DEPARTMENT OF STATE REVENUE

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Letter of Findings: 10-0383
Corporate Income Tax
For the Years 2004 through 2007

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ISSUES

I. Intercompany Interest Expenses – Corporate Income Tax.

Authority: IC § 6-3-2-2(l); IC § 6-3-2-2(l)(4); IC § 6-3-2-2(l), (m); IC § 6-8.1-5-1(c).

Taxpayer argues that the Department of Revenue's audit erred in disallowing certain intercompany interest expenses.

II. Calculation Error – Corporate Income Tax.

Authority: IC § 6-8.1-5-1(c).

In disallowing the interest expenses addressed in Part I above, Taxpayer maintains that the audit miscalculated the actual amount of interest expenses to be disallowed.

STATEMENT OF FACTS

Taxpayer is the parent and principal operating member of a group of companies engaged in the manufacture and marketing of building products. Taxpayer's wood products are used primarily to build new homes, repair and remodel older homes, and to construct "manufactured" homes. Taxpayer purchases some of the wood fiber used to produce its products and also harvests its own timber. Taxpayer sells its products to retail home centers, wholesale distributors, dealers, and manufactured housing producers.

Taxpayer has a molding plant located in Indiana.

Taxpayer owned California timber property previously held for investment purposes. Taxpayer decided to form two "bankruptcy remote entities" here referred to as "Holding Companies." Taxpayer transferred its California timber property to the Holding Companies "in a qualified IRC § 351 reorganization."

The Holding Companies sold the California timber assets for cash and for notes receivable. The Holding Companies loaned the cash to Taxpayer for use as operating capital.

The Holding Companies pledged the notes receivable as collateral to obtain third-party bank loans and then loaned those additional proceeds to Taxpayer for operating capital.

The Holding Companies paid the banks interest on the third-party bank loans. Taxpayer claimed interest expenses attributable to the amount of interest the Holding Companies paid to the bank and also for the loan of the Holding Companies' cash.

The Department of Revenue conducted an audit review of Taxpayer's tax returns and financial records. The audit resulted in an additional assessment of corporate income tax. Taxpayer disagreed with at least a portion of the assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer's representatives further explained the basis for the protest. This Letter of Findings results.

I. Intercompany Interest Expenses – Corporate Income Tax.

DISCUSSION

As noted above, the two Holding Companies hold various notes generated by the sale of properties transferred to them by Taxpayer. These notes are used as collateral to obtain loans from various third-party banks. The Holding Companies then loaned Taxpayer the money borrowed from the banks. Taxpayer pays interests to the Holding Companies. As explained in the audit report, "[T]he holding companies act as a conduit for [Taxpayer's] borrowing from the third-party banks." Taxpayer explains that, "[T]he banks would not allow the receivables from the property sales to be used as collateral unless they were held in bankruptcy remote entities, the holding companies."

During the audit, the Department questioned the amount of interest being paid to the Holding Companies. As stated in the report, "Examination of records during the audit revealed interest expense incurred by [Taxpayer] separately to be much greater than that incurred by the two holding companies...." In addition, the audit found that an "[e]xamination of records during the audit also revealed that [Taxpayer] had significant liability accounts labeled 'inter-intracompany liability' reflected in the other liability section of [Taxpayer's] separately stated balance sheet." This account consisted primarily in "notes payable to the two holding companies."

Taxpayer stated in an August 2009 memo that "the notes are increased by accrued interest and decreased by unreimbursed expenses paid by [Taxpayer] for the related subsidiary." In reviewing the agreements between Taxpayer and the Holding Companies, the audit found that these "Agreements do not show a schedule of required payments as the loans are revolving loans due on demand. Interest rates are set at the 30-day London InterBank Offered Rate."

The audit found that, "[T]he two notes have been increasing by accrued interest and also adjusted by book entries pertaining to unreimbursed expenses paid by [Taxpayer] on behalf of the holding companies." However, the audit found that the "Schedules show principal or interest payments made to the holding companies by this taxpayer... which if made would result in decreases to the liability accounts, and corresponding decreases to interest amounts owed to the holding companies by the [T]axpayer." The audit found that at the end of 2007, the liability accounts exceeded one billion dollars.

The audit concluded in part as follows:

The result of the transactions as described above is that [Taxpayer] incurs interest expense to its two holding companies subsidiaries, eliminated on the combined profit and loss statement, well in excess of the amounts [of] the holding company subsidiaries' interest expense. As noted above, the holding companies are the entities borrowing the funds from third party banks needed by [Taxpayer] to conduct its activities.

The position of the Indiana Department of Revenue is that the above described transactions have the effect of distorting taxpayer's Indiana income, and that the Indiana income tax returns as presently filed by [Taxpayer] do not fairly reflect income derived from Indiana activities. Before the [California timber assets] in question were transferred to the holding companies, [the assets] were used in [Taxpayer's] business activities. Deductions relating to the properties such as maintenance and depreciation were used to determine income subject to tax in Indiana after required apportionment calculations as the [T]axpayer had activities in multiple states. However, before the assets were sold and began generating income rather than deductions, they were transferred via tax free reorganizations to [Holding Companies] which are not filing returns in Indiana. The Indiana Department of Revenue feels that this disparate treatment has the effect of distorting [T]axpayer's Indiana income in the years after the transfer.

As described in the audit report, the question posed by Taxpayer's business arrangement was described as:

In the current audit periods this entity [Taxpayer] incurs interest expense payable to the holding companies in excess of what the holding companies are paying on the necessary borrowing from the banks. This difference is due to the increase on intercompany notes due primarily to accrued but unpaid interest.

The audit addressed the perceived economic distortion as follows:

The audit is disallowing the intercompany interest paid by [Taxpayer] as reflected in the intercompany interest expense eliminations, less the amounts of interest expense of the holding companies, per the taxpayer this is interest [actually] paid to third party banks. This will allow this taxpayer [] the benefit of interest expense paid to third party lenders for funds it needs to conduct its operations, but not allow the additional interest expense accrued to the related holding companies, interest which was not actually paid the unpaid amounts resulting in increasing amounts owed to the holding companies and increasing amounts of accrued interest.

(Emphasis added).

The audit made the adjustment pursuant to the authority found at IC § 6-3-2-2(l) and (m) as follows:

(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.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing 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."

Taxpayer raises numerous objections. Taxpayer argues that the Department's audit failed to establish that the Taxpayer's original filing was distortive. Taxpayer acknowledged that it deducted interest expense in excess of the interest the Holding Companies paid to the third-party banks but claims that this "is not indicative of distortion" because Taxpayer claimed interest expense based not only on the third-party bank loans but also on the money received from the sale of the California assets. In addition, Taxpayer states that the "intercompany loans were at arm's length rates." However, the fact that Taxpayer may have arguably demonstrated an "arms length" arrangement does not necessarily alleviate questions regarding the economic substance of the subject transactions. The "economic-substance" doctrine looks beyond whether a transaction is conducted at arm's length, and instead considers the transaction's economic effects. Accordingly, a finding of business purpose does not preclude reviewing the economic substance of financial transfers between related entities. In this case, the audit raised legitimate concerns regarding the amount of interest being paid to the Holding Companies on loans for which the Holding Companies paid a substantially lesser amount of interest; in addition, the audit raised legitimate and entirely reasonable concerns questioning interest expenses which were "accrued" but were never actually paid.

For purposes of this Letter of Finding perhaps the most significant objection is that the audit did not have the statutory authority to make the adjustment it did. According to Taxpayer, IC § 6-3-2-2(l) and (m) allows an adjustment to a taxpayer's "allocation and apportionment" and does not encompass the remedy to which the audit resorted. As to this argument, the Department must respectfully disagree. In essence, Taxpayer argues that IC § 6-3-2-2(l) permits the Department to adjust only the allocation and apportionment of Taxpayers' I.R.C. § 63 adjusted gross income, and that the Department is wholly without authority to disallow the interest deductions allowed under the federal tax scheme. Taxpayers place too formalistic an interpretation on the authority granted the Department under IC § 6-3-2-2(l). The plain language of the law states that "[i]f 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 department may require, in respect to all or any part of the taxpayer's business activity... the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." (Emphasis added). IC § 6-3-2-2(l)(4) specifically permits "the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income." The audit indeed was without authority to contravene the interest expense deductions legitimately claimed on Taxpayers' federal return. However, if the auditor believed that the effect of those deductions was to misallocate Taxpayers' Indiana income, IC § 6-3-2-2(l) granted the Department the authority to ignore the effect of the federal deductions and allocate that income to Indiana. The audit reasonably could have concluded that permitting the Taxpayer to claim the accrued interest as expenses offsetting its income would not lead to an "allocation and apportionment" of Taxpayer's income which would "fairly reflect" Taxpayer's Indiana source income.

Taxpayer also points out that the creation of the Holding Companies – as bankruptcy remote entities – not only produced deductions that lowered Indiana tax liability but also increased the Indiana apportionment factor. In addition, according to Taxpayer, "Indiana benefits from accruing interest [which] counterbalances this negative impact." For example, Taxpayer claims that the additional available cash made it possible for Taxpayer to purchase a Indiana based company.

Taxpayer claims that disallowance of the interest expense deduction creates distortion rather than "repairing" it because the intercompany interest expense is directly responsible for increasing the availability of working capital from which Taxpayer's income, taxable in Indiana and other states, increases.

Taxpayer raises these and numerous other objections to the adjustments made by the Department's audit. In effect, Taxpayer states that the loan arrangement made with the Holding Companies had beneficial effects not contemplated by the audit adjustment and that the audit should have taken another route to reach the desired outcome; an equitable apportionment of Taxpayer's Indiana source income. Taxpayer raises legitimate concerns but the issue is not whether the audit should have resorted to an alternative methodology or whether the methodology chosen may have had unanticipated results but whether, under IC § 6-8.1-5-1(c), Taxpayer has met its burden of demonstrating that the proposed assessment is wrong.

As noted above, the audit raised legitimate questions concerning Taxpayer's claimed interest expenses and – as a result of those concerns – adopted an entirely legitimate and narrowly tailored alternative "method [intended] to effectuate an equitable allocation and apportionment of the taxpayer's income." Taxpayer has not demonstrated that the remedy to which the audit resorted is "wrong."

FINDING

Taxpayer's protest is respectfully denied.

II. Calculation Error – Corporate Income Tax.

DISCUSSION

Taxpayer claims that the audit made an "adjustment error" as follows:

> [Taxpayer] files a separate Indiana return that includes some but not all of the entities included in its Federal Consolidated return. The auditor, in calculating the "distortive" interest expense added back all intercompany interest expense eliminated on the Federal Consolidated return. This adjustment appears to be in error as the auditor's assertion throughout the audit summary was to effectively eliminate only the transactions between [Taxpayer] and [the Holding Companies]. (Emphasis deleted).

> The audit report addressed its adjustment as follows: "The audit is disallowing the intercompany interest paid by [Taxpayer] as reflected in the intercompany interest expense eliminations, less the amounts of interest expense of the holding companies, per the taxpayer this is interest [actually] paid to third party lenders for funds it needs to conducts its operations...." (Emphasis added).

Taxpayer raises a reasonable concern. Under IC § 6-8.1-5-1(c), Taxpayer has not proven that the assessment is wrong but has raised an issue which should be considered during a supplemental audit. The audit division is requested to review the audit report, the accompanying documentation, and to make whatever adjustments it deems warranted.

FINDING

Subject to the result of a supplemental audit, Taxpayer's protest is sustained.

SUMMARY

Taxpayer's substantive protest is denied in its entirety; the audit division is requested to review the calculation underlying the disallowance of claimed interest expenses and to assure that the calculation comports with the findings of the corresponding audit report.

Posted: 11/24/2010 by Legislative Services Agency

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