DEPARTMENT OF STATE REVENUE

02-20090918.LOF

Letter of Findings: 09-0918
For 2005, 2006, and 2007
Corporate Income Tax

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ISSUES

I. Combined Return – Adjusted Gross Income Tax.

Authority: IC § 6-3-2-2(l), (m); IC § 6-8.1-5-1(c).

Taxpayer objects to the Department of Revenue's decision requiring Taxpayer to file a "combined return" along with certain – but not all – of its affiliated entities having a unitary relationship with one another.

II. Administration – Ten Percent Negligence Penalty.

Authority: IC § 6-8.1-5-1(c); IC § 6-8.1-10-2.1(a)(3); IC § 6-8.1-10-2.1(a)(4); IC § 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer maintains that the decision imposing a ten-percent negligence penalty is unjustified and that it is entitled to an abatement of the penalty.

STATEMENT OF FACTS

Taxpayer is an out-of-state corporation that operates stores. Taxpayer's stores are located in Indiana and at out-of-state locations. The Department of Revenue (Department) conducted an audit review of Taxpayer's business records and tax returns. The audit resulted in the assessment of approximately two million dollars in additional corporate income tax.

Taxpayer objected to the additional assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives explained the basis for the protest. This Letter of Findings results.

I. Combined Return – Adjusted Gross Income Tax.

DISCUSSION

Taxpayer is an out-of-state company that operates various business establishments and retail stores in Indiana.

Taxpayer is owned by an out-of-state parent company (hereinafter "Parent Company").

Parent Company also owns directly another chain of stores (hereinafter "Second Indiana Store Chain"). Both Taxpayer and Second Indiana Store Chain are the only members of a group of businesses which operate within Indiana and which file Indiana income tax returns.

As noted, Parent Company owns Taxpayer which, in turn, owns a chain of stores that operate in the western United States. This third set of stores is hereinafter referred to as "Western Stores."

Parent Company owns Taxpayer which, in turn, also owns a business which provides the design, store lay-out, and various furnishings for Taxpayer. Hereinafter, this branch of the business is referred to as "Supply Business."

Parent Company owns Taxpayer which, in turn, owns Western Stores, which owns a business which provides packaged products and certain other retail supplies. Hereinafter, this branch of the business is referred to as "Distribution Business."

Parent Company owns Taxpayer which, in turn, owns a business which operates yet a third chain of stores. This third chain of stores also owns valuable intellectual property rights consisting of, according to the audit report, "processes, designs and know-how relating to the development and processing of food items and certain marketing intangibles, including copyrights, patents, and trademarks...." Hereinafter, this branch of the business is referred to as "Property Business." It should be noted that Property Business is an out-of-state corporation.

Parent Company owns – either directly or indirectly – other business entities which are relevant to the "combined return" issue but are not specifically or necessarily relevant to the discussion here.

After reviewing Taxpayer's business organization and financial transactions, the Department's audit concluded that in order to "fairly reflect income derived from Indiana sources," Taxpayer should be included in a "combined return" which included interrelated entities but with a number of exceptions; for example, the "combined return" did not include Parent Company and did not include Second Indiana Store Chain. Taxpayer objected on the ground that requiring a combined return was justified neither in fact or law.

A. Law

As a threshold issue, it is the Taxpayer's responsibility to establish that the tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

The Department's audit arrived at its adjustment under authority of IC § 6-3-2-2(l), (m).

(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.

1. Intellectual Property/Royalties: The audit found that Property Business owned the group's intellectual property. Distribution Business paid a fee to Property Business for the use of the intellectual property. Distribution Business then sublicensed that intellectual property to all the interrelated operating entities, including Taxpayer, for use at their individual business locations. However, Taxpayer incurred all expenses related to the development of new products and processes and then reduced these costs through a reduction of the royalty payments Taxpayer made to Property Business. In addition, the fee for the use of Property Business's intellectual property was passed on to the operating entities through intercompany purchases made from Distribution Business.

The audit reported that, "Concerning the intellectual property rights, it is important to note that [Taxpayer] started the original concept of the... store design" and that "the development of product image, style, trademarks, name recognition, copyrights, etc. occurred over time by [Taxpayer] for the first [several] years." According to the audit report, after Taxpayer developed the intellectual property, it was transferred to Property Business when the business went through a structural reorganization.

The audit report concluded that, "The manner in which the intellectual property rights are accounted for dilutes the Indiana income of [Taxpayer] by failing to properly match inter-company revenue with inter-company expenses."

2. Service Expenses: In addition to the issue stemming from the payment of royalty expenses, the audit determined that Taxpayer paid for certain expenses and performed various services on behalf of other members of the related group. For example, Taxpayer conducted accounting services, payroll services, internal legal expenses, maintenance and repair expenses, printing services, computer services, financial planning, risk management services, quality assurance services, and local and national public relation services.

3. Intercompany Loans: In addition to the royalty and expense issues, the audit found that Taxpayer borrowed money from other related entities. According to the audit report, "[Taxpayer] has effectively borrowed money from all the affiliates in the [Taxpayer] group of companies." In addition, the report noted that "[t]he borrowing entities pay monthly interest amounts against the loans, but the loan documents do not provide for regular principle [sic] payments." When questioned about the parties' loan arrangement, Taxpayer indicated – according to the audit report – that, "Principle [sic] payments are made from time to time depending upon the available cash in the business."

The Department's audit found the borrowing arrangements significant noting that, "The intercompany interest payments result in income being shifted from [Taxpayer] to other affiliates outside Indiana."

4. Section 482 Pricing: In addition to concerns related to payment of royalties and interest, the audit report noted a pricing arrangement between Taxpayer and Distribution Business. Pursuant to that arrangement, Distribution business provided all packaged products and certain retail items to Taxpayer's stores at "cost plus a return on assets as determined by [a] Sec. 482 inter-company pricing study conducted by [accounting firm]." The audit found that "income earned by the operations of [Taxpayer] is paid out to [Distribution Business] by allowing a return on assets (approximately 15 [percent]) on the products and supplies purchased from [Distribution Business] in exchange for the use of... intellectual property." In effect, "[Distribution Business] is paying a royalty to [Property Business] for the use of the same intellectual property [and that the] income is also moved away from the operations of [Taxpayer] to other [Taxpayer] entities by use of the interest payments on money that is rarely, if ever, repaid."

5. Real Estate Investment Trust: The audit found that Western Stores owned business locations outside of Indiana. Western Stores, in turn, owned a Real Estate Investment Trust that held the mortgages for numerous other stores owned – directly or indirectly – by entities related to Parent Company. The Real Estate Investment Trust distributed all of its income back to Taxpayer in the form of a dividend but the Real Estate Investment Trust did not have any activity in Indiana.

B. Issue

The audit concluded that, "The relationship between all [Taxpayer's] affiliates is so intermingled that it is if they are one in the same." The entities which received the "the various payments are located outside Indiana and do not file Indiana returns, while those same payments are expensed on the books of [Taxpayer] and apportioned to Indiana." In summary, the audit found that, "The failure to properly match the inter-company revenues with the inter-company expenses results in the income earned in Indiana not being fairly reflected when [Taxpayer] file[d] a separate Indiana return."

Having concluded that Taxpayer's business relationships were "unitary" and that Taxpayer's method of reporting its Indiana income and expenses did not "fairly reflect" Taxpayer's Indiana source income, the Department's purportedly suggested three alternative methods to resolve the perceived "fairly reflect" issues.

C. Alternatives

In the first alternative, the suggestion was made to "[a]dd back to federal taxable income a portion of the inter-company profit paid by [Taxpayer] to [Distribution Business]... and the inter-company interest expenses paid by [Taxpayer] to all other entities before Indiana apportionment."

In the second alternative, the suggestion was made to "[e]liminate all the net inter-company expenses with the other [Taxpayer] entities from the federal taxable income of [Taxpayer] entities from the federal taxable income of [Taxpayer] before Indiana apportionment."

In the third alternative, the suggestion was made to "[i]nclude all the [Taxpayer] entities in one combined Indiana return."

The Department's audit rejected the first two alternatives choosing instead a "partial combination." Relying on the authority found in IC § 6-3-2-2(l), (m), the audit combined all the entities having a direct vertical relationship with Taxpayer on the ground that "a combined return property matches the inter-company income and expenses." However, the audit excluded from the combined return, the "Parent Company," and two other store chains "due to a lack of substantial transaction and activity with the other [Taxpayer] entities." According to the audit report, this methodology "also gives the taxpayer factor relief by allowing the apportionment factors of property, payroll and receipts of the other [Taxpayer] entities to reduce the Indiana apportionment percent." The audit report concluded that "[t]his approach most fairly reflects the activity of [Taxpayer] within Indiana and reflects fairly to the taxpayer as well."

D. Taxpayer Objections

Taxpayer's first objection to the assessment is that Taxpayer never had the opportunity to discuss with the Department the three alternative methodologies noted above. Taxpayer states that it first received notice of the audit's concerns – and the three suggested alternatives – on May 29 but that the final audit Summary was issued on August 14 without ever having the opportunity to refute the audit's assertions or to substantively discuss the posited alternatives. According to Taxpayer's representatives, the audit was concluded with "no closing conference."

Taxpayer argues that the modified, partial combination was inappropriate and makes the following arguments:

E. Taxpayer's Arguments

Taxpayer claims that it "has established that many of the expenses that the Department contends resulted in distortion were either not taken as deductions or were reimbursed and therefore included as offsetting income." Taxpayer maintains that the royalty expenses and the charges made for store layout "were never taken on the returns and, administrative expenses for affiliates and expenses for new product development were reimbursed and included in taxable income on the returns."

Taxpayer makes a second argument stating that it "has provided substantial and probative evidence that the transactions that gave rise to deductions that were taken on its Indiana returns had economic substance, were with entities that had considerable economic substance, and were at arm's length rates or commercially reasonable rates." In sum, Taxpayer maintains that there were "no shams or sham transaction...."

Taxpayer makes a third argument arguing that it "has established that it should be allowed deductions for the expenses it incurred in purchasing products from [Distribution Business]" which, according to Taxpayer, has "substantial operations and transactions with third party suppliers...." Specifically, Taxpayer objects to the characterization that Taxpayer conducts business with Distribution Business on a "cost plus basis" for the items it sells to Taxpayer. According to Taxpayer, it "remits to Distribution Business determined by an "appropriate intercompany Section 482 profit based on a return on assets method" and this particular methodology was "confirmed by two contemporaneous studies."

In addressing the concerns raised by the inter-entity loans, Taxpayer maintained that "interest [was] paid by [Taxpayer] at commercially reasonable rates."

Going to the methodology employed by the Department's audit, Taxpayer states that "Indiana law provides that the Department may not require forced combination unless there is no other way to fairly reflect income derived from Indiana sources [and that]... [t]he auditor failed to make a reasonable effort to evaluate other methodologies, as evidenced by the fact there was no closing conference/discussion of any nature extended to this taxpayer."

An audit report resulting from a close, reasoned, collaboration between an Indiana taxpayer and the Department's staff is – of course – an ideal resolution to a dispute such as described herein. There is information to establish that the Department forwarded to Taxpayer in May of 2009 an indication of its substantive concerns and the three alternative methodologies offered to suggest those concerns. In an email to Taxpayer dated May 2009, the Department's representative stated that, "The filing of a separate return in Indiana by [Taxpayer] without taking steps to address the inter-company transactions between the members of the federal affiliated group, results in income not properly matching expenses. The [Taxpayer] entities are so intertwined together in business activity and transactions that separating one entity from the rest is very difficult." After noting the three specific alternatives as cited above in Part C above, the email asked, "Do you have any suggestions or alternatives regarding the reporting of income by [Taxpayer] that would achieve the desired results?" Noting that the audit report was not issued until August 2009, the Department cannot conclusively agree with Taxpayer that it was wholly denied the opportunity to propose an alternative to the suggested methodologies.

Taxpayer also objects to the "partial combination" on the ground that the omission of the Parent Company was erroneous, because the omission was "unsupported by substantial evidence and ignores costs incurred by [Parent Company] for its operating affiliates. Taxpayer states that the "partial combination" is inconsistent with the Department's position that "if combined filing is required it should be 'water's edge.'"

The Department is unable to agree with Taxpayer's assertion that the Department is precluded from resorting to a "partial combination" of entities operating in a unitary relationship. IC § 6-3-2-2(m) would clearly seem to open up the possibility that the Department would proceed with precisely such a methodology and the possibility is permitted under the law:

> 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. (Emphasis added).

Nonetheless, Taxpayer has raised substantive issues as cited above which the Department notes and takes seriously. Taxpayer argues that the certain of the expenses objected to in the audit report were actually reimbursed and included as offsetting income, that many of the transactions that gave rise to the expenses deductions were with entities that had "considerable economic substance," that there was no evidence of sham transactions, that the expenses deductions were governed by Sec. 482 inter-company pricing studies, that the transactions with "Distribution Business" were "commercially reasonable," and that the interest paid on inter-company loans was also commercially reasonable. However, even assuming that Taxpayer's substantive arguments were correct, the Department must continue to disagree with Taxpayer's most fundamental objection as stated:

> The auditor's calculation comparing [Taxpayer's] sales and taxable income with the entire [Parent Company] federal affiliated group's sales and taxable income does not show distortion on [Taxpayer's] Indiana returns. Indiana law does not require a taxpayer to report its proportionate share of its federal affiliated group's taxable income. (Emphasis added).

Taxpayer is referencing the specific findings found on page four of the audit report. In those findings, the audit compared the income of the Parent Company, Taxpayer, and Property Business. As follows the audit report states that "Of the total net sales of [Parent Company], [Taxpayer] represents [in excess of 50 percent] for FYE [2005, 2006, and 2007] respectively." However, in comparing Taxpayer's net sales to taxable income, "[O]f the taxable income of the [Parent Company], [Taxpayer] represents [less than 15 percent] for the same fiscal years respectively." (For simplicity sakes, the percentage amounts have been rounded to the nearest whole number). After expense adjustments driven by the various expenses, loans, royalty payments, and Section 482 Pricing payments, the comparative amount of Indiana source income drops from in excess of 50 percent to less than 15 percent.

Equally telling is a comparison between the amount of Parent Company income and that of Property Business. Of the Parent Company's total net sales before adjustment, Property Business represented less than 5 percent of the Parent Company's sales during each of the three audit years; however following the various adjustment, expenses, and payments originally contemplated, Property Business's taxable income increased to in excess of 40 percent for each of the three respective years considered in the audit report. As succinctly described in the audit report:

> [Taxpayer] had the majority of the sales but [Property Business] had the majority of the taxable income.

Taxpayer is, of course, entitled to structure its business affairs in any manner its sees fit and to vigorously pursue any tax advantage attendant upon the management of its business affairs. However, in determining the nature of a business transaction and the resultant tax consequences, the Department is required to look at "the substance rather than the form of the transaction." Bethlehem Steel Corp. v. Ind. Dept. of State Revenue, 597 N.E.2d 1327, 1331 (Ind. Tax Ct. 1992), aff'd 639 N.E.2d 264 (Ind. 1994). In developing its business structure and its financial plan, Taxpayer sought for a variety of reasons to make the decisions it did and – for purposes of this discussion – the Department has no quarrel with any of the particulars of its business plan; the Department agrees that there is no evidence of a "sham" or improper behavior on the part of Taxpayer. However, when one considers the "substance" of the various transactions, the Department was – on its face – legitimately concerned that Taxpayer had shifted a substantial portion of its Indiana source income outside the state, that Taxpayer's Indiana income did not match its claimed Indiana expenses, and that it appropriate to take steps to assure that Taxpayer's taxable income fairly reflected the income attributable to Indiana sources. In effect, the audit's concerns were justified, the "partial combination" was narrowly-tailored to address those concerns, and the resolution was supported by Indiana law.

FINDING

Taxpayer's protest is respectfully denied.

II. Administration – Ten Percent Negligence Penalty.

DISCUSSION

Taxpayer objects to assessment of the ten-percent negligence penalty. As stated by Taxpayer, "Incredibly, the proposed assessments include penalties, suggesting that [Taxpayer] should have been clairvoyant and realized the Department was going to force combination for the Years In Issue."

IC § 6-8.1-10-2.1(a)(3) requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. IC § 6-8.1-10-2.1(a)(4) requires a ten-percent penalty if the taxpayer "fails to pay the full amount of tax shown on the person's return on or before the due date for the return or payment."

IC § 6-8.1-10-2.1(d) states that, "If a person subject to the penalty imposed under this section can show that the failure to... pay the full amount of tax shown on the person's return... or pay the deficiency determined by the department was due to reasonable cause and not due to willful neglect, the department shall waive the penalty."

Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC § 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that 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 IC § 6-8.1-5-1(c), "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." An assessment – including the negligence penalty – is presumptively valid.

Although the Department may have initially believed that Taxpayer erred in choosing the reporting methodology it did, there is scant information to establish that Taxpayer's position was so egregious as to constitute "willful neglect." Based on a "case-by-case" analysis and after reviewing "the facts and circumstances of each taxpayer" the Department agrees that the ten-percent negligence penalty should be abated.

FINDING

Taxpayer's protest is sustained.

SUMMARY

The ten-percent negligence penalty will be abated; in all other respects, Taxpayer's protest is denied.

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