DEPARTMENT OF STATE REVENUE

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Letter of Findings Number: 08-0708
Income Tax
For Tax Years 2004-06

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ISSUES

I. Adjusted Gross Income Tax–Consolidated Return Adjustments.

Authority: Walgreen Co. v. Gross Income Tax Division, 75 N.E.2d 484 (Ind. 1947); IC § 6-3-2-2; IC § 6-3-4-14; IC § 6-8.1-3-3; IC § 6-8.1-5-1; 45 IAC 3.1-1-62.

Taxpayer protests the Department's assessment of additional adjusted gross income tax.

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 a corporation. As the result of an audit, the Indiana Department of Revenue ("Department") determined that Taxpayer and a group of related companies which filed a consolidated return had not accurately reported Indiana adjusted gross income for the tax years 2004, 2005, and 2006. These related consolidated companies will, if required, be referred to as "CON 1," "CON 2," and "CON 3" below. The Department made several adjustments to Taxpayer's consolidated return. The primary adjustment was to add back deductions for losses the Indiana consolidated group had incurred from the sale of accounts receivable ("AR") to related companies which were included in its federal combined returns but were not included on the Indiana consolidated returns. These non-consolidated companies will be referred to as "NON 1," "NON 2," and "NON 3" below. The Department then recalculated Taxpayer's income and issued proposed assessments for adjusted gross income tax, interest, and negligence penalties for those tax years. Taxpayer protests that it did report accurately for those years and that the addback of deductions was not required or legal. Taxpayer also protests several other adjustments. Taxpayer therefore protests the proposed assessments of adjusted gross income tax and the negligence penalty. Further facts will be supplied as required.

I. Adjusted Gross Income Tax–Consolidated Return Adjustments.

DISCUSSION

Taxpayer protests the Department's determination to add-back certain deductions and other adjustments to its consolidated return as unwarranted and the resulting assessments of adjusted gross income tax for the tax years 2004, 2005, and 2006. Taxpayer protests the Department's determination that losses incurred from the sale of accounts receivable from members of the Indiana consolidated return to related companies which were in the federal affiliated group but not the Indiana consolidated group were improperly deducted from Taxpayer's Indiana adjusted gross income. Taxpayer states that the sales were conducted for legitimate business reasons and were conducted 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 consolidated income tax returns as originally reported. Taxpayer presents several points of protest in support of this position. 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.

(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.

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 explained its position in its audit report. The sale of the AR from Taxpayer to the related companies was at less than face value. For example, CON 1 would sell its AR to NON 1 at ninety-five percent of face value. NON 1 would simultaneously hire CON 1 to service the AR which CON 1 had just sold to NON 1. Since all of these related companies were included on Taxpayer's federal affiliated group, the federal effect of such a transfer was revenue-neutral. The effect of this arrangement was that, while over half of the federal affiliated group's gross receipts were earned in Indiana, the Indiana consolidated group reported losses for these years.

Taxpayer's federal affiliated group did not lose or gain income on the transactions between the related companies, but Indiana income was reduced for all years. Indiana income was reduced in 2005 to the point that the Indiana consolidated group reported a net operating loss ("NOL"). The Department determined that the reductions and NOL were the direct result of the inter-company AR transactions in which the overall group of companies owned by Taxpayer did not really lose income. The Department considered that the losses claimed by Taxpayer on the sale of AR did not fairly reflect the true Indiana income of the companies listed on the consolidated returns for the years 2004, 2005, and 2006.

Taxpayer's first point of protest is that the Department's audit report noted that if Taxpayer had filed a combined return, the inter-company eliminations would be revenue-neutral, as they were on the federal return. Taxpayer protests that combined filing is not the default filing method in Indiana and that a combined return is not the standard against which all filing methods must be measured. Further, Taxpayer states that under the consolidated filing method, only companies with Indiana-sourced income are allowed to be included on the return as provided by IC § 6-3-4-14.

The Department notes that the audit report only mentions the results of a theoretical combined return. The audit report explained that the result would be revenue-neutral for Indiana. This would be a similar result to the federal filing which was also revenue-neutral. The audit report's discussion of Indiana combined returns did not state that a combined return was required. In fact, the entire extent of the audit report's discussion of Indiana combined returns is limited to one sentence. The audit report then explains that the Department made adjustments to the consolidated return to achieve a fair reflection of the consolidated group's Indiana income. Taxpayer is protesting an action which has not been taken by the Department.

Taxpayer's second point of protest is that the preceding audit allowed the same filing method with the same deductions. Taxpayer believes that this not only shows that it was filing correctly for the audit period under protest here, but that the Department has now changed its interpretation of a listed tax, and must therefore publish a new rule explaining such a change, as provided by IC § 6-8.1-3-3(b). Taxpayer has not established that the Department specifically approved of the deductions in the prior audit. The lack of adjustments in a prior audit is logically explained as an oversight by the Department. Oversight does not constitute a statement of approval. The adjustments made in this audit are simply correcting the error of oversight in the previous audit. Since there is no evidence that the Department affirmatively approved of these deductions in a prior audit, there is no need for the Department to publish a new rule prior to making adjustments in the instant case. Also, the Indiana Supreme Court has previously addressed this situation in Walgreen Co. v. Gross Income Tax Division, 75 N.E.2d 484 (Ind. 1947) in which it explained:

> Evidently appellant was not injured by appellee's failure to assess taxes during the three year period mentioned. The failure to assert its rights to assess taxes under the statute for the time mentioned cannot be binding upon the appellee or indicate its opinion that the statute is ambiguous. The taxing authorities of the state during the period mentioned, could not by failing to do their duty, or by any act or failure to act, waive the right and duty of the state to assess and collect the taxes for the years following.
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> Id. at 487, (Emphasis added).

Taxpayer's third point of protest is that the Department did not state or assert that the transactions were not at arm's-length. As part of the protest process, Taxpayer has provided documentation supporting its position that the transactions were conducted at arm's-length. Upon review, Taxpayer is correct that the Department did not challenge the arm's-length status of the transactions. However, the arm's-length status of the transactions is not a factor upon which the adjustments were based.

Rather, the Department explained that the transactions had no impact, positive or negative, on the overall income of the federal affiliated group. Since Taxpayer is the overall parent of CON 1, CON 2, CON 3, NON 1, NON 2, and NON 3, and since there is no impact on Taxpayer's affiliated group, and since there is a strong negative impact on Taxpayer's Indiana consolidated group's Indiana adjusted gross income, the Department concluded that the transactions unfairly represented the Indiana consolidated group's Indiana-sourced income. The audit report did not contest the arm's-length nature of the transactions because that factor is not germane to the determination of whether or not Taxpayer's consolidated group's deductions fairly reflect Taxpayer's consolidated group's Indiana adjusted gross income.

Taxpayer's fourth point of protest regards 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 45 IAC 3.1-1-62 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. 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 inter-company losses and then applying the standard allocation and apportionment procedures.

Taxpayer's fifth point of protest is that the audit report states that the Department added back royalties which had been deducted for 2004, 2005, and 2006. Taxpayer states that royalties were not deducted for 2004 and 2005, due to steps Taxpayer took to eliminate such deductions. A small amount of royalties were deducted in 2006, which the Department added back, and which Taxpayer does not dispute. The protest file will be returned to the audit division for verification that royalties were not deducted in 2004 and 2005.

Taxpayer's sixth point of protest is that the Department made calculation errors regarding credits for research and development and enterprise zone expenses. Taxpayer states that this is only an issue if the disallowance of deductions for losses on the sale of the AR is determined to be correct. The protest file will be returned to the audit division for verification of the claimed credits.

In conclusion, the Department's passing reference to combined returns did not require Taxpayer and its related companies to file a combined return. Therefore, the reference resulted in no difference in the Department's treatment of Taxpayer's consolidated return. The prior audit's oversight of the deduction method did not constitute approval of that method. No publication of a change in the Department's interpretation of a listed tax is necessary. The arm's-length nature of the transactions is not a determinative factor in the Department's determination that the claimed deductions do not fairly reflect Taxpayer's Indiana adjusted gross income. The Department is allowed to use other methods than standard allocation and apportionment to fairly reflect Taxpayer's income. The status of royalty deductions and claimed credits will be verified in a supplemental audit.

FINDING

Taxpayer's protest is denied regarding the add-back of claimed losses on the sale of accounts receivable. Taxpayer's protest is sustained regarding claimed credits, subject to audit verification. The audit division will also verify that royalties were not deducted in 2004 and 2005.

II. Adjusted Gross Income Tax–Net Operating Losses.

DISCUSSION

Taxpayer protests the Department's decision to add back the deductions to the consolidated group's returns, thereby eliminating the NOL reported by the consolidated group for 2005. In a separate action from the audit and protest discussed in this Letter of Findings, Taxpayer filed amended returns carrying the NOL claimed from 2005

to 2003 and 2004 via the filing of amended returns. The 2003 amended return claimed a refund of adjusted gross income tax for that year. The Department denied the refund on the basis that Taxpayer and the Department had entered into a settlement agreement which closed 2003 regarding adjusted gross income tax for purposes of audit, assessment, claim of refund, and litigation. As a result of the instant audit and the determination that Taxpayer actually owed taxes for 2005, the Department determined that the application of 2005 NOL to 2004 via the amended return was unavailable.

Taxpayer protests that, since the year 2003 was subject to a settlement agreement between Taxpayer and the Department which closed that year to such adjustments, the Department was not allowed to audit 2003 in the instant audit report. A review of the audit report shows that the Department referred to 45 IAC 3.1-1-9, which explains Indiana NOL, and then included an NOL worksheet which explained how the 2005 NOL which had been applied should be undone. This worksheet did include 2003, but did not result in an assessment for 2003. Page one of the audit report lists adjustments to tax amounts for 2003, 2004, 2005, and 2006. Again, there was no assessment of adjusted gross income tax for 2003. Therefore, even though the audit report included the NOL worksheet which included calculations for 2003 and a listed adjustment to taxes for 2003, there has been no assessment for 2003. While Taxpayer is correct that 2003 is closed to audit and assessment for adjusted gross income tax under the settlement agreement, any references to 2003 in the instant audit report are simply extraneous since there was no assessment for 2003.

Taxpayer believes that the AR deductions were proper and that the Department must restore the NOL as claimed for 2004. Taxpayer also believes that any NOL leftover must be available for future years. As determined in Issue I, the Department properly added the claimed deductions back to Taxpayer's consolidated return. This eliminated the claimed NOL for 2004. No NOL exists for 2005 which means that no 2005 NOL is available for future years.

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). As explained in Issue I, the Department did not make adjustments to Taxpayer's filing method in a prior audit. However, the Department's oversight does not relieve Taxpayer of the reasonableness requirement found in 45 IAC 15-11-2(c). 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 is denied on Issue I regarding addback of deductions with audit verification that royalties were not deducted in 2004 and 2005. Taxpayer is sustained on Issue I regarding application of credits, pending audit verification. Taxpayer is denied on Issue II regarding adjustments to net operating losses. Taxpayer is denied on Issue III regarding imposition of negligence penalty.

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