.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. Adjusted Gross Income Tax–Accounts Receivable.

Authority: Monarch Beverage Co., Inc. v. Indiana State Dep't of Revenue, 589 N.E.2d 1209 (Ind. Tax Ct. 1992); IC § 6-3-1-3.5; IC § 6-3-2-2; IC § 6-8.1-5-1; 45 IAC 3.1-1-62.

Taxpayer protests the disallowance of deductions based on losses incurred from the sale of accounts receivable.

II. Adjusted Gross Income Tax–Net Operating Losses.

Authority: 45 IAC 3.1-1-9.

Taxpayer protests the Department's adjustment to Net Operating Losses for years subject to a prior settlement agreement.

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 an out-of-state corporation with operations in Indiana and many other states. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer had improperly deducted losses incurred in the sale of accounts receivable ("AR") to a related Delaware corporation ("Related") and had improperly calculated its net operating losses ("NOLs") for application during the audit years running from the one ending March 31, 2003 through the one ending March 31, 2007. Therefore, the Department issued proposed assessments for adjusted gross income tax, interest and ten percent negligence penalty. Taxpayer protests the assessment of adjusted gross income tax and a ten percent negligence penalty. An administrative hearing was held and this Letter of Findings results. Further facts will be supplied as required.

I. Adjusted Gross Income Tax–Accounts Receivable.

DISCUSSION

Taxpayer protests the Department's determination that losses incurred from the sale of accounts receivable from Taxpayer to Related were improperly deducted from Taxpayer's Indiana adjusted gross income. Taxpayer states that the sales were conducted for legitimate business reasons and at arm's-length rates. Therefore, Taxpayer believes that the deductions for losses from the sales of AR were legitimate and properly included on its Indiana income tax returns as originally reported. 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 adjusted gross income tax is imposed under IC § 6-3-2-2, which states in relevant parts:

(a) With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:

(1) income from real or tangible personal property located in this state;
(2) income from doing business in this state;
(3) income from a trade or profession conducted in this state;
(4) compensation for labor or services rendered within this state; and
(5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter.

. . .

(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) the exclusion of any one (1) or more of the factors;
(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.

Also, 45 IAC 3.1-1-62 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.

The Department determined that Taxpayer's sale of AR did not fairly reflect Taxpayer's Indiana income for the years at issue. Taxpayer is one of several related companies which sell AR to Related. Related takes the AR from the various related companies and puts them into a pool of AR which were then used to securitize loans from third parties. Related then distributed those loans to Taxpayer and the other related companies, which had contributed AR to the pool, in the form of a revolving credit account. Related paid service fees in the amount of.5 percent of the receivable balance to Taxpayer to perform collection and administration functions regarding the AR which Taxpayer had sold to Related. The Department viewed the transactions as creating an artificial loss which shifted Taxpayer's Indiana income to Related, which did not file any state income tax returns. In the Department's view, this resulted in a distortion of Taxpayer's Indiana income. The Department added the claimed losses and interest payments on the loans back to Taxpayer's Indiana income and deducted the service fees Related paid to Taxpayer for those years and recalculated Indiana income tax.

Taxpayer disagrees with the Department's conclusion and states that there is no distortion of its Indiana income. Taxpayer states that it had third-party pricing studies done to establish the rates for sale of the AR and to ensure that they were conducted at arm's-length pricing. Taxpayer refers to IC § 6-3-1-3.5(b), which states:

(b) In the case of corporations, the same as "taxable income" (as defined in Section 63 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 or deductions allowed or allowable pursuant to Section 170 of the Internal Revenue Code.

(3) Add an amount equal to any deduction or deductions allowed or allowable pursuant to Section 63 of the Internal Revenue Code for taxes based on or measured by income and levied at the state level by any state of the United States.

(4) Subtract an amount equal to the amount included in the corporation's taxable income under Section 78 of the Internal Revenue Code.

(5) Add or subtract the amount necessary to make the adjusted gross income of any taxpayer that owns property for which bonus depreciation was allowed in the current taxable year or in an earlier taxable year equal to the amount of adjusted gross income that would have been computed had an election not been made under Section 168(k) of the Internal Revenue Code to apply bonus depreciation to the property in the year that it was placed in service.

(6) Add an amount equal to any deduction allowed under Section 172 of the Internal Revenue Code.

(7) Add or subtract the amount necessary to make the adjusted gross income of any taxpayer that placed Section 179 property (as defined in Section 179 of the Internal Revenue Code) in service in the current taxable year or in an earlier taxable year equal to the amount of adjusted gross income that would have been computed had an election for federal income tax purposes not been made for the year in which the property was placed in service to take deductions under Section 179 of the Internal Revenue Code in a total amount exceeding twenty-five thousand dollars ($25,000).

(8) Add an amount equal to the amount that a taxpayer claimed as a deduction for domestic production activities for the taxable year under Section 199 of the Internal Revenue Code for federal income tax purposes.

(9) Add to the extent required by IC 6-3-2-20 the amount of intangible expenses (as defined in IC 6-3-2-20) and any directly related intangible interest expenses (as defined in IC 6-3-2-20) for the taxable year that reduced the corporation's taxable income (as defined in Section 63 of the Internal Revenue Code) for federal income tax purposes.

(10) Add an amount equal to any deduction for dividends paid (as defined in Section 561 of the Internal Revenue Code) to shareholders of a captive real estate investment trust (as defined in section 34.5 of this chapter).

(11) Subtract income that is:

(A) exempt from taxation under IC 6-3-2-21.7; and

(B) included in the corporation's taxable income under the Internal Revenue Code.

Taxpayer believes that the language of IC § 6-3-1-3.5(b) not only allows, but actually requires taxpayers to

deduct losses such as those it incurred here. Taxpayer does not specify which of the eleven provisions found in IC § 6-3-1-3.5(b) require it to deduct these losses.

Taxpayer states that the losses are legitimate since it followed the pricing studies conducted by third parties. Since the arm's-length pricing was the same as anyone on the open market would pay, Taxpayer asserts, its losses were bona fide and properly deductable *[sic]*. Taxpayer states that the Department erroneously referred to the sales as "artificial" in its audit report. Taxpayer reiterates that these were real transactions which produced real losses for Taxpayer. In support of its position that Related was a real company with real functions, Taxpayer provided documentation showing the various functions performed by Related.

Upon review of the audit report, it is clear that the Department's use of the term "artificial" was not intended to refer to the pricing or the losses incurred by Taxpayer. The artifice was Taxpayer's claim of losses and subsequent deductions on transactions which transferred AR to Related but which Taxpayer continued to administer. What was also determined in the course of the protest process is that Related had only one employee earning less than thirty thousand dollars per year. The Department is not convinced that a single employee at a relatively modest pay scale would be able to perform all of Related's business functions, which involved tens of millions of dollars of AR and loans between the third parties to Related and from Related to Taxpayer. As explained in the audit report, the functions "performed" by Related were actually services which Related paid Taxpayer to perform. In other words, Taxpayer transferred its AR to Related but Taxpayer's employees continued to perform all functions of ownership related to the AR. This is the artificial nature of the transactions to which the Department referred in its audit report.

The result of this arrangement was that Taxpayer continued business as usual while Related did not really perform any real functions concerning ownership of the AR. Added to this scenario is the fact that Related used the AR to securitize funding which it then loaned to Taxpayer via a revolving credit account. Again, since Related had only one low-paid employee, the Department is not convinced that Related performed this activity either. Taxpayer paid interest to Related which it then deducted from its Indiana income. Taxpayer states that lending and securitization regulations ensure that arm's-length interactions are observed at all stages of the process. Again, the arm's-length nature of any payments or loans is not at issue. What is at issue is Taxpayer's claim of losses on the sale of AR when Taxpayer continued to perform all functions of ownership of the AR. The artificial nature of these activities and distortion of Taxpayer's Indiana income to which the Department referred in the audit report is clear.

Taxpayer also points out that the Internal Revenue Service ("IRS") has audited the relevant entities three times since the inception of the AR securitization arrangement and made no adjustments in any of the three audits. The Department is not convinced that this is relevant, since the federal taxing authority would be concerned with federally taxable income. The IRS would not be concerned with whether or not Taxpayer's Indiana income was fairly reflected by its Indiana filing method. Related's reliance on and payment to Taxpayer for administration of the AR may have been conducted at arm's-length pricing, particularly from the federal point of view. That does nothing to alter the fact that two related companies were "rotating" Indiana income to a company which did not report to Indiana while Taxpayer continued to perform all of the functions associated with owning the AR at issue.

Taxpayer protests the Department's reference to 45 IAC 3.1-1-62 in its audit report. Taxpayer states that this regulation only allows the Department to make changes in allocation and apportionment methods, not to add back claimed losses as was done here. Taxpayer also points to the language in the regulation which explains that the Department will only depart from the standard methods in limited and unusual circumstances which ordinarily will be unique and nonrecurring. Taxpayer states that its circumstances are not unique and nonrecurring, but rather are its normal and recurring circumstances, thereby invalidating the Department's authority to make the changes at issue.

The Department notes that the regulation also uses the word "ordinarily" in the reference to unique and nonrecurring circumstances. It does not use the word "only," which is the definition Taxpayer wants to apply. The use of the word "ordinarily" makes it clear that the regulation anticipated that there would be some situations which were not unique and nonrecurring but which would still require departure from the standard allocation and apportionment methods. Also, the Department refers to IC § 6-3-2-2(l), which allows the Department, when standard allocation and apportionment methods do not fairly reflect a taxpayer's Indiana income, to use any other method to calculate a fair allocation and apportionment of a taxpayer's Indiana income. In this case fair allocation and apportionment is achieved by adding back deductions from artificially created losses and then applying allocation and apportionment procedures.

Finally, Taxpayer states that the Department's real motivation is revealed in the audit report's repeated references that the losses should be disallowed because they lower Taxpayer's taxable income. Taxpayer believes the Department's determination to disallow the losses and thereby increase taxable income is arbitrary, capricious, and contrary to the most fundamental aspects of Indiana income tax, which recognizes that ordinary and necessary business losses are deductible in arriving at taxable income, as provided by IC § 6-3-1-3.5.

The Department does not agree with Taxpayer's interpretation of the circumstances. The fact that the audit report repeatedly references that the losses should be disallowed is in the nature of an audit report. The

explanation of why the loss deduction does not fairly represent Taxpayer's Indiana income takes up one page of a thirty-one page audit report. This does not appear excessive. Rather, the Department's explanation is a rather straight-forward explanation of why the sale of AR, revolving credit, and service fees between related companies distorts Taxpayer's Indiana income.

Taxpayer is correct that the Department's real motivation is revealed in the audit report. The revelation is that Taxpayer was creating an artificial loss by creating a paper transfer of AR to Related but continuing to perform all of the duties it had previously performed regarding the AR, while deducting losses on the sale of the AR and on the interest it paid to Related. The Department's motivation was to correct this situation to fairly reflect Taxpayer's Indiana income. This decision was not arbitrary, capricious, or opposed to the idea that ordinary and necessary business losses are deductible, since these losses were neither ordinary nor necessary.

In conclusion, the fact that Taxpayer sold the AR to Related at arm's-length pricing is not determinative since Related simply paid a miniscule fraction of the losses incurred in the sale to Taxpayer to perform all of the activities required to administer the AR. As the Indiana Tax Court stated in Monarch Beverage Co., Inc. v. Indiana State Dep't of Revenue, 589 N.E.2d 1209, 1215 (Ind. Tax Ct. 1992), "Tax consequences are generally determined by the substance rather than the form of a transaction." The substance of these intertwining activities is that Taxpayer's Indiana income is shifted via the losses incurred in the AR sales to Related, which does not file returns in Indiana, at which point Related securitizes the AR and arranges for loans which it redistributes to Taxpayer, which then deducts the interest it pays to Related. The Department's use of the term "artificial" was appropriate in light of the nature of the relationship and activities between Taxpayer and Related. The Department is allowed to make necessary changes to a taxpayer's reporting method in order to fairly reflect Indiana income, as provided by IC § 6-3-2-2(l). The Department's adjustments were not arbitrary, capricious or contrary to IC § 6-3-1-3.5. The Department's adjustments were plainly and clearly stated. Taxpayer has not met the burden of proving the proposed assessment wrong, as required by IC § 6-8.1-5-1(c).

FINDING

Taxpayer's protest is denied.

II. Adjusted Gross Income Tax–Net Operating Losses.

DISCUSSION

Taxpayer protests that the Department was not allowed to adjust net operating losses for the years at issue and prior to the years at issue due to a prior settlement agreement between Taxpayer and the Department. Taxpayer states that those years are closed under the settlement and cannot now be opened. The Department referred to 45 IAC 3.1-1-9 which explains Indiana NOLs. The Department then made adjustments to Taxpayer's NOLs for the audit period protested in this Letter of Findings. These adjustments made recalculation of NOLs to the prior audit period necessary. The result of these adjustments was to eliminate the NOLs Taxpayer had claimed for the tax year ending March 31, 2006, and for the tax year ending March 31, 2007.

As part of the settlement agreement, the two parties agreed not to reveal the existence of the agreement or to discuss any of the terms and conditions included in the agreement. However, since Taxpayer has based its protest of this issue on the agreement, the Department will discuss the agreement in general terms. A review of the settlement agreement shows that the subject of NOLs is not mentioned. Rather, the Department agreed not to make adjustments to Taxpayer's calculations for the years ending March 31, 1999, through the year ending March 31, 2003, regarding Indiana income tax liabilities from royalty and interest payments made by Taxpayer to an affiliated corporation. The affiliated corporation is not "Related" which is discussed in Issue I above.

Therefore, the agreement does not specifically address NOLs, and the subject of that agreement was wholly separate from the issues raised in this protest for this audit period. The Department was not barred from the NOL calculations and adjustments by the settlement agreement. The NOL adjustments were therefore correct.

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). Taxpayer has not affirmatively established that its failure to pay the deficiency was due to reasonable cause and not due to negligence, as required by 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest is denied.

CONCLUSION

Taxpayer's protest is denied regarding the addback of losses in Issue I. Taxpayer's protest is denied regarding adjustments to NOLs in Issue II. Taxpayer's protest is denied regarding imposition of penalty in Issue III.

Posted: 09/30/2009 by Legislative Services Agency
An html version of this document.