DEPARTMENT OF STATE REVENUE

02-20060494.SLOF

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

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ISSUES

I. Tax Administration – Statute of Limitations for Assessment.

Authority: IC § 6-8.1-5-1; IC § 6-8.1-5-2; IC § 6-3-2-2; Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests that the Department was barred by the statue of limitations from assessing Taxpayer for additional tax for 2002.

II. Adjusted Gross Income Tax – Required Combination.

Authority: IC § 6-3-2-2; IC § 6-3-2-2.2; 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); Wabash Inc. v. Dep't of State Revenue, 729 N.E.2d 620 (Ind. Tax Ct. 2000).

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

III. Adjusted Gross Income Tax – Exclusion of Financial Institutions.

Authority: IC § 6-5.5 generally.

Taxpayer protests that two of the entities included in the combined income tax return are financial institutions and therefore should not be included on the return.

IV. Adjusted Gross Income Tax – Net Operating Loss.

Authority: IC § 6-8.1-5-1; 45 IAC 15-9-2; Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007).

Taxpayer protests the disallowance of a net operating loss.

V. 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.

VI. Tax Administration–Underpayment Penalty.

Authority: IC § 6-3-4-4.1; IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of a ten percent underpayment penalty.

STATEMENT OF FACTS

Taxpayer is a commercial printer with operations throughout the United States. Taxpayer and its subsidiaries provide integrated production 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 a Letter of Findings was issued denying Taxpayer's protest. Taxpayer requested rehearing. Though timely, the request did not specify the grounds for the request of rehearing. Taxpayer was given extensive time to elaborate the grounds upon which Taxpayer requested rehearing. Due to the fact that Taxpayer was separately protesting similar issues for a subsequent audit, the Department agreed to allow Taxpayer to combine the rehearing relating to this protest with the hearing on the protest of a subsequent audit but asked that Taxpayer be clear in distinguishing between the unique issues relating to the rehearing granted on the protest of the 2002 assessment and the issues relating to the hearing on the protest of the assessments for the years 2003 through 2005. The rehearing was held and this Supplemental Letter of Findings ensues regarding the 2002 assessment. The protest of the assessments for the years 2003 through 2005 will be addressed in a separate Letter of Findings. Additional facts will be provided as required.

I. Tax Administration – Statute of Limitations for Assessment.

DISCUSSION

Taxpayer protests on rehearing in a brief dated March 17, 2009, that the Department was barred by a statute of limitations from assessing Taxpayer for the year at issue. Taxpayer argues that IC § 6-8.1-5-2 "provides the Department three years in which to commence and complete an audit, and, if appropriate issue a proposed assessment." Taxpayer further argues that the Department's authority under IC § 6-8.1-5-1 to issue a proposed

assessment based upon "best information available" was "not intended by the Legislature as a means to circumvent the statutorily imposed limitation period for an audit when the Department does not initiate an audit in time to complete it."

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 § 6-8.1-5-2 states in relevant part:

(a) Except as otherwise provided in this section, the department may not issue a proposed assessment under section 1 of this chapter more than three (3) years after the latest of the date the return is filed, or either of the following:

(1) The due date of the return.

(2) In the case of a return filed for the state gross retail or use tax, the gasoline tax, the special fuel tax, the motor carrier fuel tax, the oil inspection fee, or the petroleum severance tax, the end of the calendar year which contains the taxable period for which the return is filed.

(b) If a person files a utility receipts tax return (IC 6-2.3), an adjusted gross income tax (IC 6-3), supplemental net income tax (IC 6-3-8) (repealed), county adjusted gross income tax (IC 6-3.5-1.1), county option income tax (IC 6-3.5-6), or financial institutions tax (IC 6-5.5) return that understates the person's income, as that term is defined in the particular income tax law, by at least twenty-five percent (25 [percent]), the proposed assessment limitation is six (6) years instead of the three (3) years provided in subsection (a).

IC § 6-8.1-5-1(b) states:

If the department reasonably believes that a person has not reported the proper amount of tax due, the department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the department. The amount of the assessment is considered a tax payment not made by the due date and is subject to IC 6-8.1-10 concerning the imposition of penalties and interest. The department shall send the person a notice of the proposed assessment through the United States mail.

Taxpayer does not provide substantiation of its statement as to the Legislature's intent regarding the Department's authority to propose assessments based on the "best information available." Since the Indiana legislature does not retain a legislative history, the Department relies on the plain language of IC § 6-8.1-5-1(b) which conditions the Department's authority to propose "best information available" assessments on the Department's reasonable belief that a person has not reported the proper amount of tax due. In this instance, the Department stated a reasonable belief that Taxpayer's reported Indiana income did not "fairly reflect" – pursuant to IC § 6-3-2-2 – its business activity in Indiana as documented in the Department's audit summary report.

FINDING

Taxpayer's protest of this issue is respectfully denied.

II. Adjusted Gross Income Tax – Required Combination.

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 required combination as it related to three entities: Company C, Company R, and Company H whose functions are briefly recapped below. On rehearing Taxpayer mostly reiterates the same arguments it made originally. This discussion will repeat the original Letter of Finding's analysis only where necessary, and will address any additional arguments or facts Taxpayer presented on rehearing. A review of the three companies follows:

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.

Company R was incorporated in Nevada and was also a wholly-owned subsidiary of Taxpayer. Company R purchased and managed receivables from Taxpayer and its affiliates. The receivables were purchased at a discount on a non-recourse basis. According to Taxpayer, the discount reflected the credit risk, the time value of money, and the administrative costs associated with holding the receivables, but that the price of purchase was otherwise at arm's length. Taxpayer 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.

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 Company H with all rights, title, and interest in the trademarks, trade names.

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;

(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).

First, Taxpayer argues that the Department had no basis for requiring combination because Taxpayer and the three companies referenced above were not unitary. Taxpayer describes the activities of these companies as it did during the original protest.

The U.S. Supreme Court has considered the issue of a unitary relationship for adjusted gross income tax in several cases as discussed in the original Letter of Findings. This Supplemental Letter of Findings will not revisit the analysis already presented to Taxpayer except to summarize that the relationships of the Companies C, R, and H to Taxpayer demonstrate substantial integration and dependency. Taxpayer merely argues that these companies are "managed and operated autonomously" and are not printing companies.

This argument is an oddly formalistic argument given the inter-dependent nature of Taxpayer's transactions with Companies C, R, and H. Company R engaged in activities relating to the collection, analysis, and maintenance of receivables generated by Taxpayer's customers for printing and related services, including those from Indiana customers. Likewise, Company H's intellectual property, transferred to it from Taxpayer in 1995, was created as a direct result of Taxpayer's printing business. Company H owned no other intellectual property, did not license to any entity outside Taxpayer's group, and had no third party revenue. Also, all of Company H's revenue consisted of royalties received from Taxpayer, and all of Taxpayer's royalty fees were paid to Company H. Lastly, Company C was primarily involved in intercompany lending and borrowing among members of Taxpayer's group. Interest income accounted for well over 90 percent of Company C's total revenue and, except for one isolated event in the late 1990s, Company C had no third party income and did not engage in lending activities outside Taxpayer's group. Company C paid dividends to Taxpayer throughout the years at issue. None of these companies would exist independently of Taxpayer and none of them had any significant income other than from Taxpayer.

Furthermore, Taxpayer, in its March 17, 2009, letter states on page 4 that:

The LOF repeats many of the mistakes in the Audit Report, and states conclusions which are wrong as well. After referencing the fact that accrued interest is added to principal, and that loans can be repaid any time without premium or penalty, the LOF states that "[t]his is not the sort of loan that would be available from an unrelated third party operating at arm's length." (p.3) That is simply not accurate.

Here is the complete statement from the Letter of Findings on this point:

[In discussing the loans Taxpayer is granted from Company C] 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.

Taxpayer fails to reference a key point in the LOF's analysis of this issue, which is that the loans that Company C extends to Taxpayer, and the interest on the loans, are generally not repaid to it. Thus, the LOF concludes on this point – which addresses Taxpayer's argument generally that these transactions are at arm's length rates – that "this is not the sort of loan that would be available from an unrelated third party operating at arm's length." Again, Taxpayer's argument is that the loan rates reflect arm's length rates. Nonetheless, the loan arrangement overall does not reflect the sort of loan repayment arrangements that would be set by unrelated parties. Taxpayer has not provided evidence that this arrangement is one that unrelated third parties would enter into. Taxpayer states that the LOF is inaccurate, but then provides no explanation as to why the statement "is simply not accurate." The Department is unable to respond to Taxpayer's accusation of inaccuracy in the absence of a particular reference to the specific facts that demonstrate the inaccuracy. Again, Taxpayer's argument that these loans are made at market rates is incomplete. 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 on 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.

Second, Taxpayer argues that the returns, as filed, fairly represent income derived from sources within Indiana. Taxpayer argues that its Indiana consolidated return included those entities that were required by law. Taxpayer states that it did not include the three companies discussed above because they were autonomous, and all the transactions between Taxpayer and these affiliates were at arm's length. Taxpayer recites that the market rates on the loans can be "easily corroborated" by reference to rates published in the Wall Street Journal, that the market rates on the sale of the receivables can also be corroborated by transactions of other factoring companies, and that the royalty rates were set based on a transfer pricing study. Taxpayer then states that "[i]f that were not enough, I.C. § 6-3-2-2.2 makes it clear that royalty, interest and other intangible income received by a non-domiciliary corporation is not income derived from sources within Indiana, so the exclusion of such income per se fairly represent[s] the taxpayer's income derived from sources within the state of Indiana."

As stated previously in the LOF and in this Supplemental LOF, the Department concluded that Taxpayer and the three companies were highly inter-dependent. Other than the transfer pricing study, Taxpayer does not provide the "easily corroborated" rates. Furthermore, even if, for the sake of argument, the transactions were set at arm's length rates, this tells only half the arm's length story in the context of the overall arrangements that undergird these transactions - exemplified by the discussion above on the loans between Taxpayer and Company C, which did not reflect arm's length business arrangements – including the overall flow of funds between Taxpayer and the three companies. The rates cannot be viewed in isolation of the terms of the transactions and the overall flow of monies amongst the players.

As for IC § 6-3-2-2.2, it states:

> (a) Interest income and other receipts from assets in the nature of loans or installment sales contracts that are primarily secured by or deal with real or tangible personal property are attributable to this state if the security or sale property is located in Indiana.
>
> (b) Interest income and other receipts from consumer loans not secured by real or tangible personal property are attributable to this state if the loan is made to a resident of Indiana, whether at a place of business, by a traveling loan officer, by mail, by telephone, or by other electronic means.
>
> (c) Interest income and other receipts from commercial loans and installment obligations not secured by real or tangible personal property are attributable to this state if the proceeds of the loan are to be applied in Indiana. If it cannot be determined where the funds are to be applied, the income and receipts are attributable to the state in which the business applied for the loan. As used in this section, "applied for" means initial inquiry (including customer assistance in preparing the loan application) or submission of a completed loan application, whichever occurs first.
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> (d) Interest income, merchant discount, and other receipts including service charges from financial institution credit card and travel and entertainment credit card receivables and credit card holders' fees are attributable to the state to which the card charges and fees are regularly billed.
>
> (e) Receipts from the performance of fiduciary and other services are attributable to the state in which the benefits of the services are consumed. If the benefits are consumed in more than one (1) state, the receipts from those benefits are attributable to this state on a pro rata basis according to the portion of the benefits consumed in Indiana.
>
> (f) Receipts from the issuance of traveler's checks, money orders, or United States savings bonds are attributable to the state in which the traveler's checks, money orders, or bonds are purchased.
>
> (g) Receipts in the form of dividends from investments are attributable to this state if the taxpayer's commercial domicile is in Indiana.

Taxpayer argues that the Department attempts to capture income from intangibles expressly excluded by statute from the list of items constituting income derived from sources within Indiana because the companies are not domiciled in Indiana. Taxpayer states that the proposed assessment "is nothing more than an attempt at an end run around IC § 6-3-2-2.2 and defeat the legislative intent."

According to Taxpayer's logic, even if the Department proves beyond a shadow of doubt that the transactions at issue were not at arm's length and therefore were distortive of Taxpayer's Indiana activities, IC § 6-3-2-2.2 would still prevent combination in this instance. Taxpayer's logic would certainly render the Department's legislative grant of authority to require combination under IC§ 6-3-2-2(l), a nullity when the inter-company transactions involve intangibles – certainly a defeat of legislative intent.

The Department's authority to require combination does not rest on the same statutory requirements that the affiliates would have to meet if they were filing separate or consolidated Indiana returns which would require reliance on IC § 6-3-2-2.2. Taxpayer confuses IC § 6-3-2-2.2, a sourcing statute, with IC § 6-3-2-2(l) a "corrective" statute. The required combination brings in these commonly-controlled, unitary entities in order to better reflect the proper apportionment of income of the entire unitary businesses and thus reflect the substance of the business activity conducted in Indiana in light of the fact that Taxpayer's reporting for 2002 did not "fairly

represent" that activity.

Third, Taxpayer argues that the Department's audit report did not meet the requirements of IC § 6-3-2-2(l) which Taxpayer argues means that the Department can only apply the unitary business doctrine if the transactions are not at arm's length. Even then, Taxpayer argues the Department has the burden to also show that Taxpayer's reported income did not fairly reflect Taxpayer's business activity in Indiana; i.e., it is not enough to show that the businesses are unitary. Taxpayer argues that the Department has not developed any standards that allow Taxpayer to understand when its reporting does not fairly reflect its activities. Taxpayer argues that, therefore, the Department's failure to provide standards is a violation of its constitutional Due Process rights.

As an administrative agency, it is not within the purview of the Department to address constitutional arguments. This Supplemental Letter of Findings will not address Taxpayer's Due Process argument. Taxpayer's concerns regarding notice are more appropriately addressed in consideration of penalty issues.

As for the rest of Taxpayer's argument, even presuming the Taxpayer sets out a correct interpretation of what the requirements of IC § 6-3-2-2(l) are, the Department has already addressed the issue of "arm's length rates" and the fair representation of Indiana source income at length in the original LOF and in this Supplemental LOF showing that Taxpayer's reported income is markedly out of proportion with its business activities in the state. The Department correctly found that the companies were functionally integrated. The net income to Taxpayer from its sales in Indiana was clearly significantly reduced by the flow of funds to and from its related entities thus not fairly reflecting Taxpayer's taxable income in Indiana.

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 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. However, 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 the required combination. Even if arguably these intercompany transactions were at arm's length rates, the transactions themselves cannot be viewed in isolation of the circular flow that removes income Taxpayer earned in Indiana from Indiana as evidenced by the $340,000,000 in deductible expenses of which 90-percent are returned to Taxpayer in the form of $300,000,0000 in non-taxable dividends. Therefore, if Taxpayer's method of filing were not changed to more fairly reflect its Indiana activity, Taxpayer will continue to significantly underreport Indiana adjusted gross income tax liability. The Department in this case did not disallow the expenses, but required combination in order to remove the distortive effect of Taxpayer's transactions.

IC § 6-3-2-2 states in relevant part:

(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.

(n) For purposes of allocation and apportionment of income under this article, a taxpayer is taxable in another state if:

(1) in that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business, or a corporate stock tax; or

(2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact, the state does or does not.

(o) Notwithstanding subsections (l) and (m), the department may not, under any circumstances, require that income, deductions, and credits attributable to a taxpayer and another entity be reported in a combined income tax return for any taxable year, if the other entity is:

(1) a foreign corporation; or

(2) a corporation that is classified as a foreign operating corporation for the taxable year by section 2.4 of this chapter.

(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).

(q) Notwithstanding subsections (o) and (p), one (1) or more taxpayers may petition the department under subsection (l) for permission to file a combined income tax return for a taxable year. The petition to file a combined income tax return must be completed and filed with the department not more than thirty (30) days after the end of the taxpayer's taxable year. A taxpayer filing a combined income tax return must petition the department within thirty (30) days after the end of the taxpayer's taxable year to discontinue filing a combined income tax return.

In its discussion of the Department's burden to show "distortion," Taxpayer cites to Wabash Inc. v. Dep't of State Revenue, 729 N.E.2d 620, at 624, 625 (Ind. Tax [Court] 2000) for the proposition that the Department bore the burden to show how the taxpayer's apportionment unfairly reflected Indiana-source income. Upon review, the audit issue that Wabash deals with is the interpretation of IC § 6-3-2-2(b) which sets out the apportionment formula for calculating the Indiana source income of a multistate corporation, doing business inside and outside Indiana.

The issue in Wabash was whether a company that the petitioner-taxpayer wanted to include on its consolidated return had Indiana sourced income pursuant to P.L. 86-272 analysis therefore allowing it to enter its losses into the apportionment of Indiana income. The Department argued that the company's Indiana contacts were minimal and therefore the company's losses should not be included in calculating the consolidated group's apportioned Indiana income. That is, the argument was whether certain activities in Indiana were sufficient to establish Indiana nexus for purposes of including a particular company in a consolidated return. Wabash did not deal with a required combination. At trial, the Department raised the issue of whether the apportionment method fairly reflected the taxpayer's business activities in Indiana and stated its preference for using the stacked method instead. The Tax Court stated that "having raised this issue, the Department bears the burden of proving that Wabash's Indiana income does not fairly reflect Indiana-sourced income." Id. at 624. This means that having raised this issue at trial, the Department, having not previously stated its rationale, then had the burden to show how the apportionment method did not fairly represent the taxpayer's Indiana business activity. In this case, the Department's audit (and the Letter of Findings) both had, as previously stated, reasonably showed that Taxpayer's reported income did not "fairly represent" Taxpayer's business activity in the state.

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.

III. Adjusted Gross Income Tax – Exclusion of Financial Institutions.

DISCUSSION

Taxpayer repeats the argument made at the hearing that Company C and Company R are financial institutions because more than eighty (80) percent of their income is respectively from interest or from factoring receivables and therefore subject to Indiana Financial Institutions Tax.

As stated in the original Letter of Findings, Taxpayer is mistaken, Company R is not subject 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 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.

FINDING

Taxpayer's protest is respectfully denied.

IV. Adjusted Gross Income Tax – Net Operating Loss.

DISCUSSION

The Department disallowed Taxpayer's Net Operating Loss ("NOL") deduction on the ground that 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.

On rehearing, Taxpayer argues that the Department's audit did not show that Taxpayer was unitary with the affiliates in 1995 when the NOLs were created and assumes that the Taxpayer's 1995 return did not fairly reflect its Indiana source income. Taxpayer points to the prior 1997-1999 audit that did not require combination. Taxpayer believes this is evidence that no combination should be required in this case, because the facts of the prior audit were chronologically closer to 1995 than those of the current audit.

First, 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). Second, Taxpayer did not show that the structure, operations, or business activities of it and the affiliates were substantially different in 1995 than in 2002. Presumably, Taxpayer would have done so had the facts been substantially different. As previously discussed, the prior audit does not have bearing on the current audit.

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 and 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 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.

V. Tax Administration – Negligence Penalty.

DISCUSSION

The Department issued ten percent negligence penalties for the tax year in question. Taxpayer protests the imposition of the penalties. The Department refers to IC § 6-8.1-10-2.1(a)(3), which provides "if a person... 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.

The Department may waive a negligence penalty as provided in 45 IAC 15-11-2(c), as follows:

> 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.

Taxpayer has met its burden of proof to show that the deficiencies they incurred are due to reasonable cause and are therefore not subject to a penalty under IC § 6-8.1-10-2.1(a).

FINDING

Taxpayer's protest is sustained.

VI. Tax Administration–Underpayment Penalty.

DISCUSSION

The Department issued proposed assessments and the ten percent underpayment penalty for the tax year in question. Taxpayer protested the imposition of penalty. Further inquiry shows that the underpayment penalty for the year at issue was abated on January 22, 2009.

FINDING

Taxpayer's protest of the underpayment penalty is moot since the penalty has already been abated.

CONCLUSION

Taxpayer's protest of the assessment of negligence penalty is sustained. Taxpayer's protest of the assessment of the underpayment penalty is moot since that penalty has already been abated. Taxpayer's protest of all remaining issues is denied.

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