

**Letter of Findings Number: 09-0862**  
**Indiana Corporate Income Tax**  
**Tax Years: 2005-2007**

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**ISSUES**

**I. Adjusted Gross Income Tax – Modifications Made to Adjusted Gross Income.**

**Authority:** IRC § 63; IC § 6-3-1-3 [repealed 1980]; IC § 6-3-1-3.5; IC § 6-3-2-2; IC § 6-8.1-5-1; [45 IAC 3.1-1-62](#); Moline Properties, Inc. v. Commissioner, 319 U.S. 436, 63 S.Ct. 1132 (1943); Indiana Dep't of Revenue v. Endress & Hauser, Inc., 404 N.E.2d 1173 (Ind. Ct. App. 1980); Park 100 Dev. Co. v. Indiana Dep't of State Revenue, 429 N.E.2d 220 (Ind. 1981); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007); Sweetland v. Franchise Tax Board, 13 Cal. Rptr. 432 (Cal. Ct. App. 1961).

Taxpayer protests the adjustment of adjusted gross income in order to fairly reflect Indiana income.

**II. Tax Administration – Negligence Penalty.**

**Authority:** IC § 6-8.1-10-2.1; [45 IAC 15-11-2](#).

Taxpayer protests the imposition of the ten percent negligence penalty.

**STATEMENT OF FACTS**

Taxpayer is a Nevada corporation doing business in Indiana. Taxpayer operates and manages related businesses within Indiana. Taxpayer filed Indiana consolidated income tax returns on behalf of related entities in an affiliated group that have activity in Indiana. As the result of an audit conducted for the tax years at issue, the Indiana Department of Revenue ("Department") issued proposed assessments for additional adjusted gross income tax based on adjustments the auditor made in order to fairly reflect Indiana income, primarily pertaining to disallowing deductions of interest expenses.

Taxpayer protests the assessments resulting from the addback of interest expenses and the imposition of a negligence penalty. An administrative hearing was held, and this Letter of Findings results. Further facts will be supplied as necessary.

**FINDING**

**I. Adjusted Gross Income Tax – Modifications Made to Adjusted Gross Income.**

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

During the years at issue, Taxpayer and Taxpayer's parent corporation paid interest expenses on loans that originated with different third parties. Taxpayer deducted interest expenses on its Indiana consolidated income tax return. The Department disallowed a portion of this deduction in order to fairly reflect Taxpayer's Indiana income, claiming that not all of the interest expenses related to Indiana. In support of that position, the audit report cited to [45 IAC 3.1-1-62](#) which states:

Special Formulas for Division of Income. All corporations doing business in more than one state shall use the allocation and apportionment provisions described in [\[45 IAC 3.1-1-37–45 IAC 3.1-1-61\]](#) unless such provisions do not result in a division of income which fairly represents the taxpayer's income from Indiana sources. In such case the taxpayer must request in writing or the Department may require the use of a more equitable formula for determining Indiana income. However, the Department will depart from use of the standard formula only if the use of such formula works a hardship or injustice upon the taxpayer, results in an arbitrary division of income, or in other respects does not fairly attribute income to this state or other states. It is anticipated that these situations will arise only in limited and unusual circumstances (which ordinarily will be unique and nonrecurring) when the standard apportionment provisions produce incongruous results.

The cited regulatory provision provides the Department with authority to apportion or allocate income derived from Indiana sources among commonly owned organizations in order to fairly reflect Indiana income.

Taxpayer asserts that the full amount of the interest expenses that it claimed as a deduction should be allowed. Taxpayer points to IRC § 63 as the starting point to determine Indiana taxable income, and then maintains that the auditor changed Taxpayer's federal taxable income or Indiana adjusted gross income contrary to what is specifically provided for under IC § 6-3-1-3.5(b). Taxpayer also makes the point that, in addition to their position that the Department did not have the statutory authority to make the adjustments that were made, there were also no facts to back up the Department's claims.

Taxpayer primarily relies on Indiana Dep't of Revenue v. Endress & Hauser, Inc., 404 N.E.2d 1173 (Ind. Ct. App. 1980) in making its argument that the Department did not have the authority to make any adjustments to Taxpayer's federal taxable income or Indiana adjusted gross income. In that case, the Department disallowed the

deduction of net operating losses incurred in another state prior to the business moving to Indiana, which had reduced the business's Indiana adjusted gross income to zero. The court held that since the legislature did not specifically provide for this type of adjustment under IC § 6-3-1-3, the "[f]ailure to adhere to the strict statutory formula provided by [IC 6-3-1-3\(b\)](#) would open the door to the Department to apportion or disallow the other deductions permitted by Section 63 of the Code based on the same reasoning," and therefore the Department was prohibited from making the adjustment. *Endress & Hauser*, 404 N.E.2d at 1176.

Taxpayer is mistaken. The general authority provided by IC § 6-3-2-2 would allow the Department to make adjustments in order to fairly reflect and report Taxpayer's income derived from sources within Indiana. Pursuant to IC § 6-3-2-2 and [45 IAC 3.1-1-62](#), the Department could implement any reasonable means to fairly reflect and report Taxpayer's income derived from sources within Indiana, including disallowing Taxpayer's deduction.

Along those same lines, it is well-settled that corporations are free to adopt the corporate form and to engage in activities they deem appropriate. The Supreme Court has stated that the "doctrine of corporate entity" serves a useful purpose and that "so long as [the] purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity." *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436, 438-439, 63 S.Ct. 1132, 1134 (1943). However, the Court continued "in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal. In such situations the form is a bald and mischievous fiction." *Id.* at 439. The state courts have been consistent in applying this "business purpose" doctrine, holding that tax avoidance in and of itself is not a valid "business purpose." See *Park 100 Dev. Co. v. Indiana Dep't of State Revenue*, 429 N.E.2d 220 (Ind. 1981); *Sweetland v. Franchise Tax Board*, 13 Cal. Rptr. 432 (Cal. Ct. App. 1961).

Finally, *Endress & Hauser* dealt with a matter of statutory construction of IC § 6-3-1-3, which has since been repealed. Since the publication of *Endress & Hauser* in 1980, IC § 6-3 et. seq. has been amended numerous times to allow the Department further authority to make adjustments to a taxpayer's adjusted gross income in order to more fairly reflect income derived from sources within Indiana. The court also noted that the facts of the case were "unique." Therefore, whatever conclusion could be drawn from this case is limited, and it has no application to the case at hand.

With that being said, the Department's audit disallowed Taxpayer's interest expense deduction because the Department believed that Taxpayer should not have deducted the interest expense when it filed its income tax returns in the first place. The audit concluded that:

[T]he income reported to Indiana in all three years of the audit period did not fairly reflect income earned in Indiana. It was also apparent from this examination that the Indiana Federal Taxable Income should not start with a loss since the only two operations the taxpayer has in Indiana are the two [Indiana businesses] who both operate at a profit. Further examination of the taxpayer's expenses in relationship to expenses of the other entities on the Federal and State consolidated return revealed that the taxpayer paid over 70 [percent] of the interest expense for the Federal Consolidated group. The interest expense was the reason that the taxpayer... was reporting huge losses on the Indiana Consolidated income tax returns.

...

After analyzing interest expense of the other entities on the Federal and State income tax returns, it was apparent that the interest expense deducted under the taxpayer... had to have some relationship to the entities reported under the Federal consolidated return but not included on the Indiana consolidated return. The other entities on the Federal and State consolidated income tax returns had very little interest expense or no interest expense.

While the audit report correctly noted that the claimed expenses significantly reduced the amount of the income subject to tax in Indiana, based upon the facts presented there is little to indicate that the deductions for interest expenses constituted an abusive tax avoidance scheme such that the claimed expenses did not "fairly reflect" Taxpayer's Indiana source income. There is evidence to show that the loans were made with third parties at arm's length rates. There is no evidence of a "circular flow" of funds between related parties, for that matter, and the audit report does not document loan transactions with related parties. The loans were for legitimate business purposes, including building and renovating facilities in Indiana. These are some of the factors that the Department has looked at consistently when determining whether interest expenses constitute legitimate business expenses. Since, based on the facts presented, there is insufficient evidence that Taxpayer's interest expenses are anything other than legitimate business expenses, the Department should not have concluded that the interest expenses did not "fairly reflect" Taxpayer's Indiana source income.

Accordingly, as a legitimate business expense, the interest expenses are subject to apportionment, pursuant to IC § 6-3-2-2. This has been the Department's consistent policy, in matters both favorable and unfavorable to the Department. Had the Department found an unfair reflection of income, the Department would have been within its rights to use IC § 6-3-2-2(l) & (m) and [45 IAC 3.1-1-62](#), which allows the Department, when standard allocation and apportionment methods do not fairly reflect a taxpayer's Indiana income, to use any other method to calculate a fair allocation and apportionment of a taxpayer's Indiana income. Based on the facts presented, all evidence indicates that Taxpayer fairly allocated and apportioned its income when it deducted the interest expenses. Therefore, in this particular case, Taxpayer has met its statutory burden under IC § 6-8.1-5-1(c) of

demonstrating that the Department's decision disallowing some of the interest expense deductions is incorrect.

**FINDING**

Taxpayer's protest is sustained.

**II. Tax Administration – Negligence Penalty.**

Taxpayer requests that the Department abate the ten-percent negligence penalty.

IC § 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. 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... "

Taxpayer has established that it did not owe any additional tax. Therefore, there is no subsequent penalty to assess.

**FINDING**

Taxpayer's protest is sustained.

**CONCLUSION**

Taxpayer's protest of the assessment of gross income tax and penalties are sustained.

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