DEPARTMENT OF STATE REVENUE

02-20090399.LOF

Letter of Findings: 09-0399
Income Tax
For the Years 2004, 2005, 2006, 2007

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ISSUES

I. Adjusted Gross Income Tax – Required Combination.

Authority: IC § 6-3-1-3.5; 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); Kohl's Dept. Stores, Inc. v. Indiana Dep't of State Revenue, 822 N.E.2d 297 (Ind. Tax Ct.2005).

Taxpayer protests the Department's decision to require filing a combined return with several of its affiliates.

II. Adjusted Gross Income Tax – Negligence & Underpayment Penalties Associated with the 2004 RAR Adjustment.

Authority: 2008 Settlement Agreement between Taxpayer and the Indiana Department of Revenue.

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's principal place of business is out of state. Taxpayer is in the business of selling retail apparel to the general public through stores located in several states, including Indiana. Taxpayer and a sister company ("Services Co."), which also had Indiana nexus, filed separate Indiana returns.

The Department audited Taxpayer for the years 2005, 2006, 2007, and 2008. The audit required combination of Taxpayer with several related companies, including Services Co. As a result of the audit, Taxpayer was assessed additional corporate income tax, negligence and underpayment penalties, and interest. Taxpayer protested the required combination and the ensuing assessments of additional corporate income tax and the penalties. A hearing was held and this Letter of Findings ensues. Additional facts will be provided as required.

Please note that there is a separate 2004 RAR adjustment issue that related to a prior audit and which is addressed below.

I. Adjusted Gross Income Tax – Required Combination.

DISCUSSION

The Department's audit required Taxpayer to file a combined Indiana return with several of Taxpayer's affiliates because Taxpayer's circumstances and reporting for the years at issue did not fairly represent Taxpayer's business activities in Indiana. In requiring combination, the Department's audit cited to authority under IC § 6-3-2-2(l), established a unitary relationship between Taxpayer and its affiliates, and pointed to the closely related and interdependent transactions among Taxpayer and its affiliates. Taxpayer buys its inventory from a sister company ("Management Co."). Management Co. entered into an agreement with another sister company ("Royalty Co.") to pay a royalty fee based on Taxpayer's sales. Royalty Co. then pays dividends to yet another sister company ("Finance Co."). Finance Co. loans money to Taxpayer and Taxpayer pays interest in Finance Co. The Department's audit concludes:

> The net effect of this inter-company business arrangement is that large amounts of royalty, interest and dividend income reported and corresponding large royalty, interest and dividend expense reduces taxable income apportioned to all states where the taxpayer does business and does not file a unitary income tax return.

Management Co. is also a Delaware company with its principal place of business in the same location as Taxpayer's. Management Co. is primarily engaged in the design, procurement, and wholesale distribution of apparel and associated products.

Services Co. is a Delaware company as well, with its principal place of business at the same location as its sister companies. Services Co. provides accounting, information technology, and human resources services to its affiliates, including Taxpayer, for which it receives a fee.

Royalty Co. is a Nevada company with its principal place of business in Nevada. Royalty Co. owns and manages the intellectual property of the federal consolidated group.

Finance Co. is a Nevada company that provides financing to its affiliates, including Taxpayer.

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).

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 U.S. 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 common 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 the companies 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, such as accounting, management, and tax preparation services. The Department found that unity of use by the substantial amount of intercompany transactions among all of these companies as described above.

At the outset Taxpayer protests that the Department's assessments are invalid because they violate the Due Process and Commerce Clause of the United States Constitution. As an administrative agency, it is not within the purview of the Department to address constitutional arguments.

In its statement of facts and supporting documentation (including transfer pricing agreements and a purchase agreement), Taxpayer sets out to demonstrate that Taxpayer and the referenced affiliates have a valid business purpose, engage in substantive activities, and have substantial assets, and in the case of Management Co., engages in transactions with numerous third parties. Taxpayer further sets out to demonstrate that its intercompany transactions are set at arm's length rates. Taxpayer argues that Services Co. receives management fees established at arms' length; Management Co. sells the goods it procures to Taxpayer at prices that are the equivalent to what would have been charged in transactions between unrelated parties; the interest rates Finance Co. charges its affiliates are set at arm's length rates. Taxpayer states that Royalty Co. licenses certain intellectual property to Management Co. in exchange for a royalty payment, but emphasizes that it does not license any intellectual property to Taxpayer and Taxpayer makes no royalty payments to Royalty Co.

The purchase agreement between Taxpayer and Management Co. states, under the section that discusses "cost structure of purchases" (section 3.1), that services which are directly or indirectly performed will be the measure of management cost structures. These cost structures are discussed in general terms without clear guidelines on how costs will be determined; certainly no specific rates or percentages are referenced.

Taxpayer also provided a transfer pricing study. The transfer pricing study deals only with the sale of tangible personal property between Management Co. and Taxpayer, but does not discuss other intercompany transactions such as those involving royalty payments or interest on loans. Furthermore, the formula of "budgeted operating profit" (see pages 44-45) sets transfer prices for inventory for upcoming years at amounts that target a budgeted gross margin. The Department is unable to agree that this arrangements reflects the manner in which business operates in the real world and certainly does not reflect the incentives in transactions between unrelated parties. Lastly, the study developed a percentage range for setting the appropriate operating margin for the stores. Taxpayer chose a lower range due to certain generally stated functional and risk factors – and apparently a highly artificial process that is geared to maximizing expense deductions and therefore lowering taxable income and does not appear to be connected to the realities of the market place. Lowering taxable income is, of course, an laudable goal for any business, however, the arrangements that lead to this particular cost structure at the very least call into question whether these are arrangements unrelated third parties would agree to.

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 including the overall flow of funds between Taxpayer and the target companies. The rates cannot be viewed in isolation of the terms of the transactions and the overall flow of monies amongst the players. 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 could 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.

Taxpayer then argues that the Department had no basis for requiring combination under IC § 6-3-2-2(p)

unless the Department failed first to fairly reflect Taxpayer's Indiana adjusted gross income through the use of its powers under either subsection (l) or (m). 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:
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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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> (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....
>
> (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).
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> (Emphasis added).

Taxpayer is reminded that the Department's audit acted under the authority of IC § 6-3-2-2(l), and not IC § 6-3-2-2(p), and combined Taxpayer with only certain affiliates. In Kohl's, the Indiana Tax Court acknowledged that the Department does have the authority to so act under IC § 6-3-2-2(l):

> Through combined reporting, a group of corporations operating as a unitary business may aggregate their earnings before apportionment in order to more fairly represent their income derived from sources within the state of Indiana. See also A.I.C. § 6-3-2-2(l).
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> Kohl's Dept. Stores, Inc. v. Indiana De'p. of State Revenue, 822 N.E.2d 297, 299 (Ind. Tax Ct. 2005).

IC § 6-3-2-2(p) does not require the Department to apply the subsections of IC § 6-3-2-2 in the order in which they are written. There is nothing on the face of IC § 6-3-2-2 that requires the Department to apply the subparts of IC § 6-3-2-2 in the order in which they are written. The statute is clear on its face, and it is devoid of any step-by-step instructions on how or in what order to apply subparts (l), (m) and (p). IC § 6-3-2-2(l) provides that the Department may require "in respect to all or any part of the taxpayer's business activity, if reasonable," one of several methods to fairly represent the taxpayer's Indiana source income. The clause "if reasonable" qualifies the methodology used to fairly represent the taxpayer's income from Indiana business activities, but it does not impose any order on which methodology must be used first, or second, or third, and so on. This point is underscored by IC § 6-3-2-2(m), which speaks to an entirely different set of circumstances than is addressed under IC § 6-3-2-2(l) or (p).

IC § 6-3-2-2(m) applies to two or more entities "owned or controlled directly or indirectly by the same interests." This ownership requirement is not part of IC §§ 6-3-2-2(l) or (p) and so it makes no sense to require application of (l) before (m), or (m) before (p). IC § 6-3-2-2(m) is its own mandatory provision whereby the Department must distribute, apportion, or allocate income between certain affiliated entities to "fairly reflect and report" Indiana source income earned by more than one Indiana taxpayer.

Certainly the legislature knows how to provide an order of operations if it intends that the order suggested by Taxpayer be followed. For example, the definition of "adjusted gross income" provides that "[i]n the case of corporations, [the term 'adjusted gross income' means] the same as 'taxable income' (as defined in Section 63 of the Internal Revenue Code) adjusted as follows:...." Ind. Code § 6-3-1-3.5(b). What follows are eleven mathematical operations that must be performed in the order enumerated under the statute, as is plainly signified by the clause "as follows." See id. There is no similar qualification under IC § 6-3-2-2 that would confine the Department to an inflexible, mechanical application of its powers under the statute.

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 in the audit report showing that Taxpayer's reported Indiana income is out of proportion with its business activities in the state. 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. Taxpayer argues that intercompany transactions are all arm's length transactions. 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. 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.

Lastly, Taxpayer reinforces it's contention that Indiana had rejected a combined reporting regime. Taxpayer is generally correct. When the Indiana General Assembly repealed its previous mandatory combination regime it demonstrated its preference not to require combination in all cases. However, the Indiana General Assembly also expressed in its new statutory regime an emphasis on a fair and reasonable reflection of income earned from business activities within the state.

Taxpayer did not sustain its burden of showing that the Department incorrectly combined Taxpayer with some of its affiliates to more fairly reflect its Indiana adjusted gross income.

FINDING

Taxpayer's protest is respectfully denied.

II. Adjusted Gross Income Tax – Negligence & Underpayment Penalties Associated with the 2004 RAR Adjustment.

DISCUSSION

Taxpayer protests penalties assessed against a 2004 RAR adjustment that resulted in a small underpayment. Taxpayer's adjusted gross income tax liabilities for the year 2004 were subject to a 2008 settlement agreement ("Agreement") with the Department. Taxpayer is not protesting the adjustment, but protests the associated assessment of negligence and estimated tax penalties totaling $15,595. The Agreement waives all penalties and interest for 2004.

FINDING

Per the Agreement, Taxpayer's protest is sustained.

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 IC or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

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

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section.

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

FINDING

Taxpayer's protest is sustained.

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.
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> 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 penalty 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, as is the assessment of penalty relating to the 2004 RAR adjustment. Taxpayer's protest of the required combination with its affiliates is denied.

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