DEPARTMENT OF STATE REVENUE

02-20080482.LOF

Letter of Findings: 08-0482
Income Tax
For the Years 2003, 2004, 2005

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ISSUES

I. Adjusted Gross Income Tax – Required Combination.

Authority: IC § 6-3-2-2; IC § 6-3-3-2.2; 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); Meadwestvaco Corp. v. Illinois Dep't of Revenue, 553 US 16 (2008); Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768, 112 S.Ct. 2251 (1992); Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 103 S.Ct. 2933 (1983); ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 102 S.Ct. 3103 (1982); 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.

II. Adjusted Gross Income Tax – Net Operating Loss.

Authority: 45 IAC 15-9-2.

Taxpayer protests the disallowance of net operating loss.

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.

IV. Tax Administration – Underpayment Penalty.

Authority: IC § 6-3-4-4.1.

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 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 years at issue, Taxpayer had printing plants in Indiana. Taxpayer filed Indiana consolidated returns with one other company.

The Indiana Department of Revenue ("Department") conducted an income tax audit of Taxpayer for the years 2003, 2004, and 2005. 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. Taxpayer protested the Department's requirement that it file a combined return with its federal consolidated group. Taxpayer also protested the disallowance of net operating losses from prior periods. Lastly, Taxpayer protested the imposition of negligence and underpayment penalties.

At Taxpayer's request the hearing on this protest was held at the same time that a rehearing on a separate protest of proposed assessments from an audit of Taxpayer for 2002 was held. The issues relating to both protests were substantially similar. A separate Supplemental Letter of Findings was issued pertaining to the 2002 assessments (02-20060494.SLOF). Additional facts will be provided as required.

I. Adjusted Gross Income Tax – Required Combination.

DISCUSSION

For the years at issue Taxpayer filed consolidated Indiana income tax returns that included Taxpayer and another company ("Company B"). The Department's audit proposed a combination of Taxpayer's 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.

Company C was incorporated in Delaware and was a wholly-owned subsidiary of Taxpayer. Company C maintained and managed Taxpayer's investments. Company C also 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 C's directors and officers are high ranking employees of Taxpayer.

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 years 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 along with all rights, title, and interest in the trademarks, trade names. All of Company H's officers are employees of Taxpayer. Company H's federal returns shows officer compensation of about between $23,000 and $45,000 for the years at issue and no salaries and wages.

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:
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> (1) separate accounting;
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> (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;
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> (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
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> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.
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> (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 with Taxpayer. Taxpayer argues that these companies are "managed and operated autonomously" and are not printing companies and therefore cannot be unitary with Taxpayer.

The U.S. Supreme Court has considered the issue of a unitary relationship for adjusted gross income tax in several cases. The essential characteristic the Court requires for a unitary business is that the individual entities are functionally integrated in a common business. Meadwestvaco Corp. v. Illinois Dep't of Revenue, 553 US 16 (2008); Allied-Signal, Inc. v. Director, Division of Taxation, 504 U.S. 768, 112 S.Ct. 2251 (1992); Container Corp. of America v. Franchise Tax Board, 463 U.S. 159, 103 S.Ct. 2933 (1983); ASARCO, Inc. v. Idaho State Tax Comm'n, 458 U.S. 307, 102 S.Ct. 3103 (1982). The Supreme Court found that unitary businesses that were functionally integrated shared many common characteristics. They had common ownership ("unity of ownership"). They had centralized management with a corporate strategy including the various entities ("unity of use"). Lastly, the individual businesses were operated in such a manner as to further a common purpose (for example, accounting, payroll, pension, advertising, etc.) ("unity of operation").

In the instant case, the Department found that the companies were functionally integrated and that it satisfied the three unities test. The Department found unity of ownership since all of Taxpayer's subsidiaries were either directly or indirectly 100 percent owned or controlled by Taxpayer. The Department found unity of operations because Taxpayer provided administrative services to its subsidiaries. Taxpayer had centralized functions such as human resources, accounting, legal, tax reporting and compliance, treasury, information technology, risk management and other similar services which it provided to the subsidiaries. Services which were deemed to be corporate functions were paid for by Taxpayer and were not allocated to the subsidiaries. The Department found that unity of use is evidenced by the inter-company charges for interest, royalties, logistics, satellite services, commercial photography, graphic design, [etc.]. The subsidiaries have different managers but have officers and directors that are employees, some of them high ranking officers, of the parent company.

Taxpayer's argument that these companies "are autonomous and are not printing companies" is an overly 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 100 percent of Company C's total income for the years at issue 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.

Second, Taxpayer argues that "the suggestion that the mere presence of inter-company charges requires the combined/unitary approach appears overreaching and fails to acknowledge transactions conducted on an arm's length basis with separate legal entities." 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. In particular, Taxpayer presents additional background on three of its related entities ("Company C," "Company R," and "Company H") as examples of why Taxpayer should not be combined with its entire federal consolidated group.

Taxpayer argued that Company C is a legitimate enterprise because it paid and charged interest to its affiliate company debtors and creditors at market rates. However, 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. The fact that these loans are made at market rates, as Taxpayer argues, is only half the arm's length story. Company C reports minimal cash on its balance sheet for the years in question and for some of the years at issue its "notes receivables" exceed Taxpayer's total assets or even Taxpayer's sales as reported in its Indiana income tax returns. 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 each of the years at issue.

Also Company R paid $150 million in dividends to Taxpayer in 2003 and 2004. By incorporating Taxpayer's credit and collection function into Company R, income taxable in Indiana shifted to a state where there is no corporate income tax. Also, dividend income received by Taxpayer from Company R located outside Indiana is not subject to tax in Indiana. This circular flow of funds reduces Taxpayer's taxable income in Indiana to such an extent that it no longer fairly reflects Taxpayer's income generating activities in Indiana. It appears that no value was assigned to the trademarks that were transferred to Company H because its balance sheet showed its intangible assets at zero. Most of its assets and retained earnings were in the form of notes receivables. Company H loaned all of its net earnings to Company C. Its only asset, therefore, besides a miniscule amount of cash, was its Trade Notes Receivables from Company C. The interest income reported by Company H represented interest on notes receivable from Company C. Company C paid Company H just enough of its loan so that Company H could turn around and pay Taxpayer a dividend of at least $50 million a year. Taxpayer provided the Department a copy of the transfer pricing study that set the amount of the royalty fee charged to Taxpayer by Company H at 2.25 percent of net sales from September 1, 1995, to February 28, 2004, and 1 percent after March 1, 2004. In summary, Taxpayer pays royalty fees on trademarks that are still on its books, which are managed and maintained by its own employees, and where the royalty fees it pays Company H are loaned to Company C in exchange for interest payments that are then returned by Company H to Taxpayer in the form of dividends.

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 – for example, 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.

Taxpayer is the one entity among all its related entities that has the largest operation in Indiana. The Department correctly found that the companies were functionally integrated and satisfied the three unities test. The net income to Taxpayer from its sales in Indiana was clearly reduced by the flow of funds to and from its related entities thus not fairly reflecting Taxpayer's taxable income in Indiana. Even if Taxpayer may establish that its transactions were at arm's length rates, the overall circular flow of funds calls into question whether an unrelated third party would have accepted these terms.

Third, Taxpayer argues 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."

IC § 6-3-2-2.2 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.

(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.

Fourth, 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 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 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 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 audit report 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 $300,000,000 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.

Fifth, Taxpayer protests in its April 14, 2008, email that the Department has not met the burden prescribed in IC § 6-3-2-2(p), which prescribes a prerequisite for requiring a combined filing. Taxpayer argues that:

> Indiana Code 6-3-2-2(p) specifically provides that the Department "may not require that income, deductions, and credits attributable to a taxpayer and another entity... be reported in a combined tax return for any taxable year, unless the department is unable to fairly reflect the taxpayer's adjusted gross income for the taxable year" under Indiana Code 6-3-2-2(l) or (m). In addition, the Taxpayer points out that under prior law, combination was mandatory. In repealing mandatory combination – and enacting Indiana Code 6-3-2-2(p) – the General Assembly demonstrated its preference against combination except as a last resort. As such, it is clear that Indiana Code 6-3-2-2(p) allows a forced combination only as a last resort, and further requires that the Department establish that any remedies available to the Department under Indiana Code 6-3-2-2(l) or (m) are not sufficient. Thus the Department clearly bears the burden of proof.

The Department found no such method to be more fairly reflective of Taxpayer's income earning activities in Indiana and therefore made its assessment of additional adjusted gross income tax by combining Taxpayer with its federal consolidated group. The Department's audit solicited Taxpayer's input on alternatives to combination after Taxpayer had a chance to review a draft of the audit report's extensive analysis, but Taxpayer was not responsive. The Department's audit considered the alternative of disallowing the interest and royalty expense deductions (resulting in only eight percent less tax due than under combination), but found that "combination is the solution because the group operates as one economic entity" as discussed in the audit's finding of unitary relationship.

As to Taxpayer's argument relating to the General Assembly's demonstrated preference, all that is demonstrated by the Indiana General Assembly's repeal of its old mandatory combination regime is that it would not force combination in all cases. The current regime's emphasis is on a fair and reasonable reflection of income earned from business activities within the state.

Sixth and last, Taxpayer argues that Company C and Company R are financial institutions because more than 80 percent of their income is respectively from interest or from factoring receivables and therefore subject to Indiana Financial Institutions Tax under IC § 6-5.5 et seq.

Taxpayer is mistaken, Company R is not subjected 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 that are 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.

Based on all of the above, if Taxpayer's method of filing were not changed to more fairly reflect its Indiana activity, Taxpayer will continue to report no Indiana adjusted gross income tax liability for years to come – not only because of large deductions for royalties, interest and factoring expense (which the above discussion demonstrates clearly) but also from the large net operating loss deduction built up since 1995 which are discussed in Issue II.

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.

II. Adjusted Gross Income Tax – Net Operating Loss.

DISCUSSION

The Department disallowed Taxpayer's Net Operating Loss ("NOL") deduction because 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 the years at issue. Taxpayer protests this determination by the Department that its NOLs should be adjusted to zero.

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 open years, the Department acted properly within the statute of limitations.

Taxpayer reported millions in Indiana net operating losses despite generating an average of 70 percent of the consolidated group's sales for the audit period. Taxpayer has claimed consecutive net operating losses in Indiana for consecutive years starting in 1995 while the consolidated group was consistently profitable over those years. 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 the audit period.

FINDING

Taxpayer's protest of the disallowance of NOLs is respectfully denied.

III. Tax Administration – Negligence Penalty.

DISCUSSION

The Department issued ten percent negligence penalties for the tax years 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.

Given the conflation of issues and timing of a prior audit protest and the current audit assessments being protested, 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.

IV. Tax Administration–Underpayment Penalty.

DISCUSSION

The Department issued proposed assessments and the ten percent underpayment penalty for the tax year in question under IC § 6-3-4-4.1(d). Taxpayer protested the imposition of underpayment penalty.

IC 6-3-4-4.1(d) states:

> The penalty prescribed by IC 6-8.1-10-2.1(b) shall be assessed by the department on corporations failing to make payments as required in subsection (c) or (f). However, no penalty shall be assessed as to any estimated payments of adjusted gross income tax which equal or exceed:
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> (1) the annualized income installment calculated under subsection (c); or
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> (2) twenty-five percent (25 [percent]) of the final tax liability for the taxpayer's previous taxable year.
>
> In addition, the penalty as to any underpayment of tax on an estimated return shall only be assessed on the difference between the actual amount paid by the corporation on such estimated return and twenty-five percent (25 [percent]) of the corporation's final adjusted gross income tax liability for such taxable year.

Taxpayer has provided sufficient documentation demonstrating that the imposition of the underpayment is not appropriate.

FINDING

Taxpayer's protest of the underpayment penalty is sustained.

CONCLUSION

Taxpayer's protest of the assessment of negligence and underpayment penalties are sustained. Taxpayer's protest of all remaining issues is denied.

Posted: 05/26/2010 by Legislative Services Agency
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